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COMPANY NAME: LUMBERMENS MUTUAL CASUALTY COMPANY



## **LUMBERMENS MUTUAL CASUALTY COMPANY**

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

December 31, 2007 and 2006

(With Independent Auditors' Report Thereon)



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

## **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 (the Company) as of December 31, 2007 and 2006. These statutory financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these statutory financial statements based on our audits.

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

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

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the statutory financial statements referred to above do not present fairly, in conformity with U.S. generally accepted accounting principles, the financial position of Lumbermens Mutual Casualty Company as of December 31, 2007 and 2006.

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, 2007 and 2006, on the basis of accounting described in Note 2.

As discussed in Note 2 to the statutory financial statements, the Division of Insurance has prescribed or permitted certain accounting practices under a Corrective Order which result in an increase to policyholder surplus of \$400 million and \$453 million as of December 31, 2007 and 2006, respectively. These accounting practices differ from the National Association of Insurance Commissioners *Accounting Practices and Procedures Manual*.



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

The accompanying statutory financial statements and supplementary information have been prepared assuming that the Company will continue as a going concern. As discussed in Note 9 to the statutory financial statements, the Division of Insurance imposes risk-based capital (RBC) requirements on insurance enterprises, including the Company. As of December 31, 2007 and 2006, the Company's total adjusted capital, as reported in the 2007 and 2006 Annual Statements filed with the Division of Insurance, is at the "authorized control level" based on the RBC calculation required by the Division of Insurance. Excluding the benefit of prescribed or permitted accounting practices, the Company's total adjusted capital is at the "mandatory control level" as of December 31, 2007 and 2006. At the "authorized control level" and "mandatory control level", the Division of Insurance has substantial authority to exercise control over the Company, its subsidiaries and affiliates. The Division of Insurance is mandated to place a company at the "mandatory control level" under its control, except where, as is the case with 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 Division of Insurance has discretion to allow the continued run-off. In the first half of 2003, as a result of a combination of various business factors including certain ratings downgrades and the Company's deteriorating statutory surplus, the Company substantially ceased underwriting activities. Since July 2003, the Company and most of its subsidiaries and affiliates have been subject to a Corrective Order by the Division of Insurance not to write any new or renewal business except as necessary to comply with contractual commitments or as expressly permitted by the Division of Insurance. On March 19, 2004, the Company submitted to the Division of Insurance its commercial run-off plan which was approved on June 9, 2004.

The Division of Insurance could seek to place the Company in 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 as discussed in Note 9 to the statutory financial statements.

There are a number of factors that could adversely affect the Company's surplus and liquidity position and its adequacy through future years. There can be no assurance that the Company will be successful to the extent necessary to avoid a negative surplus in future years. In addition, as of December 31, 2007, the Company has approximately \$722 million of invested assets that are encumbered by being on deposit or held in trust or escrow arrangements and access to these amounts is subject to certain limitations.



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

KPMG LLP

May 22, 2008

**LUMBERMENS MUTUAL CASUALTY COMPANY**  
Statutory Statements of Admitted Assets, Liabilities, and Surplus  
December 31, 2007 and 2006

<b>Admitted Assets</b>	<u><b>2007</b></u>	<u><b>2006</b></u>
Cash, cash equivalents, and short-term investments	\$ 155,761,516	130,978,945
Common stocks:		
Affiliated	57,775,711	85,535,429
Unaffiliated	2,769,180	2,256,556
Bonds	1,142,842,600	1,394,363,713
Real estate held for sale	—	4,172,747
Investment in affiliate held for sale	1,901,620	—
Other invested assets	<u>6,171,061</u>	<u>28,898,383</u>
Total cash and invested assets	1,367,221,688	1,646,205,773
Reinsurance recoverable on paid losses and loss adjustment expenses	150,861,249	236,048,560
Other admitted assets	61,052,447	66,420,523
Agents' balances and uncollected premiums	29,151,952	56,982,368
Accrued retrospective premiums	16,881,174	34,138,540
Amounts billed and receivable under high deductible policies	16,343,662	28,306,088
Funds held by or deposited with reinsured companies	11,568,086	12,677,226
Equities and deposits in pools and associations	10,644,513	13,539,537
Funds held by claim service provider	10,029,880	12,254,905
Investment income due and accrued	9,527,871	13,876,735
Reinsurance accounted for as a deposit	811,766	12,798,675
Net adjustments in assets and liabilities due to foreign exchange rates	153,226	—
Receivable from subsidiaries and affiliates	<u>—</u>	<u>3,209,996</u>
Total admitted assets	<u><u>\$ 1,684,247,514</u></u>	<u><u>2,136,458,926</u></u>

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

<b>Liabilities and Surplus</b>	<b>2007</b>	<b>2006</b>
	<u>2007</u>	<u>2006</u>
Liabilities:		
Losses and loss adjustment expenses	\$ 1,237,396,641	1,575,632,542
Amounts withheld for others	123,516,395	153,814,393
Accounts payable and other liabilities	66,985,376	88,170,204
Taxes, licenses, and fees payable	38,989,454	43,722,214
Reinsurance payable on paid losses and loss adjustment expenses	21,314,152	33,129,868
Other expenses payable	14,016,142	22,763,756
Remittances and items not allocated	9,227,740	7,281,322
Federal and foreign income taxes	6,079,827	6,053,607
Ceded reinsurance premiums payable	5,621,847	12,639,888
Unearned premium	5,405,172	9,463,192
Funds held under reinsurance treaties	3,031,038	3,787,577
Commissions payable	1,509,174	1,414,716
Payable to subsidiaries	490,170	—
Net adjustments in assets and liabilities due to foreign exchange rates	—	4,993,035
Total liabilities	<u>1,533,583,128</u>	<u>1,962,866,314</u>
Guaranty fund	1,500,000	1,500,000
Surplus notes	698,355,598	698,355,598
Unassigned deficit	<u>(549,191,212)</u>	<u>(526,262,986)</u>
Total surplus	<u>150,664,386</u>	<u>173,592,612</u>
Total liabilities and surplus	<u><u>\$ 1,684,247,514</u></u>	<u><u>2,136,458,926</u></u>

## LUMBERMENS MUTUAL CASUALTY COMPANY

Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2007 and 2006

### (1) Business Operations

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

As further discussed in note 9, the Company's risk-based capital (RBC) ratio, as filed, fell below the "authorized control level" as of December 31, 2002, and has remained below that level to date. The Company's RBC ratio and the reduction of the Company's ratings have had and will continue to have a significant impact on the Company's operations.

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

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

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

## LUMBERMENS MUTUAL CASUALTY COMPANY

### Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2007 and 2006

nonadmitted for statutory accounting purposes. Additionally, changes in the balances of deferred tax assets and liabilities result in increases or decreases in net income under GAAP, whereas under statutory accounting principles, these changes are charged or credited to surplus;

- ceded reinsurance balances are netted against direct and assumed balances on the statutory balance sheets rather than shown gross under GAAP;
- liabilities for losses and loss adjustment expenses (LAE) are discounted using discount rates prescribed by the Division of Insurance; and
- certain assets and liabilities originated in foreign currency are adjusted to U.S. dollars through a direct charge to surplus.

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

#### *Prescribed and Permitted Practices*

The Company's reported surplus at December 31, 2007 and 2006 reflects increases of approximately \$400 million and \$453 million, respectively, over what would have been reported without accounting practices prescribed or permitted by the Division of Insurance.

Pursuant to the prescribed practices in 2007 and 2006, the Company:

- Discounted all its loss and LAE liabilities at 4.2% (the Company's net effective yield on its cash and invested assets for 2007 approximated the 4.2% discount rate.);
- Reflected as admitted assets the amounts that the Company has prepaid for claim handling services to two third-party administrators related to unallocated LAE (ULAE);
- Established a general provision for uncollectible reinsurance, net of discount (This provision has been established using the same 4.2% discount rate used for the Company's discounted underlying loss and LAE liabilities.);
- Recognized amounts due from Washington National Insurance Company (formerly National Fidelity Life Insurance Company) as an admitted receivable to reflect the "economic basis" of certain annuity reinsurance contracts;
- Discounted the liability for loss-based assessments and premium deficiency at 4.2%; and
- Admitted at December 31, 2006 an anticipated refund from the California Insurance Guarantee Association (CIGA) as a receivable (The Company subsequently received this refund in February 2007).

Pursuant to the permitted practices in 2007 and 2006:

- The Company is permitted to account for certain reinsurance contracts that meet the definition of retroactive reinsurance agreements as prospective reinsurance agreements.
- The Company is permitted to forego the requirement to obtain financial statements prepared on the basis of GAAP for certain of the Company's noninsurance company subsidiaries. The Company

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Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2007 and 2006

believes that the statutory carrying values of these subsidiaries approximate the carrying values that would be determined under the Manual if GAAP statements were prepared.

The accompanying table details the effects on surplus as of December 31, 2007 and 2006 of the prescribed and permitted practices as described above by reconciling the reported positive surplus of the Company to the negative surplus that would have been reported in the absence of prescribed and permitted practices:

	<b>Surplus</b>	
	<b>2007</b>	<b>2006</b>
	(In thousands)	
As reported herein	\$ 150,664	173,593
Increase (decrease) as a result of prescribed and permitted practices:		
Discount liability for loss and LAE	(299,656)	(378,769)
Prepaid ULAE	(24,800)	(32,671)
Provision for uncollectible reinsurance	(46,854)	9,635
Annuity reinsurance contracts	(8,926)	(9,273)
Discount loss-based assessment and premium deficiency liability	(16,300)	(17,000)
CIGA admitted asset	—	(16,365)
Retroactive reinsurance agreements	—	—
Subsidiary GAAP financials	(3,895)	(9,479)
Total prescribed and permitted practices	(400,431)	(453,922)
Manual basis	\$ (249,767)	(280,329)

***Invested Assets and Related Income***

Bonds, cash equivalents, and short-term investments are generally valued at amortized cost; however, bonds rated NAIC 3 or below 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 loan-backed securities, over the estimated life of the security. Amortization of the discount or premium from loan-backed securities is recognized retrospectively based on the estimated timing and amount of prepayments of the underlying assets and is adjusted to reflect differences, which arise between the prepayments originally anticipated and the actual prepayments received and currently anticipated. Prepayment assumptions used for loan-backed securities are derived using an external securities information service and are consistent with the current interest rate and economic environment.

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

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### Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2007 and 2006

Unaffiliated common stocks are generally carried at fair value with unrealized gains and losses recorded in surplus.

Affiliated common stocks are generally carried at the underlying statutory equity of the respective entity's financial statements. The Company's investment in its remaining foreign subsidiary at December 31, 2007 is recorded at its estimated sale price net of anticipated costs to sell.

Other invested assets include notes receivable and joint venture interests. Notes receivable are carried at amortized cost, net of any impairments. Joint ventures in which the Company has a less than 10% ownership interest are carried at cost after impairment writedowns. The Company's insurance company joint venture in Texas (see note 3) in which the Company had a greater than 10% ownership interest at December 31, 2006 was carried at the underlying statutory equity of the joint venture's financial statements. The Company also has a real estate joint venture which is accounted for as a real estate acquisition, development, and construction arrangement (ADC) and accordingly is carried at its estimated fair value, net of anticipated costs to sell, which approximates its underlying statutory equity.

Real estate owned is held for sale and is valued at the lower of its carrying amount or fair value less estimated costs to sell.

