LUMBERMENS MUTUAL CASUALTY COMPANY

Statutory Financial Statements and Schedules

December 31, 2004 and 2003

(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, 2004 and 2003 and the related statutory statements of operations, surplus, and cash flow for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes 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 includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

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

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of Lumbermens Mutual Casualty Company as of December 31, 2004 and 2003 or the results of its operations or its cash flows for the years then ended.

As more fully described in note 1 to the financial statements, the Company has identified certain errors related to the financial statements as of and for the year ended December 31, 2003, which have been reported as adjustments to the Company's surplus balance as of January 1, 2004 in accordance with Statement of Statutory Accounting Principles No. 3, Accounting Changes and Corrections of Errors.

KPMG LLP, a U.S. limited liability partnership, is the U.S.
member firm of KPMG International, a Swiss cooperative.

In our opinion, except for the effects on the 2003 financial statements of the errors as discussed in the preceding paragraph, the 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, 2004 and 2003, and the results of its operations and its cash flow for the years then ended, on the basis of accounting described in note 1.

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

The accompanying financial statements and supplementary information have been prepared assuming that the Company will continue as a going concern. As discussed in note 8 to the financial statements, the Division of Insurance imposes risk-based capital (RBC) requirements on insurance enterprises, including the Company. As of December 31, 2004, the Company's total adjusted capital, as reported in the 2004 Annual Statement filed with the Division of Insurance, is at the "mandatory control level," based on the RBC calculation required by the Division of Insurance. At this 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 this level under its control, except where, as is the case with the Company, such company is a property and casualty insurance company that is no longer writing new business and is running off its existing business, in which case the Director of the Division of Insurance has discretion to allow the continued run-off. As required, the Company in early 2003 proposed an RBC plan to address its RBC level. The Division of Insurance did not accept that plan. 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 a formal proceeding (receivership, rehabilitation, or other) at any time based on the Company's financial condition or operating performance. This risk of a proceeding would be further increased if the Company fails to execute successfully on its commercial run-off plan, if the Company fails to have sufficient liquid assets to meet its current obligations, or if the Company's reported statutory liabilities at any time would exceed its reported statutory assets as discussed in note 9 to the financial statements. The Division of Insurance has prescribed four accounting allowances under a Corrective Order which had an impact to policyholder surplus as of December 31, 2004 (see note 1). These accounting allowances differ from the National Association of Insurance Commissioners *Accounting Practices and Procedures Manual*. Such allowances and related policyholder surplus impact as of December 31, 2004 include the following:

(a) the discounting of loss reserves at 4.2% which resulted in an approximate increase to policyholder surplus of $577 million;

(b) the recognition of prepaid unallocated loss adjustment expenses which resulted in an approximate increase to policyholder surplus of $66 million;

(c) the replacement of the reinsurance Schedule F penalty with a credit-related bad debt allowance for uncollectible reinsurance which resulted in an approximate increase to policyholder surplus of $4 million; and

(d) the exclusion of the inter-company loan between the Company and its Singapore-based subsidiary from reported liabilities which resulted in an approximate increase to policyholder surplus of $5 million.

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, the Company has $1 billion of cash, short-term investments, and bonds on deposit with various government authorities and access to these amounts is subject to certain limitations.

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

Chicago, Illinois
August 19, 2005

LUMBERMENS MUTUAL CASUALTY COMPANY

Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2004 and 2003

Admitted Assets	2004	2003
Bonds	$ 1,583,567,169	1,673,351,862
Common stocks:		
Affiliated	96,246,251	260,674,361
Nonaffiliated	2,464,446	8,044,323
Preferred stocks	68,030	13,388,287
Mortgage loans on real estate	1,835,467	17,147,650
Real estate	34,965,386	40,855,789
Receivable for securities sold	2,405,798	3,287,363
Other invested assets	49,908,335	104,331,557
Cash and short-term investments	908,597,084	1,870,573,731
Total cash and invested assets	2,680,057,966	3,991,654,923
Reinsurance recoverable on paid losses and loss adjustment expenses	368,821,781	347,048,068
Agents' balances and uncollected premiums, net	197,709,648	310,077,131
Other admitted assets	136,849,284	203,265,013
Accrued retrospective premiums	107,837,509	157,532,537
Receivable from subsidiaries and affiliates	59,672,555	20,562,031
Amounts billed and receivable under high deductible policies	55,053,097	17,908,300
Reinsurance accounted for as a deposit	43,011,255	55,190,454
Equities and deposits in pools and associations	25,384,230	21,248,595
Advance to claim service provider	21,273,837	34,542,835
Funds held by or deposited with reinsured companies	16,561,259	19,418,156
Investment income due and accrued	15,581,714	14,827,958
Electronic data processing equipment	2,174,949	2,643,386
Insurance recoveries related to subsidiary	—	12,400,000
Rabbi Trust assets	—	21,622,250
Total admitted assets	$ 3,729,989,084	5,229,941,637

See accompanying notes to statutory financial statements.

Liabilities and Surplus	2004	2003
Liabilities:		
Losses and loss adjustment expenses	$ 2,819,780,013	3,823,969,795
Amounts withheld for others	252,686,725	289,257,547
Accounts payable and other liabilities	191,340,672	198,174,541
Reinsurance payable on paid losses and loss adjustment expenses	82,963,829	70,032,122
Ceded reinsurance premiums payable, net	57,359,770	6,844,721
Taxes, licenses and fees payable	57,331,110	35,849,671
Unearned premium reserve	43,108,518	111,595,492
Reinsurance funds held related to retroactive reinsurance	38,950,767	63,600,832
Other expenses payable	31,207,385	140,695,970
Federal and foreign income taxes	29,742,368	22,803,106
Remittances and items not allocated	29,297,811	69,487,545
Funds held under reinsurance treaties	17,114,358	34,078,748
Minimum pension liability	7,940,399	128,479,243
Net adjustments in assets and liabilities due to foreign exchange rates	5,519,042	12,602,499
Commissions payable	3,612,040	9,049,177
Payable for securities purchased	50,283	128
Dividends payable to policyholders	—	22,228,022
Retroactive reinsurance recoverable	—	(11,233,487)
Total liabilities	3,668,005,090	5,027,515,672
Guaranty fund	1,500,000	1,500,000
Surplus notes	698,355,598	698,355,598
Unassigned deficit	(637,871,604)	(497,429,633)
Total surplus	61,983,994	202,425,965
Total liabilities and surplus	$ 3,729,989,084	5,229,941,637

LUMBERMENS MUTUAL CASUALTY COMPANY

Statutory Statements of Operations

Years ended December 31, 2004 and 2003

	2004	2003
Underwriting:		
Premiums earned	$ 48,410,809	398,380,309
Losses and expenses incurred:		
Losses	(112,061,559)	(21,660,812)
Loss adjustment expenses	354,887,855	(25,391,745)
Underwriting expenses	77,766,222	346,081,925
Change in premium deficiency reserve	(3,428,954)	7,806,675
Total underwriting deductions	317,163,564	306,836,043
Net underwriting (loss) gain	(268,752,755)	91,544,266
Investment income:		
Net investment income	96,109,930	101,308,546
Net realized capital gains (losses) on investments	10,415,852	(397,630,117)
Net investment income (loss)	106,525,782	(296,321,571)
Other income:		
Retroactive gain (loss) on reinsurance	838,570	(470,605,704)
Other income	13,959,325	230,859,763
Other income (loss), net	14,797,895	(239,745,941)
Loss before dividends to policyholders and Federal and foreign income taxes	(147,429,078)	(444,523,246)
Dividends to policyholders benefit (expense)	26,131,358	(16,972,607)
Loss before Federal and foreign income taxes	(121,297,720)	(461,495,853)
Federal and foreign income tax (expense) benefit	(12,317,644)	27,168,635
Net loss	$ (133,615,364)	(434,327,218)

See accompanying notes to statutory financial statements.

LUMBERMENS MUTUAL CASUALTY COMPANY

Statutory Statements of Surplus

Years ended December 31, 2004 and 2003

	2004	2003
Surplus at beginning of year	$ 202,425,965	413,120,397
Correction of errors	(41,063,947)	—
Net loss	(133,615,364)	(434,327,218)
Other increases (decreases) in surplus:		
Net unrealized capital gains (losses)	(31,843,586)	191,087,433
Reinsurance allowance	(71,872,631)	(70,000,000)
Changes in:		
Nonadmitted assets	(91,871,938)	(101,450,633)
Minimum pension liability	107,057,685	31,790,452
Net deferred income taxes	115,524,244	84,473,107
Provision for reinsurance	—	84,106,200
Net adjustments due to foreign exchange rates	7,243,566	3,626,227
Net decrease in surplus	(140,441,971)	(210,694,432)
Surplus at end of year	$ 61,983,994	202,425,965

See accompanying notes to statutory financial statements.

LUMBERMENS MUTUAL CASUALTY COMPANY

Statutory Statements of Cash Flow

Years ended December 31, 2004 and 2003

	2004	2003
Cash from operations:		
Premiums collected, net of reinsurance	$ 119,692,496	(176,569,523)
Losses and loss adjustment expenses paid	(985,807,056)	328,566,582
Underwriting expenses paid	(511,098,446)	(438,290,399)
Cash used in underwriting	(1,377,213,006)	(286,293,340)
Net investment income	101,328,232	93,484,788
Other miscellaneous items	17,654,792	(251,607,137)
Dividends paid to policyholders	103,300,716	(56,349,208)
Federal and foreign income taxes recovered	(5,378,382)	21,470,303
Net cash used in operations	(1,160,307,648)	(479,294,594)
Proceeds from investments sold, matured or repaid:		
Bonds	691,743,477	986,642,235
Stocks, including affiliates	284,985,793	1,101,055,536
Mortgage loans	17,519,311	40,127,929
Real estate	—	36,337,105
Other invested assets	62,160,014	68,069,854
Net losses on short-term investments and other	(183,121)	(15,000,020)
Miscellaneous proceeds	939,777	—
Total investment proceeds	1,057,165,251	2,217,232,639
Cost of investments acquired:		
Bonds	(608,850,613)	(1,252,477,030)
Stocks, including affiliates	(121,346,233)	(257,074,538)
Mortgage loans	—	(4,349,116)
Real estate	—	(268,216)
Other invested assets	(27,206,632)	(68,408,229)
Miscellaneous applications	—	(153,659,310)
Total investments acquired	(757,403,478)	(1,736,236,439)
Net cash provided by investing	299,761,773	480,996,200
Cash from (used in) financing and miscellaneous sources:		
Other cash (used) provided	(101,430,772)	858,885,619
Net transfers from affiliates	—	(94,559,390)
Net cash (used in) provided by financing and miscellaneous sources	(101,430,772)	764,326,229
Net change in cash and short-term investments	(961,976,647)	766,027,835
Cash and short-term investments:		
Beginning of year	1,870,573,731	1,104,545,896
End of year	$ 908,597,084	1,870,573,731

See accompanying notes to statutory financial statements.

(1) Business Operations and Summary of Significant Accounting Policies

Basis of Presentation

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

As further discussed in notes 8 and 9, the Company's risk-based capital ratio, as filed, fell below the "authorized control level" as of December 31, 2002, and is at the "mandatory control level" at December 31, 2004 and 2003. The Company's risk-based capital ratio and the reduction of the Company's ratings have had and will continue to have a significant impact on the Company's operations.

Accounting Policies

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

- the costs related to acquiring business are charged to income when incurred rather than deferred and amortized over the life of the related insurance policy;
- investments in bonds are generally carried at amortized cost, regardless of the planned level of portfolio activity;
- assets are included in the statutory statements of admitted assets, liabilities, and surplus (the statutory balance sheet) at admitted asset value and nonadmitted assets are excluded through a charge against surplus;
- majority owned subsidiaries are carried under the equity method, are not consolidated and adjustments reflecting the equity in earnings of affiliated companies are credited or charged directly to surplus as net unrealized capital gains or losses rather than being recorded through income;
- surplus notes are reflected as a component of surplus rather than as a liability, and interest on such notes is not recorded as a liability or expense until payment has been approved by the Division of Insurance;
- deferred Federal income taxes do not completely provide for the temporary differences between the carrying value of assets and liabilities and their tax bases and are recorded directly to surplus;
- the costs of providing pension benefits and postretirement benefits other than pensions are calculated without regard to active nonvested employees;
- ceded reinsurance balances are netted against direct and assumed balances on the statutory balance sheet rather than shown gross;

- a provision is made through a charge to surplus for unearned premium and losses recoverable in excess of appropriate collateral, on business reinsured with companies not authorized by license in Illinois, and for certain overdue reinsurance balances;
- loss and loss adjustment expense reserves are discounted using discount rates prescribed by the Division of Insurance;
- dividends to policyholders are expensed at the earlier of payment or declaration by the Company's board of directors (the Board), rather than based on estimated ultimate payments to policyholders on the earned portions of policies;
- certain assets and liabilities originated in foreign currency are adjusted to U.S. dollars through a direct charge to surplus;
- the estimated rental cost of office facilities owned is presented in the statutory statements of operations as both income and expense;
- the correction of errors related to previously issued financial statements is charged directly to surplus rather than restating prior period results;
- the statutory statements of cash flow are presented in a specified format which differs from the formats prescribed by Statement of Financial Accounting Standards No. 95, *Statement of Cash Flows*; and
- comprehensive income is not determined for statutory reporting purposes.

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

Accounting Allowances

2004

The accompanying statutory financial statements of the Company at December 31, 2004 reflect a $652.0 million increase in the Company's reported surplus at that date over what would have been reported without the following four accounting allowances:

1. Loss Reserve Discounting. The Company discounts all its loss reserves at 4.2%. Prior to 2003, the Company discounted at 3.5% only certain categories of liabilities on its statutory balance sheet, essentially the tabular discount on pension liabilities, pursuant to prescribed accounting allowances. At December 31, 2004, the total amount of the discount, included on the statutory balance sheet and on Schedule P is $764.1 million. The 4.2% discount rate exceeds the Company's current investment portfolio yield. With the allowance, the Company's surplus as of December 31, 2004 is estimated to be approximately $577.0 million more than it would have been under the tabular discount.

2. Prepaid Unallocated Loss Adjustment Expense (ULAE). The statutory balance sheet of the Company at December 31, 2004 reflects as an admitted asset the amounts that the Company has prepaid for claim handling services to NATLSCO/Broadspire (approximately $50.0 million) and to

National Indemnity Company (approximately $16.0 million). Approximately $39.0 million of ULAE expenses related to these two service providers were expensed in 2004. With the allowance, the Company's surplus as of December 31, 2004 is estimated to be approximately $66.0 million more than it would have been without the allowance.

3. Change in Estimate for Uncollectible Reinsurance. The Company has established a general provision for uncollectible reinsurance of $141.9 million at December 31, 2004. The Schedule F penalty otherwise prescribed by the Manual would have been $146.2 million. Therefore, the net benefit to the Company's surplus at December 31, 2004 from this allowance amounted to approximately $4.3 million. Additionally, the provision at December 31, 2004 reflects a benefit of approximately $23.0 million due to the allowance to discount loss reserves at 4.2%.

4. Intercompany loan. In the audited financial statements of the Company's Singapore-based subsidiary at December 31, 2004, a $4.7 million loan that the subsidiary had originally made to the Company in 2003 was fully impaired. At December 31, 2004, the Company anticipated that the loan would be distributed to the Company as a property dividend; however, that dividend did not occur until the first half of 2005. In the absence of an allowance prescribing that the Company not reflect the loan as a liability on its statutory financial statements at December 31, 2004, the Company's surplus would have been adversely impacted by the $4.7 million impairment until the dividend was distributed to the Company in 2005.

2003

The accompanying statutory financial statements of the Company at December 31, 2003 reflect a $925 million increase in the Company's reported surplus at that date over what would have been reported without the following five accounting allowances prescribed:

1. Loss Reserve Discounting. The Company discounts all its loss reserves at 4.2%. Prior to 2003, the Company discounted at 3.5% only certain categories of liabilities on its statutory balance sheet, essentially the tabular discount on pension liabilities, pursuant to prescribed accounting allowances. At December 31, 2003, the total amount of the discount, included on the statutory balance sheet and on Schedule P is $1.1 billion. The 4.2% discount rate exceeds the Company's current investment portfolio yield. With the allowance, the Company's surplus as of December 31, 2004 is estimated to be approximately $610.0 million more than it would have been under the tabular discount.

2. Prepaid Unallocated Loss Adjustment Expense (ULAE). The statutory balance sheet of the Company at December 31, 2003 reflected as an admitted asset the amounts that the Company had then prepaid for claim handling services to NATLSCO/Broadspire (approximately $82.0 million) and to National Indemnity Company (approximately $23.0 million). Approximately $15.0 million of ULAE expenses related to these two service providers were expensed in 2003. With the allowance, the Company's surplus as of December 31, 2003 is estimated to be approximately $90.0 million more than it would have been without the allowance.

3. Defined Benefit Plans Accumulated Benefit Obligation (ABO). The statutory balance sheet of the Company at December 31, 2003 reflected a change in the applicable interest rate assumption for calculating the ABO liability under the qualified Kemper Retirement Plan and the unqualified Kemper Supplemental Retirement Plan from 6.25% to 7.5%. The higher rate assumption reduced the ABO liability at December 31, 2003 by approximately $118.0 million from what the lower rate assumption would have produced. The Company's liabilities under both plans were eliminated in 2004.

