

Liberty Mutual Holding Company Inc.

Third Quarter 2014

Consolidated Financial Statements

Liberty Mutual Holding Company Inc.

Consolidated Statements of Income

(dollars in millions)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Revenues				
Premiums earned	\$ 8,949	\$ 8,754	\$ 26,349	\$ 25,358
Net investment income	818	686	2,505	2,246
Fee and other revenues	351	318	1,021	893
Net realized (losses) gains	(33)	80	(192)	(54)
Total revenues	10,085	9,838	29,683	28,443
Claims, Benefits and Expenses				
Benefits, claims and claim adjustment expenses	6,032	6,152	18,210	17,776
Operating costs and expenses	1,824	1,623	5,436	4,858
Amortization of deferred policy acquisition costs	1,231	1,196	3,651	3,513
Interest expense	106	110	310	315
Interest credited to policyholders	68	66	198	194
Total claims, benefits and expenses	9,261	9,147	27,805	26,656
Loss on extinguishment of debt	(29)	(96)	(29)	(156)
Realignment benefit	-	11	-	8
Income before income tax expense, non-controlling interest, and discontinued operations	795	606	1,849	1,639
Income tax expense	190	131	513	417
Consolidated net income before discontinued operations	605	475	1,336	1,222
Discontinued operations (net of income tax expense of \$22 and \$17 for the nine months ended September 30, 2014 and 2013)	-	4	(81)	14
Consolidated net income	605	479	1,255	1,236
Less: Net loss attributable to non-controlling interest	(4)	(2)	(19)	(11)
Net income attributable to Liberty Mutual Holding Company Inc.	\$ 609	\$ 481	1,274	\$ 1,247
Net Realized (Losses) Gains				
Other-than-temporary impairment losses:	2014	2013	2014	2013
Total other-than-temporary impairment losses	\$ (68)	\$ (41)	(334)	\$ (277)
Change in portion of loss recognized in other comprehensive income	-	-	-	-
Other-than-temporary impairment losses	(68)	(41)	(334)	(277)
Other net realized gains	35	121	142	223
Net realized (losses) gains	\$ (33)	\$ 80	(192)	\$ (54)

See accompanying notes to the unaudited consolidated financial statements.

Liberty Mutual Holding Company Inc.

Consolidated Statements of Comprehensive Income

(dollars in millions)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Consolidated net income	\$ 605	\$ 479	\$ 1,255	\$ 1,236
Other comprehensive (loss) income, net of taxes:				
Unrealized (losses) gains on securities	(380)	(87)	435	(1,571)
Reclassification adjustment for gains and losses included in consolidated net income	(19)	(70)	89	15
Foreign currency translation and other adjustments	(223)	193	(171)	135
Other comprehensive (loss) income, net of taxes	(622)	36	353	(1,421)
Comprehensive (loss) income	\$ (17)	\$ 515	\$ 1,608	\$ (185)

See accompanying notes to the unaudited consolidated financial statements.

Liberty Mutual Holding Company Inc.

Consolidated Balance Sheets

(dollars in millions)

(Unaudited)

	September 30, 2014	December 31, 2013
Assets:		
Investments		
Fixed maturities, available for sale, at fair value (amortized cost of \$60,475 and \$62,446)	\$ 63,356	\$ 64,256
Equity securities, available for sale, at fair value (cost of \$2,605 and \$2,508)	3,105	2,952
Short-term investments	556	393
Commercial mortgage loans	1,701	1,583
Other investments	5,457	4,920
Total investments	74,175	74,104
Cash and cash equivalents	4,647	4,778
Premium and other receivables	10,553	10,283
Reinsurance recoverables	14,226	11,786
Deferred income taxes	370	1,251
Deferred acquisition costs	3,188	3,115
Goodwill	4,867	4,820
Prepaid reinsurance premiums	1,296	1,341
Separate account assets	108	109
Other assets	10,323	9,695
Total assets	\$ 123,753	\$ 121,282
Liabilities:		
Unpaid claims and claim adjustment expenses and future policy benefits:		
Property and casualty	\$ 50,950	\$ 52,750
Life	8,814	8,308
Other policyholder funds and benefits payable	5,693	5,126
Unearned premiums	18,230	17,326
Funds held under reinsurance treaties	202	207
Current maturities of long-term debt	47	343
Long-term debt	6,939	6,285
Separate account liabilities	108	109
Other liabilities	12,149	11,816
Total liabilities	103,132	102,270
Equity:		
Unassigned equity	19,602	18,328
Accumulated other comprehensive income	994	640
Total policyholders' equity	20,596	18,968
Non-controlling interest	25	44
Total equity	20,621	19,012
Total liabilities and equity	\$ 123,753	\$ 121,282

See accompanying notes to the unaudited consolidated financial statements.

Liberty Mutual Holding Company Inc.

Consolidated Statements of Changes in Total Equity

(dollars in millions)

(Unaudited)

	Nine Months Ended September 30,	
	2014	2013
Balance at beginning of the year	\$ 19,012	\$ 18,525
Comprehensive income:		
Consolidated net income	1,255	1,236
Other comprehensive income (loss), net of taxes	353	(1,421)
Total comprehensive income (loss)	1,608	(185)
Capital contributions	1	-
Balance at end of the period	<u>\$ 20,621</u>	<u>\$ 18,340</u>

See accompanying notes to the unaudited consolidated financial statements.

Liberty Mutual Holding Company Inc.