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

#### ***Premium Balances***

Premiums are earned on a daily pro rata basis over the term of the policies. Unearned premiums are stated after deduction for premiums ceded to reinsurers. Premiums received in advance are recorded as a liability and are not considered income until due. Agents' balances and uncollected premiums receivable are recorded at the effective date of the underlying contract or in the case of audit premiums in accordance with the terms of the underlying contracts. The Company evaluates the collectibility of all receivables for possible impairment. When the Company determines it is probable a receivable balance will not be collected, such amount is written off. The Company anticipates investment income as a factor in determining the premium deficiency liability. As of December 31, 2007 and 2006, the Company recorded an ending premium deficiency liability of \$4.0 million, net of discount.

The Company has recorded an admitted asset for accrued retrospective premiums which includes amounts due the Company for additional premiums for loss sensitive programs and dividend recalls. Such amounts have been estimated based on actuarial techniques and as such are subject to periodic re-evaluation. Changes in the valuation of this asset will result in a corresponding benefit or expense on dividends to policyholders, but do not reflect any agreement or expectation to pay any such dividends.

#### ***Liability for Losses and Loss Adjustment Expenses***

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

## LUMBERMENS MUTUAL CASUALTY COMPANY

### Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

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actuarial techniques reflecting historical patterns of development of paid and reported losses adjusted for current trends.

The Division of Insurance has prescribed an accounting practice under a Corrective Order pursuant to which the Company discounts all its loss and LAE liabilities at 4.2% in the accompanying statutory balance sheets as of December 31, 2007 and 2006. At December 31, 2007 and 2006, the total amount of the discounts related to this prescribed practice included in the accompanying statutory balance sheets are \$300 million and \$379 million, respectively.

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

The Company reflects its liability for losses net of anticipated salvage and subrogation recoveries. Those anticipated recoveries were \$50.7 million and \$32.3 million at December 31, 2007 and 2006, respectively.

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

#### ***Federal 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. The agreement provides that 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 and its affiliate's current financial position, all settlements of intercompany tax balances are subject to approval by the Division of Insurance.

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### Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

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#### *Nonadmitted Assets*

Assets included in the statutory balance sheets are at admitted asset value. Certain assets designated as “nonadmitted assets” are excluded from the statutory balance sheets and are charged to unassigned surplus at December 31, 2007 and 2006 as follows:

	<u>2007</u>	<u>2006</u>
	(In thousands)	
Deferred tax assets	\$ 705,046	701,689
Premiums receivable	22,134	34,394
Other assets nonadmitted	16,076	29,748
Total nonadmitted assets	<u>\$ 743,256</u>	<u>765,831</u>

#### *Provision for Uncollectible Reinsurance*

The Division of Insurance has prescribed an accounting practice under a Corrective Order pursuant to which the Company has established a general provision for uncollectible reinsurance. Changes in this liability are charged directly against surplus.

The general provision for uncollectible reinsurance, net of discount, was \$38.1 million and \$55.0 million at December 31, 2007 and 2006, respectively. The Schedule F penalty otherwise prescribed would have been \$85.0 million and \$45.4 million at December 31, 2007 and 2006, respectively.

#### *Use of Estimates*

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

As further discussed in the accompanying notes to the statutory balance sheets, significant estimates and assumptions affect various provisions including losses and policyholder dividends. The liabilities for losses and LAE 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 4, 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) are estimated based on similar assumptions used to estimate the ultimate liabilities for losses and LAE. Currently, under the Corrective Order, the Company is prohibited from paying policyholder dividends. 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. Actual results could differ from those estimates.

### (3) **Invested Assets and Investments in Subsidiaries**

#### *Bonds*

The fair values of the Company’s bonds have been determined using prices provided by the Securities Valuation Office of the NAIC (the SVO), or when such values are not available from the SVO, using

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Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

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prices from independent pricing services, prices provided by brokers, or prices determined in good faith by the Company's engaged portfolio manager. Such values are referred to in the accompanying tables as "NAIC fair value."

The statement value and NAIC fair value of bonds at December 31, 2007 and 2006 were as follows:

<b>2007</b>				
<b>Statement value</b>	<b>Gross unrealized gains</b>	<b>Gross unrealized losses</b>	<b>NAIC fair value</b>	
(In thousands)				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 237,455	3,503	(3)	240,955
State, political subdivision, and special revenue obligations	29,946	604	(104)	30,446
Debt securities issued by foreign governments	2,226	1	(1)	2,226
Corporate securities	491,367	680	(46,125)	445,922
Asset-backed securities	109,897	268	(191)	109,974
Mortgage-backed securities	271,952	570	(2,386)	270,136
Total bonds	\$ 1,142,843	5,626	(48,810)	1,099,659

<b>2006</b>				
<b>Statement value</b>	<b>Gross unrealized gains</b>	<b>Gross unrealized losses</b>	<b>NAIC fair value</b>	
(In thousands)				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 502,416	40	(12,364)	490,092
State, political subdivision, and special revenue obligations	52,582	773	(198)	53,157
Debt securities issued by foreign governments	2,312	1	(74)	2,239
Corporate securities	575,274	171	(32,583)	542,862
Asset-backed securities	97,424	433	(80)	97,777
Mortgage-backed securities	164,356	58	(422)	163,992
Total bonds	\$ 1,394,364	1,476	(45,721)	1,350,119

Bonds in an unrealized loss position are regularly reviewed for other-than-temporary declines in value. Factors considered in determining whether a decline is other-than-temporary include the length of time a bond has been in an unrealized loss position and the reasons for the decline in value. Assessments include

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judgments about an obligor's current and projected financial position, an issuer's current and projected ability to service and repay its debt obligations, the existence of, and realizable value for, any collateral backing the obligations, and the macro-economic and micro-economic outlooks for specific industries and issuers. Assessing the duration of loan-backed securities can also involve assumptions regarding underlying collateral such as prepayment rates, default and recovery rates, and third-party servicing abilities.

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

The Company defines its exposure to subprime mortgage related risk as being composed of all fixed income securities primarily backed by mortgage pools with the following characteristics calculated on a weighted average basis:

- First lien mortgages where borrowers have FICO scores less than 650
- First lien mortgages with loan-to-value ratios greater than 95%
- Second lien mortgages where borrowers have FICO scores less than 675
- Borrowers with less than conventional documentation of their income and/or net assets and FICO scores less than 650

At December 31, 2007, the Company's subprime exposure includes only residential mortgage-backed securities owned by the Company and its subsidiaries with a statement value of \$14.9 million and fair value of \$13.2 million, and during 2007 it did not recognize any other-than-temporary impairment losses related to subprime mortgages.

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

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

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As of December 31, 2007 and 2006, the gross unrealized losses that were in that position for more than twelve months and for less than twelve months were as follows:

	2007			2006		
	Number of issues	Gross unrealized losses	NAIC fair value	Number of issues	Gross unrealized losses	NAIC fair value
	(In thousands)					
Bonds in a loss position						
more than 12 months:						
U.S. Treasury securities and obligations of U.S. government corporations and agencies	—	\$ —	—	18	\$ (12,211)	451,866
State, political subdivision, and special revenue obligations	3	(104)	6,013	3	(162)	5,571
Debt securities issued by foreign governments	1	(1)	2,150	1	(74)	2,163
Corporate securities <sup>1</sup>	15	(42,982)	262,515	24	(30,531)	310,966
Asset-backed securities	3	(75)	32,402	2	(8)	6,907
Mortgage-backed securities	5	(1,371)	17,237	14	(354)	25,521
	27	(44,533)	320,317	62	(43,340)	802,994
Bonds in a loss position						
less than 12 months:						
U.S. Treasury securities and obligations of U.S. government corporations and agencies	3	(3)	2,714	2	(153)	24,125
State, political subdivision, and special revenue obligations	—	—	—	2	(36)	3,584
Corporate securities <sup>2</sup>	11	(3,143)	62,350	18	(2,052)	172,382
Asset-backed securities	3	(116)	40,130	4	(72)	38,079
Mortgage-backed securities	20	(1,015)	65,286	9	(68)	66,643
	37	(4,277)	170,480	35	(2,381)	304,813
Total bonds in a loss position	64	\$ (48,810)	490,797	97	\$ (45,721)	1,107,807

<sup>1</sup> Includes three Berkshire Hathaway Group (Berkshire) (which is rated “AAA”) bonds with gross unrealized losses of \$42,356 thousand and NAIC fair values of \$204,856 thousand at December 31, 2007 and two Berkshire bonds with gross unrealized losses of \$28,885 thousand and NAIC fair values of \$217,981 thousand at December 31, 2006 (see note 5).

<sup>2</sup> Includes one Berkshire bond with gross unrealized losses of \$1,676 thousand and NAIC fair values of \$24,535 thousand at December 31, 2006 (see note 5).

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The following table sets forth the maturity aging schedule of bonds at December 31, 2007. 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.

	<b>Statement value</b>	<b>NAIC fair value</b>
(In thousands)		
One year or less	\$ 83,041	82,873
Over one year through five years	466,938	467,543
Over five years through ten years	26,189	26,856
Over ten years	248,323	205,949
Securities not due at a single maturity date	318,352	316,438
Total bonds	\$ 1,142,843	1,099,659

At December 31, 2007 and 2006, cash, cash equivalents, short-term investments, and bonds carried at \$455.0 million and \$614.4 million, respectively, were on deposit with government authorities as required by law. The Company's cash and invested assets were also encumbered at December 31, 2007 and 2006, by \$267.0 million and \$293.9 million, respectively, related to various collateral requirements.

Proceeds from sales of investments in bonds prior to maturity during 2007 and 2006 were \$286.3 million and \$231.9 million, respectively.

***Common Stocks***

Gross unrealized gains on common stocks, excluding affiliated companies, at December 31, 2007 and 2006 amounted to \$602 thousand and \$81 thousand, respectively. Gross unrealized losses on common stocks at December 31, 2007 and 2006 amounted to \$9 thousand and \$0, respectively. The cost of common stock held at December 31, 2007 and 2006, excluding affiliated companies, was \$2.2 million. Consideration on sales of unaffiliated common stock totaled \$0 in 2007 and \$1.5 million in 2006.

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### *Investments in Affiliated Companies*

The Company's investments in common stocks of affiliated companies at December 31, 2007 and 2006 are summarized below:

	2007		2006	
	Cost	Statement value	Cost	Statement value
	(In thousands)			
American Motorists Insurance Company <sup>1</sup>	\$ —	23,201	—	25,846
Specialty Surplus Insurance Company	19,229	17,334	23,609	21,714
Kemper Casualty Insurance Company	2,506	12,617	22,506	28,496
Kemper Insurance Company of Texas	2,000	2,630	—	—
Kemper International Corporation	1,902	1,932	6,462	7,553
LGA-17, Inc.	1,734	1,963	1,798	1,926
	\$ 27,371	59,677	54,375	85,535

<sup>1</sup> The Company's cost basis in American Motorists Insurance Company (AMICO) was reduced to \$0 as a result of return of capital dividends received in 2004.

### *Significant Transactions Involving Affiliates*

#### **Kemper Insurance Company of Texas**

Effective November 30, 2007, a Texas-domiciled affiliate previously organized as a joint venture under Texas statutory provisions for Lloyds plan operations and historically controlled by officers and employees of the Company, Kemper Lloyds Insurance Company, converted into a wholly owned subsidiary of the Company. In connection with the conversion, the subsidiary changed its name to Kemper Insurance Company of Texas (KICT). Following the conversion, in late 2007, KICT paid to the Company a cash dividend of approximately \$20.5 million. See "*Return of Capital and Income Dividends*" below.

#### **Premium Tax Credits**

At December 31, 2006, the Company owned certain Texas guaranty fund premium tax credits that previously had ceased to be carried on the Company's statutory balance sheets after the Company had entered run-off status in 2003. In the first quarter of 2007, the Company and certain affiliates sold these premium tax credits in two sales transactions. Both transactions received regulatory approvals in both Texas and Illinois. Most of the credits were sold to two subsidiaries of Unitrin, Inc. (Unitrin) in February 2007. The Company also sold \$370 thousand of its credits to four affiliates, who collectively paid the Company in February 2007, as follows: AMM, \$28 thousand; AMICO, \$119 thousand; KCIC, \$14 thousand; and KICT, \$207 thousand. The sales together added approximately \$4.6 million to the Company's 2007 net income, surplus, and liquidity.