4. Accrued Post-Retirement Benefit Obligation. Effective January 1, 2004, the Company amended its post-retirement benefit plans to reduce benefits. The economic effect of the entire reduction in liability attributable to this change, a difference of approximately $32.0 million at December 31, 2003, was recorded immediately rather than as a gradual reduction of the liability over the average life span of the retirees at that time.

5. Change in Estimate for Uncollectible Reinsurance. The Company established a general provision for uncollectible reinsurance of $70.0 million at December 31, 2003. The net benefit to the Company's surplus at December 31, 2003 from this allowance over the general Schedule F penalty provision for uncollectible reinsurance amounted to approximately $75.0 million.

(Continued)

A reconciliation of the Company's net income for 2004 and 2003 and surplus as of December 31, 2004 and 2003 as prepared using the Manual versus accounting allowances is shown below.

	2004	2003
	(in millions)	
Net loss as reported with accounting allowances	$ (154)	(434)
Increase (decrease) as a result of allowances:		
Loss reserve discounting	274	(610)
Pre-paid ULAE	39	(90)
Pension plan discount rate	118	(118)
Post-retirement benefit obligation	32	(32)
Singapore loan	(5)	—
Total allowances	458	(850)
Net income (loss), Manual	$ 304	(1,284)
Statutory surplus as reported with accounting allowances	$ 62	202
Increase (decrease) as a result of allowances:		
Loss reserve discounting	(577)	(610)
Pre-paid ULAE	(66)	(90)
Singapore loan	(5)	—
Schedule F provision	(4)	(75)
Pension plan discount rate	—	(118)
Post-retirement benefit obligation	—	(32)
Total state allowances	(652)	(925)
Statutory surplus, Manual	$ (590)	(723)

Correction of Errors

The Company has identified the following correction of errors related to the 2003 statutory financial statements which have been reported as adjustments to the Company's surplus balance as of January 1, 2004 in accordance with SSAP No. 3, *Accounting Changes and Corrections of Errors*:

- During 2004, the Company determined that the realized loss recorded in 2003 on the sale of a subsidiary was overstated by $36.8 million. Accordingly, this amount was reported as a correction of an error in 2004, which resulted in a corresponding increase to the Company's surplus.
- During 2004, the Company determined that its calculation for accrued retrospective premiums (dividend recalls) contained certain errors that existed at December 31, 2003. These errors amounted to $11.5

million. Accordingly, these amounts were reported as a correction of an error in 2004 which resulted in corresponding decreases to the Company's surplus and accrued retrospective premium asset.

- During 2004, the Company determined that the adjustment it made to loss reserves in 2003 relating to the change in discount rate from 3.5% to 4.2% was overstated by $16.9 million which resulted in a corresponding decrease to the Company's surplus.
- During 2004, the Company determined that certain insurance policies related to a guaranteed cost program were recorded to premium incorrectly in prior years. These errors amounted to $3.8 million. Accordingly, these amounts were recorded as a correction of an error in 2004 which resulted in corresponding decreases to the Company's surplus and premium suspense account.
- During 2004, the Company determined that certain facts related to its various reinsurance programs were misapplied by way of either over-ceding losses or under-accruing ceded premiums. These errors totaled $29.0 million. Accordingly, these amounts were recorded as corrections of errors in 2004 which resulted in corresponding decreases to the Company's surplus.
- During 2004, the Company determined that certain facts related to its reinsurance annuities were misapplied by overvaluing the amount of expected reinsurance recoveries. The amount of this error was $16.6 million. Accordingly, this amount was recorded as a correction of an error in 2004 which resulted in a corresponding decrease to the Company's surplus.

Other Adjustments

During 2004, the Company determined that certain facts related to various statement of operations and surplus accounts were misapplied. Accordingly, as shown in note 12 as others miscellaneous adjustment, the Company recorded an additional $6.1 million to expense to the statement of operations and an additional $2.0 million as direct charges to surplus. The total affect of these adjustments was to decrease the Company's surplus at December 31, 2004 by $8.1 million.

Invested Assets and Related Income

Bonds and short-term investments are valued generally 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 mortgage-backed and asset-backed securities, over the estimated life of the security. Such amortization is included in investment income. Amortization of the discount or premium from mortgage-backed and asset-backed securities is recognized based on the estimated timing and amount of prepayments of the underlying assets and is adjusted to reflect differences which arise between the prepayments originally anticipated and the actual prepayments received and currently anticipated. To the extent the estimated lives of such securities change as a result of changes in prepayment rates, the adjustment is also included in investment income. Prepayment assumptions used for mortgage-backed and asset-backed securities were obtained from an external securities information service and are consistent with the current interest rate and economic environment.

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

Investments in affiliated common stocks are carried at the underlying statutory equity of the respective entity's financial statements.

Mortgage loans are carried at their unpaid principal balance, net of any impairments. The maximum percentage of a loan to the value of the security at the time of the loan was 90%. Other invested assets include notes receivable and joint venture partnerships. Notes receivable are carried at their unpaid principal balance. Joint ventures in which the Company has a less than 10% ownership interest are carried at underlying GAAP equity. Joint ventures in which the Company has a greater than 10% ownership interest are carried at the underlying statutory equity of the joint venture's financial statements. The Company also has a joint venture which holds undeveloped real estate and is carried at its estimated fair value, net of anticipated costs to sell.

Real estate owned is held for sale and is carried at the lower of cost or fair value, less estimated costs to sell.

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

The Company does not accrue interest income on fixed maturities deemed to be impaired on an other-than-temporary basis, or on real estate-related investments when it judges that the likelihood of collection of interest is doubtful.

Premiums and Policy Acquisition Costs

Premiums are earned on a daily pro-rata basis over the term of the policies and are net of reinsurance placed with reinsurers. Unearned premiums are also stated after deduction for premiums ceded to reinsurers. Premiums received in advance are recorded as a liability and are not considered income until due. Agents' balances and uncollected premiums receivable are recorded at the effective date of the underlying contract or in the case of audit premiums in accordance with the terms of the underlying contracts. Such receivables are recorded net of balances over 90-days past due and such other balances as required by the Manual. The Company evaluates the collectibility of all receivables for possible impairment. When the Company determines it is probable a receivable balance will not be collected, such amounts are written off and charged to other income. Policy acquisition costs such as commissions, premium taxes, and other underwriting and agency expenses are charged to income as incurred. The Company anticipates investment income as a factor in determining premium deficiency reserves. As of December 31, 2004 and 2003, the Company recorded ending premium deficiency reserves of $5.0 million and $8.5 million, respectively.

Liabilities for Losses and Loss Adjustment Expenses

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

statistical and actuarial techniques reflecting historical patterns of development of paid and reported losses adjusted for current trends. Certain liabilities for unpaid losses related to workers' compensation pension cases and long-term disability losses are discounted to present value.

The Division of Insurance has prescribed an accounting allowance under a Corrective Order pursuant to which the Company discounts all its loss and loss adjustment expense reserves at 4.2% in the accompanying financial statements as of December 31, 2004. At December 31, 2004, the total amount of the discount included in the accompanying financial statements is $764.1 million. The Company's current discounting of all its loss and loss adjustment expense reserves at 4.2% substantially exceeds its currently projected investment portfolio yield.

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

The Company reflects its liability for losses net of anticipated salvage and subrogation recoveries. Those recoveries were $71.0 million and $91.1 million at December 31, 2004 and 2003, respectively. Salvage and subrogation received and changes in estimates of future recoveries are reflected in current year underwriting results.

Management believes the liabilities for losses and LAE are adequate to cover the ultimate liability; however, due to the underlying risks and high degree of uncertainty associated with the determination of the liability for losses, such estimates may be more or less than the amounts ultimately paid when the claims are settled. In the event reinsurance companies 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. 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

(Continued)

upon the Company's current financial position, all settlements or inter-company tax balances are subject to approval by the Division of Insurance.

Nonadmitted Assets

Assets included in the statutory balance sheet are at admitted asset value. Nonadmitted assets, principally deferred tax assets, agents' balances over 90-days past due, computer hardware and equipment, and 10% of unsecured policyholder dividends recoverable, are excluded through a charge against surplus. Assets nonadmitted at December 31, 2004 amounted to $841.0 million.

The Company's investment in computer hardware and equipment as of December 31, 2004 and 2003 was as follows:

		2004	2003
		(In thousands)	
Computer hardware and equipment	$	3,728	49,561
Less accumulated depreciation		(1,553)	(46,918)
Net computer hardware and equipment	$	2,175	2,643

Computer hardware and equipment are depreciated over three years and total depreciation expense amounted to $2.3 million and $20.2 million as of December 31, 2004 and 2003, respectively. Due to the Company's run-off status, the decision was made in 2003 to write off all remaining net fixed assets excluding computer hardware and equipment. As of December 31, 2003, the Company wrote off $55.4 million of fixed assets which were recorded as realized capital losses.

Provision for Reinsurance

The Company has established a liability for unsecured reinsurance balances from companies not authorized to do business in Illinois and hence not subject to its jurisdiction and regulation. An additional liability is also required when portions of reinsurance balances from authorized companies are overdue. Such liabilities are charged directly against surplus. At December 31, 2004 and 2003, the Division of Insurance prescribed an accounting allowance which differed from the Manual (see *Accounting Allowances* above).

Cash Flow Information

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

In conjunction with the year-end 2004 financials, the Company recorded a series of reclassification entries, from what had been previously reported in the 2004 annual statement, decreasing cash and short term securities by $29.4 million with $5.7 million of the offset being recorded as miscellaneous expenses incurred and the majority of the remainder being reclassified to various asset and liability accounts.

Use of Estimates

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

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

Renewal Rights Transactions

In 2002, the Company and certain of its affiliates entered into a renewal rights and asset sale transaction transferring, over time, substantially all its personal lines business to Unitrin, Inc. (Unitrin). In 2003, the Company and its affiliates entered into several other renewal rights transactions. These transactions allowed the Company and its affiliates to receive future commissions from other insurance companies that renewed certain in-force business when such business expired or cancelled from the Company or its affiliates. In some cases, employees and leases were also transferred related to certain of the Company's business lines, resulting in future expense savings related to severance and lease costs. Presented below is the revenue from those transactions which is shown on the underwriting expenses line of the statutory statements of operations:

Kemper business line	Purchaser of renewal rights		Renewal rights revenue earned by LMC in 2004
Small and middle market accounts	St. Paul Companies	$	7,638,330
Personal lines	Unitrin, Inc.		35,375,493
Directors and officers liability	AXIS Capital Holdings		849,855
Bundled large risk accounts	Argonaut Insurance Company		161,511
Alternative risk programs	Hartford Fire Insurance Company		32,044
Environmental casualty	Zurich Insurance		42,918
Unbundled large risk accounts	Old Republic		478,996
		$	44,579,147

The 2004 renewal rights revenue total includes $7.6 million related to the May 2003 sale to the St. Paul Companies of renewal rights for small business and middle market commercial insurance policies. This amount, plus another $10.0 million earned in 2003, became payable in 2004. The amounts payable by the

St. Paul Companies, although they are not disputed, had not been paid as of December 31, 2004. Approximately $17.6 million is reflected as a receivable on the Company's December 31, 2004 statutory balance sheet. The St. Paul Companies withheld payment as an asserted offset on amounts they claim are due to other St. Paul Companies on entirely unrelated matters arising from certain surety operations. The issue on the other transactions was resolved in the second quarter of 2005, and the Company collected a preliminary settlement of approximately $16.7 million. The Company expects to collect the remaining receivable during 2005.

The 2004 renewal rights revenue total also includes $35.4 million received from Unitrin, and its subsidiary, Trinity Universal Insurance Company (Trinity), related to the sale in 2002 of the Company's and its affiliates' U.S. personal lines business. (Renewal rights revenue from Unitrin and Trinity in 2003 totaled $7.8 million.) Of the Unitrin amount for 2004, $31.5 million was received by the Company in the third quarter. The amounts paid in the third quarter of 2004 were primarily due to a mutual agreement, approved by the Division of Insurance, to settle future contingent commission payment obligations owed to the Company. Pursuant to this agreement, Unitrin also extended its and its affiliates' five-year license to use the Kemper name in the acquired personal lines businesses to 100 years. This transaction resulted in a benefit to the Company's surplus and liquidity of approximately $31.5 million.

In connection with the sale to Unitrin in 2002, the Company and Unitrin entered into administrative service agreements whereby Unitrin continues to monitor and service the run-off of the Company's retained personal lines policies (Unitrin did not acquire renewal rights to policies issued in Alaska, Michigan, Delaware, or Arkansas or to policies produced by independent agents whose authority to write new business had been terminated prior to April 19, 2002.) The Company and certain of its affiliates agreed to front for Trinity during a transition period in those states where Trinity (or an 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. Unitrin substantially completed that transition process in 2004. As of December 31, 2004, approximately $44.9 million of the Company's loss and loss adjustment expense reserves are fronted policies that are 100% reinsured by Trinity. Not only are the reinsured policies fully administered (including claims handled) by the Unitrin subsidiaries, the fronted policies are covered by a cut-through provision allowing the insureds to seek direct recourse from Trinity in the event of any insolvency of the Company.

(2) Invested Assets and Investments in Subsidiaries

Bonds

The Company is generally carrying its bond portfolio at amortized cost. The carrying value of bonds is adjusted for other-than-temporary declines in values or situations where the Company has made a decision to sell a security at an amount below the security's carrying value. The fair values of the Company's bonds have been determined using market quotations provided by the SVO, independent pricing services that use prices provided by market makers or estimates of fair values obtained from yield data relating to instruments or securities with similar characteristics, or fair value as determined in good faith by the Company's portfolio managers, when such values are not available from the SVO. 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, 2004 and 2003 were as follows:

	2004			
	Statement value	**Gross unrealized gains**	**Gross unrealized losses**	**NAIC fair value**
	(In thousands)			
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	$ 892,320	2,184	(7,018)	887,486
State, political subdivision, and special revenue obligations	49,358	3,012	(175)	52,195
Debt securities issued by foreign governments	11,937	105	(23)	12,019
Corporate securities	455,457	2,452	(31,263)	426,646
Asset-backed securities	19,169	238	—	19,407
Mortgage-backed securities	155,326	733	(613)	155,446
Total bonds	$ 1,583,567	8,724	(39,092)	1,553,199

	2003			
	Statement value	**Gross unrealized gains**	**Gross unrealized losses**	**NAIC fair value**
	(In thousands)			
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	$ 654,930	4,150	(5,113)	653,967
State, political subdivision, and special revenue obligations	66,149	3,588	(503)	69,234
Debt securities issued by foreign governments	22,419	592	—	23,011
Corporate securities	491,736	6,390	(1,258)	496,868
Asset-backed securities	53,188	298	(205)	53,281
Mortgage-backed securities	384,930	4,520	(876)	388,574
Total bonds	$ 1,673,352	19,538	(7,955)	1,684,935

As of December 31, 2004 and 2003, the unrealized losses on bonds were $39.1 million and $8.0 million, respectively. Of the 2004 unrealized losses on bonds, $4.0 million were in that position for more than 12 months while the remaining losses were in that position for less than 12 months. All of the 2003 unrealized losses were in that position for less than 12 months. Management has determined the unrealized losses to be temporary.

The following table sets forth the maturity aging schedule of bonds at December 31, 2004. The actual maturities may differ from the contractual maturities because debtors may have the right to call or prepay obligations with or without call or prepayment penalties.

		Statement value	NAIC fair value
		(In thousands)	
One year or less	$	250,871	250,826
Over one year through five years		557,527	555,249
Over five years through ten years		224,982	225,135
Over ten years		375,692	347,136
Securities not due at a single maturity date		174,495	174,853
Total bonds	$	1,583,567	1,553,199

At December 31, 2004 and 2003, cash, short-term investments and bonds carried at $1.1 billion were on deposit with government authorities as required by law. The Company's cash and invested assets were also encumbered at December 31, 2004 and 2003, by $460.1 million and $593.8 million, respectively, related to various collateral requirements.

Proceeds from sales of investments in bonds prior to maturity during 2004 and 2003 were $374.9 million and $469.6 million, respectively. Gross gains of $7.8 million and gross losses of $434 thousand were realized on those sales during 2004. Gross gains of $24.2 million and gross losses of $3.0 million were realized on those sales during 2003.

Equity Securities

Gross unrealized gains on equity securities (common stocks and preferred stocks), excluding affiliated companies, at December 31, 2004 and 2003 amounted to $64 thousand and $5.9 million, respectively. Gross unrealized losses on equity securities at December 31, 2004 and 2003 amounted to $35 thousand and zero, respectively. The cost of equity securities held at December 31, 2004 and 2003, excluding affiliated companies, was $2.5 million and $15.6 million, respectively. Consideration on sales of unaffiliated equity securities totaled $17.9 million including net gains of $5.5 million in 2004 and for 2003 totaled $17.3 million including $1.1 million of net gains.

