

# Response Ability



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# Response. Ability.

When a person or a business seeks out an insurer, they are thinking two things: Will they respond when the worst happens? Do they have the ability to meet my needs?

At Liberty Mutual Insurance Group, our claims response (whether to the catastrophic or everyday event) is quick and thorough. But that's not enough. We also believe every customer should be treated with complete care and compassion. Throughout this Annual Review, you'll meet Liberty claims employees who fulfill this promise; employees like Janet Lucas, who, moments after the deadly outbreak of tornadoes in Alabama in April 2011, volunteered to go to the scene and help customers—simply because she could and it was the right thing to do.

We also understand that our customers seek convenience and an insurer who can make their lives easier. From developing smartphone technology for our on-the-go customers to helping agents with digital marketing, the following pages detail the advances we're making today while we continue to look ahead to tomorrow.

Simply put, while our responsiveness and ability set us apart, it's our ongoing commitment to responsibility that makes us who we are.

*Be sure to visit the online version of the 2011 Annual Review at [www.libertymutualgroup.com/2011annualreview](http://www.libertymutualgroup.com/2011annualreview) for video features that help us tell our story.*

# Financial Highlights

<i>(Dollars in millions)</i> December 31,	2011	2010	2009
<b>Liberty Mutual Insurance Group</b>			
Revenues	\$34,671	\$33,193	\$31,035
Pre-tax operating income	249	1,919	1,125
Net income	365	1,678	1,023
Cash flows from operations	2,101	2,761	2,487
Combined ratio	107.4%	101.2%	99.9%
<b>Personal Markets</b>			
Revenues	\$8,046	\$7,502	\$7,001
Pre-tax operating income	328	673	654
Cash flows from operations	646	1,134	1,012
Combined ratio	100.7%	95.7%	94.8%
<b>Commercial Markets</b>			
Revenues	\$6,382	\$6,331	\$6,607
Pre-tax operating income	88	278	425
Cash flows from operations	537	469	671
Combined ratio	117.0%	110.9%	106.1%
<b>Liberty Mutual Agency Corporation (LMAC)</b>			
Revenues	\$11,410	\$11,687	\$10,937
Pre-tax operating income	97	1,007	1,455
Cash flows from operations	322	1,113	951
Combined ratio	105.5%	97.6%	93.6%
<b>Liberty International</b>			
Revenues	\$8,566	\$7,928	\$7,589
Pre-tax operating income	290	740	480
Cash flows from operations	1,305	1,240	1,328
Combined ratio	103.8%	99.8%	100.6%
<b>Other*</b>			
Revenues	\$267	\$(255)	\$(1,099)
Pre-tax operating income	(554)	(779)	(1,889)
Cash flows from operations	(709)	(1,195)	(1,475)

Liberty Mutual Insurance Group results include all significant business units of the Company. Each business unit is reported in accordance with U.S. Generally Accepted Accounting Principles.

\* Other includes discontinued operations (including asbestos and environmental), interest expense, internal reinsurance programs, net investment income after allocations to business units, certain expenses not allocated to the business units, income (loss) related to limited partnership and limited liability company investments (excluding LMAC), other revenues from corporate subsidiaries, and federal and foreign tax payments.

## A Message from Our Chairman



“Our operations have learned how to be successful over time in an array of environments, be it the economic headwinds in Spain, hyperinflation in Venezuela, rapid growth in China or underpriced commercial lines in the U.S.”

Edmund F. Kelly  
Chairman

We insure things people own and value and are tested when nature is particularly harsh. As David Long discusses in his letter, we were truly tested in 2011 as catastrophic storms worldwide made it a tough year for Liberty Mutual and indeed the entire property and casualty industry. We came through it well, and I am proud of our people’s performance in meeting our policyholders’ needs.

So I am very confident about the strength and direction of our Company. First and foremost, David was elected Chief Executive Officer in June, and he demonstrates continuously that our Board of Directors selected the right person as my successor; I couldn’t be more pleased. Secondly, the strengths of the company are evident in the underlying operating performance over the year.

More important, Liberty Mutual is very well positioned for continued success. Our well-diversified portfolio of products, distribution channels and geographies allows us to weather the vagaries of local conditions or stresses in different areas of business. Our operations have learned how to be successful over time in an array of environments, be it the economic headwinds in Spain, hyperinflation in Venezuela, rapid growth in China or underpriced commercial lines in the U.S. And our

more than 45,000 employees around the globe demonstrated in their response to the unprecedented wave of catastrophes and in their day-to-day work that we have the best employees in the industry.

I want to thank David, his management team and every Liberty Mutual employee for their dedication and hard work in 2011. I thank my fellow directors for their continued support and commitment. And I thank you, our policyholders, customers and distribution partners, for continuing to place your trust in us.

A handwritten signature in cursive script that reads "Edmund F. Kelly".

**Edmund F. Kelly**  
Chairman

# A Message from Our President and CEO

2011 was a year marked by unprecedented catastrophes and severe weather events. It was the second-worst year on record for insured global catastrophic losses, and the litany is long: floods in Australia and Thailand, earthquakes in New Zealand and Japan and, in the U.S., a record 875 tornadoes in one month, Hurricane Irene, and a very unusual late-October Northeast snowstorm.

As an insurer, the costs to us were high, but the real damage was incurred by those whose lives were lost, whose loved ones were hurt, and whose homes, businesses and possessions were damaged or destroyed. At just the time when our customers needed us most, we responded, and I am extremely proud of how we did so. As you will see in the pages of this Annual Review, our personal and commercial lines claims professionals across the globe responded to this seemingly endless barrage of events with compassion and professionalism in helping our policyholders put their lives and businesses back together.

This extraordinary but expected service to our customers in 2011 is a fitting prelude to our 100th Anniversary, which we celebrate in 2012. Ever since we issued our first policy in Massachusetts in 1912, keeping our promises has been the cornerstone upon which this great company has been built.

Not surprisingly, the \$2.7 billion impact of these catastrophes and weather events was reflected in our earnings. Pre-tax operating income decreased \$1.7 billion from the prior year to \$249 million. We did, however, end the year with \$365 million in net income, a testament to the solid core earnings within each of our business units and outstanding investment results in a very challenging environment. The underlying strength of our businesses was further demonstrated by a healthy 4.5 percent increase in revenues to \$34.7 billion, and an \$880 million increase in equity to \$17.9 billion. Total assets increased \$4.8 billion over 2010 to \$117.1 billion.

Operationally, we continued to build each of our businesses for the future.

Personal Markets, which distributes its products and services under the Liberty Mutual Insurance brand, remained among the top three personal lines carriers in terms of auto and property direct written premium

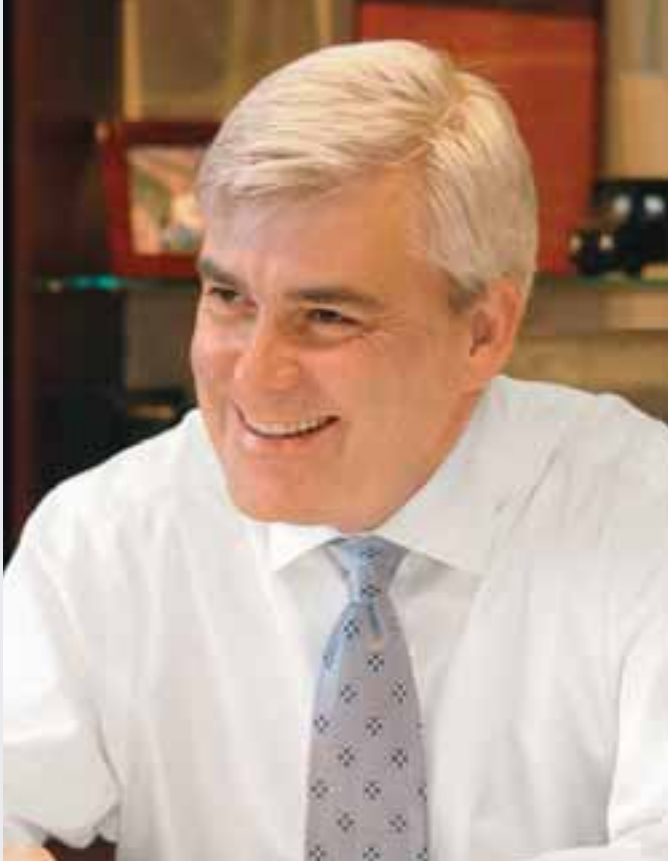
growth. Its multichannel distribution strategy and market leadership in affinity relationships continued to fuel this growth. In fact, in 2011 our largest affinity relationship—CUNA Mutual—surpassed the \$1 billion premium mark, a key milestone in our 13-year partnership.

Commercial Markets continued to diversify its book of business to include more property and liability risks and to improve its profitability through better risk selection and more sophisticated pricing techniques. It is critical that we attain an appropriate price for each risk assumed in order to build a solid foundation for future profitability.

Liberty Mutual Agency Corporation, which sells personal and commercial lines through independent agents, made significant progress integrating systems and enhancing business processes. Efforts included the rollout of a new policy administration system for our eight regional companies, new product and marketing advancements at Safeco and enhancements to Liberty Mutual Surety's agency internet portal. I am confident LMAC is on solid footing for future profitable growth with independent agents.

Liberty International continued to perform well despite experiencing major catastrophes through both its country operations and our Lloyd's Syndicate. We continued to expand our global footprint with an acquisition in Ireland, the approval of a joint venture partnership in India, and the opening of a new branch in Guangdong Province in China, a market of more than 100 million people.

On a personal note, Helen Sayles, formerly head of Human Resources and Administration, retired in February 2012, after a 36-year career with Liberty Mutual. Under her guidance and steady leadership, Liberty Mutual has policies, processes and procedures for compensation and benefits, talent and performance management, and



“Looking ahead, we will continue to diversify our business across lines, products, geographies and distribution channels. We expect to be a leader in each market we enter, to differentiate ourselves with quality service and to obtain appropriate prices for risk assumed.”

David H. Long  
President and Chief Executive Officer

real estate and administrative services that are among the best in the industry. We thank her, and wish Helen and her husband DuWayne the very best in retirement.

Looking ahead, we will continue to diversify our business across lines, products, geographies and distribution channels. We expect to be a leader in each market we enter, to differentiate ourselves with quality service and to obtain appropriate prices for risk assumed.

I am extremely confident in our company’s prospects as we look to our second century. I draw this confidence from the more than 45,000 Liberty Mutual employees hard at work across the globe. It’s their integrity, enthusiasm, commitment and dedication that have brought us to where we are today, and I have no doubt they will continue to drive this success—for our Company and our policyholders—in the future.

I thank our Board of Directors for their continued guidance, and I am particularly grateful to retiring directors Gary Countryman, John Hamill and Stephen Page. Their insights, advice and support have been invaluable to Liberty Mutual and to me personally, and each will be missed. I also thank our many distribution partners—affinity, independent agents and brokers—for your support.

Finally, I thank our policyholders and customers for your business, and for continuing to place your confidence in us.

A handwritten signature in cursive script that reads "David H. Long".

**David H. Long**  
President and Chief Executive Officer



# Personal Markets

Personal Markets, which sells under the Liberty Mutual Insurance brand, offers automobile, homeowners and personal property and casualty insurance coverage, as well as a wide range of life and annuity products, to individuals in the United States. Using a multichannel platform, it distributes its products through more than 2,200 licensed local sales representatives, approximately 500 licensed telesales representatives, third-party producers and the Internet.

Personal Markets' largest source of new business is its 13,500 sponsored affinity group relationships, including employers, professional and alumni associations, credit unions and other partnerships. Personal Markets' affinity program is the industry's most sponsored voluntary auto and home insurance benefit.





**Timothy M. Sweeney**

President  
Personal Markets

“We begin 2012 on solid financial footing, with a proven strategy and market-leading distribution capabilities that position us well for continued profitable growth.”

## Personal Markets

The U.S. personal lines marketplace remained extremely competitive in 2011 as dramatic increases in advertising continued to drive consumer shopping. Despite these competitive pressures, Personal Markets was among the fastest-growing personal lines insurers in the country.

Also making 2011 a challenging year for Personal Markets and the entire personal lines industry was the weather, as record catastrophes and severe storms throughout the U.S. impacted earnings. Despite the high volume of claims resulting from these events, Personal Markets' claims professionals handled every claim with

professionalism and compassion, demonstrating outstanding service to customers when they needed us most.

Personal Markets generated strong new business growth across all distribution channels. Online shopping fueled much of this growth, as consumers increasingly start the shopping process online, even though they prefer to complete the purchase in person or over the phone. Personal Markets' industry-leading affinity marketing program also remained a key driver of new business growth.

JANET LUCAS



## Response

### “You Need Only Look in Their Eyes”

On most days, Janet Lucas is a claims adjuster with Liberty Mutual Insurance's Customer Response Center in Lake Mary, Florida, where she processes homeowner claims that can be handled over the phone.

But, in April 2011, when tornadoes devastated portions of Alabama, Lucas, a 25-year employee, put down the phone, walked into her manager's office, and volunteered to help staff one of Liberty Mutual's RV-sized Customer Response Vehicles (CRV). Six hours later, she was on a flight to Birmingham, and for the next grueling and sleep-deprived 21 days, she did everything from helping to triage and process claims to keeping

the CRV clean and stocked with snacks, water and claims documents.

What makes Janet's story stand out is not only what she did, but the compassion with which she did it. “When you meet with a customer whose home has been badly damaged or destroyed by a tornado, you need only look in their eyes, and listen to their voices, to understand the trauma they've experienced,” she explained. “In a way, my job was as much friend and listener as it was claims adjuster.”

After the Alabama tornadoes, Janet returned to Florida, but not for long. Last summer, she spent three weeks in the CRV helping customers in the aftermath of Hurricane Irene.

Watch related video at [www.libertymutualgroup.com/2011annualreview](http://www.libertymutualgroup.com/2011annualreview)

In 2011, Personal Markets continued to enhance its market position through the growth of all distribution channels, the development of a new Internet quoting application, ongoing expansion of online and mobile capabilities, the development of a new market-leading claims system, and the expansion of its auto, home and life product offerings.

With significant growth and a strong operational foundation in place, Personal Markets is well positioned for the future.

**Personal Markets generated strong new business growth across all distribution channels. Online shopping fueled much of this growth, as consumers increasingly start the shopping process online.**



## Ability

### Smartphone Savvy Find Convenience in App

If you're one of the 302 million smartphone users worldwide, you've likely let a five-ounce device make its way into your daily life, while demanding more capabilities. The same applies to our smartphone-savvy customers—and that's why Personal Markets developed an innovative app for iPhone and Android users.

After an accident, customers can use the smartphone app to map their location using GPS, take pictures of damage for their claim, share their insurance information and use voice note to record key details. During less stressful

times, customers can use the company's mobile eService website to access their policy and view their auto insurance ID card.

With nearly 27,000 downloads, the app has received positive reviews. Said one customer:

*"A delivery van backed into me.... Then I realized I had this app. Turns out, I was able to open a claim, upload all my pictures, enter all info and, best of all, tell what happened in my own words, all within the app!"*

Watch related video at [www.libertymutualgroup.com/2011annualreview](http://www.libertymutualgroup.com/2011annualreview)

# Liberty Mutual Agency Corporation

Liberty Mutual Agency Corporation (LMAC) offers property and casualty (P&C) insurance through approximately 12,000 independent insurance agents to individuals and small and mid-sized businesses throughout the United States.

LMAC offers personal lines products nationally under the Safeco Insurance brand, and commercial lines products through the eight regional companies that compose the Regional Companies Group: America First Insurance, Colorado Casualty, Golden Eagle Insurance, Indiana Insurance, Liberty Northwest, Montgomery Insurance, Ohio Casualty and Peerless Insurance.

Liberty Mutual Agency Underwriters offers specialty commercial products, including excess casualty and program business nationally. Liberty Mutual Surety provides nationwide contract and commercial surety and fidelity bonds, and its Liberty SuretyFirst brand meets the bonding needs of individuals and small to mid-sized businesses.





**J. Paul Condrin, III**

President and Chief Executive Officer  
Liberty Mutual Agency Corporation

“We have tremendous market position in each of our businesses, built upon mutually supportive and responsive partnerships with independent agents.”

## Liberty Mutual Agency Corporation

As with the entire U.S. P&C insurance industry, LMAC's personal and commercial lines companies were impacted by the year's tornadoes, hailstorms, hurricanes and wildfires. In response, its claims professionals and front-line teams worked tirelessly when customers and agents needed them most (see article below).

Despite these weather-related events, as well as a depressed economy, LMAC experienced many successes in 2011. Its underlying fundamentals remained strong in personal lines and surety, and it continued to strengthen its commercial lines.

LMAC's Regional Companies Group (RCG) continued to roll out its expanded policy administration and quoting

system, which delivers a broadened product set and an easy-to-use interface for agents. RCG is also focused on improving the efficiency of its underwriting process to ensure its companies meet agents' expectations on improving quality, timeliness and consistency of service.

Liberty Mutual Surety, the nation's second-largest surety business, consolidated its bond platforms and introduced a new agency portal to agents that provides personalized tools and resources in a single location.

Safeco Insurance achieved significant growth relative to the industry in 2011. Demonstrating its strong commitment to customer satisfaction, its service, sales and claims call centers have all been recognized by the



RICK PRICE  
AND  
BRIGITTE PIPPIN



## Response

### “The Worst I’ve Seen”

On the afternoon of Sunday, May 22, 2011, one of the deadliest tornadoes in U.S. history tore through Joplin, Missouri, carving out a path of destruction a mile wide and eight miles long.

Arriving quickly on the scene was Rick Price, a claims adjuster and 18-year employee with America First Insurance. “You arrive and find yourself speechless. It’s sobering, and as a claims professional, it reinforces the importance of what I do,” Price said.

One of Price’s claims was from a dry cleaning business owned by Brigitte Pippin and her husband, Ken, which was completely leveled by the tornado.

“When I arrived, they were digging to find their customers’ laundry tickets,” Price said. “In the process, Ken cut himself severely, so we went straight to the temporary medical center at the Joplin Town Hall, where we all got tetanus shots.”

Nine months later, the Pippins were back in business in a completely new building on the same site, albeit surrounded by vacant lots, a daily reminder of the devastation that had transpired.

“After an event like this, the worst I’ve seen, we know that customers like the Pippins can’t be expected to get their business back up and running on their own,” Price said.

Watch related video at [www.libertymutualgroup.com/2011annualreview](http://www.libertymutualgroup.com/2011annualreview)

J.D. Power and Associates Call Center Certification Program for providing “An Outstanding Customer Service Experience.” And positioning itself firmly in the competitive auto insurance environment, Safeco introduced a new advertising campaign to appeal to its “Do More” customers.

LMAC begins 2012 with strong momentum and an unrelenting focus on strengthening agent relationships while providing responsive service and quality products to its agent partners and policyholders.

**LMAC’s underlying fundamentals remained strong in personal lines and surety, and it continued to strengthen its commercial lines.**



## Ability

### Bricks & Clicks™ Helps Agents Compete in the Digital Space

Developing an effective website or figuring out how to market on social channels can be a daunting—if not impossible—task for independent insurance agents with limited digital-marketing resources. But thanks to Bricks & Clicks, agents are forging and strengthening customer relationships in the digital space.

Bricks & Clicks provides a growing slate of services, including customized insurance websites optimized for search and mobile, for a small fee. The program also offers online and face-to-face workshops on web-related topics, such as the use of social media to connect with customers.

Bricks & Clicks also recently launched Search-Score, a tool that grades agencies on how easily prospects and customers can find their sites—then provides specific improvement tips.

“We’re providing independent agents with the feedback and tools they need to grow their business,” said Dale Steinke, Bricks & Clicks manager for Safeco Insurance.

The program continues to grow. In 2011, Bricks & Clicks built more than 500 agent websites and provided digital-marketing expertise to more than 2,400 agents.

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# Commercial Markets

Commercial Markets offers a wide array of property and casualty (P&C) and group benefits insurance coverage through independent agents, brokers and benefit consultants throughout the United States.

Commercial Markets P&C provides commercial lines products and services to mid-sized and large businesses. Group Benefits furnishes mid-sized and large businesses with group life and short- and long-term disability insurance products and administrative services. Summit sells workers compensation coverage in the Southeast, primarily to small businesses. Liberty Mutual Reinsurance provides reinsurance programs for domestic and foreign insurance and reinsurance companies. Commercial Markets is also a servicing carrier for state-based workers compensation involuntary market pools.





