LUMBERMENS MUTUAL CASUALTY COMPANY

Statutory Financial Statements and Schedules

December 31, 2003 and 2002

(With Independent Auditors' Report Thereon)

Independent Auditors' Report

The Board of Directors
Lumbermens Mutual Casualty Company:

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of Lumbermens Mutual Casualty Company (Company) as of December 31, 2003 and 2002 and the related statutory statements of operations, surplus, and cash flow for the years then ended. 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 of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the statutory financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in note 1, the Company prepared these statutory financial statements using accounting practices prescribed or permitted by the State of Illinois Department of Insurance (Department of Insurance), which differ from accounting principles generally accepted in the United States of America. The effects on the statutory financial statements of the variances between the statutory basis of accounting and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the matters discussed in the preceding paragraph, the statutory financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of Lumbermens Mutual Casualty Company as of December 31, 2003 and 2002 or the results of its operations or its cash flows for the years then ended.

Also, in our opinion, the statutory financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of Lumbermens Mutual Casualty Company as of December 31, 2003 and 2002, and the results of its operations and its cash flow for the years then ended, on the basis of accounting described in note 1.

Our audits were made for the purposes of forming an opinion on the basic statutory financial statements as a whole. The supplementary information included on the Summary Investment Schedule and Supplemental Investment Risk Interrogatories 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. As discussed in note 8 to the financial statements, the Department of Insurance imposes risk-based capital (RBC) requirements on insurance enterprises, including the Company. At December 31, 2003, the Company's total adjusted capital, as reported in the 2003 Annual Statement filed with the Department of Insurance, was within the "mandatory control level" at December 31, 2003, based on the RBC calculation required by the Department of Insurance. At this level, the Department of Insurance has substantial authority to exercise control over the Company and its affiliates. The Department of Insurance is mandated to place a company at this level under its control, except where, as is the case with the Company, 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 Department of Insurance has discretion to allow the continued run-off. Beginning on December 20, 2002, the Company's claims-paying ability/financial strength ratings were lowered by all three of the major rating agencies. Currently, A.M. Best assigns 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 the Company's request, they ceased rating the Company. In the first half of 2003, as a result of a combination of various business factors including the ratings downgrades and the Company's deteriorating statutory surplus, the Company substantially ceased underwriting activities. Since July 2003, the Company and most of its affiliates have been subject to a Corrective Order by the Department of Insurance not to write any new or renewal business except as necessary to comply with contractual commitments or as expressly permitted by the Department. As required, the Company in early 2003 proposed an RBC plan to address its RBC level. The Department of Insurance did not accept that plan. On March 19, 2004, the Company submitted to the Department its commercial run-off plan which was approved on June 9, 2004.

The Department of Insurance could seek to place the Company in a formal proceeding (receivership, rehabilitation, or other) at any time based on the Company's financial condition or operating performance. This risk of a proceeding would be further increased if the Company fails to execute successfully on its commercial run-off plan, if the Company fails to have sufficient liquid assets to meet its current obligations, or if the Company's reported statutory liabilities at any time would exceed its reported statutory assets. The Company has been granted an accounting allowance to discount all of its loss reserves at 4.2%, resulting in an increase in the Company's surplus at December 31, 2003 of approximately $610 million (see note 1). Regarding the aforementioned risk, the Company's current discounting of all its loss and loss adjustment expense reserves at 4.2% substantially exceeds its currently projected 3.1% investment portfolio yield. The difference at December 31, 2003 between a discount at 4.2% versus 3.1% is approximately a $213 million surplus improvement. Further, amortization of the discount is anticipated to significantly exceed investment income, which will strain the Company's surplus position at a time when expenses will also exceed income. Additionally, under the existing Corrective Order, the Company has been granted four other Department of Insurance accounting allowances which permit the application of accounting principles which are not in conformity with the National Association of Insurance Commissioners "Accounting Practices and Procedures Manual." Such allowances and related policyholder surplus impact as of December 31, 2003 include the following:

(a) the recognition of prepaid unallocated loss adjustment expenses in the amount of $90 million;

(b) the application of a 7.5% discount rate used in the calculation of the accumulated benefit obligation under the Kemper Retirement Plan with an increase to surplus of $118 million;

(c) immediate recognition of a reduced liability in the amount of $32 million for accrued post retirement benefit obligations; and

(d) the replacement of the reinsurance Schedule F penalty with a credit-related bad debt allowance for uncollectible reinsurance which resulted in an approximate increase to policyholder surplus of $75 million.

The Company's commercial run-off plan also includes initiatives for the purpose of offsetting management's projected surplus deficiencies, particularly in years 2005 and 2006. However, there can be no assurance that the Company will be successful to the extent necessary to avoid a negative surplus in future years.

The matters discussed in the previous three 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 the Company's commercial run-off plan and the continued permission to apply the aforementioned accounting allowances. Management's plans in regard 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.

As described more fully in note 1 to the statutory financial statements in 2002, the Company changed its method of accounting for dividends resulting in an increase to surplus of $111.3 million as of December 31, 2002. In accordance with Statement of Statutory Accounting Principles No. 3, the change in accounting has been recorded as an adjustment to unassigned deficit in 2002. Additionally, as more fully described in note 1, during 2002, the Company revised the measurement date for determining the liabilities associated with its retirement benefit plans to November 30 from December 31. As discussed above, in 2003 the Company changed its accounting to reflect five accounting allowances granted by the Department of Insurance.

Chicago, Illinois
June 9, 2004

LUMBERMENS MUTUAL CASUALTY COMPANY

Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2003 and 2002

Admitted Assets		2003	2002
Bonds	$	1,673,351,862	1,400,273,576
Common stocks:			
Affiliated		260,674,361	1,181,730,351
Nonaffiliated		8,044,323	15,525,033
Preferred stocks		13,388,287	6,416,808
Mortgage loans on real estate		17,147,650	54,123,969
Real estate:			
Properties occupied by the Company		—	68,439,898
Properties held for sale		40,855,789	15,852,993
Cash and short-term investments		1,870,573,731	1,104,545,896
Other invested assets		104,331,557	133,960,868
Receivable for securities sold		3,287,363	1,495,321
Total cash and invested assets		3,991,654,923	3,982,364,713
Agents' balances and uncollected premiums, net		310,077,131	1,003,508,897
Accrued retrospective premiums		157,532,537	123,216,344
Reinsurance recoverable on paid losses		347,048,068	233,768,427
Reinsurance accounted for as a deposit		55,190,454	172,155,499
Advance to claim service provider		34,542,835	89,455,374
Insurance recoveries related to subsidiary		12,400,000	49,446,248
Amounts billed and receivable under high deductible policies		17,908,300	34,626,920
Rabbi Trust assets		21,622,250	31,221,499
Investment income due and accrued		14,827,958	18,314,976
Other admitted assets		202,735,867	14,083,703
Equities and deposits in pools and associations		21,248,595	13,013,999
Funds held by or deposited with reinsured companies		19,418,156	7,556,960
Electronic data processing equipment		2,643,386	3,331,986
Guaranty funds receivable or on deposit		529,146	1,064,447
Net deferred tax asset		—	—
Receivable from subsidiaries and affiliates		20,562,031	—
Total admitted assets	$	5,229,941,637	5,777,129,992

See accompanying notes to statutory financial statements.

Liabilities and Surplus	2003	2002
Liabilities:		
Losses	$ 3,094,210,933	2,730,727,148
Loss adjustment expenses	729,758,862	771,410,165
Reinsurance payable on paid losses and loss adjustment expenses	70,032,122	13,330,496
Ceded reinsurance premiums payable, net	6,844,721	1,019,386,610
Reinsurance funds held related to retroactive reinsurance	63,600,832	327,927,675
Amounts withheld for others	289,257,547	272,375,603
Unearned premium reserve	111,595,492	269,409,686
Minimum pension liability	128,479,243	173,847,315
Other expenses payable	140,695,970	167,862,966
Accounts payable and other liabilities	198,174,541	124,418,785
Funds held under reinsurance treaties	34,078,748	122,647,943
Remittances and items not allocated	69,487,545	120,599,908
Provision for reinsurance	—	84,106,200
Payable to subsidiaries and affiliates	—	73,997,359
Payable for securities purchased	128	66,661,743
Commissions payable	9,049,177	54,948,991
Taxes, licenses and fees payable	35,849,671	50,593,239
Federal and foreign income taxes	22,803,106	28,501,438
Dividends payable to policyholders	22,228,022	25,216,544
Premiums received in advance	—	19,188,035
Net adjustments in assets and liabilities due to foreign exchange rates	12,602,499	14,454,621
Retroactive reinsurance recoverable	(11,233,487)	(1,167,602,875)
Total liabilities	5,027,515,672	5,364,009,595
Surplus notes	698,355,598	698,355,598
Special surplus from retroactive reinsurance contracts	—	348,899,363
Unassigned deficit	(495,929,633)	(634,134,564)
Total surplus	202,425,965	413,120,397
Total liabilities and surplus	$ 5,229,941,637	5,777,129,992

LUMBERMENS MUTUAL CASUALTY COMPANY

Statutory Statements of Operations

Years ended December 31, 2003 and 2002

		2003	2002
Underwriting:			
Premiums earned	$	398,380,309	1,462,619,452
Losses and expenses incurred:			
Losses		(21,660,812)	(1,128,108,771)
Loss adjustment expenses		(25,391,745)	(303,819,375)
Underwriting expenses		346,081,925	(258,637,686)
Change in premium deficiency reserve		7,806,675	—
Total underwriting deductions		306,836,043	(1,690,565,832)
Net underwriting gain (loss)		91,544,266	(227,946,380)
Investment income:			
Net investment income		101,308,546	124,982,837
Net realized capital losses on investments		(397,630,117)	(332,639,222)
Net investment loss		(296,321,571)	(207,656,385)
Other income:			
Retroactive gain (loss) on reinsurance		(470,605,704)	142,282,503
Other income		230,859,763	9,861,756
Other income, net		(239,745,941)	152,144,259
Loss before dividends to policyholders and Federal and foreign income taxes		(444,523,246)	(283,458,506)
Dividends to policyholders		(16,972,607)	(55,400,810)
Loss before Federal and foreign income taxes		(461,495,853)	(338,859,316)
Federal and foreign income tax benefit		27,168,635	49,888,771
Net loss	$	(434,327,218)	(288,970,545)

See accompanying notes to statutory financial statements.

LUMBERMENS MUTUAL CASUALTY COMPANY

Statutory Statements of Surplus

Years ended December 31, 2003 and 2002

	2003	2002
Surplus at beginning of year	$ 413,120,397	1,266,575,405
Net loss	(434,327,218)	(288,970,545)
Other increases (decreases) in surplus:		
Net unrealized capital gains (losses)	191,087,433	(261,942,908)
Correction of errors	—	(60,552,286)
Cumulative effect of changes in accounting principles	—	111,346,668
Reinsurance allowance	(70,000,000)	—
Changes in:		
Nonadmitted assets	(101,450,633)	(247,011,469)
Minimum pension liability	31,790,452	(133,068,885)
Net deferred income taxes	84,473,107	66,970,200
Provision for reinsurance	84,106,200	(36,727,200)
Net adjustments due to foreign exchange rates	3,626,227	(3,552,895)
Surplus notes	—	54,312
Net decrease in surplus	(210,694,432)	(853,455,008)
Surplus at end of year	$ 202,425,965	413,120,397

See accompanying notes to statutory financial statements.

LUMBERMENS MUTUAL CASUALTY COMPANY

Statutory Statements of Cash Flow

Years ended December 31, 2003 and 2002

	2003	2002
Cash from operations:		
Premiums collected, net of reinsurance	$ (176,569,523)	1,761,692,410
Losses and loss adjustment expenses paid	328,566,582	(1,250,332,019)
Underwriting expenses paid	(438,290,399)	(364,571,655)
Cash provided by (used in) underwriting	(286,293,340)	146,788,736
Net investment income	93,484,788	184,460,764
Agents' balances charged off	—	(7,614,279)
Net funds held under reinsurance treaties	—	(302,283,992)
Net amount withheld or retained for account of others	—	(27,348,530)
Other miscellaneous items	(251,607,137)	231,457,899
Dividends paid to policyholders	(56,349,208)	(96,927,812)
Federal and foreign income taxes recovered	21,470,303	42,346,611
Net cash (used in) provided by operations	(479,294,594)	170,879,397
Proceeds from investments sold, matured or repaid:		
Bonds	986,642,235	2,885,782,870
Stocks, including affiliates	1,101,055,536	184,921,899
Mortgage loans	40,127,929	12,603,680
Real estate	36,337,105	37,694,064
Other invested assets	68,069,854	91,050,411
Net gains (losses) on short-term investments and other	(15,000,020)	66,792,288
Total investment proceeds	2,217,232,639	3,278,845,212
Cost of investments acquired:		
Bonds	(1,252,477,030)	(926,183,915)
Stocks, including affiliates	(257,074,538)	(1,026,097,824)
Mortgage loans	(4,349,116)	—
Real estate	(268,216)	(10,696,712)
Other invested assets	(68,408,229)	(22,524,561)
Miscellaneous applications	(153,659,310)	(46,248,464)
Total investments acquired	(1,736,236,439)	(2,031,751,476)
Net cash provided by investing	480,996,200	1,247,093,736
Cash from financing and miscellaneous sources:		
Change in surplus notes	—	54,312
Other cash provided	858,885,619	27,578,205
Net transfers from affiliates	(94,559,390)	120,952,666
Other applications	—	(708,193,066)
Net cash from (used in) financing and miscellaneous sources	764,326,229	(559,607,883)
Net change in cash and short-term investments	766,027,835	858,365,250
Cash and short-term investments:		
Beginning of year	1,104,545,896	246,180,646
End of year	$ 1,870,573,731	1,104,545,896

See accompanying notes to statutory financial statements.

(1) Business Operations and Summary of Significant Accounting Policies

Basis of Presentation

Lumbermens Mutual Casualty Company (LMC) is a mutual, property, and casualty insurance company domiciled in the State of Illinois. LMC is the lead company of a group of insurers, now in run-off status, which has operated under the trade name of the *Kemper Insurance Companies* (Kemper).

The significant majority of the business written by member insurance companies of Kemper has historically been ceded to LMC through quota share reinsurance agreements with some companies retaining a portion of the business written and through a quota share pooling agreement (the Pool or the Pooling Agreement) by and among LMC, one of LMC's wholly owned subsidiaries, American Motorists Insurance Company (AMICO), and one of LMC's affiliated companies, American Manufacturers Mutual Insurance Company (AMM). Prior to 2003, of the insurance business directly written by LMC or ceded to LMC, including all business written by AMICO and AMM, LMC ceded, net of third-party, unaffiliated, reinsurance, and excluding Canadian business, 15% to AMICO and 8% to AMM. Third-party reinsurance has generally attached after cessions by affiliates to LMC, although some specific risks have been subject to facultative or other reinsurance before cession to LMC. Effective January 1, 2003, the Pooling Agreement was amended to eliminate the 15% cession to AMICO, and effective December 31, 2003, the Pooling Agreement was amended to eliminate the 8% cession to AMM. The effect of both amendments was for LMC to retain all previously ceded risks, and the amendments were accompanied by transfers of assets by each of AMICO and AMM in order to satisfy the liabilities transferred to LMC by the Pooling Agreement amendments. As a result, at December 31, 2003, the net reserves of each of AMICO and AMM is zero.

As further discussed in notes 8, 9, and 13, the Company's risk-based capital ratio, as filed, fell below the authorized control level as of December 31, 2002, and is currently at the mandatory control level at December 31, 2003, and the Company's claims-paying ability/financial strength ratings were lowered in late 2002 and through the first half of 2003. The Company's risk-based capital ratio and the reduction of the Company's ratings have had and will continue to have a significant impact on the Company's future operations. Additionally, as discussed in note 10, the Company has received notice from the State of Illinois Department of Insurance (the Department of Insurance) that the Company's request to make interest payments on the surplus notes otherwise due in June and July 2003 has been denied.

Reinsurance Transaction between the Company and AMM

Effective December 31, 2003, the Company and AMM entered into a reinsurance transaction, the results of which included 1) an amendment to the Pooling Agreement that removed AMM from the Pool (see note 1) and ceded all net liabilities of AMM at December 31, 2003 to the Company and 2) the issuance by the Company of a new insurance policy to each and every policyholder of AMM other than those policyholders already fully reinsured by Trinity Universal Insurance Company, a subsidiary of Unitrin, Inc. (Unitrin). In exchange for the issuance of these new insurance policies, AMM incurred an approximate charge of $229.2 million and the Company recorded income of the same amount for the year ended December 31, 2003. Absent this reinsurance transaction as well as certain accounting allowances granted by the Department of Insurance (see note 1), the statutory surplus of the Company at December 31, 2003 would have been negative. In turn, AMM's solvency would also be at risk given AMM's significant reliance on its substantial reinsurance recoverables from the Company.

Historically, AMM and other Kemper Insurance Companies have ceded their directly written insurance business to the Company as their reinsurer, and the Company in turn has ceded to AMM 8% of that pooled business. As part of the reinsurance transaction described herein, the 8% cession from the Company to AMM was eliminated, with the Company receiving as payment from AMM assets equal to AMM's loss and loss expense reserves/liabilities (approximately $370 million) assumed by the Company. AMM then also paid to the Company an amount equal to the remainder of AMM's December 31, 2003 statutory surplus less $10 million. The payments were in cash, securities, and the assignment of assets or beneficial rights to assets where the legal title to such assets could not be directly accomplished by December 31, 2003. (Legal title to certain assets of AMM which are restricted from transfer, because they are statutory deposits or collateral for other purposes or subject to other restrictions, is to be transferred to the Company at the earliest practicable date.)

The Company assumed most of AMM's liabilities, agreed to perform for AMM all insurance policy-related obligations including handling and paying claims, and issued to each holder of a policy ever issued by AMM, including any policy no longer in force but excluding any policy reinsured by Unitrin, an additional policy which is substantively identical to the policy previously issued by AMM. The additional Company policy assures affected AMM policyholders that their claims will be treated equally with the claims of other Company policyholders not only in the event of a managed run-off of the Company and AMM but also in the event of any insolvency proceedings with respect to the two companies.

Because the reinsurance transaction was not assumption reinsurance and AMM policies were not novated, the affected policyholders now hold separate policies issued by both AMM and the Company. AMM remains liable for policy liabilities in the event the Company does not comply with all the terms of the affected policies. AMM has $1.3 billion in reinsurance due from the Company.

The reinsurance transaction was approved by the Department of Insurance, as well as by independent committees of the boards of directors of each of the Company and AMM following receipt of fairness opinions by their respective independently engaged financial advisors.

Renewal Rights Transactions

In 2003, the Company and its affiliates entered into several renewal rights transactions allowing the Company and its affiliates to receive future commissions from other insurance companies that renew certain in-force business when such business expires or cancels from the Company or its affiliates. In some cases, employees and leases were also transferred related to certain of the Company's business lines, resulting in future expense savings related to severance and lease costs.

The Company and its affiliates entered into the following renewal rights transactions:

Kemper business line	Purchaser of renewal rights	Renewal rights revenue earned in 2003
Small and middle market accounts	St. Paul Companies	$ 24,963,270
Excess casualty	St. Paul Companies	2,000,000
Personal lines	Unitrin, Inc.	7,830,032
Directors and officers liability	AXIS Capital Holdings	5,699,999
Bundled large risk accounts	Argonaut Insurance Company	5,125,803
Alternative risk programs	Hartford Fire Insurance Company	1,391,901
Environmental casualty	Zurich Insurance	837,352
Unbundled large risk accounts	Old Republic	353,664
		$ 48,202,021

The Company's share of the renewal rights revenue earned in 2003 was $44,345,859.

Accounting Policies

The accompanying statutory financial statements have been prepared in accordance with the National Association of Insurance Commissioners (NAIC) *Annual Statement Instructions*, the *Accounting Practices and Procedures Manual* (the Manual), and in conformity with accounting allowances granted by the State of Illinois Department of Insurance (the Department), which vary in material respects from accounting principles generally accepted in the United States of America (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, regardless of the planned level of portfolio activity;
- assets are included in the statutory statements of admitted assets, liabilities, and surplus at admitted asset value and nonadmitted assets are excluded through a charge against surplus;
- majority owned subsidiaries are carried under the equity method, are not consolidated and adjustments reflecting the equity in earnings of affiliated companies are credited or charged directly to surplus as net unrealized capital gains or losses rather than being recorded through income;
- goodwill is amortized directly to surplus over a period not to exceed 10 years, rather than carrying goodwill at its unamortized value, subjected to periodic impairment reviews.
- surplus notes are reflected as a component of surplus rather than as a liability, and interest on such notes is not recorded as a liability or expense until payment has been approved by the Department of Insurance;

- deferred Federal income taxes do not completely provide for the temporary differences between the carrying value of assets and liabilities and their tax bases and are recorded directly to surplus;
- the costs of providing pension benefits and postretirement benefits other than pensions are calculated without regard to active nonvested employees;
- ceded reinsurance balances are netted against direct and assumed balances on the statutory statements of admitted assets, liabilities, and surplus rather than shown gross;
- a provision is made through a charge to surplus for unearned premium and losses recoverable, in excess of appropriate collateral, on business reinsured with companies not authorized by license in Illinois, and for certain overdue reinsurance balances;
- loss reserves on certain lines of business are discounted using statutory discount rates rather than rates based on current market conditions;
- dividends to policyholders are expensed at the earlier of payment or declaration by the Company's board of directors (the Board), rather than based on estimated ultimate payments to policyholders on the earned portions of policies;
- certain assets and liabilities originated in foreign currency are adjusted to U.S. dollars through a direct charge to surplus;
- the estimated rental cost of office facilities owned is presented in the statutory statements of operations as both income and expense;
- the correction of errors related to previously issued financial statements is charged directly to surplus rather than restating prior period results;
- the statutory statements of cash flow are presented in a specified format which differs from the formats prescribed by Statement of Financial Accounting Standards No. 95, *Statement of Cash Flows*; and
- comprehensive income is not determined for statutory reporting purposes.