Investments in Affiliated Companies

The Company's investments in common stocks of affiliated companies at December 31, 2004 and 2003 are summarized below:

	2004		2003	
	Cost	Statement value	Cost	Statement value
	(In thousands)			
Kemper Casualty Inc.	$ 22,506	22,126	66,990	65,668
Kempes Inc.	26,895	25,071	47,994	53,790
Kemper Financial Protection Inc.	—	—	44,679	50,465
American Motorists Insurance Co.	—	30,819	—	29,907
Kemper International Corp.	21,204	15,749	28,312	28,312
Kemper Employers Group Inc.	—	—	14,315	21,584
Kemper Insurance Group Inc.	—	—	2,595	3,267
GreatLand Holdings Inc.	—	—	1,840	2,382
Kemper Insurance Holdings #2 Inc.	—	—	202	2,195
All other	1,939	2,481	1,938	3,104
	$ 72,544	96,246	208,865	260,674

Significant Transactions involving Affiliates

Sale of Kemper Mexico

On April 30, 2004, the Company closed the sale of 100% of the stock of Kemper de Mexico, Compania de Seguros, S.A., for $9.25 million. The sale resulted in no gain or loss to surplus in 2004. In 2003, the Company recognized an impairment for approximately $13.9 million on this subsidiary in anticipation of the sale in early 2004.

Subsidiary Mergers

On August 31, 2004, three indirect wholly owned subsidiaries of the Company, Kemper Indemnity Insurance Company, Kemper Surplus Lines Insurance Company, and Pacific Eagle Insurance Company, merged with and into American Motorists Insurance Company (AMICO), another wholly owned subsidiary of the Company. On December 31, 2004, two other indirect wholly owned subsidiaries, American Protection Insurance Company (AMPICO) and Specialty National Insurance Company (SNIC), merged with and into AMICO. AMICO was the surviving entity in the five mergers. As a result of the mergers, the Company and AMICO obtained approval from the Division of Insurance for AMICO to declare and pay to the Company an extraordinary distribution of approximately $161.7 million on December 31, 2004.

SeaBright Insurance Company

Following the September 30, 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 initially in the amount of $1.6 million (in addition to an escrow in the amount of $4.0 million). Being subject to adjustment in the event of adverse development of pre-sale KEIC reserves, the amount in the trust was increased by the Company adding approximately $3.2 million to the trust in the fourth quarter of 2004. The adverse development also resulted in the Company recording a $4.7 million detriment ($2.7 million net of discount) to its surplus as of December 31, 2004.

Broadspire

The Company sold its NATLSCO, Inc. subsidiary and related claim service operations to Broadspire LLC in July 2003. Based on purchase price adjustment provisions in the sale contract, the Company initially asserted a claim against Broadspire for $22.9 million and carried that amount as an asset on the Company's December 31, 2003 statutory balance sheet. The carried amount was reduced to $17.9 million on the December 31, 2004 statutory balance sheet. On June 22, 2005, a binding arbitration ruling awarded the Company $23.2 million from Broadspire on the asserted claim. On June 30, 2005, Broadspire paid $19.0 million and asserted an offset right to the remaining amount of $4.2 million. (See *Significant Transactions with Affiliates – NATLSCO*, below.)

International Operations

The Company has seven international insurance operations in six countries. These operations accounted for approximately $52.3 million of the Company's surplus at December 31, 2004. These operations consist of a branch of the Company in Canada, another branch in Japan, a branch of AMICO (formerly a branch of SNIC) in Canada, and four insurance company subsidiaries, one in each of Australia, Belgium, Bermuda, and Singapore. Total surplus of the non-Canadian affiliates is $18.3 million at December 31, 2004.

The Company is exploring reinsurance alternatives for the closure of the two Canadian branches. Such closure may cost a significant minority portion of the surplus of the branches. Combined as of December 31, 2004, the two branches have more than $34.0 million of assets in excess of recorded liabilities. Virtually all of the invested assets in Canada, approximately $56.4 million, are encumbered in trust. The trust is required by Canadian regulators who must approve any releases of assets from the trust. In 2005, the Canadian regulators have approved releases only to pay branch expenses. Certain Canadian claims in 2005, therefore, are being paid from the Company's U.S. assets. The closing of the branches would increase the Company's liquidity which would be the consequence of the repatriation to the U.S. of any surplus amounts held in the Canadian branches.

In 2004, the Company concluded loss portfolio reinsurance transactions in each of Japan and Singapore as a prelude to an orderly liquidation of the Japanese branch and the Singapore subsidiary. In the second quarter of 2005, the Company received from its Japanese branch repatriation of approximately $1.9 million and from its Singapore subsidiary dividends consisting of cash of $4.0 million and return and cancellation of a $4.7 million intercompany loan to the subsidiary from the Company. That loan has been reduced to

zero in the Company's December 31, 2004 statutory financial statements in anticipation of the planned dividend of the loan as part of the formal voluntary liquidation of the subsidiary in 2005. The Company also reduced its carrying value in the Singapore entity as of December 31, 2004. Thus, the two Singapore actions taken as of December 31, 2004 (reduction of the loan liability and the reduction in the carrying value of the affiliate) have a neutral surplus effect on the Company in 2004 and the related transactions in 2005 are also surplus neutral to the Company. The Company projects that the remaining assets of approximately $600 thousand in Singapore and $300 thousand in Japan will be transferred to the Company as both of those foreign locations are liquidated and closed in the second half of 2005.

The Company is exploring reinsurance and/or sale alternatives for its Belgium and Australian subsidiaries and has initiated a solvent scheme in Bermuda to address most of its subsidiary's existing liabilities there.

UBIC Surety Bonds

Universal Bonding Insurance Company (UBIC) is a wholly owned subsidiary of the Company domiciled in New Jersey. In connection with certain surety bonds fronted by the Company for UBIC prior to 2003, the Company realized cumulative losses of approximately $107.0 million through 2004. The losses arose primarily in connection with a series of unauthorized bond programs implemented by UBIC, then 80% owned by the Company, the true nature of which was not fully disclosed to certain members of UBIC's management or to the Company until mid-2002. In 2002, the Company began pursuing an investigation into the validity, available defenses, and potential recoveries of such unauthorized bonds, and UBIC entered run-off status and discontinued issuing any further bonds, except those bonds which UBIC was statutorily obligated to renew. As of December 31, 2004, the Company carries approximately $11.5 million of net recoverables from insurers and reinsurers related to UBIC bond losses, some of which are the subject of litigation. As of December 31, 2004, the Company carries its investment in UCIC at zero. UBIC has no employees, and the Company provides certain administrative and claim services for the subsidiary.

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), entered into a reinsurance agreement, effective for a three-year period (2005, 2006, and 2007), facultatively reinsuring a corresponding three-year A-side management liability policy issued by an unaffiliated third party to the Company and American Manufacturers Mutual Insurance Company (AMM). In May 2005, SSIC deposited the reinsurance premium ($15.0 million) it received into trust for the benefit of the third-party insurer to collateralize the reinsurance obligation. If and to the extent there are no claims on the D&O policy, then ratably over the three years, SSIC can earn the reinsurance premium, which would increase its surplus and therefore the Company's surplus on a consolidated basis over that time period and liquidity after the end of the period.

Service Net Solutions, LLC

On July 2, 2003, a wholly owned subsidiary of the Company, Kemper Warranty Services, Inc. (KWS), sold its 51% ownership stake in Service Net Solutions, LLC (Service Net) for a purchase price of $6.5 million and a release of the Company's future financial obligations arising under the original purchase agreement. The purchase price is to be paid in installments through December 31, 2006. Purchase price installments of $3.25 million were received in 2003 and $1.25 million was received in 2004. The Company

realized a net gain in 2003 of $732 thousand as a result of the sale. As part of the transaction, the Company established a collateral trust initially in the amount of $35.0 million. The trust secures and funds obligations arising out of contractual liability policies issued to Service Net by the Company and its affiliates to reimburse Service Net for its payments under consumer warranty contracts sold by Service Net to its customers during the time from early 2001, when the Company owned 51% of Service Net. Trust assets at December 31, 2004 and 2003 were $6.8 million and $25.8 million, respectively. The Company is not obligated to add any amounts to the trust, but the Company remains liable for its contractual liability policies.

NATLSCO, Inc.

On July 22, 2003, the Company sold its wholly owned subsidiary NATLSCO, Inc. and related service operations (NATLSCO) to a buyer (Broadspire LLC) owned by Platinum Equity LLC (Broadspire). NATLSCO's operations included most of the assets used in the administration of the Company's general liability, workers compensation, and employer liability claims, as well as third-party claim servicing operations. As part of the transaction, Broadspire hired approximately 3,300 of the Company's employees. The Company agreed to share in any severance costs incurred by Broadspire, up to a maximum of $6.0 million for two years following the closing date. The Company assumed that the full $6.0 million would be incurred for purposes of calculating the realized loss on the transaction (the Company has paid approximately $2.2 million of this amount through December 31, 2004). In 2003, the Company booked a realized loss on the transaction of $180.8 million, assigning no value to contingent earn out payments which the Company could realize in years 2004 through 2007. A benefit to surplus of $36.8 million was recorded in 2004 related to a purchase price adjustment to the original sale price (see *Significant Transactions with Affiliates – Broadspire*, above).

The Company also entered into a long-term Claim Administration Agreement with NATLSCO (now 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 a four-year period commencing January 1, 2006. The Company is not obligated to add any assets to the trust. The Company receives the interest on Broadspire's trust assets. In accordance with the prescribed accounting allowance more fully described in note 1, the Company reflects as an admitted asset the prepaid amount for claim handling services (approximately $82.0 million as of December 31, 2003 and $50.0 million as of December 31, 2004).

Kemper Cost Management, Inc.

On August 16, 2003, a wholly owned subsidiary of the Company, Kemper Cost Management Holding Company, Inc., sold 100% of the capital stock of its wholly owned subsidiary, Kemper Cost Management, Inc. (KCM). KCM is a provider of contract maintenance alternatives for commercial equipment. In conjunction with the sale, the buyer of KCM agreed to retain its staff of 36 employees. As part of the transaction, the Company agreed to pay $850 thousand for future claims services provided to the Company by KCM for managing the runoff of contractual liability policies issued by the Company and its affiliates. The Company realized a loss of $1.1 million in 2003 as a result of the sale.

Lumbermens Life Agency, Inc.

On September 8, 2003, the Company sold 100% of the capital stock of its wholly owned subsidiary, Lumbermens Life Agency, Inc., an Illinois corporation that markets life insurance and annuities through independent agents. The agency has since been renamed MGN Agency LLC. The sale included four subsidiaries of the agency and certain assets used in the business as well as the transfer of 14 employees. The Company realized a gain of $1.4 million from the transaction in 2003.

Eagle Insurance Companies

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

A. From KEG, SeaBright acquired 100% of the capital stock of each of two other KEG subsidiaries, Kemper Employers Insurance Company (KEIC), an Illinois insurance company, and PointSure Insurance Services, Inc., a Washington corporation and insurance agency. Immediately before the sale, the Company and KEIC commuted their intercompany reinsurance agreement, with KEIC reassuming from the Company approximately $13.0 million of previously ceded liabilities in return for a cash payment by the Company of the same amount. In connection with the commutation, the Company agreed to reinsure KEIC for any adverse development on pre-closing date KEIC policy liabilities. The Company's claim handling prepayments to NATLSCO (see description of NATLSCO sale above in this note) cover unallocated loss adjusting expenses of approximately $852 thousand for KEIC's pre-closing claims. Following the sale, KEIC changed its name to SeaBright Insurance Company.

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

The purchase price for the two companies was $14.2 million, of which Eagle Pacific's share was $2.6 million and Pacific Eagle's was $133 thousand. The Company's December 31, 2003 surplus included a $1.8 million gain on the above transactions with SeaBright. That amount increased by $700 thousand in 2004, reflecting a post-closing adjustment based on the final closing statutory balance sheet completed in 2004 and contingent renewal rights commissions earned in 2004.

On December 31, 2003, Eagle Pacific and the Company commuted their intercompany reinsurance agreements under which most of Eagle Pacific's business was ceded to the Company (which agreements also effectively reinsured with the Company most of Pacific Eagle's 2003 business since that business was subject to a pooling agreement (the Pool or the Pooling Agreement) between the two Eagle companies).

This commutation was immediately followed by a merger of Eagle Pacific into another wholly owned, Illinois-domiciled subsidiary of the Company, AMPICO. The surviving company, AMPICO, pursuant to a previously existing intercompany reinsurance agreement with the Company, reinsured 100% of its business with the Company. Both AMPICO and Pacific Eagle merged into AMICO in 2004 (see *Significant Transactions involving Affiliates – Subsidiary Mergers* above).

Other Affiliate Transactions

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

During 2004 and 2003, the Company made additional capital contributions to several of its affiliates primarily to fund cash flow operating needs, as follows:

	2004	2003
	(In thousands)	
NATLSCO	$ —	140,878
Kemper International Corporation	1,642	1,594
Kemper Casualty, Inc.	—	15,971
Kemper Cost Management, Inc.	—	2,497
Kemper Financial Protection, Inc.	—	456
Kemper Warranty Services, Inc.	—	5,323
Kemper Employers Group, Inc.	—	2,506
All other	26	653
	$ 1,668	169,878

Goodwill

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

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

Impairment Write-downs

Excluding goodwill (which is charged directly to surplus), the Company recognized impairment write-downs as realized capital losses for the following investments in subsidiaries during 2004 and 2003:

Company		2004	2003
		(In thousands)	
Kemper Insurance Group, Inc.	$	—	106,446
Kemper International Corporation		—	27,382
Universal Bonding Holding Company		—	16,899
Kempes, Inc.		—	16,557
Kemper Financial Protection, Inc.		—	4,402
Kemper Casualty, Inc.		—	1,136
LGA-3, Inc.		26	1,007
Kemper Employers Group, Inc.		5,166	914
Kemper Cost Management Holding Company, Inc.		—	338
American Protection Property & Casualty Agency, Inc.		—	20
Kemper Realty Corporation		—	2
All other		—	349
	$	5,192	175,452

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

The Company recorded ordinary cash dividends from the following subsidiaries and affiliates during 2004 and 2003:

		2004	2003
		(In thousands)	
American Motorists Insurance Company	$	33,793	12,730
Kemper International Corporation		—	13,613
Total	$	33,793	26,343

Mortgage Loans and Other Invested Assets

Mortgage loans and other real estate-related investments, and other invested assets, consisted of the following as of December 31, 2004 and 2003:

		2004	2003
		(In thousands)	
Mortgage loans and other real estate-related investments:			
Residential mortgage loans	$	1,836	12,648
Commercial mortgages		—	4,500
Real estate joint venture		5,982	7,762
Properties held for sale		34,965	40,856
		42,783	65,766
Other non real estate-related invested assets:			
Venture capital partnerships and hedge funds		4,075	56,661
Other notes receivable and equity investments		39,851	39,908
		43,926	96,569
Total mortgage loans, other invested assets and other real estate-related investments	$	86,709	162,335

In November 2004, the Company agreed to sell its residential mortgage portfolio. During the due diligence period, several deficiencies in documentation were discovered resulting in 26 loans being excluded from the sale. Seven of the 26 loans which had an aggregate outstanding principal of approximately $1.5 million were completely written off in December 2004. During 2003, the Company recorded an impairment write-down of $3.9 million on a commercial loan. The Company's mortgage portfolio is distributed by geographic locations. The Company monitors its mortgage loan portfolio for loans not making payments in accordance with the loan terms and reviews these loans for impairment. Because the Company's mortgage review process includes estimates, there can be no assurance that current estimates will prove accurate over time due to changing economic conditions and other factors. As of December 31, 2004, the Company did not have any mortgage loans on a nonaccrual status. As of December 31, 2003, the Company had a $4.5 million mortgage loan on nonaccrual status.

The Company also has a real estate joint venture, which was 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 $6.0 million, or 14% of the Company's total real estate portfolio, at December 31, 2004. The partnership's underlying investment consisted primarily of a water development project located in California's Sacramento River Valley. During 2003, the Company abandoned its plans for the water development project and has actively sought an exit from this investment. The Company recorded impairment write-downs to the fair value of the undeveloped land net of anticipated costs to sell of $1.8 million and $100 thousand during 2004 and 2003, respectively.

During 2003, the Company reclassified all of its remaining real estate owned from company-occupied to held for sale and obtained appraisals for properties not sold. As a result of the appraisals, the Company

recorded impairment write-downs of $19.2 million related to its real estate held for sale. Also during 2003, the Company sold its Plantation, Florida office property for $33.5 million and realized a gain of $11.9 million on the sale. In the third quarter of 2004, the Company signed a definitive agreement to sell its home office complex in Long Grove, Illinois, and to lease back a portion of that office space for the Company's current operations. In anticipation of the proposed sale terms, the Company recorded an impairment write-down on the property of $5.9 million. The Company received net proceeds of $29.8 million at closing on March 16, 2005, and recorded a realized gain on the sale of $300 thousand in 2005.

The majority of the Company's investments in venture capital partnerships were sold during 2004. The Company received net proceeds of $44.7 million on these sales. As of December 31, 2004, the Company had two notes receivable totaling $18.7 million on nonaccrual status.

