



FINANCIAL STATEMENTS

Liberty Mutual Holding Company Inc.  
December 31, 2012 and 2011 and each of the  
Three Years in the Period Ended December 31, 2012

Ernst & Young LLP

 **ERNST & YOUNG**

## Report of Independent Registered Public Accounting Firm

The Board of Directors  
Liberty Mutual Holding Company Inc.

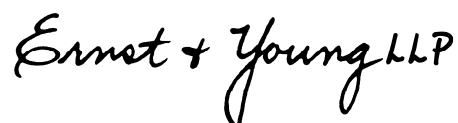
We have audited the accompanying consolidated balance sheets of Liberty Mutual Holding Company Inc. as of December 31, 2012 and 2011, and the related consolidated statements of income, comprehensive income, changes in total equity, and cash flows for each of the three years in the period ended December 31, 2012. 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, 2012 and 2011, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2012, in conformity with U.S. generally accepted accounting principles.

As discussed in Note (1) to the consolidated financial statements, in 2012 Liberty Mutual Holding Company Inc. changed its method of accounting for costs associated with acquiring or renewing insurance contracts.

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, 2012, 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 25, 2013 expressed an unqualified opinion thereon.



March 25, 2013



Liberty Mutual Group

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## 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, 2012, 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, 2012.

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, 2012, 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 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 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, 2012, 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 auditing standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Liberty Mutual Holding Company Inc. as of December 31, 2012 and 2011, and the consolidated statements of income, comprehensive income, changes in total equity, and cash flows for each of the three years in the period ended December 31, 2012 of Liberty Mutual Holding Company Inc. and our report dated March 25, 2013 expressed an unqualified opinion thereon.

*Ernst + Young LLP*

March 25, 2013

**Liberty Mutual Holding Company Inc.**

**Consolidated Statements of Income**

(dollars in millions)

	<b>Years Ended December 31,</b>		
	<b>2012</b>	<b>2011</b>	<b>2010</b>
<b>Revenues</b>			
Premiums earned	\$ 32,165	\$ 30,119	\$ 28,699
Net investment income	3,237	3,523	3,328
Fee and other revenues	1,008	871	764
Net realized gains	534	158	402
Total revenues	36,944	34,671	33,193
<b>Claims, Benefits and Expenses</b>			
Benefits, claims and claim adjustment expenses	24,716	24,145	20,933
Insurance operating costs and expenses	6,051	5,315	5,189
Amortization of deferred policy acquisition costs	4,272	4,133	4,035
Interest expense	419	439	456
Interest credited to policyholders	248	243	232
Total claims, benefits and expenses	35,706	34,275	30,845
Loss on extinguishment of debt	(193)	(110)	-
Realignment expense	(99)	-	-
Income before income tax expense (benefit) and non-controlling interest	946	286	2,348
Income tax expense (benefit)	90	(75)	647
Consolidated net income	856	361	1,701
Less: Net income attributable to non-controlling interest	27	3	6
Net income attributable to Liberty Mutual Holding Company Inc.	\$ 829	\$ 358	\$ 1,695
<b>Net Realized Gains</b>			
Other-than-temporary impairment losses:	<b>2012</b>	<b>2011</b>	<b>2010</b>
Total other-than-temporary impairment losses	\$ (110)	\$ (70)	\$ (55)
Change in portion of loss recognized in other comprehensive income	(5)	(9)	(1)
Other-than-temporary impairment losses	(115)	(79)	(56)
Other net realized gains	649	237	458
Net realized gains	\$ 534	\$ 158	\$ 402

See accompanying notes to the audited consolidated financial statements.

Liberty Mutual Holding Company Inc.