Consolidated Statements of Cash Flows

(dollars in millions)

(Unaudited)

		Nine Months Ended September 30,	
		2014	2013
		<u> </u>	<u> </u>
Cash flows from operating activities:			
Consolidated net income	\$	1,255	\$ 1,236
Adjustments to reconcile consolidated net income to net cash provided by operating activities:			
Depreciation and amortization		567	542
Realized losses (including loss on sale of discontinued operations)		267	54
Undistributed private equity investment gains		(560)	(308)
Premium, other receivables, and reinsurance recoverables		(3,414)	(1,013)
Deferred acquisition costs		(185)	(225)
Liabilities for insurance reserves		1,603	2,722
Taxes payable, net of deferred		557	334
Other, net		(22)	(214)
Total adjustments		<u>(1,187)</u>	<u>1,892</u>
Net cash provided by operating activities		<u>68</u>	<u>3,128</u>
Cash flows from investing activities:			
Purchases of investments		(10,543)	(14,447)
Sales and maturities of investments		11,214	10,665
Property and equipment purchased, net		(613)	(771)
Cash (paid) received for disposals and acquisitions, net of cash on hand		(1,043)	(2)
Other investing activities		297	104
Net cash used in investing activities		<u>(688)</u>	<u>(4,451)</u>
Cash flows from financing activities:			
Net activity in policyholder accounts		424	253
Debt financing, net		325	153
Net security lending activity and other financing activities		52	417
Net cash provided by financing activities		<u>801</u>	<u>823</u>
Effect of exchange rate changes on cash		<u>(312)</u>	<u>(128)</u>
Net decrease in cash and cash equivalents		(131)	(628)
Cash and cash equivalents, beginning of year		<u>4,778</u>	<u>5,484</u>
Cash and cash equivalents, end of period	\$	<u><u>4,647</u></u>	\$ <u><u>4,856</u></u>

See accompanying notes to the unaudited consolidated financial statements.

Liberty Mutual Holding Company Inc.

Notes to Consolidated Financial Statements

(dollars in millions)

(Unaudited)

(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 accompanying 2013 consolidated financial statements to conform with the 2014 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) recoverability of deferred acquisition costs, (5) valuation of goodwill and intangible assets, (6) deferred income tax valuation allowance, and (7) pension and postretirement benefit obligations. While the amounts included in the accompanying consolidated financial statements reflect management’s best estimates and assumptions, these amounts ultimately could vary.

Adoption of Accounting Standards

The Company has not adopted any accounting standards through the third quarter of 2014.

Accounting Standards Not Yet Adopted

There are no accounting standards not yet adopted by the Company that are expected to have a material impact on its financial position or results of operations.

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, are as follows:

	<u>September 30, 2014</u>	<u>December 31, 2013</u>
Unrealized gains on securities	\$1,813	\$1,289
Foreign currency translation & other adjustments	(169)	46
Pension liability funded status ⁽¹⁾	(650)	(695)
Accumulated other comprehensive income	\$994	\$640

⁽¹⁾ Includes \$60 for the nine months and year ended September 30, 2014 and December 31, 2013, respectively, due to the recognition of deferred taxes related to the Medicare Part D subsidy.

The following table presents the consolidated other comprehensive (loss) income reclassification adjustments for the three and nine months ended September 30, 2014 and 2013, respectively.

	Unrealized (losses) gains on securities	Change in pension and post retirement plans funded status	Foreign currency translation and other adjustments	Total
Three months ended September 30, 2014				
Unrealized change arising during the period	\$(549)	\$ -	\$(259)	\$(808)
Less: Reclassification adjustments included in consolidated net income	30	(21)	-	9
Total other comprehensive (loss) income, before income tax (benefit) expense	(579)	21	(259)	(817)
Less: Income tax (benefit) expense	(180)	7	(22)	(195)
Total other comprehensive (loss) income, net of income tax (benefit) expense	\$(399)	\$14	\$(237)	\$(622)

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	Unrealized (losses) gains on securities	Change in pension and post retirement plans funded status	Foreign currency translation and other adjustments	Total
Three months ended September 30, 2013				
Unrealized change arising during the period	\$(200)	\$154	\$77	\$31
Less: Reclassification adjustments included in consolidated net income	108	(44)	-	64
Total other comprehensive (loss) income, before income tax (benefit) expense	(308)	198	77	(33)
Less: Income tax (benefit) expense	(151)	71	11	(69)
Total other comprehensive (loss) income, net of income tax (benefit) expense	<u>\$(157)</u>	<u>\$127</u>	<u>\$66</u>	<u>\$36</u>
Nine months ended September 30, 2014				
Unrealized change arising during the period	\$724	\$ -	\$(245)	\$479
Less: Reclassification adjustments included in consolidated net income	(136)	(69)	-	(205)
Total other comprehensive income (loss), before income tax expense (benefit)	860	69	(245)	684
Less: Income tax expense (benefit)	336	24	(29)	331
Total other comprehensive income (loss), net of income tax expense(benefit)	<u>\$524</u>	<u>\$45</u>	<u>\$(216)</u>	<u>\$353</u>
Nine months ended September, 2013				
Unrealized change arising during the period	\$(2,420)	\$154	\$(57)	\$(2,323)
Less: Reclassification adjustments included in consolidated net income	(23)	(140)	-	(163)
Total other comprehensive (loss) income, before income tax (benefit) expense	(2,397)	294	(57)	(2,160)
Less: Income tax (benefit) expense	(841)	105	(3)	(739)
Total other comprehensive (loss) income, net of income tax (benefit) expense	<u>\$(1,556)</u>	<u>\$189</u>	<u>\$(54)</u>	<u>\$(1,421)</u>

(2) ACQUISITIONS AND DISPOSITIONS

In December 2013, Liberty UK and Europe Holdings Limited (“Liberty UK”) purchased 99,000,000 ordinary shares representing the remaining 49% non-controlling interest in Liberty Mutual Ireland Investment Holdings Limited (“Ireland Holdings”) from an affiliate of Irish Bank Resolution Corporation Limited (in Special Liquidation). In November 2011, Ireland Holdings, through its subsidiary, Liberty Insurance Limited, acquired certain of the assets and assumed certain of the liabilities of Quinn Insurance Limited (“QIL”) related to QIL’s marketing and underwriting of insurance policies in the Republic of Ireland, representing a 51% controlling interest. As a result of these actions, Liberty UK owns 100% of Ireland Holdings.

On January 9, 2014, the Company announced the sale of Summit Holdings Southeast, Inc. and its related companies (“Summit”), a Business Insurance mono-line workers compensation company based in Florida, to American Financial Group. The transaction closed on April 1, 2014. Accordingly, for the nine months ended September 30, 2014 and for all prior periods, the results of Summit have been classified as discontinued operations in the consolidated statements of income.