Net Realized Capital Gains/Losses

Net realized capital gains (losses) by category for the years ended December 31, 2004 and 2003 were as follows:

		2004	2003
		(In thousands)	
Cash and short-term investments	$	(183)	(15,000)
Common stocks:			
Affiliate write-downs		(5,192)	(175,452)
Sale of NATLSCO		(5,000)	(180,799)
Extraordinary distribution from AMICO		8,461	60,421
Loss on Berkshire Letter of Intent		—	799
Other affiliate transactions		11,463	24,635
Unaffiliated		4,482	767
Bonds		5,253	14,384
Real estate-related		(5,463)	(7,453)
Other invested assets		(3,405)	(35,174)
Loss on sale of assets		—	(29,322)
Other fixed asset write-downs		—	(55,436)
Net realized capital gains (losses)	$	10,416	(397,630)

During 2004, the Company recorded realized losses related to other-than-temporary declines in fair values of $3.7 million related to bonds, $1.0 million related to equity securities, excluding affiliated companies, $900 thousand related to venture capital partnerships, $9.2 million related to real estate-related investments, and $3.3 million related to notes receivable included in other invested assets. During 2003, the Company recorded realized losses related to other-than-temporary declines in fair values of $15.0 million related to short-term investments, of $6.8 million related to bonds, $290 thousand related to equity securities, excluding affiliated companies, $32.5 million related to venture capital partnerships, $23.1 million related to real estate-related investments, and $3.8 million related to notes receivable included in other invested assets. The determination of fair value for such write-downs is based upon estimated fair value.

Net Investment Income

The sources of the Company's net investment income as of December 31, 2004 and 2003 were as follows:

		2004	2003
		(In thousands)	
Bonds	$	51,854	69,325
Common stocks:			
Affiliated		33,793	26,343
Unaffiliated		702	1,612
Cash and short-term investments		13,320	13,209
Real estate owned		5,523	12,425
Mortgage loans on real estate		649	2,532
Other invested assets		3,173	7,673
Gross investment income		109,014	133,119
Less:			
Interest expense		(299)	(283)
Investment expenses		(12,605)	(28,750)
Depreciation expense on real estate		—	(2,777)
Total investment expense		(12,904)	(31,810)
Net investment income	$	96,110	101,309

(3) Losses and Loss Adjustment Expenses

The Company establishes loss reserves to cover its estimated ultimate liability for property and casualty losses and LAE with respect to reported claims and claims incurred but not yet reported as of the end of each accounting period, except for certain liabilities for unpaid losses related to workers' compensation pension cases and long-term disability losses, which are discounted to present value. As required by applicable accounting rules, no reserves are established until a loss, including a loss from a catastrophe, occurs. Reserves are estimates of what the Company expects the ultimate settlement and administration of claims will cost based on facts and circumstances then known, predictions of future events and estimates of future trends in claims severity and frequency, judicial theories of liability, and other factors. The inherent uncertainties of estimating insurance reserves are generally greater for liability coverages or where judicial and political climates involving certain types of claims are changing, than for property coverages due to the longer periods of time (the tail) that elapse before a definitive determination of ultimate loss may be made.

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

		2004	2003
		(In thousands)	
Balance as of January 1, net of reinsurance recoverables of $4,045,750 in 2004 and $5,136,680 in 2003	$	3,823,969	3,502,137
Incurred (benefit) related to:			
Current accident year		99,461	532,892
Prior accident years		143,366	(579,945)
Total incurred (benefit)		242,827	(47,053)
Correction of errors (see below)		33,541	—
Paid (received) related to:			
Current accident year		(48,617)	81,341
Prior accident years		(1,231,940)	287,544
Total paid (received)		(1,280,557)	368,885
Balance as of December 31, net of reinsurance recoverables of $3,041,424 in 2004 and $4,045,750 in 2003	$	2,819,780	3,823,969

The liabilities for losses and LAE related to prior accident years increased on a net basis by $143.4 million in 2004 and decreased by $(579.9) million in 2003. The adverse development on prior accident years in 2004 of $143.4 million is comprised of $146.0 million of favorable development related to commutation, novation and buyback activity with the remaining $289.4 million of adverse development attributable to $144.0 million of expected amortization of discount and $145.4 million of worse than expected development in products liability occurrence, workers compensation, commercial multi-peril and non-proportional reinsurance.

Also during 2004, the Company determined that certain facts related to its loss and LAE reserves had been misapplied. Accordingly, the Company recorded an additional $37.1 million to its loss and LAE reserves, primarily on its surety business.

The favorable development in 2003 of $579.9 million is comprised of a benefit from the prescribed allowance discount of $548.8 million, a benefit from a large novated account of $203.3 million with the remainder of $172.2 million of adverse development attributable to worse than expected developments in workers compensation, other liability occurrence, surety, and non-proportional assumed liability.

During 2004, the Company determined that the adjustment it made to loss reserves in 2003 relating to the change in discount rate from 3.5% to 4.2% was overstated by $16.9 million.

During 2004, the Company determined that an adjustment made to ceded reinsurance annuity reserves in 2003 was overstated by $16.6 million.

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

Asbestos Related Losses

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

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

The asbestos related losses (including coverage dispute costs) as of December 31, 2004 and 2003, gross of reinsurance, were as follows:

		2004	2003
		(In thousands)	
Beginning reserves	$	799,587	767,234
Incurred losses and LAE		(111,910)	113,263
Calendar year payments for losses and LAE		(100,645)	(80,910)
Ending asbestos related loss reserves	$	587,032	799,587

The asbestos-related losses (including coverage dispute costs) as of December 31, 2004 and 2003, net of reinsurance, were as follows:

		2004	2003
		(In thousands)	
Beginning reserves	$	443,809	390,094
Incurred losses and LAE		(86,693)	29,232
Calendar year payments for losses and LAE		(82,316)	24,483
Ending asbestos related loss reserves	$	274,800	443,809

The total asbestos related loss reserves at December 31, 2004 include IBNR reserves in the amount of $98.3 million gross of reinsurance and $44.0 million net of reinsurance. These IBNR reserves and the comparable amounts for prior years cover both losses and defense and cost containment expenses. The Company also includes adjusting and other expenses in the amounts shown above.

The asbestos related loss reserves stated above are not discounted. Pursuant to an accounting allowance (see note 1), the amount of the discount on reserves at December 31, 2004 is $94.2 million gross of reinsurance and $94.2 million net of reinsurance.

Environmental Related Losses

The environmental related losses (including coverage dispute costs) as of December 31, 2004 and 2003, gross of reinsurance, were as follows:

		2004	2003
		(In thousands)	
Beginning reserves	$	147,011	155,319
Incurred losses and LAE		3,979	(2,506)
Calendar year payments for losses and LAE		(47,098)	(5,802)
Ending environmental loss reserves	$	103,892	147,011

The environmental related losses (including coverage dispute costs) as of December 31, 2004 and 2003, net of reinsurance, were as follows:

		2004	2003
		(In thousands)	
Beginning reserves	$	125,862	104,946
Incurred losses and LAE		(6,290)	(3,068)
Calendar year payments for losses and LAE		(31,262)	23,984
Ending environmental loss reserves	$	88,310	125,862

The total environmental loss reserves at December 31, 2004 include IBNR reserves in the amount of $43.8 million gross of reinsurance and $47.6 million net of reinsurance. These IBNR reserves and the comparable amounts for prior years cover both losses and defense and cost containment expenses. The Company also includes adjusting and other expenses in the amounts shown above.

The environmental related loss reserves stated above are not discounted. Pursuant to an accounting allowance (see note 1), the amount of the discount on reserves at December 31, 2004 is $16.8 million gross of reinsurance and $16.8 million net of reinsurance.

Discounting of Losses and LAE

2004 Tabular Discount
Included in Schedule P, Part 1

Line of business	Case	IBNR	Total
		(In thousands)	
Workers' compensation	$ —	187,535	187,535

2004 Non-Tabular Discount

Line of business	Case	IBNR	Defense and cost containment	Adjusting and other expense	Total
			(In thousands)		
Homeowners/farmowners	$ —	773	—	—	773
Private passenger auto/truck liability/medical	—	6,746	—	—	6,746
Commercial auto/truck liability/medical	—	16,513	—	—	16,513
Workers' compensation	—	332,876	—	—	332,876
Commercial multi peril	—	41,315	—	—	41,315
Medical malpractice:					
Claims-made	—	421	—	—	421
Occurrence	—	3	—	—	3
Specialty liability	—	1,497	—	—	1,497
Other liability – claims made	—	13,443	—	—	13,443
Other liability – occurrence	—	121,941	—	1,245	123,186
Special property	—	1,247	—	—	1,247
Auto physical damage	—	(9)	—	—	(9)
Fidelity/surety	—	3,950	—	—	3,950
Other (including credit, A&H)	—	3,129	—	—	3,129
Reinsurance nonproportional assumed liability	—	34,311	—	—	34,311
Product liability – claims made	—	(5)	—	—	(5)
Products liability – occurrence	—	(2,824)	—	—	(2,824)
Total	—	575,327	—	1,245	576,572
Grand total	$ —	762,862	—	1,245	764,107

2003 Tabular Discount
Included in Schedule P, Part 1

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

2003 Non-Tabular Pension Discount
Included in Schedule P, Part 1

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

2003 All Other Non-Tabular Discount

Line of business	Case	IBNR	Defense and cost containment	Adjusting and other expense	Total
			(In thousands)		
Homeowners/farmowners	$ —	1,021	—	50	1,071
Private passenger auto/truck liability/medical	—	10,144	—	520	10,664
Commercial auto/truck liability/medical	—	18,430	—	833	19,263
Workers' compensation	—	255,194	—	9,686	264,880
Commercial multi peril	—	29,530	—	1,401	30,931
Medical malpractice:					
Claims-made	—	744	—	28	772
Specialty liability	—	608	—	32	640
Other liability – occurrence	—	75,290	—	3,595	78,885
Special property	—	1,197	—	34	1,231
Auto physical damage	—	(61)	—	(3)	(64)
Fidelity/surety	—	7,217	—	376	7,593
Other (including credit, A&H)	—	3,642	—	167	3,809
Reinsurance nonproportional assumed liability	—	6,138	—	344	6,482
Products liability – occurrence	—	181,139	—	2,390	183,529
Total	—	590,233	—	19,453	609,686
Grand total	$ 194,961	635,996	—	19,453	850,410

(4) Reinsurance

Effective December 31, 2003, the Company and AMM entered into a reinsurance transaction, the results of which included 1) an amendment to the Pooling Agreement that removed AMM from the Pool and ceded all net liabilities of AMM at December 31, 2003 to the Company and 2) the issuance by the Company of a new insurance policy to each and every policyholder of AMM other than those policyholders already fully reinsured by Unitrin's subsidiary, Trinity (see "Renewal Rights Transactions" in note 1.) In exchange for the issuance of these new insurance policies, AMM incurred an approximate charge of $229.2 million and the Company recorded income of the same amount for the year-ended December 31, 2003. Absent this reinsurance transaction as well as certain accounting allowances prescribed by the Division of Insurance, the statutory surplus of the Company at December 31, 2004 and 2003 would have been negative. In turn, AMM's solvency would also be at risk given AMM's significant reliance on its substantial reinsurance recoverables from the Company.

Historically, AMM and other Kemper Insurance Companies have ceded their directly written insurance business to the Company as their reinsurer, and the Company in turn has ceded to AMM 8% of that pooled business. As part of the reinsurance transaction described herein, the 8% cession from the Company to AMM was eliminated, with the Company receiving as payment from AMM assets equal to AMM's loss and LAE reserves/liabilities (approximately $370.0 million) assumed by the Company. AMM then also paid to the Company an amount equal to the remainder of AMM's December 31, 2003 statutory surplus less $10.0 million. The payments were in cash, securities, and the assignment of assets or beneficial rights to assets where the legal title to such assets could not be directly accomplished by December 31, 2003. Legal title to certain assets of AMM which are restricted from transfer, because they are statutory deposits or collateral for other purposes or subject to other restrictions, is to be transferred to the Company at the earliest practicable date.

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

Because the reinsurance transaction was not assumption reinsurance and AMM policies were not novated, the affected policyholders now hold separate policies issued by both AMM and the Company. AMM remains liable for policy liabilities in the event the Company does not comply with all the terms of the affected policies. AMM has $600.0 million in reinsurance recoverables due from the Company.

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

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

(Continued)

the aggregate for all companies and allocated to certain Company subsidiaries based on the business retained within those companies.

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

The Company's aggregate excess of loss reinsurance treaties relate to the 1998 through 2002 accident years, and they cover substantially all of the Company's lines of business. Recoveries under the treaties are payable when the paid covered net losses, as defined in the contracts, 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. Ceded premiums under contracts accounted for as prospective reinsurance, net of ceding commission, were zero for 2004 and 2003. Additional premiums may also be payable under the terms of certain treaties in future years. The pretax benefit (loss) related to the aggregate excess of loss reinsurance treaties accounted for as prospective reinsurance amounted to $0 and $(5.8) million as of December 31, 2004 and 2003, respectively. Liabilities ceded under contracts accounted for as prospective reinsurance were $0 and $6.0 million at December 31, 2004 and 2003, respectively.

Reinsurance Adjustments

In conjunction with the preparation of 2004 statutory financial statements, the Company recognized that in previous years it had misapplied certain facts related to various reinsurance agreements impacting ceded premiums as well as ceded losses and loss adjustment expenses. The Company recognized it had not properly accrued for future premium obligations contractually owed to reinsurers. These obligations were in the form of reinstatement premiums calculated based on ceded ultimate losses (case reserves and IBNR), additional premiums triggered by ceded ultimate losses in excess of the contractually stipulated limit, and premium adjustments. The total premium-related impact, net of related commission and other expenses, on these agreements is approximately $9.2 million. The Company also established a ceded reinsurance premium accrual of approximately $3.1 million at December 31, 2004 which represents its estimated additional premium obligation on reinsurance agreements with captive reinsurers. Additionally, the Company recognized it had over-ceded losses and allocated loss adjustment expenses on an ultimate basis totaling $7.0 million.

Berkshire Hathaway Insurance Group and Kemper Commercial Insurance Company

On June 20, 2003, the Company and AMM and certain affiliates of Berkshire Hathaway Inc. (Berkshire) commuted two reinsurance agreements entered into at year-end 2001 and during 2002, returning to the Company and AMM substantially all reinsurance premium, net of loss recoveries, previously paid thereunder (approximately $697.3 million); amended a claim services agreement to return to the Company (and its affiliates) a previously paid deposit ($89.0 million); and replaced existing security arrangements

which had been entered into in early 2003 (in connection with Berkshire affiliates issuing cut-through agreements for the benefit of insureds of the Company and its affiliates) with both (a) a collateral trust (encumbering approximately $250.8 million of the Company's and AMM's assets at June 20, 2003) and (b) the purchases from Berkshire (and corresponding pledges of the same to Berkshire) by the Company and AMM of Berkshire debt instruments (Schedule D bonds totaling approximately $257.3 million). In addition, a stock subsidiary of the Company, Kemper Insurance Group, Inc. (KIG), repurchased for $125.0 million Berkshire's 15% interest in KIG on June 20, 2003; Berkshire had acquired that minority interest for $125.0 million approximately a year earlier, on June 28, 2002. Substantially all of the Company's investments in KIG, approximately $603.1 million, were transferred back to the Company in the second half of 2003.

Effective December 31, 2001, the Company and certain of its insurance company affiliates (Kemper) entered into an Asbestos and Environmental Loss Portfolio Transfer Agreement (the A&E Reinsurance Agreement) with National Fire & Marine Insurance Company (National Fire) and National Indemnity Company (National Indemnity), wholly owned subsidiaries of Berkshire. Under the terms of the A&E Reinsurance Agreement, Kemper ceded to National Fire and National Indemnity, at the rate of 65% of subject losses, $550.0 million of asbestos, environmental, and other mass tort reserves, for $352.5 million in cash. Kemper also had an option to buy an additional $50.0 million of coverage for an additional premium of $8.0 million. This contract at that time resulted in a retroactive reinsurance gain for Kemper increasing then-reported statutory surplus by $197.5 million. In connection with this contract, National Fire and National Indemnity assumed administration of the claims settlement process, and in accordance with the terms of the contract, Kemper prepaid $27.5 million for the claim services and deposited another $89.0 million with the claim service provider. As described in the preceding paragraph, on June 20, 2003, the latter amount was returned to Kemper and the A&E Reinsurance Agreement was commuted. The commutation in 2003 resulted in the recognition of a retroactive loss on reinsurance, reducing the Company's statutory surplus by $197.5 million.

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

In connection with the National Fire transaction in the first half of 2002, Kemper entered into certain reinsurance agreements, including a Loss Reserve Reinsurance Agreement (the ADC Reinsurance Agreement) with National Fire and National Indemnity. Under the terms of this agreement, Kemper paid National Fire and National Indemnity a total of $405.0 million in cash during the first quarter of 2002 to protect Kemper against adverse loss development from policies with accident year dates of December 31, 2001 and prior. This contract resulted in a retroactive reinsurance gain increasing then-reported statutory

surplus by $120.0 million. On June 20, 2003, as mentioned above, the ADC Reinsurance Agreement was commuted. The commutation in 2003 resulted in the recognition of a retroactive loss on reinsurance, reducing the Company's statutory surplus by $124.2 million.