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### **Subsidiary Mergers and Dissolutions**

During 2006, Universal Bonding Insurance Company (UBIC), the Company's indirectly wholly owned, New Jersey-domiciled, subsidiary, merged into one of the Company's wholly owned Illinois-domiciled subsidiaries, Kemper Casualty Insurance Company (KCIC). KCIC was the surviving entity in the merger. Since 2002, UBIC was carried at no value on the books of the Company. The merger and related transactions resulted in a surplus benefit to the Company of approximately \$18.4 million in 2006. This benefit is primarily due to the related cancellation of a \$12.3 million intercompany liability previously recorded as owed by the Company to UBIC. Surplus notes originally issued by UBIC to the Company in 2002 and 2003 were also canceled in 2006 without any impact to the surplus of the Company. As a result of the merger itself, KCIC's (and the Company's) surplus increased by approximately \$6.1 million (part of the \$18.4 million) reflecting UBIC's net assets and a slight benefit from the application of accounting practices prescribed or permitted by the Division of Insurance.

### **Canada Branch Office**

Assets of the Company's Canadian branch, reflected in the Company's statutory balance sheets, totaled \$45.5 million at December 31, 2007, down from \$48.0 million at December 31, 2006. The Company repatriated \$11.0 million in 2007 and \$2.2 million in 2006. The Company's Canadian branch accounted for approximately \$24.5 million, or 16.3%, of the Company's statutory surplus at December 31, 2007, down from \$30.1 million, or 17.3%, at December 31, 2006. Most of the remaining assets of the branch in Canada are encumbered in trust (see note 10). Canadian regulatory approvals are required for any releases of assets from the trust, including releases to pay Canadian claims and expenses.

### **Other International Operations**

The Company's other international operations at year-end 2007 consisted of an Australian subsidiary and the Canadian branch of AMICO. Both of those operations have been in run-off in their respective jurisdictions for more than 10 years. After a write-down of the Company's investment in Australia by approximately \$1.0 million to reflect anticipated net proceeds from an ultimately unsuccessful sale transaction in 2007, the Australian subsidiary accounted for \$1.9 million, and \$2.8 million of the Company's surplus at December 31, 2007 and 2006, respectively. The Company has guaranteed most policies issued in Australia, and the Company also reinsures most of those policies for any losses in excess of \$50 thousand. The Australian subsidiary remains available for sale. AMICO's Canadian branch accounted for \$1.3 million and \$1.1 million of the Company's surplus at December 31, 2007 and 2006, respectively. Liquidation and closure of AMICO's Canadian branch was completed in the first quarter of 2008, with repatriation to AMICO of \$1.3 million.

During 2007 and 2006, the other international operations also included three other foreign insurance company subsidiaries, one in Belgium, which was sold in late 2007, and one in each of Bermuda and Singapore, the liquidations and closures of which were completed with no impact on income or surplus in 2006. The sale, prior operations, and closures of the Belgium operations produced a net loss (and adverse surplus impact) to the Company totaling \$1.8 million in 2007, reflecting a realized loss on the sale of the Belgium subsidiary. The net income (and positive surplus impact) from the Belgium, Bermuda, and

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Singapore operations was approximately \$200 thousand in 2006, primarily reflecting a stronger Euro and the Belgium subsidiary's net investment income.

The Company received net cash from the other international operations totaling \$1.0 million in 2007 and \$6.1 million in 2006. In addition, the 2007 sale of the Belgium subsidiary was accompanied by commutation of all intercompany reinsurance, releasing the Company from any future liability to the subsidiary for any outstanding claims and any adverse development, and in connection therewith, the purchaser of the subsidiary agreed to indemnify the Company in the event of any claims against the Company under the subsidiary's policies that have been issued by the subsidiary and covered by a parental guaranty by the Company since 2001.

### **Other Affiliate Transactions**

In 2006, following approval by the Division of Insurance, the Company contributed certain real-estate related promissory notes to AMICO, which in turn contributed them to its wholly owned subsidiary, AMICO Realty Corporation, which holds other notes and related real estate investments. The notes were valued at \$0 by the Company at the date of contribution, and therefore the transfer to AMICO Realty resulted in no change to either the value of the assets carried on the Company's statutory balance sheets or the Company's surplus.

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 of the Division of Insurance (the Director) at least 30 days prior to the proposed payment date and may be paid only if not disapproved. The Illinois insurance laws also prohibit, in the absence of approval by the Director, the payment of any dividend to the extent the dividend would exceed the stock insurance company's earned surplus (such surplus being calculated as exclusive of most unrealized gains). Corrective Orders issued by the Division of Insurance further restrict the payment of dividends by prohibiting any transfers of assets, including any dividend, to the Company from any affiliate without the approval of the Director.

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The Company recorded return of capital and income dividends from the following subsidiaries during 2007 and 2006:

	<b>2007</b>	<b>2006</b>
	(In thousands)	
KICT <sup>1</sup>	\$ 20,475	—
KCIC <sup>2</sup>	20,000	—
Specialty Surplus Insurance Company <sup>3</sup>	6,500	10,000
AMICO <sup>4</sup>	4,020	5,009
Kemper International Corporation	904	536
American Underwriting Corporation	—	432
LGA-17, Inc.	64	140
Total	\$ 51,963	16,117

<sup>1</sup> KICT's Board of Directors approved a \$14,324 thousand return of capital dividend and a \$6,151 thousand income dividend payable December 5, 2007, to the Company.

<sup>2</sup> KCIC's Board of Directors approved a \$20,000 thousand return of capital dividend payable December 28, 2007, to the Company.

<sup>3</sup> SSIC's Board of Directors approved a \$4,380 thousand return of capital dividend and a \$2,120 thousand income dividend payable December 28, 2007, to the Company. SSIC's Board of Directors also approved a \$3,286 thousand return of capital dividend and a \$6,714 thousand income dividend payable December 29, 2006, to the Company.

<sup>4</sup> AMICO's Board of Directors approved a \$2,645 thousand return of capital dividend and a \$1,375 thousand income dividend payable December 28, 2007, to the Company. AMICO's Board of Directors also approved a \$4,973 thousand return of capital dividend and a \$36 thousand income dividend payable December 29, 2006, to the Company.

The Company recognized an impairment write-down of \$3.7 million for its investment in Kemper International Corporation (KIC) during 2007. The write-down was based upon the Company's view that the value of the subsidiary was impaired on an other-than-temporary basis, due to the sale of KIC's Belgium subsidiary and the anticipated sale of KIC's Australian subsidiary.

***Real Estate Held for Sale***

At December 31, 2006, the Company classified its remaining real estate owned, an office/warehouse building in Lake Zurich, Illinois, as held for sale. The building was sold in 2007 for \$4.0 million with the Company recording a \$158 thousand realized loss.

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### *Other Invested Assets*

Other invested assets consisted of the following as of December 31, 2007 and 2006:

	2007	2006
	(In thousands)	
Kemper Lloyds Insurance Co. joint venture <sup>1</sup>	\$ —	22,351
Real estate joint venture	5,315	5,315
Other notes receivable and equity investments	856	1,232
Other invested assets	\$ 6,171	28,898

<sup>1</sup> See *Significant Transactions involving Affiliates* above in this note.

The Company has a real estate joint venture, which is 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 \$5.3 million at December 31, 2007 and 2006. The partnership's underlying investment consisted primarily of a water development project located in California's Sacramento River Valley. During 2003, the partnership abandoned its plans for the water development project. During 2006, the Company recorded impairment write-downs based on the fair value of the undeveloped land net of anticipated costs to sell of \$1.1 million.

The Company's \$0.8 million note receivable was on nonaccrual status as of December 31, 2006. During 2007, this note receivable was exchanged for a new note receivable as a result of a bankruptcy court approved plan of reorganization. The Company's \$0.8 million note receivable is performing as of December 31, 2007.

#### **(4) Liability for Losses and Loss Adjustment Expenses**

The Company establishes a liability for losses and LAE to cover its estimated ultimate liability for property and casualty losses and LAE with respect to reported claims and claims IBNR as of the end of each accounting period. These estimates are then reduced for reinsurance recoverables and discounted to present value. As required by applicable accounting rules, no liabilities are established until a loss, including a loss from a catastrophe, occurs. Loss and LAE liabilities are estimates of what the Company expects the ultimate settlement and administration of claims will cost based on facts and circumstances then known, predictions of future events and estimates of future trends in claims severity and frequency, judicial theories of liability, and other factors. The inherent uncertainties of estimating insurance liabilities are generally greater for liability coverages, or where judicial and political climates involving certain types of claims are changing, than for property coverages due to the longer periods of time (the tail) that elapse before a definitive determination of ultimate loss may be made.

As of December 31, 2007 and 2006, the Company carried a liability for losses and LAE of \$1.2 billion and \$1.6 billion, respectively, reflecting reinsurance recoverables on unpaid losses of \$1.1 billion and \$1.5 billion and tabular and nontabular discount of \$0.4 billion and \$0.5 billion, respectively.

The Company's exposure to asbestos and environmental claims arises principally from general liability insurance contracts. Establishing liabilities for asbestos and environmental claims is subject to greater

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

The total asbestos liability for losses and LAE at December 31, 2007 and 2006 of \$163.7 million and \$196.3 million, respectively, includes IBNR liabilities in the amount of \$88.5 million and \$92.6 million gross of reinsurance recoverables and \$51.7 million and \$56.3 million net of reinsurance recoverables, respectively. These IBNR liabilities and the comparable amounts for prior years cover both losses and defense and cost containment expenses. The Company also includes adjusting and other expenses in the amounts shown above. Pursuant to a prescribed accounting practice, the amount of the discount on asbestos liabilities at December 31, 2007 and 2006 is \$54.0 million and \$67.8 million net of reinsurance recoverables, respectively.

The total environmental liability for losses and LAE at December 31, 2007 and 2006 of \$38.6 million and \$63.4 million, respectively, includes IBNR liabilities in the amount of \$12.6 million and \$5.0 million gross of reinsurance recoverables and \$8.8 million and \$2.9 million net of reinsurance recoverables, respectively. These IBNR liabilities and the comparable amounts for prior years cover both losses and defense and cost containment expenses. The Company also includes adjusting and other expenses in the amounts shown above. Pursuant to a prescribed accounting practice, the amount of the discount on environmental liabilities at December 31, 2007 and 2006 is \$12.7 million and \$17.5 million net of reinsurance recoverables, respectively.

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***Discounting of Losses and LAE***

The Company discounts its liability for losses and LAE for all lines of business pursuant to a prescribed accounting practice. The Company utilizes a cash-flow methodology approach in determining the amount of this discount which is based on the underlying payout patterns for each line of business. The Company segregates a portion of the discount that is associated with permanent total indemnity benefits. This amount is identified as tabular discount. The discount for these claims is based on industry tabular factors and statutory interest rates. Any supplemental discount associated with the Company's higher interest rate assumption is treated as nontabular discount. The Company's tabular and nontabular discounts by line of business as of December 31, 2007 and 2006 were as follows:

	<b>2007 *Case and IBNR</b>	<b>2006 *Case and IBNR</b>
	(In thousands)	
Tabular discount:		
Workers' compensation	\$ 139,979	153,117
Nontabular discount:		
Homeowners/farmowners	221	252
Private passenger auto/truck liability/medical	665	1,815
Commercial auto/truck liability/medical	11,715	10,989
Workers' compensation	186,961	233,222
Commercial multi peril	16,463	20,898
Medical malpractice – claims made	89	255
Medical malpractice – occurrence	64	37
Specialty liability	684	2,468
Other liability – claims made	9,184	11,884
Other liability – occurrence	40,764	50,285
Special property	(104)	(462)
Auto physical damage	(6)	(8)
Fidelity/surety	2,352	1,928
Other (including credit, A&H)	82	97
Reinsurance nonproportional assumed liability	13,901	22,828
Products liability – occurrence	16,621	22,282
Total	299,656	378,770
Grand total	\$ 439,635	531,887

\*Includes liabilities for losses and LAE.