### Christopher L. Peirce

President  
Commercial Markets

“We will build on the positive momentum gained in 2011 and continue to realize improvements in profitability and diversification in 2012. We have a clear strategy and the right people in place to execute it.”

## Commercial Markets

Catastrophes and severe weather-related events were “the story” in 2011, and Commercial Markets’ catastrophe losses, and those for the U.S. commercial lines industry as a whole, were substantially higher than anticipated. Despite this challenging environment, Commercial Markets made significant strides toward realizing its goal of long-term, profitable growth.

Topping the list is Commercial Markets’ workers compensation claims next-generation predictive model (see article below right), the latest addition to the Liberty Mutual Insurance VantageComp™ integrated approach to claims management. This predictive model helps to more quickly and accurately identify claims with the potential to escalate well beyond the norm, and apply the

proper resources to deliver the best possible outcomes for injured employees and their employers.

To further enhance its partnership with brokers and agents, Commercial Markets combined three former service functions into a single, easier-to-access organization, and expanded its underwriting footprint on the East and West Coasts to better align with key distribution partners.

Commercial Markets P&C also continued its push for product diversification in 2011. Primarily a workers compensation insurer just a few years ago, its product mix is much more diverse today, thanks in large part to a focused effort to expand its underwriting appetite across all lines. Additionally, Commercial Markets developed and implemented more sophisticated pricing

MEL JEFFERS  
AND MIKRON'S  
JEFF YORK



TORNADO-DAMAGED  
MIKRON PLANT



## Response

### “And Then We Got Hit”

Rich Ingram, facilities maintenance manager for Mikron, which manufactures window and door components and systems at its Richmond, Kentucky, plant, was in a meeting room overlooking a parking lot when he noticed the change.

“First the wind was blowing hard right to left, and then it abruptly switched direction. Next thing I knew, the roof blew off the firehouse across the street, and then we got hit,” he said. It was Friday evening of the Mother’s Day weekend, and without warning, a tornado had struck.

Onsite the next day were Liberty Mutual Insurance property adjusters Mel Jeffers and Will Prebil.

“Mikron runs a 24/7 operation,” Jeffers said, “and once they knew their employees were safe and unhurt, their top concern was getting three major shipments out the door.”

Jeffers and Prebil brought in specialists to help with the cleanup, and by Monday afternoon, even though its facility would undergo repairs for months, Mikron had returned to full manufacturing.

“After an event like this, it’s difficult to prioritize what needs to be done,” said Jeff York, vice president, Process Innovation for Mikron.

“Mel’s expertise and calming influence made all the difference.”

Watch related video at [www.libertymutualgroup.com/2011annualreview](http://www.libertymutualgroup.com/2011annualreview)

tools to ensure the proper focus on profitability as it expands its book across lines. Commercial Markets' other businesses—Group Benefits, Liberty Mutual Reinsurance and Summit—continued to invest in building expertise and relationships, while maintaining a strong presence in challenging markets.

Today, with an exclusive focus on agent and broker distribution, and reorganized in a cohesive, functional structure, Commercial Markets, together with its committed and engaged employees, is in a solid position for future profitable growth.

Primarily a workers compensation insurer just a few years ago, Commercial Markets today has a much more diverse product mix thanks in large part to a focused effort to expand its underwriting appetite across all lines.



GEORGE NEALE

## Ability

### Predictive Modeling Results in Superior Claims Outcomes

With a small number of workers compensation claims driving the vast majority of total claim costs, it's crucial that Liberty Mutual Insurance identify and act on those needle-in-a-haystack claims early on, before their costs escalate. That's the thinking behind VantageComp™—the company's integrated approach to workers compensation claims management.

"VantageComp is really the end result of a vision and a continuous journey in the innovation of workers compensation claims management," said George Neale, executive vice president and general claims manager.

A key VantageComp component is its next-generation predictive model, winner of a 2012 *Business Insurance* Innovation Award. This series of models runs over the life of a claim and uses case file data, billing details and non-medical factors to identify cases likely to escalate.

Earlier identification of at-risk claims lets Liberty Mutual Insurance claims handlers intervene sooner with more sophisticated claims management strategies. Applying the right resources—at the right time—changes the trajectory of these claims, helps control costs and produces the best possible medical outcomes for injured workers.

Watch related video at [www.libertymutualgroup.com/2011annualreview](http://www.libertymutualgroup.com/2011annualreview)

# Liberty International



Liberty International provides insurance products and services through two distinct approaches:

Liberty International Holdings' country operations sell property, casualty, health and life insurance products to individuals and businesses in Latin America, Europe and the Asia-Pacific region (see map on pages 24–25). Private passenger automobile insurance is the single largest line of business.

Liberty International Underwriters (LIU) writes casualty, specialty casualty, marine, energy, construction, aviation, property, crisis management and trade credit coverages and other specialty programs through offices in Asia, Australia, Europe, the Middle East, North America and Latin America. LIU, through its Lloyd's Syndicate 4472, also provides multiline insurance and reinsurance worldwide.



### Luis Bonell

Chief Executive Officer  
Liberty International Holdings Inc.

“We have aggressive growth goals, and I trust we can meet them, especially if we use our strong global network of knowledge and resources to our best ability.”



### Daniel T.N. Forsythe

Chief Executive Officer  
Liberty International Underwriters (LIU)

“Market conditions will be challenging in all lines as capacity remains abundant. However, the opportunity remains for LIU to innovate, prosper and grow in this phase of the underwriting cycle.”

## Liberty International

Liberty International continued its impressive record of profitable growth in 2011 despite the uncertain world economic environment. Today, nine of its 14 country operations, which sell both personal and commercial lines, rank in the top ten in their industry, and its specialty commercial business, Liberty International Underwriters (LIU), continues to innovate, prosper and grow.

A particular point of pride was the response of country operation LMG Insurance in Thailand to that nation's devastating floods (see below), which impacted 65 of that country's 77 provinces. In addition to responding to the needs of its customers and employees, many of whom had to evacuate their homes, the company distributed 8,000 relief packages to flood victims. LIU also assisted with local efforts in Thailand, and in response to the

earthquake and tsunami in Japan, flooding in Australia, and the earthquake in New Zealand, with major financial support via reinsurance.

Other highlights from Liberty International's country operations include the association of Liberty Seguros (Brazil) with the 2014 FIFA World Cup as a national supporter and exclusive insurance provider, the opening of a branch in Guangdong, China, the country's largest property and casualty insurance market, and the acquisition of an insurer in Ireland.

Ever since its launch in 1999 as a specialty lines company, LIU has continued to launch unique niche products, including cyber liability (see article, below right), through its 49 offices worldwide.

JOHN FU



## Response

### “We Were All In This Together.”

From July 2011 to mid-January 2012, the worst flooding in a millennium struck Thailand, home of Liberty International's country operation, LMG Insurance. One-third of the nation's provinces were declared disaster areas, with the flooding impacting more than 13 million people, 3.3 million homes and 100,000 vehicles.

LMG Insurance's response was to help not only its customers and employees, but the community at large.

“We had three branches flooded and more than 100 employees forced to evacuate their homes but, as a personal lines insurer, we couldn't just ignore the needs of our customers while we

tended to our own,” said LMG Insurance President John Fu.

Not only did LMG Insurance find temporary housing for its employees, it ran its call center at full throttle. The company responded to thousands of auto and property claims, deployed a team of adjusters with catastrophe experience and proactively called customers in the flood zone to arrange towing.

And it didn't stop there. LMG Insurance employees volunteered to assemble and deliver 8,000 relief packages to flood victims in six communities. “It was the least we could do,” Fu said. “We were all in this together.”

Watch related video at [www.libertymutualgroup.com/2011annualreview](http://www.libertymutualgroup.com/2011annualreview)

Significant LIU achievements in 2011 include: LIU Europe's push into the mid-market commercial sector in the United Kingdom with new offices in Birmingham, Leeds and London; LIU Asia Pacific's initiative to position itself as a provider of choice for infrastructure and construction projects; LIU U.S.'s expansion into excess and surplus lines property, and the relaunching of its marine offering; and Liberty Syndicates trading in agricultural reinsurance, marine and specialty motor segments.

Looking ahead, Liberty International intends to continue to expand its presence around the world and capture an appropriate share of the global specialty lines and reinsurance business as well as emerging property and casualty insurance business.

Today, nine of Liberty International's 14 country operations rank in the top ten in their industry, and its specialty commercial business, Liberty International Underwriters (LIU), continued to innovate, prosper and grow in 2011.



## Ability

### Protecting Intangible Assets

Protection against privacy intrusion and computer hacking continues to emerge as something companies big and small can't afford to ignore.

Responding to this threat, Liberty International Underwriters (LIU) Europe and, more recently, LIU U.S. introduced cyber and privacy products covering everything from loss or damage to digital assets to business interruption, privacy liability and reputational risk.

"Data security can mean anything from minor intrusions on a company's email to a full-scale, denial-of-service attack that cripples a company," said Matthew Hogg, who heads up LIU Europe's Strategic Assets Division.

And, he said, it's no longer just an IT issue as "more and more companies seek data security insurance to help protect their operations."

Hogg and his team work closely with niche brokers who specialize in cyber risk in the London market and beyond.

"Innovation in cyber liability is critical, because each day brings new ways of attacking business, and it's an area of ever-increasing regulatory focus as well," Hogg said.

"As the attacks evolve and data breaches continue to make headlines, we'll be there with innovative products to meet the increased demand."

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# Company Overview

Boston-based Liberty Mutual Insurance Group is a diversified global insurer and the third-largest property and casualty insurer in the U.S. based on A.M. Best Company's report of 2010 direct written premium. The Company also ranks 82nd on the Fortune 500 list of largest corporations in the U.S. based on 2010 revenue.

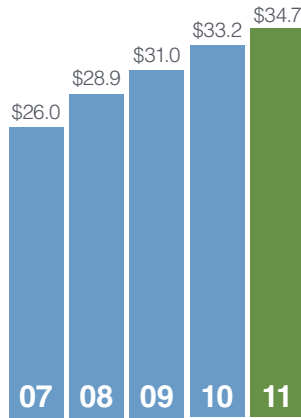
As of December 31, 2011, the Company had \$117.1 billion in consolidated assets, \$99.3 billion in consolidated liabilities and \$34.7 billion in annual consolidated revenues.

Liberty Mutual Insurance Group employs more than 45,000 people in more than 900 offices throughout the world.

Liberty Mutual Insurance Group's pre-tax operating income for 2011 was \$249 million, a decrease of 87 percent from 2010. Net investment income was approximately \$3.5 billion on cash flows from operations of \$2.1 billion.

Net income decreased to \$365 million, a decrease of \$1.3 billion or 78.2 percent from 2010, and total equity increased by \$880 million to \$17.9 billion.

**Revenues**  
in billions





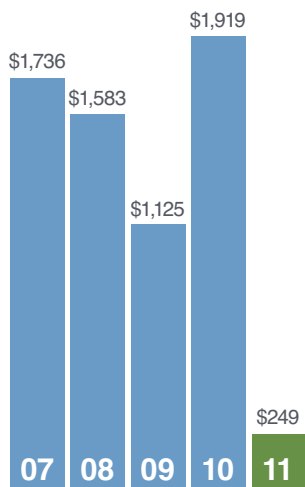
Liberty Mutual Insurance Group offers a wide range of insurance products and services, including personal automobile, workers compensation, homeowners, commercial multiple peril, commercial automobile, general liability, global specialty, group disability, assumed reinsurance, fire and surety through four strategic business units:

- Personal Markets
- Liberty Mutual Agency Corporation
- Commercial Markets
- Liberty International

Each business unit operates independently of the others and has dedicated sales, underwriting, claims, actuarial, financial and certain information technology resources.

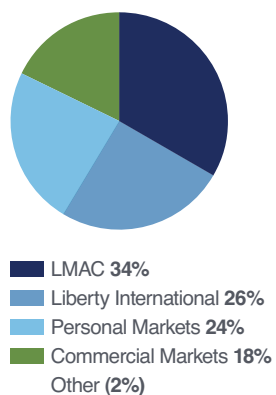
### Pre-Tax Operating Income

in millions



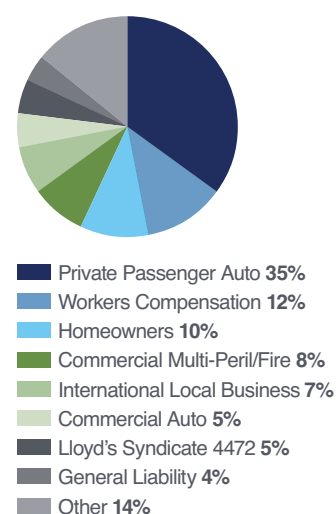
### Strategic Business Units

\$31.2 billion in 2011 net written premium



### Significant Lines of Business

\$31.2 billion in 2011 net written premium



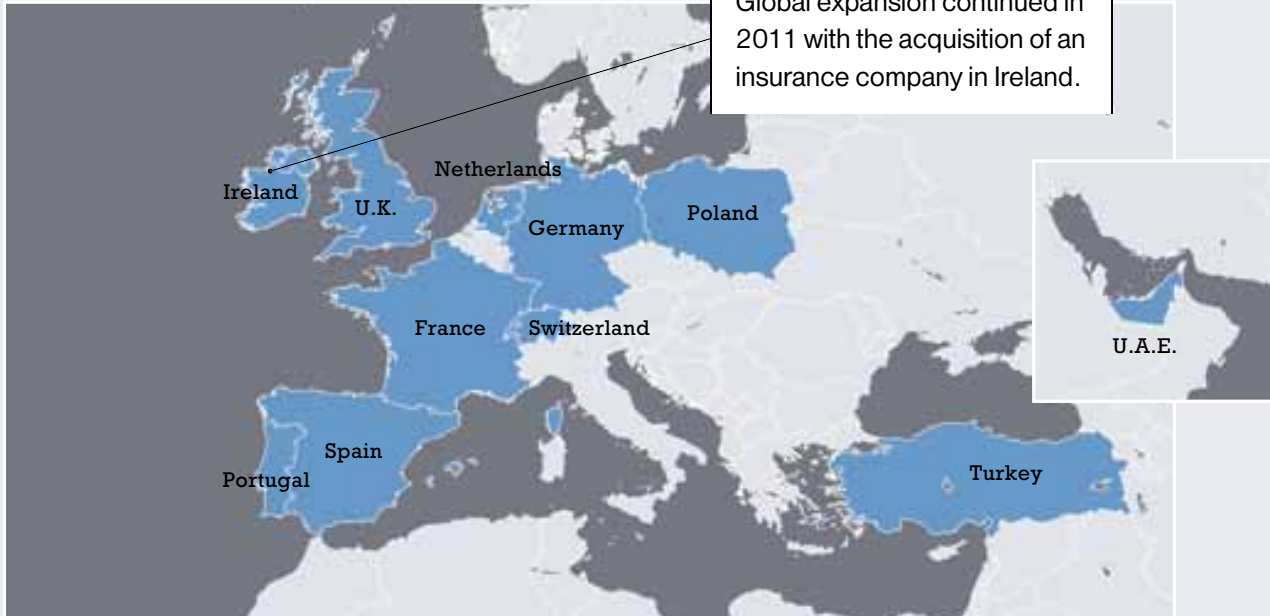
# Our Global Presence

Liberty Mutual Insurance Group operates in the Americas, Europe, Asia Pacific and the Middle East through local company operations and specialty lines offices.

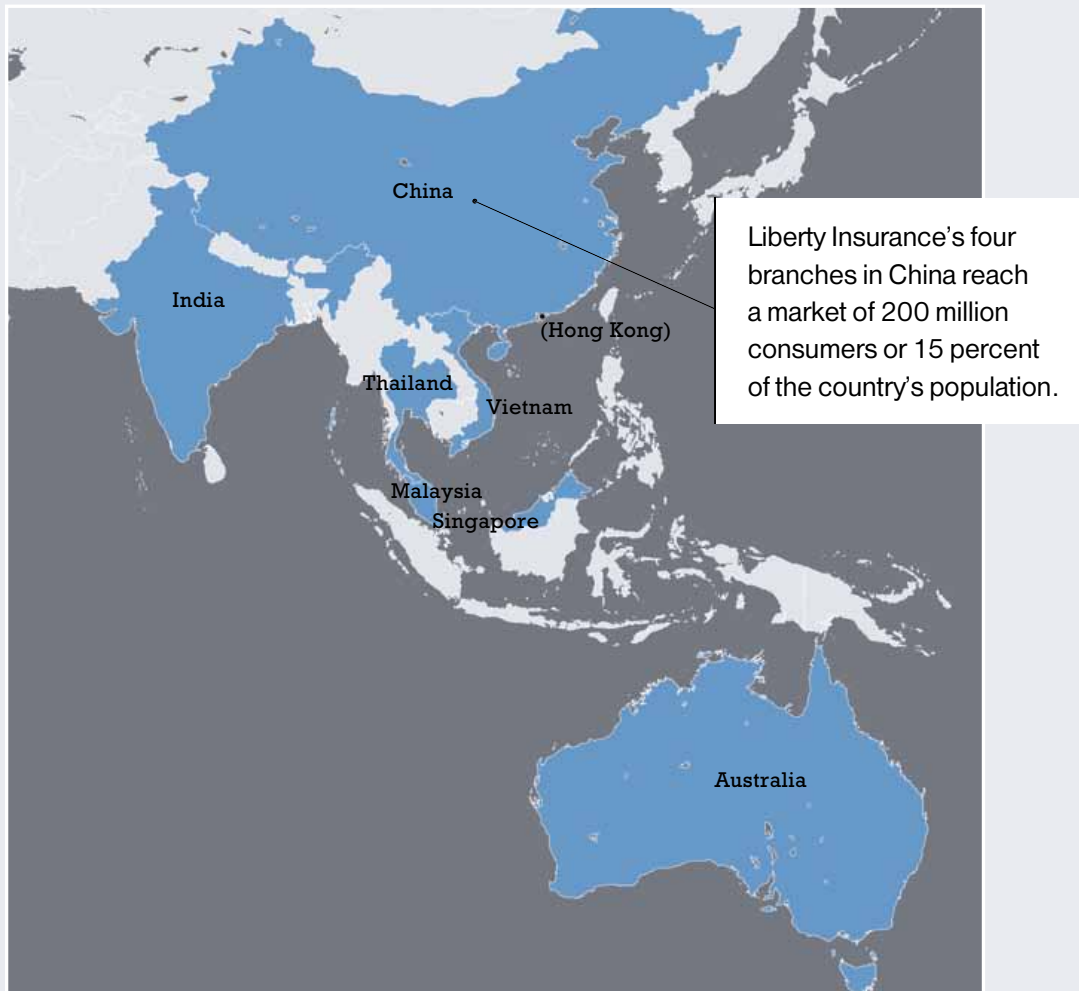
## The Americas



## Europe/Middle East



## Asia Pacific



# Board of Directors

LIBERTY MUTUAL HOLDING COMPANY INC.