The effects of such differences on the statutory financial statements have not been determined but are presumed to be material.

Cumulative Effect of Changes in Accounting Principles

Accounting changes adopted to conform to the provisions of the Manual are reported as changes in accounting principles. The cumulative effect of the changes in accounting principles is reported as an adjustment to surplus in the period in which the company adopts and changes to the new accounting principle. The cumulative effect is the difference between the amount of surplus at the beginning of the period and the amount of surplus that would have been reported at that date if the new accounting principles had been applied retroactively for all prior periods.

2002 Accounting Changes

During 2002, the Department of Insurance allowed the Company to change its method of accounting for dividends (see *Permitted Accounting Practices* – Dividends Payable to Policyholders and Accrued

Retrospective Premiums below). The cumulative effect of the change in method was treated as a change in accounting principle resulting in an increase to surplus of $111.3 million as of December 31, 2002.

During 2002, the Department of Insurance required the Company to change its method of accounting for medical claim loss reserves. (See Permitted Accounting Practices – Discounting of Loss Reserves). There was no impact to surplus resulting from this change as of December 31, 2002.

Accounting Allowances

2003

At December 31, 2003, there are five accounting allowances granted by the Department of Insurance under Corrective Orders that are reflected in the accompanying financial statements of the Company.

1. Loss Reserve Discounting: At December 31, 2002, the Company discounted at 3.5% only certain categories of liabilities on its balance sheet (see note 3). On June 19, 2003, the Company was granted an allowance to discount all its loss reserves at 3.5% beginning with the Company's financial statements for the quarter ended June 30, 2003. On December 23, 2003, the Department of Insurance granted the Company's request for an accounting allowance to increase the discount to 4.2%. At December 31, 2003, the total amount of the discount, included on the balance sheet and on Schedule P, Part 1, is $1.1 billion, approximately $131 million of which relates to the increase from 3.5% to 4.2%. The 4.2% discount rate exceeds the Company's current investment portfolio yield (see note 9). The estimated increase in the Company's surplus as of December 31, 2003 is approximately $610 million.

2. Prepaid Unallocated Loss Adjustment Expense (ULAE): As a result of an accounting allowance granted on December 23, 2003, the balance sheet of the Company at December 31, 2003 reflects as an admitted asset the amounts that the Company has prepaid for claim handling services to NATLSCO/Broadspire (approximately $82 million; see note 2) and to National Indemnity Company (approximately $23 million; see note 4). Approximately $15 million of ULAE expenses related to these two service providers were expensed in 2003.

3. Defined Benefit Plans Accumulated Benefit Obligation (ABO): The balance sheet of the Company at December 31, 2003 reflects a change in the applicable interest rate assumption for calculating the ABO liability under the qualified Kemper Retirement Plan and the unqualified Kemper Supplemental Retirement Plan (see note 7) from 6.25% to 7.5%. Implemented pursuant to an accounting allowance granted on December 23, 2003, the higher rate assumption reduced the ABO liability by approximately $118 million from what the lower rate assumption would have produced.

4. Accrued Post-Retirement Benefit Obligation: Effective January 1, 2004, the Company amended its post-retirement benefit plans (see note 7). On December 23, 2003, the Department of Insurance granted the Company's request for an accounting allowance to reflect the economic effect of the entire reduction in liability attributable to this change, a difference of approximately $32 million, at December 31, 2003 rather than a gradual reduction of the liability over the average life span of the retirees.

5. Change in Estimate for Uncollectible Reinsurance: In the second half of 2003, the Company reviewed the credit of certain of its reinsurers with respect to reinsurance recoverables. On the basis of that review, the Company established a general provision for uncollectible reinsurance of $48 million at September 30, 2003 and an additional $22 million at December 31, 2003. In addition, the Company wrote off approximately $13 million of reinsurance recoverables in 2003. In light of the Company's newly established $70 million general provision for uncollectible reinsurance, on December 23, 2003, the Department of Insurance granted the Company's request for an allowance for the elimination of the Schedule F penalty. The net benefit to the Company's surplus at December 31, 2003 from this accounting allowance offset by the newly established general provision for uncollectible reinsurance amounted to approximately $75 million (see note 4).

The combined effect of these accounting allowances granted in 2003 benefited the Company's reported statutory surplus at December 31, 2003 by approximately $1 billion and the statutory statement of operations for 2003 by approximately $642 million. Of this amount, approximately $570 million was only realized as a benefit because the Company, in contemplation of receiving approval for the June 2003 accounting allowance on loss reserve discounting, commuted certain reinsurance contracts to improve liquidity (see note 4).

2002

Beginning in 2000, the Company was permitted by the Department of Insurance to modify its accrual for policyholder dividends in order to accrue for the ultimate dividend payment, rather than just dividends declared by the Board. As a result of this permitted practice, the amount of dividends accrued, but not yet declared by the Company's Board, decreased pre-tax net income by $42,260,746 at December 31, 2002. On October 1, 2002, the Department of Insurance allowed the Company to revert to the statutory accounting rules included in the Manual. As such, the amounts included in the December 31, 2002 statutory statement of admitted assets, liabilities, and surplus related to dividends payable and accrued retrospective premiums only reflect dividends declared by the Board as of December 31, 2002. The cumulative effect of the change in method of accounting for dividends amounted to an increase in surplus of $111,346,668 and was recorded directly to surplus as of December 31, 2002 as a component of the cumulative effect of changes in accounting principles.

Correction of Errors

During 2002, the Company determined that certain finite and other types of reinsurance contracts did not pass the risk transfer rules documented in SSAP No. 62, *Property and Casualty Reinsurance* (SSAP 62). In compliance with SSAP No. 75, *Reinsurance Deposit Accounting*, reinsurance contracts which do not pass risk transfer are required to be accounted for as deposits rather than reinsurance.

During 2002, the Company determined that certain of the Company's aggregate excess of loss reinsurance treaties related to the 1998 through 2001 accident years contain certain optionality provisions which allow the Company to determine the timing of cessions into these treaties. As a result of these provisions, only the original calendar cessions which equate to the same treaty accident year qualify for prospective reinsurance accounting treatment with subsequent cessions treated as retroactive reinsurance. The Company also amended its 2001 aggregate excess of loss treaty during early 2003 to conform with SSAP 62. As a result, cessions to the 2001 treaty as of December 31, 2001 have been reclassified to retroactive accounting as of December 31, 2002. Although total net income and total surplus were correct as stated, the combined impact on losses ceded from the reclassification of these treaties from prospective to retroactive reinsurance accounting amounted to $284.0 million. Of this amount, $100.0 million related to 2001 accident year losses placed into the 2001 treaty and $184.0 million related to 2000 accident year losses placed into the 2000 treaty.

During 2002 and 2003, the Company also completed a project to reconcile a number of balance sheet accounts related to amounts billed and receivable under high deductible policies, remittances and items not allocated, and other miscellaneous assets and liabilities.

The decrease in surplus as of December 31, 2002 related to these corrections on the Company's previously issued statutory financial statements is as follows:

	Risk transfer and reconciliation project	Aggregate excess of loss reinsurance treaties	Total
Reinsurance related	$ (67,284,914)	—	(67,284,914)
Completion of reconciliation project	(39,014,389)	—	(39,014,389)
	(106,299,303)	—	(106,299,303)
Less amounts ceded to AMICO and AMM	45,747,017	—	45,747,017
Amount retained by the Company before equity pick-up in AMICO	$ (60,552,286)	—	(60,552,286)

In accordance with SSAP No. 3, *Accounting Changes and Corrections of Errors*, the Company recorded the correction of these errors directly to surplus as of December 31, 2002 and did not restate prior period results.

Invested Assets and Related Income

Investment-grade bonds and short-term investments are valued at amortized cost. Below investment grade bonds are carried at the lower of amortized cost or fair value. 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 mortgage-backed and asset-backed securities, over the estimated life of the security. Such amortization is included in net investment income. Amortization of the discount or premium from mortgage-backed and asset-backed securities is recognized 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. To the extent the estimated lives of such securities change as a result of changes in prepayment rates, the adjustment is also included in net investment income. Prepayment assumptions used for mortgage-backed and asset-backed securities are obtained from an external securities information service and are consistent with the current interest rate and economic environment. All of the Company's loan-backed securities were acquired subsequent to January 1, 1994.

Investments in unaffiliated common stocks are generally carried at market values provided by the NAIC, and unaffiliated preferred stocks are carried at cost in accordance with the methods in the *Purposes and Procedures Manual of the Securities Valuation Office* (SVO) of the NAIC.

Investments in affiliated common and preferred stocks are generally carried at their underlying statutory equity of the respective entity's financial statements, adjusted for unamortized goodwill. Goodwill is amortized over 10 years, and goodwill amortization or goodwill which is deemed to be impaired on an other-than-temporary basis is charged directly to surplus. The Company periodically assesses the recoverability of goodwill to determine if a change in events or circumstances indicate that the carrying amount of the goodwill may not be recoverable. In the event the goodwill is deemed by the Company to be impaired on an other-than-temporary basis, the goodwill is written down to fair value.

Mortgage loans are carried at their unpaid principal balance net of impairments. The maximum percentage of a loan to the value of the security at the time of the loan was 90%. Other invested assets include notes receivable and joint venture partnerships. Notes receivable are carried at their unpaid principal balance. Joint ventures in which the Company has a less than 10% ownership interest are carried at underlying GAAP equity. Joint ventures in which the Company has a greater than 10% ownership interest are carried at the underlying statutory equity of the joint venture's financial statements. The Company also has a real estate joint venture which was originally accounted for as a real estate Acquisition, Development and Construction (ADC) arrangement prior to December 31, 2002 and, accordingly, was carried at its underlying statutory equity. In early 2003, the Company abandoned its plans for this joint venture, accordingly, at December 31, 2003 and 2002, the Company carries the underlying undeveloped real estate at its estimated fair value, net of anticipated costs to sell.

At December 31, 2002, properties occupied by the Company were carried at a cost less accumulated depreciation. As a result of events during late 2002, the Company decided to sell or lease two office buildings previously occupied by the Company and assessed the recoverability of the carrying amount of the two office buildings to determine if the current events and circumstances indicated that the carrying value of the buildings was not fully recoverable. As of December 31, 2002, the Company transferred these two buildings from properties occupied by the Company to properties held for sale and carried the properties at the lower of cost or fair value less estimated costs to sell. During 2003, the Company reclassified all of its remaining real estate owned from company-occupied to held for sale and carries all of its properties at the lower of cost or fair value, less estimated costs to sell.

Realized gains or losses on the sale of investments, the recognition of other-than-temporary declines in value, or situations where the Company has made a decision to sell a security prior to its maturity at an amount below the security's carrying value are determined on the basis of specific identification of the acquisition lots of the respective investment sold or written down and are reflected as a component of income.

Unrealized gains or losses on revaluation of investments are credited or charged to surplus. Real estate-related reserves and valuation allowances on real estate-related investments deemed to be impaired on an other-than-temporary basis are charged to income. The Company does not accrue interest income on fixed maturities deemed to be impaired on an other-than-temporary basis, or on real estate-related investments when it judges that the likelihood of collection of interest is doubtful.

Premiums and Policy Acquisition Costs

Premiums are earned on a daily pro-rata basis over the term of the policies and are net of reinsurance placed with reinsurers. Unearned premiums are also 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. Such receivables are recorded net of balances over 90-days past due and such other balances as required by the Manual. 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 amounts are written off and charged to other income. Policy acquisition costs such as commissions, premium taxes, and other underwriting and agency expenses are charged to income as incurred. The Company anticipates investment income as a factor in determining premium deficiency reserves. As of December 31, 2003, the Company recorded an ending premium deficiency reserve of $8,485,516. As of December 31, 2002, the Company did not require an ending premium deficiency reserve.

Liabilities for Losses and Loss Adjustment Expenses

The Company records liabilities for unpaid claims, losses, and related loss expenses 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. Reserves 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. Certain liabilities for unpaid losses related to workers' compensation pension cases and long-term disability losses are reduced to present value, as discussed above.

Because the ultimate settlement of claims is subject to future events, no single loss or loss adjustment expense (LAE) reserve can be considered accurate with certainty. The Company's analysis of the reasonableness of loss or LAE reserve estimates includes an analysis of the amount of variability in the estimate. The Company develops its estimate considering a range of reserve 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.

The Company reflects its liability for losses net of anticipated salvage and subrogation recoveries of $91.1 million and $146.5 million at December 31, 2003 and 2002, respectively. Salvage and subrogation received and changes in estimates of future recoveries are reflected in current year underwriting results.

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 or the pooling participants are unable to pay their portion of any claim under reinsured policies, the Company would remain liable for such payments.

(Continued)

Federal and Foreign Income Taxes

The Company files a consolidated Federal income tax return with its subsidiaries. Federal and foreign 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.

The Company has a tax allocation agreement which provides that current Federal income taxes will generally be paid to or recovered from the Company on the basis of each subsidiary company's taxable income or taxable loss as if the subsidiary were filing a separate Federal income tax return. In the event of a Federal income tax benefit on a separate return basis which is greater than the subsidiary company's actual amount recoverable on a consolidated return basis, the amount recoverable will be apportioned among all such companies entitled to a recovery on a pro rata basis. Settlement among the companies occurs within a reasonable time period following the filing of the consolidated Federal tax return. Based upon the Company's current financial position, all settlements or inter-company tax balances are subject to approval by the Department of Insurance.

Nonadmitted Assets

Assets included in the statutory statements of admitted assets, liabilities, and surplus are at admitted asset value. Nonadmitted assets, principally deferred tax assets, agents' balances over 90-days past due, computer software, other equipment, and 10% of unsecured policyholder dividends recoverable, are excluded through a charge against surplus. Assets nonadmitted at December 31, 2003 amounted to $783.5 million.

The Company's investment in computer software and hardware as well as other fixed assets as of December 31, 2003 and 2002 was as follows:

	2003	2002
	(In thousands)	
Internally developed and purchased software	$ —	76,899
Computer hardware and equipment	49,561	40,196
Furniture and office equipment	—	13,535
Leasehold improvements	—	8,552
Automobiles and other assets	—	1,425
	49,561	140,607
Less accumulated depreciation	(46,918)	(56,800)
Net fixed assets	2,643	83,807
Less nonadmitted assets	—	(80,475)
Electronic data processing equipment	$ 2,643	3,332

Depreciation expense is computed on a straight line basis over five years for internally developed and purchased software and furniture. Computer hardware and equipment, office equipment, automobiles, and other assets are depreciated over three years and leasehold improvements are depreciated over the shorter of five years or the remaining term of the lease agreement. Total depreciation expense amounted to $20.2 million and $14.6 million as of December 31, 2003 and 2002, respectively. Depreciation expense for internally developed and purchased software, included in the above amounts, amounted to $14.1 million and $9.7 million as of December 31, 2003 and 2002, respectively. Due to the Company's run-off status, the decision was made in 2003 to write off all remaining net fixed assets excluding computer hardware and equipment. As of December 31, 2003 and 2002, the Company wrote-off $55.4 million and $7.5 million of fixed assets which were recorded as realized capital losses.

Provision for Reinsurance

As of December 31, 2002, the Company established a liability for unsecured reinsurance balances from companies not authorized to do business in Illinois and hence not subject to its jurisdiction and regulation. An additional liability is also required when portions of reinsurance balances from authorized companies are overdue. Such liabilities are charged directly against surplus. At December 31, 2003, the Company received an accounting allowance to replace the statutory provision for reinsurance with an amount representing a general provision for uncollectible reinsurance. (See Accounting Allowances for 2003 in this note).

Cash Flow Information

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.

Use of Estimates

The preparation of the statutory financial statements requires management to make estimates and assumptions that affect the reported financial statement balances as well as the disclosure of contingent assets and liabilities. Accordingly, actual results reported in the accompanying statutory financial statements could differ from those estimates.

As further discussed in the accompanying notes to the statutory financial statements, significant estimates and assumptions affect various provisions including losses and policyholder dividends. The liabilities for losses and LAE and related reinsurance recoverables, although supported by actuarial analysis and other data, are ultimately based on management's reasoned expectations of future events. As further described in note 3, estimates of losses and LAE related to environmental and asbestos claims are also subject to a greater degree of uncertainty and variability. Policyholder dividend recalls (accrued retrospective premiums) and dividends payable to policyholders are estimated based on similar assumptions used to estimate the ultimate liabilities for losses and LAE. Additionally, valuation of the Company's real estate-related investments is subjective and estimated by management based upon current and expected future real estate market conditions and other factors.

Reclassifications

Certain 2002 amounts have been reclassified to conform with the 2003 presentation.

(2) Invested Assets and Investments in Subsidiaries

Bonds

The Company is generally carrying its bond portfolio at amortized cost. The carrying value of bonds is adjusted for other-than-temporary declines in values or situations where the Company has made a decision to sell a security prior to its maturity at an amount below the security's carrying value. The fair values of the Company's bonds have been determined using market quotations determined by the NAIC, or independent pricing services that use prices provided by market makers or estimates of fair values obtained from yield data relating to instruments or securities with similar characteristics, or fair value as determined in good faith by the Company's portfolio managers, when such values are not available from the NAIC. 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, 2003 and 2002 were as follows:

	2003			
	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	$ 654,930	4,150	(5,113)	653,967
State, political subdivision, and special revenue obligations	66,149	3,588	(503)	69,234
Debt securities issued by foreign	22,419	592	—	23,011
Corporate securities	491,736	6,390	(1,258)	496,868
Asset-backed securities	53,188	298	(205)	53,281
Mortgage-backed securities	384,930	4,520	(876)	388,574
Total bonds	$ 1,673,352	19,538	(7,955)	1,684,935

	2002			
	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	$ 177,581	6,597	(151)	184,027
State, political subdivision, and special revenue obligations	44,162	4,945	—	49,107
Debt securities issued by foreign	37,360	1,007	—	38,367
Corporate securities	223,568	9,382	(921)	232,029
Asset-backed securities	217,653	3,308	(16,181)	204,780
Mortgage-backed securities	699,950	21,759	—	721,709
Total bonds	$ 1,400,274	46,998	(17,253)	1,430,019

As of December 31, 2003 and 2002, the unrealized losses on bonds of $8.0 million and $17.3 million, respectively, have been in this position for less than 12 months and management has determined them to be temporary.

The following table sets forth the maturity aging schedule of bonds at December 31, 2003. 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	$ 84,846	85,317
Over one year through five years	471,296	477,328
Over five years through ten years	316,994	317,522
Over ten years	362,098	362,913
Securities not due at a single maturity date	438,118	441,855
Total bonds	$ 1,673,352	1,684,935

At December 31, 2003, cash, short-term investments and bonds carried at $1.1 billion were on deposit with governmental authorities as required by law. The Company's assets were also encumbered by $593.8 million related to various collateral requirements.

Proceeds from sales of investments in bonds prior to maturity during 2003 and 2002 were $469.6 million and $2.56 billion, respectively. Gross gains of $24.2 million and gross losses of $3.0 million were realized on those sales during 2003. Gross gains of $94.4 million and gross losses of $73.2 million were realized on those sales during 2002.

Equity Securities

Gross unrealized gains on equity securities (common stocks and preferred stocks), excluding affiliated companies, at December 31, 2003 and 2002 amounted to $5.9 million and $2.4 million, respectively. There were no unrealized losses on equity securities at December 31, 2003 and 2002. The cost of equity securities held at December 31, 2003 and 2002, excluding affiliated companies, was $15.6 million and $23.3 million, respectively.

Investments in Affiliated Companies

The Company's investments in common stocks of affiliated companies at December 31, 2003 and 2002 are summarized below:

	2003		2002	
	Cost	**Statement value**	**Cost**	**Statement value**
	(In thousands)			
Kemper Casualty Inc.	$ 66,990	65,668	58,081	58,169
Kempes Inc.	47,994	53,790	70,368	51,621
Kemper Financial Protection Inc.	44,679	50,465	15,102	11,346
American Motorists Insurance Co.	—	29,907	309,949	366,915
Kemper International Corp.	28,312	28,312	55,548	52,981
Kemper Employers Group Inc.	14,315	21,584	84,609	84,821
Kemper Insurance Group Inc.	2,595	3,267	712,141	577,083
GreatLand Holdings Inc.	1,840	2,382	13,148	13,142
Kemper Insurance Holdings #2 Inc.	202	2,195	10,001	11,505
Kemper Safeguard Surplus Insurance Co.	—	—	20,000	23,370
NATLSCO Inc.	—	—	39,922	(72,533)
All other	1,938	3,104	2,629	3,310
	$ 208,865	260,674	1,391,498	1,181,730

Significant Transactions with Affiliates

Service Net Solutions, LLC

On July 2, 2003, a wholly owned subsidiary of the Company, Kemper Warranty Services, Inc. (KWS), sold its 51% ownership stake in Service Net Solutions, LLC (Service Net) for $6.5 million and a release of future financial obligations arising under the original purchase agreement. The Company realized a net gain in 2003 of $732 thousand as a result of the sale. Service Net retained its current staff of approximately 40 employees. As part of the transaction, the Company established a collateral trust in the amount of $35 million to secure obligations arising out of contractual liability policies issued by the Company and its affiliates to Service Net to insure the consumer warranty contracts sold by Service Net to its customers. Trust assets at December 31, 2003 were $25.8 million.

NATLSCO, Inc.