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

In addition to the investment in KIG, as part of the National Fire transaction, Kemper also entered into the AMM Middle Market Multi Line Quota Share Reinsurance Agreement (the Middle Market QS Agreement) with National Fire effective January 1, 2002. The Middle Market QS Agreement covered business written or renewed related to commercial package, commercial casualty, and automobile lines between January 1, 2002 and December 31, 2003 produced through Kemper's middle market profit center. Under the terms of the Middle Market QS Agreement, Kemper ceded 80% of the gross net written premium produced by the profit center in exchange for an 80% quota share participation of subject losses. Kemper also received a ceding commission equal to the lesser of 80% of actual allocated expenses or 30% of premiums ceded to National Fire. As of December 31, 2004, Kemper had ceded to National Fire from inception net written premiums of $536.6 million and subject losses and loss adjusting expenses of $340.8 million.

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

The Berkshire Letter of Intent with National Indemnity as amended January 13, 2003 provided Kemper with immediate access to cut-through agreements issued by National Indemnity. The cut-through agreements were applied to certain standard commercial and specialty lines of insurance. This cut-through agreement allows a Kemper insured to directly submit claims to National Indemnity in the event Kemper (as the insurance company which issued the policy) is unable to pay such claims as a result of its insolvency or a court or regulatory order prohibiting claim payments due to the issuing company's financial condition. Cut-through agreements were added to certain policies in-force as of December 23, 2002 and to certain new policies issued on and after December 23, 2002 until September 30, 2003. From inception of the use of the cut-throughs in late December 2002 through 2004, Kemper incurred net cut-through agreement fees of approximately $15.0 million, substantially all of which was incurred by the Company during 2003 and prior.

Under the Berkshire Letter of Intent with National Indemnity, Kemper immediately provided collateral available to National Indemnity if and to the extent National Indemnity makes any payments under any cut-through agreements. The collateral includes offset rights prescribed to National Indemnity for reinsurance proceeds payable by either National Indemnity or National Fire to Kemper or its affiliates; a collateral trust in an amount of approximately $250.0 million of the invested assets of the parties to the Pooling Agreement as of the end of June 2003 which amount was reduced, by payments of claims (losses and loss adjustment expenses) and mid-term cancellations of policies, to approximately $206.7 million at December 31, 2003; and an investment of $257.3 million in Berkshire corporate obligations which the Company and AMM purchased from (and pledged as security to) Berkshire in 2003. If National Indemnity makes no payments under the cut-through agreements, then of the $257.3 million of pledged obligations, $100.0 million matures in March 2025, while the remaining $157.3 million is subject to mandatory redemption as and when the Company pays claims on policies covered by the cut-through agreements following exhaustion of the assets in the aforementioned collateral trust which must first be applied to such claim payments. The Company projects that at current claim payment rates, the trust assets will be reduced to zero by late 2005 or early 2006.

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

Other Reinsurance Disclosures

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

		Assumed	Ceded
		(In thousands)	
2004:			
Written premiums	$	28,123	60,083
Unearned premiums		15,271	24,229
Outstanding losses and LAE (including IBNR)		735,197	3,015,526
Paid losses		568,477	1,123,421
2003:			
Written premiums	$	73,158	558,106
Unearned premiums		23,805	155,050
Outstanding losses and LAE (including IBNR)		1,002,516	3,701,254
Paid losses		260,545	1,707,019

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

		Assumed	**Ceded**
		(In thousands)	
2004:			
Written premiums	$	(9,821)	5,255
Unearned premiums		37,098	—
Outstanding losses and LAE (including IBNR)		2,724,663	25,898
Paid losses		119,088	(830,174)
2003:			
Written premiums	$	985,361	268,677
Unearned premiums		179,458	13,397
Outstanding losses and LAE (including IBNR)		3,918,446	344,496
Paid losses		280,462	595,729

(Continued)

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. Reinsurance recoverables are reported after allowances for uncollectible amounts. The Company also holds collateral, including escrow funds, letters of credit, and trust funds, under certain reinsurance agreements. The Company monitors the financial condition of reinsurers on an ongoing basis, and reviews its reinsurance arrangements periodically. Reinsurers have been selected based on their financial condition and business practices. As of December 31, 2004, approximately 74.8% of the Company’s $2.4 billion of unsecured recoverables from reinsurers, excluding the Company’s participation in third-party pools, were from reinsurers rated A or better by A.M. Best Company or Standard & Poor’s, and approximately 79.6% of the Company’s $2.4 billion of unsecured recoverables were rated A– or better by A.M. Best Company or Standard & Poor’s.

As of December 31, 2004, the Company had unsecured aggregate recoverables from outside reinsurers for losses paid, losses unpaid, LAE, and unearned premium that exceed 3% of the Company's total surplus with the following reinsurers (and related group members):

Reinsurer	FEIN Code	NAIC Group #	NAIC Code	Net Recoverable
				(In thousands)
Allstate Insurance Co.	36-0719665	8	19232	$12,679
		8 Total		12,679
American Home Assurance Co.	13-5124990	12	19380	188
Hartford Steam Boil Inspection & Insurance Co.	06-0384680	12	11452	3,462
Insurance Co. of the State of Pennsylvania	13-5540698	12	19429	2,102
Transatlantic Reinsurance Co.	13-5616275	12	19453	65,645
		12 Total		71,397
Cologne Reinsurance Co. of America	06-0949141	31	33197	18
General Reinsurance Corp.	13-2673100	31	22039	135,950
National Fire & Marine Insurance Co.	47-6021331	31	20079	210,934
National Indemnity Co.	47-0355979	31	20087	12
National Reinsurance Corp.	13-1988169	31	34835	579
		31 Total		347,493
California Casualty Indemnity Exchange	94-6064430	33	20117	2,089
		33 Total		2,089
Affiliated FM Insurance Co.	05-0254496	65	10114	5
Factory Mutual Insurance Co.	05-0316605	65	21482	1,909
		65 Total		1,914
Motors Insurance Co.	38-0855585	79	22012	8,339
		79 Total		8,339
Hartford Fire Insurance Co.	06-0383750	91	19682	18,368
		91 Total		18,368
Berkley Insurance Co.	47-0574325	98	32603	39,214
Firemen's Insurance Co. of Washington D.C.	53-0067060	98	21784	361
Tri State Insurance Co. of Minnesota	41-1232071	98	31003	287
		98 Total		39,862
Employers Insurance of Wausau	39-0264050	111	21458	7,802
Liberty Mutual Insurance Co.	04-1543470	111	23043	1,715
		111 Total		9,517
National Casualty Co.	38-0865250	140	11991	3,588
Nationwide Mutual Insurance Co.	31-4177100	140	23787	686
		140 Total		4,274

(Continued)

Reinsurer	FEIN Code	NAIC Group #	NAIC Code	Net Recoverable
				(In thousands)
North River Insurance Co.	22-1964135	158	21105	$2
Odyssey America Reinsurance Co.	47-0698507	158	23680	9,845
Odyssey Reinsurance Corp.	13-2781282	158	25070	32,785
		158 Total		42,632
Reliance Insurance Co.	23-0580680	159	24457	4,509
		159 Total		4,509
American States Insurance Co.	35-0145400	163	19704	2,063
		163 Total		2,063
Discover Property & Casualty Insurance Co.	36-2999370	164	36463	25
St. Paul Fire & Marine Insurance Co.	41-0406690	164	24767	28,349
United States Fidelity & Guaranty Co.	52-0515280	164	25887	2,282
		164 Total		30,656
Sentry Insurance A Mutual Co.	39-0333950	169	24988	2,089
		169 Total		2,089
State Farm Fire & Casualty Co.	37-0533080	176	25143	2,716
		176 Total		2,716
Swiss Reinsurance America Corp.	13-1675535	181	25364	234,635
Swiss Reinsurance Life & Health America Inc.	06-0839705	181	82627	3,551
Underwriters Reinsurance Co.	16-0366830	181	22314	24,568
		181 Total		262,754
Zurich American Insurance Co. of Illinois	36-2781080	212	27855	2,362
		212 Total		2,362
Trinity Universal Insurance Co.	75-0620550	215	19887	59,953
		215 Total		59,953
Continental Casualty Co.	36-2114545	218	20443	29,882
Continental Insurance Co.	13-5010440	218	35289	16
Continental Reinsurance Corp.	13-1941984	218	20923	11
Encompass Insurance Co. of America	36-3976913	218	10071	530
		218 Total		30,439
Reliastar Life Insurance Co.	41-0451140	229	67105	107,351
		229 Total		107,351
Employers Reinsurance Corp.	48-0921045	350	39845	76,932
GE Reinsurance Corp.	36-2667627	350	22969	201,230
Westport Insurance Corp.	13-1941868	350	34207	522
		350 Total		278,684
American Re-Insurance Co.	13-4924125	361	10227	278,286
		361 Total		278,286

(Continued)

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Reinsurer	FEIN Code	NAIC Group #	NAIC Code	Net Recoverable
				(In Thousands)
American National Insurance Co.	74-0484030	408	60739	$7,526
		408 Total		7,526
Gerling America Insurance Co.	13-3071466	604	41343	52
Gerling Global Reinsurance Corp. - U.S. Branch	13-6107326	604	11266	4
Gerling Global Reinsurance Corp. of America	13-5009848	604	21032	21,634
		604 Total		21,690
American United Life Insurance Co.	35-0145825	619	60895	3,257
		619 Total		3,257
Ace American Insurance Co.	95-2371728	626	22667	2,969
Ace American Reinsurance Co.	23-1740414	626	22705	1,661
Ace Property & Casualty Insurance Co.	06-0237820	626	20699	5,490
Insurance Co. of North America	23-0723970	626	22713	14,398
Westchester Fire Insurance Co.	13-5481330	626	21121	12
		626 Total		24,530
General Security National Insurance Co.	13-3029255	749	39322	4,707
Scor Reinsurance Co.	75-1444207	749	30058	31,879
		749 Total		36,586
Radian Asset Assurance Inc.	22-2712977	766	36250	2,035
		766 Total		2,035
Pennsylvania Manufacturers Assn. Insurance Co.	23-1642962	767	12262	330
PMA Capital Insurance Co.	23-2153760	767	39675	4,410
		767 Total		4,740
Q.B.E Reinsurance Corp.	23-1641984	796	10219	5,541
		796 Total		5,541
AXA Corporate Solutions Insurance Co.	13-3594502	968	33022	264
AXA Corporate Solutions Reinsurance Co.	36-2994662	968	36552	482
AXA RE America Insurance Co.	04-1590940	968	11835	6,437
		968 Total		7,183
Highlands Insurance Co.	74-1296673	1116	22489	1,997
		1116 Total		1,997
Everest Reinsurance Co.	22-2005057	1120	26921	32,978
		1120 Total		32,978
American Healthcare Indemnity Co.	59-2048400	1125	39152	3,139
		1125 Total		3,139
American Employers Insurance Co.	04-1027270	1129	20613	266
Folksamerica Reinsurance Co.	13-2997499	1129	38776	9,560
		1129 Total		9,826

(Continued)

Reinsurer	FEIN Code	NAIC Group #	NAIC Code	Net Recoverable
				(In Thousands)
Arch Insurance Co.	43-0990710	1279	11150	$1,102
Arch Reinsurance Co.	06-1430254	1279	10348	6,146
		1279 Total		7,248
X.L. Insurance America Inc.	75-6017952	1285	24554	16
X.L. Reinsurance America Inc.	13-1290712	1285	20583	27,237
		1285 Total		27,253
Trenwick America Reinsurance Corp.	06-1117063	1314	34894	93,748
		1314 Total		93,748
Alea North American Insurance Co.	06-1022232	1325	24899	11,256
Alea North American Specialty Insurance Co.	51-0335732	1325	44776	3,554
		1325 Total		14,810
Converium Reinsurance North America Inc.	06-1325038	3018	39136	175,243
		3018 Total		175,243
Gulf Insurance Co.	43-6028696	3321	22217	8,175
Northland Insurance Co.	41-6009967	3321	24015	1,017
Travelers Indemnity Co.	06-0566050	3321	25658	762
		3321 Total		9,954
Partner Reinsurance Co. of the U.S.	13-3031176	3483	38636	11,431
PartnerRe Insurance Co. of New York	13-3531373	3483	10006	236
		3483 Total		11,667
Associated Aviation Underwriters	AA-9995013			160,477
Patriot Insurance Co. Ltd.	AA-3190450			35,704
Texas Workers Compensation	AA-9991444			24,576
Commercial Risk Re-Insurance Co.	03-0331391		27955	19,310
Alea Bermuda Ltd.	AA-3190800			19,185
Lloyd's of London (Authorized)	AA-1122000			18,337
Hannover Ruckversicherungs AG	AA-1340125			15,847
National Fidelity Life Insurance Co.	44-0367450		66559	14,995
Overseas Partners U.S. Reinsurance Co.	23-2745904		10019	10,370
Security Mutual Casualty Co.				9,590
Lloyd's Syndicate Number 2020	AA-1128020			9,388
TOA-Reinsurance Co. of America	13-2918573		42439	7,654
Seven Continents Insurance Co. Ltd. (The)	AA-3190196			7,361
New Jersey Unsatisfied Claim & Judgment Fund	AA-9991160			6,595
Mutual Reinsurance Bureau	AA-9995035			6,473
Wurttembergische Versicherung AG	AA-1340255			6,243

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Reinsurer	FEIN Code	NAIC Group #	NAIC Code	Net Recoverable
				(In Thousands)
Workers Compensation Reinsurance Assn.	41-1357750		10181	$6,106
American Fuji Fire & Marine Insurance Co.	36-3155373		40398	5,651
Q.B.E Int'l Insurance Ltd.	AA-1120481			4,865
Lloyd's Syndicate Number 1241	AA-1127241			4,122
Texas Small Premium Policy Plan	AA-9992082			3,667
Royal & Sun Alliance PLC	AA-1121275			3,623
Lloyd's Syndicate Number 2791	AA-1128791			3,577
Washington Assigned Risk Pool				3,335
Lloyd's of London (Authorized)	AA-1123000			2,967
Renaissance Reinsurance Ltd.	AA-3190339			2,784
Lloyd's Syndicate Number 1212	AA-1127212			2,229
American International Reinsurance Co. Ltd.	AA-3190005			2,006
Michigan Catastrophic Claims Assn.	AA-9991159			1,921
North Carolina Reinsurance Facility	AA-9991139			1,909
Grand Total				$ 2,542,246

Uncollectible Reinsurance

During 2004, the Company wrote off $3.3 million related to reinsurance paid loss recoverable balances with Reliance Insurance Company and related affiliates which was ordered into liquidation on October 3, 2001. The Company also wrote off during 2004 a total of $358 thousand related to paid loss recoverable balances with other reinsurers deemed no longer collectable.

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, 2004 was as follows:

		Assumed reinsurance		Ceded reinsurance		Net	
		Premium reserve	Commission equity	Premium reserve	Commission equity	Premium reserve	Commission equity
		(1)	(2)	(3)	(4)	(5)	(6)
(i)	Affiliates	$ 37,097,460	18,427,897	—	—	37,097,460	18,427,897
(ii)	All other	15,271,378	4,598,439	24,229,094	2,150,143	(8,957,716)	2,448,296
(iii)	Total	$ 52,368,838	23,026,336	24,229,094	2,150,143	28,139,744	20,876,193

Commutation of Ceded Reinsurance

The Company has reported in its operations in the current year as a result of commutation of reinsurance with the companies listed below, amounts which are reflected as:

Agreement	Reinsurer	FEIN Code	NAIC Code	Amount	Reflected As
Commutation #1	PX Reinsurance Ltd.	AA-3194137	N/A	$ 425,000	Other Income
Commutation #2	PXRe Reinsurance Company	06-1206728	29807	(3,000,000)	Losses Incurred
Commutation #3	GE Reinsurance Corporation	36-2667627	22969	(1,825,469)	Losses Incurred
Commutation #4	Employers Reinsurance Corporation	48-0921045	39845	(195,712)	Losses Incurred
Commutation #5	National Workers Compensation Reinsurance Pool	AA-9992118	N/A	—	Other Income
Commutation #6	Illinois Workers Compensation Reinsurance Pool	AA-9991413	N/A	—	Other Income
Commutation #7	Massachusetts Workers Compensation Reinsurance Pool	AA-9991421	N/A	—	Other Income
Commutation #8	Arkansas Workers Compensation Reinsurance Pool	AA-9992112	N/A	—	Other Income
Total				$ (4,596,181)	

Retroactive Reinsurance

As of December 31, 2004, the Company did not engage in any assumed retroactive reinsurance transactions. As of December 31, 2003, the Company did participate in one ceded retroactive reinsurance transaction which is referenced below as Ceded Contract #1. Ceded Contract #1 was 90% commuted in 2003 with one reinsurer remaining. That reinsurer was commuted in 2004. There are currently no retroactive reinsurance agreements. Contract #1 covered all lines of business and was referred as the "Aggregate Excess of Loss Reinsurance Treaty for 2000."