Consolidated Statements of Comprehensive Income

(dollars in millions)

	Years Ended December 31,		
	2012	2011	2010
Consolidated net income	\$ 856	\$ 361	\$ 1,701
Other comprehensive income, net of taxes:			
Unrealized gains on securities	925	90	184
Change in pension and post retirement plans funded status	(869)	(227)	560
Foreign currency translation and other adjustments	(6)	(181)	45
Other comprehensive income, net of taxes	<u>50</u>	<u>382</u>	<u>789</u>
Consolidated comprehensive income	906	743	2,490
Less: Comprehensive income (loss) attributable to non-controlling interest	50	(3)	5
Comprehensive income attributable to Liberty Mutual Holding Company Inc.	<u>\$ 856</u>	<u>\$ 746</u>	<u>\$ 2,485</u>

See accompanying notes to the audited consolidated financial statements.

**Liberty Mutual Holding Company Inc.**

**Consolidated Balance Sheets**

(dollars in millions)

	<u>December 31,</u> <u>2012</u>	<u>December 31,</u> <u>2011</u>
<b>Assets:</b>		
Investments		
Fixed maturities, available for sale, at fair value (amortized cost of \$59,366 and \$57,108)	\$ 64,094	\$ 60,576
Equity securities, available for sale, at fair value (cost of \$2,213 and \$1,942)	2,495	1,954
Short-term investments	208	201
Commercial mortgage loans	1,335	1,196
Other investments	4,444	3,789
Total investments	<u>72,576</u>	<u>67,716</u>
Cash and cash equivalents	5,484	5,972
Premium and other receivables	9,479	8,840
Reinsurance recoverables	13,232	13,272
Deferred income taxes	1,102	952
Deferred acquisition costs	2,732	2,391
Goodwill	4,850	4,766
Prepaid reinsurance premiums	1,475	1,518
Separate account assets	352	4,087
Other assets	8,778	7,337
Total assets	<u>\$ 120,060</u>	<u>\$ 116,851</u>
<b>Liabilities:</b>		
Unpaid claims and claim adjustment expenses and future policy benefits:		
Property and casualty	\$ 51,885	\$ 50,228
Life	7,758	7,139
Other policyholder funds and benefits payable	4,564	4,061
Unearned premiums	16,287	14,987
Funds held under reinsurance treaties	1,287	1,277
Current maturities of long-term debt	286	205
Long-term debt	5,990	5,341
Separate account liabilities	352	4,087
Other liabilities	13,126	11,927
Total liabilities	<u>101,535</u>	<u>99,252</u>
<b>Equity:</b>		
Unassigned equity	16,610	15,781
Accumulated other comprehensive income	1,707	1,680
Total policyholders' equity	<u>18,317</u>	<u>17,461</u>
Non-controlling interest	208	138
Total equity	<u>18,525</u>	<u>17,599</u>
Total liabilities and equity	<u>\$ 120,060</u>	<u>\$ 116,851</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	Total Policyholders' Equity	Non- Controlling Interest	Total Equity
<b>Balance, January 1, 2010</b>	\$ 14,014	\$ 500	\$ 14,514	\$ 1	\$ 14,515
Cumulative effect of adoption of ASU 2010-26 at January 1, 2010 (Note 1)	(286)	2	(284)	-	(284)
Comprehensive income					
Consolidated net income	1,695	-	1,695	6	1,701
Other comprehensive income (loss), net of taxes	-	790	790	(1)	789
Total comprehensive income			2,485	5	2,490
<b>Balance, December 31, 2010</b>	\$ 15,423	\$ 1,292	\$	6	\$ 16,721
Comprehensive income (loss)					
Consolidated net income	358	-	358	3	361
Other comprehensive income (loss), net of taxes	-	388	388	(6)	382
Total comprehensive income (loss)			746	(3)	743
Capital contributions from non-controlling interest	-	-	-	135	135
<b>Balance, December 31, 2011</b>	\$ 15,781	\$ 1,680	\$ 17,461	\$ 138	\$ 17,599
Comprehensive income					
Consolidated net income	829	-	829	27	856
Other comprehensive income, net of taxes	-	27	27	23	50
Total comprehensive income			856	50	906
Capital contributions from non-controlling interest	-	-	-	59	59
Dividends to non-controlling interest	-	-	-	(39)	(39)
<b>Balance, December 31, 2012</b>	\$ 16,610	\$ 1,707	\$ 18,317	\$ 208	\$ 18,525

See accompanying notes to the audited consolidated financial statements.