On July 22, 2003, the Company sold its wholly owned subsidiary NATLSCO, Inc. and related service operations (NATLSCO) to a buyer (Broadspire LLC) owned by Platinum Equity LLC (the Buyer). Resident in NATLSCO were the assets used in the administration of the Company's general liability, workers compensation and employer liability claims, and the third-party claim servicing operation. The Company booked a realized loss on the transaction of $180.8 million, assigning no value to contingent earn out payments the Company could realize in years 2004 through 2007. The realized loss is subject to change based on the final post-closing settlement with the Buyer, which is anticipated to occur in the second quarter of 2004. As part of the transaction, the Buyer hired approximately 3,300 of the Company's employees. The Company agreed to share in any severance costs incurred by the Buyer, up to a maximum of $6 million dollars, for two years following the closing date. The Company assumed that the $6 million would be incurred for purposes of calculating the realized loss above.

The Company also entered into a long-term Claim Administration Agreement with NATLSCO for the servicing of most of the Company's existing workers' compensation, general liability, and employer liability claims. The Company paid NATLSCO $95,257,000 in advance for the future servicing of such claims, of which $56,760,000 was placed in trust by Buyer to be drawn down monthly over a four-year period commencing January 1, 2006. The Company does receive the interest on the Buyer's trust assets. In accordance with the accounting allowance more fully described in note 1, the Company reflects this prepaid amount for claim handling services (approximately $82 million as of December 31, 2003) as an admitted asset.

Kemper Cost Management, Inc.

On August 16, 2003, a wholly owned subsidiary of the Company, Kemper Cost Management Holding Company, Inc. (KCMHC), sold 100% of the capital stock of its wholly owned subsidiary, Kemper Cost Management, Inc. (KCM). KCM is a provider of contract maintenance alternatives for commercial equipment. In conjunction with the sale, the buyer of KCM agreed to retain its current staff of 36 employees. As part of the transaction, the Company agreed to pay $850 thousand, comprised of $500 thousand in cash paid at closing and $350 thousand placed in a collateral trust (to be drawn down over a nine-month period), for future claims services provided to the Company by KCM for managing the runoff of contractual liability policies issued by the Company and its affiliates. In addition, the agreement allows the Company to receive a profit share from KCM as policies originally issued by the Company and its affiliates are renewed by KCM's new underwriting market, Great American Insurance Companies. The Company realized a loss of $1.1 million in 2003 as a result of the sale.

Lumbermens Life Agency, Inc.

On September 8, 2003, the Company sold 100% of the capital stock of its wholly owned subsidiary, Lumbermens Life Agency, Inc. (LLA), an Illinois corporation that markets life insurance and annuities through independent agents. The sale included LLA's four subsidiaries and certain assets used in the business as well as the transfer of fourteen employees. The Company realized a gain of $1.4 million from the transaction in the third quarter of 2003.

Eagle Insurance Companies

On September 30, 2003, the Company, one of its wholly owned holding company subsidiaries, Kemper Employers Group, Inc. (KEG), and two wholly owned non-Illinois insurance subsidiaries of KEG, Eagle Pacific Insurance Company, then a Washington-domiciled company (Eagle Pacific), and Pacific Eagle Insurance Company, a California-domiciled company (Pacific Eagle), entered into a transaction with SeaBright Insurance Holdings LLC (SeaBright) pursuant to which SeaBright acquired the following companies and assets:

A. From KEG, SeaBright acquired 100% of the capital stock of each of two other KEG subsidiaries, Kemper Employers Insurance Company, an Illinois insurance company (KEIC), and PointSure Insurance Services, Inc., a Washington corporation and insurance agency. Immediately before the sale, the Company and KEIC commuted their intercompany reinsurance agreement, with KEIC reassuming from the Company approximately $13 million of previously ceded liabilities in return for a cash payment by the Company of the same amount. In connection with the commutation, the Company agreed to reinsure KEIC for any adverse development on pre-closing date KEIC policy liabilities. The Company's claim handling prepayments to NATLSCO (see description of NATLSCO sale above and see note 1) cover unallocated loss adjusting expenses of approximately $852,000 for KEIC's pre-closing claims. The Company placed into an eight-year collateral trust $1.6 million to secure its stop loss reinsurance obligations to KEIC. Following the sale, KEIC changed its name to SeaBright Insurance Company.

B. From Eagle Pacific and Pacific Eagle, SeaBright acquired the renewal rights to all business previously written by the Eagle companies and the tangible and intangible assets used in the writing and administration of the business of the Eagle companies. In connection with this transaction, SeaBright hired all of the more than 100 employees of Eagle and the Company, most located in Seattle, Washington, who had been handling the Eagle business. SeaBright also agreed to provide administrative and claim handling services to the Eagle companies which then moved into run-off status.

The purchase price for the two companies, based on preliminary closing date numbers, was $14.2 million, of which Eagle Pacific's share was $2.6 million and Pacific Eagle's was $133 thousand. The purchase agreement provides for purchase price and commutation adjustments based on actual September 30, 2003 financials. The Company has proposed to SeaBright, and recorded in the Company's December 31, 2003 financial statements, approximately $1 million of adjustments as additional amounts due the Company. In compliance with the purchase agreement, SeaBright is expected to respond to the proposed adjustments in June 2004. The Company's December 31, 2003 surplus includes a $1.8 million gain on the above transactions with SeaBright.

On December 31, 2003, Eagle Pacific and the Company commuted their intercompany reinsurance agreements under which most of Eagle Pacific's business was ceded to the Company (which agreements also effectively reinsured with the Company most of Pacific Eagle's 2003 business since that business is subject to a pooling agreement between the two Eagle companies). This commutation was immediately followed by a merger of Eagle Pacific into another wholly owned, Illinois-domiciled subsidiary of the Company, American Protection Insurance Company (AMPICO). The surviving company, AMPICO, pursuant to a previously existing intercompany reinsurance agreement with the Company, reinsures 100%

of its business with the Company. The Company is contemplating the merger of Pacific Eagle into AMPICO by mid-2004.

Kemper Direct

Effective June 28, 2002, the Company sold substantially all its renewal rights for its U.S. produced personal lines business to Trinity Universal Insurance Company (Trinity), a subsidiary of Unitrin (Trinity and Unitrin, Inc. are together referred to as Unitrin). Unitrin did not acquire renewal rights to policies issued in Alaska, Michigan, Delaware, or Arkansas or to policies produced by independent agents whose authority to write new business had been terminated prior to April 19, 2002. The transaction with Unitrin included the transfer of approximately 1,100 employees and the sale of equipment and computer systems which supported the personal lines operations. Unitrin also acquired two of the Company's wholly owned insurance subsidiaries, Kemper Auto & Home Insurance Company (Kemper Auto & Home) and Kemper Independence Insurance Company (KIIC), which comprised the Kemper Direct operation. Unitrin also obtained a license to use the Kemper name in the acquired businesses for up to five years.

As a result of the transaction, the Company recognized a realized loss of $523,910 related to the sale of Kemper Auto & Home and KIIC and a realized loss of $16,481,946 primarily related to the sale of equipment and computer systems. Under the terms of the agreement, Unitrin is obligated to pay the Company a 1% renewal commission for all personal lines premiums written in 2003, 2004, and 2005. During 2003, the Company earned $7.8 million in renewal commissions, of which $1.9 million was accrued as a receivable at December 31, 2003.

In connection with the sale, the Company and Unitrin have also entered into administrative service agreements whereby Unitrin continues to monitor and service the Company's run-off of its retained personal lines policies, and the Company and certain of its affiliates agreed to front for Unitrin for a transition period in those states where Unitrin is currently seeking licenses and making form and rate filings necessary for the issuance of Unitrin policies in place of renewals of policies issued by the Company or its affiliates.

UBIC

During the second quarter of 2002, the Company was notified of claims on surety bonds issued in connection with a series of unauthorized programs by Universal Bonding Insurance Company (UBIC), then an 80% owned subsidiary domiciled in the State of New Jersey, the true nature of which was not fully disclosed to certain members of UBIC's management or to the Company. As a result, the Company began pursuing an investigation into the validity, available defenses, and potential recoveries of such bonds. On July 9, 2002, UBIC discontinued issuing any further bonds, except those bonds which UBIC was statutorily obligated to renew.

In addition to recognizing the above net loss on the unauthorized bonds, the Company also wrote off the following related to UBIC during 2002: 1) the Company's remaining investment, including goodwill, in UBIC; 2) $45.5 million of surplus notes issued to UBIC during 2002 in order to enable UBIC to satisfy its other claim obligations and operating expenses; and 3) $474 thousand of intercompany receivables due from UBIC (also see note 4 regarding Discontinued Operations).

The write-off of the goodwill was treated as a direct charge to surplus as a component of the change in net unrealized capital losses. The original investment in UBIC, the net exposure to the unauthorized bonds, the surplus note fundings, the reserve for discontinued operations, and the intercompany balances were treated as net realized capital losses as of December 31, 2002 as follows:

		Net realized capital losses	Net unrealized capital losses	Total impact on surplus
			(In thousands)	
Impairment of original investment	$	11,014	—	11,014
Goodwill impairment		—	7,229	7,229
Surplus note fundings		45,500	—	45,500
Accrual for discontinued operations		2,900	—	2,900
Insurance claims on unauthorized surety				—
bond claims in excess of recoveries		11,792	—	11,792
Write-off of intercompany receivables		474	—	474
	$	71,680	7,229	78,909

As of December 31, 2003, settlement negotiations have been concluded with respect to nearly all of the unauthorized bonds that have been identified. The Company has pursued significant defenses and avenues of recovery (including but not limited to proceeds from various insurance and reinsurance coverage, salvage and subrogation, and recoveries from responsible third parties). The ultimate loss and LAE on these bonds as of December 31, 2003 is $103.1 million before reinsurance and other recoveries, and $10.9 million after anticipated recoveries. Based upon the Company’s review as of December 31, 2003, the claims payable and insurance recoverable balances related to UBIC were adjusted resulting in an additional $27.5 million recognized loss on the statement of operations.

Other Affiliate Transactions

During 2003, AMICO transferred to the Company all of the issued and outstanding common stock of Kemper Warranty Services, Inc. which had a statement value of $2.6 million and of LGA-3, Inc. which had a statement value of $86 thousand to the Company.

During 2002, The Company contributed all of the issued and outstanding common stock of Lou Jones and Associates, which had a statement value of $18.1 million to AMICO.

During 2003 and 2002, the Company made additional capital contributions, or loans treated as equity contributions, to several other of its affiliates primarily to fund cash flow operating needs, as follows:

		2003	2002
		(In thousands)	
NATLSCO	$	140,878	42,414
Kemper International Corporation		1,594	38,448
Specialty National Insurance Company (SNIC)		—	25,000
Kemper Enterprise Group, Inc.		—	22,500
LGA-1, Inc.		—	14,015
Nekema, Inc.		—	6,765
Kemper Casualty, Inc.		15,971	5,076
Kemper Cost Management, Inc.		2,497	5,129
Kemper Financial Protection, Inc.		456	3,030
Kemper Warranty Services, Inc.		5,323	—
Kemper Employers Group, Inc.		2,506	—
All other		653	2,333
	$	169,878	164,710

Goodwill

Over the past several years, the Company purchased several operating insurance companies and various nonoperating insurance company shells primarily to expand its specialty underwriting operations. Such acquisitions have been placed under insurance holding companies, all of which are ultimately 100% owned by the Company. As a result of these aforementioned acquisitions, unamortized goodwill at December 31, 2003 and 2002 was as follows:

		2003	2002
		(In thousands)	
Kemper Casualty, Inc.	$	—	5,305
Kemper Employers Group, Inc.		—	28,102
Kempes, Inc.		—	5,817
Kemper International Corporation		—	282
Unamortized goodwill	$	—	39,506

During 2002, the Company wrote-off $33.5 million of unamortized goodwill related to the acquisition of a block of business acquired from Reliance Insurance Company’s large risk casualty unit and $6.0 million of unamortized goodwill related to Kemper, Inc. due to the termination in early 2003 of a letter of intent to sell the subsidiary.

Also during 2002, the Company’s wholly owned subsidiary, AMICO, also wrote-off $16.3 million of unamortized goodwill related to the acquisition of the stock of Lou Jones and Associates, a producer of surety contracts, and $12.6 million related to Kemper Warranty Services, Inc. due to the company’s decision in early 2003 to exit the warranty line of business.

During 2003, the Company wrote off all remaining unamortized goodwill in the amount of $61.8 million due to its impaired value, all of which related to purchases of operating insurance companies and various nonoperating insurance company shells over the last five years.

The write-off of the above goodwill in 2003 and 2002 was the result of the Company's decision to cease its underwriting operations, subject to nonrenewal and withdrawal notices under applicable state insurance laws and certain third party contractual commitments, and place the Company into a commercial run-off. These write-offs were charged directly to surplus as a component of the change in net unrealized capital losses.

Impairment Write-downs

Excluding goodwill (which is charged directly to surplus) and UBIC, the Company recognized impairment write-downs as realized capital losses for the following investments in subsidiaries during 2003:

Company		2003	2002
		(In thousands)	
Kemper Insurance Group, Inc.	$	106,446	—
NATLSCO		—	30,047
Kemper International Corporation		27,382	29,280
Kempes, Inc.		16,557	—
Kemper Financial Protection, Inc.		4,402	—
Kemper Casualty, Inc.		1,136	20,090
LGA-3, Inc.		1,007	—
Kemper Employers Group, Inc.		914	—
Kemper Cost Management Holding Company, Inc.		338	12,722
LGA-1, Inc.			9,245
American Protection Property & Casualty Agency, Inc.		20	—
LGA-17, Inc.		—	1,589
Greatland Hldgs, Inc.		—	1,088
Kemper Realty Corporation		2	7,300
All other		349	409
	$	158,553	111,770

The write-downs were based upon the Company's view that the unrealized losses, previously recognized in surplus, related to such subsidiaries were impaired on an other than temporary basis. Statement value for such subsidiaries, adjusted for nonadmitted assets deemed to be recoverable, were used as a proxy for fair value.

The Company recorded dividends from the following subsidiaries and affiliates during 2003 and 2002:

	2003	2002
	(In thousands)	
Kemper International Corporation	$ 13,613	—
American Motorists Insurance Company	12,730	—
NATLSCO	—	32,500
Total	$ 26,343	32,500

Mortgage Loans and Other Invested Assets

Mortgage loans and other real estate-related investments, excluding properties occupied by the Company, and other invested assets consisted of the following as of December 31, 2003 and 2002:

	2003	2002
	(In thousands)	
Mortgage loans and other real estate-related investments:		
Residential mortgage loans	$ 12,648	17,111
Commercial mortgages	4,500	37,013
Real estate joint venture	7,762	7,728
Short-term notes receivable	—	2,000
Properties held for sale	40,856	15,853
	65,766	79,705
Other non real estate-related invested assets:		
Venture capital partnerships and hedge funds	56,661	81,777
Other notes receivable and equity investments	39,908	44,456
	96,569	126,233
Total mortgage loans, other invested assets and other real estate-related investments	$ 162,335	205,938

The Company's mortgage portfolio is distributed by geographic locations and property type. The Company monitors its mortgage loan portfolio for loans not making payments in accordance with the loan terms and reviews these loans for impairment. During 2003, the Company recorded an impairment writedown of $3.9 million on a commercial loan. Because the Company's mortgage review process includes estimates, there can be no assurance that current estimates will prove accurate over time due to changing economic conditions and other factors.

The Company also has a real estate joint venture, which is a accounted for as a real estate ADC arrangement, through a master limited partnership between a subsidiary of the Company and subsidiaries of a former affiliate, which amounted to $7.8 million, or 11.8% of the Company's total real estate portfolio, at December 31, 2003. The partnership's underlying investment consisted primarily of a water development project located in California's Sacramento River Valley. During 2003, the Company abandoned its plans for the water development project and has actively sought an exit from this investment. As a result, the Company recorded a $29.3 million impairment writedown to the fair value of the undeveloped land net of anticipated costs to sell as of December 31, 2002 and an additional writedown of $0.1 million during 2003.

During 2003, the Company reclassified all of its remaining real estate owned from company-occupied to held for sale and obtained appraisals for properties not sold. As a result of the appraisals, the Company recorded impairment writedowns of $19.2 million related to its real estate held for sale. During 2002, impairment writedowns of $25.5 million were recorded on properties held for sale. Also during 2003, the Company sold its Plantation, Florida office property for $33.5 million and realized a gain of $11.9 million on the sale.

The Company does not accrue investment income on real estate-related investments when it judges that the likelihood of collection of interest is doubtful. As of December 31, 2003, the Company had a $4.5 million mortgage loan on nonaccrual status. As of December 31, 2002, the Company had no mortgage loans on nonaccrual status.

Net Realized Capital Losses

Net realized capital gains (losses) by category for the years ended December 31, 2003 and 2002 were as follows:

		2003	2002
		(In thousands)	
Cash and short-term investments	$	(15,000)	3,099
Equity securities:			
UBIC related write-downs		(16,899)	(71,680)
All other affiliate write-downs		(158,553)	(111,770)
Sale of NATLSCO		(180,799)	—
Extraordinary distribution from AMICO		60,421	—
Loss on Berkshire Letter of Intent		799	(23,162)
Other affiliate transactions		24,635	(23,072)
Unaffiliated		767	(8,308)
Bonds		14,384	(6,536)
Real estate-related		(7,453)	(27,971)
Other invested assets		(35,174)	(39,276)
Loss on sale of assets		(29,322)	(16,482)
Other fixed asset write-downs		(55,436)	(7,481)
Net realized capital losses	$	(397,630)	(332,639)

During 2003, the Company recorded realized losses related to other-than-temporary declines in fair values of $15.0 million related to short-term investments, of $6.8 million related to bonds, $290 thousand related to equity securities, excluding affiliated companies, $32.5 million related to venture capital partnerships, $23.1 million related to real estate-related investments, and $3.8 million related to notes receivable included in other invested assets. During 2002, the Company recorded realized losses related to other-than-temporary declines in fair values of $27.8 million related to bonds, $16.3 million related to equity securities, excluding affiliated companies, $36.5 million related to venture capital partnerships, $54.9 million related to real estate-related investments, and $6.2 million related to notes receivable included in other invested assets. The determination of fair value for such write-downs is based upon estimated fair value.

During 2003 and 2002, the Company used external money managers to invest most of the assets of the Company. The Company has established investment guidelines with each individual manager in accordance with the guidelines established by the State of Illinois. The Company did not restrict its managers in their trading strategies, but may from time to time restrict certain securities from being traded. As a result, the Company on occasion had different managers trading in (buying or selling) the same securities with third parties, for different reasons, thereby creating wash sale transactions. Also, an external manager may buy and/or sell securities in a short time period due to volatile changes in valuation that differ from that manager's belief of market fair value.

The Company did not have any 2003 sales of NAIC designation 3 or below securities which were reacquired within 30 days of the sale date. The details by NAIC designation 3 or below of securities sold during the twelve months ended December 31, 2002 and reacquired within 30 days of the sale date were as follows:

	2002			
	Number of transactions	**Book value of securities sold**	**Cost of securities repurchased**	**Gain (loss)**
			(In thousands)	
Bonds:				
NAIC 3	3	$ 368	449	46
NAIC 4	6	2,177	1,561	(255)
NAIC 5	4	820	533	(217)
NAIC 6	—	—	—	—
Preferred stocks:				
NAIC 3	2	154	151	(1)
NAIC 4	—	—	—	—
NAIC 5	1	976	237	(295)
NAIC 6	—	—	—	—
		$ 4,495	2,931	(722)

Net Investment Income

The sources of the Company's net investment income as of December 31, 2003 and 2002 were as follows:

	2003	2002
	(In thousands)	
Bonds	$ 69,325	160,670
Equity securities:		
Affiliated	26,343	32,500
Unaffiliated	1,612	1,685
Cash and short-term investments	13,209	5,955
Real estate owned	12,425	13,402
Mortgage loans	2,532	4,716
Other invested assets	7,673	14,145
Gross investment income	133,119	233,073
Less:		
Interest expense	(283)	(76,787)
Investment expenses	(28,750)	(26,984)
Depreciation expense on real estate	(2,777)	(4,319)
Total investment expense	(31,810)	(108,090)
Net investment income	$ 101,309	124,983

Securities Lending Program

The Company participates in a securities lending program whereby certain stocks and bonds were loaned to third parties, primarily major brokerage firms. In accordance with agreements with the custodian bank facilitating such lending, collateral with a fair value at least equal to 102% of the fair value of the loaned securities is required when securities are loaned and additional collateral is required if the fair value of the collateral drops below 100% during the term of the loan. To further minimize the credit risks related to this lending program, the Company monitors the financial condition of counterparties to these agreements. Securities loaned at December 31, 2003 had carrying values and fair values of less than $1 thousand. Cash, which is not available for the general use of the Company, was held by the custodian bank as collateral at December 31, 2003.

(3) Losses and Loss Adjustment Expenses

The Company establishes loss reserves to cover its estimated ultimate liability for property and casualty losses and LAE with respect to reported claims and claims incurred but not yet reported as of the end of each accounting period, except for certain liabilities for unpaid losses related to workers' compensation pension cases and long-term disability losses, which are reduced to present value. As required by applicable accounting rules, no reserves are established until a loss, including a loss from a catastrophe, occurs. Reserves 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 reserves 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.

Activity in the liabilities for losses and LAE is summarized as follows:

	2003	2002
	(In thousands)	
Balance as of January 1, net of reinsurance recoverables of $3,193,365 in 2003 and $2,591,820 in 2002	$ 3,502,137	3,183,425
Incurred related to:		
Current accident year	532,892	1,088,525
Prior accident years (excluding correction of errors and cumulative effect of changes in accounting principle)	(579,945)	343,403
Total incurred	(47,053)	1,431,928
Correction of errors (see note 1):		
Risk transfer	—	174,790
Retroactive reinsurance accounting	—	218,680
Total corrections and changes	—	393,470
Paid related to:		
Current accident year	81,341	(421,660)
Prior accident years	287,544	(1,085,026)
Total paid	368,885	(1,506,686)
Balance as of December 31, net of reinsurance recoverables of $3,750,385 in 2003 and $3,193,365 in 2002	$ 3,823,969	3,502,137

The liabilities for losses and LAE related to prior accident years decreased on a net basis by $(579.9) million in 2003 and increased by $343.4 million in 2002. The development in 2003 is comprised of permitted practice discount of $(548.8) million and a large novated account of $(203.3) million. The remaining adverse development of $172.2 million was primarily attributable to worse than expected developments in workers compensation, other liability occurrence, surety, and nonproportional assumed liability.