	Ceded Contract #1 1/1/2000	Total
A – Reserves transferred:		
Initial reserves	$ 17,510,300	17,510,300
Adjustments – prior year(s)	(6,276,813)	(6,276,813)
Adjustments – current year	1,744,491	1,744,491
Current total	$ 12,977,978	12,977,978
B – Consideration paid or received:		
Initial consideration	$ 11,555,952	11,555,952
Adjustments – prior year(s)	669,945	669,945
Adjustments – current year	—	—
Current total	$ 12,225,897	12,225,897
C – Paid losses reimbursed or recovered:		
Prior year(s)	$ 10,110,139	10,110,139
Current year	—	—
Current total	$ 10,110,139	10,110,139
D – Special surplus from retroactive reinsurance:		
Initial surplus gain or loss	$ 5,954,348	5,954,348
Adjustments – prior year(s)	(6,946,758)	(6,946,758)
Adjustments – current year	1,744,491	1,744,491
Current year restricted surplus	—	—
Cumulative total transferred to unassigned funds	$ 752,081	752,081

(Continued)

E – Included in the summary totals above are the following reinsurers with their respective ceded reserve amounts currently transferred:

Ceded contract	Covered business	Reinsurer	FEIN Code	NAIC Code	Participation percentage	Ceded amount
Contract #1	All Lines	PXRE Reinsurance Co.	AA-3194137	N/A	100.00%	$ 12,977,978
Total						$ 12,977,978

F – As of December 31, 2004, the Retroactive agreement had been commuted so it did not have any paid loss recoverables.

Reinsurance Recoverable in Dispute

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

Name of reinsurer	Total amount in dispute (including IBNR)	Notification	Arbitration	Litigation
Patriot Insurance Co. Ltd.	$ 41,139,209	—	—	41,139,209
Transatlantic Reinsurance Co.	15,445,237	8,691,234	6,754,003	—
Front Range Insurance Co.	14,516,282	—	—	14,516,282
X.L. Reinsurance America Inc.	6,921,057	6,921,057	—	—
American Re-insurance Co.	5,130,624	5,130,624	—	—
Q.B.E. Int'l Insurance Ltd.	4,748,435	—	4,748,435	—
Converium Reinsurance North America	4,299,269	4,299,269	—	—
Lloyd's Syndicate Number 2020	4,183,094	4,183,094	—	—
Employers Reinsurance Co.	3,748,705	2,923,860	824,845	—
Everest Reinsurance Co.	3,248,062	—	3,248,062	—
Hannover Ruckverischerungs AG	3,109,308	3,109,308	—	—
Continental Casualty Co.	2,931,061	2,931,061	—	—
Wurttembergische Versicherung Ag	2,769,057	2,769,057	—	—
Odyssey Reinsurance Corp.	2,711,557	720,721	1,990,836	—
Allstate Insurance Co.	2,641,423	—	2,641,423	—
Insurance Co. of North America	2,593,721	2,593,721	—	—
Underwriters Reinsurce Co.	2,503,136	2,503,136	—	—
Royal & Sun Alliance PLC	2,172,258	2,172,258	—	—
Zurich American Insurance Co. of Illinois	2,062,254	2,062,254	—	—
Employers Insurance of Wausau	1,957,362	—	1,957,362	—
GE Reinsurance Corp.	1,869,470	—	1,869,470	—
Lloyd's Syndicate Number 2791	1,715,634	88,849	1,626,785	—
Mutual Reinsurance Bureau	1,616,989	306,365	1,310,624	—
Folksamerica Reinsurance Co.	1,396,562	1,396,562	—	—
Lloyd's Syndicate Number 1212	1,196,952	1,196,952	—	—
Lloyd's of London (Authorized)	1,187,896	1,187,896	—	—
Liberty Mutual Insurance Co. (Mass) Ltd.	1,062,494	1,062,494	—	—
Lloyd's Syndicate Number 1241	982,261	982,261	—	—
National Casualty Co.	962,554	—	962,554	—
TOA-Reinsurance Co. of America	961,180	—	961,180	—
Argonaut Insurance Co.	928,770	928,770	—	—
Lloyd's Syndicate Number 250	884,777	884,777	—	—
Lloyd's Syndicate Number 183	676,520	676,520	—	—
Lloyd's Syndicate Number 510	579,037	579,037	—	—
Zurich Vers Ges AG	542,049	—	542,049	—
Swiss Reinsurance America Corp.	347,991	347,991	—	—

(Continued)

Name of reinsurer		Total amount in dispute (including IBNR)	Notification	Arbitration	Litigation
Northland Insuance Co.	$	282,721	282,721	—	—
St. Paul Fire & Marine Insurance Co.		258,828	258,828	—	—
Excess Insurance Co. Ltd.		237,505	237,505	—	—
General Reinsurance Corp.		231,471	231,471	—	—
Lloyd's Syndicate Number 138		177,177	177,177	—	—
Lloyd's Syndicate Number 727		177,177	177,177	—	—
American States Insurance Co.		151,945	151,945	—	—
Canadian Reinsurance Co.		74,453	74,453	—	—
Scor Reinsurance Co.		59,076	59,076	—	—
Factory Mutual Insurance Co.		57,501	57,501	—	—
American Employers Insurance Co.		56,237	56,237	—	—
Nationwide Mutual Insurance Co.		55,509	—	55,509	—
Q.B.E. Reinsurance Corp.		40,681	40,681	—	—
Lloyd's of London (Unauthorized)		31,478	31,478	—	—
Endurance Specialty Insurance Ltd.		17,885	17,885	—	—
Odyssey American Reinsurance Co.		15,202	15,202	—	—
Total	$	147,668,170	62,519,544	29,493,136	55,655,491

Events of September 11, 2001

The terrorist attacks of September 11, 2001 resulted in a tremendous loss of life and property. In the past, insurance companies have incurred losses as a result of catastrophes such as earthquakes, hurricanes, and even other terrorist attacks. However, these events are unprecedented in the United States in terms of the magnitude of the losses incurred and the number of entities affected. Through December 31, 2004, the Company’s inception-to-date gross incurred loss and LAE related to the September 11 events are estimated as follows:

		Inception-to-date through December 31, 2004
		(In thousands)
Gross losses and LAE incurred	$	226,263
Reinsurance losses and LAE ceded		(174,612)
Net losses and LAE incurred	$	51,651

The incurred losses were primarily attributable to the commercial multiple peril and other liability lines of business.

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. As of December 31, 2004, the Company had a total remaining deposit balance of $43.0 million after taking into account interest income deposits and cash recoveries, as follows:

(Amounts in thousands)

	Contract #1	Contract #2	Total
Effective yield	5.64%	9.12%	
2000:			
Initial payment	$ 22,007	—	22,007
Cash deposits	—	—	—
Interest income	124	—	124
Cash recoveries	(29)	—	(29)
Deposit balance	22,102	—	22,102
2001:			
Initial payment	—	—	—
Cash deposits	20,976	3,887	24,863
Interest income	618	240	858
Cash recoveries	(1,538)	(1,454)	(2,992)
Deposit balance	42,158	2,673	44,831
2002:			
Initial payment	—	—	—
Cash deposits	22,411	—	22,411
Interest income	1,047	290	1,337
Cash recoveries	(6,235)	(967)	(7,202)
Deposit balance	59,381	1,996	61,377
2003:			
Initial payment	—	—	—
Cash deposits	765	—	765
Interest income	7,342	114	7,456
Cash recoveries	(13,870)	(538)	(14,408)
Deposit balance	53,618	1,572	55,190
2004:			
Initial payment	—	—	—
Cash deposits	206	—	206
Interest income	1,954	—	1,954
Cash recoveries	(14,339)	—	(14,339)
Deposit balance	$ 41,439	1,572	43,011

(Continued)

(5) Federal and Foreign Income Taxes

The components of the Company's net deferred tax asset as of December 31, 2004 and 2003 were as follows:

		2004	2003
		(In thousands)	
Total of gross deferred tax assets	$	732,431	622,073
Total of deferred tax liabilities		(3,579)	(8,745)
Net deferred tax asset		728,852	613,328
Deferred tax asset nonadmitted		(728,852)	(613,328)
Net admitted deferred tax asset	$	—	—
Increase in nonadmitted asset	$	(115,524)	(84,473)

The Company's income tax (expense) benefit for the year-ended December 31, 2004 and 2003 consisted of the following major components:

		2004	2003
		(In thousands)	
Federal	$	(14,496)	21,967
Foreign		2,178	5,202
Federal and foreign income tax (expense) benefit	$	(12,318)	27,169

(Continued)

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, 2004 and 2003 were as follows:

		2004	2003
		(In thousands)	
Deferred tax assets:			
Loss carryforwards	$	423,049	268,841
Accrued liabilities		35,526	108,997
Reserves		48,448	52,483
Investments		73,233	80,730
Receivables		106,889	87,641
Reinsurance adjustments		30,465	—
Other		14,821	23,381
Total deferred tax assets		732,431	622,073
Nonadmitted deferred tax assets		(728,852)	(613,328)
Admitted deferred tax assets		3,579	8,745
Deferred tax liabilities:			
Salvage and subrogation		(3,441)	(6,594)
Investments		(138)	(2,151)
Total deferred tax liabilities		(3,579)	(8,745)
Net admitted deferred tax asset	$	—	—

The change in net deferred income taxes as of December 31, 2004 and 2003 was comprised of the following:

		2004	2003		Change
			(In thousands)		
Total deferred tax assets	$	732,431	622,073		110,358
Total deferred tax liabilities		(3,579)	(8,745)		5,166
Net deferred tax asset	$	728,852	613,328		115,524
Tax effect of unrealized gains or losses					—
Increase in net deferred income tax in surplus				$	115,524

(Continued)

The actual Federal and foreign income tax (expense) benefit as of December 31, 2004 and 2003 differed from "expected" tax (expense) benefit (expected tax is computed by applying the corporate tax rate of 35% to income before Federal and foreign income taxes) as follows:

		2004	2003
		(In thousands)	
Computed "expected" tax benefit	$	42,454	161,523
Capital gain adjustment		24,687	(142,063)
Unearned premium reserve adjustments		4,794	11,047
Net operating loss adjustment		(134,145)	(43,099)
Accrued liabilities		46,360	(21,831)
Prior year tax adjustments		(15,079)	5,614
Reinsurance adjustments		(21,275)	—
Policyholder dividends		4,015	—
Loss reserve discounting		19,270	42,916
Tax-exempt investment income		11,978	6,055
Depreciation		5,772	(2,324)
Foreign income taxes		2,178	5,202
Reserves		575	—
Other, net		(3,902)	4,129
Federal and foreign income tax (expense) benefit	$	(12,318)	27,169

		2004	2003
Provision computed at statutory rate	$	42,454	161,523
Investments		(40)	(120,328)
Accrued liabilities		(27,149)	(20,613)
Tax-exempt investment income		11,978	5,757
Prior period adjustment		(12,900)	10,816
Reinsurance adjustment		10,165	—
Receivables		24,300	59,071
Reserves		24,957	3,558
Subsidiary mergers		32,092	—
Other		(2,651)	11,858
Total statutory income taxes	$	103,206	111,642
Federal and foreign income taxes incurred	$	(12,318)	27,169
Change in net deferred income taxes		115,524	84,473
Total statutory income taxes	$	103,206	111,642

(Continued)

At December 31, 2004, the Company had $1.2 billion of operating loss carryforward which originated and expires as follows:

Origination year	Expiration year	Amount (In thousands)
2000	2020	$ 155,349
2001	2021	364,381
2002	2022	139,043
2003	2023	166,840
2004	2024	383,099
		$ 1,208,712

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 2000 are closed for IRS examination. The Company is not currently under examination by the Internal Revenue Service for any open tax years.

The Company files a consolidated Federal income tax return which includes the Company as the common parent corporation and the following affiliated entities: AMICO, AMICO Realty Corporation, AMPICO, American Protection Property & Casualty Agency, Inc., American Protection Property & Casualty Agency, Inc. of Texas, American Protection Property and Casualty Insurance Agency, Inc., American Underwriting Corporation, GreatLand Holdings, Inc., GreatLand Insurance Company, Juris Prudent, Inc., Kemper Casualty, Inc., Kemper Casualty, Kemper Commercial, Kemper Comprehensive Insurance Company, Kemper Cost Management Holding Company, Inc., Kemper Employers Group, Inc., Kemper Environmental Managers, Inc., Kemper Financial Protection, Inc., Kemper Indemnity, Kemper Insurance Group, Inc., Kemper Insurance Holdings #2, Inc., Kemper International Corporation, Kemper Lloyds Insurance Company, Kemper Realty Corporation, Kemper Surplus Lines Insurance Company, Kemper Technology Services, Inc., KWS, Kempes, Inc., K-P Plaza Dallas, LGA-1, Inc., LGA-2, Inc., LGA-3, Inc., LGA-16, Inc., LGA-17, Inc., Lou Jones & Associates, Nereus Holdings, Inc., Pacific Eagle, Point & Quote Insurance Services, Inc., RidgeLand Insurance Company, Specialty Insurance Managers, Inc., SNIC, Specialty Resource Risk Services, Inc., SSIC, UBIC, and Universal Bonding Holding Company.

(6) Transactions with Affiliates and Related Parties

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

In various other notes to the financial statements, transactions with affiliates and related parties are also discussed.

(Continued)

(7) Employee Benefit Plans

Pension Plans

The Company had a noncontributory defined benefit pension plan (Plan A) in which all of its full-time employees with one year of service participate and become fully vested after five years of service. The Company also has a nonqualified supplemental plan which provides additional pension benefits to certain key employees and officers. Effective January 15, 2004, the Company adopted an amendment to freeze both the qualified and nonqualified noncontributory defined benefit pension plans. This freeze triggered a one-time expense related to prior service cost of $40 thousand. The Company also has a frozen noncontributory defined benefit pension plan (Plan B) which relates to a previous wholly owned subsidiary divested in 1998. As previously discussed (see note 2), the Company sold its claim servicing division (NATLSCO) in July 2003. The sale involved the transfer of approximately 3,300 employees which 1,700 were participants in the Qualified Non-Contributory defined benefit plan which triggered a one-time pension plan curtailment expense of $161 thousand.

During 2004, the Company funded and accrued a total of $21.5 million into its non-contributory qualified defined benefit pension plans. As previously reported at December 31, 2003, the Company had recorded directly against surplus a minimum pension liability of $128.5 million, reflecting the difference between the pension plans' accumulated benefit obligation and the market value of the pension plans' assets at that time.

On October 19, 2004, the Pension Benefit Guaranty Corporation (the PBGC), the federal corporation responsible for guaranteeing payment of pension benefits, notified the Company that the PBGC would move to take control of the Company's defined benefit pension plans effective October 21, 2004. The benefits under the pension plans are insured through the PBGC; it is anticipated that the benefit levels for the majority of the approximately twelve thousand plan participants will not be significantly affected by this development; and payments to retirees will continue uninterrupted. Future retirees will receive their pension from the PBGC when they are eligible to retire.

The Company and the PBGC entered into an agreement in late 2004 resolving the Company's liabilities under the qualified plan. As a result of the PBGC action and the agreement, the Company's surplus as of December 31, 2004 increased approximately $107.0 million, reflecting the benefit of the release of the minimum pension liability previously recorded at December 31, 2003 ($128.5 million), less the sum of the amounts funded and accrued during 2004 ($21.5 million).

As of the end of the second quarter of 2004, the Company carried a $33.2 million liability for its non-qualified supplemental retirement plan and related liabilities (SRP) which historically provided the promise of future benefits to certain highly compensated employees. Former employees represented all of the accrued SRP liabilities. In the third quarter of 2004, in light of the Company's financial condition and with the approval of the Division of Insurance, the Company offered to pay SRP participants who had vested benefits a substantially discounted present value of those benefits. As a result, in the third quarter of 2004, the Company paid to SRP participants $4.6 million, reflecting an average discount of over 86%, and the Company recorded a benefit increasing policyholders surplus by $28.6 million.

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

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

(Continued)

	December 31, 2003			
	Qualified pension plan		Nonqualified	
	Plan A	Plan B	pension plan	Total
Expense for 2003:				
Service cost	$ 18,963,312	—	1,554,595	20,517,907
Interest cost	48,375,701	450,093	2,723,233	51,549,027
Expected return on assets	(57,598,051)	(779,820)	—	(58,377,871)
Amortization of unrecognized:				
Transition asset	(13,742,545)	—	—	(13,742,545)
Prior service cost	17,826	—	—	17,826
Net loss	3,983,757	17,959	746,475	4,748,191
Net periodic benefit cost	—	(311,768)	5,024,303	4,712,535
One-time expense	269,344	—	—	269,344
Total expense	$ 269,344	(311,768)	5,024,303	4,981,879
Less amounts allocated to AMM				(398,550)
Amount retained by the Company				$ 4,583,329
Obligation for active nonvested employees, November 30, 2003	$ 1,188,621	—	1,194,498	2,383,119

Savings and Profit Sharing Plans

The Company's Savings and Profit Sharing Plan is qualified under Section 401(a) of the Internal Revenue Code. For the year-ended December 31, 2004, employer and employee contributions were $1.5 million and $3.3 million, respectively, while for 2003, employer and employee contributions were $8.0 million and $16.5 million, respectively.