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New York, New York

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Chairman and Chief Executive Officer  
Clough Capital Partners, LP  
Boston, Massachusetts

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Chairman Emeritus  
Liberty Mutual Insurance Company  
Liberty Mutual Fire Insurance Company  
Boston, Massachusetts

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Innovation and Technology  
IBM Corporation  
Armonk, New York

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Retired Chairman  
Sovereign Bank New England  
Boston, Massachusetts

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Liberty Mutual Holding Company Inc.  
Boston, Massachusetts

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Liberty Mutual Holding Company Inc.  
Boston, Massachusetts

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Boston Capital Corporation  
Boston, Massachusetts

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NSTAR  
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Booth School of Business  
Chicago, Illinois

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Lisle, Illinois

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Blue Cross and Blue Shield of Massachusetts  
Boston, Massachusetts

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NRStor Incorporated  
Toronto, Ontario, Canada

# Corporate Officers

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Executive Vice President and Chief Investment Officer

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Executive Vice President

## Timothy M. Sweeney

Executive Vice President

## Paul G. Alexander

Senior Vice President

## J. Eric Brosius

Senior Vice President and Corporate Actuary

## Melanie J. Foley

Senior Vice President

## Dennis J. Langwell

Senior Vice President and Chief Financial Officer

## Christopher C. Mansfield

Senior Vice President and General Counsel

## James M. McGlennon

Senior Vice President and Chief Information Officer

## John D. Doyle

Vice President and Comptroller

## Dexter R. Legg

Vice President and Secretary

## Laurance H.S. Yahia

Vice President and Treasurer

## Personal Markets

### **Timothy M. Sweeney** President

**Edward J. Gramer III**  
Executive Vice President and General Manager, Claims

**Stephen S. McAnena**  
Executive Vice President and General Manager, Distribution

**Cheryl K. Neal**  
Executive Vice President and Chief Operating Officer, Individual Life

**Alan R. Schlosberg**  
Executive Vice President and Chief Product Officer

**Gregory C. Gordon**  
Senior Vice President and Manager, Marketing

## Liberty Mutual Agency Corporation

### **J. Paul Condrin, III** President and Chief Executive Officer

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President  
Regional Companies Group

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Executive Vice President and Chief Underwriting  
and Product Officer

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Executive Vice President and Chief Operating Officer

**E. Janney Wilson**  
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Senior Vice President and Manager, Claims

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Colorado Casualty

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President and Chief Executive Officer  
Indiana Insurance

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President and Chief Executive Officer  
America First Insurance

**Julie A. Burnett**  
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Liberty Northwest

**Michael R. Christiansen**  
President and Chief Executive Officer  
Peerless Insurance

**Spencer J. Donkin**  
President and Chief Executive Officer  
Golden Eagle Insurance

**Michael J. Plavnicky**  
President and Chief Executive Officer  
Montgomery Insurance

**Michael A. Winner**  
President and Chief Executive Officer  
Ohio Casualty

**Michael H. Hughes**  
President  
Safeco Insurance

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Executive Vice President and Chief Operating Officer

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Liberty Mutual Surety

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Executive Vice President, Field Operations

**Ronald F. Goetsch**  
Executive Vice President and Manager, Claims

**Roderick A. Williams**  
Executive Vice President and Chief Underwriting Officer

## Commercial Markets

### **Christopher L. Peirce** President

**James M. Hinchley**  
Executive Vice President and Chief Underwriting Officer

**George A. Neale**  
Executive Vice President and General Manager, Claims

**Tracy A. Ryan**  
Executive Vice President and Chief Product Officer

**Mark A. Butler**  
President, Distribution and Service Management

**Deborah L. Michel**  
Executive Vice President and General Manager, Major Accounts  
President, Helmsman Management Services

### **Executive Vice Presidents and General Managers**

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**David R. Dwartz**

**David E. Eaglen**

**Rodolfo Ortiz**

**George D. Townsend**

**Peter L. Wise**

**Michael T. Finnegan**  
Chief Operating Officer  
Liberty Mutual Reinsurance

**Jean M. Scarrow**  
Chief Operating Officer and General Manager  
Group Benefits

**Carol P. Sipe**  
President and Chief Executive Officer  
Summit Holdings

## International

### COUNTRY OPERATIONS

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**Chief Executive Officer**

**Liberty International Holdings Inc.**

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Executive Vice President and Chief Operating Officer  
Latin America

#### **Roberto Salas**

Executive Vice President and Chief Operating Officer  
Europe

#### **Luciano Suzuki**

Executive Vice President and Chief Operating Officer  
Asia Pacific

#### **Susana Agustin**

President  
Liberty ART and Liberty Seguros  
Argentina

#### **Pablo Barahona**

President  
Liberty Seguros  
Brazil

#### **Martin Bridger**

Managing Director  
Liberty Insurance  
Singapore

#### **John Fu**

President  
LMG Insurance  
Thailand

#### **Mauricio García**

President  
Liberty Seguros  
Colombia

#### **Nick Helms**

President  
Liberty Insurance  
Hong Kong

#### **Enrique Huerta**

President  
Liberty Seguros  
Spain

#### **Oscar Huerta**

President  
Liberty Seguros  
Chile

#### **Michał Kwieciński**

President  
Liberty Direct  
Poland

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President  
Seguros Caracas de Liberty Mutual  
Venezuela

#### **Patrick O'Brien**

President  
Liberty Insurance  
Ireland

#### **José Antonio de Sousa**

President  
Liberty Seguros  
Portugal

#### **Jackson Tang**

Managing Director  
Liberty Insurance  
China

#### **Carlos Vanegas**

President  
Liberty Insurance  
Vietnam

#### **I. Ragip Yergin**

Director and General Manager  
Liberty Sigorta  
Turkey

#### **Joe H. Hamilton**

**Executive Vice President and  
Chief Strategy and Business Development Officer**

### LIBERTY INTERNATIONAL UNDERWRITERS

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**Chief Executive Officer**

#### **Gordon J. McBurney**

President and Chief Underwriting Officer

#### **Michael J. Abdallah**

President and Chief Executive Officer  
LIU Asia Pacific

#### **David A. Cohen**

President  
LIU U.S.

#### **Michael Molony**

President  
LIU Canada

#### **Sean Rocks**

Chief Executive Officer  
LIU Europe

#### **Nicholas Metcalf**

Chief Executive Officer  
Liberty Syndicates

## **Annual Meeting**

Liberty Mutual Holding Company Inc. holds its Annual Meeting on the second Wednesday of April at 10 a.m. at the World Headquarters in Boston.

Policyholders of Liberty Mutual Insurance Company (a stock insurance company), Liberty Mutual Fire Insurance Company (a stock insurance company), Employers Insurance Company of Wausau (a stock insurance company) and Liberty Mutual Personal Insurance Company (a stock insurance company) are members of Liberty Mutual Holding Company Inc. If you are a policyholder of any of these entities, you are entitled to vote, either in person or by proxy. You may obtain a proxy form by writing to the Secretary of Liberty Mutual Holding Company Inc. at 175 Berkeley Street, Boston, MA 02116.

Any member may obtain the most recent financial statements of Liberty Mutual Holding Company Inc. in writing by sending a request to that same address. Financial Statements are also available at [www.libertymutualgroup.com/liberty-mutual-investor-relations](http://www.libertymutualgroup.com/liberty-mutual-investor-relations).

## **Online Version of Annual Review**

To view the 2011 Annual Review online, including video of the featured stories, please visit [www.libertymutualgroup.com/2011annualreview](http://www.libertymutualgroup.com/2011annualreview)



175 Berkeley Street  
Boston, MA 02116  
[libertymutualgroup.com](http://libertymutualgroup.com)





FINANCIAL STATEMENTS

Liberty Mutual Holding Company Inc.  
December 31, 2011 and 2010 and each of the  
Three Years in the Period Ended December 31, 2011

Ernst & Young LLP

 **ERNST & YOUNG**

## Report of Independent Registered Public Accounting Firm

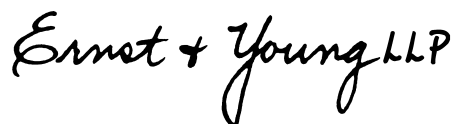
The Board of Directors  
Liberty Mutual Holding Company Inc.

We have audited the accompanying consolidated balance sheets of Liberty Mutual Holding Company Inc. (the Company) as of December 31, 2011 and 2010, and the related consolidated statements of income, changes in total equity, and cash flows for each of the three years in the period ended December 31, 2011. 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 generally accepted auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes 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.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Liberty Mutual Holding Company Inc. at December 31, 2011 and 2010, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2011, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with attestation standards established by the American Institute of Certified Public Accountants and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States), Liberty Mutual Holding Company Inc.'s internal control over financial reporting as of December 31, 2011, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 2, 2012 expressed an unqualified opinion thereon.



Boston, Massachusetts  
March 2, 2012

## **Management's Report on the Effectiveness of Internal Control Over Financial Reporting**

### **The Board of Directors Liberty Mutual Holding Company Inc.**

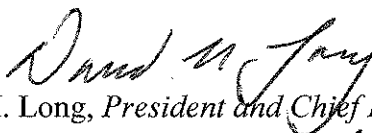
Management of Liberty Mutual Holding Company Inc. (the Company) is responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control over financial reporting is a process designed to provide reasonable assurance to our management and Board of Directors regarding the reliability of financial reporting and the preparation of the consolidated financial statements in accordance with U.S. generally accepted accounting principles.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management has assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2011, based on the framework established in Internal Control – Integrated Framework published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Based on its assessment, management concluded that the Company's internal control over financial reporting was effective to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company's consolidated financial statements as of December 31, 2011.

Ernst & Young LLP, our independent registered public accounting firm, has issued its report on the effectiveness of the Company's internal control over financial reporting, which follows this report.



David H. Long, *President and Chief Executive Officer*



Dennis J. Langwell, *Senior Vice President and Chief Financial Officer*

## Report of Independent Registered Public Accounting Firm on the Effectiveness of Internal Control Over Financial Reporting

The Board of Directors  
Liberty Mutual Holding Company Inc.

We have audited Liberty Mutual Holding Company Inc.'s internal control over financial reporting as of December 31, 2011 based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Liberty Mutual Holding Company Inc.'s management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on the Effectiveness of Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

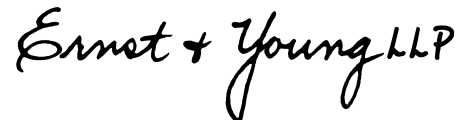
We conducted our audit in accordance with attestation standards established by the American Institute of Certified Public Accountants and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Liberty Mutual Holding Company Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on the COSO criteria.

We also have audited, in accordance with generally accepted auditing standards as established by the Auditing Standards Board (United States) and in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Liberty Mutual Holding Company Inc. as of December 31, 2011 and 2010, and the related consolidated statements of income, changes in total equity and cash flows for each of the three years in the period ended December 31, 2011 and our report dated March 2, 2012 expressed an unqualified opinion thereon.

A handwritten signature in black ink that reads 'Ernst & Young LLP'.

Boston, Massachusetts  
March 2, 2012

Liberty Mutual Holding Company Inc.

Consolidated Statements of Income

(dollars in millions)

	<b>Years Ended December 31,</b>		
	<u>2011</u>	<u>2010</u>	<u>2009</u>
<b>Revenues</b>			
Premiums earned	\$ 30,119	\$ 28,699	\$ 27,791
Net investment income	3,523	3,328	2,482
Fee and other revenues	871	764	736
Net realized gains	<u>158</u>	<u>402</u>	<u>26</u>
Total revenues	<u>34,671</u>	<u>33,193</u>	<u>31,035</u>
<b>Claims, Benefits and Expenses</b>			
Benefits, claims and claim adjustment expenses	24,205	20,984	20,169
Insurance operating costs and expenses	4,623	4,490	4,336
Amortization of deferred policy acquisition costs	4,811	4,757	4,692
Interest expense	439	456	483
Interest credited to policyholders	<u>186</u>	<u>185</u>	<u>204</u>
Total claims, benefits and expenses	34,264	30,872	29,884
(Loss) gain on extinguishment of debt	<u>(110)</u>	<u>-</u>	<u>59</u>
Income before income tax (benefit) expense and non-controlling interest	297	2,321	1,210
Income tax (benefit) expense	<u>(71)</u>	<u>637</u>	<u>187</u>
Consolidated net income	368	1,684	1,023
Less: Net income attributable to non-controlling interest	3	6	-
Net income attributable to Liberty Mutual Holding Company, Inc.	<u>\$ 365</u>	<u>\$ 1,678</u>	<u>\$ 1,023</u>
<b>Net Realized Gains</b>			
Other-than-temporary impairment losses:	<u>2011</u>	<u>2010</u>	<u>2009</u>
Total other-than-temporary impairment losses	\$ (70)	\$ (55)	\$ (244)
Change in portion of loss recognized in other comprehensive income	<u>(9)</u>	<u>(1)</u>	<u>13</u>
Other-than-temporary impairment losses	(79)	(56)	(231)
Other net realized gains	<u>237</u>	<u>458</u>	<u>257</u>
Net realized gains	<u>\$ 158</u>	<u>\$ 402</u>	<u>\$ 26</u>

See accompanying notes to the audited consolidated financial statements.

Liberty Mutual Holding Company Inc.

Consolidated Balance Sheets

(dollars in millions)

	December 31, 2011	December 31, 2010
	<u>2011</u>	<u>2010</u>
<b>Assets:</b>		
Investments		
Fixed maturities, available for sale, at fair value (amortized cost of \$57,108 and \$56,375)	\$ 60,576	\$ 58,553
Equity securities, available for sale, at fair value (cost of \$1,942 and \$1,552)	1,954	1,733
Short-term investments	201	313
Mortgage loans	1,196	1,206
Other investments	3,789	3,067
Total investments	<u>67,716</u>	<u>64,872</u>
Cash and cash equivalents	5,972	4,930
Premium and other receivables	8,840	8,072
Reinsurance recoverables	13,272	14,310
Deferred income taxes	815	796
Deferred acquisition costs	2,808	2,771
Goodwill	4,766	4,750
Prepaid reinsurance premiums	1,518	1,404
Separate account assets	4,087	3,893
Other assets	7,337	6,552
Total assets	<u>\$ 117,131</u>	<u>\$ 112,350</u>
<b>Liabilities:</b>		
Unpaid claims and claim adjustment expenses and future policy benefits:		
Property and casualty	\$ 50,228	\$ 48,059
Life	7,151	6,781
Other policyholder funds and benefits payable	4,061	3,629
Unearned premiums	14,987	13,977
Funds held under reinsurance treaties	1,277	1,784
Current maturities of long-term debt	205	1
Long-term debt	5,341	5,635
Separate account liabilities	4,087	3,893
Other liabilities	11,930	11,607
Total liabilities	<u>99,267</u>	<u>95,366</u>
<b>Equity:</b>		
Unassigned equity	16,057	15,692
Accumulated other comprehensive income	1,669	1,286
Total policyholders' equity	<u>17,726</u>	<u>16,978</u>
Non-controlling interest	138	6
Total equity	<u>17,864</u>	<u>16,984</u>
Total liabilities and equity	<u>\$ 117,131</u>	<u>\$ 112,350</u>

See accompanying notes to the audited consolidated financial statements.

Liberty Mutual Holding Company Inc.

Consolidated Statements of Changes in Total Equity

(dollars in millions)

	Unassigned Equity	Accumulated Other Comprehensive Income (Loss)	Total Policyholders' Equity	Non-Controlling Interest	Total Equity
<b>Balance, January 1, 2009</b>	\$ 12,963	\$ (2,560)	\$ 10,403	\$ 1	\$ 10,404
Cumulative effect of adoption of ASC 320 at January 1, 2009 (Note 1)	28	(28)	-	-	-
Comprehensive income					
Consolidated net income	1,023	-	1,023	-	1,023
Other comprehensive income, net of taxes:					
Unrealized gains on securities	-	2,568	2,568	-	2,568
Less: reclassification adjustment for gains and losses included in net income	-	4	4	-	4
Change in pension and post retirement plans funded status	-	298	298	-	298
Foreign currency translation and other adjustments	-	218	218	-	218
Other comprehensive income, net of taxes	-	3,088	3,088	-	3,088
Total comprehensive income	-	-	4,111	-	4,111
<b>Balance, December 31, 2009</b>	\$ 14,014	\$ 500	\$ 14,514	\$ 1	\$ 14,515
Comprehensive income					
Consolidated net income	1,678	-	1,678	6	1,684
Other comprehensive income (loss), net of taxes:					
Unrealized gains on securities	-	451	451	-	451
Less: reclassification adjustment for gains and losses included in net income	-	(269)	(269)	-	(269)
Change in pension and post retirement plans funded status	-	560	560	-	560
Foreign currency translation and other adjustments	-	44	44	(1)	43
Other comprehensive income (loss), net of taxes	-	786	786	(1)	785
Total comprehensive income	-	-	2,464	5	2,469
<b>Balance, December 31, 2010</b>	\$ 15,692	\$ 1,286	\$ 16,978	\$ 6	\$ 16,984
Comprehensive income (loss)					
Consolidated net income	365	-	365	3	368
Other comprehensive income (loss), net of taxes:					
Unrealized gains on securities	-	853	853	-	853
Less: reclassification adjustment for gains and losses included in net income	-	(67)	(67)	-	(67)
Change in pension and post retirement plans funded status	-	(227)	(227)	-	(227)
Foreign currency translation and other adjustments	-	(176)	(176)	(6)	(182)
Other comprehensive income (loss), net of taxes	-	383	383	(6)	377
Total comprehensive income (loss)	-	-	748	(3)	745
Capital contributions	-	-	-	135	135
<b>Balance, December 31, 2011</b>	\$ 16,057	\$ 1,669	\$ 17,726	\$ 138	\$ 17,864

See accompanying notes to the audited consolidated financial statements.



Liberty Mutual Holding Company Inc.

Consolidated Statements of Cash Flows

(dollars in millions)

	Years Ended December 31,		
	2011	2010	2009
<b>Cash flows from operating activities:</b>			
Consolidated net income	\$ 368	\$ 1,684	\$ 1,023
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	588	459	397
Realized gains	(158)	(402)	(26)
Undistributed private equity investment (gains) losses	(583)	(364)	423
Premium, other receivables, and reinsurance recoverables	(543)	(132)	526
Deferred acquisition costs	(153)	(167)	(131)
Liabilities for insurance reserves	3,103	1,081	197
Taxes payable, net of deferred	(280)	649	(173)
Other, net	(241)	(47)	251
Total adjustments	1,733	1,077	1,464
Net cash provided by operating activities	2,101	2,761	2,487
<b>Cash flows from investing activities:</b>			
Purchases of investments	(14,080)	(19,578)	(18,874)
Sales and maturities of investments	12,704	17,721	14,928
Property and equipment purchased, net	(682)	(507)	(355)
Cash acquired through acquisitions, net of cash paid	1,125	-	-
Other investing activities	(194)	(40)	173
Net cash used in investing activities	(1,127)	(2,404)	(4,128)
<b>Cash flows from financing activities:</b>			
Net activity in policyholder accounts	283	194	122
Debt financing, net	(195)	(301)	(84)
Net security lending activity and other financing activities	77	50	621
Net cash provided by (used in) financing activities	165	(57)	659
Effect of exchange rate changes on cash	(97)	(217)	(19)
Net increase (decrease) in cash and cash equivalents	1,042	83	(1,001)
Cash and cash equivalents, beginning of year	4,930	4,847	5,848
Cash and cash equivalents, end of year	\$ 5,972	\$ 4,930	\$ 4,847
<b>Supplemental disclosure of cash flow information:</b>			
Income tax paid (refund)	\$ 209	\$ (2)	\$ 366

See accompanying notes to the audited consolidated financial statements.

# LIBERTY MUTUAL HOLDING COMPANY INC

Notes to Consolidated Financial Statements

(dollars in millions, except per share amounts)

## (1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Basis of Presentation

The accompanying consolidated financial statements include the accounts of Liberty Mutual Holding Company Inc., entities over which the Company exercises control including majority and wholly owned subsidiaries, and variable interest entities when the Company is deemed the primary beneficiary (collectively “LMHC” or the “Company”). The minority ownership of consolidated affiliates is represented in equity as noncontrolling interest. All material intercompany transactions and balances have been eliminated. Certain reclassifications have been made to the 2010 and 2009 consolidated financial statements to conform with the 2011 presentation.

The accompanying consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles (“GAAP”). The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The Company’s principal estimates include (1) unpaid claims and claim adjustment expense reserves, including asbestos and environmental liability reserves and loss sensitive premium attributable to prior years, (2) reinsurance recoverables and associated uncollectible allowance, (3) fair value determination and other-than-temporary impairments of the investment portfolio, (4) deferred acquisition costs, (5) valuation of goodwill and intangible assets, and (6) deferred income tax valuation allowance. While the amounts included in the consolidated financial statements reflect management’s best estimates and assumptions, these amounts ultimately could vary.

### Nature of Operations

The Company conducts substantially all of its business through four strategic business units: Liberty Mutual Agency Corporation (“LMAC”), International, Personal Markets, and Commercial Markets.

The Company’s LMAC business unit, with \$11,410 of revenues in 2011, sells personal and commercial insurance products and services to individuals and small to mid-sized businesses through independent agents throughout the United States. Commercial lines products are offered through eight regional insurance companies that combine local underwriting, market knowledge and service orientation with the scale advantages of a national company. Personal lines products are distributed nationally under the Safeco brand, with an emphasis on service, and product and pricing sophistication. Liberty Mutual Surety is a leading provider of nationwide contract and commercial surety bonds to businesses of all sizes.