The following table details the major assets and liabilities related to Summit, included in the consolidated balance sheet:

	<u>September 30, 2014</u>	<u>December 31, 2013</u>
Assets:		
Cash and investments	\$ -	\$1,208
Reinsurance recoverables	-	116
Goodwill and intangibles	-	42
DAC and other assets	-	90
Total assets	<u>\$ -</u>	<u>\$1,456</u>
Liabilities:		
Unpaid claims and claims adjustment expenses	\$ -	\$1,133
Other liabilities	-	92
Total liabilities	<u>\$ -</u>	<u>\$1,225</u>

Liberty Mutual Holding Company Inc.

Notes to Consolidated Financial Statements

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(Unaudited)

The table below shows the discontinued operating results related to Summit:

	Nine Months Ended September	
	30,	
	2014	2013
Total revenues	\$148	\$464
Income from operations of Summit (net of income tax expense of \$22 and \$14 in 2014 and 2013)	\$13	\$25

On February 21, 2014, Liberty International Argentina Holdings S.A. (“LIAAR”) and Liberty Risk Services Argentina S.A. (“LRSAR”) were sold by Liberty International Latin America Holdings LLC (“LILAH”) and Liberty UK and Europe Holdings Limited (“LITBUK”) to LAFO S LLC and LAFT S LLC., resulting in a net loss of \$77. The results of LIAAR, LRSAR and their two Argentina subsidiaries, Liberty Seguros Argentina S.A. and Liberty Compania Argentina de Reaseguros Sociedad Anonima, are presented as Discontinued Operations on the accompanying Consolidated Statements of Income. All prior periods have been restated to reflect the sale.

On June 12, 2014, the Company announced its plans to acquire Hughes Insurance (“Hughes Insurance Agreement”), an independent insurance broker in Northern Ireland, for approximately \$73. This transaction is expected to close on or about July 1, 2015. The Company’s subsidiary in Ireland has agreed to become the primary underwriter of Hughes Insurance in Northern Ireland.

On July 8, 2014, the Company acquired Mexican surety company Primero Finanzas from Grupo Valores Operativos Monterray, a private investor group. The parties have not disclosed the financial terms of the transaction. Primero Finanzas had approximately \$33 of gross written premium in 2013.

On July 16, 2014, the Company completed the acquisition of Uni.Asia Capital Sdn Bhd’s 68.09% stake in Uni.Asia General Insurance Berhad (“UniAsia”) for approximately \$118. On September 8, 2014 the Company purchased 18,679,881 ordinary shares representing an additional 18.68% stake in UniAsia through a mandatory tender offer for approximately \$32. As a result of these actions, the Company now owns 86.77% of Uni.Asia.

(3) INVESTMENTS

The amortized cost, gross unrealized gains and losses and fair values of available for sale investments as of September 30, 2014 and December 31, 2013, are as follows:

September 30, 2014	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. government and agency securities	\$2,962	\$174	\$(18)	\$3,118
Residential MBS ⁽¹⁾	7,898	271	(48)	8,121
Commercial MBS	1,489	24	(16)	1,497
Other MBS and ABS ⁽²⁾	2,631	67	(27)	2,671
U.S. state and municipal	13,085	880	(50)	13,915
Corporate and other	26,577	1,543	(127)	27,993
Foreign government securities	5,833	255	(47)	6,041
Total fixed maturities	60,475	3,214	(333)	63,356
Common stock	2,213	597	(62)	2,748
Preferred stock	392	20	(55)	357
Total equity securities	2,605	617	(117)	3,105
Total securities available for sale	\$63,080	\$3,831	\$(450)	\$66,461

⁽¹⁾ Mortgage-backed securities (“MBS”)

⁽²⁾ Asset-backed securities (“ABS”)

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(Unaudited)

December 31, 2013	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. government and agency securities	\$2,948	\$161	\$(28)	\$3,081
Residential MBS	8,404	272	(102)	8,574
Commercial MBS	1,729	22	(34)	1,717
Other MBS and ABS	2,291	63	(48)	2,306
U.S. state and municipal	13,964	680	(283)	14,361
Corporate and other	26,475	1,263	(354)	27,384
Foreign government securities	6,635	270	(72)	6,833
Total fixed maturities	<u>62,446</u>	<u>2,731</u>	<u>(921)</u>	<u>64,256</u>
Common stock	2,122	524	(21)	2,625
Preferred stock	386	18	(77)	327
Total equity securities	<u>2,508</u>	<u>542</u>	<u>(98)</u>	<u>2,952</u>
Total securities available for sale	<u><u>\$64,954</u></u>	<u><u>\$3,273</u></u>	<u><u>\$(1,019)</u></u>	<u><u>\$67,208</u></u>

Of the \$2,748 and \$2,625 of common stock as of September 30, 2014 and December 31, 2013, respectively, \$431 and \$397, respectively, related to securities associated with non-guaranteed unit linked products where the policyholder bears the investment risk.

The fair value of fixed maturities as of September 30, 2014 and December 31, 2013, by contractual maturity are as follows:

	As of September 30, 2014	As of December 31, 2013
Due to mature:		
One year or less	\$3,520	\$3,521
Over one year through five years	17,926	19,107
Over five years through ten years	17,029	17,331
Over ten years	12,592	11,700
MBS and ABS of government and corporate agencies	12,289	12,597
Total fixed maturities	<u><u>\$63,356</u></u>	<u><u>\$64,256</u></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. Due to the potential for prepayment on MBS and ABS, they are not categorized by contractual maturity.