The adverse development during 2002 was attributable to a $63.7 million increase in the asbestos and environmental liability for losses and a $279.7 million increase in the liability for losses on other liability, product liability, and commercial multiple peril lines, including adverse loss development on workers' compensation claims, some of which is attributable to the amortization of discount. The resulting one and two year developments shown in Schedule P Part 2 are $733.4 million and $893.1 million, respectively. The reserve developments for 2002 as recorded in Schedule P are overstated by the impact of reserve increases associated with the correction of errors related to the accounting for reinsurance contracts (see note 1). Reserves ceded to these reinsurance contracts have not changed, only the accounting treatment has been altered. Had these contracts met the requirements of SSAP 62, the amounts shown for loss and allocated loss adjustment expenses one and two year developments in Schedule P Part 2 as recorded in 2002 would have been $339.9 million and $499.6 million, respectively.

The Company's exposure to asbestos and environmental claims arise principally from general liability insurance contracts. Establishing reserves 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, reserves for asbestos and environmental claims cannot be estimated with traditional loss reserving techniques. Loss reserves 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 reserves on all known losses and LAE and by computing IBNR losses based on previous experience.

Asbestos Related Losses

The Company has exposure to asbestos and environmental claims that arise principally from general liability insurance contracts.

The Company estimates the impact of these exposures by establishing case basis reserves on all known losses and LAE and by computing IBNR losses based on previous experience.

The asbestos related losses (including coverage dispute costs) as of December 31, 2003 and 2002, gross of reinsurance, were as follows:

		2003	2002
		(In thousands)	
Beginning reserves	$	767,234	763,742
Incurred losses and LAE		113,263	54,608
Calendar year payments for losses and LAE		(80,910)	(51,116)
Ending asbestos related loss reserves	$	799,587	767,234

The asbestos-related losses (including coverage dispute costs) as of December 31, 2003 and 2002, net of reinsurance, were as follows:

		2003	2002
		(In thousands)	
Beginning reserves	$	390,094	382,891
Codification adjustment at January 1, 2001		—	—
Incurred losses and LAE		29,232	34,448
Calendar year payments for losses and LAE		24,483	(27,245)
Ending asbestos related loss reserves	$	443,809	390,094

The total asbestos related loss reserves at December 31, 2003 include IBNR reserves in the amount of $239,521,000 gross of reinsurance and $146,012,000 net of reinsurance. These IBNR reserves 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 asbestos related loss reserves stated above are not discounted. Pursuant to an accounting allowance (see note 1), the amount of the discount on reserves at December 31, 2003 is $167,843,000 gross of reinsurance and $167,843,000 net of reinsurance.

Environmental Related Losses

The environmental related losses (including coverage dispute costs) as of December 31, 2003 and 2002, gross of reinsurance, were as follows:

		2003	2002
		(In thousands)	
Beginning reserves	$	155,319	105,488
Incurred losses and LAE		(2,506)	54,551
Calendar year payments for losses and LAE		(5,802)	(4,720)
Ending environmental loss reserves	$	147,011	155,319

The environmental related losses (including coverage dispute costs) as of December 31, 2003 and 2002, net of reinsurance, were as follows:

		2003	2002
		(In thousands)	
Beginning reserves	$	104,946	69,188
Incurred losses and LAE		(3,068)	29,244
Calendar year payments for losses and LAE		23,984	6,514
Ending environmental loss reserves	$	125,862	104,946

(Continued)

The total environmental loss reserves at December 31, 2003 include IBNR reserves in the amount of $80,793,000 gross of reinsurance and $81,241,000 net of reinsurance. These IBNR reserves 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 environmental related loss reserves stated above are not discounted. Pursuant to an accounting allowance (see note 1), the amount of the discount on reserves at December 31, 2003 is $11,077,000 gross of reinsurance and $11,077,000 net of reinsurance.

Discounting of Losses and LAE

Statutory accounting rules promulgated by the Manual allow workers' compensation tabular indemnity reserves and long-term disability claims which have fixed and reasonably determinable payments to be discounted. However, the Department of Insurance has allowed the Company to discount all its loss and loss adjustment expense reserves at December 31, 2003, using a 4.2% interest rate assumption (see note 1). The table below highlights both the indemnity pension discount allowed by the Manual, which the Company reflects in its financial statements at December 31, 2002 and 2003, and the additional discount as allowed by the Department of Insurance, which the Company reflects only at December 31, 2003.

The indemnity loss portion of unpaid workers' compensation pension cases on a tabular basis are discounted using the 1989/1991 United States Decennial Life Tables for Female and Male Population at 3.5%, except for cases from Massachusetts, New Jersey, and New York. The Company discounts cases from Massachusetts using the 1979/1981 United States Decennial Life Tables for Total Population at 3.5% adjusted for injured workers' mortality. New Jersey cases use the 1989/1991 United States Decennial Life Tables for Female and Male Population at 5.0%. New York cases use New York Special Bulletin 222 from the New York State Workers' Compensation Board at 3.0% or 6.0% depending on the accident date. The liabilities at December 31, 2003 include $242,144,154 of such tabular indemnity loss reserve discount.

The Company also discounts its unpaid loss reserves for the medical portion of workers' compensation pension cases using the 1989/1991 United States Decennial Life Tables for Female and Male Population. Accordingly, the Department of Insurance permitted the Company in 2002 and 2003 to continue discounting such reserves. The reserves are first increased by a 5% medical cost inflation factor and then discounted by 3.5%. The medical loss reserve discounts are shown in Schedule P as nontabular discounts following the Company's permitted practice. The liabilities at December 31, 2003 include $240,724,329 for such medical loss reserve discount.

Pursuant to the previously mentioned accounting allowance, the Company discounts all unpaid loss and loss adjustment expense reserves at a 4.2% interest rate at December 31, 2003. The additional workers' compensation pension discount associated with using a 4.2% interest rate instead of the 3.5% interest rate has been categorized as All Other Non-Tabular Discount in the table that follows. The combined discount for unpaid loss and unpaid defense and cost containment expenses are all included in the discount for unpaid loss column. The discount associated with unpaid adjusting and other expenses is split out separately. The liabilities at December 31, 2003 include $609,685,640 of accounting allowance discount in excess of the amount allowed by the Manual and the prior permitted practice.

(In thousands)

Tabular Pension Discount
Included in Schedule P, Part 1

Line of business	Case	IBNR	Total
Workers' compensation	$ 212,650	29,494	242,144

Non-Tabular Pension Discount

Line of business	Case	IBNR	Total
Workers' compensation	$ 194,961	45,763	240,724

All Other Non-Tabular Discount

Line of business	Case	IBNR	Defense and cost containment	Adjusting and other expense	Total
Homeowners/farmowners	$ —	1,021	—	50	1,071
Private passenger auto/truck liability/medical	—	10,144	—	520	10,664
Commercial auto/truck liability/medical	—	18,430	—	833	19,263
Workers' compensation	—	255,194	—	9,686	264,880
Commercial multi peril	—	29,530	—	1,401	30,931
Medical malpractice:					
Claims-made	—	744	—	28	772
Specialty liability	—	608	—	32	640
Other liability – occurrence	—	75,290	—	3,595	78,885
Special property	—	1,197	—	34	1,231
Auto physical damage	—	(61)	—	(3)	(64)
Fidelity/surety	—	7,217	—	376	7,593
Other (including credit, A&H)	—	3,642	—	167	3,809
Reinsurance nonproportional assumed liability	—	6,138	—	344	6,482
Products liability – occurrence	—	181,139	—	2,390	183,529
Total	—	590,233	—	19,453	609,686
Grand total	$ 407,611	665,490	—	19,453	1,092,554

(4) Reinsurance

The Company is the lead company of the group of affiliated and associated companies (the Group) that have operated under the trade name of the Kemper Insurance Companies. The significant majority of the business written by member insurance companies of the Group has historically been ceded to the Company through quota share reinsurance agreements with some Company subsidiaries retaining a portion of the business written and through a quota share pooling agreement by and among the Company, American Motorists Insurance Company (AMICO), and American Manufacturers Mutual Insurance Company (AMM). Prior to 2003, of the insurance business directly written by the Company or ceded to the Company, including all business written by AMICO and AMM, the Company ceded (net of third-party, unaffiliated, reinsurance, and excluding Canadian business) 15% to AMICO and 8% to AMM. (Third-party reinsurance has generally attached after cessions by affiliates to the Company, although some specific risks have been subject to facultative or other reinsurance before cession to the Company.) Effective January 1, 2003, the pooling agreement was amended to eliminate the 15% cession to AMICO, and effective December 31, 2003, the pooling agreement was amended to eliminate the 8% cession to AMM. The effect of both amendments was for the Company to retain all previously ceded risks, and the amendments were accompanied by transfers of assets by each of AMICO and AMM in order to satisfy the liabilities transferred to the Company by the pooling agreement amendments. As a result, at December 31, 2003, the net reserves at each of AMICO and AMM are zero. Loss and loss expense reserves for the Group were analyzed in the aggregate for all companies and allocated to certain Company subsidiaries based on the business retained within those companies.

The Company utilizes a variety of reinsurance agreements to control exposures to large property-casualty losses including: (i) facultative reinsurance, in which reinsurance is provided for all or a portion of the insurance provided by a single policy; (ii) treaty reinsurance, in which reinsurance is provided for a specified type or category of risks; (iii) catastrophe reinsurance, in which the ceding company is indemnified for an amount of loss in excess of a specified retention with respect to losses resulting from a catastrophic event; and (iv) aggregate excess of loss reinsurance, in which the ceding company is indemnified against additional losses for defined losses and LAE in excess of a defined loss ratio or loss retention for each accident year.

The Company's aggregate excess of loss reinsurance treaties relate to the 1998 through 2002 accident years and they cover substantially all of the Company's lines of business. Recoveries under the treaties are payable when the paid covered net losses, as defined in the contracts, exceeds the retention. Under the aggregate excess of loss reinsurance treaties, interest expense generally accrues on the funds withheld account at a rate of approximately 7% per annum. As further discussed in note 1, certain of the Company's aggregate excess of loss reinsurance treaties were accounted for as prospective reinsurance rather than as retroactive reinsurance as of December 31, 2001. Ceded premiums under contracts accounted for as prospective reinsurance, net of ceding commission, amounted to $0 million and $17.3 million for 2003 and 2002, respectively. Additional premiums may also be payable under the terms of certain treaties in future years. The pretax benefit (loss) related to the aggregate excess of loss reinsurance treaties accounted for as prospective reinsurance amounted to $(5.8) million and $(11.7) million as of December 31, 2003 and 2002, respectively. Liabilities ceded under contracts accounted for as prospective reinsurance were $6.0 million and $310.9 million at December 31, 2003 and 2002, respectively.

Berkshire Hathaway Insurance Group and Kemper Commercial Insurance Company

On June 20, 2003, the Company and AMM and certain affiliates of Berkshire Hathaway Inc. (Berkshire) commuted two reinsurance agreements entered into at year-end 2001 and during 2002, returning to the Company and AMM substantially all reinsurance premium, net of loss recoveries, previously paid thereunder (approximately $697.3 million); amended a claim services agreement to return to the Company (and its affiliates) a previously paid deposit ($89 million); and replaced existing security arrangements which had been entered into in early 2003 (in connection with Berkshire affiliates issuing cut-through agreements for the benefit of insureds of the Company and its affiliates) with both (a) a collateral trust (encumbering approximately $250.8 million of the Company's and AMM's assets at June 20, 2003) and (b) the purchases from Berkshire (and corresponding pledges of the same to Berkshire) by the Company and AMM of Berkshire debt instruments (Schedule D bonds totaling approximately $257.3 million). In addition, a stock subsidiary of the Company, Kemper Insurance Group, Inc. (KIG), repurchased for $125 million Berkshire's 15% interest in KIG on June 20, 2003; Berkshire had acquired that minority interest for $125 million approximately a year earlier, on June 28, 2002. Substantially all of the Company's investments in KIG, approximately $603.1 million, were transferred back to the Company in the second half of 2003.

Effective December 31, 2001, the Company and certain of its insurance company affiliates (Kemper) entered into an Asbestos and Environmental Loss Portfolio Transfer Agreement (the A&E Reinsurance Agreement) with National Fire & Marine Insurance Company (National Fire) and National Indemnity Company (National Indemnity), wholly owned subsidiaries of Berkshire. Under the terms of the A&E Reinsurance Agreement, Kemper ceded to National Fire and National Indemnity, at the rate of 65% of subject losses, $550.0 million of asbestos, environmental, and other mass tort reserves, for $352.5 million in cash. Kemper also had an option to buy an additional $50.0 million of coverage for an additional premium of $8.0 million. This contract at that time resulted in a retroactive reinsurance gain for Kemper increasing then reported statutory surplus by $197.5 million. In connection with this contract, National Fire and National Indemnity assumed administration of the claims settlement process, and in accordance with the terms of the contract, Kemper prepaid $27.5 million for the claim services and deposited another $89 million with the claim service provider. As described in the preceding paragraph, on June 20, 2003, the latter amount was returned to Kemper and the A&E Reinsurance Agreement was commuted. The commutation in 2003 resulted in the recognition of a retroactive loss on reinsurance, reducing the Company's statutory surplus by $197.5 million.

The Company formed Kemper Commercial Insurance Company (Kemper Commercial) under the insurance laws of the State of Illinois in March 1999 as a wholly owned subsidiary of KIG. On June 28, 2002, three Berkshire affiliates, namely, National Fire, National Indemnity, and Columbia Insurance Company (Columbia, and together with National Fire and National Indemnity, the Berkshire Investor) acquired for $125.0 million a 15% equity position in KIG plus warrants to acquire an additional 2.5% equity stake in KIG (this June 28, 2002 transaction herein referred to as the National Fire transaction). The Company held all of the equity in KIG other than what the Berkshire Investor held. Berkshire and the Berkshire Investor filed with the Department of Insurance a disclaimer of control with respect to Kemper Commercial in June 2002. On June 20, 2003, as mentioned above and further described below, KIG repurchased the minority interest held by the Berkshire Investor.

In connection with the National Fire transaction in the first half of 2002, Kemper entered into certain reinsurance agreements, including a Loss Reserve Reinsurance Agreement (the ADC Reinsurance Agreement) with National Fire and National Indemnity. Under the terms of this agreement, Kemper paid National Fire and National Indemnity a total of $405.0 million in cash during the first quarter of 2002 to protect Kemper against adverse loss development from policies with accident year dates of December 31, 2001 and prior. This contract resulted in a retroactive reinsurance gain increasing then reported statutory surplus by $120.0 million. On June 20, 2003, as mentioned above, the ADC Reinsurance Agreement was commuted. The commutation in 2003 resulted in the recognition of a retroactive loss on reinsurance, reducing the Company's statutory surplus by $122.4 million.

Also as part of the National Fire transaction, the Company, through KIG, contributed an additional $697.0 million of paid-in capital to Kemper Commercial and entered into a quota share reinsurance agreement with Kemper Commercial effective as of January 1, 2002 (the Kemper Commercial Reinsurance Agreement). Under the terms of the Kemper Commercial Reinsurance Agreement, the Company ceded to Kemper Commercial 80% of the premium income, losses, and expenses of certain of its lines of commercial casualty and specialty insurance businesses, with policy effective dates as of January 1, 2002 and subsequent. In addition to the reimbursement of 80% of the costs and expenses of those businesses by Kemper Commercial, Kemper Commercial paid the Company a 0.25% ceding commission.

In addition to the investment in KIG, as part of the National Fire transaction, Kemper also entered into the AMM Middle Market Multi Line Quota Share Reinsurance Agreement (the Middle Market QS Agreement) with National Fire effective January 1, 2002. The Middle Market QS Agreement covered business written or renewed related to commercial package, commercial casualty, and automobile lines between January 1, 2002 and December 31, 2003 produced through Kemper's middle market profit center. Under the terms of the Middle Market QS Agreement, Kemper ceded 80% of the gross net written premium produced by the profit center in exchange for an 80% quota share participation of subject losses. Kemper also received a ceding commission equal to the lesser of 80% of actual allocated expenses or 30% of premiums ceded to National Fire. As of December 31, 2003, Kemper had ceded to National Fire from inception net written premiums of $538.1 million and subject losses and loss adjusting expenses of $333.8 million.

Effective December 22, 2002, Kemper and National Indemnity entered into a letter of intent (the Berkshire Letter of Intent) whereby the Company agreed in principle to repurchase or cause KIG to repurchase for $125.0 million the Berkshire Investor's 15% interest in KIG (plus the KIG warrants), subject to approvals by the respective boards of directors and the Department of Insurance. As a result of the repurchase of this interest, the Company's statutory surplus at June 30, 2003 was reduced by $23.2 million.

The Berkshire Letter of Intent with National Indemnity as amended January 13, 2003 provided Kemper with immediate access to cut-through agreements issued by National Indemnity. The cut-through agreements were applied to certain standard commercial and specialty lines of insurance. This cut-through agreement allows a Kemper insured to directly submit claims to National Indemnity in the event Kemper (as the insurance company which issued the policy) is unable to pay such claims as a result of its insolvency or a court or regulatory order prohibiting claim payments due to the issuing company's financial condition. Cut-through agreements were added to certain policies in-force as of December 23, 2002 and to certain new policies issued on and after December 23, 2002 until September 30, 2003. From inception of the use of the cut-throughs in late December 2002 to December 31, 2003, Kemper incurred net cut-through agreement fees of approximately $14.1 million, of which approximately $5.9 million was incurred by the Company during 2003.

Under the Berkshire Letter of Intent with National Indemnity, Kemper immediately provided collateral available to National Indemnity if and to the extent National Indemnity makes any payments under any cut-through agreements. The collateral includes offset rights granted to National Indemnity for reinsurance proceeds payable by either National Indemnity or National Fire to Kemper or its affiliates; a collateral trust in an amount of approximately $250.0 million of the invested assets of the parties to the Pooling Agreement as of the end of June 2003 which amount was reduced, by payments of claims (losses and loss adjustment expenses) and mid-term cancellations of policies, to approximately $206.7 million at December 31, 2003; and an investment of $257.3 million in Berkshire corporate obligations which the Company and AMM purchased from (and pledged as security to) Berkshire in 2003. If National Indemnity makes no payments under the cut-through agreements, then of the $257.3 million of pledged obligations, $100 million matures in March 2025, while the remaining $157.3 million is subject to mandatory redemption as and when the Company pays claims on policies covered by the cut-through agreements following exhaustion of the assets in the aforementioned collateral trust which must first be applied to such claim payments. The Company projects that at current claim payment rates, the trust assets will be reduced to zero by late 2005 or early 2006.

In the third quarter of 2003, following KIG's June 20, 2003 repurchase of Berkshire's 15% ownership in KIG (which resulted in the Company regaining 100% indirect ownership of Kemper Commercial), Kemper Commercial paid an extraordinary dividend of $547.9 million to KIG (which in turn paid the same dividend amount to the Company), and the Company and Kemper Commercial commuted the Kemper Commercial Reinsurance Agreement with the payment to the Company by Kemper Commercial of $337.0 million. Kemper Commercial was dissolved effective December 31, 2003, with the last remaining assets of Kemper Commercial (approximately $3.3 million) being transferred to the Company in early 2004.

Other Reinsurance Disclosures

The Company's and the Pool participants' assumptions from and cessions to unaffiliated reinsurers accounted for as prospective reinsurance were as follows:

		Assumed	Ceded
		(In thousands)	
2003:			
Written premiums	$	73,158	558,106
Unearned premiums		23,805	155,050
Outstanding losses and LAE (including IBNR)		1,002,516	3,701,254
Paid losses		260,545	1,707,019

		Assumed	Ceded
		(In thousands)	
2002:			
Written premiums	$	283,002	2,532,369
Unearned premiums		73,015	964,471
Outstanding losses and LAE (including IBNR)		732,092	3,736,145
Paid losses		166,823	822,097

The Company's cessions to Kemper Commercial during 2002 were as follows:

		Ceded
		(In thousands)
Written premiums	$	1,130,109
Unearned premiums		533,284
Outstanding losses and LAE (including IBNR)		340,188
Ceded reinsurance premiums payable, net		471,677
Paid losses		60,815

The Company reinsures a portion of the risks it underwrites in an effort to control its exposure to losses and protect surplus. The Company cedes to reinsurers a portion of these risks and pays 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, the Company remains primarily liable as the direct insurer on all risks reinsured. Reinsurance recoverables are reported after allowances for uncollectible amounts. The Company also holds collateral, including escrow funds, letters of credit, and trust funds, under certain reinsurance agreements. The Company monitors the financial condition of reinsurers on an ongoing basis, and reviews its reinsurance arrangements periodically. Reinsurers are selected based on their financial condition and business practices. As of December 31, 2003, approximately 62% of the Company's $3.2 billion of unsecured recoverables from reinsurers, excluding the Company's participation in third-party pools, were from reinsurers rated A or better by A.M. Best Company or Standard & Poor's, and approximately 76% of the Company's $3.2 billion of unsecured recoverables were rated A- or better by A.M. Best Company or Standard & Poor's.