The Company’s International business unit, with \$8,566 of revenues in 2011, sells insurance products and services through two distinct approaches: local businesses, which sell personal and small commercial lines products, and Liberty International Underwriters (“LIU”) which sells specialty commercial insurance and reinsurance worldwide. International’s local business operations consist of local insurance operations selling property, casualty, health and life insurance products to individuals and businesses in three geographic regions: Latin America, including Venezuela, Brazil, Colombia, Argentina and Chile; Europe, including Spain, Portugal, Turkey, Poland and Ireland; and Asia, including Thailand, Singapore, China (including Hong Kong) and Vietnam. Private passenger automobile insurance is the single largest line of business. LIU writes casualty, specialty casualty, marine, energy, construction, aviation, property, crisis management and trade credit coverage and other specialty programs through offices in Asia, Australia, Europe, the Middle East, North America and Latin America. LIU, through its Lloyd’s Syndicate 4472, also provides multi-line insurance and reinsurance worldwide. In November 2011, the International business unit completed the acquisition of the Republic of Ireland business from Quinn Insurance Limited. See Note 2 for details regarding this transaction.

The Company’s Personal Markets business unit, with \$8,046 of revenues in 2011, sells automobile, homeowners and other types of property and casualty insurance coverage, as well as a wide range of life and annuity products, to individuals and insurance companies in the United States. Products are distributed through licensed captive sales representatives, licensed telesales counselors, third-party producers (including banks for life products) and the Internet. Personal Markets’ largest source of new business is through its sponsored affinity groups (including employers, professional and alumni associations, credit unions, and other partnerships).

The Commercial Markets business unit, with \$6,382 of revenues in 2011, sells a wide array of property & casualty and group benefits insurance coverages through independent agents, brokers and benefit consultants throughout the United States. Commercial Markets P&C provides commercial lines products and services to mid-sized and large businesses. Group Benefits provides mid-sized and large businesses with short- and long-term disability insurance products and administrative services and group life insurance through Liberty Life Assurance Company of Boston, a subsidiary of the Company. Summit provides workers compensation in the Southeast (mainly Florida) primarily to small businesses. Liberty Mutual Reinsurance provides reinsurance programs to domestic and foreign insurance and reinsurance companies. The Company is also a servicing carrier for state based workers compensation involuntary market pools. Effective January 1, 2010, Summit, a mono-line workers compensation company for Florida and the Southeast, previously included in LMAC, became part of the Commercial Markets strategic business unit. On July 14, 2010, Commercial Markets established a new distribution and service organization, Commercial Markets P&C, combining Middle Market, National Market, Specialty Lines and Liberty Mutual Property. This operating model provides agents and brokers a single point of entry for accessing Commercial Markets’ property, casualty and specialty lines insurance as well as claims and loss controls services for national accounts and mid-sized business clients.

### Adoption of New Accounting Standards

Effective January 1, 2009, the Company adopted new guidance for accounting for other-than-temporary impairments, as codified in Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 320, *Investments – Debt and Equity Securities*. This guidance amends the accounting for other-than-temporary impairment of debt securities, requires the establishment of a policy for determining when

# LIBERTY MUTUAL HOLDING COMPANY INC

## Notes to Consolidated Financial Statements

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“credit losses” exist, and provides direction on determining the amount of impairment to be recognized in the statement of income. The adoption of the new guidance resulted in an increase of \$28 (net of tax) to policyholders’ unassigned equity and a corresponding decrease to accumulated other comprehensive income.

### Future Adoption of New Accounting Standards

In October 2010, the FASB issued Accounting Standards Update 2010-26, *Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts* (“ASU 2010-26”). This guidance, as codified in ASC 944, *Financial Services - Insurance*, specifies that deferred acquisition costs should include only those costs that are directly related to the acquisition or renewal of insurance contracts. All other acquisition related costs, including market research, training, administration, unsuccessful acquisition or renewal efforts, and product development, should be charged to expense as incurred. Either prospective or retrospective application is permitted. The Company is required to adopt ASU 2010-26 effective January 1, 2012. The Company is applying the guidance retrospectively, and the cumulative effect of the adoption will result in a decrease in the opening balance of policyholders’ equity as of January 1, 2012 of \$265, net of tax. The impact to the consolidated statements of income for the year ended December 31, 2012 is expected to be immaterial.

### Investments

Fixed maturity securities classified as available for sale are debt securities that have principal payment schedules, are held for indefinite periods of time, and are used as a part of the Company’s asset/liability strategy or sold in response to risk/reward characteristics, liquidity needs or similar economic factors. These securities are reported at fair value with changes in fair values, net of deferred income taxes, reported in accumulated other comprehensive income.

Equity securities classified as available for sale include common equities and non-redeemable preferred stocks and are reported at quoted fair values. Changes in fair values, net of deferred income taxes, are reported in accumulated other comprehensive income.

Realized gains and losses on sales of investments are recognized in income using the specific identification method. Unrealized losses that are other-than-temporary are recognized as realized losses. The Company reviews fixed income, public equity securities, private equity securities and private equity co-investment securities for impairment on a quarterly basis. Securities are reviewed for both quantitative and qualitative considerations including, but not limited to, (1) the extent of the decline in fair value below book value, (2) the duration of the decline, (3) significant adverse changes in the financial condition or near term prospects for the investment or issuer, (4) significant changes in the business climate or credit ratings of the issuer, (5) general market conditions and volatility, (6) industry factors, and (7) the past impairment of the security holding or the issuer.

For fixed maturity securities that the Company does not intend to sell or for which it is more likely than not that the Company would not be required to sell before an anticipated recovery in value, the Company separates impairments into credit loss and non-credit loss components. The determination of the credit loss component of the impairment charge is based on the Company’s best estimate of the present value of the cash flows expected to be collected from the debt security compared to its amortized cost and is reported as part of net realized gains. The non-credit component, the residual difference between the credit impairment component and the fair value, is recognized in other comprehensive income. The factors considered in making an evaluation of credit versus non-credit other-than-temporary impairment include the following: (1) failure of the issuer of the security to make scheduled interest or principal payments (including the payment structure of the debt security and the likelihood the issuer will be able to make payments that increase in the future), (2) performance indicators of the underlying assets in the security (including default and delinquency rates), (3) vintage, (4) geographic concentration, and (5) industry analyst reports, sector credit ratings, and volatility of the security’s fair value.

For equity investments and fixed maturity investments the Company intends to sell or for which it is more likely than not that the Company will be required to sell before an anticipated recovery in value, the full amount (fair value less amortized cost) of the impairment is included in net realized gains.

Upon recognizing an other-than-temporary impairment, the new cost basis of the investment is the previous amortized cost basis less the other-than-temporary impairment recognized in net realized gains. The new cost basis is not adjusted for any subsequent recoveries in fair value; however, for fixed maturity investments the difference between the new cost basis and the expected cash flows is accreted to net investment income over the remaining expected life of the investment.

All mortgage-backed securities (“MBS”) and asset-backed securities (“ABS”) are reviewed for other-than-temporary impairment treatment in accordance with the guidance of ASC 320, *Investments – Debt and Equity Securities* and ASC 325, *Investments - Other*.

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

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

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

All Variable Interest Entities (“VIEs”) for which the Company is the primary beneficiary are consolidated into the Company’s financial statements.

Other investments are primarily comprised of limited partnerships and other alternative investments, which are reported at their carrying value with the change in carrying value accounted for under the equity method and, accordingly, the Company’s share of earnings are included in net investment income. Recognition of limited partnerships and other alternative investment income is delayed due to the availability of the related financial statements, as private equity and other funds are generally on a three-month delay. Equity investments in privately held businesses are carried at fair value.

Mortgage loans are stated at amortized cost less a valuation allowance for potentially uncollectible amounts.

### Derivatives

All derivatives are recognized on the balance sheet at fair value. On the date a contract is entered into, the Company designates the derivative as (1) a hedge of a fair value of a recognized asset (“fair value hedge”), (2) an economic hedge (“non-designated derivative”), or (3) a cash flow hedge.

The Company entered into interest rate-lock agreements that are classified as cash flow hedges. The effective portion of the gain or loss on these instruments is reported as a component of other comprehensive income and reclassified into earnings in the same period in which the hedged items affect earnings. The Company’s cash flow hedges are 100% effective and are not material to the financial statements.

The Company owns fixed maturity securities which have an option to convert to equity. The derivative features embedded are ancillary to the overall investment. This type of activity is unrelated to hedging. In addition, there may be call, put or conversion options embedded in certain bonds it has purchased. These derivatives are not material to the Company’s financial statements.

### Securities Lending

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

### Goodwill and Intangible Assets

Goodwill is tested for impairment at least annually using either a qualitative or a quantitative process. Election of the approach can be made at the reporting unit level. The reporting unit has the option to skip the qualitative test and move directly to completion of the quantitative process. The Company’s strategic business units are deemed reporting units. In 2011, the Company utilized the qualitative and quantitative approaches across its business units. In 2010 and 2009, the Company utilized only the quantitative approach.

The qualitative approach can be used to evaluate if there are any indicators of impairment. Through this process, the reporting unit must determine if there is indication that it is more likely than not that the fair value of the reporting unit is less than its carrying amount, including goodwill. If it is determined that there is an indication of potential impairment, the reporting unit must complete the quantitative process. The quantitative approach is a two-step process. The first step is performed to identify potential impairment and, if necessary, the second step is performed for the purpose of measuring the amount of impairment, if any. Impairment is recognized only if the carrying amount is not recoverable from the discounted cash flows using a “market” rate and is measured as the difference between the carrying amount and the implied fair value. Other changes in the carrying amount of goodwill are primarily caused by foreign currency translation adjustments and acquisitions.

Indefinite-lived intangible assets held by the Company are reviewed for impairment on at least an annual basis. The classification of the asset as indefinite-lived is reassessed, and an impairment is recognized if the carrying amount of the asset exceeds its fair value.

Intangible assets that are deemed to have finite useful lives are amortized over their useful lives. The carrying amounts of intangible assets with finite useful lives are regularly reviewed for indicators of impairment in value. Impairment is recognized only if the carrying amount of the intangible asset is not recoverable from its undiscounted cash flows and is measured as the difference between the carrying amount and the fair value of the asset.

The Company has intangible assets included in other assets on the accompanying consolidated balance sheets related to the Safeco Corporation (“Safeco”) and Ohio Casualty Corporation (“Ohio Casualty”) acquisitions that occurred in 2008 and 2007, respectively. As of December 31, 2011, intangible assets related to these acquisitions were as follows: Safeco agency relationship of \$481, Ohio Casualty agency relationship of \$117, trademarks of \$262, state licenses of \$82, and other intangibles of \$15. As of December 31, 2010, intangible assets related to these acquisitions were as follows: Safeco agency relationship of \$523, Ohio Casualty agency relationship of \$125, trademarks of \$262, state licenses of \$82, and

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other intangibles of \$16. The amortization applied to the Safeco agency relationship, Ohio Casualty agency relationship, and other intangible assets is 15 years on the straight-line method, 20 years on the straight-line method, and 10 years using the present value mid-year convention, respectively. The intangible assets above are net of accumulated amortization of \$169 and \$118 as of December 31, 2011 and 2010, respectively. All other intangible assets are not subject to amortization.

For the years ended December 31, 2011 and 2010, the Company recognized \$51 and \$50, respectively, of amortization expense related to these acquisitions which is reflected in insurance operating costs and expenses on the accompanying consolidated statements of income. Estimated amortization for the years ended December 31, 2012 through 2016 is \$51, \$52, \$52, \$52 and \$52, respectively.

### Deferred Policy Acquisition Costs

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

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

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

### Real Estate and Other Fixed Assets

The costs of buildings, furniture, and equipment are depreciated, principally on a straight-line basis, over their estimated useful lives (a maximum of 39.5 years for buildings, 10 years for furniture, and 3-5 years for equipment). Expenditures for maintenance and repairs are charged to income as incurred while expenditures for improvements are capitalized and depreciated.

### Separate Account Assets and Liabilities

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

### Insurance Liabilities and Reserves

For short-duration contracts, the Company establishes reserves for unpaid insurance claims and claim adjustment expenses covering events that occurred in 2011 and prior years. These reserves reflect estimates of the total cost of claims reported but not yet paid and the cost of claims not yet reported, as well as the estimated expenses necessary to settle the claims. Reserve estimates are based on past loss experience modified for current claim trends, as well as prevailing social, economic and legal conditions. Final claim payments, however, may ultimately differ from the established reserves, since these payments might not occur for several years. Reserve estimates are continually reviewed and updated, and any resulting adjustments are reflected in current operating results. The Company does not discount reserves other than discounting on the long-term indemnity portion of workers compensation settled claims, the long-term disability portion of group accident and health claims as permitted by insurance regulations in certain states, the long-term portion of certain workers compensation claims of foreign subsidiaries, and specific asbestos structured settlements. Reserves are reduced for estimated amounts of salvage and subrogation and deductibles recoverable from policyholders. The Company discounts the long-term indemnity portion of workers compensation claims at risk-free discount rates determined by reference to the U.S. Treasury yield curve. The weighted average discount rates were 5.3%, 5.3%, and 5.5% for 2011, 2010, and 2009, respectively. The held discounted reserves on these unpaid workers compensation claims, net of all reinsurance, as of December 31, 2011 and 2010 were \$2,252 and \$2,116, respectively.

The held discounted reserves on unpaid asbestos structured settlement claims as of December 31, 2011 and 2010 were \$30 and \$29, respectively. As of December 31, 2011, there was one remaining structured settlement subject to discounting.

The discounting of disability claims is based on the 1987 Commissioners Group Disability Table at annual discount rates varying from 3.5% to 7.0% and 4.0% to 7.0% in 2011 and 2010, respectively. Unpaid disability claims and claim adjustment expenses as of December 31, 2011 and 2010 include liabilities at discounted values of \$1,293 and \$1,155, respectively.

For long-duration contracts, measurement of liabilities is based on generally accepted actuarial techniques but requires assumptions about mortality, lapse rates, and assumptions about future returns on related investments. Annuity and structured settlement contracts without significant mortality or morbidity risk are accounted for as investment contracts, whereby the premium received plus interest credited less policyholder withdrawals represents the investment contract liability. Implied credited interest rates for domestic structured settlement contracts

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in force were between 5.7% and 6.0% for 2011, 2010 and 2009. Implied credited interest rates for foreign structured settlement contracts in force were between 2.5% and 6.0% in 2011, 2010, and 2009. Credited rates for domestic universal life contracts in force were between 3.5% and 5.0% in 2011 and 2010, and 3.5% and 6.3% in 2009. Credited rates for foreign universal life contracts in force were between 1.1% and 6.0% in 2011, 0.9% and 6.0% in 2010, and 1.3% and 6.0% in 2009. Liabilities for future policy benefits for traditional life policies have been computed using the net level premium method based upon estimated future investment yields (between 2.5% and 10.3% in 2011, 2010, and 2009), mortality assumptions (based on the Company's experience relative to standard industry mortality tables) and withdrawal assumptions (based on the Company's experience).

### Policyholder Dividends

Policyholder dividends are accrued using an estimate of the ultimate amount to be paid in relation to premiums earned based on the related insurance policies.

For domestic property-casualty insurance, certain insurance contracts, primarily workers compensation policies, are issued with dividend plans to be paid subject to approval by the insurer's board of directors. The premium related to such policies approximated 2% of domestic property-casualty insurance premiums written for each of the years ended December 31, 2011, 2010, and 2009. Additionally, certain jurisdictions impose excess profits taxes, which limit the profitability of particular lines of business, and any excess is returned to the policyholder in the form of a dividend.

For life insurance, dividends to participating policyholders are calculated as the sum of the difference between the assumed mortality, interest and loading, and the actual experience of the Company relating to participating policyholders. As a result of statutory regulations, the major portion of earnings from participating policies inures to the benefit of the participating policyholders and is excluded from net income and policyholders' equity. Participating policies approximate 29%, 31%, and 34% of ordinary life insurance in force for the years ended December 31, 2011, 2010, and 2009, respectively. Participating policies approximate 12%, 15%, and 23% of life premium for the years ended December 31, 2011, 2010, and 2009, respectively.

### Long-Term Incentive and Performance Based Incentive Plans

The Company maintains short-term and long-term incentive compensation plans. Long-term plans that vest over the requisite service period and are based upon notional units are accounted for under ASC 718, *Compensation – Stock Compensation*, using the intrinsic value method. Additionally, the Company provides performance based incentive compensation to the majority of employees meeting the participation requirements of the respective plans. Compensation cost related to these plans is determined in accordance with plan formulas and recorded over the years the employee service is provided.

### Revenue Recognition

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

### Reinsurance

All assets and liabilities related to ceded reinsurance contracts are reported on a gross basis in the accompanying consolidated balance sheets. Prospective reinsurance premiums, claims, and claim adjustment expenses are accounted for on a basis consistent with the terms of the reinsurance contracts. The accompanying consolidated statements of income reflect premiums, benefits, and settlement expenses net of reinsurance ceded.

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

Amounts recoverable from reinsurers include unpaid losses estimated in a manner consistent with the claim liabilities associated with the reinsured business. The Company evaluates reinsurance collectability, and a provision for uncollectible reinsurance is recorded.

### Translation of Foreign Currencies

The Company translates the financial statements of its foreign operations into U.S. dollars from the functional currency designated for each foreign unit, generally the currency of the primary economic environment in which that operation does its business. Assets and liabilities are translated into U.S. dollars at period-end exchange rates, while income and expenses are translated using average rates for the period. Translation adjustments are recorded as a separate component of accumulated other comprehensive income, net of tax, to the extent applicable. Foreign currency amounts are re-measured to the functional currency, and the resulting foreign exchange gains or losses are reflected in earnings.

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For subsidiaries operating in highly inflationary economies, monetary assets and liabilities are re-measured at the rate of exchange as of the balance sheet date and non-monetary items are re-measured at historical rates. The functional currency for these subsidiaries is the U.S. dollar. Gains and losses from balance sheet re-measurement adjustments and foreign currency transactions are included in net income.

The aggregate exchange gains (losses) included in income from continuing operations for the years ended December 31, 2011, 2010, and 2009 were \$1, \$(109), and \$(1), respectively. These amounts have been included in insurance operating costs and expenses in the accompanying consolidated statements of income.

### Income Taxes

The income tax provision is calculated under the liability method. The Company recognizes deferred income tax assets and liabilities for the expected future tax effects attributable to temporary differences between the financial statement and tax return basis of assets and liabilities based on enacted tax rates and other provisions of the tax law. The effect of a change in tax laws or rates on deferred tax assets and liabilities is recognized in income in the period in which such change is enacted. Deferred tax assets are reduced by a valuation allowance if it is more likely than not that all or some portion of the deferred tax assets will not be realized. Deferred tax positions are not established for adjustments arising from foreign operations whose earnings are considered to be permanently reinvested.

### Fee and Other Revenues

Fee and other revenues primarily consist of revenues from the Company's energy production operations, universal life cost of insurance and administrative fees, group life administrative service contract fees, and service fees generated from processing business for involuntary assigned risk pools, self-insured customers, and risk retention groups. Service fees are earned on a pro-rata basis over the term of the related policies.

### Accumulated Other Comprehensive Income

Accumulated other comprehensive income consists principally of unrealized gains and losses on certain investments in debt and equity securities, foreign currency translation adjustments, and pension and postretirement liability adjustments.

The components of accumulated other comprehensive income, net of related deferred acquisition costs and taxes, for the years ended December 31, 2011, 2010, and 2009 are as follows:

	2011	2010	2009
Unrealized gains on securities	\$2,055	\$1,269	\$1,115
Foreign currency translation and other adjustments	137	313	269
Pension liability funded status <sup>(1)</sup>	(523)	(296)	(856)
Cumulative effect of adoption of ASC 320 at January 1, 2009	-	-	(28)
Accumulated other comprehensive income	<u>\$1,669</u>	<u>\$1,286</u>	<u>\$500</u>

<sup>(1)</sup> Includes \$60, \$60, and \$68 for the years ended December 31, 2011, 2010, and 2009, respectively, due to the recognition of deferred taxes related to the Medicare Part D subsidy.

## (2) ACQUISITIONS AND JOINT VENTURES

### Quinn Insurance Limited

In April 2011, the Company, through its subsidiary Liberty ITB UK and Europe Limited, entered into an agreement with Anglo Irish Bank ("Anglo") to establish Liberty Mutual Ireland Investment Holdings Company Limited ("Ireland Holdings"). The Company has 51% ownership of Ireland Holdings and consolidates the financial position and results of operations. Anglo has the remaining 49% ownership.

On November 11, 2011, Ireland Holdings completed the acquisition of the Republic of Ireland business from Quinn Insurance Limited, a mid-sized insurer in Ireland, for one Euro. Preliminary goodwill recognized from the transaction was \$64. The operations of Quinn Insurance Limited were merged into the International strategic business unit. The Company believes the acquisition provides the International strategic business unit the opportunity for continued diversification in the European market.