The following table summarizes the Company's gross realized gains and losses by asset type for the three and nine months ended September 30, 2014 and 2013, respectively:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
<i>Components of Net Realized (Losses) Gains</i>				
Fixed maturities:				
Gross realized gains	\$31	\$46	\$127	\$137
Gross realized losses	(6)	(51)	(319)	(329)
Equities:				
Gross realized gains	27	146	95	218
Gross realized losses	(22)	(26)	(34)	(41)
Other:				
Gross realized gains	5	15	47	39
Gross realized losses	(68)	(50)	(108)	(78)
Total net realized (losses) gains	<u><u>\$(33)</u></u>	<u><u>\$80</u></u>	<u><u>\$(192)</u></u>	<u><u>\$(54)</u></u>

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(dollars in millions)

(Unaudited)

The following table summarizes the gross unrealized losses and fair value of fixed income and equity securities by the length of time that individual securities have been in a continuous unrealized loss position as of September 30, 2014 and that are not deemed to be other-than-temporarily impaired:

September 30, 2014	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	\$(2)	\$488	\$(16)	\$700
Residential MBS	(7)	1,075	(41)	1,386
Commercial MBS	(1)	108	(15)	470
Other MBS and ABS	(1)	153	(26)	832
U.S. state and municipal	(8)	569	(42)	973
Corporate and other	(48)	3,935	(79)	2,195
Foreign government securities	(19)	956	(28)	852
Total fixed maturities	(86)	7,284	(247)	7,408
Common stock	(53)	550	(9)	54
Preferred stock	-	-	(55)	253
Total equities	(53)	550	(64)	307
Total	\$(139)	\$7,834	\$(311)	\$7,715

Unrealized losses decreased from \$1,019 as of December 31, 2013 to \$450 as of September 30, 2014 primarily related to a decrease in treasury yields and spread tightening. Unrealized losses less than 12 months decreased from \$755 at December 31, 2013 to \$139 as of September 30, 2014. Unrealized losses 12 months or longer increased from \$264 as of December 31, 2013 to \$311 as of September 30, 2014. Of the \$9 unrealized losses 12 months or longer on common stock, \$3 relates to securities associated with non-guaranteed unit linked products where the policyholder bears the investment risk. As of September 30, 2014, there were 1,170 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. 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 maturity securities before they recover their fair value.

If the Company believes a decline in the value (including foreign exchange devaluation adjustments) of a particular investment is temporary, the decline is recorded as an unrealized loss in policyholders' equity. If the decline is believed to be other-than-temporary, and the Company believes that it will not be able to collect all cash flows due on its fixed maturity securities, then the carrying value of the investment is written down to the expected cash flow amount and a realized loss is recorded as a credit impairment. A non-credit impairment loss is recognized in other comprehensive income, net of applicable taxes, as the difference between expected cash flows and fair value. For the three and nine months ended September 30, 2014, the Company recorded \$1 and \$258, respectively, of fixed maturity impairment losses. Fixed maturity impairment losses for the nine months ended are primarily driven by the Company's decision to treat the Venezuela devaluation as an other-than-temporary impairment. The Company has concluded that the remaining gross unrealized losses of fixed maturity securities as of September 30, 2014 are temporary.

For equity securities, if the decline is believed to be other-than-temporary, the carrying value of the investment is written down to fair value and a realized loss is recorded. The gross unrealized losses recorded on equity securities at September 30, 2014 resulted primarily from decreases in quoted fair values from the dates that certain investment securities were acquired as opposed to fundamental changes in the issuer's financial performance and near-term financial prospects. For the three and nine months ended September 30, 2014, the Company recorded \$6 and \$9, respectively, in impairment losses on equity securities. The Company has concluded that the gross unrealized losses of equity securities as of September 30, 2014 are temporary.

The Company reviews fixed maturity, public equity securities and private equity 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: (a) the extent of the decline in fair value below book value, (b) the duration of the decline, (c) significant adverse changes in the financial condition or near term prospects of the investment or issuer, (d) significant change in the business climate or credit ratings of the issuer, (e) general market conditions and volatility, (f) industry factors, and (g) 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 fixed maturity 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 for credit versus non-credit other-than-temporary impairment include the following: (a) failure of the issuer of the security to make

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scheduled interest or principal payments (including the payment structure of the fixed maturity security and the likelihood the issuer will be able to make payments that increase in the future), (b) performance indicators of the underlying assets in the security (including default and delinquency rates), (c) vintage, (d) geographic concentration, (e) impact of foreign exchange rates on foreign currency denominated securities and (f) industry analyst reports, sector credit ratings, and volatility of the security's fair value. In addition, the Company's accounting policy for other-than-temporary impairment recognition requires an other-than-temporary impairment charge be recorded when it is determined the security will be sold or it is more likely than not that the Company will be required to sell the security before recovery of the security's amortized cost basis (all fixed maturity securities and certain preferred equity securities) or the Company does not have the 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.

Variable Interest Entities

The Company invests in limited partnerships and other entities subject to variable interest entity ("VIE") analysis under the VIE subsections of Accounting Standards Codification ("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 September 30, 2014, the Company has determined that it is the primary beneficiary of one VIE in the low-income housing tax credit 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 as of September 30, 2014 and December 31, 2013 were 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*. These 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 a majority, of this variability. The net carrying value of non-consolidated VIEs in which the Company has a significant variable interest was \$312 and \$212 as of September 30, 2014 and December 31, 2013, respectively, and the Company's maximum exposure to loss was \$622 and \$242 as of September 30, 2014 and December 31, 2013, respectively. 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 VIEs. There is no recourse provision to the general credit of the Company for any VIEs beyond the full amount of the Company's loss exposure.

(4) 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. 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 reported reinsurance recoverables of \$14,226 and \$11,786 as of September 30, 2014 and December 31, 2013, respectively, net of allowance for doubtful accounts of \$150 and \$163, respectively. The increase in reinsurance recoverables is primarily due to the retroactive reinsurance agreement with National Indemnity Company ("NICO") (see below for additional details). Included in these balances are \$653 and \$607 of paid recoverables and \$13,723 and \$11,342 of unpaid recoverables, respectively.

As part of its reinsurance security oversight, the Company has established a Credit Risk 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 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.