**Liberty Mutual Holding Company Inc.**

**Consolidated Statements of Cash Flows**

(dollars in millions)

	<b>Years Ended December 31,</b>		
	<b>2012</b>	<b>2011</b>	<b>2010</b>
<b>Cash flows from operating activities:</b>			
Consolidated net income	\$ 856	\$ 361	\$ 1,701
Adjustments to reconcile consolidated net income to net cash provided by operating activities:			
Depreciation and amortization	694	588	459
Realized gains	(534)	(158)	(402)
Undistributed private equity investment gains	(309)	(554)	(364)
Premium, other receivables, and reinsurance recoverables	(778)	(543)	(132)
Deferred acquisition costs	(327)	(139)	(190)
Liabilities for insurance reserves	3,508	3,157	1,124
Taxes payable, net of deferred	(91)	(284)	659
Other, net	(108)	(270)	(47)
Total adjustments	<u>2,055</u>	<u>1,797</u>	<u>1,107</u>
Net cash provided by operating activities	<u>2,911</u>	<u>2,158</u>	<u>2,808</u>
<b>Cash flows from investing activities:</b>			
Purchases of investments	(20,513)	(14,080)	(19,578)
Sales and maturities of investments	17,670	12,704	17,721
Property and equipment purchased, net	(849)	(682)	(507)
Cash (paid) acquired for acquisitions, net of cash on hand (paid)	(6)	1,125	-
Other investing activities	(56)	(194)	(40)
Net cash used in investing activities	<u>(3,754)</u>	<u>(1,127)</u>	<u>(2,404)</u>
<b>Cash flows from financing activities:</b>			
Net activity in policyholder accounts	311	226	147
Debt financing, net	532	(195)	(301)
Net security lending activity and other financing activities	(524)	77	50
Net cash provided by (used in) financing activities	<u>319</u>	<u>108</u>	<u>(104)</u>
Effect of exchange rate changes on cash	<u>36</u>	<u>(97)</u>	<u>(217)</u>
Net (decrease) increase in cash and cash equivalents	(488)	1,042	83
Cash and cash equivalents, beginning of year	5,972	4,930	4,847
Cash and cash equivalents, end of year	<u>\$ 5,484</u>	<u>\$ 5,972</u>	<u>\$ 4,930</u>
<b>Supplemental disclosure of cash flow information:</b>			
Income taxes paid (refund)	\$ 193	\$ 209	\$ (2)

See accompanying notes to the audited consolidated financial statements.

# LIBERTY MUTUAL HOLDING COMPANY INC

## Notes to Consolidated Financial Statements

(dollars in millions)

### (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 non-controlling interest. All material intercompany transactions and balances have been eliminated. Certain reclassifications have been made to the 2011 and 2010 consolidated financial statements to conform with the 2012 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, 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

On July 24, 2012, the Company announced the realignment of its four Strategic Business Units ("SBUs") into: Personal Insurance, Commercial Insurance, Liberty International and Global Specialty. A summary of each SBU follows:

The Company's Personal Insurance business unit, with \$14,530 of revenues in 2012, sells automobile, homeowners and other types of property and casualty insurance coverage, as well as life and annuity products, to individuals and insurance companies in the United States. Personal Insurance is comprised of two market segments: Personal Lines (including Individual Life) and independent agent distributions (under the Safeco Corporation ("Safeco") brand). Personal Lines products are distributed through licensed captive sales representatives, licensed telesales counselors, third-party producers (including banks for life products) and the Internet. Personal Lines' largest source of new business is through its sponsored affinity groups (including employers, professional and alumni associations, credit unions, and other partnerships). Safeco products are distributed nationally through independent agents.