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The Company is in the process of finalizing the fair value of the acquired business; therefore, the allocation of the purchase price is subject to refinement. The following is a condensed balance sheet of the acquired business at November 11, 2011:

Assets:	
Cash and cash equivalents	\$1,125
Goodwill	64
Other assets	121
Total assets	\$1,310
Liabilities:	
Unpaid claims and claim adjustment expenses	\$1,021
Unearned premiums	142
Other liabilities	147
Total liabilities	\$1,310

The results of operations for the acquired business from the date of acquisition, which are not material, are included in the accompanying consolidated statements of income.

**(3) INVESTMENTS**

*Components of Net Investment Income*

	Years Ended December 31,		
	2011	2010	2009
Taxable interest income	\$2,487	\$2,426	\$2,301
Tax-exempt interest income	474	539	623
Dividends	50	42	41
Limited partnerships and limited liability companies	583	398	(411)
Commercial mortgage loans	77	73	68
Other investments	(4)	6	9
Gross investment income	3,667	3,484	2,631
Investment expenses	(144)	(156)	(149)
Net investment income	\$3,523	\$3,328	\$2,482

*Components of Net Realized Gains*

	Years Ended December 31,		
	2011	2010	2009
Fixed maturities			
Gross realized gains	\$177	\$421	\$173
Gross realized losses	(122)	(72)	(259)
Equities			
Gross realized gains	101	52	146
Gross realized losses	(73)	(3)	(64)
Other			
Gross realized gains	116	73	84
Gross realized losses	(41)	(69)	(54)
Net realized gains	\$158	\$402	\$26

As of December 31, 2011 and 2010, other-than-temporary impairments recognized through accumulated other comprehensive income were \$46 and \$55, respectively.

During the years ended December 31, 2011, 2010, and 2009, proceeds from sales of fixed maturities available for sale were \$4,032, \$9,177, and \$4,859, respectively. The gross realized gains (losses) on such sales totaled \$127 and \$(33) in 2011, \$357 and \$(22) in 2010, and \$145 and \$(67) in 2009.



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***Components of Change in Net Unrealized Investment Gains***

	<b>2011</b>	<b>2010</b>	<b>2009</b>
Fixed maturities	\$1,415	\$357	\$3,864
Equities	(185)	71	206
Other	(17)	(10)	18
Adjustments to deferred policy acquisition costs	(104)	(8)	(169)
Net change in unrealized investment gains	1,109	410	3,919
Deferred income tax expense	(323)	(228)	(1,347)
Net change in unrealized investment gains, net of tax	<u>\$786</u>	<u>\$182</u>	<u>\$2,572</u>

***Available for Sale Investments***

The amortized cost, gross unrealized gains and losses and fair values of available for sale investments as of December 31, 2011 and 2010, are as follows:

<b>December 31, 2011</b>	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Value</b>
U.S. government and agency securities	\$3,044	\$312	\$ -	\$3,356
Residential MBS	9,018	525	(46)	9,497
Commercial MBS	2,086	74	(3)	2,157
Other MBS and ABS	1,645	132	(2)	1,775
U.S. state and municipal	12,530	1,159	(24)	13,665
Corporate and other	23,978	1,596	(319)	25,255
Foreign government securities	4,807	158	(94)	4,871
Total fixed maturities	57,108	3,956	(488)	60,576
Common stock	1,510	235	(137)	1,608
Preferred stock	432	17	(103)	346
Total equity securities	1,942	252	(240)	1,954
Total securities available for sale	<u>\$59,050</u>	<u>\$4,208</u>	<u>\$(728)</u>	<u>\$62,530</u>

<b>December 31, 2010</b>	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Value</b>
U.S. government and agency securities	\$3,008	\$197	\$(13)	\$3,192
Residential MBS	9,628	455	(50)	10,033
Commercial MBS	2,378	99	(4)	2,473
Other MBS and ABS	1,661	93	(6)	1,748
U.S. state and municipal	12,414	438	(120)	12,732
Corporate and other	22,907	1,274	(206)	23,975
Foreign government securities	4,379	106	(85)	4,400
Total fixed maturities	56,375	2,662	(484)	58,553
Common stock	1,000	253	(23)	1,230
Preferred stock	552	35	(84)	503
Total equity securities	1,552	288	(107)	1,733
Total securities available for sale	<u>\$57,927</u>	<u>\$2,950</u>	<u>\$(591)</u>	<u>\$60,286</u>

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Approximately 77% of the Company's securitized portfolio is explicitly backed by the U.S. government (GNMA and SBA) or by government-sponsored entities (FHLMC and FNMA). Over 93% of the mortgage and asset-backed holdings are rated AAA. The commercial MBS portfolio is well diversified and of high quality with over 98% rated AA or above with approximately 20% of the underlying collateral having been defeased with U.S. Treasuries.

As of December 31, 2011, no single issuer, excluding U.S. Treasuries, agency securities and MBS, accounted for more than 1.4% of invested assets.

Of the \$1,608 and \$1,230 of common stock as of December 31, 2011 and 2010, respectively, \$271 and \$304, respectively, related to securities associated with non-guaranteed unit linked products where the policyholder bears the investment risk.

As of December 31, 2011 and 2010, securities carried at \$4,386 and \$4,281, respectively, were on deposit with regulatory authorities as required by law.

As of December 31, 2011 and 2010, the fair values of fixed maturities loaned were approximately \$1,296 and \$1,687, respectively. Cash and short-term investments received as collateral in connection with the loaned securities were approximately \$1,310 and \$1,336 as of December 31, 2011 and 2010, respectively. Other investments received as collateral in connection with the loaned securities was approximately \$24 and \$396 as of December 31, 2011 and 2010, respectively.

The amortized cost and fair value of fixed maturities as of December 31, 2011, by contractual maturity are as follows:

	<b>Amortized Cost</b>	<b>Fair Value</b>
Due to mature:		
One year or less	\$2,816	\$2,847
Over one year through five years	17,042	17,738
Over five years through ten years	13,605	14,489
Over ten years	10,896	12,073
MBS and ABS of government and corporate agencies	12,749	13,429
Total fixed maturities	<u>\$57,108</u>	<u>\$60,576</u>

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

The following table shows a schedule of the Company's unrealized losses and fair value by security type and by duration that individual securities have been in a continuous unrealized loss position as of December 31, 2011 and 2010, that are not deemed to be other-than-temporarily impaired.

	<b>Less Than 12 Months</b>		<b>12 Months or Longer</b>	
	<b>Unrealized Losses</b>	<b>Fair Value of Investments with Unrealized Losses</b>	<b>Unrealized Losses</b>	<b>Fair Value of Investments with Unrealized Losses</b>
U.S. government and agency securities	\$ -	\$8	\$ -	\$ -
Residential MBS	(5)	131	(41)	314
Commercial MBS	(1)	109	(2)	37
Other MBS and ABS	-	40	(2)	12
U.S. state and municipal	(1)	47	(23)	142
Corporate and other	(186)	3,865	(133)	821
Foreign government securities	(12)	289	(82)	711
Total fixed maturities	<u>(205)</u>	<u>4,489</u>	<u>(283)</u>	<u>2,037</u>
Common stock	(104)	513	(33)	124
Preferred stock	(2)	12	(101)	224
Total equities	<u>(106)</u>	<u>525</u>	<u>(134)</u>	<u>348</u>
Total	<u><u>\$(311)</u></u>	<u><u>\$5,014</u></u>	<u><u>\$(417)</u></u>	<u><u>\$2,385</u></u>

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December 31, 2010

	Less Than 12 Months		12 Months or Longer	
	Unrealized Losses	Fair Value of Investments with Unrealized Losses	Unrealized Losses	Fair Value of Investments with Unrealized Losses
U.S. government and agency securities	\$(13)	\$571	\$ -	\$ -
Residential MBS	(14)	1,182	(36)	403
Commercial MBS	(2)	103	(2)	62
Other MBS and ABS	(1)	17	(5)	31
U.S. state and municipal	(84)	2,295	(36)	214
Corporate and other	(96)	3,601	(110)	892
Foreign government securities	(43)	1,536	(42)	305
Total fixed maturities	(253)	9,305	(231)	1,907
Common stock	(8)	178	(15)	98
Preferred stock	(2)	51	(82)	308
Total equities	(10)	229	(97)	406
Total	\$(263)	\$9,534	\$(328)	\$2,313

Unrealized losses increased from \$591 as of December 31, 2010 to \$728 as of December 31, 2011 primarily due to volatility in the equity markets. As of December 31, 2011, there were 805 securities that were in an unrealized loss position for 12 months or longer. The Company monitors the difference between the amortized cost and estimated fair value of debt securities to ascertain whether declines in value are temporary in nature. In addition, the Company also monitors its intent and ability to hold certain equity securities for a period of time that is sufficient to allow for any anticipated recovery in fair value. The Company currently does not have the intent to sell these securities and has determined it is not more likely than not that it would be required to sell these fixed income or equity securities before they recover their fair value.

**Variable Interest Entities**

The Company invests in energy, private equity and real estate limited partnerships and other entities subject to VIE analysis under the VIE subsections of ASC 810, *Consolidation*. The Company analyzes each investment to determine whether it is a VIE, and if so, whether the Company is the primary beneficiary or a significant interest holder based on a qualitative and quantitative assessment. The Company evaluates the design of the entity, the risks to which the entity was designed to expose the variable interest holder and the extent of the Company's control of and variable interest in the VIE. As of December 31, 2011, the Company determined that it is the primary beneficiary of one VIE in the energy investment sector, and as such, this VIE has been consolidated in the Company's financial statements. The carrying value of assets and liabilities, and the Company's maximum exposure to loss of the consolidated VIE is immaterial to the Company.

The Company has variable interests in VIEs for which it is not the primary beneficiary and accounts for these VIEs under the equity method in accordance with ASC 323, *Investments – Equity Method and Joint Ventures*. The VIEs are principally private equity limited partnerships in which the Company has invested as a passive limited partner. The partnerships were deemed to be VIEs because the equity holders as a group lack the power to direct the activities that most significantly impact the respective entity's economic performance. The VIEs generate variability primarily from investment portfolio performance and that variability is passed to equity holders. For these VIEs, the Company absorbs a portion, but not majority, of this variability. The carrying value of assets was \$250 and \$94 as of December 31, 2011 and December 31, 2010, respectively and the Company's maximum exposure to loss was \$309 and \$123 as of December 31, 2011 and December 31, 2010, respectively for unconsolidated VIEs in which the Company has a significant variable interest. The assets are included in Other Investments on the accompanying consolidated balance sheets. Maximum exposure to loss includes the carrying value and unfunded commitment of the VIE. There is no recourse provision to the general credit of the Company for any VIE beyond the full amount of the Company's loss exposure.

**Investments in Mortgage Loans**

As of December 31, 2011 and 2010, the carrying values of commercial mortgage loans were \$1,196 and \$1,206 respectively. The carrying values reflect allowances of \$18 and \$14 as of December 31, 2011 and 2010, respectively. Additionally, the Company's participation in any one commercial mortgage loan acquired does not exceed 49% of the loan value. As of December 31, 2011, the average total loan size was \$1, and the average loan participation size was less than \$1. The number of loans in the portfolio increased from 2,948 as of December 31, 2010, to 3,272 as of December 31, 2011. Approximately 91% of the loans are full or partial recourse to borrowers.

## LIBERTY MUTUAL HOLDING COMPANY INC

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### (4) DEFERRED POLICY ACQUISITION COSTS

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

	Years Ended December 31,		
	2011	2010	2009
Balance at beginning of year	\$2,771	\$2,636	\$2,541
Acquisition costs deferred and other	4,848	4,892	4,787
Amortization charged to income	(4,811)	(4,757)	(4,692)
Balance at end of year	\$2,808	\$2,771	\$2,636

### (5) UNPAID CLAIMS AND CLAIM ADJUSTMENT EXPENSES

The Company establishes reserves for payment of claims and claim adjustment expenses that arise from the policies issued. As required by applicable accounting rules, no reserves are established until a loss, including a loss from a catastrophe, occurs. The Company's reserves are segmented into three major categories: reserves for reported claims (estimates made by claims adjusters); IBNR representing reserves for unreported claims and supplemental reserves for reported claims; and reserves for the costs to settle claims. The Company establishes its reserves net of salvage and subrogation by line of business or coverage and year in which losses occur.

Establishing loss reserves, including loss reserves for catastrophic events that have occurred, is an estimation process. Many factors can ultimately affect the final settlement of a claim and, therefore, the necessary reserve. Changes in the law, results of litigation, medical costs, the costs of repair materials, and labor rates can all affect ultimate claim costs. In addition, time can be a critical part of reserving determinations since the longer the span between the incidence of a loss and the payment or settlement of the claim, the more variable the ultimate settlement can be. Accordingly, "short-tail" claims, such as property damage claims, tend to be easier to estimate than "long-tail" claims, such as workers compensation or general liability claims.

As information develops that varies from past experience, provides additional data, or in some cases, augments data that previously was not considered sufficient for use in determining reserves, changes in the Company's estimate of ultimate liabilities may be required. The effects of these changes are reflected in current operating results.

Catastrophes are an inherent risk of the property-casualty insurance business and have contributed to material period-to-period fluctuations in the Company's results of operations and financial position. Catastrophe losses are severe losses resulting from natural and man-made events, including risks such as fire, earthquake, windstorm, explosion, terrorism, and other similar events. The extent of losses from a catastrophe is a function of both the total amount of insured exposure in an area affected by the event and the severity of the event. The level of catastrophe losses experienced in any period cannot be predicted and can be material to the results of operations and financial position of the Company. Catastrophe losses incurred during the years ended December 31, 2011, 2010, and 2009 were \$2,699, \$1,253, and \$709, respectively.

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

	2011	2010	2009
Balance as of January 1	\$48,059	\$48,355	\$48,311
Less: unpaid reinsurance recoverables <sup>(1)</sup>	11,526	12,052	12,423
Net balance as of January 1	36,533	36,303	35,888
Balance attributable to acquisitions <sup>(2)</sup>	1,021	-	56
Incurred attributable to:			
Current year	22,589	20,033	19,584
Prior years:			
Asbestos and environmental	385	(7)	311
All other	(289)	(366)	(998)
Discount accretion	121	128	154
Total incurred	22,806	19,788	19,051
Paid attributable to:			
Current year	11,776	10,205	9,583
Prior years	9,471	9,138	9,385
Total paid	21,247	19,343	18,968
Amortization of deferred retroactive reinsurance gain <sup>(3)</sup>	134	54	74
Net adjustment due to foreign exchange	(166)	(269)	202
Add: unpaid reinsurance recoverables <sup>(1)</sup>	11,147	11,526	12,052
Balance as of December 31	\$50,228	\$48,059	\$48,355

<sup>(1)</sup> In addition to the unpaid reinsurance recoverable balances noted above, and as a result of retroactive reinsurance agreements, the Company has recorded retroactive reinsurance recoverable balances of \$1,258, \$1,992, and \$2,067 as of December 31, 2011, 2010, and 2009, respectively.

<sup>(2)</sup> The balance attributable to acquisitions represents the 2011 acquisition of Quinn Insurance Limited (See Note 2 for further discussion) and opening balance sheet adjustments recorded in 2009 primarily related to the 2008 Safeco acquisition.

<sup>(3)</sup> The increase in deferred gain amortization during the year ended December 31, 2011, was due to the commutation of two workers compensation excess of loss retroactive reinsurance agreements. See Note 6 for further discussion.

Incurred attributable to prior years, excluding asbestos and environmental, includes \$134, \$54, and \$74 of amortization of deferred retroactive gain in the years ended December 31, 2011, 2010, and 2009, respectively. In 2011, favorable incurred attributable to prior years, excluding asbestos and environmental and amortization of deferred retroactive gain, is primarily attributable to commercial multiple peril, personal automobile, surety, LIU reinsurance, and general liability lines of business, partially offset by workers compensation. The commercial multiple peril favorable development is driven by better than expected severity trends. The personal automobile, surety and general liability favorable development is driven by better than expected frequency and severity trends. The LIU reinsurance favorable development is driven by better than expected frequency of large loss events. The workers compensation unfavorable development is driven by worse than expected frequency and severity trends. In 2010, incurred attributable to prior years, excluding asbestos and environmental and amortization of deferred retroactive gain, is primarily attributable to favorable prior year development driven by the personal automobile and LIU reinsurance lines of business. The personal automobile favorable development is driven by better than expected severity trends, and the LIU reinsurance favorable development is driven by better than expected severity of large loss events. In 2009, incurred attributable to prior years, excluding asbestos and environmental and amortization of deferred retroactive gain, is primarily attributable to favorable prior year development driven by the workers compensation and general liability lines of business. The workers compensation favorable development is driven by the involuntary market workers compensation pools and the general liability favorable development is due to better than expected frequency and severity trends.

For certain commercial lines of insurance, the Company offers experience-rated insurance contracts whereby the ultimate premium is dependent upon the claims incurred. As of December 31, 2011 and 2010, the Company held \$3,681 and \$4,156, respectively, of unpaid claims and claim adjustment expenses related to experience-rated contracts. Premiums receivable included accrued retrospective and unbilled audit premiums of \$461 and \$635 as of December 31, 2011 and 2010, respectively. For the years ended December 31, 2011, 2010, and 2009, the Company recognized a decrease in premium income of \$26, \$64, and \$85, respectively, relating to prior years.

Unpaid claims and claim adjustment expenses are recorded net of anticipated salvage and subrogation of \$1,166 and \$1,143 as of December 31, 2011 and 2010, respectively.

As of December 31, 2011 and 2010, the reserve for unpaid claim reserves was reduced by \$4,931 and \$4,823, respectively, for large dollar deductibles. Large dollar deductibles billed and recoverable were \$203 and \$221 as of December 31, 2011 and 2010, respectively.

**Asbestos and Environmental Reserves**

The Company has exposure to asbestos and environmental claims that emanate principally from general liability policies written prior to the mid-1980's. In establishing the Company's asbestos and environmental reserves, the Company estimates case reserves for anticipated losses and bulk reserves for claim adjustment expenses and incurred but not reported claims reserves ("IBNR"). The Company maintained casualty excess of loss reinsurance during the relevant periods. The reserves, including cessions reported by ceding reinsurers on assumed reinsurance contracts, are

## LIBERTY MUTUAL HOLDING COMPANY INC

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reported in unpaid claims and claim adjustment expenses, and ceded reserves are included in reinsurance recoverables on the accompanying consolidated balance sheets.

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

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

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

In the last few years the Company, as well as the industry generally, has seen decreases in the number of asbestos claims being filed. This turn to a more favorable trend is due to a number of factors. Screening activity used by some lawyers to find new plaintiffs utilized questionable practices discovered in the Federal Silica Multi District Litigation. Court decisions in several key states (e.g., Mississippi) have been favorable to defendants. Most importantly, several states have enacted and sustained legislation in the past few years that contain medical criteria provisions aimed at reducing the number of lawsuits filed by unimpaired plaintiffs and providing prompt and fair compensation to those who meet the criteria.

In the third quarter of 2011, the Company completed ground-up asbestos and environmental reserve studies. The studies were completed by a multi-disciplined team of internal claims, legal, reinsurance and actuarial personnel, and they included all major segments of the Company's direct, assumed, and ceded asbestos and environmental claims. As part of the internal reviews, potential exposures of certain policyholders were individually evaluated using the Company's proprietary stochastic model, which is consistent with published actuarial papers on asbestos reserving. Among the factors reviewed in depth by the team of specialists were the type of business, level of exposure, coverage limits, geographic distribution of products, types of injury, state jurisdictions, legal defenses, and reinsurance potential. The remaining policyholders (those with less potential exposure) were evaluated using aggregate methods that utilized information and experience specific to these insureds. The studies resulted in an increase to reserves of \$338.

As a result of the significant uncertainty inherent in determining a company's asbestos and environmental liabilities and establishing related reserves, the amount of reserves required to adequately fund the Company's asbestos and environmental claims cannot be accurately estimated using conventional reserving methodologies based on historical data and trends. As a result, the use of conventional reserving methodologies frequently has to be supplemented by subjective considerations including managerial judgment. In that regard, the estimation of asbestos claims and associated liabilities and the analysis of environmental claims considered prevailing applicable law and certain inconsistencies of court decisions as to coverage, plaintiffs' expanded theories of liability, and the risks inherent in major litigation and other uncertainties, the Company believes that in future periods it is possible that the outcome of the continued uncertainties regarding asbestos and environmental related claims could result in an aggregate liability that differs from current reserves by an amount that could be material to the Company's future operating results and financial condition.