As of December 31, 2003, the Company had unsecured aggregate recoverables from outside reinsurers for losses paid, losses unpaid, LAE, and unearned premium that exceed 3% of the Company's total surplus with the following reinsurers (and related group members):

Reinsurer	FEIN Code	NAIC Group #	NAIC Code	Aggregate recoverable (In thousands)
Allstate Insurance Co.	36-0719665	8	19232	$ 14,718
Group total				
American Home Assurance Co.	13-5124990	12	19380	262
Hartford Steam Boil Inspec & Ins Co.	06-0384680	12	11452	8,655
National Union Fire Ins Co of Pittsburgh	25-0687550	12	19445	2,148
Putnam Reinsurance Co.	13-3333610	12	35157	21
Transatlantic Reinsurance Co.	13-5616275	12	19453	65,843
Group total				76,929
Cologne Reinsurance Co. of America	06-0949141	31	33197	23
General Reinsurance Corp.	13-2673100	31	22039	202,784
National Fire & Marine Insurance Co.	47-6021331	31	20079	249,552
National Indemnity Co.	47-0355979	31	20087	221
National Reinsurance Corp.	13-1988169	31	34835	452
Group total				453,032
Motors Insurance Corp.	38-0855585	79	22012	13,844
Group total				
Berkley Insurance Co.	47-0574325	98	32603	29,229
Firemens Ins Co. of Washington DC	53-0067060	98	21784	314
Tri State Insurance Co. of Minnesota	41-1232071	98	31003	173
Group total				29,716
Employers Insurance of Wausau	39-0264050	111	21458	8,935
Liberty Mutual Insurance Co.	04-1543470	111	23043	1,014
Group total				9,949
North River Insurance Co.	22-1964135	158	21105	61
Odyssey America Reinsurance Co.	47-0698507	158	23680	10,930
Odyssey Reinsurance Corp.	13-2781282	158	25070	46,794
Group total				57,785

Reinsurer	FEIN Code	NAIC Group #	NAIC Code	Aggregate recoverable (In thousands)
Fidelity & Guaranty Insurance Co.	42-1091525	164	35386	$ —
St Paul Fire & Marine Insurance Co.	41-0406690	164	24767	26,933
United States Fidelity & Guaranty Co.	52-0515280	164	25887	660
Group total				27,593
Swiss Reinsurance America Corp.	13-1675535	181	25364	320,331
Swiss Re Life & Health America Inc.	06-0839705	181	82627	5,829
Underwriters Reinsurance Co.	16-0366830	181	22314	16,383
Group total				342,543
Trinity Universal Insurance Co.	75-0620550	215	19887	250,995
Unitrin Preferred Insurance Co.	13-5460208	215	25909	—
Group total				250,995
Continental Casualty Co.	36-2114545	218	20443	36,242
Continental Insurance Co.	13-5010440	218	35289	14
Encompass Insurance Co. of America	36-3976913	218	10071	884
Group total				37,140
Philadelphia Reinsurance Corp.	23-1620930	229	12319	3,289
Reliastar Life Insurance Co.	41-0451140	229	67105	15,072
Group total				18,361
Employers Reinsurance Corp.	48-0921045	350	39845	75,601
GE Reinsurance Corp.	36-2667627	350	22969	177,729
Westport Insurance Corp	13-1941868	350	34207	603
Group total				253,933
American Re-Insurance Co.	13-4924125	361	10227	384,458
American National Insurance Co.	74-0484030	408	60739	7,082
Insurance Corp. of Hanover	36-3030511	517	37257	8,348
Gerling America Insurance Co.	13-3071466	604	41343	66
Gerling Global Rein Corp of America	13-5009848	604	21032	25,908
Gerling Global Reinsurance Corp. – U.S.	13-6107326	604	11266	4
Group total				25,978

Reinsurer	FEIN Code	NAIC Group #	NAIC Code	Aggregate recoverable (In thousands)
Ace American Insurance Co.	95-2371728	626	22667	$ 335
Ace American Reinsurance Co.	23-1740414	626	22705	3,482
Ace Property & Casualty Insurance Co.	06-0237820	626	20699	4,585
Insurance Co. of North America	23-0723970	626	22713	18,056
Group total				26,458
General Security National Ins Co.	13-3029255	749	39322	7,799
SCOR Reinsurance Co.	75-1444207	749	30058	44,659
Group total				52,458
AXA Corporate Solutions Insurance Co.	13-3594502	968	33022	474
AXA Corporate Solutions Reinsurance Co.	36-2994662	968	36552	556
AXA Re America Insurance Co.	04-1590940	968	11835	11,052
AXA Reinsurance Property & Casualty Insurance Co.	04-2482364	968	16187	86
Group total				12,168
Everest Reinsurance Co.	22-2005057	1120	26921	39,328
American Healthcare Indemnity Co.	59-2048400	1125	39152	10,202
American Employers Insurance Co.	04-1027270	1129	20613	583
Folksamerica Reinsurance Co.	13-2997499	1129	38776	8,900
Group total				9,483
Arch Insurance Co.	43-0990710	1279	11150	7,430
Arch Reinsurance Co.	06-1430254	1279	10348	6,343
Group total				13,773
XL Reinsurance America Inc.1	13-1290712	1285	20583	37,361
Insurance Corp. of New York	13-5339725	1314	18341	303
Trenwick America Reinsurance Corp.	06-1117063	1314	34894	74,163
Group total				74,466
Converium Rein (North America) Inc.	06-1325038	3018	39136	114,992

(Continued)

Reinsurer	FEIN Code	NAIC Group #	NAIC Code	Aggregate recoverable (In thousands)
Gulf Insurance Co.	43-6028696	3321	22217	$ 6,373
Northland Insurance Co.	41-6009967	3321	24015	3,187
Travelers Indemnity Co.	06-0566050	3321	25658	1,521
Group total				11,081
Partner Reinsurance Co of the U.S.	13-3031176	3483	38636	8,473
PartnerRe Insurance of New York	13-3531373	3483	10006	(225)
Group total				8,248
Associated Aviation Underwriters	AA-9995013	N/A	N/A	192,164
PXRE Reinsurance Co.	06-1206728	N/A	29807	51,049
National Fidelity Life Insurance Co.	44-0367450	N/A	66559	47,642
National Workers Compensation Reinsurance Pool	AA-9992118	N/A	N/A	42,196
Texas Workers Compensation Pool	AA-9991444	N/A	N/A	36,352
Patriot Insurance Co Ltd.	AA-3190450	N/A	N/A	37,447
Excess & Casualty Reinsurance Assn. (ECRA)	AA-9995022	N/A	N/A	24,982
Lloyd’s of London (Authorized)	AA-1122000	N/A	N/A	22,730
New Jersey Unsatisfied Claim & Judgment Fund	AA-9991160	N/A	N/A	14,333
Hannover Ruckversicherungs AG	AA-1340125	N/A	N/A	12,038
TOA-Reinsurance Co. of America	13-2918573	N/A	42439	10,783
Lloyd’s Syndicate Number 2020	AA-1128020	N/A	N/A	9,590
Workers Compensation Reinsurance Assn.	41-1357750	N/A	10181	9,242
Mutual Reinsurance Bureau	AA-9995035	N/A	N/A	6,986
American Fuji Fire & Marine Insurance Co.	36-3155373	N/A	40398	6,943
Overseas Partners U.S. Reinsurance Co.	23-2745904	N/A	10019	6,583
Total aggregate reinsurance recoverables in excess of 3% of the company’s surplus				$ 2,976,698

(Continued)

During 2003, the Company wrote off $12,482,111 related to reinsurance paid loss recoverable balances with the following reinsurers:

FEIN code	NAIC code	Name of reinsurer		Amount (In thousands)
06-0237820	20699	Ace Property & Casualty Insurance Co.	$	477
36-2763106	18910	American Protection Insurance Co.		570
35-0145400	19704	American States Insurance Co.		13
94-1390273	19801	Argonaut Insurance Co.		114
04-1590940	11835	AXA America Insurance Co.		544
AA-1120355		CX Reinsurance Co. Ltd.		83
AA-9995022	16691	Excess and Casualty Reinsurance Assn.		5,152
31-0501234		Great American Insurance Co.		500
AA-1340125		Hannover Ruckversicherungs AG		121
06-0384680	11452	Hartford Steam Boil Inspection & Insurance Co.		706
74-1296673	22489	Highlands Insurance Co.		399
AA-1122000		Lloyd's of London (Authorized)		767
AA-1127212		Lloyd's Syndicate Number 1212		4
AA-1127900		Lloyd's Syndicate Number 1900		11
AA-1126991		Lloyd's Syndicate Number 991		1
AA-1121425		Markel International Insurance Co. Ltd.		34
38-0855585	22012	Motors Insurance Corp.		472
25-0687550	19445	National Union Fire Insurance Co. of Pittsburgh		112
23-2745904	10019	Overseas Partners U.S. Reinsurance Co.		250
39-0333950	24988	Sentry Insurance A Mutual Co.		66
41-0406690	24767	St. Paul Fire & Marine Insurance Co.		262
06-0839705	82627	Swiss Reinsurance Life & Health America, Inc.		27
06-1117063	34894	Trenwick America Reinsurance Corp.		1,002
AA-1121480		Union America Insurance Co. Ltd.		12
AA-3190450		Patriot Insurance Co. Ltd.		783
			$	12,482

The estimated maximum amount of return commission due reinsurers if all of the Company's reinsurance was canceled as of December 31, 2003 was as follows:

		Assumed reinsurance		Ceded reinsurance		Net	
		Premium reserve	Commission equity	Premium reserve	Commission equity	Premium reserve	Commission equity
		(1)	(2)	(3)	(4)	(5)	(6)
(i)	Affiliates	$ 179,457,246	23,390,862	(9,204,257)	(993,041)	170,252,989	22,397,821
(ii)	All other	23,806,325	7,444,492	(159,242,367)	(25,774,304)	(135,436,042)	(18,329,812)
(iii)	Total	$ 203,263,571	30,835,354	(168,446,624)	(26,767,345)	34,816,947	4,068,009

(iv) Direct Unearned Premium Reserve: $76,778,545

Additional or return commission, predicated on loss experience or on any other form of profit sharing arrangements in this annual statement as a result of existing contractual arrangements is accrued as of December 31, 2003 as follows:

		Reinsurance			
		Direct (1)	Assumed (2)	Ceded (3)	Net (4)
(i)	Contingent commission	$ (60,546,967)	62,028,753	(24,335)	1,457,451
(ii)	Sliding scale adjustments	—	—	—	—
(iii)	Other profit commission arrangements	—	—	—	—
(iv)	Total	$ (60,546,967)	62,028,753	(24,335)	1,457,451

Retroactive Reinsurance

During 2003, the Company completed several material commutations which are referenced in this note as Ceded Contracts #1 through #9. Ceded Contract #1 covers all lines of business for selected business units and is referred to as the "Underlying Stop Loss Reinsurance Contract." Ceded Contract #2 covers personal lines and surety exposures for selected business units and is referred to as the "Aggregate Stop Loss Reinsurance Agreement" and "IFG Casualty Catastrophe Excess of Loss Reinsurance Contract" (two agreements). Ceded Contract #3 covers environmental, asbestos, and other mass tort exposures and is referred to as the "Asbestos and Environmental Loss Portfolio Transfer Agreement." Ceded Contract #4 covers all lines of business and is referred to as the "Adverse Loss Development Reinsurance Agreement." Ceded Contracts #5 through #9 cover all lines of business and are referred to as the "Aggregate Excess of Loss Reinsurance Treaties". Ceded Contract #7 was not fully commuted. The remaining reinsurer has a 10% participation. Ceded Contract effective dates and reinsurer information is contained in the tables below. The impact to "other expense" of $(365,196,455) was largely offset by decreases to incurred losses resulting from receiving an accounting allowance to discount the Company's loss and loss adjustment expense reserves at 4.2% (see note 1).

Ceded contract	Reinsurer	FEIN Code	NAIC Code	Participation percentage	Amount (income expense)
Contract #1	Underwriters Reinsurance Co. (Barbados) Inc.	AA-3160079	NA	100.0	$ 221,002
Contract #2	Underwriters Reinsurance Co. (Barbados) Inc.	AA-3160079	NA	100.0	(229,176)
Contract #3	National Fire & Marine Ins. Co.	47-6021331	20079	100.0	(197,500,000)
Contract #4	National Fire & Marine Ins. Co.	47-6021331	20079	100.0	(122,400,000)
Contract #5	Underwriters Reinsurance Co. (Barbados) Inc.	AA-3160079	N/A	25.0	(3,638,146)
	Scandinavian Reinsurance Co.	AA-3190174	N/A	25.0	(3,638,146)
	London Life & Casualty Reinsurance Corp. (Barbados)	AA-3161009	N/A	20.0	(2,910,517)
	Inter-Ocean Re-Ins Co.	AA-3190458	N/A	30.0	(4,365,775)
Contract #6	Underwriters Reinsurance Co. (Barbados) Inc.	AA-3160079	N/A	32.5	(5,507,837)
	Scandinavian Reinsurance Co.	AA-3190174	N/A	25.0	(4,236,798)
	London Life & Casualty Reinsurance Co. (Barbados)	AA-3161009	N/A	20.0	(3,389,438)
	Max Re Ltd.	AA-3190829	N/A	22.5	(3,813,118)
Contract #7	Underwriters Reinsurance Co. (Barbados) Inc.	AA-3160079	N/A	38.9	(10,336,177)
	Scandinavian Reins Co.	AA-3190174	N/A	27.8	(7,382,984)
	London Life & Casualty Reinsurance Corp. (Barbados)	AA-1780047	N/A	8.3	(2,214,895)
	London Life & General Company Limited		N/A	25.0	(6,644,685)
Contract #8	Underwriters Reinsurance Co. (Barbados) Inc.	AA-3160079	N/A	100.0	20,647,782
Contract #9	Underwriters Reinsurance Co. (Barbados) Inc.	AA-3160079	NA	100.0	(7,857,548)
Total					$ (365,196,456)

As of December 31, 2003, the Company did not engage in any assumed retroactive reinsurance transactions. The remaining recoverable balance associated with Ceded Contract #1 was collected in 2003. Ceded Contract #6 was partially commuted in 2003. One reinsurer with a 10% participation remains on the contract. This contract covers all lines of business and is referred to as the “Aggregate Excess of Loss Reinsurance Treaty.” All other ceded retroactive transactions have been fully commuted. Contract effective date and reinsurer information is contained in the tables below:

	Ceded contracts							
Effective date	**Contract #1 December 2, 1998**	**Contract #2 December 31, 2001**	**Contract #3 December 31, 2001**	**Contract #4 January 1, 1998**	**Contract #5 January 1, 1999**	**Contract #6 January 1, 2000**	**Contract #7 January 1, 2001**	**Total**
A – Reserves transferred:								
Initial reserves	$ 48,750,000	550,000,000	527,400,000	80,543,000	163,625,000	175,103,000	225,000,000	1,770,421,000
Adjustments – prior year(s)	(975,000)	—	—	—	—	—	—	(975,000)
Adjustments – current year	—	(550,000,000)	(527,400,000)	(16,953,360)	(17)	(62,768,126)	(65,396,037)	(1,222,517,540)
Current total	$ 47,775,000	—	—	63,589,640	163,624,983	112,334,874	159,603,963	546,928,460
B – Consideration paid or received:								
Initial consideration	$ 33,075,000	352,500,000	407,400,000	54,379,592	126,614,146	115,559,517	175,046,394	1,264,574,649
Adjustments – prior year(s)	(661,500)	1,250,000	—	—	—	—	—	588,500
Adjustments – current year	—	(353,750,000)	(407,400,000)	2,519,828	631	6,699,452	18,091,894	(733,838,195)
Current total	$ 32,413,500	—	—	56,899,420	126,614,777	122,258,969	193,138,288	531,324,954
C – Paid losses reimbursed or recovered:								
Prior year(s)	$ 46,569,441	42,884,189	—	—	163,625,000	—	—	253,078,630
Current year	1,205,559	(42,884,189)	—	63,589,640	(17)	101,101,387	159,603,963	282,616,343
Current total	$ 47,775,000	—	—	63,589,640	163,624,983	101,101,387	159,603,963	535,694,973
D – Special surplus from retroactive reinsurance:								
Initial surplus gain or loss	$ 15,675,000	197,500,000	120,000,000	26,163,408	37,010,854	59,543,483	49,953,606	505,846,351
Adjustments – prior year(s)	(313,500)	(1,250,000)	—	—	—	—	—	(1,563,500)
Adjustments – current year	—	(196,250,000)	(120,000,000)	(19,473,188)	(648)	(69,467,578)	(83,487,931)	(488,679,345)
Current year restricted surplus	—	—	—	—	—	—	—	—
Cumulative total transferred to unassigned funds	$ 15,361,500	—	—	6,690,220	37,010,206	(9,924,095)	(33,534,325)	15,603,506

Reinsurance Recoverable in Dispute

The Company has reinsurance recoverable balances with the following reinsurers which are in dispute and in the aggregate exceed 10% of the Company's policyholder surplus.

Name of reinsurer	Total amount in dispute (including IBNR)	Notification	Arbitration	Litigation
Patriot Insurance Co. Ltd.	$ 39,307,532	—	—	39,307,532
PXRE Reinsurance Co.	29,100,000	—	—	29,100,000
Transatlantic Reinsurance Co.	13,772,012	7,392,391	6,379,621	—
Front Range Insurance Co.	12,957,555	—	—	12,957,555
Swiss Reinsurance America Corp.	11,501,820	11,501,820	—	—
Hartford Steam Boil & Inspection Co.	7,201,299	7,201,299	—	—
X.L. Reinsurance America Inc.	6,920,088	6,920,088	—	—
GE Reinsurance Corp.	6,697,299	—	6,697,299	—
QBE International Insurance Ltd.	4,747,481	—	4,747,481	—
American Re-Insurance Co.	4,535,765	4,535,765	—	—
Converium Reinsurance North America Inc.	4,370,273	4,370,273	—	—
Lloyd's Syndicate #2020	4,184,284	4,184,284	—	—
Employers Reinsurance Corp. (ERC)	3,748,700	—	3,748,700	—
Continental Casualty Co. (CNA)	3,434,354	3,434,354	—	—
Everest Reinsurance Co.	3,248,062	—	3,248,062	—
Hannover Ruckversicherungs AG	3,144,550	3,144,550	—	—
Allstate Insurance Co.	3,099,335	—	3,099,335	—
Insurance Co. of North America	3,091,455	3,091,455	—	—
Wurttembergische Versicherungs AG	2,768,564	2,768,564	—	—
Employers Insurance Co. of Wausau	2,519,648	—	2,519,648	—
Odyssey America Reinsurance Corp.	2,240,589	250,138	1,990,451	—
Royal & Sun Alliance PLC	2,171,660	2,171,660	—	—
Lloyd's (Auth)	1,892,923	1,892,923	—	—
Mutual Reinsurance Bureau	1,592,466	119,858	1,472,608	—
Lloyd's Syndicate #2791	1,547,499	1,547,499	—	—
Folksamerica Reinsurance Co.	1,242,825	1,242,825	—	—
Lloyd's Syndicate #1212	1,196,745	1,196,745	—	—
National Casualty Co.	1,169,499	—	1,169,499	—
Liberty Mutual (UK) Ltd.	1,061,771	1,061,771	—	—
Lloyd's Syndicate #1241	981,908	981,908	—	—
TOA Reinsurance Co. of America	896,261	—	896,261	—
Lloyd's Syndicate #250	884,175	884,175	—	—
Argonaut Insurance Co.	735,728	735,728	—	—
Lloyd's Syndicate #183	676,521	676,521	—	—
American Healthcare Indemnity Co.	592,551	—	592,551	—
General Reinsurance Co.	590,601	590,601	—	—

Name of reinsurer		Total amount in dispute (including IBNR)	Notification	Arbitration	Litigation
Lloyd's Syndicate #510	$	578,789	578,789	—	—
Turegum Insurance Co.		470,704	470,704	—	—
Zurich Vers Ges AG		458,042	—	458,042	—
Lloyd's (Unauth)		343,312	343,312	—	—
Excess Insurance Co. Ltd.		263,007	263,007	—	—
PMA Capital Insurance Co.		237,020	—	237,020	—
Lloyd's Syndicate #138		177,596	177,596	—	—
Lloyd's Syndicate #727		177,596	177,596	—	—
American States Insurance Co.		140,993	140,993	—	—
New Jersey Reinsurance Co.		140,396	—	140,396	—
Partner Reinsurance New York		64,139	—	64,139	—
Nationwide Mutual Insurance Co.		55,509	—	55,509	—
Odyssey Reinsurance Corp.		53,540	53,540	—	—
QBE Reinsurance Corp.		40,360	40,360	—	—
Total	$	193,024,801	74,143,092	37,516,622	81,365,087

Events of September 11, 2001

The terrorist attacks of September 11, 2001 resulted in a tremendous loss of life and property. In the past, insurance companies have incurred losses as a result of catastrophes such as earthquakes, hurricanes, and even other terrorist attacks. However, these events are unprecedented in the United States in terms of the magnitude of the losses incurred and the number of entities affected. At December 31, 2003, the Company's inception to date total incurred losses and LAE related to the September 11 events were as follows:

		Inception to date as of December 31, 2003
		(In thousands)
Gross losses and LAE incurred	$	270,263
Reinsurance losses and LAE ceded		(223,612)
Net losses and LAE incurred		46,651
Less amounts allocated to AMICO and AMM		3,732
Net amount retained by the Company	$	42,919

The incurred losses were primarily attributable to the commercial multiple peril and other liability lines of business. As of December 31, 2003, the Company has recovered a total of $140,478,000 from its reinsurers, against $176,579,000 in total claim payments. As of December 31, 2003, approximately 62% of the Company's unsecured recoverables from all reinsurers, excluding the Company's participation in third-party pools, were from reinsurers rated A or better by A. M. Best Company or Standard & Poor's. Approximately 76% of the unsecured recoverables from reinsurers were rated A- or better by A. M. Best Company or Standard & Poor's. The Company continues to closely monitor its exposure to all reinsurers.