The Company's Commercial Insurance business unit, with \$11,376 of revenues in 2012, offers a wide array of property-casualty and group benefits insurance coverages through independent agents, brokers and benefit consultants throughout the United States. Commercial Insurance is organized into the following four market segments: Business Insurance, National Insurance, Group Benefits, and Other Commercial Insurance. Business Insurance serves the small and middle market segments through a regional operating model that combines local underwriting, market knowledge and service orientation with the scale advantages of a national company. National Insurance provides commercial lines products and services, including third-party administration, to large businesses. Group Benefits provides mid-sized and large businesses with short- and long-term disability insurance products and group life insurance. Other Commercial Insurance primarily consists of internal reinsurance and assumed business from state based workers compensation involuntary market pools. Commercial Insurance is also a servicing carrier for state based workers compensation involuntary market pools.

The Company's Liberty International business unit, with \$6,019 of revenues in 2012, sells property, casualty, health and life insurance products and services to individuals and businesses in three geographic regions: Latin America, including Venezuela, Brazil, Colombia, Argentina (Liberty ART S.A., a workers compensation business, was sold in June 2012, Liberty Seguros Argentina S.A. remains), Chile and Ecuador (as a result of the Panamericana de Seguros del Ecuador S.A. and Cervantes S.A. Compania de Seguros y Reaseguros acquisitions in August 2012); Europe, including Spain, Portugal, Turkey, Poland, Ireland (as a result of the Quinn Insurance Limited ("QIL") acquisition in November 2011), United Kingdom (as a result of exercising the renewal rights option over the Great Britain and Northern Ireland portfolios of QIL) and Russia (as a result of the KIT Finance Insurance acquisition in March 2012); and Asia, including Thailand, Singapore, China (including Hong Kong) and Vietnam. Private passenger automobile insurance is the single largest line of business. See Note 2 for details regarding the acquisitions and dispositions noted above.

The Company's Global Specialty business unit, with \$4,607 of revenues in 2012, is composed of a wide array of products and services offered through three market segments: Liberty International Underwriters ("LIU"), Liberty Mutual Surety ("LMS"), and Liberty Mutual Reinsurance ("LMR"). LIU, which sells specialty commercial insurance and reinsurance worldwide, 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 the Company's Lloyd's Syndicate 4472, also provides multi-line insurance and reinsurance worldwide written through the Lloyd's platform. LMS is a leading provider of nationwide contract and commercial surety bonds to businesses of all sizes. LMR provides reinsurance to domestic and foreign insurance and reinsurance companies.

#### Adoption of New Accounting Standards

In October 2010, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2010-26, *Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts* ("ASU 2010-26"). This guidance, as codified in Accounting Standards Codification ("ASC") 944, *Financial Services - Insurance*, specifies that deferred acquisition costs should include only those costs that are directly related to the acquisition or

# LIBERTY MUTUAL HOLDING COMPANY INC

## Notes to Consolidated Financial Statements

(dollars in millions)

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 was required to adopt ASU 2010-26 effective January 1, 2012. The Company applied the guidance retrospectively, and the cumulative effect of the adoption as of January 1, 2010 resulted in (decreases) increases in the opening balance of unassigned equity and accumulated other comprehensive income of \$(286) and \$2, respectively. The impact to the consolidated statements of income for the year ended December 31, 2012 is immaterial.

For the year ended December 31, 2011, the accounting change resulted in (decreases) increases in benefits, claims and claim adjustment expenses, insurance operating costs and expenses, amortization of deferred policy acquisition costs, income tax (benefit) expense, unrealized gains on securities, and foreign currency translation and other adjustments of \$(3), \$692, \$(678), \$(4), \$4, and \$1, respectively. For the year ended December 31, 2010, the accounting change resulted in (decreases) increases in benefits, claims and claim adjustment expenses, insurance operating costs and expenses, amortization of deferred policy acquisition costs, income tax (benefit) expense, unrealized gains on securities, and foreign currency translation and other adjustments of \$(4), \$699, \$(722), \$10, \$2, and \$2, respectively. As of December 31, 2011, the accounting change resulted in the following changes to previously reported balances: (decreases) increases in deferred acquisition costs, deferred income taxes, life unpaid claims and claim adjustment expenses and future policy benefits, other liabilities, unassigned equity, and accumulated other comprehensive income of \$(417), \$137, \$(12), \$(3), \$(276), and \$11, respectively.