**(5) Reinsurance**

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

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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, exceed 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. There were no ceded premiums under contracts accounted for as prospective reinsurance, net of ceding commission for 2007 and 2006. Additional premiums may also be payable under the terms of certain treaties in future years.

### ***Berkshire Hathaway Insurance Group and Kemper Commercial Insurance Company***

In early 2003, shortly after the Kemper Insurance Companies were downgraded to below an "A" level, National Indemnity Company (NICO), a member of "AAA" rated Berkshire, provided the Company and its affiliates with immediate access to cut-through agreements issued by NICO. The cut-through agreements were applied to certain standard commercial and specialty lines policies of insurance in-force as of December 23, 2002 and to certain new policies issued by certain of the Kemper Insurance Companies on and after December 23, 2002 until September 30, 2003. With respect to each policy to which the NICO cut-through agreement applies, the cut-through allows a Kemper insured to directly submit claims to NICO in the event the respective Kemper Insurance Company (as the issuer of 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.

As an agreed condition for NICO to provide the cut-through agreements, the Company and its affiliates immediately provided collateral available to NICO if and to the extent NICO makes any payments under any cut-through agreements. The collateral includes offset rights granted to NICO for reinsurance proceeds payable by either NICO or its affiliate, National Fire & Marine Insurance Company (National Fire), to the Company or its affiliates; a collateral trust initially in an amount of \$251.1 million as of the end of June 2003, which amount was subject to quarterly reductions by payments of claims (losses and LAE) and mid-term cancellations of policies (the trust amount decreased to \$0 in the third quarter of 2006); and investments of \$257.3 million in Berkshire corporate obligations (Schedule D admitted assets) which the Company has pledged as security to Berkshire. The Berkshire corporate obligations were reduced to \$226.6 million by year-end 2007, with cash in the amount of the reduction being released to the Company in accordance with existing agreements. The investments were further reduced in early 2008, by approximately \$29.6 million, due to a mandatory redemption payment by Berkshire to the Company. If NICO makes no payments under the cut-through agreements, then of the pledged investments, \$100.0 million matures in March 2025. The remaining amount is subject to mandatory redemption annually provided the Company is paying claims on policies covered by the cut-through agreements and NICO is not required to pay any amounts under any cut-through agreement. Because the Berkshire corporate obligations have been pledged as collateral to Berkshire, the Company does not have the intent or, in the absence of a voluntary agreement from Berkshire, the ability to dispose of the investments prior to maturity or redemption. At December 31, 2007 and 2006, respectively, \$50.9 million and \$80.6 million of the Company's gross policy liabilities were protected by the NICO cut-through. As a table below shows,

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the Company cedes to the Berkshire Hathaway Group (group 31) liabilities totaling \$205.9 million at December 31, 2007. Portions of that amount also serve as additional security for any payments that may be made under any NICO cut-through agreements.

NICO also separately provides, for initial and annual fees, an appeals bond facility that the Company and its affiliates use primarily in connection with litigated claims. The Company fully collateralizes the appeal bonds with the pledge of an investment in a Berkshire corporate obligation (Schedule D admitted asset) purchased from Berkshire. At December 31, 2007 and 2006, respectively, the Company has pledged \$20.6 million and \$26.2 million of its assets as collateral for this purpose.

In connection with a now commuted reinsurance arrangement in 2001, the Company entered into a long-term claim administration agreement with National Fire for the servicing of most of the Company's and its affiliates' existing asbestos and environmental claims. The Company paid \$27.5 million in advance for the future servicing of such claims. In accordance with a prescribed accounting practice more fully described in note 2, the Company reflects as an admitted asset the remaining prepaid amount for claim handling services; that amount has declined to approximately \$7.4 million and \$9.4 million at December 31, 2007 and 2006, respectively.

#### *Affiliate Assumed Reinsurance*

The significant majority of the business written by members of the Kemper Insurance Companies 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, AMICO, and American Manufacturers Mutual Insurance Company (AMM).

AMM is an affiliated mutual insurance company that shares with the Company common management and the same members of their respective boards of directors. AMM has been one of the Kemper Insurance Companies for over 50 years. In 2003, 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 a Company policy to each holder of a policy ever issued by AMM, including any policy no longer in force but excluding any policy that is cut-through reinsured by Unitrin, Inc. The additional Company policy is substantively identical to the policy previously issued by AMM, although the Company policy is nonparticipating and nonvoting with respect to the Company's corporate governance. 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. AMM remains liable for its policy liabilities in the event the Company does not comply with all the terms of the affected policies. AMM has approximately \$232 million and \$315 million in reinsurance due from the Company as of December 31, 2007 and 2006, respectively.

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***Other Reinsurance Disclosures***

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

	<u>Assumed</u>	<u>Ceded</u>
	(In thousands)	
2007:		
Unearned premiums	\$ 452	2,733
Outstanding losses and LAE (including IBNR)	283,513	1,129,907
2006:		
Unearned premiums	\$ 1,280	5,085
Outstanding losses and LAE (including IBNR)	389,828	1,460,320

The Company's assumptions from and cessions to affiliated reinsurers accounted for as prospective reinsurance were as follows:

	<u>Assumed</u>	<u>Ceded</u>
	(In thousands)	
2007:		
Unearned premiums	\$ 6,325	38
Outstanding losses and LAE (including IBNR)	1,170,049	5,295
2006:		
Unearned premiums	\$ 11,001	—
Outstanding losses and LAE (including IBNR)	1,527,341	430

The Company historically has reinsured portions of the risks it underwrote in an effort to control its exposure to losses and protect surplus. The Company ceded to reinsurers a portion of these risks and paid premiums based upon the risk and exposure of the policies subject to such reinsurance. Reinsurance is subject to collectibility in all cases and to aggregate loss limits in certain cases. Although the reinsurer is liable to the extent of the reinsurance limits purchased, the Company remains primarily liable as the direct insurer on all risks reinsured. 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.

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As of December 31, 2007, the Company had unsecured undiscounted 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):

<u>Reinsurer</u>	<u>FEIN code</u>	<u>NAIC group #</u>	<u>NAIC code</u>	<u>Net recoverable</u> (In thousands)
Allstate Insurance Co.	36-0719665	8	19232	\$ 6,728
Encompass Insurance Co. of America	36-3976913	8	10071	450
8 Total				<u>7,178</u>
American Home Assurance Co.	13-5124990	12	19380	35
Hartford Steam Boil Inspection & Insurance Co.	06-0384680	12	11452	(276)
Insurance Co. of the State of Pennsylvania	13-5540698	12	19429	4
National Union Fire Insurance Co. of Pittsburgh	25-0687550	12	19445	1,460
Transatlantic Reinsurance Co.	13-5616275	12	19453	13,332
12 Total				<u>14,555</u>
Converium Reinsurance North America, Inc.	06-1325038	31	39136	95,158
General Reinsurance Corp.	13-2673100	31	22039	35,074
National Fire & Marine Insurance Co.	47-6021331	31	20079	75,122
National Reinsurance Corp.	13-1988169	31	34835	507
31 Total				<u>205,861</u>
Motors Insurance Corp.	38-0855585	79	22012	5,139
79 Total				<u>5,139</u>
Berkley Insurance Co.	47-0574325	98	32603	18,775
Firemen's Insurance Co. of Washington D.C.	53-0067060	98	21784	565
Tri State Insurance Co. of Minnesota	41-1232071	98	31003	559
98 Total				<u>19,899</u>
Employers Insurance of Wausau	39-0264050	111	21458	5,401
Liberty Mutual Insurance Co.	04-1543470	111	23043	(98)
111 Total				<u>5,303</u>
Clearwater Insurance Co.	13-2781282	158	25070	12,343
Clearwater Select Insurance Co.	23-2745904	158	10019	6,403
Odyssey America Reinsurance Co.	47-0698507	158	23680	4,379
Old Lyme Insurance Co. of RI Inc.	13-3306163	158	19160	75
158 Total				<u>23,200</u>

**LUMBERMENS MUTUAL CASUALTY COMPANY**

Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

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Reinsurer	FEIN code	NAIC group #	NAIC code	Net recoverable (In thousands)
Employers Reinsurance Corp.	48-0921045	181	39845	\$ 36,866
Swiss Reinsurance Life & Health America Inc.	06-0839705	181	82627	5,775
Swiss Reinsurance America Corp.	13-1675535	181	25364	206,279
Westport Insurance Corp.	13-1941868	181	34207	240
181 Total				<u>249,160</u>
Trinity Universal Insurance Co.	75-0620550	215	19887	13,225
Unitrin Preferred Insurance Co.	13-5460208	215	25909	603
215 Total				<u>13,828</u>
Continental Casualty Co.	36-2114545	218	20443	17,577
Continental Insurance Co.	13-5010440	218	35289	533
218 Total				<u>18,110</u>
Reliastar Life Insurance Co.	41-0451140	229	67105	65,305
229 Total				<u>65,305</u>
Munich Reins America, Inc.	13-4924125	361	10227	124,429
361 Total				<u>124,429</u>
Ace American Insurance Co.	95-2371728	626	22667	3,108
Ace Property & Casualty Insurance Co.	06-0237820	626	20699	4,314
Insurance Co. of North America	23-0723970	626	22713	14,311
626 Total				<u>21,733</u>
Commerical Risk Re-Insurance Co.	03-0331391	749	27955	(2,433)
General Security National Insurance Co.	13-3029255	749	39322	4,302
SCOR Reinsurance Co.	75-1444207	749	30058	19,581
749 Total				<u>21,450</u>
Folksamerica Reinsurance Co.	13-2997499	1129	38776	7,531
1129 Total				<u>7,531</u>
Northland Insurance Co.	41-6009967	3548	24015	407
St. Paul Fire & Marine Insurance Co.	41-0406690	3548	24767	5,525
Travelers Ind. Co.	06-0566060	3548	25658	(1,537)
US Fidelity & Guaranty Co.	52-0515280	3548	25887	1,182
3548 Total				<u>5,577</u>

**LUMBERMENS MUTUAL CASUALTY COMPANY**

Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

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<u>Reinsurer</u>	<u>FEIN code</u>	<u>NAIC group #</u>	<u>NAIC code</u>	<u>Net recoverable</u> (In thousands)
Associated Aviation Underwriters	AA-9995013			\$ 84,497
Texas Workers Compensation	AA-9991444			12,646
Workers Compensation Reinsurance Assn.	41-1357750		10181	<u>8,221</u>
Grand total				\$ <u><u>913,622</u></u>

***Reinsurance Assumed and Ceded***

The estimated maximum amount of return commission due reinsurers if all of the Company's reinsurance was canceled as of December 31, 2007 is as follows:

	<u>Assumed reinsurance</u>		<u>Ceded reinsurance</u>		<u>Net</u>	
	<u>Unearned premium liability</u>	<u>Commission equity</u>	<u>Unearned premium liability</u>	<u>Commission equity</u>	<u>Unearned premium liability</u>	<u>Commission equity</u>
	(In thousands)					
Affiliates	\$ 6,325	332	38	(3)	6,287	335
All other	<u>452</u>	<u>(32)</u>	<u>2,733</u>	<u>(28)</u>	<u>(2,281)</u>	<u>(4)</u>
Total	\$ <u><u>6,777</u></u>	<u><u>300</u></u>	<u><u>2,771</u></u>	<u><u>(31)</u></u>	<u><u>4,006</u></u>	<u><u>331</u></u>