Reinsurance Accounted for as a Deposit

The Company entered into various reinsurance agreements in previous years which were determined to be of a deposit type nature in the fourth quarter of 2002. During 2003, contracts #1 and #2 were novated and contracts #5 and #6 were commuted. As of December 31, 2003, the Company had a total remaining deposit balance of $55,190,454 after taking into account interest income and cash recoveries, as follows:

(Amounts in thousands)

	Contract #1	Contract #2	Contract #3	Contract #4	Contract #5	Contract #6	Total
Effective yield	0.00%	0.00%	6.68%	11.28%	0.00%	0.00%	
2000:							
Initial payment	$ 72,612	—	22,007	—	—	—	94,619
Cash deposits	—	—	—	—	—	—	—
Interest income	994	—	124	—	—	—	1,118
Cash recoveries	(993)	—	(29)	—	—	—	(1,022)
Deposit balance	72,613	—	22,102	—	—	—	94,715
2001:							
Initial payment	—	—	—	—	26,750	10,408	37,158
Cash deposits	76,637	—	20,976	3,887	—	—	101,500
Interest income	4,583	—	618	240	487	—	5,928
Cash recoveries	(23,177)	—	(1,538)	(1,454)	—	—	(26,169)
Deposit balance	130,656	—	42,158	2,673	27,237	10,408	213,132
2002:							
Initial payment	—	—	—	—	—	—	—
Cash deposits	8,727	2,500	22,411	—	—	12,002	45,640
Interest income	6,501	65	1,047	290	496	(2,293)	6,106
Cash recoveries	(34,097)	—	(6,235)	(967)	—	—	(41,299)
Deposit balance	111,787	2,565	59,381	1,996	27,733	20,117	223,579
2003:							
Initial payment	(72,612)	—	—	—	—	—	(72,612)
Cash deposits	(85,364)	(2,500)	765	—	—	—	(87,099)
Interest income	(12,078)	(65)	7,342	114	(221)	371	(4,537)
Cash recoveries	58,267	—	(13,870)	(538)	(27,512)	(20,488)	(4,141)
Deposit balance	$ —	—	53,618	1,572	—	—	55,190

(5) Federal and Foreign Income Taxes

The components of the Company's net deferred tax asset as of December 31, 2003 and 2002 were as follows:

		December 31	
		2003	**2002**
		(In thousands)	
Total of gross deferred tax assets	$	622,073	535,110
Total of deferred tax liabilities		(8,745)	(6,255)
Net deferred tax asset		613,328	528,855
Deferred tax asset nonadmitted		(613,328)	(528,855)
Net admitted deferred tax asset	$	—	—
Increase in nonadmitted asset	$	(84,473)	

The Company's income tax benefit (expense) as of December 31, 2003 and 2002 consisted of the following major components:

		2003	**2002**
		(In thousands)	
Federal	$	21,967	51,689
Foreign		5,202	(1,800)
Federal and foreign income tax benefit	$	27,169	49,889

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, 2003 and 2002 were as follows:

	December 31	
	2003	**2002**
	(In thousands)	
Deferred tax assets:		
Loss carryforwards	$ 268,841	214,338
Accrued liabilities	108,997	112,312
Reserves	52,483	99,102
Investments	80,730	57,957
Receivables	87,641	26,839
Real estate	—	1,725
Other	23,381	22,837
Total deferred tax assets	622,073	535,110
Nonadmitted deferred tax assets	(613,328)	(528,855)
Admitted deferred tax assets	8,745	6,255
Deferred tax liabilities:		
Salvage and subrogation	(6,594)	(5,778)
Other	(2,151)	(477)
Total deferred tax liabilities	(8,745)	(6,255)
Net admitted deferred tax asset	$ —	—

The change in net deferred income taxes as of December 31, 2003 and 2002 was comprised of the following:

	December 31		
	2003	**2002**	**Change**
		(In thousands)	
Total deferred tax assets	$ 622,073	535,110	86,963
Total deferred tax liabilities	(8,745)	(6,255)	(2,490)
Net deferred tax asset	$ 613,328	528,855	84,473
Tax effect of unrealized gains or losses			—
Increase in net deferred income tax in surplus			$ 84,473

The actual Federal and foreign income tax benefit (expense) as of December 31, 2003 and 2002 differed from "expected" tax benefit (expense) (expected tax is computed by applying the corporate tax rate of 35% to income before Federal and foreign income taxes) as follows:

		2003	2002
		(In thousands)	
Computed "expected" tax benefit (expense)	$	161,253	118,601
Capital gain adjustment		(142,063)	(115,856)
Unearned premium reserve adjustments		11,047	49,022
Net operating loss adjustment		(43,099)	(47,784)
Accrued liabilities		(21,831)	(3,411)
Prior year tax adjustments		5,614	40,452
Policyholder dividends		—	(24,180)
Loss reserve discounting		42,916	13,308
Tax-exempt investment income		6,055	11,906
Foreign exchange adjustment		533	9,311
Depreciation		(2,324)	8,346
Foreign income taxes		5,202	(1,800)
Other, net		3,596	(8,026)
Federal and foreign income tax benefit	$	26,899	49,889

Provision computed at statutory rate	$	161,523	118,601
Investments		(120,328)	(90,673)
Accrued liabilities		(20,613)	64,571
Policyholder dividends		—	(44,393)
Prior period adjustment		10,816	40,452
Receivables		59,071	12,512
Unutilized losses		—	11,491
Surplus adjustments		—	—
Other		21,173	4,298
Total statutory income taxes	$	111,642	116,859
Federal and foreign income taxes incurred	$	27,169	49,889
Change in net deferred income taxes		84,473	66,970
Total statutory income taxes	$	111,642	116,859

At December 31, 2003, the Company had a capital loss carry forward of $31.6 million originating in 2003 which expires, if unused, in 2008.

At December 31, 2003, the Company had $736.5 million of operating loss carryforward which originated and expires as follows:

Origination year	Expiration year		Amount
			(In thousands)
2000	2020	$	129,674
2001	2021		355,129
2002	2022		132,067
2003	2023		119,602
		$	736,472

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

Tax returns for the years through 1997 are closed. The Company is currently under examination by the Internal Revenue Service for the years 1998 through 2000.

The Company files a consolidated Federal income tax return which includes the Company as the common parent corporation and the following affiliated entities: AMICO, AMICO Realty Corporation, American Protection Insurance Company, American Protection Property & Casualty Agency, Inc., American Protection Property & Casualty Agency, Inc. of Texas, American Protection Property and Casualty Insurance Agency, Inc., American Underwriting Corporation, Eagle Pacific, GreatLand Holdings, Inc., GreatLand Insurance Company, Juris Prudent, Inc., Kemper Castlebridge, Inc., Kemper Casualty, Inc., Kemper Casualty, Kemper Commercial, Kemper Comprehensive Insurance Company, Kemper Cost Management, Inc., Kemper Cost Management Holding Company, Inc., Kemper Employers Claim Service, Inc., Kemper Employers Group, Inc., Kemper Employers, Kemper Environmental Managers, Inc., Kemper Financial Protection, Inc., Kemper Indemnity, Kemper Insurance Group, Inc., Kemper Insurance Holdings #2, Inc., Kemper International Corporation, Kemper Lloyds Insurance Company, Kemper National Services, Inc., Kemper Realty Corporation, Kemper Safeguard Surplus Insurance Company, Kemper Surplus Lines Insurance Company, Kemper Technology Services, Inc., Kemper Ventures Management Company, Inc., Kemper Warranty Services, Inc., Kempes, Inc., K-P Plaza Dallas, LGA-1, Inc., LGA-2, Inc., LGA-3, Inc., LGA-4, Inc., LGA-5, Inc., LGA-6, Inc., LGA-7, Inc., LGA-8, Inc., LGA-9, Inc., LGA-10, Inc., LGA-11, Inc., LGA-12, Inc., LGA-13, Inc., LGA-14, Inc., LGA-15, Inc., LGA-16, Inc., LGA-17, Inc., LGA-18, Inc., LGA-19, Inc., LGA-20, Inc., LLA Life Agency/Massachusetts, Inc., LLA Life Agency/New Hampshire, Inc., LLA Life Agency/New Jersey, Inc., LLA Life Agency/Texas, Inc., Long Grove Insurance Company, Lou Jones & Associates, Lumbermens Life Agency, Inc., NATLSCO, National Loss Control Service Corporation, Nereus Holdings, Inc., Pacific Eagle, Pillar Services, Inc., Point & Quote Insurance Services, Inc., PointSure Insurance Services, Inc., RidgeLand Insurance Company, Specialty Insurance Managers, Inc., Specialty National, Specialty Resource Risk Services, Inc., Specialty Surplus Insurance Company, UBIC and Universal Bonding Insurance Company.

(Continued)

(6) Transactions with Affiliates and Related Parties

The Company charges certain affiliated companies for utilizing the services of the employees and the office facilities of the Company. Charges for such services provided for AMM and AMICO are based on their participation in the Pooling Agreement during 2002 and 2003. Charges for services for other affiliated companies are based on actual expenses incurred in accordance with their use of the services and facilities and have been credited to the various functional expense categories in the accompanying statutory statements of operations.

Transactions with affiliates and related parties are also discussed in the various notes to these statutory financial statements.

(7) Employee Benefit Plans

Pension Plans

The Company has a noncontributory defined benefit pension plan (Plan A) in which all of its full-time employees with one year of service participate and become fully vested after five years of service. The Company also has a nonqualified supplemental plan which provides additional pension benefits to certain key employees and officers. Effective January 15, 2004, the Company adopted an amendment to freeze both the qualified and nonqualified noncontributory defined benefit pension plans. This freeze triggered a one-time expense related to prior service cost of $40,179. The Company also has a frozen noncontributory defined benefit pension plan (Plan B) which relates to a previous wholly owned subsidiary divested in 1998. As previously discussed (see note 2), the Company sold its claim servicing division (NATLSCO) in July 2003. The sale involved the transfer of approximately 3,300 employees in total of which 1,700 were participants in the Qualified Non-Contributory defined benefit plan which triggered a one-time pension plan curtailment expense of $160,967.

From November 1, 2000, any newly hired employees of the Company earned benefits under a cash balance plan. The cash balance plan defined an employee's benefit as the amount credited to the employee's account each year. Existing employees of the Company had a one-time election option to either continue to accrue their benefit under the current defined benefit plan or transfer the value of their accrued benefit to the cash balance plan. The cash balance plan was also frozen on January 15, 2004.

The benefits in the defined benefit plan are based on each employee's career-average annual compensation, with an annual benefit accrued based on a percentage of each year's annual compensation. A minimum benefit is provided based on years of service and the employee's compensation during the last five years of employment. The Company's funding policy for its qualified plans is to contribute actuarially determined minimum funding amounts required under the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (IRC). Company contributions in 2003 to the qualified plan were $66,332,864. If the liability relief under ERISA and the IRC which expired on December 31, 2003 is not extended for 2004, the Company estimates its funding obligations to the qualified plan in 2004 will be $39,266,322. If the existing relief is extended, the Company's funding obligation in 2004 is estimated to be $15,364,215. The Company estimates it will distribute approximately $3,200,000 in 2004 to participants in the nonqualified pension plan.

The discount rate used in determining the plan's benefit obligations was 7.5% for all plans (see accounting allowances discussed in note 1). The long-term rate of return on the plan's assets was 8.5% for all plans. The average salary increase was 4.0% for Plan A and the nonqualified pension plan.

	Qualified pension plan		Nonqualified	
	Plan A	Plan B	pension plan	Total
Accumulated benefit obligation (ABO), November 30, 2003	$ 645,000,648	6,335,660	35,097,803	686,434,111
Change in projected benefit obligation during year:				
Benefit obligation, January 1, 2003	$ 694,976,273	6,549,132	33,139,878	734,665,283
Service cost	18,963,312	—	1,554,595	20,517,907
Interest cost	48,375,701	450,093	2,723,233	51,549,027
Curtailments due to workforce reductions	(36,268,426)	—	(1,244,598)	(37,513,024)
Curtailments due to plan freeze	(3,907,476)	—	(886,825)	(4,794,301)
Actuarial (gain) loss	(32,264,971)	(309,604)	2,032,183	(30,542,392)
Benefits paid	(44,751,232)	(353,961)	(2,213,995)	(47,319,188)
Benefit obligation, November 30, 2003	$ 645,123,181	6,335,660	35,104,471	686,563,312
Change in plan assets during year:				
Plan assets at fair value, January 1, 2003	$ 432,300,210	6,087,499	—	438,387,709
Return on plan assets	62,639,563	883,618	—	63,523,181
Company contributions	66,332,864	—	2,213,995	68,546,859
Benefits paid	(44,751,232)	(353,961)	(2,213,995)	(47,319,188)
Plan assets at fair value, November 30, 2003	$ 516,521,405	6,617,156	—	523,138,561
Reconciliation of prepaid/(accrued) benefit cost:				
Funded status of the plan	$ (128,601,776)	281,496	(35,104,471)	(163,424,751)
Unrecognized:				
Transition asset	(45,621,986)	(3,587,067)	—	(49,209,053)
Prior service cost	—	—	—	—
Net loss	239,463,453	4,325,317	4,774,319	248,563,089
Prepaid (accrued) benefit cost, November 30, 2003	65,239,691	1,019,746	(30,330,152)	35,929,285
Contributions paid between December 1 and December 31, 2003	—	—	184,500	184,500
Prepaid (accrued) benefit cost, December 31, 2003	$ 65,239,691	1,019,746	(30,145,652)	36,113,785

(Continued)

	Qualified pension plans		Nonqualified	
	Plan A	**Plan B**	**pension plan**	**Total**
Expense for 2003:				
Service cost	$ 18,963,312	—	1,554,595	20,517,907
Interest cost	48,375,701	450,093	2,723,233	51,549,027
Expected return on assets	(57,598,051)	(779,820)	—	(58,377,871)
Amortization of unrecognized:				
Transition asset	(13,742,545)	—	—	(13,742,545)
Prior service cost	17,826	—	—	17,826
Net loss	3,983,757	17,959	746,475	4,748,191
Net periodic benefit cost	—	(311,768)	5,024,303	4,712,535
One-time expense	269,344	—	—	269,344
Total expense	$ 269,344	(311,768)	5,024,303	4,981,879
Less amounts allocated to AMM				$ (398,550)
Amount retained by the Company				$ 4,583,329
Obligation for Active Nonvested Employees, November 30, 2003	$ 1,188,621	—	1,194,498	2,383,119

The Company is required to accrue for a minimum pension liability when the qualified pension plans' accumulated benefit obligation (ABO) exceeds the market value of the qualified pension plans' assets. The Company has recorded the following minimum pension liability directly to surplus as of December 31, 2003 and 2002:

	2003	2002
	(In thousands)	
ABO	$ 651,618	664,164
Market value of plan assets	(523,139)	(438,388)
Minimum pension liability	128,479	225,776
Less amounts allocated to AMICO and AMM	—	(51,929)
	128,479	173,847
Add amounts funded to plan	66,333	—
Less adjustment to liability	(826)	—
Less amounts accrued in previous years	(225,776)	(40,778)
Change in minimum pension liability charged directly to surplus	$ (31,790)	133,069

During 2002, the Company changed its measurement date from December 31 to November 30. The assets, obligations, and assumptions of the Company's noncontributory defined benefit pension plans at December 31, 2002 were as follows:

		December 31, 2002			
		Qualified pension plans		Nonqualified	
		Plan A	Plan B	pension plan	Total
		(in thousands)			
Accumulated benefit obligation, December 31, 2002	$	657,614	6,550	30,320	694,484
Change in projected benefit obligation during year:					
Benefit obligation, January 1, 2002	$	640,810	6,196	23,696	670,702
Service cost		18,509	—	1,643	20,152
Interest cost		46,166	441	2,107	48,714
Special termination benefits		790	—	863	1,653
Curtailments		(3,288)	—	—	(3,288)
Actuarial loss		25,144	223	6,232	31,599
Benefits paid		(33,155)	(311)	(1,401)	(34,867)
Benefit obligation, November 30, 2002	$	694,976	6,549	33,140	734,665
Change in plan assets during year:					
Plan assets at fair value, January 1, 2002	$	545,652	7,584	—	553,236
Return on plan assets		(80,198)	(1,186)	—	(81,384)
Company contributions		—	—	1,401	1,401
Benefits paid		(33,154)	(310)	(1,401)	(34,865)
Plan assets at fair value, November 30, 2002	$	432,300	6,088	—	438,388
Reconciliation of accrued benefit cost:					
Funded status of the plan	$	(262,676)	(461)	(33,140)	(296,277)
Unrecognized:					
Transition asset		(59,365)	(3,587)	—	(62,952)
Prior service cost		287	—	—	287
Net loss		320,930	4,048	5,620	330,598
Accrued benefit cost,		(824)	—	(27,520)	(28,344)
Contributions paid between December 1 and December 31, 2002		—	—	121	121
Accrued benefit cost, December 31, 2002	$	(824)	—	(27,399)	(28,223)
Less amounts allocated to AMICO and AMM					6,491
Amount retained by the Company					$ (21,732)

	December 31, 2002			
	Qualified pension plan		Nonqualified	
	Plan A	Plan B	pension plan	Total
Net periodic expense for 2002:				
Service cost	$ 18,509	—	1,643	20,152
Interest cost	46,166	441	2,107	48,714
Expected return on assets	(56,389)	(441)	—	(56,830)
Amortization of unrecognized:				
Transition asset	(8,308)	—	—	(8,308)
Prior service cost	22	—	—	22
Net loss	—	—	124	124
Net periodic benefit expense	—	—	3,874	3,874
One-time curtailment and special benefit expense	824	—	863	1,687
Total expense	$ 824	—	4,737	5,561
Less amounts allocated to AMICO and AMM				(1,279)
Amount retained by the Company				$ 4,282
Obligation for active nonvested employees, November 30, 2002	$ 18,621	—	7,453	26,074

The discount rate used in determining the plan's benefit obligations was 7.0% for all plans. The long-term rate of return on the plan's assets was 8.5% for all plans. The average salary increase was 4.0% for Plan A and the nonqualified pension plan.

Savings and Profit Sharing Plans

The Company's Savings and Profit Sharing Plan is qualified under Section 401(a) of the Internal Revenue Code. For the year ended December 31, 2003, employer and employee contributions were $8.0 million and $16.5 million, respectively, while 2002 employer and employee contributions were $16.2 million and $26.9 million, respectively.

Restricted Stock and Stock Option Plans

Certain of the Company's affiliates have had restricted stock and variable stock option incentive plans available to certain key officers and employees of both the Company and its affiliates. The value of such incentives, which has been subject to Board approval, was determined using an adjusted book value calculation. The value of the restricted stock, which was determined at the date of the grant, and changes in the value of the stock option plans from the original grant price were accrued as compensation expense using the vesting periods contained in the stock plans. The restricted stock and stock option compensation expense was charged to surplus as a component of net unrealized capital losses. In February of 2003, the Board terminated the restricted stock and stock option programs. As of December 31, 2003, the Company accrued $2.9 million of such compensation expense directly to surplus through a reduction in the carrying value of subsidiaries. The remaining unvested value of the restricted stock and stock option plans amounting to $2.5 million will vest in 2005.

Other Post-retirement Benefits Other than Pensions

The Company provides nonpension retirement benefits consisting of certain health care benefits and life insurance for retired employees. The Company is self-insured. The cost of the health care benefit is borne jointly by the Company and its employees at varying percentages depending on the age and service of the plan participant. Effective January 1, 2003, the Company placed a cap on the level of subsidy provided by the Company to its retirees. For all current and future groups who receive subsidized coverage, the Company costs were capped at 120% of the 2003 subsidy levels. In addition, effective January 1, 2004, the Company (i) changed its funding policy for post-retirement medical, shifting more of the annual costs to the retiree while reducing the amount the Company pays for post retirement medical, and (ii) changed its eligibility requirements for post retirement medical so only active employees age 55 or older as of January 1, 2004 with ten or more years of service with the Company are eligible for medical benefits at retirement. The impact of the change reduces the prior service cost at December 31, 2003. The Company obtained the approval of the Department of Insurance to account for the changes implemented as of January 1, 2004 as a permanent curtailment of the benefit, allowing the Company to reduce its prior service cost at December 31, 2003 from $64,088,727 to $32,297,407 (see note 1).