Effective January 1, 2012, the Company adopted ASU 2011-05, *Comprehensive Income* ("ASU 2011-05"). This guidance requires companies to present the total of comprehensive income, components of net income, and components of other comprehensive income ("OCI") in one continuous statement or in two separate but consecutive statements. The Company has elected to present this financial information in two separate, consecutive statements.

### Future Adoption of New Accounting Standards

None of the accounting standards issued in 2012 will have a material impact on the Company in the future.

### 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.

# LIBERTY MUTUAL HOLDING COMPANY INC

## Notes to Consolidated Financial Statements

(dollars in millions)

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.

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. Due to the availability of financial statements, limited partnership and other alternative investment income are generally recorded on a three-month delay. Equity investments in privately held businesses are carried at fair value.

Commercial 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 and reported as other assets and other liabilities. 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 entered into a total return swap agreement that is classified as an economic hedge. The derivative is used to hedge against credit deterioration of the Company's fixed maturity assets. Hedge accounting is not applied to these derivatives and subsequent changes in fair value are recorded in net realized gains on the consolidated statements of income. These derivatives are not material to the Company's 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 Company's strategic business units are deemed reporting units. The reporting unit has the option to skip the qualitative test and move directly to completion of the quantitative process. 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 acquisitions, dispositions, and foreign currency translation adjustments.

As a result of the realignment of the Company's SBUs on July 24, 2012, the Company performed a relative fair value assessment to reallocate the existing goodwill to the realigned SBUs as well as a quantitative impairment assessment of goodwill for each of the SBUs. A qualitative test was performed by each of the SBUs as of August 31, 2012 in accordance with the Company's accounting policy. In 2011, the Company utilized the

# LIBERTY MUTUAL HOLDING COMPANY INC

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qualitative and quantitative approaches across its business units. In 2010, the Company utilized only the quantitative approach. The Company recognized goodwill impairment of \$1 in 2012, and \$0 in both 2011 and 2010.

Indefinite-lived intangible assets held by the Company are reviewed for impairment on at least an annual basis using a qualitative process. 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 and Ohio Casualty Corporation ("Ohio Casualty") acquisitions that occurred in 2008 and 2007, respectively. As of December 31, 2012, intangible assets related to these acquisitions were as follows: Safeco agency relationship of \$441, Ohio Casualty agency relationship of \$110, trademarks of \$229, state licenses of \$82, and other intangibles of \$12. 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 a result of the Company's July 24, 2012 realignment, an impairment charge of \$33 was taken on the Ohio Casualty trademark intangible asset balance related to the decision to discontinue the regional company brands. 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 \$219 and \$169 as of December 31, 2012 and 2011, respectively. All other intangible assets are not subject to amortization.

The Company recognized \$50, \$51 and \$50 of amortization expense related to these acquisitions for the years ended December 31, 2012, 2011, and 2010, respectively. Amortization expense is reflected in insurance operating costs and expenses on the accompanying consolidated statements of income. The Company recognized \$33 of impairments related to these acquisitions for the year ended December 31, 2012 and \$0 for the years ended December 31, 2011 and 2010, respectively. Impairment expense is reflected in realignment expense on the accompanying consolidated statements of income. Estimated amortization is \$52, \$52, \$52, \$52 and \$50 for the years ended December 31, 2013 through 2017, respectively.

### Deferred Policy Acquisition Costs

Costs that are directly related to the acquisition or renewal of insurance contracts are deferred and amortized over the respective policy terms. All other acquisition related costs, including market research, training, administration, unsuccessful acquisition or renewal efforts, and product development are charged to expense as incurred. 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 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 2012 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

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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 5.2%, 5.3%, and 5.3% for 2012, 2011, and 2010, respectively. The held discounted reserves on these unpaid workers compensation claims, net of all reinsurance, as of December 31, 2012 and 2011 were \$2,379 and \$2,252, respectively.