On July 17, 2014, Liberty Mutual Insurance Company ("LMIC") entered into a reinsurance agreement with NICO, a subsidiary of Berkshire Hathaway Inc., on a combined aggregate adverse development cover for substantially all of the Company's U.S. workers compensation, asbestos and environmental liabilities (the "NICO Reinsurance Transaction"), attaching at \$12,522 of combined aggregate reserves, with an aggregate limit of \$6,500 and sublimits of \$3,100 for asbestos and environmental ("A&E") liabilities and \$4,507 for certain workers compensation ("WC")

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liabilities. At the closing of the NICO Reinsurance Transaction, but effective as of January 1, 2014, the Company ceded \$3,320 of existing liabilities under this retroactive reinsurance agreement. NICO will provide \$3,180 of additional aggregate adverse development cover. The Company paid NICO total consideration of \$3,046, and recorded a pre-tax loss of \$128.

In general terms, the covered business includes post December 31, 2013 development on: (1) A&E liabilities arising under policies of insurance and reinsurance with effective dates prior to January 1, 2005; and (2) WC liabilities arising out of policies on the books of the Company's Commercial Insurance SBU as of December 31, 2013, as respects injuries or accidents occurring prior to January 1, 2014.

The following table displays the impact of the NICO Reinsurance Transaction on the accompanying consolidated statements of income:

Nine months ended September 30, 2014

A&E (favorable)/unfavorable development before consideration of NICO Reinsurance Transaction	<u>\$ 110</u>
WC (favorable)/unfavorable development before consideration of NICO Reinsurance Transaction	<u>(25)</u>
Total additional amounts ceded under NICO Reinsurance Transaction	85
Retroactive reinsurance benefits recognized into income	<u>(85)</u>
Pretax impact of unrecognized deferred retroactive reinsurance benefit	<u>\$ -</u>

During 2014, the Company recorded \$85 of net A&E and WC adverse development. As a result of the NICO Reinsurance Transaction, the Company was able to recognize the full \$85 as a benefit to income. Once the aggregate of WC and A&E development exceeds the original pre-tax loss of \$128, deferred gains will be recorded. Deferred gains are subsequently recognized into earnings as if the revised estimate was available at the inception date of the NICO Reinsurance Transaction.

The Company has an aggregate stop loss program covering substantially all of Commercial Insurance's voluntary workers compensation business from the fourth quarter 2000 through the fourth quarter 2002 accident year periods. A significant portion of the consideration was retained on a "funds held" basis and interest is credited on the balance at an average rate of 8.5% annually. Under the contract, 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.

During 2013, the Company commuted four workers compensation excess of loss retroactive reinsurance agreements. The commutations, which represent the complete and final settlement and discharge of all the present and future obligations between the parties arising out of the agreements, resulted in a gain to the Company of \$227, net of tax.

The above aggregate stop loss program and the four commuted reinsurance agreements resulted in deferred gains that are amortized into income using the effective interest method over the estimated settlement period. As of September 30, 2014 and December 31, 2013, deferred gains were \$8 and \$8, respectively, and are included in other liabilities within the accompanying consolidated balance sheets. Interest credited to the funds held balances for the three and nine months ended September 30, 2014 was \$1 and \$2, respectively, as compared to \$21 and \$63 for the three and nine months ended September 30, 2013, respectively. Deferred gain amortization was \$1 and \$2 for the three and nine months ended September 30, 2014, respectively, as compared to \$159 and \$178 for the three and nine months ended September 30, 2013, respectively. Reinsurance recoverables related to these transactions were \$68 and \$72 as of September 30, 2014 and December 31, 2013, respectively.

On March 6, 2012, the Company entered into two multi-year property catastrophe reinsurance agreements with Mystic Re III Ltd. ("Mystic III"), a Cayman Islands domiciled reinsurer, to provide a total of \$275 of reinsurance coverage for the Company and its affiliates for a U.S. hurricane or earthquake event. The reinsurance agreements are collateralized. Such collateral is provided by Mystic III using proceeds from the issuance of certain catastrophe bonds. The reinsurance agreements provide coverage based on actual reported losses by the Company and its affiliates. The Company has not recorded any recoveries under this program. Mystic III does not have any other reinsurance in force.

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(5) DEBT OUTSTANDING

Debt outstanding as of September 30, 2014 and December 31, 2013 includes the following:

Current maturities of long-term debt:

	2014	2013
Current maturities of long-term debt	\$47	\$343

Long-term debt:

	2014	2013
5.588% Mortgage Loan due 2015	\$ -	\$47
6.70% Notes, due 2016	249	249
7.00% Junior Subordinated Notes, due 2067 ⁽¹⁾	300	300
5.00% Notes, due 2021	600	600
4.95% Notes, due 2022	750	750
4.25% Notes, due 2023	1,000	1,000
8.50% Surplus Notes, due 2025	140	140
7.875% Surplus Notes, due 2026	227	227
7.625% Notes, due 2028	3	3
3.91% - 4.25% Federal Home Loan Bank Borrowings due 2032	300	300
7.00% Notes, due 2034	231	231
6.50% Notes, due 2035	471	471
7.50% Notes, due 2036	19	19
7.80% Junior Subordinated Notes, due 2087 ⁽²⁾	700	700
10.75% Junior Subordinated Notes, due 2088 ⁽³⁾	204	255
6.50% Notes, due 2042	750	750
4.85% Notes, due 2044	750	-
7.697% Surplus Notes, due 2097	260	260
	6,954	6,302
Unamortized discount	(15)	(17)
Total long-term debt	\$6,939	\$6,285

⁽¹⁾ The par value call date and final fixed rate interest payment date is March 15, 2017, subject to certain requirements.

⁽²⁾ The par value call date and final fixed rate interest payment date is March 15, 2037, subject to certain requirements.

⁽³⁾ The par value call date and final fixed rate interest payment date is June 15, 2038, subject to certain requirements.

Debt Transactions and In-Force Credit Facilities

During the three and nine months ended September 30, 2014, the Company repurchased \$51 of the 10.75% Junior Subordinated notes due 2088 compared to repurchases of \$164 and \$268, respectively, in 2013. Pre-tax losses of \$29 were recorded on these transactions for the three and nine months ended September 30, 2014 compared to pre-tax losses of \$96 and \$156, respectively, in 2013 and are included in loss on extinguishment of debt in the accompanying consolidated statements of income.