A summary of the obligations and assumptions of the nonpension retirement benefit plan at year-end 2003 is as follows:

	Fiscal 2003		
	Retiree Medical	**Retiree Life Insurance**	**Total**
Change in benefit obligation during the year:			
Benefit obligation, January 1, 2003	$ 129,458,986	13,797,395	143,256,381
Service cost	1,713,834	—	1,713,834
Interest cost	6,084,557	948,188	7,032,745
Plan amendments	(98,874,252)	—	(98,874,252)
Actuarial (gain) loss	7,261,414	(465,974)	6,795,440
Benefits paid	(10,825,000)	(1,070,000)	(11,895,000)
Benefit obligation, November 30, 2003	$ 34,819,539	13,209,609	48,029,148
Reconciliation of accrued benefit cost:			
Funded status of the plan	$ (34,819,539)	(13,209,609)	(48,029,148)
Unrecognized:			
Transition obligation	—	8,834,399	8,834,399
Prior service cost	(32,297,407)	—	(32,297,407)
Net (gain) loss	33,883,946	(1,522,513)	32,361,433
Accrued benefit cost, November 30, 2003	(33,233,000)	(5,897,723)	(39,130,723)
Contributions paid between December 1 and December 31, 2003	902,083	89,167	991,250
Accrued benefit cost, December 31, 2003	$ (32,330,917)	(5,808,556)	(38,139,473)
Expense for 2003:			
Service cost	$ 1,713,834	—	1,713,834
Interest cost	6,084,557	948,188	7,032,745
Expected return on assets	—	—	—
Amortization of unrecognized:			
Transition obligation	—	631,029	631,029
Prior service cost	(630,254)	—	(630,254)
Net loss	1,690,136	—	1,690,136
Net periodic benefit cost	$ 8,858,273	1,579,217	10,437,490
Less amounts allocated to AMM			(834,999)
Amount retained by the Company			$ 9,602,491
Obligation for active nonvested employees, November 30, 2003	$ —	—	—

	Fiscal 2003		
	Retiree Medical	**Retiree Life Insurance**	**Total**
Key assumptions, year-end 2003:			
Discount rate for obligations	7.50%	7.50%	7.50%
Discount rate for expense	7.00%	7.00%	7.00%
Health care trend rate	9.0% grading to 6.0% in 2006	N/A	9.0% grading to 6.0% in 2006

		1% increase	**1% decrease**
Impact of 1% change in assumed health trend rate:			
Effect on service cost and interest cost	$	550,065	(515,063)
Effect on postretirement benefit obligation		2,115,506	(1,983,251)

A summary of the obligations and assumptions of the nonpension retirement benefit plan at year-end 2002 is as follows:

		December 31, 2002		
		Retiree medical	**Retiree life insurance**	**Total**
			(In thousands)	
Change in benefit obligation during the year:				
Benefit obligation, January 1, 2002	$	112,946	13,407	126,353
Service cost		3,051	—	3,051
Interest cost		8,194	958	9,152
Actuarial loss		12,806	417	13,223
Benefits paid		(7,538)	(985)	(8,523)
Benefit obligation, November 30, 2002	$	129,459	13,797	143,256
Reconciliation of accrued benefit cost:				
Funded status of the plan	$	(129,459)	(13,797)	(143,256)
Unrecognized:				
Transition obligation		34,155	9,465	43,620
Net (gain) loss		28,313	(1,057)	27,256
Accrued benefit cost, November 30, 2002		(66,991)	(5,389)	(72,380)

	December 31, 2002		
	Retiree medical	Retiree life insurance	Total
		(In thousands)	
Contributions paid between December 1 and December 31, 2002	$ 685	90	775
Accrued benefit cost, December 31, 2002	$ (66,306)	(5,299)	(71,605)
Less amounts allocated to AMICO and AMM			16,469
Amount retained by Company			$ (55,136)
Net periodic expense for 2002:			
Service cost	$ 3,051	—	3,051
Interest cost	8,194	958	9,152
Amortization of unrecognized:			
Transition obligation	2,623	631	3,254
Net (gain) loss	373	(19)	354
Net periodic benefit cost	$ 14,241	1,570	15,811
Less amounts allocated to AMICO and AMM			(3,636)
Amount retained by Company			$ 12,175
Obligation for active nonvested employees, November 30, 2002	$ 38,139	—	38,139
Key assumptions, year-end 2002:			
Discount rate for obligations	7.00%	7.00%	7.00%
Discount rate for expense	7.50%	7.50%	7.50%
Health care trend rate	9.0% grading to 6.0% in 2006	N/A	9.0% grading to 6.0% in 2006

	1% increase	1% decrease
Impact of 1% change in assumed health trend rate:		
Effect on service cost and interest cost	$ 1,233	(1,054)
Effect on postretirement benefit obligation	11,436	(9,953)

Other Benefit Plans

The Kemper Benefit Plan (the Plan) consists of the health, dental, life, long-term disability, and accident benefits within the Kemper Tax Saver Benefit Plan and benefit programs funded through the Trust. The Plan is sponsored by the Company and provides benefits covering eligible employees, retired employees, and eligible dependents of employees and retired employees of the Company. The Plan is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA).

Certain coverages of the Plan require both employer and employee contributions, while others require either an employer or employee contribution. The Company makes contributions to the Trust necessary to provide the benefits offered under the Plan. All employer contributions are conditioned upon their deductibility under Section 419 of the Internal Revenue Code of 1986, as amended. Employees make specified monthly contributions for the coverages selected. The contribution rates for both the employer and employee are determined annually by the Welfare Benefit Trust Committee of the Company. The assets of the Plan are generally available to pay covered claims for employees of the Company. Plan assets are not identified or segregated by benefit type. In accordance with provisions of the Plan, eligible employees, retired employees, and eligible dependents of employees and retired employees of the Company who incur claims are entitled to receive benefits under the Plan.

At December 31, 2003 and 2002, total assets of the Plan were $1.6 million and $1.4 million, respectively. Employer and employee contributions for 2003 were $124.6 million and $13.2 million, respectively, while 2002 employer and employee contributions were $95.3 million and $23.2 million, respectively. For 2003 and 2002, total benefit payments under the Plan were $136.3 million and $114.0 million, respectively.

The Company also has short-term bonus and long-term incentive plans for its officers and employees. Amounts earned under these plans are expensed as incurred.

(8) Risk-based Capital

The NAIC utilizes a risk-based capital formula intended for regulatory monitoring of property/casualty insurers. Under risk-based capital 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. In Illinois the law provides for four different levels of regulatory action depending on the ratio of a company’s total adjusted capital to its risk-based capital. The law requires increasing degrees of regulatory oversight and intervention as an insurance company’s risk-based capital declines. The level of regulatory oversight ranges from requiring the insurance company to inform and obtain approval from the Department of Insurance of a risk-based capital plan to mandatory regulatory intervention requiring an insurance company to be placed under regulatory control in rehabilitation or liquidation proceedings.

In Illinois, the “Company Action Level” is triggered if a company’s total adjusted capital is less than 200% but greater than or equal to 150% of its risk-based capital. At this level a company must submit a risk-based capital plan to the regulatory authority which discusses proposed corrective actions to improve its capital position. The “Regulatory Action Level” is triggered if a company’s total adjusted capital is less than 150% but greater than or equal to 100% of its risk-based capital. At this level the regulatory authority will perform a special examination of the company and issue a corrective order specifying corrective actions that must be followed. The “Authorized Control Level” is triggered if a company’s total adjusted capital is less than 100% but greater than or equal to 70% of its risk-based capital. At this level the regulatory authority may take any action it deems necessary, including placing the company under regulatory control. The “Mandatory Control Level” is triggered if a company’s total adjusted capital is less than 70% of its risk-based capital. At this level the regulatory authority is mandated to place the company under its control, except in the case of a property and casualty insurance company which is no longer writing new business and which is running off existing business. In such event, the Director of the

Department of Insurance of the State of Illinois (the Director) may allow the company to continue its run-off under the supervision of the Director.

As of December 31, 2003, the Company's level of capital and surplus is at the "mandatory control level" under the risk-based capital rules. At this level, the Department of Insurance has substantial authority to exercise control over the Company and its affiliates. The Department of Insurance is mandated to place a company at this level under its control, except where, as is the case with the Company, 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 Department of Insurance has discretion to allow the continued run-off. Exercising its supervisory authority, the Department has issued Corrective Orders. As required, the Company in early 2003 proposed an RBC plan to address its RBC level. The Department of Insurance did not accept that plan. The Company submitted a commercial run-off plan to the Department on March 19, 2004, based on the Company's results and financial condition at December 31, 2003. This plan was approved on June 9, 2004.

The Department of Insurance could seek to place the Company in a formal proceeding (receivership, rehabilitation, or other) at any time based on the Company's current financial condition. This risk of a proceeding would be further exacerbated if the Company fails to propose a plan which the Department of Insurance accepts, or if the Company subsequently fails to execute successfully on that plan, or if the Company fails to have sufficient liquid assets to meet its current obligations, or if the Company's reported statutory liabilities at any time would exceed its reported statutory assets.

Regarding the latter risk, the Company's current discounting of all its loss and loss adjustment expense reserves at 4.2%, as permitted by one of its accounting allowances (see note 1), substantially exceeds its currently projected 3.1% investment portfolio yield. The 3.1% yield reflects management's recent revised judgments relating to elements of the developing run-off plan including, among other factors, requirements to avoid substantial credit risk and to match duration of investments to anticipated rates and amounts of claim payments over time. The difference between discount at the higher rate versus discount at 3.1% is approximately a $213 million surplus improvement as of December 31, 2003. Further, amortization of the discount is anticipated to significantly exceed investment income, which will strain the Company's surplus position at a time when expenses will also exceed income. The Company's run-off plan will include initiatives for the purpose of offsetting these projected surplus deficiencies, particularly in years 2005 and 2006. However, there can be no assurance that the Company will be successful to the extent necessary to avoid a negative surplus in future years.

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

Ratings

Beginning on December 20, 2002, the Company's claims-paying ability/financial strength ratings were lowered by all three of the major rating agencies. At that time, A.M. Best lowered the Company's rating to below A-; currently, A.M. Best assigns 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 the Company's request, they ceased rating the Company. The downgrades to below A- effectively ended the Company's and its affiliates' ability to write most new commercial lines business or retain existing policyholders. In early 2003, the Company attempted to continue marketing commercial insurance policies by providing certain of the policies with the benefit of cut-through agreements from National Indemnity Company. That proved unsuccessful. In the first half of 2003, therefore, as a result of a combination of various business factors including the ratings downgrades and the Company's deteriorating statutory surplus, the Company substantially ceased underwriting activities other than as required by contract or law and except for its Eagle insurance subsidiaries which ceased as of September 30, 2003 and its Mexican insurance company subsidiary which is subject to a definitive agreement to be sold in the second quarter of 2004.

Since July 2003, the Company and most of its affiliates have been subject to a Corrective Order by the Department of Insurance not to write any new or renewal business except as necessary to comply with contractual commitments or as expressly permitted by the Department. The only remaining contractual commitment of the Company is to allow Unitrin to continue to use Kemper as the direct insurer (100% reinsured by the Unitrin affiliate) until said entity obtains its own licenses in all the jurisdictions where it is not currently licensed, which is anticipated to be completed in 2004. In connection with the downgrades and the decision to move to run-off status, the Company determined that certain lines of business would, to the extent possible, be discontinued, sold, or subject to renewal rights transactions.

Sources of Liquidity

In the insurance industry, liquidity refers to the ability of an enterprise to generate adequate amounts of cash from its operations, including its investment portfolio, to meet its financial commitments, which are principally obligations under the insurance policies and reinsurance contracts it has written. Liquidity requirements of insurance companies are influenced significantly by product mix, level of claims, capital and regulatory requirements, and other factors.

Prior to its decision to enter into run-off, LMC's cash inflows consisted of premiums, deposits on insurance policies, income from investments, and sales and maturities of investments. These operating cash flows, along with the portion of the investment portfolio that is held in cash and highly liquid short-term securities, historically allowed LMC to meet the its liquidity requirements of its operations without needing access to external sources of capital or liquidity. When an insurance company ceases to engage in underwriting, all new premium income stops except for premium payments on existing policies. Accordingly, one of the normal sources of liquidity, premiums from ongoing new underwriting, has and will continue to dramatically decline and eventually stop for LMC. Most other sources of revenue derived from operating an ongoing insurance business, such as serving as a fronting company, also diminishes very quickly. Additionally, the ability of an insurer in run-off to collect reinsurance recoverables from reinsurers in a normal and customary manner generally declines once a run-off is announced. Therefore, in 2004, LMC's cash inflows will primarily consist of income from investments and sales and maturities of investments. To a much lesser extent, LMC also has cash inflows from the renewal rights sold in 2003 and from the premium payments on existing policies.

Capital Commitments

Pursuant to certain investment partnership agreements, LMC could be obligated to contribute capital up to specified limits upon the occurrence of the events specified in such commitments. The total of all such commitments at December 31, 2003 was $21.5 million. In early 2004, LMC signed definitive agreements to sell such investments for a purchase price of approximately $49.2 million and transfer all of the related commitments to an unaffiliated third party. LMC currently expects to close the transaction at the beginning of the third quarter of 2004. LMC remains obligated to fund such capital commitments if the transaction fails to close. The purchaser would be obligated to reimburse LMC at closing for any commitments funded prior to the closing.

Subsidiary Guarantees

LMC has guaranteed the minimum capital and surplus requirements under state law for two of its wholly owned, Illinois-domiciled, subsidiaries: Kemper Casualty Insurance Company and SNIC. LMC has also guaranteed (a) minimum risk based capital ratios of SNIC, as calculated under its statutory Annual Statement and (b) the obligations under policies issued on and after January 1, 2002 by Kemper, Societe Anonyme, a wholly owned subsidiary incorporated under the laws of Belgium. Additionally, during 2003, LMC provided guarantees as required by state insurance regulators for the voluntary dissolutions of the following companies: Kemper Safeguard Surplus Insurance Company, Long Grove Insurance Company, GreatLand Insurance Company, RidgeLand Insurance Company, Kemper Commercial Insurance Company, and Kemper Comprehensive Insurance Company.

Securities on Deposit and Encumbered Assets

Approximately $1.7 billion of LMC’s invested assets at December 31, 2003 are encumbered by being on deposit or held in trust or escrow arrangements. The majority of the encumbrances are deposits with state insurance departments, approximately $1.0 billion, with California accounting for the majority of that amount, or $827.9 million. LMC’s run-off plan anticipates reducing these amounts significantly as reserves are reduced to augment its liquidity needs in 2004 and subsequent years, but there are significant uncertainties with respect to the legal and regulatory issues related to releases of encumbered assets.

Approximately $478.1 million of LMC’s assets at December 31, 2003 are in collateral trusts for the benefit of or are otherwise pledged to Berkshire affiliates.

Approximately $25 million of LMC’s assets at December 31, 2003 are in a collateral trust for the benefit of NATLSCO as collateral for obligations under the transaction agreements related to the sale of NATLSCO in July 2003. Other transaction-related collateral trusts and escrow arrangements encumber another $30.0 million of LMC’s assets at December 31, 2003.

LMC, as an assuming reinsurer on business written by LMC’s Equus Re division prior to its sale in late 1999, has deposited approximately $45 thousand in cash with a reinsured company as security under certain reinsurance agreements. In addition, LMC is contingently liable to post up to an estimated additional $23.9 million in collateral due to ratings triggers in similar reinsurance agreements where it is a reinsurer. Of this amount, approximately $12.5 million has been funded with assets of the purchaser of the Equus Re division for business written by LMC after the 1999 sale which is 100% reinsured by the purchaser.

As of December 31, 2003, a wholly owned subsidiary, AMPICO as successor by merger to Eagle Pacific has deposited with four of its reinsureds AMPICO assets in the approximate amount of $9.8 million as security under assumed reinsurance agreements dating back to before LMC acquired the Eagle subsidiary in 1998. Until November and December 2003, the security was in the form of letters of credit; however, when those letters of credit expired in late 2003, the subsidiary and LMC were unable to obtain letters of credit from any banks due to LMC’s deteriorating financial condition. Of the $9.8 million assets on deposit, the reinsured is informally disputing the amount, seeking an increase of up to another $6.0 million.

LMC has deposited securities with a carrying value of $22.0 million at December 31, 2003 in an escrow account to collateralize a bank loan to an independent agent. In late 2003, LMC recognized a $15.0 million charge related to this guarantee.

Approximately $27.9 million of LMC's invested assets at December 31, 2003 are in collateral trusts for the benefit of its reinsurers as of December 31, 2003.

Where required to post court bonds, including supersedeas or appeal bonds, LMC, due to its financial condition, has had to post cash or other security totaling in most cases 100% of the bond. At December 31, 2003, LMC had pledged approximately $27.1 million for bonds, a majority of which are issued by a Berkshire affiliate.

In connection with the run-off of the operations of UBIC, LMC made capital contributions during 2003 and 2002 of $27.5 million and $45.5 million to maintain UBIC's capital and surplus at a level above $2.5 million as of December 31, 2003 and 2002 LMC may be required to fund additional capital during 2004 and thereafter.

To discharge certain insurance claim liabilities, LMC has purchased structured settlement annuities with the claimant as payee. The aggregate December 31, 2003 value of loss reserves eliminated by the purchase of these annuities was $142,714,005. LMC remains contingently liable should the issuers of the annuities fail to perform.

The total value of annuities due from a life insurer in excess of 1% of LMC's surplus is shown in the table below.

Carrier	Location		LMC reportable amounts
SAFECO Life Insurance Co.	Seattle, WA	$	35,921,471
First Colony Life Insurance Co.	Lynchburg, VA		24,614,677
United Pacific Life Insurance Co.	Seattle, WA		23,886,681
Federal Home Life Insurance Co.	Richmond, VA		16,670,235
Metropolitan Life Insurance Co.	New York, NY		12,030,370
Prudential Life Insurance Co.	Newark, NJ		4,175,870
Transamerica Occidental Life Insurance Co.	Cedar Rapids, IA		3,472,992
Presidential Life Insurance Co.	Nyack, NY		2,963,024
Manufacturers Life of Canada	Toronto, ON		2,142,727

Litigation

As described in note 10, Surplus, the Company issued $700 million in aggregate principal amount of surplus notes in 1996 and 1997. On March 20, 2003 and November 3, 2003, the Director of the Illinois Department of Insurance denied the Company's requests for payment of interest on the surplus notes due on June 1 and July 1, 2003 and on December 1, 2003 and January 1, 2004. Subsequent payments of interest on the surplus notes have also been prohibited by the Director. Following the March 20, 2003 denial, in June and July, 2003, several lawsuits were filed in the Circuit Court of Cook County, Illinois by certain

(Continued)

current holders of surplus notes aggregating approximately $368 million and naming the Company, various directors or former directors, of the Company and Kemper Commercial Insurance Company, a subsidiary of the Company, as defendants. In January, 2004, a purported class action lawsuit on behalf of all persons who purchased surplus notes between 1996 and March 2003 was also filed in the Circuit Court of Cook County against the Company, various directors of the Company, and Kemper Commercial Insurance Company. These lawsuits allege that the Company breached the agreements relating to the surplus notes by adopting a divestiture plan to sell all or substantially all of the Company's assets and ongoing businesses without requiring the acquiring entities to assume the Company's surplus notes or obtaining the consent of a majority of the holders of the surplus notes. The complaints further allege that the directors breached their fiduciary duties and committed corporate waste, and that the Company and Kemper Commercial engaged in a fraudulent conveyance. The complaints, among other things, seek a declaratory judgment of the parties' rights, an injunction against further asset sales, and monetary damages. The class action complaint also alleges that Kemper Commercial intentionally interfered with the contractual relationships between the Company and the surplus noteholders. To date, only one of the complaints has been served upon the Company and the Company moved to dismiss that complaint. Following the filing of that motion, the plaintiffs stated their intention to file an amended complaint but have not yet done so. The Company has not yet been required to file a motion to dismiss or answer with respect to the other complaints. The Company intends to vigorously defend against these lawsuits.

In addition to the above, 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 financial statements due to established reserves and anticipated insurance and reinsurance recoverables.

Other Items

The Company leases office space and equipment under various noncancelable operating lease agreements. Rental expense for 2003 and 2002 was $23,961,783 and $22,853,014, respectively, net of costs shared by the Company with AMM under the terms of the Pooling Agreement.

At December 31, 2003, the total aggregate minimum rental payments on operating leases is $88,586,627 and future minimum rental payments for the next six years are as follows:

		Minimum payments (Dollars in thousands)
Year ending December 31:		
2004	$	28,529
2005		19,650
2006		14,364
2007		10,176
2008		7,863
2009 and thereafter		8,005
	$	88,587

Certain rental commitments have renewal options extending through the year 2022. Some of these renewals are subject to adjustments in future periods.

The Company is liable for guaranty fund assessments related to certain unaffiliated companies that have become insolvent during the years 2003 and prior. The Company's financial statements include provisions for all known assessments that are expected to be levied against the Company as well as an estimate of amounts (net of estimated future premium tax recoveries) that the Company believes it will be assessed in the future for which the insurance industry has estimated the cost to cover losses to policyholders. As of December 31, 2003, the Company has accrued a liability of $8.7 million for such assessments and has also recorded a receivable for future premium tax offsets related to such assessments, as well as previous assessments paid, of $1.1 million which are anticipated to be received in 2003. The Company is contingently liable for any future guaranty fund assessments related to insolvencies of unaffiliated insurance companies, for which the insurance industry has been unable to estimate the cost to cover losses to policyholders. No specific amount can be reasonably estimated for such insolvencies as of December 31, 2002.

The Company has established a liability for premium and loss based assessments of $28.0 million as of December 31, 2003. The Company has also recorded a receivable for such assessments paid of $1.1 million which are anticipated to be recovered from future policyholder surcharge assessments in 2003.

(10) Surplus

Surplus Notes

The Company had the following surplus notes issued and outstanding as of December 31, 2003:

Description	Interest rate	Maturity date	Par or face value	Carrying value	Interest paid in 2003	Inception to-date interest paid	Accrued interest at December 31, 2003
					(In thousands)		
30-Year Notes	9.15%	07/01/2026	$ 400,000	399,123	—	220,312	—
40-Year Notes	8.30%	12/01/2037	200,000	199,507	—	83,461	—
100-Year Notes	8.45%	12/01/2097	100,000	99,726	—	42,485	—
			$ 700,000	698,356	—	346,258	—

The unamortized discount at issuance has been charged against surplus. The unamortized discount amounted to $1.6 million at December 31, 2003 and 2002.