The discounting of disability claims is based on the 1987 Commissioners Group Disability Table at annual discount rates varying from 3.0% to 7.0% and 3.5% to 7.0% in 2012 and 2011, respectively. Unpaid disability claims and claim adjustment expenses as of December 31, 2012 and 2011 include liabilities at discounted values of \$1,358 and \$1,293, 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. The average implied credited interest rates for domestic structured settlement contracts in force were 5.5%, 5.8%, and 5.7% for 2012, 2011 and 2010, respectively. Implied credited interest rates for foreign structured settlement contracts in force were between 2.5% and 6.0% for each of the years ending December 31, 2012, 2011, and 2010. Credited rates for domestic universal life contracts in force were between 3.5% and 5.0% in 2012 and 2011, and 3.5% and 4.3% in 2010. Credited rates for foreign universal life contracts in force were between 1.3% and 6.0% in 2012, 1.1% and 6.0% in 2011, and 0.9% and 6.0% in 2010. 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 2012, 2011, and 2010), 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 1%, 2%, and 2% of domestic property-casualty insurance premiums written for the years ended December 31, 2012, 2011, and 2010, respectively. 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. 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 consolidated net income and total equity. Participating policies approximate 27%, 29%, and 31% of ordinary life insurance in force for the years ended December 31, 2012, 2011, and 2010, respectively. Participating policies approximate 10%, 12%, and 15% of life premium for the years ended December 31, 2012, 2011, and 2010, 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.

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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.

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 consolidated net income.

The aggregate exchange (losses) gains included in consolidated net income for the years ended December 31, 2012, 2011, and 2010 were \$(5), \$1, and \$(109), 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.



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**Non-Controlling Interest**

The components of non-controlling interest for the years ended December 31, 2012, 2011, and 2010 are as follows:

	<b>Years Ended December 31,</b>		
	<b>2012</b>	<b>2011</b>	<b>2010</b>
Non-controlling interest, beginning of year	\$138	\$6	\$1
Comprehensive income (loss) attributable to non-controlling interest:			
Net income attributable to non-controlling interest	27	3	6
Other comprehensive income (loss), net of taxes:			
Unrealized gains on securities	25	-	-
Foreign currency translation and other adjustments	(2)	(6)	(1)
Other comprehensive income (loss), net of taxes	23	(6)	(1)
Total comprehensive income (loss) attributable to non-controlling interest	50	(3)	5
Capital contributions from non-controlling interest	59	135	-
Dividends to non-controlling interest	(39)	-	-
Non-controlling interest, end of year	<u>\$208</u>	<u>\$138</u>	<u>\$6</u>

**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, 2012, 2011, and 2010 are as follows:

	<b>Years Ended December 31,</b>		
	<b>2012</b>	<b>2011</b>	<b>2010</b>
Unrealized gains on securities	\$2,963	\$2,063	\$1,273
Foreign currency translation and other adjustments	136	140	315
Pension liability funded status <sup>(1)</sup>	(1,392)	(523)	(296)
Accumulated other comprehensive income	<u>\$1,707</u>	<u>\$1,680</u>	<u>\$1,292</u>

<sup>(1)</sup> Includes \$60 for each of the years ended December 31, 2012, 2011, and 2010, due to the recognition of deferred taxes related to the Medicare Part D subsidy.

The following table presents the consolidated other comprehensive income (loss) reclassification adjustments for the years ended December 31, 2012, 2011, and 2010, respectively.