**LUMBERMENS MUTUAL CASUALTY COMPANY**

Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

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***Reinsurance Recoverable in Dispute***

The Company has reinsurance recoverable balances as of December 31, 2007 with the following reinsurers which are in dispute and in the aggregate exceed 10% of the Company's policyholder surplus:

<u>Name of reinsurer</u>	<u>Total amount in dispute (including IBNR)</u>	<u>Notification</u>	<u>Arbitration</u>	<u>Litigation</u>
		(In thousands)		
Converium Reins. North America, Inc.	\$ 89,618	—	89,618	—
Insurance Co. of North America	11,409	—	11,409	—
Reliastar Life Insurance Co.	8,836	—	8,836	—
Continental Casualty Co.	6,167	—	6,167	—
Munich Reinsurance America Inc.	4,860	—	—	4,860
Employers Insurance of Wausau A Mutual Co.	4,076	—	4,076	—
Transatlantic Reinsurance Co.	2,948	2,948	—	—
Ace American Insurance/Cigna Insurance Co.	2,510	—	2,510	—
National Casualty Co.	1,966	—	1,966	—
Excess Insurance Co. Ltd.	1,261	—	1,261	—
Arch Reinsurance Co.	537	537	—	—
Continental Insurance Co.	533	—	533	—
Vermont Reserve Insurance Co.	437	437	—	—
R&Q Reinsurance Co.	292	—	292	—
Partner Reinsurance New York	207	207	—	—
Argonaut Insurance Co.	168	168	—	—
Texas Small Premium Policy Plan	38	38	—	—
Nationwide Mutual Insurance Co.	21	—	21	—
General Reinsurance Corp.	21	21	—	—
American Employers Insurance Co.	6	6	—	—
Swiss Reinsurance America Corp.	3	3	—	—
Total	<u>\$ 135,914</u>	<u>4,365</u>	<u>126,689</u>	<u>4,860</u>

***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. The Company had a total remaining deposit balance of \$0.8 million and \$12.8 million at December 31, 2007 and 2006, respectively.

**LUMBERMENS MUTUAL CASUALTY COMPANY**

Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2007 and 2006

**(6) Federal and Foreign Income Taxes**

The components of the Company's net deferred tax asset as of December 31, 2007 and 2006 were as follows:

	<b>2007</b>	<b>2006</b>
	(In thousands)	
Total gross deferred tax assets	\$ 710,429	704,530
Total gross deferred tax liabilities	(5,383)	(2,841)
Net deferred tax asset	705,046	701,689
Deferred tax asset nonadmitted	(705,046)	(701,689)
Net admitted deferred tax asset	\$ —	—
(Increase) decrease in nonadmitted asset	\$ (3,357)	58,279

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, 2007 and 2006 were as follows:

	<b>2007</b>	<b>2006</b>
	(In thousands)	
Deferred tax assets:		
Loss carryforwards	\$ 592,135	563,767
Investments	41,693	37,546
Receivables	27,365	41,545
Accrued liabilities	19,447	24,064
Reserves	9,090	15,060
Section 197 intangibles	7,953	9,011
Other	12,746	13,537
Total deferred tax assets	710,429	704,530
Nonadmitted deferred tax assets	(705,046)	(701,689)
Admitted deferred tax assets	5,383	2,841
Deferred tax liabilities:		
Investments	(4,547)	(1,240)
Salvage and subrogation	(836)	(1,601)
Total deferred tax liabilities	(5,383)	(2,841)
Net admitted deferred tax asset	\$ —	—

**LUMBERMENS MUTUAL CASUALTY COMPANY**

Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

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The change in net deferred income taxes as of December 31, 2007 and 2006 comprised the following:

	<b>2007</b>	<b>2006</b>	<b>Change</b>
	(in thousands)		
Total deferred tax assets	\$ 710,429	704,530	5,899
Total deferred tax liabilities	(5,383)	(2,841)	(2,542)
Net deferred tax asset	\$ 705,046	701,689	3,357
Increase in net deferred income tax in surplus			\$ 3,357

At December 31, 2007, the Company had \$1.7 billion of operating loss carryforward, which originated and expires as follows:

<b>Origination year</b>	<b>Expiration year</b>	<b>Amount</b>
		(In thousands)
2000	2020	\$ 179,079
2001	2021	404,748
2002	2022	38,885
2003	2023	211,668
2004	2024	399,689
2005	2025	177,705
2006	2026	178,657
2007	2027	76,744
		\$ 1,667,175

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 2003 are closed for Internal Revenue Service (IRS) examination. The Company is not currently under examination by the IRS for any open tax years.

The Company files as part of a consolidated federal income tax return, which includes the Company as the common parent corporation and includes or included the following affiliated entities: American Motorists Insurance Company (AMICO), AMICO Realty Corporation (AMICO Realty), American Underwriting Corporation, Kemper Casualty Insurance Company (KCIC), Kemper International Corporation, Kemper Insurance Company of Texas, Kemper Realty Corporation, Kemper Technology Services, Inc., LGA-2, Inc., LGA-3, Inc., LGA-17, Inc., Lou Jones & Associates, Nereus Holdings, Inc., Point & Quote Insurance Services, Inc., Specialty Surplus Insurance Company, and Universal Bonding Holding Company, Inc.

## LUMBERMENS MUTUAL CASUALTY COMPANY

Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2007 and 2006

### (7) 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 services for other affiliated companies are based on actual expenses incurred in accordance with their use of the services and facilities.

#### **Affiliate Support for D&O Insurance**

In connection with a portion of the Company's and its affiliates' corporate insurance program, a wholly owned subsidiary of the Company, Specialty Surplus Insurance Company (SSIC), extended a reinsurance agreement, effective December 31, 2007 for a three-year period (2008, 2009, and 2010), facultatively reinsuring a corresponding three-year A-side management liability policy issued by an unaffiliated third party to the Company and AMM. SSIC maintains in a trust the \$15.0 million reinsurance premium it received from its affiliates for the benefit of the third-party insurer to collateralize the reinsurance obligation. The Company's income, surplus, and liquidity were unchanged by the extension except to the extent of a \$275 thousand administrative fee paid to the unaffiliated third party in 2008.

### (8) Employee Benefit Plans

#### ***Retention Plans***

The Company's workforce decreased to 261 employees at December 31, 2007, from 274 employees at December 31, 2006. To help stabilize the workforce, the Company maintains a retention plan providing for scheduled quarterly payments. The retention payments for 2007 and 2006 totaled \$5.0 million and \$4.7 million, respectively.

As an additional retention plan, the Company maintains an employee severance program which provides a maximum benefit of up to one year of salary depending on the employee's level and service time with the Company. Severance liabilities are not reflected on the Company's balance sheets until a decision is reached that a specific employee or group of employees is to be terminated without cause. Severance payments in 2007 and 2006 totaled \$0.3 million and \$0.8 million, respectively, and severance liabilities recorded at both December 31, 2007 and 2006 totaled \$0.5 million. In 2006, with the approval of the Division of Insurance, the Company made a one-time deposit of \$4.75 million in a long-term retention trust to secure its contingent severance obligations.

#### ***Incentive Plans***

The Company has maintained since 2004 an annual incentive plan linked to successfully achieving or exceeding certain targets as anticipated from time to time in the Company's run-off plan (the Short-Term Plan). The Short-Term Plan payments totaled \$8.8 million in 2007 and \$3.6 million in 2006. In addition to the Short-Term Plan, the Company, with final approval from the Division in 2006, established a long-term incentive plan linked to the successful maintenance of the commercial run-off as anticipated in the Company's run-off plan. At December 31, 2007, the Company has accrued approximately \$4.2 million under the incentive plans for payments to be made in 2008.

#### ***Deferred Compensation***

The Company carried deferred compensation liabilities of approximately \$0.3 million and \$1.3 million at December 31, 2007 and 2006, respectively.

## LUMBERMENS MUTUAL CASUALTY COMPANY

Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2007 and 2006

### *Other Benefit Plans*

The Kemper Benefit Plan (the Plan) consists of the health, dental, life, long-term disability, and accident benefits. The Plan is sponsored by the Company and provides benefits covering eligible employees, and eligible dependents of 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 and its employees make specified monthly contributions for the coverages selected. The contribution rates for both the employer and employee are determined annually by the Company. In accordance with provisions of the Plan, eligible employees, and eligible dependents of employees of the Company who incur claims are entitled to receive benefits under the Plan.

Employer and employee contributions for 2007 were \$2.4 million and \$1.4 million, respectively, while 2006 employer and employee contributions were \$2.2 million and \$1.2 million, respectively. For 2007 and 2006, total benefit payments under the Plan were \$3.8 million and \$3.4 million, respectively.

The Company also provides disability benefits to employees on long-term disability. The related obligation was \$1.1 million and \$1.8 million as of December 31, 2007 and 2006, respectively.

### **(9) Risk-Based Capital**

The NAIC utilizes a RBC formula intended for regulatory monitoring of property-casualty insurers. Under RBC rules in Illinois, state regulators may mandate remedial action for inadequately capitalized companies. The focus of the capital rules is a risk-based formula that applies prescribed factors to various risk elements in an insurer's business and investments to develop a minimum capital requirement designed to be proportional to the amount of risk assumed by the insurer. For the last four years (and for 2007 and 2006 excluding the benefit of prescribed and permitted accounting practices), the Company's level of surplus has been at the "mandatory control level" under the RBC rules. At this level, the Division of Insurance has substantial authority to exercise control over the Company and its affiliates. The Division 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 has discretion to allow the continued run-off.

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

Risks and uncertainties involved in implementing the run-off plan include the need to achieve significant policy buybacks and novations (the volume of which has declined in each of the last three years as overall

## LUMBERMENS MUTUAL CASUALTY COMPANY

### Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2007 and 2006

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

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

The Company has also entered into consent agreements with certain other states under which the Company agreed to cease writing business in those jurisdictions. In addition, in 2005, the Company agreed to its license being suspended in Tennessee, with the Company permitted to maintain its licenses but not permitted to write any new business. In 2006, the Company appealed its license suspension in the State of North Carolina as not being in the best interests of the Company's policyholders or claimants. In 2007, the Florida Office of Insurance Regulation notified the Company that its license (certificate of authority to conduct insurance business in Florida) expired by operation of law due to the prior suspension of the license in 2004 (after the Company had entered run-off status). The license is not required for the Company to continue to handle claims, or to liquidate assets or liabilities, from its prior operations.

#### **(10) Commitments, Contingent Liabilities, Liquidity, and Other Contingencies**

##### ***Ratings***

In early 2005, at the Company's request, A.M. Best ceased rating the Company. As of December 31, 2004, A.M. Best had assigned the Company a D (poor) rating. In June and July 2003, respectively, Moody's Investor Services and Standard & Poor's 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 of business or retain existing policyholders. In the first half of 2003, as a result of a combination of various business factors including the ratings downgrades and the Company's deteriorating statutory surplus, the Company substantially ceased underwriting activities other than as required by contract or law. Since July 2003, the Company and most of its affiliates have been subject to Corrective Orders by the Division of Insurance not to write any new or renewal business except as necessary to comply with contractual commitments or as expressly permitted by the Division of Insurance.