All surplus notes were issued pursuant to Rule 144A of the Securities Act of 1933. All surplus notes are unsecured and subordinated to all present and future indebtedness, policy claims, and prior claims of the Company. The surplus notes are not entitled to a sinking fund. The Company is not restricted from incurring any future indebtedness, policy claims, or prior claims. Under statutory accounting, the surplus notes are part of surplus for financial statement purposes. The 30-year notes and the 40-year notes may not be redeemed at the option of the Company or any holder of the notes prior to maturity. Upon the occurrence and during the continuation of certain events, as described in the Offering Circular, the Company has the right, if certain conditions are met, to shorten the maturity of the 100-year notes; or subject to the prior written approval of the Director, redeem them in whole but not in part. Each payment of interest on and/or repayment of principal of the surplus notes may be made only with the prior approval of the Director, which approval will only be granted if, in the judgment of the Director, the financial condition of the Company warrants the making of such payments and the Company's surplus reflects sufficient funds to cover the amount of such payment. On March 20, 2003, the Company received notice from the Department of Insurance that the Company's request to make the interest payments on the surplus notes due on June 1, 2003 and July 1, 2003 has been denied. The amount of interest due and not paid during 2003 plus interest that is not accrued for at December 31, 2003 is $61,650,000. In addition, any payment of interest on or repayment of principal of the surplus notes would reduce the surplus of the Company.

Dividend Restrictions

Dividend distributions from the Company's insurance subsidiaries to the Company are restricted by various state insurance laws. In Illinois, where most of the Company's subsidiaries are domiciled, if such dividend, together with other distributions during the 12 preceding months would exceed the greater of (a) 10% of the insurer's statutory surplus as regards policyholders as of the preceding December 31, or (b) the statutorily adjusted net income for the preceding calendar year, then such proposed dividend must be reported to the Director at least 30 days prior to be proposed payment date and may be paid only if not disapproved. The Illinois insurance laws also permit payment of dividends only out of earned surplus, exclusive of most unrealized capital gains. The maximum amount of dividends which can be paid to the

Company by its insurance subsidiaries without prior approval in 2004 is $17.3 million; however, pursuant to corrective orders, LMC cannot enter into any transaction that involves the transfer of assets to or from affiliates of LMC without the prior approval of the Director of the Department. LMC received cash dividends from its insurance subsidiaries of $12.7 million and $0 during 2003 and 2002, respectively. LMC also recorded cash dividends of $13.6 million and $32.5 million in 2003 and 2002, respectively, from its noninsurance subsidiaries.

(11) 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. For example, the Company's subsidiaries are not considered financial instruments, and their value has not been incorporated into the fair value estimates. 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:

Bonds and stocks: Fair values for bonds and stocks have been determined by using market values determined by the NAIC, or independent pricing services that use prices provided by market makers or estimates of fair values obtained from yield data relating to instruments or securities with similar characteristics, or fair value as determined in good faith by the Company's portfolio managers, when such values are not available from the NAIC.

Cash, short-term investments, and receivables for securities sold: The statement values reported for these instruments approximate fair value.

Mortgage loans and real estate: Fair values for mortgage loans and real estate were estimated based upon the investments observable market price, net of estimated costs to sell, based upon internal and third party appraisals. The estimates of fair value should be used with care given the inherent difficulty of estimating the fair value of real estate due to the lack of a liquid quotable market.

Other invested assets: Fair values for venture capital partnerships and hedge funds were estimated based upon the underlying fair value of the assets invested in by the partnership or fund.

The fair value of notes receivable approximates their statement value due to the rate at which the notes were issued compared with current market interest rates. The fair value of other equity investments is based upon fair values as determined in good faith by the Company's portfolio managers or investment advisors.

The statement values and estimated fair values of the Company's financial instruments at December 31, 2003 and 2002 are as follows:

	2003		2002	
	Statement value	**Estimated fair value**	**Statement value**	**Estimated fair value**
	(In thousands)			
Financial instruments recorded as assets:				
Bonds	$ 1,673,352	1,684,935	1,400,274	1,430,019
Cash and short-term investments	1,870,574	1,870,574	1,104,546	1,104,546
Real estate:				
Properties occupied by the Company	—	—	68,440	81,167
Properties held for sale	40,856	43,911	15,853	16,423
Mortgage loans	17,148	17,148	54,124	54,730
Nonaffiliated stocks	21,433	22,540	21,942	21,942
Other invested assets:				
Venture capital partnerships and hedge funds	56,661	55,974	81,777	81,870
Notes receivable	19,083	19,083	24,116	24,116
Other equity investments	28,588	28,588	28,068	28,068
Receivables for securities sold	3,287	3,287	1,495	1,495

(12) Reconciliation of 2003 Audited Statutory Financial Statements to 2003 Annual Statements as Filed

Subsequent to the completion of the Company's 2002 Annual Statement, as filed with the Department of Insurance on or about March 1, 2003, the Company became aware of a number of facts that provided additional evidence with respect to conditions or circumstances that existed at the date of filing. These additional facts affected the estimates inherent in the process of preparing the 2002 audited financial statements and are referred to as Type I subsequent events in SSAP No. 9, *Subsequent Events* (SSAP No. 9). In accordance with SSAP No. 9, all information that becomes available prior to the issuance of the financial statements relating to a material Type I subsequent event shall be used by management to determine the related accounting estimate.

As such, the following table reconciles the accompanying statutory net loss for 2003 to that filed in the Annual Statement based upon certain adjustments made in 2002:

		Net loss
As filed in 2003 Annual Statement	$	(517,377,785)
Adjustments related to:		
Market value declines identified subsequent to year-end resulting in other-than-temporary impairment of securities:		
Bonds		10,563,044
Equity securities		7,227,150
Other-than-temporary impairments or adjustments related to new facts, circumstances or decisions made by the Company:		
Market for sale certain office buildings previously occupied by the Company		25,510,259
Abandonment of plans for water development joint venture project		29,346,776
Change in agreement with internet joint venture partners		10,095,450
Termination of letter of intent to sell subsidiary resulting in goodwill impairment		—
Effects of terminating the surplus note tender offer on admissibility of deferred tax assets		—
Other adjustments:		
Revenue recognition adjustment at NATLSCO		—
Overaccrual related to incentive compensation		(10,280,198)
Misapplication of facts related to receivables		10,588,085
Nonadmitted deferred premiums receivable		—
Equity pick-up for AMICO related to AMICO's share of pooled adjustments and other items		—
As per accompanying financial statements	$	(434,327,219)

Reconciliation of 2002 Audited Statutory Financial Statements to 2002 Annual Statements as Filed

Subsequent to the completion of the Company's 2002 Annual Statement, as filed with the Department of Insurance on or about March 1, 2003, the Company became aware of a number of facts that provided additional evidence with respect to conditions or circumstances that existed at the date of filing. These additional facts affected the estimates inherent in the process of preparing the 2002 Annual Statement and are referred to as Type I subsequent events in SSAP No. 9, *Subsequent Events* (SSAP No. 9). In accordance with SSAP No. 9, all information that becomes available prior to the issuance of the financial statements relating to a material Type I subsequent event shall be used by management to determine the related accounting estimate.

As such, the Company has recorded the following adjustments in the accompanying statutory financial statements which are different from the amounts as filed in the Company's 2002 Annual Statement as follows:

	Net loss	Total surplus
As filed in 2002 Annual Statement	$ (205,919,979)	696,846,043
Adjustments related to:		
Market value declines identified subsequent to year-end resulting in other-than-temporary impairment of securities:		
Bonds	(10,563,044)	(9,951,907)
Equity securities	(7,227,150)	(7,227,150)
Other-than-temporary impairments or adjustments related to new facts, circumstances or decisions made by the Company:		
Market for sale certain office buildings previously occupied by the Company	(25,510,259)	(25,510,259)
Abandonment of plans for water development joint venture project	(29,346,776)	(15,141,303)
Change in agreement with internet joint venture partners	(10,095,450)	(10,095,450)
Termination of letter of intent to sell subsidiary resulting in goodwill impairment	—	(5,976,869)
Effects of terminating the surplus note tender offer on admissibility of deferred tax assets	—	(86,369,468)
Other adjustments:		
Revenue recognition adjustment at NATLSCO	—	(72,892,000)
Overaccrual related to incentive compensation	10,280,198	10,280,198
Misapplication of facts related to receivables	(10,588,085)	(10,588,085)
Nonadmitted deferred premiums receivable	—	(30,800,000)
Equity pick-up for AMICO related to AMICO's share of pooled adjustments and other items	—	(19,453,353)
As per accompanying financial statements	$ (288,970,545)	413,120,397

(13) Subsequent Events

On February 5, 2004, the Company announced that its filing of a run-off plan with the Department of Insurance was delayed due to the need for the Company to complete its December 31, 2003 financial statements. As part of that announcement, the Company informed its employees that enhanced compensation payments would be suspended pending filing of the financial statements and approval of the run-off plan. Enhanced compensation payments include payments under subsidiary restricted stock and stock option plans (see note 12), annual and stay bonuses, and certain guaranteed termination payments, and any severance payments in excess of the Company's standard severance policies. If and when the Department of Insurance approves the run-off plan, the Department of Insurance will then decide whether enhanced compensation payments will be made. The unpaid accrued amount in suspension as of the end of February 2004 is estimated to be $9 million.

On March 19, 2004, the Company submitted a Run-Off Plan to the Department of Insurance. The plan was approved on June 9, 2004.

Schedule 1

LUMBERMENS MUTUAL CASUALTY COMPANY

Summary Investment Schedule

December 31, 2003

The following is a summary of certain financial data as of December 31, 2003 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 2003 Annual Statement as filed with the Department of Insurance of the State of Illinois.

Investment categories	Gross investment holdings		Admitted assets as reported in the annual statement	
	Amount	**Percentage**	**Amount**	**Percentage**
Bonds:				
U.S. Treasury securities	$ 554,362,260	13.888 %	$ 554,362,260	13.888 %
U.S. Government agency and corporate obligations (excluding mortgage-backed securities):				
Issued by U.S. Government sponsored agencies	100,568,010	2.520	100,568,010	2.520
Foreign government (including Canada, excluding mortgage-backed securities)	22,419,297	0.562	22,419,297	0.562
Securities issued by states, territories, and possessions and political subdivisions in the U.S.:				
Revenue and assessment obligations	66,148,724	1.657	66,148,724	1.657
Mortgage-backed securities (includes residential and commercial MBS):				
Pass-through securities:				
Guaranteed by GNMA	9,656,387	0.242	9,656,387	0.242
Issued by FNMA and FHLMC	37,054,625	0.928	37,054,625	0.928
Other mortgage-backed securities:				
Issued by FNMA and FHLMC	321,249,918	8.048	321,249,918	8.048
All other privately issued	16,969,179	0.425	16,969,179	0.425
Other debt and other fixed income securities (excluding short-term):				
Unaffiliated domestic securities (includes credit tenant loans rated by the SVO)	521,010,895	13.053	521,010,895	13.053
Unaffiliated foreign securities	23,912,567	0.599	23,912,567	0.599
Affiliated securities	19,082,580	0.478	19,082,580	0.478

(Continued)

Schedule 1

LUMBERMENS MUTUAL CASUALTY COMPANY

Summary Investment Schedule

December 31, 2003

Investment categories	Gross investment holdings Amount	Gross investment holdings Percentage	Admitted assets as reported in the annual statement Amount	Admitted assets as reported in the annual statement Percentage
Equity interests:				
Preferred stocks:				
Unaffiliated	$ 13,388,287	0.335 %	$ 13,388,287	0.335 %
Publicly traded equity securities (excluding preferred stocks):				
Unaffiliated	5,873,248	0.147	5,873,248	0.147
Other equity securities:				
Affiliated	260,674,361	6.530	260,674,361	6.530
Unaffiliated	2,171,075	0.054	2,171,075	0.054
Other equity interests including tangible personal property under lease:				
Affiliated	32,287,543	0.809	32,287,543	0.809
Unaffiliated	52,961,434	1.327	52,961,434	1.327
Mortgage loans:				
Construction and land development	4,500,000	0.113	4,500,000	0.113
Single family residential properties	12,647,650	0.317	12,647,650	0.317
Real estate investments:				
Property held for sale	40,855,789	1.024	40,855,789	1.024
Receivables for securities	3,287,363	0.082	3,287,363	0.082
Cash and short-term investments	1,870,573,731	46.862	1,870,573,731	46.862
Total invested assets	$ 3,991,654,923	100.000 %	$ 3,991,654,923	100.000 %

See accompanying independent auditors’ report.

LUMBERMENS MUTUAL CASUALTY COMPANY

Supplemental Investment Risk Interrogatories

December 31, 2003

The following interrogatories as of December 31, 2003 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 stating the applicable U.S. dollar amounts and percentages of the reporting entity's total admitted assets held in that category of investments as shown on the Summary Investment Schedule. All reporting entities must answer interrogatories 1 through 4, 11, 13 through 17, 19, and if applicable 20 through 24. Answer each of interrogatories 5 through 10 only if the reporting entity's aggregate holding in the gross investment category addressed in that interrogatory 4 equals or exceeds 2.5% of the reporting entity's total admitted assets. Answer interrogatory 12 only if the reporting entity's aggregate holding in the gross investment category addressed in interrogatory 11 equals or exceeds 2.5% of the reporting entity's total admitted assets. Answer interrogatory 18 only if the reporting entity's aggregate holding in the gross investment category addressed in interrogatory 17 equals or exceeds 2.5% of the reporting entity's total admitted assets.

1. State the reporting entity's total admitted assets as reported on page 2 of the Company's Annual Statement: $5,229,941,637

2. State by investment category the 10 largest exposures to a single issuer/borrower/investment, excluding U.S. Government, U.S. Government agency securities, and those U.S. Government money market funds listed in the Appendix to the SVO Purposes and Procedures Manual as exempt, property occupied by the Company, and policy loans:

	Investment category	**Amount**	**Percentage of total admitted assets**
1.	Cat. 8. – 590266102 – Merrimac Ser – CL 1 MMF	$ 373,994,915	7.2%
2.	Cat. 8. – 02368W101 – American AAdvantage Select Fd – Cl 1 MMF	330,682,940	6.3%
3.	Cat. 8. – 825252695 – Short Term Invts. Co. – CL 1 MMF	302,790,777	5.8%
4.	Cat 2.1 – 184670B#4, 084670C*7 and 084670C@5 – Berkshire Hathaway, Inc. – Bond	273,337,726	5.2%
5.	Cat. 8. – 81118P871 – Scudder Money Mkt Tr – CL 1 MMF	264,214,165	5.1%
6.	Cat. 8. – BNY Western Tr Co – Cash	197,409,894	3.8%
7.	Cat. 8. – 590901104 – Merrill Lynch Inst1 Fd – CL 1 MMF	118,162,856	2.3%
8.	Cat. 3.41 – 48850#106 – Kemper Casualty Inc – Common (Affiliated)	65,668,203	1.3%
9.	Cat. 1.3 and Cat. 8. – 135087WH3 and 135087WU4 – Canadian Govt. – Bonds;	60,521,504	1.2%
10.	Cat. 3.41 – 48851*109 – Kempes Inc – Common (Affiliated)	53,789,650	1.0%

(Continued)

LUMBERMENS MUTUAL CASUALTY COMPANY

Supplemental Investment Risk Interrogatories

December 31, 2003

3. State the 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	$ 3,254,704,086	62.2%	P/RP-1	$ —	0.0%
NAIC-2	47,540,759	0.9%	P/RP-2	13,289,947	0.3%
NAIC-3	—	0.0%	P/RP-3	—	0.0%
NAIC-4	—	0.0%	P/RP-4	—	0.0%
NAIC-5	11,373,516	0.2%	P/RP-5	72,051	0.0%
NAIC-6	428,000	0.0%	P/RP-6	26,289	0.0%

4. State the amounts and percentages of the reporting entity's total admitted assets held in foreign investments (regardless of whether there is any foreign currency exposure) and unhedged foreign currency exposure (defined as the statement value of investments denominated in foreign currencies which are not hedged by financial instruments qualifying for hedge accounting as specified in SSAP No. 31 – Derivative Instruments and SSAP No. 86 – Derivative Instruments), including foreign-currency-denominated investments of $2,409,602; 0.0% supporting insurance liabilities denominated in that same foreign currency of $5,885,608; 0.1% and excluding Canadian investments and currency exposure of $75,886,070; 1.5%.

   Assets held in foreign investments less than 2.5% of the reporting entity's total admitted assets, therefore detail not required for interrogatories 5 – 10: Yes [X] No [ ]

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

   Not applicable.

6. Two largest foreign investment exposures to 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.

(Continued)

LUMBERMENS MUTUAL CASUALTY COMPANY

Supplemental Investment Risk Interrogatories

December 31, 2003

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

   Not applicable.

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

   Not applicable.

11. State the amounts and percentages of the reporting entity's total admitted assets held in Canadian investments and unhedged Canadian currency exposure, including Canadian currency-denominated investments of $63,991,812; 1.2% supporting Canadian-denominated insurance liabilities of $49,063,000; 0.9%.

   Assets held in Canadian investments less than 2.5% of the reporting entity's total admitted assets, therefore detail not required for interrogatory 12: Yes [X] No [ ]

12. Aggregate Canadian investment exposure:

   Not applicable.

13. State the aggregate amounts and percentages of the reporting entity's total admitted assets held in investments with contractual sales restrictions (defined as investments having restrictions that prevent investments from being sold within 90 days).

   Assets held in investments with contractual sales restrictions less than 2.5% of the reporting entity's total admitted assets, therefore detail not required for interrogatory 13: Yes [X] No [ ]

14. State the aggregate amounts and percentages of admitted assets held in the largest 10 equity interests (including investments in shares of mutual funds, preferred stocks, publicly traded equity securities, and other equity securities, and excluding money market and bond mutual funds listed in the Appendix to the SVO Purposes and Procedures Manual as exempt or Class 1).

LUMBERMENS MUTUAL CASUALTY COMPANY

Supplemental Investment Risk Interrogatories

December 31, 2003

Assets held in equity interests less than 2.5% of the reporting entity's total admitted assets, therefore detail not required for interrogatory 14: Yes [ ] No [X]

	Investment category	Amount	Percentage of total admitted assets
1.	Cat. 3.41 – 48850#106 – Kemper Casualty Inc – Common (Affiliated)	$ 65,668,203	1.3%
2.	Cat. 3.41 – 48850#106 – Kemper Inc – Common (Affiliated)	53,789,650	1.0%
3.	Cat. 3.41 – 48855@103 – Kemper Financial Protection, Inc – Common (Affiliated)	50,465,461	1.0%
4.	Cat. 3.41 – 02761*105 – American Motorists Insurance Company – Common (Affiliated)	29,906,897	0.6%
5.	Cat 3.41 – 48841@100 – Kemper International Corporation – Common (Affiliated)	28,312,368	0.5%
6.	Cat. 3.41 – 48851#105 – Kemper Employers Group, Inc. – Common (Affiliate)	21,584,126	0.4%
7.	Cat. 3.51 – Kemper Lloyds Insurance Company 100% JV Interest – Other equity interests (Affiliated)	20,825,202	0.4%
8.	Cat. 3.52 – Capital Z Financial Srvcs Fund 11 – Other equity interests (Unaffiliated)	14,224,920	0.3%
9.	Cat. 3.22 – 337357AA5 – First Un Cap One Redeemable Pfd Stock – Preferred Stock	10,382,947	0.2%
10.	Cat. 3.52 – Delta Welands Joint Venture – Other equity interests (Affiliate)	7,762,341	0.1%

15. State the amounts and percentages of the entity's total admitted assets held in nonaffiliated, privately placed equities (included in other equity securities) and excluding securities eligible for sale under Securities Exchange Commission (SEC) Rule 144a or SEC Rule 144 without volume restrictions.

    Assets held in nonaffiliated, privately placed equities less than 2.5% of the reporting entity's total admitted assets, therefore detail not required for interrogatory 15: Yes [X] No [ ]

16. State the amounts and percentages of the entity's total admitted assets held in general partnership interests (included in other equity securities).

    Assets held in general partnership interests less than 2.5% of the reporting entity's total admitted assets, therefore detail not required for interrogatory 16: Yes [X] No [ ]

17. With respect to mortgage loans reported in Schedule B, state the amounts and percentages of the reporting entity's total admitted assets held.

LUMBERMENS MUTUAL CASUALTY COMPANY

Supplemental Investment Risk Interrogatories

December 31, 2003

Mortgage loans reported in Schedule B less than 2.5% of the reporting entity's total admitted assets, therefore detail not required for interrogatories 17 and 18: Yes [X] No [ ]

18. Aggregate mortgage loans having the following loan-to-value ratios as determined from the most current appraisal as of the annual statement date:

    Not applicable.

19. State the amounts and percentages of the reporting entity's total admitted assets held in each of the five largest investments in one parcel or group of contiguous parcels of real estate reported in Schedule A, excluding property occupied by the company.

    Assets held in each of the five largest investments in one parcel or group of contiguous parcels of real estate reported in Schedule A less than 2.5% of the reporting entity's total admitted assets, therefore detail not required for interrogatory 19: Yes [X] No [ ]

20. State the amounts and percentages of the reporting entity's total admitted assets subject to the following types of agreements:

	At year-end	Percentage of total admitted assets	1st Quarter	2nd Quarter	3rd Quarter
Securities lending (do not include assets held as collateral for such transactions)	$ 134	0.0%	$ 70,086,274	25,373,141	82,963,202
Repurchase agreements	—	0.0%	—	—	—
Reverse repurchase agreements	—	0.0%	—	—	—
Dollar repurchase agreements	—	0.0%	—	—	—
Dollar reverse repurchase agreements	—	0.0%	—	—	—

21. State the amounts and percentages indicated below for warrants not attached to other financial instruments, options, caps, and floors:

    None.

(Continued)

LUMBERMENS MUTUAL CASUALTY COMPANY

Supplemental Investment Risk Interrogatories

December 31, 2003

22. State the amounts and percentages indicated below of potential exposure (defined as the amount determined in accordance with the NAIC Annual Statement Instructions) for collars, swaps, and forwards:

    None.

23. State the amounts and percentages indicated below of potential exposure (defined as the amount determined in accordance with the NAIC Annual Statement Instructions) for futures contracts:

    None.

24. State the amounts and percentages of the 10 largest investments included in the Write-ins for Invested Assets category included on the Summary Investment Schedule:

    None.

See accompanying independent auditors' report.