	<b>Unrealized gains on securities</b>	<b>Change in pension and post retirement plans funded status</b>	<b>Foreign currency translation and other adjustments</b>	<b>Total</b>
<b>Year ended December 31, 2012</b>				
Unrealized change arising during the period	\$1,579	\$(1,360)	\$(4)	\$215
Less: Reclassification adjustments included in consolidated net income	249	(36)	-	213
Total other comprehensive income (loss), before income tax expense (benefit)	1,330	(1,324)	(4)	2
Less: Income tax expense (benefit)	405	(455)	2	(48)
Total other comprehensive income (loss), net of income tax expense (benefit)	<u>\$925</u>	<u>\$(869)</u>	<u>\$(6)</u>	<u>\$50</u>
<b>Year ended December 31, 2011</b>				
Unrealized change arising during the period	\$1,218	\$(358)	\$(185)	\$675
Less: Reclassification adjustments included in consolidated net income	103	(9)	-	94
Total other comprehensive income (loss), before income tax expense (benefit)	1,115	(349)	(185)	581
Less: Income tax expense (benefit)	325	(122)	(4)	199
Total other comprehensive income (loss), net of income tax expense (benefit)	<u>\$790</u>	<u>\$(227)</u>	<u>\$(181)</u>	<u>\$382</u>
<b>Year ended December 31, 2010</b>				
Unrealized change arising during the period	\$824	\$776	\$64	\$1,664
Less: Reclassification adjustments included in consolidated net income	414	(97)	-	317
Total other comprehensive income, before income tax expense	410	873	64	1,347
Less: Income tax expense	226	313	19	558
Total other comprehensive income, net of income tax expense	<u>\$184</u>	<u>\$560</u>	<u>\$45</u>	<u>\$789</u>

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### (2) ACQUISITIONS, JOINT VENTURES, DISPOSITIONS AND REALIGNMENT

#### Quinn Insurance Limited

In April 2011, the Company, through its subsidiary Liberty UK and Europe Holdings Limited, entered into an agreement with Irish Bank Resolution Corporation (“IBRC”) to establish Liberty Mutual Ireland Investment Holdings Limited (“Ireland Holdings”). The Company has 51% ownership of Ireland Holdings and consolidates the financial position and results of operations. IBRC 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. Goodwill recognized from the transaction was \$83. In 2012 refinements to purchase accounting were completed, resulting in increase to goodwill of \$19. The operations of Quinn Insurance Limited were merged into Liberty International. The Company believes the acquisition provides Liberty International the opportunity for continued diversification in the European market. The following is a condensed balance sheet of the acquired business at November 11, 2011:

Assets:	
Cash and cash equivalents	\$1,125
Goodwill	83
Other assets	247
Total assets	<u>\$1,455</u>
Liabilities:	
Unpaid claims and claim adjustment expenses	\$1,104
Unearned premiums	143
Other liabilities	208
Total liabilities	<u>\$1,455</u>

Included in the condensed balance sheet of the acquired business at the purchase date is a contingent liability of \$134 to Quinn Insurance Limited. Claims related to business written prior to the acquisition date are subject to a 36 month completion reserve review therefore limiting the Company's additional loss exposure.

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.

#### KIT Finance Insurance

Effective March 28, 2012, the Company completed the acquisition of the Russian insurance company KIT Finance Insurance for \$39. The Company believes the acquisition provides Liberty International the opportunity for continued diversification in the European market. 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.

#### Liberty ART S.A.

Effective June 22, 2012, the Company completed the sale of its wholly owned subsidiary Liberty ART S.A., within Liberty International and received proceeds of \$39, resulting in a gain of \$25.

#### Liberty Videocon General Insurance Company Ltd.

During the second quarter of 2012, Liberty Videocon General Insurance Company Ltd. (“Liberty Videocon”), a joint venture between the Company and Videocon Industries Ltd. (“Videocon Group”), received the necessary license from India’s insurance regulatory authority to commence its operations. For the year ended December 31, 2012, Videocon Group contributed \$54 to Liberty Videocon, which is included in the accompanying consolidated statements of changes in total equity. The Company has a 26% ownership and consolidates the financial position and results of operations of Liberty Videocon because it bears the predominant financial risk of the joint venture.

#### Panamerica de Seguros del Ecuador S.A. and Cervantes S.A. Compania de Seguros y Reaseguros

Effective August 28, 2012 and August 30, 2012, the Company completed the acquisitions of Panamericana de Seguros del Ecuador S.A. and Cervantes S.A. Compania de Seguros y Reaseguros (“Liberty Ecuador”) for \$16 and \$13, respectively. The Company believes the acquisitions provide Liberty International the opportunity for continued diversification in the Latin American market. 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.