## LUMBERMENS MUTUAL CASUALTY COMPANY

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### *Liquidity*

As a run-off company, the Company's cash outflows exceed its cash inflows. There are a number of factors that could adversely affect the Company's liquidity position and its adequacy. Accelerated claim payments or imposition of requirements to secure future maturing obligations by court order or otherwise, deterioration of reinsurance collections, increases in operating expenses, and other unanticipated strains on liquidity could cause the Company to have insufficient liquid and unencumbered assets to continue to pay obligations as they become due. As liquidity declines, there can be no assurance that formal proceedings would not be initiated by the Division of Insurance significantly before the Company's projected liquidity would reach \$0. The Company's reported \$645.2 million of unencumbered assets at December 31, 2007 shown in the table under *Securities on Deposit and Encumbered Assets* below in this note includes \$99.3 million that, although unencumbered, are not necessarily immediately available funds, as this amount consists of such items as assets held in subsidiaries and working capital requirements.

The Company is addressing potential future liquidity challenges by taking a number of actions, including, but not limited to, seeking the release of what the Company believes is excess collateral held by various governmental agencies, merging or dissolving subsidiaries, converting illiquid assets to liquid assets, negotiating liquidity-enhancing novations, continuing to collect on its reinsurance, and evaluating the possibility of, and implementing, certain reinsurance commutations. The Company's run-off plan anticipates that portions of state deposits will continue to be released as claims are paid and the remaining reserves are reduced. There are significant uncertainties with respect to the legal and regulatory issues related to releases of encumbered assets.

Also to supplement liquidity, the Company during 2006 merged or dissolved three insurance company subsidiaries, and the Company during 2007 converted its Texas Lloyds affiliate into a stock subsidiary, sold its Belgium subsidiary, and dissolved six other non-insurance company subsidiaries (See note 3). The liquidity benefits from these actions include minor reductions in expenses from not needing to maintain corporate entities and, following regulatory approvals, allowed certain dividends from subsidiaries to the Company.

Prompt collection of reinsurance recoverables is a primary driver of the Company's liquidity at all times. Reinsurance provided approximately \$446 million of liquidity to the Kemper Insurance Companies during 2007 and approximately \$800 million during 2006. The Company's gross reinsurance recoverables totaled \$1.3 billion at December 31, 2007, down from \$1.6 billion at December 31, 2006.

The Company recognizes the general principle that commutations of ceded reinsurance, if executed, could substantially increase liquidity. Reinsurance commutations, however, would also be anticipated both to decrease surplus, since commutations involve present value or other discounting in return for cash, and to increase the risks of any future adverse development, since the reinsurers would no longer share in such developments. Management remains focused on managing liquidity, surplus, and the balance between them.

## LUMBERMENS MUTUAL CASUALTY COMPANY

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### *Securities on Deposit and Encumbered Assets*

Of the Company's cash and invested assets at December 31, 2007, \$722.0 million are encumbered by being on deposit or held in trust or escrow arrangements, compared with \$908.3 million one year earlier, as shown in the following table:

	<b>2007</b>	<b>2006</b>
	(In thousands)	
Special deposits/encumbered assets:		
State deposits	\$ 411,310	560,320
NICO Cut-Through Collateral	226,631	246,866
NICO Appeal Bond Collateral	20,581	26,210
Canada deposits	33,700	44,097
All other	29,800	30,853
	722,022	908,346
Unencumbered assets:		
Cash and bonds	576,583	616,997
Affiliate common stock	59,677	85,535
Other assets	8,940	35,328
	645,200	737,860
Cash and invested assets	\$ 1,367,222	1,646,206

The Company received releases of encumbered assets from states totaling \$149.0 million and \$132.9 million during 2007 and 2006, respectively. Releases reflect lower levels of liabilities of the Company that the state deposits have historically secured. There can be no assurance that there will be additional releases.

Where required to post court bonds, including supersedes or appeal bonds, or when using surety bonds to satisfy state deposit requirements, the Company, due to its financial condition, has had to post cash or other security totaling 100% of the bond. At December 31, 2007 and 2006, the Company had pledged invested and other assets of \$21.8 million and \$27.5 million, respectively, for such bonds, most of which are issued by NICO. (See note 5.)

Of the Company's invested assets at December 31, 2007, \$226.6 million provide collateral for Berkshire affiliates related to the NICO cut-through agreements. This amount reflects a \$20.2 million reduction from a year earlier. Of the cut-through encumbered assets at December 31, 2007, \$126.6 million are subject to release to the Company annually as claim payments are made on policies to which the NICO cut-through agreements are attached so long as NICO is not required to pay any amounts on Kemper policies that have the benefit of cut-through agreements.

The Company is contingently liable to provide up to an estimated additional \$15.8 million in collateral due to ratings triggers in reinsurance agreements where it is a reinsurer. Of this amount, \$4.9 million has been funded with assets of an unrelated third party, Alea Bermuda Ltd. (Alea), for business where the Company from late 1999 to year-end 2001 fronted assumed reinsurance contracts in the U.S. for Alea. Alea's

## LUMBERMENS MUTUAL CASUALTY COMPANY

### Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

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insurance ratings fell to below the “A” level in 2005, and Alea and its affiliates subsequently went into run-off status and have been undergoing related operational changes. Alea’s reinsurance obligations to the Company for the fronted liabilities are secured by collateral trust assets of Alea in the amount of \$96.2 million at December 31, 2007. Alea also has handled claims on behalf of the Company since 1999 on both the fronted liabilities and, at December 31, 2007, \$38.8 million of other assumed reinsurance liabilities written by the Company from 1997 through 1999.

In addition to the encumbrances applicable to the Company’s cash and invested assets which are reflected in the preceding table, the Company has certain reinsurance related assets which have been pledged or otherwise encumbered. Such encumbered assets include funds held by or deposited with reinsured companies (\$11.6 million at December 31, 2007), certain reinsurance recoverables that serve as additional security for the NICO cut-through (see note 5), and reinsurance recoverables for claims paid and to be paid by certain Markel Corporation subsidiaries related to business written by companies that the Company acquired from Markel in 1998 and 1999 (\$2.6 million at December 31, 2007). In addition, one of the Company’s wholly owned subsidiaries, SSIC, which was a Markel subsidiary until January 2000, has granted to a Markel entity a security interest in SSIC’s reinsurance recoverables related to claims from before 2000 that Markel is responsible for handling and paying; SSIC’s related encumbered reinsurance assets totaled \$93.3 million at December 31, 2007.

#### ***Structured Settlements***

In limited circumstances to settle certain insurance claim liabilities, the Company from time to time since the late 1970’s purchased from various life insurance companies structured settlement annuities naming the settling claimants as payees. In many of those settlements, the Company has remained the owner of the respective annuity and contingently liable to the claimant, that is, liable for the periodic payments in the event of the default or insolvency of the life insurance company. In a limited number of these settlements, the Company’s purchase of annuities has resulted in a full release from the settling claimants without contingent liability. Where the Company’s purchase of annuities has not fully released the Company from contingent liability, the Company has calculated the present value (at a 4.2% discount rate) of future unpaid annuity installments. As shown in the following table, at December 31, 2007, the Company reports that its contingent liabilities for future unpaid annuity installments totaled \$365.0 million. Reflecting intercompany reinsurance arrangements, \$210.9 million of the Company’s \$365.0 million of contingent liability arises on settlements of claims on policies initially issued by AMM, AMICO, and KICT.

## LUMBERMENS MUTUAL CASUALTY COMPANY

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

<u>Carrier</u> <sup>(1)</sup>	<u>Location</u>	<u>LMC Reportable amounts</u> (in thousands)
Genworth Life and Annuity Company	Richmond, VA	\$ 74,056
Executive Life Insurance Company of New York <sup>(2)</sup>	New York, NY	36,579
Symetra Life Insurance Company	Bellevue, WA	32,723
The Manufacturers Life Insurance Company	Toronto, Canada	22,085
Life Insurance Company of North America	Bloomfield, CT	21,294
AIG Annuity Insurance Company	New York, NY	21,221
Genworth Life Insurance Company	Richmond, VA	16,750
Fidelity Life Association	Oak Brook, IL	15,594
Metropolitan Life Insurance Company	Long Island City, NY	14,129
Monumental Life Insurance Company	Cedar Rapids, IA	12,432
Aviva Life Insurance Company	Quincy, MA	9,825
Presidential Life Insurance Company	Nyack, NY	8,047
Pacific Life Insurance Company	Newport Beach, CA	7,839
The Prudential Insurance Company of America	Newark, NJ	7,669
Midland National Life Insurance Company	Sioux Falls, SD	7,054
Transamerica Occidental Life Insurance Company	Cedar Rapids, IA	6,238
Protective Life Insurance Company	Birmingham, AL	5,533
The Lincoln National Life Insurance Company	Ft. Wayne, IN	4,705
Aurora National Life Assurance Company	Wethersfield, CT	3,566
Sun Life Assurance Company of Canada	Toronto, Canada	3,321
Allstate Life Insurance Company of New York	Northbrook, IL	3,265
New York Life Insurance Company	New York, NY	2,582
Allstate Life Insurance Company	Northbrook, IL	2,521
Metlife Insurance Company of Connecticut	Fort Wayne, IN	2,070
Transamerica Financial Life Insurance Company	Cedar Rapids, IA	1,911
Monarch Life Insurance Company <sup>(3)</sup>	Springfield, MA	1,824
United of Omaha Life Insurance Company	Omaha, NE	1,691
AIG Life Insurance Company	Houston, TX	1,682
The Canada Life Assurance Company	Toronto, Canada	1,665
American General Life Insurance Company	Houston, TX	1,544
All other		<u>13,632</u>
Total		<u>\$ 365,047</u>

<sup>(1)</sup> All of the life insurance companies listed in the preceding table are rated A- or better by A.M. Best, other than as follows: Presidential Life Insurance Company is rated B+; Executive Life Insurance Company of New York (ELNY) and Aurora National Life Assurance Company are not rated; and

## LUMBERMENS MUTUAL CASUALTY COMPANY

### Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2007 and 2006

Monarch Life Insurance Company (Monarch) is rated E, under supervision. In addition, all of the companies are licensed in the state of the Company's domicile, Illinois, other than ELNY.

- (2) ELNY was placed in rehabilitation under the supervision of the New York Liquidation Bureau in 1992. ELNY has continued to pay 100% on all its annuities since then; however, the extent of ELNY's ability to continue to pay its obligations as they become due is unknown. There is a reasonable possibility that a liability will be incurred, but the Company believes that an estimate of a liability currently cannot be made with available information.
- (3) Monarch was placed in rehabilitation under the supervision of the Insurance Commission of the Commonwealth of Massachusetts in June 1994 and has continued to pay 100% of its annuities. The Company's information regarding Monarch is limited to publicly available information, and on that basis, the Company is unable to conclude as to the extent of Monarch's ability to pay its obligations as they become due.

#### *Litigation*

In 1996 and 1997, the Company issued surplus notes in the aggregate principal amount of \$700.0 million (see note 11). The Company is required to seek the approval of the Director to make each and any semi-annual payments of interest on the surplus notes. Beginning in 2003, the Director has denied the Company's requests for payment of interest on the surplus notes. Following the nonpayment of interest in 2003, several lawsuits were filed in the Circuit Court of Cook County, Illinois by certain holders of surplus notes aggregating approximately \$368 million and naming, as defendants, the Company, various directors or former directors of the Company, and Kemper Commercial Insurance Company, a now dissolved subsidiary of the Company. One case was voluntarily dismissed by the plaintiff, and the other two were consolidated in 2004. The Company was not served with the consolidated amended complaint. This complaint alleged 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 complaint further alleged that the directors breached their fiduciary duties and committed corporate waste, and that the Company and Kemper Commercial Insurance Company engaged in a fraudulent conveyance. The complaint, among other things, sought a declaratory judgment of the parties' rights, an injunction against further asset sales, and monetary damages. In May 2006, the Circuit Court entered a stipulation and order whereby the lawsuit was dismissed without prejudice with leave to reinstate no earlier than October 2008.