As of December 31, 2011 and 2010, the Company's unpaid claims and claim adjustment expense reserves, net of associated reinsurance recoverables included \$1,332 and \$1,189 respectively, for asbestos and environmental-related claims.

Net asbestos losses paid in 2011, 2010, and 2009 were \$166, \$235, and \$193, respectively. The increase in paid activity during the year ended December 31, 2010, was due to the payment of the 2009 settlement with Armstrong World Industries, with which the Company had been in various insurance coverage disputes. The Company incurred \$318, \$(104), and \$398 of asbestos reserves, net of change in allowance for doubtful accounts during the years ended December 31, 2011, 2010, and 2009, respectively.

Net environmental losses paid in 2011, 2010, and 2009 were \$53, \$45, and \$65, respectively. The Company incurred \$44, \$(6), and \$4 of environmental reserves, net of change in allowance for doubtful accounts during the years ended December 31, 2011, 2010, and 2009, respectively.

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**(6) REINSURANCE**

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

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

P&C	2011		2010		2009	
	Written	Earned	Written	Earned	Written	Earned
Direct	\$33,551	\$32,432	\$31,222	\$30,751	\$30,577	\$30,385
Assumed	1,747	1,660	1,486	1,403	1,352	1,370
Ceded	5,350	5,206	4,567	4,503	4,683	4,962
Net premiums	<u>\$29,948</u>	<u>\$28,886</u>	<u>\$28,141</u>	<u>\$27,651</u>	<u>\$27,246</u>	<u>\$26,793</u>

Life & Annuity	2011		2010		2009	
	Written	Earned	Written	Earned	Written	Earned
Direct	\$1,309	\$1,307	\$1,124	\$1,122	\$1,070	\$1,056
Ceded	74	74	74	74	58	58
Net premiums	<u>\$1,235</u>	<u>\$1,233</u>	<u>\$1,050</u>	<u>\$1,048</u>	<u>\$1,012</u>	<u>\$998</u>

The Company reported reinsurance recoverables of \$13,272 and \$14,310 as of December 31, 2011 and 2010, respectively, net of allowance for doubtful accounts of \$326 and \$393, respectively. The following table summarizes the Company's reinsurance recoverables by reinsurers' Standard & Poor's ("S&P") rating (or the rating of any guarantor) as of December 31, 2011.

S&P Rating	Reinsurance Recoverables	Collateral Held	Net Recoverables <sup>(1)</sup>
AAA	\$25	\$1	\$24
AA+, AA, AA-	4,387	1,810	2,768
A+, A, A-	3,774	395	3,443
BBB+, BBB, BBB-	20	1	19
BB+ or below	16	5	12
Involuntary pools	2,687	3	2,685
Voluntary pools	352	67	303
Other <sup>(2)</sup>	2,337	2,417	686
Gross recoverables <sup>(3)</sup>	<u>\$13,598</u>	<u>\$4,699</u>	<u>\$9,940</u>
Less: allowance	326	-	-
Net recoverables	<u>\$13,272</u>	<u>\$4,699</u>	<u>\$9,940</u>

<sup>(1)</sup> Net recoverables represent gross recoverables less applicable collateral that can be specifically applied against recoverable balances.

<sup>(2)</sup> Includes \$751 and \$1,586 of reinsurance recoverables from non-rated reinsurers and captive and program business, respectively.

<sup>(3)</sup> Includes \$941 and \$12,657 of paid and unpaid reinsurance recoverables, respectively.

The Company remains contingently liable in the event reinsurers are unable to meet their obligations for paid and unpaid reinsurance recoverables and unearned premiums ceded under reinsurance agreements.

The Company has an aggregate reinsurance recoverable from Nationwide Indemnity Company in the amount of \$1,507 and \$1,638 as of December 31, 2011 and 2010, respectively. The reinsurance recoverable is guaranteed by Nationwide Mutual Insurance Company, which has a financial strength rating of A+ from Standard & Poor's. Additionally, the Company has significant reinsurance recoverable concentrations with Swiss Reinsurance Group, Munich Re, Everest Re Group and Transatlantic Holdings, Inc. Group totaling \$1,320, \$507, \$399, and \$335, respectively, as of December 31, 2011, net of offsetting collateral under the contracts.

The reinsurance recoverables from state mandated involuntary pools and associations primarily represent the Company's servicing carrier business. As a servicing carrier, the Company retains no direct underwriting risk but instead cedes 100% of the involuntary market premium and losses back to the pool. Payment of losses is shared by the pool participants in proportion to their pool participation. Reinsurer credit risk with respect to any such involuntary pool or association is a function of the creditworthiness of all of the pool participants.

As part of its reinsurance security oversight, the Company has established a Reinsurance Credit Committee ("the Committee") that meets quarterly to monitor and review the credit quality of the existing reinsurance portfolio, discuss emerging trends in the reinsurance marketplace, and ensure

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that the current portfolio of reinsurance is in compliance with the committee's security standards. The Committee is directly responsible for establishing the rating, collateral, and diversification requirements governing the Company's purchase and use of reinsurance.

Amounts recoverable from reinsurers are estimated in a manner consistent with the claim liability associated with the reinsured business. The Company evaluates and monitors the financial condition of its reinsurers under voluntary reinsurance arrangements to minimize its exposure to significant losses from reinsurer insolvencies. The Company reports its reinsurance recoverables net of an allowance for estimated uncollectible reinsurance recoverables. The allowance is based upon the Company's ongoing review of amounts outstanding, length of collection periods, changes in reinsurer credit standing and other relevant factors. Accordingly, the establishment of reinsurance recoverables and the related allowance for uncollectible reinsurance recoverables is also an inherently uncertain process involving estimates. Changes in these estimates could result in additional charges to the accompanying consolidated statements of income.

The Company is party to retroactive reinsurance arrangements where a significant portion of the consideration was retained on a "funds held" basis and interest is credited on the balance at a weighted average rate of approximately 7.8% annually. These contracts resulted in deferred gains (including experience related profit accruals of \$113) that are amortized into income using the effective interest method over the estimated settlement periods. As of December 31, 2011 and 2010, deferred gains related to these reinsurance arrangements were \$315 and \$550, respectively, and are included in other liabilities within the accompanying consolidated balance sheets. Interest credited to the funds held balances for the years ended December 31, 2011, 2010, and 2009 was \$105, \$118, and \$117, respectively. Deferred gain amortization was \$129, \$54, and \$72 for the years ended December 31, 2011, 2010, and 2009, respectively. Reinsurance recoverables related to these transactions, including experience related profit accruals, were \$1,217 and \$1,947 as of December 31, 2011 and 2010, respectively. Effective March 31, 2011, the Company commuted two workers compensation excess of loss retroactive reinsurance agreements. The commutations, which represent the complete and final settlement and discharge of all present and future obligations between the parties arising out of the agreements, resulted in a gain to the Company of \$54, net of tax.

Additionally, the Company has an aggregate stop loss program covering substantially all of Commercial Markets' voluntary workers compensation business from the fourth quarter 2000 through the fourth quarter 2002 accident year periods. Under these contracts, losses in excess of a specified loss ratio are reinsured up to a maximum loss ratio and were accounted for as prospective reinsurance at inception. However, due to a material contract change at the January 1, 2002 renewal, any premium and loss activity subsequent to December 31, 2001, is accounted for as retroactive reinsurance for coverage provided from the fourth quarter 2000 through the fourth quarter 2001 covered accident year periods. Approximately \$17 and \$10 of additional losses were ceded to these retroactive and prospective contracts, respectively, during the year ended December 31, 2011, with additional premium of \$11 and \$7, respectively. Additional premium and loss activity on these retroactive and prospective contracts was immaterial in 2010 and 2009. The impact to the accompanying consolidated statements of income from ceding the additional losses and premium on the 2001 covered accident year period was deferred for GAAP purposes and is amortized into income using the effective interest method over the estimated settlement period. The retroactive portion of the aggregate stop loss program is included in the preceding paragraph.

In 2007, the Company entered into a multi-year property catastrophe reinsurance agreement with Mystic Re II Ltd. ("Mystic Re II"), a Cayman Islands domiciled reinsurer, to provide \$150 of reinsurance coverage for the Company and its affiliates in the event of a Northeast and/or Florida hurricane event. In the first quarter 2009, the Company entered into another agreement with Mystic Re II to provide \$225 of additional reinsurance coverage for the Company in the event of a U.S. hurricane or earthquake event. The reinsurance agreements are collateralized through a trust and guarantee received by Mystic Re II from the issuance of catastrophe bonds and provides coverage for hurricane or earthquake-related losses based on industry insured losses as reported by Property Claim Services along with company specific losses on the event. The Company has not recorded any recoveries under these programs. Mystic Re II does not have any other reinsurance in force. The 2007 reinsurance agreement was terminated on June 7, 2011. Since no recoveries were recorded under this program, the associated collateral was released.

#### **Catastrophe Exposure**

The Company writes insurance and reinsurance contracts that cover catastrophic events, both natural and man-made. Although the Company purchases reinsurance to mitigate its exposure to certain catastrophic events, claims from catastrophic events could cause substantial volatility in its financial results for any fiscal year and have a material adverse effect on its financial condition.

On November 26, 2002, the Terrorism Risk Insurance Act of 2002 (the Terrorism Act) was enacted into Federal law and established the Terrorism Risk Insurance Program (the Program), a temporary Federal program in the Department of the Treasury, that provided for a system of shared public and private compensation for certain insured losses resulting from acts of terrorism or war committed by or on behalf of a foreign interest. The Program was scheduled to terminate on December 31, 2005. In December 2005, the Terrorism Risk Insurance Extension Act of 2005 (the Terrorism Extension Act) was enacted into Federal law, reauthorizing the Program through December 31, 2007, while reducing the Federal role under the Program. In December 2007, the Terrorism Risk Insurance Program Reauthorization Act of 2007 was enacted into Federal law, extending coverage to include domestic acts of terrorism and reauthorizing the Program through 2014. The three acts are hereinafter collectively referred to as "the Acts."

In order for a loss to be covered under the Program (subject losses), the loss must meet certain aggregate industry loss minimums and must be the result of an event that is certified as an act of terrorism by the U.S. Secretary of the Treasury. The annual aggregate industry loss minimum is \$100 through 2014. The original Program excluded from participation certain of the following types of insurance: Federal crop insurance, private mortgage insurance, financial guaranty insurance, medical malpractice insurance, health or life insurance, flood insurance, and reinsurance. The Terrorism Extension Act exempted from coverage certain additional types of insurance, including commercial automobile, professional liability



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(other than directors and officers), surety, burglary and theft, and farm-owners multi-peril. In the case of a war declared by Congress, only workers compensation losses are covered by the Acts. The Acts generally require that all commercial property casualty insurers licensed in the United States participate in the Program. Under the Program, a participating insurer is entitled to be reimbursed by the Federal Government for 85% of subject losses, after an insurer deductible, subject to an annual cap. The Federal reimbursement percentage is 85% through 2014.

The deductible for any calendar year is equal to 20% of the insurer's direct earned premiums for covered lines for the preceding calendar year. The Company's estimated deductible under the Program is \$1,715 for 2012. The annual cap limits the amount of aggregate subject losses for all participating insurers to \$100,000. Once subject losses have reached the \$100,000 aggregate during a program year, participating insurers will not be liable under the Program for additional covered terrorism losses for that program year. The Company has had no terrorism-related losses since the Program was established. Because the Acts are relatively new and their interpretation is untested, there is substantial uncertainty as to how they will be applied to specific circumstances. It is also possible that future legislative action could change the Acts. Further, given the unpredictable frequency and severity of terrorism losses, as well as the limited terrorism coverage in the Company's own reinsurance program, future losses from acts of terrorism, particularly "unconventional" acts of terrorism involving nuclear, biological, chemical or radiological events, could be material to the Company's operating results, financial position and/or liquidity in future periods. The Company will continue to manage this type of catastrophic risk by monitoring and controlling terrorism risk aggregations to the best of its ability.

### (7) DEBT OUTSTANDING

Debt outstanding as of December 31, 2011 and 2010 includes the following:

*Current maturities of long-term debt:*

	2011	2010
Current maturities of long-term debt	\$205	\$1

*Long-term debt:*

	2011	2010
7.25% Notes, due 2012	\$ -	\$204
8.00% Notes, due 2013	260	260
7.86% Medium Term Notes, due 2013	25	25
5.75% Notes, due 2014	500	500
7.30% Notes, due 2014	200	200
5.588% Mortgage Loan due 2015	48	49
6.70% Notes, due 2016	249	249
7.00% Junior Subordinated Notes, due 2067 <sup>1</sup>	300	300
5.00% Notes, due 2021	600	-
8.50% Surplus Notes, due 2025	140	140
7.875% Surplus Notes, due 2026	227	227
7.625% Notes, due 2028	3	3
7.00% Notes, due 2034	231	231
6.50% Notes, due 2035	471	471
7.50% Notes, due 2036	19	440
7.80% Junior Subordinated Notes, due 2087 <sup>2</sup>	700	700
10.75% Junior Subordinated Notes, due 2088 <sup>3</sup>	981	1,250
7.697% Surplus Notes, due 2097	435	435
	5,389	5,684
Unamortized discount	(48)	(49)
Total long-term debt	\$5,341	\$5,635

<sup>1</sup> The par value call date and final fixed rate interest payment date is March 15, 2017, subject to certain requirements.

<sup>2</sup> The par value call date and final fixed rate interest payment date is March 15, 2037, subject to certain requirements.

<sup>3</sup> The par value call date and final fixed rate interest payment date is June 15, 2038, subject to certain requirements.

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### Debt Transactions and In-Force Credit Facilities

During the year ended December 31, 2011, the Company repurchased \$269 of the 10.75% Junior Subordinated notes due 2088. A pre-tax loss of \$70 was recorded on these transactions and is included in loss on extinguishment of debt in the accompanying consolidated statements of income.

Liberty Mutual Insurance Company ("LMIC"), Peerless Insurance Company ("PIC"), and Liberty Life Assurance Company of Boston ("LLAC") are members of the Federal Home Loan Bank of Boston. Liberty Mutual Fire Insurance Company ("LMFIC") is a member of the Federal Home Loan Bank of Chicago. Membership provides the Company with access to a secured asset-based borrowing with loan maturities of up to 30 years. LMFIC's membership was effective January 11, 2012. As of December 31, 2011, no borrowings were outstanding.

On November 7, 2011, Liberty Mutual Insurance Europe Limited ("LMIE") entered into a 10 million pounds sterling overdraft facility which expires on March 31, 2012. The facility is available to provide working capital to the Company's international operations. In connection with the new facility, LMIE's \$20 revolving loan facility expired. As of December 31, 2011, no borrowings were outstanding under the facility.

On October 24, 2011, LMAC and Ohio Casualty terminated their \$200 unsecured three-year revolving credit facility with a syndicate of lenders.

As of December 31, 2011, Liberty Mutual Group Inc. ("LMGI") had a five-year \$750 unsecured revolving credit facility which terminates on October 17, 2016. To date, no funds have been borrowed under the facility.

The Company places commercial paper through a program issued by LMGI and guaranteed by LMIC. Effective October 17, 2011, the \$400 commercial paper program was increased to \$750 and is backed by the five-year \$750 unsecured revolving credit facility. As of December 31, 2011, there was no commercial paper outstanding.

On May 18, 2011, LMGI issued Senior Notes due 2021 (the "2021 Notes") with a face amount of \$600. Interest is payable semi-annually at a fixed rate of 5.00%. The 2021 Notes mature on June 1, 2021.

On March 21, 2011, the Company announced a tender offer for its 7.50% Senior Notes due 2036 (the "2036 Notes"). On April 15, 2011, the Company paid approximately \$449 in connection with such tender offer, including approximately \$5 in accrued and unpaid interest, to holders of the 2036 Notes tendered in such tender offer. Subsequent to the closing of the tender offer, the Company made an open market purchase of \$5 aggregate principal amount of the 2036 Notes. As a result of these transactions, the Company recorded a pre-tax \$40 loss which is included in loss on extinguishment of debt in the accompanying consolidated statements of income. After completion of the tender offer and subsequent open market purchase, \$19 aggregate principal amount of the 2036 Notes remains outstanding.

As of December 31, 2011, the Company has a \$1,000 three-year committed repurchase agreement maturing in 2013. As of December 31, 2011, no borrowings were outstanding under the agreement.

On December 10, 2009, Berkeley/St. James Real Estate LLC, a wholly-owned affiliate of the Company, entered into a five-year \$50 mortgage loan secured by the Company's headquarters located at 175 Berkeley Street and 30 St. James Avenue, Boston, Massachusetts. The mortgage loan has limited recourse to Berkeley/St. James Real Estate LLC in certain instances, and LMGI guarantees those limited recourse obligations.

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

Capital lease obligations as of December 31, 2011 and 2010 were \$171 and \$177, respectively, and are included in other liabilities in the accompanying consolidated balance sheets. Amortization of the lease obligation was \$30 and \$15 for the years ended December 31, 2011 and 2010, respectively. In 2010 and 2008, the company entered into arrangements to sell and leaseback certain furniture and equipment. The weighted average interest rate on these leases is 3.61%. The transactions are accounted for as capital leases. As of December 31, 2011, the Company's amortization of the lease obligations under the sale-leaseback agreements through maturity is approximately \$32 for 2012, \$33 for 2013, \$17 for 2014 and \$16 for 2015.

### Interest

The Company paid \$454, \$461, \$468 of interest in 2011, 2010, and 2009, respectively.

### (8) INCOME TAXES

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

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The components of Federal, state and foreign income tax (benefit) expense are:

<b>Years ended December 31,</b>	<b>2011</b>	<b>2010</b>	<b>2009</b>
Current tax (benefit) expense:			
United States Federal	\$(63)	\$121	\$108
United States Federal benefit of net operating losses	-	(8)	(27)
State	1	5	6
Foreign	219	201	147
Total current tax expense	157	319	234
Deferred tax (benefit) expense:			
United States Federal	(133)	294	(74)
Foreign	(95)	24	27
Total deferred tax (benefit) expense	(228)	318	(47)
Total United States Federal, state and foreign income tax (benefit) expense	\$(71)	\$637	\$187

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

<b>Years ended December 31,</b>	<b>2011</b>	<b>2010</b>	<b>2009</b>
Expected Federal income tax expense	\$104	\$812	\$423
Tax effect of:			
Nontaxable investment income	(147)	(168)	(191)
Change in valuation allowance	(1)	(11)	4
Goodwill	(15)	(15)	(15)
Tax litigation	-	-	(1)
Revision to estimates	8	(21)	-
Medicare legislative change	-	55	-
State	1	5	6
Foreign	(18)	(69)	(27)
Other	(3)	49	(12)
Actual income tax (benefit) expense	\$(71)	\$637	\$187

The significant components of the deferred income tax assets and liabilities as of December 31, 2011 and 2010 are summarized as follows:

	<b>2011</b>	<b>2010</b>
Deferred tax assets:		
Unpaid claims discount	\$611	\$577
Unearned premium reserves	815	779
Net operating losses	710	161
Employee benefits	623	521
Retroactive reinsurance deferred gain	143	201
Credits	144	85
Other accrued expenses	190	235
Other	523	672
	3,759	3,231
Less: valuation allowance	(136)	(153)
Total deferred tax assets	3,623	3,078
Deferred tax liabilities:		
Deferred acquisition costs	763	740
Net unrealized gains	1,268	734
Intangibles	410	407
Depreciation/amortization	218	174
Other	149	227
Total deferred tax liabilities	2,808	2,282
Net deferred tax assets	\$815	\$796

The overall decrease in the valuation allowance is primarily due to currency translation adjustments. Based on the assumption that future levels of income will be achieved, management believes it is more likely than not the remaining net deferred tax assets after valuation allowance will be realized.

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The Company's subsidiaries have foreign tax credit carry forwards of \$38, general business credit carry forwards of \$11, alternative minimum tax carry forwards of \$94, other foreign credits of \$1 and net operating loss carry forwards of \$2,041 as of December 31, 2011. The foreign tax credits will begin to expire, if not utilized, in 2019, the general business credits will begin to expire, if not utilized, in 2031, the other foreign credits will begin to expire, if not utilized, in 2021 and the alternative minimum tax credits do not expire. The net operating losses available in the United States and various non-United States tax jurisdictions will begin to expire, if not utilized, as follows:

2012	\$26
2013	29
2014	41
2015	50
2016	45
Thereafter	1,850
Total	<u><u>\$2,041</u></u>

The Company has not provided for deferred taxes on unremitted earnings of subsidiaries outside the U.S. where such earnings are permanently reinvested. As of December 31, 2011, unremitted earnings of foreign subsidiaries were \$2,120. If these earnings were distributed in the form of dividends or otherwise, the Company would be subject to U.S. income taxes less an adjustment for applicable foreign tax credits.