In the fourth quarter of 2004, the Company announced that it will cease matching contributions to the Company's 401(k) plan beginning in 2005. This action is projected to eliminate approximately $1.0 million of compensation expense for the Company in 2005. The Company had previously terminated any discretionary profit sharing; this announcement reflected a further amendment to the profit sharing plan to eliminate a previously mandatory feature pursuant to which the Company had matched each participating employee's contributions up to 4% of the employee's salary.

Retention Plan

The Company's workforce decreased to approximately 340 employees at December 31, 2004, slightly below the headcount anticipated in the run-off plan for that date. To help stabilize the workforce, the Company implemented in the third quarter of 2004, among other things, a retention plan providing for scheduled quarterly retention payments. Such retention payments totaled approximately $1.3 million in each of the third and fourth quarters of 2004. Payments under this retention plan satisfied a portion of the Company's obligations to pay otherwise guaranteed annual bonuses under certain employment agreements

with approximately 30 employees; the remaining payments to those employees in the first quarter of 2005 totaled approximately $1.3 million.

Incentive Program

In the third quarter of 2004, the Company also implemented, in lieu of any other annual short-term bonus plan, two incentive programs linked to successfully achieving or exceeding certain targets as anticipated in the Company's approved run-off plan and for a policy buyback team. The programs took into account payments under the aforementioned employment agreements and retention plan. Payments under these programs in the first quarter of 2005 totaled approximately $3.7 million (of which $3.5 million was accrued at December 31, 2004).

Restricted Stock and Stock Option Plans

Certain of the Company's stock company affiliates have had restricted stock and variable stock option incentive plans available to certain key officers and employees of both the Company and the affiliates. The value of such incentives, which has been subject to Board approval, was determined using an adjusted book value calculation. The value of the restricted stock, which was determined at the date of the grant, and changes in the value of the stock option plans from the original grant price were accrued as compensation expense using the vesting periods contained in the stock plans. The restricted stock and stock option compensation expense was charged to surplus as a component of net unrealized capital losses. In February of 2003, the Board terminated the restricted stock and stock option programs. As of September 30, 2004, certain of the Company's subsidiaries had accrued liabilities related to stock option plans totaling $2.2 million, consisting of $1.5 million previously accrued at December 31, 2003 plus amounts that vested in early 2004. In the fourth quarter of 2004, the Company paid $200 thousand to settle those liabilities, which resulted in a surplus increase of approximately $2.0 million as of December 31, 2004. The Company continues to carry deferred compensation liabilities of approximately $1.7 million at December 31, 2004.

Other Post-retirement Benefits Other than Pensions

The Company historically provided non-pension retirement benefits consisting of certain health care benefits and life insurance for retired employees. Through December 31, 2004, the cost of the health care benefit was borne jointly by the Company (which was self insured for its share) and its retirees (and spouses) at varying percentages depending on the age and service of the plan participant. Effective January 1, 2003, the Company placed a cap on the level of subsidy provided by the Company. For all current and future groups who received subsidized coverage in 2004 and 2003, the Company's costs were capped at 120% of the 2003 subsidy levels. In addition, effective January 1, 2004, the Company (i) changed its funding policy for post-retirement medical, shifting more of the annual costs to the retiree while reducing the amount the Company would then pay for post retirement medical; and (ii) changed its eligibility requirements for post retirement medical so only active employees age 55 or older as of January 1, 2004 with ten or more years of service with the Company would be eligible for medical benefits at retirement. Effective December 31, 2003, the Company received from the Division of Insurance an allowance under Corrective Orders to account for the changes implemented as of January 1, 2004 as a permanent curtailment of the benefit, allowing the Company to reduce its prior service liability at December 31, 2003 from $64.1 million to $32.3 million.

Effective December 31, 2004, the Company permanently eliminated all subsidies previously provided by the Company to its retirees for medical benefits. This resulted in a $32.3 million reduction in carried liabilities at December 31, 2004.

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

	Fiscal 2003		
	Retiree Medical	**Retiree Life Insurance**	**Total**
Change in benefit obligation during the year:			
Benefit obligation, January 1, 2003	$ 129,458,986	13,797,395	143,256,381
Service cost	1,713,834	—	1,713,834
Interest cost	6,084,557	948,188	7,032,745
Plan amendments	(98,874,252)	—	(98,874,252)
Actuarial (gain) loss	7,261,414	(465,974)	6,795,440
Benefits paid	(10,825,000)	(1,070,000)	(11,895,000)
Benefit obligation, November 30, 2003	$ 34,819,539	13,209,609	48,029,148
Key assumptions, year-end 2003:			
Discount rate for obligations	7.50%	7.50%	7.50%
Discount rate for expense	7.00	7.00	7.00
Health care trend rate	9.0% grading to 6.0% in 2006	N/A	9.0% grading to 6.0% in 2006

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

Other Benefit Plans

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

Certain coverages of the Plan require both employer and employee contributions, while others require either an employer or employee contribution. The Company makes contributions to the Trust necessary to provide the benefits offered under the Plan. All employer contributions are conditioned upon their deductibility under Section 419 of the Internal Revenue Code of 1986, as amended. Employees make specified monthly contributions for the coverages selected. The contribution rates for both the employer

and employee are determined annually by the Welfare Benefit Trust Committee of the Company. The assets of the Plan are generally available to pay covered claims for employees of the Company. Plan assets are not identified or segregated by benefit type. In accordance with provisions of the Plan, eligible employees, retired employees, and eligible dependents of employees and retired employees of the Company who incur claims are entitled to receive benefits under the Plan.

At December 31, 2004 and 2003, total assets of the Plan were $800 thousand and $1.6 million, respectively. Employer and employee contributions for 2004 were $13.0 million and $10.3 million, respectively, while 2003 employer and employee contributions were $124.6 million and $13.2 million, respectively. For 2004 and 2003, total benefit payments under the Plan were $22.4 million and $136.3 million, respectively.

The Company paid a substantially discounted present value of $2.3 million in the third quarter to buyout $9.2 million of long-term disability self-insured obligations owed to certain employees. As a result, the Company recognized a surplus benefit of $6.9 million in 2004.

(8) Risk-based Capital

The NAIC utilizes a risk-based capital (RBC) formula intended for regulatory monitoring of property-casualty insurers. Under risk-based capital rules in Illinois, state regulators may mandate remedial action for inadequately capitalized companies. The focus of the capital rules is a risk-based formula that applies prescribed factors to various risk elements in an insurer's business and investments to develop a minimum capital requirement designed to be proportional to the amount of risk assumed by the insurer. At year-end 2004 and 2003, the Company's level of capital and surplus has been at the "mandatory control level" under the risk-based capital 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 of the Division of Insurance (the Director) has discretion to allow the continued run-off. Exercising its supervisory authority, the Division of Insurance has issued Corrective Orders. As required, the Company in early 2003 proposed an RBC plan to address its RBC level. The Division of Insurance did not accept that plan, but required that the Company develop a commercial run-off plan based on the Company's results and financial condition at December 31, 2003.

On March 19, 2004, the Company and the other Illinois-domiciled Kemper Insurance Companies filed a commercial run-off plan with the Division of Insurance. On June 9, 2004, the Division of Insurance gave the Kemper Insurance Companies permission to proceed with the run-off plan as submitted. Details of the plan are confidential, pursuant to the state's risk-based capital statute. The plan is designed to help Kemper meet its goal of resolving, to the maximum extent possible, all valid policyholder claims.

Risks and uncertainties involved in implementing the plan include the needs to achieve significant policy buybacks and novations, to conclude other surplus-enhancing transactions, to commute reinsurance agreements, to conclude other liquidity-enhancing transactions, to hire and retain the staff and resources necessary to implement the plan, to further reduce expenses, and to consummate agreements with regulators and other third parties. Achieving the surplus and liquidity projections in the run-off plan requires the consummation of agreements with insureds for policy buybacks and novations, the timely

performance of payment and other contractual obligations owed to the Company by various third parties, including reinsurers as well as insureds and agents, 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 plan will 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 the last two years, the Division of Insurance retains the discretion at any time to seek to place the Company in a formal 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 plan.

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. The Company has also entered into consent agreements with certain states under which the Company agreed to cease writing business in those jurisdictions. In addition, in 2005, the Company entered into an Agreed Order with the Tennessee Division of Insurance for its license to be suspended with the Company permitted to maintain its license, but not permitted to write any new business. Florida has also sought to unilaterally suspend the Company's certificates of authority. The Company has resisted those unilateral actions by states as not being in the best interests of the Company's policyholders or claimants.

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

Ratings

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

The downgrades to below A- effectively ended the Company's and its affiliates' ability to write most new commercial lines business or retain existing policyholders. In early 2003, the Company attempted to continue marketing commercial insurance policies by providing certain of the policies with the benefit of cut-through agreements from National Indemnity Company. That proved unsuccessful. In the first half of 2003, therefore, as a result of a combination of various business factors including the ratings downgrades and the Company's deteriorating statutory surplus, the Company substantially ceased underwriting activities other than as required by contract or law and except for its Eagle insurance subsidiaries which ceased as of September 30, 2003 and its Mexican insurance company subsidiary which was sold April 30, 2004. 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.

Sources of Liquidity

The Company's net cash outflows, consisting principally of claim payments (net of reinsurance collections and releases of encumbered assets from certain collateral trusts), exceed substantially its cash inflows resulting from investment income and the limited premium income the Company is receiving. Recognizing this, and the potential liquidity issues presented, the Company routinely updates its liquidity projections.

There are a number of factors, however, that could adversely affect the Company's liquidity position and its adequacy through the end of the year. 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 mature. 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 zero.

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 subsidiaries, converting illiquid assets to liquid assets, continuing to collect on its reinsurance, and evaluating the possibility of reinsurance commutations. State, and to significantly lesser extents, foreign and the United States Department of Labor, deposits totaled approximately $1.1 billion at December 31, 2004, of which the state of California held approximately $822.0 million. The Company's run-off plan anticipates that portions of these deposits will be released as excess collateral 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. While the Company was and continues to be in discussions with various insurance regulators regarding release of portions of the deposits, as of year-end 2004 the Company did not have any agreements with any of the parties to release any governmental deposits. Approximately $188.0 million of the deposits held by California was released to the Company in the third quarter of 2005.

In the third quarter of 2004, the Company signed a definitive agreement, subject to final approvals and closing, to sell its home office complex in Long Grove, Illinois, and to lease back a fraction of that office space for the Company's current operations. In anticipation of the proposed sale terms, the Company recorded a reduction in the carrying value of the property and recognized an approximate $5.9 million surplus detriment in the third quarter. The Company received net proceeds of $29.8 million at closing on March 16, 2005, and recorded a realized gain on the sale of $300 thousand in 2005.

Also to supplement liquidity, the Company during 2004 merged five of its subsidiaries into another wholly owned subsidiary, AMICO. (See note 2 *Significant Transactions involving Affiliates – Subsidiary Mergers*.) The liquidity benefits from the mergers include minor reductions in expenses from not needing to maintain corporate entities. AMICO cedes 100% of its policy liabilities to the Company and therefore has no net liabilities to policyholders. As a result of the mergers, the Company and AMICO obtained approval from the Division of Insurance for AMICO to declare and pay to the Company an extraordinary dividend of approximately $161.7 million on December 31, 2004.

Prompt collection of reinsurance recoverables is a primary driver of the Company's liquidity at all times. Reinsurance provided approximately $1 billion of liquidity to the Company during 2004. Gross

reinsurance recoverables totaled $3.3 billion at December 31, 2004 (net of a $141.9 million reinsurance provision – see note 1), down from $4.5 billion at December 31, 2003.

The Company is developing a strategy to evaluate certain reinsurance commutations that if executed could substantially increase liquidity. Reinsurance commutations, however, would be anticipated to decrease surplus, since commutations involve present value or other discounting in return for cash. Management remains focused on managing liquidity, surplus, and the balance between them.

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

Subsidiary Guarantees

The Company has guaranteed the minimum capital and surplus requirements under state law for three of its wholly owned, Illinois-domiciled subsidiaries: Kemper Casualty Insurance Company, SSIC, and SNIC. The Company also guaranteed SSIC's and SNIC's minimum risk based capital ratios. The Company believes that the SNIC guarantees ceased to have effect as of the date, December 31, 2004, when SNIC merged into AMICO. The Company also has guaranteed the obligations under policies issued by Kemper Insurance Company Limited, a wholly owned subsidiary incorporated under the laws of Australia, and under policies issued on or after January 1, 2002 by Kemper, S.A. (Societe Anonyme), a wholly owned insurance subsidiary incorporated under the laws of Belgium. Those foreign subsidiary policies are also reinsured by the Company under excess of loss reinsurance agreements for any net loss in excess of $50 thousand.

Securities on Deposit and Encumbered Assets

Approximately $1.5 billion of the Company's invested assets at December 31, 2004 are encumbered by being on deposit or held in trust or escrow arrangements, compared with $1.7 billion one year earlier. The majority of the encumbrances, approximately $1.1 billion, are deposits with state insurance departments, with California accounting for the majority of that amount, or $822.0 million, at December 31, 2004.

Approximately $409.5 million of the Company's assets at December 31, 2004 are in a collateral trust for the benefit of or are otherwise pledged to Berkshire affiliates. This amount reflects a $68.6 million reduction from a year earlier, as the majority of these encumbered assets are subject to release to the Company each quarter as claim payments are made on policies to which are attached the cut-through agreements from National Indemnity Company and National Fire & Marine Insurance Company.

Approximately $25.0 million of the Company's assets at December 31, 2004 are in a collateral trust for the benefit of Broadspire as collateral for obligations under the transaction agreements related to the sale of NATLSCO in July 2003. Other transaction-related collateral trusts and escrow arrangements encumber another $10.8 million of the Company's assets at December 31, 2004.

More significant, the Company is contingently liable to provide up to an estimated additional $30.4 million in collateral due to ratings triggers in similar reinsurance agreements where it is a reinsurer. Of this

amount, approximately $4.6 million has been funded with assets of the purchaser of the Equus Re division (Alea Bermuda, Ltd. and affiliates) for assumed business written by the Company after the 1999 sale which is 100% reinsured by (retroceded to) Alea Bermuda.

As of December 31, 2004, AMICO as successor by mergers to Eagle Pacific and AMPICO has deposited with four of its reinsureds AMICO assets in the approximate amount of $10.0 million as security under assumed reinsurance agreements dating back to before the Company acquired the Eagle subsidiary in 1998. Until November and December 2003, the security was in the form of letters of credit; however, when those letters of credit expired in late 2003, the subsidiary and the Company were unable to obtain letters of credit from any banks due to the Company's deteriorating financial condition. Of the assets on deposit, the reinsured (Manhattan Reinsurance Company, which is also in run-off status) is informally disputing the amount, seeking an increase of up to another $6.0 million.

Several years ago, the Company deposited securities in an escrow account to collateralize a bank loan to an independent insurance agency in Texas. These encumbered assets had a carrying value of $22.0 million at December 31, 2003. In late 2003, the Company recognized a $15.0 million charge related to this guarantee. In 2004, the Company repaid the agency's bank loan in the amount of approximately $20.0 million, receiving back from the bank the $22.0 million of encumbered assets. The Company also revised its agreements with the agency and received from the agency $5.0 million in cash plus a minority stock interest in the agency. With no surplus impact in 2004, the Company's liquidity in 2004 increased by approximately $7.0 million as a result of these repayments.

Approximately $4.8 million of the Company's invested assets at December 31, 2004 are in collateral trusts for the benefit of its reinsurers.

Where required to post court bonds, including supersedes or appeal bonds, the Company, due to its financial condition, has had to post cash or other security totaling in most cases 100% of the bond. At December 31, 2004, the Company had pledged invested and other assets of approximately $53.4 million for such bonds, a majority of which are issued by a Berkshire affiliate.

To discharge certain insurance claim liabilities, LMC has purchased structured settlement annuities with the claimant as payee. The aggregate December 31, 2004 value of loss reserves eliminated by the purchase of these annuities was approximately $140.0 million. LMC remains contingently liable should the issuers of the annuities fail to perform.

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

Carrier	Location	LMC reportable amounts
SAFECO Life Insurance Co.	Seattle, WA	$ 35,220,137
First Colony Life Insurance Co.	Lynchburg, VA	23,440,930
United Pacific Life Insurance Co.	Seattle, WA	23,504,502
Federal Home Life Insurance Co.	Richmond, VA	16,826,917
Metropolitan Life Insurance Co.	New York, NY	11,841,978
Prudential Life Insurance Co.	Newark, NJ	4,123,960
Transamerica Occidental Life Insurance Co.	Cedar Rapids, IA	3,458,229
Presidential Life Insurance Co.	Nyack, NY	2,991,706
Manufacturers Life of Canada	Toronto, ON	2,061,665
Charter Security Life Insurance Company	Hartford, CT	2,037,491

Litigation

As described in note 10, *Surplus*, the Company issued $700.0 million in aggregate principal amount surplus notes in 1996 and 1997. On March 20, 2003 and November 3, 2003, the Director denied the Company's requests for payment of interest on the surplus notes due on June 1 and July 1, 2003 and on December 1, 2003 and January 1, 2004. Subsequent payments of interest on the surplus notes have also been prohibited by the Director. Following the March 20, 2003 denial, in June and July, 2003, several lawsuits were filed in the Circuit Court of Cook County, Illinois by certain current holders of surplus notes aggregating approximately $368.0 million and naming the Company, various directors or former directors of the Company and Kemper Commercial Insurance Company, a subsidiary of the Company, as defendants. One case was voluntarily dismissed by the plaintiff, and the other two were consolidated. This lawsuit alleges 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 alleges 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, seeks a declaratory judgment of the parties' rights, an injunction against further asset sales and monetary damages. The Company has not yet been served with a consolidated amended complaint, and accordingly, is not required to file an answer or a motion to dismiss. The Company intends to vigorously defend against this lawsuit.