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 balance sheets due to established liabilities and anticipated insurance and reinsurance recoverables, but there can be no assurance that such matters will not become material due to future developments, including any changes with respect to the financial condition of the Company.

## LUMBERMENS MUTUAL CASUALTY COMPANY

Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2007 and 2006

### *Other Items*

#### **Lease Commitments**

The Company leases office space and equipment under various non-cancelable operating lease agreements. Rental expense for 2007 and 2006 was \$4.3 million and \$4.2 million, respectively.

At December 31, 2007, the total aggregate minimum rental payments on operating leases is \$6.3 million, and future minimum rental payments for the next three years are as follows:

	<b>Minimum payments</b>
	(In thousands)
Year ending December 31:	
2008	\$ 3,505
2009	2,296
2010	474
2011 and thereafter	—
	<u>\$ 6,275</u>

Certain rental commitments have renewal options extending through the year 2010. Some of these renewals are subject to adjustments in future periods.

#### **Assessments**

The Company is liable for guaranty fund assessments related to certain unaffiliated companies that have become insolvent during the years 2007 and prior. The Company's statutory balance sheets includes 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. The Company is also 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, 2007. The Company has accrued a liability of \$2.7 million for guaranty fund assessments as of December 31, 2007, compared with \$3.2 million at December 31, 2006. In addition, the Company has accrued a liability for premium and loss based assessments of \$34.4 million as of December 31, 2007, compared with \$39.0 million at December 31, 2006.

#### **SeaBright Insurance Company**

Following the 2003 sale by the Company of 100% of the capital stock of Kemper Employers Insurance Company (KEIC) to SeaBright Insurance Holdings, Inc., the purchaser renamed KEIC as SeaBright Insurance Company. As part of the 2003 sale transaction, the Company provided a stop loss reinsurance agreement to KEIC, now SeaBright, and collateralized that reinsurance with a collateral trust. The Company's assets in that collateral trust totaled approximately \$3.5 million and \$5.2 million at December 31, 2007 and 2006, respectively; the decrease in 2007 was due to a release of assets reflecting revised

## LUMBERMENS MUTUAL CASUALTY COMPANY

### Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2007 and 2006

actuarial calculations of the secured liabilities, in accordance with the existing 2003 agreements. SeaBright also provides, for agreed fees, certain claim handling services with respect to approximately 500 claims (accounting for \$24.8 million of net liabilities at December 31, 2007) under policies issued by the Company's Eagle insurance operations prior to the 2003 sale of KEIC. (The Eagle operations merged into the Company's AMICO subsidiary in 2004.)

#### **Broadspire**

In July 2003, the Company sold its NATLSCO, Inc. subsidiary and related claim service operations (together subsequently renamed Broadspire). Certain purchase price adjustment provisions from the 2003 sale agreement resulted in a \$3.7 million adverse impact to the Company's surplus in 2006.

The 2003 sales agreement with Broadspire also provided for certain contingent consideration (earn-out) based on the revenue and net income of the sold business for a four-year period beginning January 1, 2004 (the Earn-out Period). The sales agreement required the acceleration and payment of remaining earn-out if Broadspire sold assets of NATLSCO during the Earn-out Period. In 2006, Broadspire paid the Company \$354 thousand as an adjustment to the 2004 earn-out. In another arbitration proceeding, the Company is disputing the accuracy of the amounts paid by Broadspire for the earn-out in both years. In addition, in a series of three transactions between December 2004 and November 2006, Broadspire disposed of NATLSCO and certain of its assets. In 2006, Broadspire paid \$3.6 million as a buy-out of the remaining earn-out (due to the asset dispositions) that Broadspire admits is due under the sales agreement. The Company is disputing the accuracy of Broadspire's calculations. The Company has recorded the payments received to date (benefiting the Company's surplus and liquidity to that extent in 2006). In accordance with the Manual, the Company is not carrying an admitted asset for any future recoveries from Broadspire.

Also in connection with the 2003 transaction, the Company entered into a long-term claim administration agreement with Broadspire for the servicing of most of the Company's existing workers' compensation, general liability, and employer liability claims. The Company paid approximately \$95.3 million in advance for the future servicing of such claims, of which \$56.8 million was placed in trust by Broadspire to be drawn down monthly over an eight-year period beginning January 1, 2004. The Company was not obligated to add any assets to the trust. At December 31, 2007, the amount remaining in this trust was \$12.3 million. The Company receives the interest on Broadspire's trust assets. In accordance with a prescribed accounting practice more fully described in note 1, the Company reflects as an admitted asset the remaining prepaid amount for claim handling services; that amount has declined to approximately \$17.4 million and \$23.2 million as of December 31, 2007 and 2006, respectively.

#### **Kemper Auto & Home: Renewal Rights and Cut-Through**

Following the sale in 2002 of the Company's and its affiliates' U.S. personal lines business to Unitrin, Inc. (Unitrin) and its subsidiaries including Trinity Universal Insurance Company (Trinity), Unitrin operates this business under the name Kemper Auto & Home. Unitrin has a 100-year license to use the Kemper name in the acquired personal lines businesses. Unitrin did not acquire then in-force or previously issued policies nor 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. Pursuant to the 2002 sale agreement, Unitrin continues to monitor and service the Company's run-off of its retained personal lines policies. Through early 2005, the Company and certain of its affiliates fronted for Trinity, at Trinity's expense, personal lines policies in states where Trinity (or an

## LUMBERMENS MUTUAL CASUALTY COMPANY

### Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2007 and 2006

affiliate) was seeking licenses and making form and rate filings necessary for the issuance of policies in place of renewals of policies originally issued by the Company or its affiliates. As of December 31, 2007 and 2006, respectively, approximately \$13.1 million and \$27.0 million of the Company's gross liabilities were from fronted policies that are 100% reinsured by (ceded to) Unitrin. Not only are these reinsured policies fully administered (including claims handled) by Unitrin subsidiaries, such policies are covered by a cut-through provision allowing the insureds to seek direct recourse to a Unitrin subsidiary in the event of any insolvency of the Company.

#### (11) Surplus

##### *Surplus Notes*

The Company had the following surplus notes issued and outstanding as of December 31, 2007:

<u>Description</u>	<u>Interest rate</u>	<u>Maturity date</u>	<u>Par or face value</u>	<u>Carrying value</u>	<u>Interest paid in 2007 and 2006</u>	<u>Inception to-date interest paid</u>	<u>Accrued interest at December 31, 2007</u>
					(In thousands)		
30-Year Notes	9.15%	07/01/2026	\$ 400,000	399,123	—	238,612	—
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	—
			<u>\$ 700,000</u>	<u>698,356</u>	<u>—</u>	<u>364,558</u>	<u>—</u>

The unamortized discount at issuance has been charged directly against surplus. The unamortized discount amounted to \$1.6 million at December 31, 2007 and 2006.

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. As it relates to the surplus notes, 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, to 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. The Director has denied the Company's 2007 and 2006 requests for payment of interest on the surplus notes due on June 1 and July 1, and on December 1, and January 1. All payments of interest scheduled since January 1, 2003 have not been paid due to disapprovals by the Director based on the Company's financial condition. The cumulative amount of interest that was scheduled to be paid but is unpaid, plus the amount otherwise accruing in 2007 for which scheduled interest payment dates have not yet arrived, totaled \$310.3 million as of December 31,

## LUMBERMENS MUTUAL CASUALTY COMPANY

Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2007 and 2006

2007. In accordance with statutory accounting principles, this total amount is not reflected as a liability on the Company's statutory balance sheets.

### **(12) 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:

Cash equivalents, short-term investments, bonds, and unaffiliated stocks: Fair values for cash equivalents, short-term investments, bonds, and unaffiliated stocks have been determined using prices provided by the SVO, or when such values are not available from the SVO, using prices from independent pricing services, prices provided by brokers, or prices determined in good faith by the Company's engaged portfolio manager.

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

Notes receivable: The fair value of notes receivable is determined in good faith by the Company's engaged portfolio manager based on the estimated timing of cash receipts and a discount rate appropriate for the borrower's credit worthiness.

**LUMBERMENS MUTUAL CASUALTY COMPANY**

Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2007 and 2006

The statement values and estimated fair values of the Company's financial instruments at December 31, 2007 and 2006 were as follows:

	2007		2006	
	Statement value	Estimated fair value	Statement value	Estimated fair value
	(In thousands)			
Financial instruments recorded as assets:				
Bonds	\$ 1,142,843	1,099,659	1,394,364	1,350,119
Cash, cash equivalents, and short-term investments	155,762	155,772	130,979	130,953
Unaffiliated stocks	2,769	3,374	2,257	2,784
Notes receivable	799	1,564	840	1,857

## LUMBERMENS MUTUAL CASUALTY COMPANY

## Supplemental Schedule of Investments

December 31, 2007

The following is a summary of certain financial data as of and for the year ended December 31, 2007 for purposes of complying with the Manual. Such data is included in the Company's 2007 Annual Statement as filed with the Division of Insurance.

Investment categories	Gross investment holdings		Admitted assets as reported in the annual statement	
	Amount	Percentage	Amount	Percentage
Bonds:				
U.S. Treasury securities	\$ 171,342,119	12.568%	\$ 171,342,119	12.532%
U.S. government agency obligations (excluding mortgage-backed securities):				
Issued by U.S. government sponsored agencies	66,113,426	4.849	66,113,426	4.835
Foreign government (including Canada, excluding mortgage-backed securities)	2,225,636	0.163	2,225,636	0.163
Securities issued by states, territories, and possessions and political subdivisions in the U.S.:				
States, territories and possessions general obligations	638,432	0.047	638,432	0.047
Revenue and assessment obligations	29,307,213	2.150	29,307,213	2.144
Mortgage-backed securities (includes residential and commercial MBS):				
Pass-through securities:				
Issued or guaranteed by GNMA	10,726	0.001	10,726	0.001
Issued or guaranteed by FNMA and FHLMC	16,535,135	1.213	16,535,135	1.209
CMOs and REMICs:				
Issued or guaranteed by GNMA, FNMA, FHLMC, or VA	134,073,578	9.834	134,073,578	9.806
All other	121,332,217	8.900	121,332,217	8.874
Other debt and other fixed income securities (excluding short-term):				
Unaffiliated domestic securities (includes credit tenant loans rated by the SVO)	599,607,693	43.981	599,607,693	43.856
Unaffiliated foreign securities	2,455,367	0.180	2,455,367	0.180

## LUMBERMENS MUTUAL CASUALTY COMPANY

## Supplemental Schedule of Investments

December 31, 2007

Investment categories	Gross investment holdings		Admitted assets as reported in the annual statement	
	Amount	Percentage	Amount	Percentage
Equity interests:				
Publicly traded equity securities (excluding preferred stocks):				
Unaffiliated	\$ 113,981	0.008%	\$ 113,981	0.008%
Other equity securities:				
Affiliated (a)	55,782,567	4.092	59,677,331	4.365
Unaffiliated	2,655,199	0.195	2,655,199	0.194
Other equity interests including tangible personal property under lease:				
Affiliated	5,315,221	0.390	5,315,221	0.389
Unaffiliated	56,898	0.004	56,898	0.004
Cash, cash equivalents, and short-term investments	155,761,516	11.425	155,761,516	11.393
Total invested assets	\$ 1,363,326,924	100.000%	\$ 1,367,221,688	100.000%

- (a) Admitted assets differ from Manual basis due to an accounting allowance from the Division of Insurance. Please see note 1 to the 2007 audited statutory financial statements for further information.