The IRS has completed its review of the Company's federal income tax returns through the 1998 tax year and is currently reviewing income tax returns for the 1999 through 2009 tax years. Any adjustments that may result from the IRS examinations of these income tax returns are not expected to have a material impact on the financial position, liquidity, or results of operations of the Company.

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

Balance as of December 31, 2009	\$221
Additions based on tax positions related to the current year	1
Additions for tax positions of prior years	138
Reductions for tax positions of prior years	(39)
Balance as of December 31, 2010	<u>\$321</u>
Additions based on tax positions related to the current year	7
Additions for tax positions of prior years	55
Reductions for tax positions of prior years	(12)
Settlements	(39)
Balance as of December 31, 2011	<u><u>\$332</u></u>

Included in the tabular roll forward of unrecognized tax benefits is interest in the amount of \$78 and \$84 as of December 31, 2011 and 2010, respectively.

Included in the balance at December 31, 2011 is \$148 related to tax positions that would impact the effective tax rate.

The Company recognizes interest and penalties related to unrecognized tax benefits in Federal, state, and foreign income tax expense. For the years ended December 31, 2011, 2010, and 2009, the Company recognized approximately \$2, \$(2), and \$18 in interest and penalties, respectively. The Company had approximately \$82 and \$80 of interest and penalties accrued as of December 31, 2011 and 2010, respectively.

The Company does not expect any material changes to the unrecognized tax benefits within 12 months of the reporting date.

### **(9) BENEFIT PLANS**

The Company sponsors non-contributory defined benefit pension plans ("the Plans") covering substantially all U.S. and Canadian employees. The benefits and eligibility are based on age, years of service, and the employee's final average compensation, as more fully described in the Plans. Some foreign subsidiaries also sponsor defined benefit pension plans.

The Company sponsors non-qualified supplemental pension plans to restore to selected highly compensated employees the pension benefits to which they would be entitled under the Company's U.S. tax qualified, defined benefit pension plan had it not been for limits imposed by the Internal Revenue Code. The supplemental plans are unfunded.

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

Assets of the U.S. tax-qualified, defined benefit pension plans consist primarily of investments in separate accounts established under a group annuity contract issued by a subsidiary life insurance company. The separate accounts invest primarily in fixed income securities and in diversified

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public equities. As of December 31, 2011 and 2010, assets of the plans totaling \$3,933, and \$3,749, respectively, were held in separate accounts of the Company.

The Company sponsors defined contribution savings plans for substantially all U.S. (a 401(k) plan) and Canadian (a Deferred Profit Sharing Plan) employees who meet certain eligibility requirements. During 2011, 2010, and 2009, employees could contribute a percentage of their annual compensation on a before and after-tax basis, subject to Federal limitations. Company contributions, a portion of which reflect Company performance, are based on the employee's contribution amount. In 2011, 2010, and 2009, the Company made matching contributions of \$139, \$148, and \$162, respectively, including the supplemental defined contribution plans.

The Safeco Cash Balance Plan (a defined benefit pension plan) was liquidated in 2010. As a result, the benefit obligation was eliminated from the Company's books resulting in a settlement charge of \$35 for the year ended December 31, 2010.

Compensation expense related to the Company's long-term and short-term incentive compensation plans was \$372, \$406, and \$434 for the years ended December 31, 2011, 2010, and 2009, respectively.

The following table sets forth the assets, obligations, and assumptions associated with the various U.S., Canadian, and certain foreign subsidiary pension and postretirement benefits. The amounts are recognized in the accompanying consolidated balance sheets as of December 31, 2011 and 2010, and accompanying consolidated statements of income for the years ended December 31, 2011, 2010, and 2009.

	Pension		Supplemental Pension		Postretirement	
	2011	2010	2011	2010	2011	2010
<b>Change in benefit obligations:</b>						
Benefit obligation at beginning of year	\$4,496	\$4,907	\$321	\$328	\$719	\$803
Service costs	111	196	6	10	17	24
Interest costs	288	290	20	20	43	46
Amendments	(37)	(2)	(2)	-	9	(71)
Curtailment	(17)	-	-	-	-	-
Actuarial losses (gains)	215	(555)	49	(22)	(54)	(53)
Currency exchange rate change	(9)	1	-	-	-	-
Acquisitions	-	3	-	-	-	-
Benefits paid	(192)	(345)	(30)	(15)	(35)	(30)
Employee contributions	1	1	-	-	-	-
Other	9	-	-	-	-	-
<b>Benefit obligations at end of year</b>	<b>\$4,865</b>	<b>\$4,496</b>	<b>\$364</b>	<b>\$321</b>	<b>\$699</b>	<b>\$719</b>
<b>Accumulated benefit obligations</b>	<b>\$4,517</b>	<b>\$4,141</b>	<b>\$329</b>	<b>\$286</b>	<b>\$699</b>	<b>\$719</b>
<b>Change in plan assets:</b>						
Fair value of plan assets at beginning of year	\$3,900	\$3,640	\$ -	\$ -	\$ -	\$ -
Actual return on plan assets	99	335	-	-	-	-
Currency exchange rate change	(4)	2	-	-	-	-
Acquisitions	-	3	-	-	-	-
Employer contribution	304	263	-	-	-	-
Benefits paid	(192)	(345)	-	-	-	-
Other	1	2	-	-	-	-
<b>Fair value of plan assets at end of year</b>	<b>\$4,108</b>	<b>\$3,900</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>
<b>Funded status of Plan</b>	<b>\$(757)</b>	<b>\$(596)</b>	<b>\$(364)</b>	<b>\$(321)</b>	<b>\$(699)</b>	<b>\$(719)</b>

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	Pension		Supplemental Pension		Postretirement	
	2011	2010	2011	2010	2011	2010
<b>Amounts recognized in the Balance Sheets:</b>						
Assets	\$4	\$6	\$ -	\$ -	\$ -	\$ -
Liabilities	(761)	(602)	(364)	(321)	(699)	(719)
<b>Net liability at end of year</b>	<b>\$(757)</b>	<b>\$(596)</b>	<b>\$(364)</b>	<b>\$(321)</b>	<b>\$(699)</b>	<b>\$(719)</b>
<b>Amounts recognized in Accumulated Other Comprehensive Loss (Income):</b>						
Net loss (gain)	\$949	\$563	\$133	\$93	\$(149)	\$(101)
Prior service costs	(16)	26	-	3	(18)	(30)
Net transition liability (asset)	3	(1)	-	-	-	-
<b>Total</b>	<b>\$936</b>	<b>\$588</b>	<b>\$133</b>	<b>\$96</b>	<b>\$(167)</b>	<b>\$(131)</b>
<b>Other changes in Plan assets and projected benefit obligation recognized in Other Comprehensive Loss (Income):</b>						
Net actuarial loss (gain)	\$393	\$(628)	\$49	\$(22)	\$(54)	\$(54)
Currency exchange rate change	(1)	1	-	-	-	-
Amortization of net actuarial (gain) loss	(7)	(82)	(9)	(9)	6	(1)
Prior service costs	(36)	(2)	(2)	-	9	(16)
Amortization of prior service cost	(6)	(6)	(1)	(3)	3	2
Transition obligation	-	-	-	-	-	(55)
Amortization of transition obligation	5	7	-	-	-	(5)
<b>Total</b>	<b>\$348</b>	<b>\$(710)</b>	<b>\$37</b>	<b>\$(34)</b>	<b>\$(36)</b>	<b>\$(129)</b>

The estimated net actuarial loss, prior service cost, and transition obligation for the pension, supplemental pension and postretirement welfare plan that will be amortized from accumulated other comprehensive income into net periodic benefit cost during the 2012 fiscal year are \$35, \$(2), and less than \$1 for pension plans, \$12, \$0, and \$0 for supplemental pension plans, and \$(7), \$(3), and \$0 for postretirement welfare plans.

The net benefit costs for the years ended December 31, 2011, 2010, and 2009, include the following components:

December 31, 2011	Pension	Supplemental Pension	Postretirement
	Components of net periodic benefit costs:		
Service costs	\$111	\$6	\$17
Interest costs	288	20	43
Expected return on plan assets	(278)	-	-
Settlement charge/curtailment	(17)	-	-
Amortization of unrecognized:			
Net loss (gain)	7	9	(6)
Prior service cost	6	1	(3)
Net transition assets	(5)	-	-
<b>Net periodic benefit costs</b>	<b>\$112</b>	<b>\$36</b>	<b>\$51</b>
<b>December 31, 2010</b>			
Components of net periodic benefit costs:			
Service costs	\$196	\$10	\$24
Interest costs	290	20	46
Expected return on plan assets	(260)	-	-
Settlement charge	35	-	-
Amortization of unrecognized:			
Net loss	47	9	1
Prior service cost	6	3	(2)
Net transition (assets) obligation	(7)	-	5
<b>Net periodic benefit costs</b>	<b>\$307</b>	<b>\$42</b>	<b>\$74</b>

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December 31, 2009	Pension	Supplemental Pension	Postretirement
Components of net periodic benefit costs:			
Service costs	\$200	\$12	\$28
Interest costs	278	19	46
Expected return on plan assets	(251)	-	-
Settlement charge	2	-	-
Amortization of unrecognized:			
Net loss	55	10	2
Prior service cost	6	2	(3)
Net transition (assets) obligation	(5)	-	9
<b>Net periodic benefit costs</b>	<b>\$285</b>	<b>\$43</b>	<b>\$82</b>

The measurement date used to determine pension and other postretirement is December 31, 2011.

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

December 31, Pension	2011	2010
Discount rate	6.30%	6.50%
Rate of compensation increase	3.70%	3.70%
<b>Supplemental Pension</b>		
Discount rate	6.30%	6.50%
Rate of compensation increase	3.90%	3.90%
<b>Postretirement</b>		
Discount rate	6.30%	6.50%

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

December 31, Pension	2011	2010	2009
Discount rate	6.50%	6.15%	6.00%
Expected return on plan assets	6.75%	6.75%	6.75%
Rate of compensation increase	3.70%	4.70%	4.70%
<b>Supplemental Pension</b>			
Discount rate	6.50%	6.15%	6.00%
Rate of compensation increase	3.90%	4.90%	4.90%
<b>Postretirement</b>			
Discount rate	6.50%	5.98%	6.00%
Expected return on plan assets	-%	-%	7.15%

The discount rate assumption used to determine the benefit obligations was based on a yield curve approach where the cash flow related to the benefit plans' liability stream was discounted at an interest rate specifically applicable to the timing of the cash flow. The process calculated the present value of these cash flows and determined the equivalent single discount rate that produced the same present value of the future cash flows. On an annual basis, the Company reviews the discount rate assumption used to determine the benefit obligations and the composition of various yield curves to ensure that the assumed discount rate reflects the Company's best estimate of the rate of return inherent in a portfolio of high-quality debt instruments that would provide the cash flows necessary to settle the Company's projected benefit payments.

In choosing the expected long-term rate of return on plan assets, the Company's Retirement Board considered the historical returns of equity and fixed income markets in conjunction with current economic and financial market conditions.

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The weighted-average healthcare cost trend rates are expected to be 8.3% in 2012 graded down to 5.5% in 2018. Healthcare cost trend rate assumptions have a material impact on the postretirement benefit obligation. A one-percentage point change in assumed healthcare cost trend rates would have the following effects:

	<u>1% point increase</u>	<u>1% point decrease</u>
Effect on Postretirement Benefit Obligation	\$54	\$(43)
Effect on total service and interest costs	\$10	\$(7)

#### Plan Assets

The assets of the domestic Plan represent approximately 97% of the total Plan assets as of December 31, 2011 and 2010, respectively. The Company's overall investment strategy for the domestic Plan's assets is to achieve a mix of approximately 65% of investments for near-term benefit payments and 35% for long-term growth with a wide diversification of asset types, fund strategies, and fund managers. The domestic Plan's goal is to achieve a total return in the range of 6%-8% annually with sufficient liquidity to meet the benefit needs of the domestic Plan.

The majority of the domestic Plan's assets are managed through separate accounts sponsored by Liberty Life Assurance Company of Boston, a wholly owned indirect subsidiary of the Company.

The target allocation for domestic Plan's assets are 62% bonds, 20% diversified public equities, 15% private equity and real estate investments, and 3% cash and short-term investments.

Fixed maturities include investment grade and high yield corporate bonds of companies from diversified industries, residential and commercial mortgage backed securities (RMBS and CMBS), asset backed securities (ABS) and collateralized mortgage obligations (CMO) along with U.S. Treasuries and Agencies (FNMA and FHLMC). Equity securities primarily include investments in large-cap and small-cap companies primarily located in the United States but also with exposures to Europe and Asia. Private equity and real estate investments include investments in private equity funds that follow several different strategies and real estate funds.

The investment strategy for each category of domestic Plan's assets is as follows:

*Fixed maturities* - Achieve superior performance against Barclays Aggregate Bond Index and Merrill High Yield Index over a three to five year period.

*U.S large cap equities* - Achieve superior performance against the Standard and Poor's 500 Index over a three to five year period.

*U.S mid and small cap equities* - Achieve superior performance against the Russell 2000 Index over a three to five year period.

*European equities* - Achieve superior performance against the MSCI Europe Index over a three to five year period.

*Asian equities* - Achieve superior performance against the MSCI Asia, ex Japan Index over a three to five year period.

*Limited partnerships* - Achieve long-term returns in excess of liquid equity securities and provide diversification to the domestic Plan's assets. Exposures are diversified by geography, manager, industry, stage and vintage year.

The domestic Plan's assets are administered by the Liberty Mutual Retirement Board who has the fiduciary responsibility for management of the domestic Plan's assets in accordance with the Liberty Mutual Retirement Benefit Plan Investment Policy. This policy has been approved by the Liberty Mutual Board of Directors.

The other assets represent foreign equities, currency hedges and real estate assets that support foreign pension plans.



**LIBERTY MUTUAL HOLDING COMPANY INC**

Notes to Consolidated Financial Statements

(dollars in millions, except per share amounts)

The following table sets forth by level, within the fair value hierarchy, the plans' assets at fair value as of December 31, 2011 and 2010.

**Fair Value Measurements as of December 31, 2011**

Asset Category	Total	Quoted Prices in	Significant	Significant
		Active Markets for Identical Assets Level 1 <sup>1</sup>	Observable Inputs Level 2 <sup>1</sup>	Unobservable Inputs Level 3 <sup>1</sup>
Cash, cash equivalents and short-term investments	\$425	\$425	\$ -	\$ -
Fixed maturities:				
U.S. government and agency securities	210	196	14	-
RMBS/CMO/ABS/CMBS	1,108	-	1,108	-
Corporate and other	1,143	3	1,140	-
Foreign government securities	33	-	33	-
U.S. large cap equities	108	108	-	-
U.S. mid and small cap equities	432	432	-	-
European equities	139	136	-	3
Asian equities	378	378	-	-
Limited partnerships	100	-	-	100
Other assets	32	17	2	13
<b>Total</b>	<b>\$4,108</b>	<b>\$1,695</b>	<b>\$2,297</b>	<b>\$116</b>

<sup>1</sup> See Note 10 for descriptions of the three levels of fair value presentation.

**Fair Value Measurements as of December 31, 2010**

Asset Category	Total	Quoted Prices in	Significant	Significant
		Active Markets for Identical Assets Level 1 <sup>1</sup>	Observable Inputs Level 2 <sup>1</sup>	Unobservable Inputs Level 3 <sup>1</sup>
Cash, cash equivalents and short-term investments	\$318	\$318	\$ -	\$ -
Fixed maturities:				
U.S. government and agency securities	332	322	10	-
RMBS/CMO/ABS/CMBS	974	-	974	-
Corporate and other	995	2	993	-
Foreign government securities	36	-	36	-
U.S. large cap equities	604	603	-	1
U.S. mid and small cap equities	154	154	-	-
European equities	148	145	-	3
Asian equities	230	230	-	-
Limited partnerships	86	-	-	86
Other assets	23	13	1	9
<b>Total</b>	<b>\$3,900</b>	<b>\$1,787</b>	<b>\$2,014</b>	<b>\$99</b>

<sup>1</sup> See Note 10 for descriptions of the three levels of fair value presentation.

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**Fair Value Measurements Using Significant  
Unobservable Inputs (Level 3)**

	<b>Balance January 1, 2011</b>	<b>Actual Return on Plan Assets Still Held</b>	<b>Actual Return on Plan Assets Sold</b>	<b>Purchases, Sales, &amp; Settlements</b>	<b>Balance December 31, 2011</b>
U.S. large cap equities	\$1	\$ -	\$ -	\$(1)	\$ -
European equities	3	2	(2)	-	3
Limited partnerships	86	(2)	13	3	100
Other assets	9	4	-	-	13
<b>Total</b>	<b>\$99</b>	<b>\$4</b>	<b>\$11</b>	<b>\$2</b>	<b>\$116</b>

**Fair Value Measurements Using Significant  
Unobservable Inputs (Level 3)**

	<b>Balance January 1, 2010</b>	<b>Actual Return on Plan Assets Still Held</b>	<b>Actual Return on Plan Assets Sold</b>	<b>Purchases, Sales, &amp; Settlements</b>	<b>Balance December 31, 2010</b>
U.S. large cap equities	\$ -	\$ -	\$ -	\$1	\$1
European equities	3	-	-	-	3
Limited partnerships	83	(4)	11	(4)	86
Other assets	6	2	-	1	9
<b>Total</b>	<b>\$92</b>	<b>\$(2)</b>	<b>\$11</b>	<b>\$(2)</b>	<b>\$99</b>

The valuation of the Plans' investments in limited partnerships is determined either internally or by an external fund manager based on recent filings, operating results, balance sheet stability, growth and other business and market sector fundamentals.

**Cash Flows**

*Contributions*

The Company contributed \$304 to the qualified plans, and directly funded \$30 to retirees in the supplemental pension plans in 2011. In addition, the Company directly funded \$35 to retirees in the postretirement benefit plans in 2011.

The Company expects to contribute approximately \$345 to the qualified plans, directly fund \$27 to retirees in the supplemental pension plans, and \$39 to the postretirement benefit plans gross of the Medicare Subsidy in 2012.

*Expected Future Benefit Payments*

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

	<b>Pension</b>	<b>Supplemental Pension</b>	<b>Postretirement Welfare Plans</b>	<b>Postretirement Medicare Subsidy</b>
2012	\$483	\$27	\$45	\$(6)
2013	226	80	38	-
2014	219	24	39	-
2015	230	24	41	-
2016	243	25	42	-
2017-2021	1,447	123	228	-

# LIBERTY MUTUAL HOLDING COMPANY INC

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## (10) FAIR VALUE OF FINANCIAL INSTRUMENTS

Fair value is the price that would be received to sell an asset or would be paid to transfer a liability in an orderly transaction between market participants at the measurement date. In determining fair value, the Company primarily uses the market approach, which generally utilizes market transaction data for identical or similar instruments.

The hierarchy level assigned to each security in the Company's available for sale portfolio is based on the Company's assessment of the transparency and reliability of the inputs used in the valuation of each instrument at the measurement date. The highest priority is given to unadjusted quoted prices in active markets for identical assets (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). Securities are classified based on the lowest level of input that is significant to the fair value measurement. The Company recognizes transfers between levels at the end of each reporting period. The three hierarchy levels are defined as follows:

- Level 1 — Valuations based on unadjusted quoted market prices in active markets for identical assets or liabilities that the Company has the ability to access.
- Level 2 — Valuations based on observable inputs (other than Level 1 prices), such as quoted prices for similar assets or liabilities at the measurement date, quoted prices in markets that are not active, or other inputs that are observable, either directly or indirectly.
- Level 3 — Valuations based on inputs that are unobservable and significant to the overall fair value measurement and involve management judgment. The unobservable inputs reflect the Company's own assumptions about the assumptions that market participants might use.

The availability of observable inputs can vary from financial instrument to financial instrument and is affected by a wide variety of factors, including, for example, the type of financial instrument, whether the financial instrument is new and not yet established in the marketplace, and other characteristics particular to the financial instrument. To the extent that valuation is based on models or inputs that are less observable or unobservable in the market, the determination of fair value requires significantly more judgment. Accordingly, the degree of judgment exercised by management in determining fair value is greatest for instruments categorized in Level 3.