On July 24, 2014, Liberty Mutual Group Inc. (“LMGI”) issued \$750 of Senior Notes due 2044 (the “2044 Notes”). Interest is payable semi-annually at a fixed rate of 4.85%. The 2044 Notes mature on August 1, 2044.

On July 1, 2014, LMIC entered into a one-year renewable \$1,000 repurchase agreement which terminates on July 2, 2015 unless renewed. To date, no funds have been borrowed under the facility.

On December 9, 2013, LMGI’s five-year \$750 unsecured revolving credit facility was amended and restated to extend to December 10, 2018. This facility backs the Company’s \$750 commercial paper program that is guaranteed by LMIC. As of September 30, 2014, there was no commercial paper or borrowings outstanding on the facility.

On June 18, 2013 and November 5, 2013, LMGI issued \$600 and \$400 of Senior Notes due 2023 (the “2023 Notes”), respectively. Interest is payable semi-annually at a fixed rate of 4.25%. The 2023 Notes mature on June 15, 2023.

On December 20, 2012, LMIC entered into a three-year \$1,000 repurchase agreement which terminates on December 20, 2015. As of September 30, 2014, there are no borrowings outstanding on the facility.

LMIC, Peerless Insurance Company (“PIC”), Liberty Life Assurance Company of Boston (“LLAC”), Liberty Mutual Fire Insurance Company (“LMFIC”), and Employers Insurance Company of Wausau (“EICOW”) are members of the Federal Home Loan Bank. On March 21, 2012,

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LMFIC borrowed \$150 at a rate of 3.91% with a maturity date of March 22, 2032. On March 23, 2012 and April 2, 2012, LMIC borrowed \$127 at a rate of 4.24% with a maturity date of March 23, 2032 and \$23 at a rate of 4.25% with a maturity date of April 2, 2032, respectively. As of September 30, 2014, all of the outstanding Federal Home Loan Bank borrowings are fully collateralized.

On January 20, 2012, LMGI entered into two interest rate swap transactions having a notional amount of \$300 with respect to LMGI's \$300 7.00% Junior Subordinated Notes due 2067. Pursuant to the terms of the swap agreements, commencing on March 15, 2017 and effective through March 15, 2037, LMGI has agreed with the counterparties to pay a fixed rate of interest on the notional amount and the counterparties have agreed to pay a floating rate of interest on the notional amount.

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.

(6) ASBESTOS AND ENVIRONMENTAL

The Company's asbestos and environmental reserves for unpaid claims and claim adjustment expenses, net of reinsurance before NICO and including uncollectible reinsurance, were \$1,282 and \$1,329 as of September 30, 2014 and December 31, 2013, respectively.

In the third quarter of 2014, the Company completed asbestos ground-up and aggregate environmental reserve studies. These studies were completed by a multi-disciplinary team of internal claims, legal, reinsurance and actuarial personnel, and included all major business segments of the Company's direct, assumed, and ceded asbestos and environmental unpaid claim liabilities. As part of the internal review, policyholders with the largest direct asbestos unpaid claim liabilities were individually evaluated using the Company's proprietary stochastic ground-up model, which is consistent with published actuarial methods of 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, injury type, jurisdiction and legal defenses. Reinsurance recoveries for these policyholders were then separately evaluated by the Company's reinsurance and actuarial personnel. Asbestos and environmental unpaid claim liabilities for all other policyholders were evaluated using aggregate methods that utilized information and experience specific to these policyholders. The studies resulted in an increase to reserves of \$111M including: \$83M of asbestos reserves, primarily associated with increased defense costs; and \$28M of pollution reserves. (See "Note (4) Reinsurance" for impact of NICO Reinsurance Transaction)

(7) INCOME TAXES

The income tax provision is calculated under the liability method of accounting. 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 bases 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.

The Company's effective tax rate on continuing operations differs from the U.S. Federal statutory rate of 35% principally due to tax-exempt investment income, general business credits, \$60M tax benefit recorded as a result of settling the IRS exam for the 2002-2005 tax years, and lower foreign tax benefits. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

Balance as of December 31, 2013	\$298
Additions for tax positions in current year	3
Additions for tax positions of prior years	48
Reductions for tax positions of prior years	(114)
Settlements	(22)
Translation	(1)
Balance as of September 30, 2014	<u>\$212</u>

Included in the tabular roll forward of unrecognized tax benefits are interest and penalties in the amount of \$55 and \$93 as of September 30, 2014 and December 31, 2013, respectively.

Included in the balance at September 30, 2014 is \$98 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 three months ended September 30, 2014 and 2013, the Company recognized \$(43) and zero of interest and penalties, respectively. For the nine

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months ended September 30, 2014 and 2013, the Company recognized \$(35) and \$5 of interest and penalties, respectively. The Company had \$61 and \$95 of interest and penalties accrued as of September 30, 2014 and December 31, 2013, respectively.

The IRS has completed its review of the Company's United States Federal income tax returns through the 2005 tax year and is currently reviewing income tax returns for the 2006 through 2011 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.

(8) BENEFIT PLANS

The net benefit costs for the three months ended September 30, 2014 and 2013, include the following components:

Three months ended September 30,	Pension Benefits		Supplemental Pension Benefits ⁽¹⁾		Postretirement Benefits	
	2014	2013	2014	2013	2014	2013
Components of net periodic benefit costs:						
Service costs	\$27	\$42	\$-	\$2	\$4	\$6
Interest costs	78	72	5	4	10	10
Expected return on plan assets	(96)	(87)	-	-	-	-
Amortization of unrecognized:						
Net loss	19	39	4	5	-	1
Prior service cost	(1)	-	-	-	(3)	(2)
Net periodic benefit costs	\$27	\$66	\$9	\$11	\$11	\$15

⁽¹⁾ 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 net benefit costs for the nine months ended September 30, 2014 and 2013, include the following components:

Nine months ended September 30,	Pension Benefits		Supplemental Pension Benefits ⁽¹⁾		Postretirement Benefits	
	2014	2013	2014	2013	2014	2013
Components of net periodic benefit costs:						
Service costs	\$79	\$128	\$2	\$5	\$13	\$20
Interest costs	235	216	14	14	30	31
Expected return on plan assets	(289)	(261)	-	-	-	-
Amortization of unrecognized:						
Net loss (gain)	57	116	12	15	(1)	4
Prior service cost	(2)	(1)	(1)	(1)	(8)	(3)
Net periodic benefit costs	\$80	\$198	\$27	\$33	\$34	\$52

⁽¹⁾ 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 has contributed \$458 to the qualified plans as of September 30, 2014 and expects to additionally contribute approximately \$1.