In addition to the above, in the ordinary course of business, the Company is involved in various legal actions for which it establishes liabilities where appropriate. In the opinion of the Company's management, based upon the advice of legal counsel, contingent liabilities arising from litigation, tax, and compliance matters are not expected to have a material adverse effect on the Company's statutory financial statements due to established reserves and anticipated insurance and reinsurance recoverables.

Other Items

The Company leases office space and equipment under various noncancelable operating lease agreements. Rental expense for 2004 and 2003 was $15.1 million and $24.0 million respectively, net of costs shared by the Company with AMM under the terms of the Pooling Agreement.

At December 31, 2004, the total aggregate minimum rental payments on operating leases is $38.1 million and future minimum rental payments for the next six years are as follows:

		Minimum payments (in thousands)
Year ending December 31:		
2005	$	11,814
2006		8,707
2007		6,970
2008		5,354
2009		4,428
2010 and thereafter		865
	$	38,138

Certain rental commitments have renewal options extending through the year 2011. Some of these renewals are subject to adjustments in future periods.

The Company is liable for guaranty fund assessments related to certain unaffiliated companies that have become insolvent during the years 2004 and prior. The Company's financial statements include provisions for all known assessments that are expected to be levied against the Company as well as an estimate of amounts (net of estimated future premium tax recoveries) that the Company believes it will be assessed in the future for which the insurance industry has estimated the cost to cover losses to policyholders. 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, 2004. As of December 31, 2004, the Company has accrued a liability of approximately $6.5 million for such assessments. The Company is seeking in various states waivers or deferrals of assessments. In 2003, the Company, recognizing that it was not able to write future business, wrote off a previously recorded receivable of $1.4 million for future premium tax offsets related to such assessments. The Company has established a liability for premium and loss based assessments of approximately $55.7 million as of December 31, 2004, compared with $49.8 million a year earlier.

(10) Surplus

Surplus Notes

The Company had the following surplus notes issued and outstanding as of December 31, 2004:

Description	Interest rate	Maturity date	Par or face value	Carrying value	Interest paid in 2004	Inception to-date interest paid	Accrued interest at December 31, 2004
					(In thousands)		
30-Year Notes	9.15%	07/01/2026	$ 400,000	399,123	—	220,312	—
40-Year Notes	8.30%	12/01/2037	200,000	199,507	—	83,461	—
100-Year Notes	8.45%	12/01/2097	100,000	99,726	—	42,485	—
			$ 700,000	698,356	—	346,258	—

The unamortized discount at issuance has been charged against surplus. The unamortized discount amounted to $1.6 million and $1.6 million at December 31, 2004 and 2003.

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, 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 2004 and 2003 requests for payment of interest on the surplus notes due on June 1 and July 1, and on December 1, and January 1. The amount of interest due and not paid plus interest that is not accrued for at December 31, 2004 is $123.3 million.

Dividend Restrictions

Dividend distributions from the Company’s insurance subsidiaries to the Company are restricted by various state insurance laws. In Illinois, where most of the Company’s subsidiaries are domiciled, if such dividend, together with other distributions during the 12 preceding months would exceed the greater of (a) 10% of the insurer’s statutory surplus as regards policyholders as of the preceding December 31, or (b) the statutorily adjusted net income for the preceding calendar year, then such proposed dividend must be reported to the Director at least 30 days prior to be proposed payment date and may be paid only if not disapproved. The Illinois insurance laws also permit payment of dividends only out of earned surplus, exclusive of most unrealized capital gains. Pursuant to Corrective Orders, LMC cannot enter into any transaction that involves the transfer of assets to or from affiliates of LMC without the prior approval of

the Director. LMC received ordinary cash dividends from its insurance subsidiaries of $33.8 million and $12.7 during 2004 and 2003, respectively. LMC also recorded cash dividends of $0 and $13.6 million in 2004 and 2003, respectively, from its noninsurance subsidiaries.

(11) Fair Value of Financial Instruments

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

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

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

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

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

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

Other invested assets: Fair values for venture capital partnerships and hedge funds were estimated based upon the underlying fair value of the assets invested in by the partnership or fund. The fair value of notes receivable and other equity investments is based upon fair values as determined in good faith by the Company's investment managers.

(Continued)

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

		2004		2003	
		Statement value	**Estimated fair value**	**Statement value**	**Estimated fair value**
		(In thousands)			
Financial instruments recorded as assets:					
Bonds	$	1,583,567	1,553,199	1,673,352	1,684,935
Cash and short-term investments		908,597	908,597	1,870,574	1,870,574
Real estate properties held for sale		34,965	36,316	40,856	43,911
Mortgage loans		1,836	1,836	17,148	17,148
Unaffiliated stocks		2,532	2,570	21,433	22,540
Other invested assets:					
Venture capital partnerships and hedge funds		4,075	4,818	56,661	55,974
Notes receivable		18,738	18,738	19,083	19,083
Other equity investments		27,095	27,095	28,588	28,588
Receivables for securities sold		2,406	2,406	3,287	3,287

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

Subsequent to the completion of the Company's 2004 Annual Statement, as filed with the Division of Insurance on or about March 1, 2005, the Company became aware of a number of facts that provided additional evidence with respect to conditions or circumstances that existed at the date of filing. These additional facts affected the estimates inherent in the process of preparing the 2004 Annual Statement and are referred to as Type I subsequent events in SSAP No. 9, *Subsequent Events* (SSAP No. 9). In accordance with SSAP No. 9, all information that becomes available prior to the issuance of the statutory financial statements relating to a material Type I subsequent event shall be used by management to determine the related accounting estimate.

As such, the Company has recorded the following adjustments in the accompanying statutory financial statements which are different from the amounts as filed in the Company's 2004 Annual Statement:

		Net loss	Surplus
As filed in 2004 Annual Statement	$	(65,968,578)	171,434,880
2004 adjustments related to:			
Market value declines identified subsequent to year end resulting in other-than-temporary impairment of securities:			
Bonds		(899,611)	(899,611)
Other invested assets		(1,551,705)	(1,551,705)
Other-than temporary impairments or adjustments related to new facts, circumstances or decisions made by the Company relating to reinsurance:			
Misapplication of facts related to over-cessions of losses and allocated loss adjustment expenses on certain reinsurance contracts		(10,592,581)	(10,592,581)
Misapplication of facts related to under-accrual of ceded reinsurance premiums on certain reinsurance contracts, net of related commissions and expenses		(11,603,950)	(11,603,950)
Provision for additional under-accrued reinsurance premium on certain contracts		(3,075,000)	(3,075,000)
Adjustments related to uncollectible reinsurance balances		(358,322)	(358,322)
Adjustment to the provision for reinsurance		—	2,785,369
Misapplication of facts related to certain reinsurance annuity contracts		3,563,811	3,563,811
Misapplication of facts related to development of certain losses and loss adjustment expenses		(37,077,780)	(37,077,780)
Other adjustments:			
Other – miscellaneous		(6,051,648)	(8,058,776)
Correction of 2003 errors		—	(42,582,341)
Total of all adjustments		(67,646,786)	(109,450,886)
As per accompanying financial statements	$	(133,615,364)	61,983,994

(13) Subsequent Events

In March 2005, the Company closed the sale of its home office building complex under a contract executed in 2004 for the purchase price of $30.6 million (see note 2). This resulted in a minor impact to surplus as the property was written down in 2004 to reflect the amount of the contract purchase price. The transaction did increase the Company's liquidity by approximately $29.8 million. In connection with this sale, the Company is leasing approximately 80,000 square feet in the complex for its ongoing operational needs at an annual cost of approximately $1.6 million for the space.

During the second quarter of 2005, the Company was awarded $23.2 million in an arbitration matter with Broadspire relating to the sale and purchase price of one of the Company's subsidiaries, NATLSCO, Inc., and resulting in a surplus benefit of $5.3 million (see note 2). Broadspire only paid the Company $19.0 million by asserting their right to offset $4.2 million that Broadspire believes is due from the Company. The Company is evaluating its legal rights and options in response to the asserted offset. Separately, and in the third quarter of 2005, $25.0 million was released by Broadspire to the Company from a two-year escrow arrangement that had been in place for the benefit of Broadspire in connection with the 2003 Broadspire/NATLSCO transaction. This escrow release had no impact on surplus.

By order dated June 29, 2005, the California Insurance Commissioner/California Department of Insurance fixed the amount of the Company's deposits in that state and ordered the withdrawal of deposits of approximately $188.0 million. The Company received the release of that amount in the third quarter of 2005.

In a separate transaction, the Company was repaid $16.7 million in July 2005 on an outstanding loan to a former insurance agency. A detriment to surplus of $92 thousand has been recorded in the 2004 statutory financial statements as a result of the circumstances surrounding the loan. There is approximately $700 thousand remaining of unpaid principal on the loan, but the Company has classified the loan as a nonadmitted asset.

Schedule I

LUMBERMENS MUTUAL CASUALTY COMPANY

Summary Investment Schedule

December 31, 2004

The following is a summary of certain financial data as of December 31, 2004 and for the year then ended for purposes of complying with the National Association of Insurance Commissioners' Accounting Practices and Procedures Manual. Such data is included in the Company's 2004 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	$ 788,788,017	29.432%	$ 788,788,017	29.432%
U.S. Government agency and corporate obligations (excluding mortgage-backed securities):				
Issued by U.S. Government sponsored agencies	103,532,440	3.863	103,532,440	3.863
Foreign government (including Canada, excluding mortgage-backed securities)	11,936,505	0.445	11,936,505	0.445
Securities issued by states, territories, and possessions and political subdivisions in the U.S.:				
States, territories and possessions general obligations	151,751	0.006	151,751	0.006
Revenue and assessment obligations	49,206,190	1.836	49,206,190	1.836
Mortgage-backed securities (includes residential and commercial MBS):				
Pass-through securities:				
Issued or guaranteed by GNMA	3,030,861	0.113	3,030,861	0.113
Issued or guaranteed by FNMA and FHLMC	12,869,513	0.480	12,869,513	0.480
CMOs and REMICs:				
Issued or guaranteed by GNMA, FNMA, FHLMC, or VA	137,425,126	5.128	137,425,126	5.128
All other	2,000,000	0.075	2,000,000	0.075
Other debt and other fixed income securities (excluding short-term):				
Unaffiliated domestic securities (includes credit tenant loans rated by the SVO)	455,869,871	17.010	455,869,871	17.010
Unaffiliated foreign securities	19,596,895	0.731	19,596,895	0.731
Affiliated securities	17,897,963	0.668	17,897,963	0.668

(Continued)

Schedule I

LUMBERMENS MUTUAL CASUALTY COMPANY

Summary Investment Schedule

December 31, 2004

Investment categories	Gross investment holdings		Admitted assets as reported in the annual statement	
	Amount	Percentage	Amount	Percentage
Equity interests:				
Preferred stocks:				
Unaffiliated	$ 68,030	0.002%	$ 68,030	0.002%
Publicly traded equity securities (excluding preferred stocks):				
Unaffiliated	314,123	0.012	314,123	0.012
Other equity securities:				
Affiliated	96,246,251	3.591	96,246,251	3.591
Unaffiliated	2,150,323	0.080	2,150,323	0.080
Other equity interests including tangible personal property under lease:				
Affiliated	27,545,266	1.028	27,545,266	1.028
Unaffiliated	3,625,106	0.135	3,625,106	0.135
Mortgage loans:				
Single family residential properties	1,835,467	0.068	1,835,467	0.068
Real estate investments:				
Property held for sale	34,965,386	1.305	34,965,386	1.305
Receivables for securities	2,405,798	0.090	2,405,798	0.090
Cash, cash equivalents and short-term investments	908,597,084	33.902	908,597,084	33.902
Total invested assets	$ 2,680,057,966	100.000%	$ 2,680,057,966	100.000%

See accompanying independent auditors' report.

LUMBERMENS MUTUAL CASUALTY COMPANY

Supplemental Investment Risk Interrogatories

December 31, 2004

The following interrogatories as of December 31, 2004 and for the year then ended are for the purpose of complying with the National Association of Insurance Commissioners *Accounting Practices and Procedures Manual.*

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

1. Reporting entity's total admitted assets as reported on page 2 of the annual statement: $3,729,989,084.

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

Issuer	exposure	Amount	assets
1. Berkshire Hathaway Inc	Bond - Cat. 2.1	$ 310,754,213	8.3%
2. The Bank of New York Tr Co NA	Cash - Cat. 8	196,531,617	5.3%
3. American AAdvantage Select Fd	Class 1 MMF - Cat. 8	120,699,445	3.2%
4. Short Term Invts Tr Liq Assets Ptf	Class 1 MMF - Cat. 8	85,930,077	2.3%
5. Canadian Government	ST Bonds - Cat. 8 and Bonds - Cat. 1.3	61,971,185	1.7%
6. GNMA CMO 38373X Ser 2002-51	Bond - Cat. 1.521	43,665,416	1.2%
7. Scudder Money Mkt Tr MM Ser	Class 1 MMF - Cat. 8	42,465,117	1.1%
8. American Motorists Ins Co	Aff.Common - Cat. 3.41	30,819,288	0.8%
9. Kempes Inc	Aff.Common - Cat. 3.41	30,471,248	0.8%
10. Long Grove Office Complex	Real estate held for sale - Cat. 5.3	29,529,610	0.8%

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

Bonds	Amount	Percentage of total admitted assets	Preferred stocks	Amount	Percentage of total admitted assets
NAIC-1	$ 2,227,468,902	59.7%	P/RP-1	$ —	—%
NAIC-2	46,639,156	1.3%	P/PSF-2	—	—
NAIC-3	—	—	P/PSF-3	—	—
NAIC-4	—	—	P/PSF-4	—	—
NAIC-5	—	—	P/PSF-5	41,741	—
NAIC-6	4,793,196	0.1%	P/PSF-6	26,289	—

(Continued)

LUMBERMENS MUTUAL CASUALTY COMPANY

Supplemental Investment Risk Interrogatories

December 31, 2004

4. Assets held in foreign investments:

1.	Are assets held in foreign investments less than 2.5% of the reporting entity's total admitted assets?		Yes [X] No [ ]
2.	Total admitted assets held in foreign investments	$ 22,945,744	0.6%
3.	Foreign-currency-denominated investments	2,311,210	0.1%
4.	Insurance liabilities denominated in that same foreign currency	1,571	—%

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 non-sovereign (i.e. non-governmental) foreign issues:

    Not applicable.

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

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

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

(Continued)

LUMBERMENS MUTUAL CASUALTY COMPANY

Supplemental Investment Risk Interrogatories

December 31, 2004

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

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

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

13. Amounts and percentages of admitted assets held in the largest 10 equity interests.

    Are assets held in equity interests less than 2.5% of the reporting entity's total admitted assets?

    Yes [ ] No [X]

    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 Ins Co - Common Affiliate	$	30,819,288	0.8%
2. Kempes Inc - Common Affiliate		25,071,248	0.7%
3. Kemper Casualty Inc - Common Affiliate		22,125,863	0.6%
4. Kemper Lloyds Ins Co - Joint Venture Affiliate		21,113,089	0.6%
5. Kemper Intl Corp - Common Affiliate		15,749,193	0.4%
6. Delta Wetlands - ADC Joint Venture Affiliate		5,982,176	0.2%
7. Kellner, Dileo & Co LP - Hedge Fund		3,216,125	0.1%
8. LGA-17 Inc - Common Affiliate		1,915,900	0.1%
9. Assurex Dev Corp - Common		1,406,624	0.0%
10. Shorebank Corp - Common		743,699	0.0%

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

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

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

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

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

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

Schedule II

LUMBERMENS MUTUAL CASUALTY COMPANY

Supplemental Investment Risk Interrogatories

December 31, 2004

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

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

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

17. Not applicable.

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

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

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

19. Amounts and percentages of the reporting entity's total admitted assets subject to the following types of agreements:

			At end of each quarter		
	At year-end	**Percentage of total admitted assets**	**1st Quarter**	**2nd Quarter**	**3rd Quarter**
Securities lending agreements (do not include assets held as collateral for such transactions)	$ —	—	$ 56,424,522	—	—
Repurchase agreements	—	—	—	—	—
Reverse repurchase agreements	—	—	—	—	—
Dollar repurchase agreements	—	—	—	—	—
Dollar reverse repurchase agreements	—	—	—	—	—

(Continued)

Schedule II

LUMBERMENS MUTUAL CASUALTY COMPANY

Supplemental Investment Risk Interrogatories

December 31, 2004

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

    None.

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

    None.

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

    None.

See accompanying independent auditors' report.