The Company used the following methods and assumptions in estimating the fair value of its financial instruments as well as the general classification of such financial instruments pursuant to the above fair value hierarchy:

### **Fixed Maturities**

At each valuation date, the Company uses various valuation techniques to estimate the fair value of its fixed maturities portfolio. The primary method for valuing the Company's securities is through independent third-party valuation service providers. For positions where valuations are not available from independent third-party valuation service providers, the Company utilizes broker quotes and internal pricing methods to determine fair values. The Company obtains a single non-binding price quote from a broker familiar with the security who, similar to the Company's valuation service providers, may consider transactions or activity in similar securities, as applicable, among other information. The brokers providing price quotes are generally from the brokerage divisions of leading financial institutions with market making, underwriting and distribution expertise regarding the security subject to valuation. The evaluation and prioritization of these valuation sources is systematic and predetermined resulting in a single quote or price for each financial instrument. The following describes the techniques generally used to determine the fair value of the Company's fixed maturities by asset class:

#### *U.S. government and agency securities*

U.S. government and agency securities consist primarily of bonds issued by the U.S. Treasury and mortgage pass-through agencies such as the Federal Home Loan Bank, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. As the fair values of the Company's U.S. Treasury securities are based on unadjusted market prices, they are classified within Level 1. The fair value of U.S. government agency securities is generally determined using observable market inputs that include quoted prices for identical or similar assets in markets that are not active, benchmark yields, reported trades, bids, offers and credit spreads. Accordingly, the fair value of U.S. government agency securities is classified within Level 2.

#### *Mortgage-backed securities*

The Company's portfolio of residential and commercial MBS are originated by both agencies and non-agencies, the majority of which are pass-through securities issued by U.S. government agencies. The fair value of MBS is generally determined using observable market inputs that include quoted prices for identical or similar assets in markets that are not active, benchmark yields, contractual cash flows, prepayment speeds, collateral performance and credit spreads. Accordingly, the fair value of MBS is primarily classified within Level 2.

#### *Asset-backed securities*

ABS include mostly investment-grade bonds backed by pools of loans with a variety of underlying collateral, including automobile loan receivables, credit card receivables, and collateralized loan obligation securities originated by a variety of financial institutions. The fair value of ABS is generally determined using observable market inputs that include quoted prices for identical or similar assets in markets that are not active, benchmark yields, contractual cash flows, prepayment speeds, collateral performance and credit spreads. Accordingly, the fair value of ABS is primarily classified within Level 2.

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#### *Municipals*

The Company's municipal portfolio comprises bonds issued by U.S. domiciled state and municipal entities. The fair value of municipal securities is generally determined using observable market inputs that include quoted prices for identical or similar assets in markets that are not active, benchmark yields, broker quotes, issuer ratings, reported trades and credit spreads. Accordingly, the fair value of municipal securities is primarily classified within Level 2.

#### *Corporate debt and other*

Corporate debt securities consist primarily of investment-grade debt of a wide variety of corporate issuers and industries. The fair value of corporate and other securities is generally determined using observable market inputs that include quoted prices for identical or similar assets in markets that are not active, benchmark yields, new issuances, issuer ratings, reported trades of identical or comparable securities, bids, offers and credit spreads. Accordingly, the fair value of corporate and other securities is primarily classified within Level 2. In the event third-party vendor valuation is not available, prices are determined using non-binding price quotes from a broker familiar with the security. In this instance, the valuation inputs are generally unobservable and the fair value is classified within Level 3.

#### *Foreign government securities*

Foreign government securities comprise bonds issued by foreign governments and their agencies along with supranational organizations. The fair value of foreign government securities is generally determined using observable market inputs that include quoted prices for identical or similar assets in markets that are not active, benchmark yields, broker quotes, issuer ratings, reported trades of identical or comparable securities and credit spreads. Accordingly, the fair value of foreign government securities is primarily classified within Level 2.

#### **Equity securities**

Equity securities include common and preferred stocks. Common stocks with fair values based on quoted market prices in active markets are classified within Level 1. Common stocks with fair values determined using observable market inputs that include quoted prices for identical or similar assets in markets that are not active are classified within Level 2. The fair value of preferred stock is generally determined using observable market inputs that include quoted prices for identical or similar assets in markets that are not active. Accordingly, the fair value of preferred stock is primarily classified within Level 2.

#### **Other investments**

Other investments include primarily international loans, foreign cash deposits and equity investments in privately held businesses. International loans and cash deposits are primarily valued using quoted prices for similar instruments in active markets; these assets are categorized within Level 2 of the fair value hierarchy. Equity investments in privately held businesses are valued using internal management estimates; they are categorized within Level 3 of the hierarchy. Limited partnership and other equity method investments, which represent the remainder of the other investment balance on the accompanying consolidated balance sheet, are not subject to these disclosures and therefore are excluded from the below table.

#### **Separate account assets**

Separate account assets, which primarily consist of fixed maturity and equity securities, are measured based on the methodologies discussed above. The activity in separate account assets is offset by an equal amount for separate account liabilities, which results in a net zero impact for the Company.

#### **Other assets**

Other assets primarily consist of fixed maturities, short-term investments, and equity securities of captive companies sponsored by the Company. These assets are measured based on the methodology for individual securities as discussed above.

#### **Life insurance obligations**

Life insurance obligations include certain variable annuity contracts which contain guaranteed minimum income benefits that contain embedded derivatives and are bifurcated from the host contract and carried at fair value. The measurements on these embedded derivatives are computed on a recurring basis using assumptions predominately classified as Level 3 (significant unobservable) inputs. While some inputs are observable in the market, such as risk free rates, volatility and historical equity returns, the underlying future policyholder behavior inputs are highly unobservable. These assumptions include mortality, lapse, and the underlying take-up rate with regard to annuitization.

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The following tables summarize the Company's assets that are measured at fair value on a recurring basis as of December 31, 2011 and December 31, 2010:

<i><b>Assets, at Fair Value</b></i>	<b>As of December 31, 2011</b>			
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
U.S. government and agency securities	\$2,376	\$964	\$16	\$3,356
Residential MBS	-	9,433	64	9,497
Commercial MBS	-	2,152	5	2,157
Other MBS and ABS	-	1,763	12	1,775
U.S. state and municipal	-	13,646	19	13,665
Corporate and other	-	24,599	656	25,255
Foreign government securities	-	4,611	260	4,871
Total fixed maturities, available for sale	2,376	57,168	1,032	60,576
Common stock	1,579	3	26	1,608
Preferred stock	-	331	15	346
Total equity securities, available for sale	1,579	334	41	1,954
Short-term investments	7	193	1	201
Other investments	-	70	129	199
Separate account assets	1,686	2,227	174	4,087
Other assets	11	37	30	78
Total assets	\$5,659	\$60,029	\$1,407	\$67,095
 <i><b>Liabilities, at Fair Value</b></i>				
Life insurance obligations	\$ -	\$ -	\$(162)	\$(162)
Total liabilities	\$ -	\$ -	\$(162)	\$(162)

<i><b>Assets, at Fair Value</b></i>	<b>As of December 31, 2010</b>			
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
U.S. government and agency securities	\$2,152	\$1,024	\$16	\$3,192
Residential MBS	-	9,854	179	10,033
Commercial MBS	-	2,453	20	2,473
Other MBS and ABS	-	1,734	14	1,748
U.S. state and municipal	-	12,718	14	12,732
Corporate and other	-	23,204	771	23,975
Foreign government securities	-	4,286	114	4,400
Total fixed maturities, available for sale	2,152	55,273	1,128	58,553
Common stock	1,212	-	18	1,230
Preferred stock	-	499	4	503
Total equity securities, available for sale	1,212	499	22	1,733
Short-term investments	119	191	3	313
Other investments	-	54	87	141
Separate account assets	1,794	1,938	161	3,893
Other assets	9	52	23	84
Total assets	\$5,286	\$58,007	\$1,424	\$64,717
 <i><b>Liabilities, at Fair Value</b></i>				
Life insurance obligations	\$ -	\$ -	\$(149)	\$(149)
Total liabilities	\$ -	\$ -	\$(149)	\$(149)

The Company did not have significant transfers between Levels 1 and 2 during the year ended December 31, 2011.

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The following tables summarize the fair values of assets on a recurring basis classified as Level 3 within the fair value hierarchy:

	Balance January 1, 2011	Net Realized Gains (Losses)	Net Unrealized Gains (Losses)	Purchases	Settlements	Sales and maturities	Transfer In to Level 3	Transfer Out of Level 3	Balance December 31, 2011
U.S. government and agency securities	\$16	\$ -	\$2	\$ -	\$ -	\$(3)	\$1	\$ -	\$16
Residential MBS	179	-	5	242	-	(2)	-	(360)	64
Commercial MBS	20	-	2	10	-	-	1	(28)	5
Other MBS and ABS	14	-	1	11	-	(6)	24	(32)	12
U.S. state and municipal	14	-	-	12	-	(7)	-	-	19
Corporate and other	771	1	2	89	-	(124)	38	(121)	656
Foreign government securities	114	-	6	112	-	(13)	408	(367)	260
Total fixed maturities	1,128	1	18	476	-	(155)	472	(908)	1,032
Common stock	18	-	1	22	-	-	-	(15)	26
Preferred stock	4	-	-	10	-	-	1	-	15
Total equity securities	22	-	1	32	-	-	1	(15)	41
Short-term investments	3	-	-	5	-	(4)	1	(4)	1
Other investments	87	25	(20)	21	-	(114)	130	-	129
Separate account assets	161	14	(1)	47	-	(37)	5	(15)	174
Other assets	23	4	-	-	3	-	-	-	30
Total assets	\$1,424	\$44	\$(2)	\$581	\$3	\$(310)	\$609	\$(942)	\$1,407

**Liabilities, at Fair Value**

Life insurance obligations	\$(149)	\$(33)	\$ -	\$ -	\$20	\$ -	\$ -	\$ -	\$(162)
Total liabilities	\$(149)	\$(33)	\$ -	\$ -	\$20	\$ -	\$ -	\$ -	\$(162)

	Balance January 1, 2010	Net Realized Gains (Losses)	Net Unrealized Gains (Losses)	Net Purchases, (Sales) and (Maturities)	Transfer in and/ or out of Level 3	Balance December 31, 2010
U.S. government and agency securities	\$44	\$ -	\$1	\$(17)	\$(12)	\$16
Residential MBS	6	-	2	175	(4)	179
Commercial MBS	15	-	(1)	17	(11)	20
Other MBS and ABS	53	(1)	5	(26)	(17)	14
U.S. state and municipal	21	-	-	(1)	(6)	14
Corporate and other	848	2	(6)	(105)	32	771
Foreign government securities	7	-	(1)	107	1	114
Total fixed maturities	994	1	-	150	(17)	1,128
Common stock	14	1	2	6	(5)	18
Preferred stock	3	1	-	-	-	4
Total equity securities	17	2	2	6	(5)	22
Short-term investments	59	(2)	(3)	(51)	-	3
Other investments	64	14	(1)	(13)	23	87
Separate account assets	187	45	(34)	(37)	-	161
Other assets	19	1	-	3	-	23
Total assets	\$1,340	\$61	\$(36)	\$58	\$1	\$1,424
Life insurance obligations	\$(143)	\$(33)	\$ -	\$27	\$ -	\$(149)
Total liabilities	\$(143)	\$(33)	\$ -	\$27	\$ -	\$(149)

There were no material unrealized gains (losses) for the period included in earnings attributable to the fair value relating to assets and liabilities classified as Level 3 that are still held as of December 31, 2011 and 2010.

For the years ended December 31, 2011, 2010, and 2009, there were impairments of \$35, \$26, and \$22, respectively, recognized for items measured at fair value on a nonrecurring basis (primarily related to direct investments in oil and gas production ventures, which are based on independent

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external studies). The Company tests for impairment on its oil and gas production ventures by comparing the undiscounted cash flows expected to be generated by a project to the property's carrying value. When a property's carrying value is less than the expected future cash flows, impairment expense is recognized to the extent that the carrying value of the property exceeds its discounted expected cash flows. In employing the discounted cash flow method described above, key inputs regarding future oil and/or gas production, commodity prices and the discount rate are based on management's expectations about outcomes with respect to these variables.

Transfers into and out of Level 3 were primarily due to changes in the observability of pricing inputs.

The Company has elected to apply the fair value option to certain financial instruments in limited circumstances. The fair value option election is made on an instrument by instrument basis. All periodic changes in the fair value of the elected instruments are reflected in the accompanying consolidated statements of income. The impact of the fair value option elections is immaterial to the Company.

The fair values and carrying values of the Company's financial instruments excluded from ASC 820 as of December 31, 2011 and 2010, are as follows:

	2011		2010	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Other investments	\$3,590	\$3,590	\$2,926	\$2,926
Mortgage loans	1,196	1,328	1,206	1,238
Cash and cash equivalents	5,972	5,972	4,930	4,930
Individual and group annuities	2,028	2,168	2,055	2,439
Debt	5,546	5,891	5,636	5,902

*Other investments:* Fair values represent the Company's equity in limited partnership net assets and other equity method investments.

*Mortgage loans:* The fair values of commercial mortgage loans were estimated using option adjusted valuation discount rates.

*Cash and cash equivalents:* The carrying amounts reported in the accompanying consolidated balance sheets for these instruments approximate fair values.

*Individual and group annuities:* Fair values of liabilities under fixed investment-type insurance contracts are estimated using discounted cash flow calculations at pricing rates as of December 31, 2011 and 2010. Also included are variable investment-type insurance contracts, for which carrying value approximates fair value as of December 31, 2011 and 2010.

*Debt outstanding:* Fair values of commercial paper and short-term borrowings approximate carrying value. Fair values of long-term debt were based upon a tiered approach using the following sources in order of availability (1) quoted prices from Morgan Markets, (2) quoted prices from Bloomberg, or (3) a yield to maturity calculation utilizing Bloomberg prices as of December 31, 2011 and 2010.

The Company has not applied ASC 820 to non-financial assets and liabilities.

### (11) COMMITMENTS AND CONTINGENT LIABILITIES

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

The Company is currently in coverage litigation with Kentile Floors, Inc. a former manufacturer of floor tile products, some of which contained asbestos. In November 1992, Kentile filed a voluntary petition for bankruptcy relief under Chapter 11 (Reorganization) of the Bankruptcy Code in the U.S. Bankruptcy Court for the Southern District of New York, and Metex Manufacturing Corporation ("Metex") emerged from the Chapter 11 Bankruptcy proceeding as the "Reorganized Debtor." Metex claims it has rights to the policies issued to Kentile, but this issue has not yet been resolved by the bankruptcy court.

In 2008, certain excess insurers of Kentile initiated a declaratory judgment action against Kentile, Metex and the other insurers of Kentile, including the Company, in state court in New York seeking, among other relief, products coverage without aggregate limits from the Company.

The Company intends to vigorously defend its position in this coverage litigation, including opposing any argument that the Kentile policies do not contain aggregate limits for products claims. Management believes that the ultimate liability, if any, to Metex will not be resolved for at least one year and very likely may not be known for several years. In the opinion of management, the outcome of these pending matters is difficult to predict and an adverse outcome could have a material adverse effect on the Company's business, financial condition and results of operation.

The Company leases certain office facilities and equipment under operating leases expiring in various years through 2022. In addition, the Company is party to two land leases expiring in 2025 and 2101. Rental expense amounted to \$205, \$226, and \$239 for the years ended December 31, 2011, 2010, and 2009, respectively. The Company also owns certain office facilities and receives rental income from tenants under operating

## LIBERTY MUTUAL HOLDING COMPANY INC

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leases expiring in various years through 2043. Rental income amounted to \$32, \$35, and \$35 for the years ended December 31, 2011, 2010, and 2009, respectively.

Future minimum rental payments and receipts under non-cancelable leases with terms in excess of one year are estimated as follows:

	<b>Operating Leases</b>	<b>Land Leases</b>	<b>Rental Income</b>	<b>Net Lease Obligations</b>
2012	\$168	\$1	\$26	\$143
2013	157	1	28	130
2014	117	1	24	94
2015	84	1	29	56
2016	84	1	16	69
2017 – 2036	144	20	18	146
2037 – 2056	-	21	-	21
2057 – 2101	-	92	-	92
Total	<u>\$754</u>	<u>\$138</u>	<u>\$141</u>	<u>\$751</u>

As of December 31, 2011, the Company had unfunded commitments in traditional private equity partnerships, real estate, energy, and other of \$900, \$271, \$1,052 and \$285, respectively.

As of December 31, 2011, the Company had commitments to purchase various residential MBS at a cost of \$88 with a fair value of \$89.

As of December 31, 2011, the Company had \$457 of undrawn letters of credit outstanding secured by assets of \$564.

Liabilities for guaranty fund and other insurance-related assessments are accrued when an assessment is probable, when it can be reasonably estimated, and when the event obligating the entity to pay an imposed or probable assessment has occurred (based on past premiums for life lines and future premiums for property and casualty lines). Liabilities for guaranty funds and other insurance-related assessments are not discounted and are included as part of other liabilities in the accompanying consolidated balance sheets. As of December 31, 2011 and 2010, the liability balance was \$236 and \$248, respectively. As of December 31, 2011 and 2010, included in other assets were \$10 and \$10, respectively, of related assets for premium tax offsets or policy surcharges. The related asset is limited to the amount that is determined based on future premium collections or policy surcharges from policies in force. Current assessments are expected to be paid out over the next five years, while premium tax offsets are expected to be realized within one year.

The Company has reinsurance funds held balances of approximately \$1,139, which are subject to ratings and surplus triggers whereby if any of the Company's insurance financial strength ratings (with the three major rating agencies) fall below the A- or A3 categories or specified surplus decreases occur, the funds may be required to be placed in trust and invested in assets acceptable to the Company. No funds were held in trust as of December 31, 2011.

## (12) POLICYHOLDERS' EQUITY

### **Statutory Surplus**

The statutory surplus of the Company's domestic insurance companies was \$15,701 and \$16,039 as of December 31, 2011 and 2010, respectively. The Company's domestic insurance subsidiaries prepare the statutory basis financial statements in accordance with the National Association of Insurance Commissioners' Accounting Practices and Procedures Manual ("NAIC APP"), subject to any deviations prescribed or permitted by the insurance commissioners of the various insurance companies' states of domicile. The Company does not have any material permitted practices that deviate from the NAIC APP.

### **Dividends**

The insurance subsidiaries' ability to pay dividends is restricted under applicable insurance law and regulations and may only be paid from unassigned surplus. Under the insurance laws of the domiciliary states of the insurance subsidiaries, an insurer may make an ordinary dividend payment if its surplus as regards to policyholders, following such dividend, is reasonable in relation to its outstanding liabilities, is adequate to its financial needs and does not exceed the insurer's unassigned surplus. However, no insurer may pay an extraordinary dividend without the approval or non-disapproval of the domiciliary insurance regulatory authority. Under the insurance laws of Massachusetts, the domiciliary state of LMIC and Liberty Mutual Personal Insurance Company ("LMPICO"), an extraordinary dividend is defined as a dividend whose fair market value, together with other dividends made within the preceding 12 months, exceeds the greater of 10% of the insurer's surplus as regards policyholders as of the preceding December 31, or the insurer's net income for the 12-month period ending on the preceding December 31. Under the insurance laws of Wisconsin, the domiciliary state of LMFIC and EICOW, an extraordinary dividend is defined as a dividend whose fair market value, together with other dividends paid within the preceding 12 months, exceeds the lesser of (a) 10% of the insurer's surplus with regard to policyholders as of the preceding December 31, or (b) the greater of (1) the insurer's net income for the calendar year preceding the date of the dividend, minus realized capital gains for that calendar year, or (2) the aggregate of the insurer's net income for the three calendar years preceding the date of the dividend, minus realized capital gains for those calendar years and minus dividends paid within the first two of the preceding three calendar years. Changes in the extraordinary dividend regulation of the domiciliary states of LMIC, LMPICO, LMFIC, and EICOW could negatively affect LMGI's ability to pay principal and interest on the notes held at LMGI, as could a redomestication, merger, or consolidation of



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Notes to Consolidated Financial Statements

(dollars in millions, except per share amounts)

LMIC, LMPICO, LMFIC, or EICOW to a different domiciliary state. The maximum dividend payout in 2012 that may be made prior to regulatory approval is \$1,410.

**(13) SUBSEQUENT EVENTS**

Management has assessed material subsequent events through March 2, 2012, the date the financial statements were available to be issued.

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