(9) 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.

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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 estimates of the assumptions that market participants would use in valuing the assets and liabilities.

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 is responsible for the determination of fair value and the supporting assumptions and methodologies. The Company gains assurance on the overall reasonableness and consistent application of valuation methodologies and inputs and compliance with accounting standards through the execution of various processes and controls designed to ensure that the Company's assets and liabilities are appropriately valued. For fair values received from third parties or internally estimated, the Company's processes are designed to determine that the valuation methodologies and inputs are appropriate and consistently applied, the assumptions are reasonable and consistent with the objective of determining fair value, and the fair values are accurately recorded. For example, on a continuing basis, the Company assesses the reasonableness of individual fair values that have stale security prices or that exceed certain thresholds as compared to previous fair values received from valuation service providers or brokers or derived from internal models. The Company performs procedures to understand and assess the methodologies, processes and controls of valuation service providers. In addition, the Company may validate the reasonableness of fair values by comparing information obtained from valuation service providers or brokers to other third party valuation sources for selected securities.

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 is 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.

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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.

Municipals

The Company's municipal portfolio is comprised of 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 include bonds issued or guaranteed by foreign governments. 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.

Short-Term Investments

The fair value of short-term investments 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 short-term investments is primarily classified within Level 2 of the fair value hierarchy.

Other Investments

Other investments include primarily foreign cash deposits and equity investments in privately held businesses. 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 table in this note.

Separate Account Assets

Separate account assets, which primarily consist of other limited partnerships 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. Separate account assets within Level 3 include other limited partnership interests. Other limited partnership interests are valued giving consideration to the value of the underlying holdings of the partnerships.

Other Assets and Other Liabilities

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.

Additionally, other assets and other liabilities classified within Level 2 represent the Company's derivatives which can be exchange-traded or traded over-the-counter ("OTC"). The Company generally values exchange-traded derivatives such as futures and options using quoted prices in active markets for identical derivatives at the balance sheet date.

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OTC derivatives are valued using market transactions and other market evidence whenever possible, including market-based inputs to models, model calibration to market clearing transactions, broker or dealer quotations or alternative pricing sources with reasonable levels of price transparency. When models are used, the selection of a particular model to value an OTC derivative depends on the contractual terms of, and specific risks inherent in the instrument, as well as the availability of pricing information in the market. The Company generally uses similar models to value similar instruments. Valuation models require a variety of inputs, including contractual terms, market prices and rates, yield curves, credit curves, measures of volatility, prepayment rates and correlations of such inputs. For OTC derivatives that trade in liquid markets, such as generic forwards, swaps and options, model inputs can generally be corroborated by observable market data by correlation or other means, and model selection does not involve significant management judgment.

Life Insurance Obligations

Life insurance obligations include certain variable annuity contracts that provide guaranteed minimum income benefits. These benefits are accounted for as embedded derivatives and are bifurcated from the host contract and carried at fair value. The fair value of 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. The significant policyholder behavior assumptions include lapse and the underlying take-up rate with regard to annuitization.

The following tables summarize the Company's assets and liabilities that are measured at fair value on a recurring basis as of September 30, 2014 and December 31, 2013:

	As of September 30, 2014			
	Level 1	Level 2	Level 3	Total
<i>Assets, at Fair Value</i>				
U.S. government and agency securities	\$2,354	\$741	\$23	\$3,118
Residential MBS	-	8,086	35	8,121
Commercial MBS	-	1,422	75	1,497
Other MBS and ABS	-	2,631	40	2,671
U.S. state and municipal	-	13,732	183	13,915
Corporate and other	-	27,668	325	27,993
Foreign government securities	-	5,520	521	6,041
Total fixed maturities, available for sale	<u>2,354</u>	<u>59,800</u>	<u>1,202</u>	<u>63,356</u>
Common stock	2,703	-	45	2,748
Preferred stock	-	355	2	357
Total equity securities, available for sale	<u>2,703</u>	<u>355</u>	<u>47</u>	<u>3,105</u>
Short-term investments	-	555	1	556
Other investments	-	465	127	592
Separate account assets	33	-	75	108
Other assets	5	35	24	64
Total assets	<u>\$5,095</u>	<u>\$61,210</u>	<u>\$1,476</u>	<u>\$67,781</u>
<i>Liabilities, at Fair Value</i>				
Life insurance obligations	\$ -	\$ -	\$(145)	\$(145)
Total liabilities	<u>\$ -</u>	<u>\$ -</u>	<u>\$(145)</u>	<u>\$(145)</u>

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<i>Assets, at Fair Value</i>	As of December 31, 2013			
	Level 1	Level 2	Level 3	Total
U.S. government and agency securities	\$2,279	\$778	\$24	\$3,081
Residential MBS	-	8,563	11	8,574
Commercial MBS	-	1,619	98	1,717
Other MBS and ABS	-	2,276	30	2,306
U.S. state and municipal	-	14,237	124	14,361
Corporate and other	-	26,984	400	27,384
Foreign government securities	-	5,931	902	6,833
Total fixed maturities, available for sale	2,279	60,388	1,589	64,256
Common stock	2,580	-	45	2,625
Preferred stock	-	325	2	327
Total equity securities, available for sale	2,580	325	47	2,952
Short-term investments	-	388	5	393
Other investments	-	139	316	455
Separate account assets	41	-	68	109
Other assets	6	72	19	97
Total assets	\$4,906	\$61,312	\$2,044	\$68,262
<i>Liabilities, at Fair Value</i>				
Life insurance obligations	\$ -	\$ -	\$(122)	\$(122)
Total liabilities	\$ -	\$ -	\$(122)	\$(122)

The Company did not have significant transfers between Levels 1 and 2 for the nine months ended September 30, 2014.