See accompanying independent auditors' report.

## LUMBERMENS MUTUAL CASUALTY COMPANY

## Supplemental Schedule of Investment Risks Interrogatories

December 31, 2007

The following interrogatories as of December 31, 2007 and for the year then ended are for the purpose of complying with the Manual.

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

- Reporting entity's total admitted assets as reported on page 2 of the annual statement: \$1,684,247,514.
- Ten largest exposures to a single issuer/borrower/investment:

Issuer	Description of exposure	Amount	Percentage of total admitted assets
1. Berkshire Hathaway Inc	Bond - Cat. 2.1	\$ 247,211,559	14.7%
2. Dreyfus Cash Mgmt CL A Fd	Class 1 MMF - Cat. 8	92,177,386	5.5
3. Canadian Government	CE & ST Bond - Cat. 8 & Bond - Cat. 1.3	33,712,064	2.0
4. General Electric Cap Corp	Bond - Cat. 2.1	28,816,571	1.7
5. AMXCA 2003-3 A - Asset-Backed	Bond - Cat. 2.1	25,009,345	1.5
6. FHR 2660 ML - Mtg Multi-Class	Bond - Cat. 1.521	23,314,495	1.4
7. American Motorists Ins Co	Affiliate Common - Cat. 3.41	23,201,091	1.4
8. Dallas-Fort Worth Tex Indl Arpt	Bond - Cat. 1.43	23,174,261	1.4
9. CHAIT 2005-A5 - Asset-Backed	Bond - Cat. 2.1	22,345,930	1.3
10. FHR 2654 OY - Mtg Multi-Class	Bond - Cat. 1.521	18,393,816	1.1

- 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	\$ 1,270,489,167	75.4%	P/RP-1	\$ —	—%
NAIC-2	17,105,282	1.0	P/RP-2	—	—
NAIC-3	—	—	P/RP-3	—	—
NAIC-4	—	—	P/RP-4	—	—
NAIC-5	—	—	P/RP-5	—	—
NAIC-6	2,455,367	0.1	P/RP-6	—	—

**LUMBERMENS MUTUAL CASUALTY COMPANY**  
 Supplemental Schedule of Investment Risks Interrogatories  
 December 31, 2007

4. Assets held in foreign investments:
- |    |  |              |   |
|----|--|--------------|---|
| 1. | Are assets held in foreign investments less than 2.5% of the reporting entity's total admitted assets? |              | Yes <input checked="" type="checkbox"/> No <input type="checkbox"/> |
| 2. | Total admitted assets held in foreign investments  | \$ 4,605,805 | 0.3%  |
| 3. | Foreign-currency-denominated investments   | —            | —%  |
| 4. | Insurance liabilities denominated in that same foreign currency  | —            | —%  |

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

5. Aggregate foreign investment exposure categorized by NAIC sovereign rating:  
 Not applicable.
6. Two largest foreign investment exposures in a single country, categorized by NAIC sovereign rating:  
 Not applicable.
7. Aggregate unhedged foreign currency exposure:  
 Not applicable.
8. Aggregate unhedged foreign currency exposure categorized by the country's NAIC sovereign rating:  
 Not applicable.
9. Two largest unhedged foreign currency exposures to a single country, categorized by the country's NAIC sovereign rating:  
 Not applicable.
10. Ten largest nonsovereign (i.e., nongovernmental) foreign issues:  
 Not applicable.
11. Amounts and percentages of the reporting entity's total admitted assets held in Canadian investments and unhedged Canadian currency exposure.
- Are assets held in Canadian investments less than 2.5% of the reporting entity's total admitted assets?  
 Yes  No

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

## LUMBERMENS MUTUAL CASUALTY COMPANY

## Supplemental Schedule of Investment Risks Interrogatories

December 31, 2007

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

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

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

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

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

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

Name of issuer	Amount	Percentage of total admitted assets
1. American Motorists Insurance Company	\$ 23,201,091	1.4%
2. Specialty Surplus Insurance Company	17,333,693	1.0
3. Kemper Casualty Insurance Company	12,617,468	0.7
4. Delta Wetlands ADC Joint Venture	5,315,221	0.3
5. Kemper Insurance Company of Texas	2,630,315	0.2
6. LGA-17, Inc	1,962,744	0.1
7. Kemper International Corporation	1,932,020	0.1
8. Assurex Dev Corporation	1,927,408	0.1
9. Shorebank Corporation	727,791	—
10. EBIX, Inc.	80,436	—

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

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

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

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

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

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

**LUMBERMENS MUTUAL CASUALTY COMPANY**  
Supplemental Schedule of Investment Risks Interrogatories  
December 31, 2007

16. Amounts and percentages of the reporting entity's total admitted assets held in mortgage loans.  
Are mortgage loans reported in Schedule B less than 2.5% of the reporting entity's total admitted assets?  
Yes  No   
If response is yes, responses are not required for the remainder of interrogatory 16 and interrogatory 17.
17. Not applicable.
18. Amounts and percentages of the reporting entity's total admitted assets held in each of the five largest investments in real estate.  
Are assets held in real estate reported in Schedule A less than 2.5% of the reporting entity's total admitted assets?  
Yes  No   
If response is yes, responses are not required for the remainder of interrogatory 18.
19. Report aggregate amounts and percentages of the reporting entity's total admitted assets held in investments in mezzanine real estate loans.  
Are assets held in investments in mezzanine real estate loans less than 2.5% of the reporting entity's total admitted assets?  
Yes  No   
If response is yes, responses are not required for the remainder of interrogatory 19.
20. Amounts and percentages of the reporting entity's total admitted assets subject to securities lending agreements, repurchase and reverse repurchase agreements, and dollar repurchase and dollar reverse repurchase agreements:  
None.
21. Amounts and percentages of the reporting entity's total admitted assets for warrants not attached to other financial instruments, options, caps, and floors:  
None.
22. Amounts and percentages of the reporting entity's total admitted assets of potential exposure for collars, swaps, and forwards:  
None.
23. Amounts and percentages of the reporting entity's total admitted assets of potential exposure for futures contracts:  
None.

See accompanying independent auditors' report.

**LUMBERMENS MUTUAL CASUALTY COMPANY**

Supplemental Schedule of Reinsurance Risk Interrogatories

December 31, 2007

1. The reporting entity does have risks reinsured under quota-share reinsurance contracts with other entities that include a provision that would limit the reinsurer's losses below the stated quota share percentage (e.g., a deductible, a loss ratio corridor, a loss cap, an aggregate limit, or any similar provisions). The amount of reinsurance credit taken on the two contracts containing such provisions reflects the reduction in quota-share coverage caused by the limiting provisions.
2. The reporting entity ceded risks under a reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during 2007: (i) it recorded a positive or negative underwriting result greater than 5% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 5% of prior year-end surplus as regards policyholders; (ii) it accounted for that contract as reinsurance and not as a deposit; and (iii) the contracts contain one or more of the following features or other features that would have similar results:
  - a. A contract term longer than two years and the contract is noncancelable by the reporting entity during the contract term;
  - b. A limited or conditional cancelation provision under which cancelation triggers an obligation by the reporting entity, or an affiliate of the reporting entity, to enter into a new reinsurance contract with the reinsurer, or an affiliate of the reinsurer;
  - c. Aggregate stop loss reinsurance coverage;
  - d. An unconditional or unilateral right by either party to commute the reinsurance contract, except for such provisions that are only triggered by a decline in the credit status of the other party;
  - e. A provision permitting reporting of losses, or payment of losses, less frequently than on a quarterly basis (unless there is no activity during the period); or
  - f. Payment schedule, accumulating retentions from multiple years or any features inherently designed to delay timing of the reimbursement to the ceding entity.

## LUMBERMENS MUTUAL CASUALTY COMPANY

## Supplemental Schedule of Reinsurance Risk Interrogatories

December 31, 2007

3. The following information is provided for contracts meeting the provisions of paragraph 2. above:
- a. A summary of the reinsurance contract terms and management's principal objectives in entering into the reinsurance contracts is presented below:

<b>Summary of Reinsurance Contract Terms</b>	<b>Related Management's Objectives</b>
<p>Contract #1 – Workers' Compensation and/or Employers Liability Excess of Loss Reinsurance Agreement – This contract, with a term from March 1, 2001 to March 1, 2002, provides excess of loss coverage of \$750,000 xs \$250,000 per occurrence for workers' compensation business. The total premium is dependent on loss experience. The aggregate limit is the lesser of 8.0% of Subject Net Written Premium or \$60 million. This contract is being reported pursuant to paragraph 2.d. above.</p>	<p>Traditional reinsurance capacity was not available at a premium that management deemed acceptable. Rather than retaining this layer of exposure, the Company reinsured it under a finite risk reinsurance agreement that combined elements of risk retention and risk transfer. This agreement effectively serves as a transition layer between the Company's net retention and traditional reinsurance coverage.</p>
<p>Contract #2 – Kemper Financial Insurance Solutions Variable Quota Share Reinsurance Agreement – This contract, with a term from December 1, 1999 through December 31, 2002, provides variable quota share reinsurance coverage. This contract is being reported pursuant to paragraph 2.a. above.</p>	<p>The Company purchased this contract in order to lock into perceived favorable terms over a multiple year period.</p>
<p>Contract #3 – Certificate of Facultative Casualty Reinsurance – This contract, with a term from August 1, 1999 through May 1, 2000, provides facultative workers' compensation reinsurance coverage. Part (A) covers the \$900,000 xs \$100,000 per occurrence exposure; Part B covers the exposure of the first \$100,000 per occurrence on an aggregate excess of loss basis, with a limit of \$15 million xs \$60 million aggregate retention. This contract is being reported pursuant to paragraph 2.c. above.</p>	<p>This contract is similar to many other traditional casualty facultative reinsurance certificates, which the Company has purchased in the traditional markets, covering per occurrence losses above a self-insured retention to protect against large losses. The significant difference in this contract is the inclusion of an aggregate stop loss element to protect against loss frequency in addition to traditional per occurrence coverage.</p>

## LUMBERMENS MUTUAL CASUALTY COMPANY

## Supplemental Schedule of Reinsurance Risk Interrogatories

December 31, 2007

- b. The aggregate financial statement impact gross of all such ceded reinsurance contracts on the statutory balance sheets is presented in the table below:

	<u>As reported</u>	<u>Reinsurance interrogatory effect</u> (In thousands)	<u>Restated without interrogatory reinsurance</u>
Year ended December 31, 2007:			
Assets	\$ 1,684,247	(74,847)	1,609,400
Liabilities	1,533,583	—	1,533,583
Surplus	150,664	(74,847)	75,817

4. During 2007, the reporting entity did not cede any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates), for which, during the period covered by the statement, it recorded a positive or negative underwriting result greater than 5% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 5% of prior year-end surplus as regards policyholders; excluding cessions to approved pooling arrangements or to captive insurance companies that are directly or indirectly controlling, controlled by, or under common control with (i) one or more unaffiliated policyholders of the reporting entity, or (ii) an association of which one or more unaffiliated policyholders of the reporting entity is a member, where:
- The written premium ceded to the reinsurer by the reporting entity or its affiliates represents fifty percent (50%) or more of the entire direct and assumed premium written by the reinsurer based on its most recently available financial statements; or
  - Twenty five percent (25%) or more of the written premium ceded to the reinsurer has been retroceded back to the reporting entity or its affiliates.
5. The reporting entity did not cede any risk under any reinsurance contract (or multiple contracts with the same reinsurer or its affiliates) during 2007 that was either:
- Accounted for as reinsurance (either prospective or retrospective) under SSAP and as a deposit under GAAP; or
  - Accounted for as reinsurance under GAAP and as a deposit under SSAP.

See accompanying independent auditors' report