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

<i>Assets, at Fair Value</i>	Balance January 1, 2014	Net Realized Gains (Losses)	Net Unrealized Gains (Losses)	Purchases	Settlements	Sales and Maturities	Transfer in to Level 3	Transfer out of Level 3	Balance September 30, 2014
U.S. government and agency securities	\$24	\$ -	\$ -	\$ -	\$ -	\$(1)	\$ -	\$ -	\$23
Residential MBS	11	-	-	38	-	-	-	(14)	35
Commercial MBS	98	-	4	30	-	(2)	24	(79)	75
Other MBS and ABS	30	-	1	88	-	(2)	-	(77)	40
U.S. state and municipal	124	-	9	51	-	(3)	27	(25)	183
Corporate and other	400	2	6	83	-	(138)	4	(32)	325
Foreign government securities	902	(255)	(183)	87	-	(22)	-	(8)	521
Total fixed maturities	1,589	(253)	(163)	377	-	(168)	55	(235)	1,202
Common stock	45	-	-	6	-	(1)	1	(6)	45
Preferred stock	2	-	-	-	-	-	-	-	2
Total equity securities	47	-	-	6	-	(1)	1	(6)	47
Short-term investments	5	-	-	1	-	(5)	-	-	1
Other investments	316	(6)	29	14	-	(5)	-	(221)	127
Separate account assets	68	-	-	-	-	-	7	-	75
Other assets	19	7	-	(2)	-	-	-	-	24
Total assets	\$2,044	\$(252)	\$(134)	\$396	\$ -	\$(179)	\$63	\$(462)	\$1,476
<i>Liabilities, at Fair Value</i>									
Life insurance obligations	\$(122)	\$(34)	\$ -	\$ -	\$11	\$ -	\$ -	\$ -	\$(145)
Total liabilities	\$(122)	\$(34)	\$ -	\$ -	\$11	\$ -	\$ -	\$ -	\$(145)

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(dollars in millions)

(Unaudited)

	Balance January 1, 2013	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, 2013
Assets, at Fair Value									
U.S. government and agency securities	\$10	\$ -	\$(1)	\$15	\$ -	\$ -	\$ -	\$ -	\$24
Residential MBS	45	-	(5)	706	-	(1)	1	(735)	11
Commercial MBS	-	-	-	139	-	(8)	-	(33)	98
Other MBS and ABS	42	-	1	35	-	(2)	-	(46)	30
U.S. state and municipal	38	-	(4)	95	-	(4)	6	(7)	124
Corporate and other	673	7	(32)	301	-	(402)	35	(182)	400
Foreign government securities	807	(182)	5	310	-	(29)	-	(9)	902
Total fixed maturities	1,615	(175)	(36)	1,601	-	(446)	42	(1,012)	1,589
Common stock	43	5	(1)	5	-	(8)	1	-	45
Preferred stock	17	2	(1)	-	-	(22)	6	-	2
Total equity securities	60	7	(2)	5	-	(30)	7	-	47
Short-term investments	5	(1)	(5)	19	-	(4)	-	(9)	5
Other investments	131	(9)	(26)	231	-	(11)	-	-	316
Separate account assets	65	(1)	-	8	-	(4)	-	-	68
Other assets	31	(9)	-	1	(4)	-	-	-	19
Total assets	\$1,907	\$(188)	\$(69)	\$1,865	\$(4)	\$(495)	\$49	\$(1,021)	\$2,044
Liabilities, at Fair Value									
Life insurance obligations	\$(206)	\$62	\$ -	\$ -	\$22	\$ -	\$ -	\$ -	\$(122)
Total liabilities	\$(206)	\$62	\$ -	\$ -	\$22	\$ -	\$ -	\$ -	\$(122)

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

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 September 30, 2014.

For the nine months ended September 30, 2014, there were impairments of \$128 recognized for items measured at fair value on a nonrecurring basis.

The Company has not applied ASC 820, *Fair Value Measurements and Disclosures*, to non-financial assets and liabilities.

(10) 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 has been in coverage litigation with Kentile Floors, Inc. ("Kentile"), a former manufacturer of floor tile products, some of which contained asbestos, since 2008. 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." On November 9, 2012, Metex filed for bankruptcy protection under Chapter 11 in the U.S. Bankruptcy Court for the Southern District of New York, staying all coverage litigation with LMIC and all other insurance carriers.

Prior to the 2012 bankruptcy filing, Metex reached agreements with each of Kentile's insurance carriers. On June 19, 2014, the Bankruptcy Court confirmed Metex's proposed Plan of Reorganization, under which each of the insurance settlements is approved. On August 1, 2014, the Federal District Court affirmed the Kentile Confirmation Order issued by the Bankruptcy Court, and the Company's obligations with respect to Kentile became fully finalized as of September 3, 2014. The Company issued its first payment of \$34 to the bankruptcy trust on October 1, 2014; a final payment of \$25 is due no later than October 1, 2017.

As of September 30, 2014, the Company had unfunded commitments in traditional private equity partnerships, natural resources, real estate, and other of \$1,336, \$2,480 (\$2,451 in energy investments), \$343, and \$597, respectively.

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As of September 30, 2014, the Company had commitments to purchase various residential MBS at a cost and fair value of \$153, and various corporate and municipal securities at a cost and fair value of \$63.

(1) SUBSEQUENT EVENTS

On October 28, 2014, LMGI issued an additional \$300 par value of Senior Notes due 2044 (the "2044 Notes"). Interest is payable semi-annually at a fixed rate of 4.85%. The 2044 Notes mature on August 1, 2044.

Management has assessed material subsequent events through November 10, 2014, the date the financial statements were available to be issued.