#### Realignment

As discussed in Note 1, the Company realigned its four SBUs during 2012. See Note 1 for a summary of each SBU. As a result of the realignment for the year ended December 31, 2012, \$99 of expense and (\$12) of net realized losses have been reported on the accompanying consolidated statements of income.

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**(3) INVESTMENTS**

*Components of Net Investment Income*

	Years Ended December 31,		
	2012	2011	2010
Taxable interest income	\$2,467	\$2,487	\$2,426
Tax-exempt interest income	449	474	539
Dividends	60	50	42
Limited partnerships and limited liability companies	353	583	398
Commercial mortgage loans	81	77	73
Other investments	(22)	(4)	6
Gross investment income	3,388	3,667	3,484
Investment expenses	(151)	(144)	(156)
Net investment income	<u>\$3,237</u>	<u>\$3,523</u>	<u>\$3,328</u>

*Components of Net Realized Gains*

	Years Ended December 31,		
	2012	2011	2010
Fixed maturities			
Gross realized gains	\$352	\$177	\$421
Gross realized losses	(107)	(122)	(72)
Equities			
Gross realized gains	76	101	52
Gross realized losses	(76)	(73)	(3)
Other			
Gross realized gains	367	105	67
Gross realized losses	(78)	(30)	(63)
Net realized gains	<u>\$534</u>	<u>\$158</u>	<u>\$402</u>

As of December 31, 2012 and 2011, other-than-temporary impairments recognized through accumulated other comprehensive income were \$41 and \$46, respectively.

During the years ended December 31, 2012, 2011, and 2010, proceeds from sales of fixed maturities available for sale were \$6,539, \$4,032, and \$9,177, respectively. The gross realized gains (losses) on such sales totaled \$289 and \$(37) in 2012, \$127 and \$(33) in 2011, and \$357 and \$(22) in 2010.

*Components of Change in Net Unrealized Investment Gains*

	Years Ended December 31,		
	2012	2011	2010
Fixed maturities	\$1,226	\$1,415	\$357
Equities	275	(185)	71
Other	(3)	(17)	(10)
Adjustments to deferred policy acquisition costs	(168)	(98)	(8)
Net change in unrealized investment gains	1,330	1,115	410
Deferred income tax expense	(405)	(325)	(226)
Net change in unrealized investment gains, net of tax	<u>\$925</u>	<u>\$790</u>	<u>\$184</u>

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**Available for Sale Investments**

The amortized cost, gross unrealized gains and losses and fair values of available for sale investments as of December 31, 2012 and 2011, are as follows:

<b>December 31, 2012</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	\$3,248	\$281	\$(1)	\$3,528
Residential MBS <sup>(1)</sup>	8,259	530	(4)	8,785
Commercial MBS	1,649	78	(1)	1,726
Other MBS and ABS <sup>(2)</sup>	2,332	155	(1)	2,486
U.S. state and municipal	13,235	1,350	(19)	14,566
Corporate and other	24,803	2,185	(53)	26,935
Foreign government securities	5,840	276	(48)	6,068
Total fixed maturities	59,366	4,855	(127)	64,094
Common stock	1,791	369	(63)	2,097
Preferred stock	422	25	(49)	398
Total equity securities	2,213	394	(112)	2,495
Total securities available for sale	\$61,579	\$5,249	\$(239)	\$66,589

<sup>(1)</sup> Mortgage-backed securities ("MBS")

<sup>(2)</sup> Asset-backed securities ("ABS")

<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	\$59,050	\$4,208	\$(728)	\$62,530

Approximately 80% of the Company's securitized portfolio is explicitly backed by the U.S. government (Government National Mortgage Association "GNMA" and Small Business Association "SBA") or by government-sponsored entities (Federal Home Loan Mortgage Corporation "FHLMC" and Federal National Mortgage Association "FNMA"). Over 94% of the mortgage and asset-backed holdings are rated AAA. The commercial MBS portfolio is well diversified and of high quality with approximately 98% rated AA or above with approximately 13% of the underlying collateral having been defeased with U.S. Treasuries.

As of December 31, 2012, no single issuer, excluding U.S. Treasuries, agency securities and MBS, accounted for more than 1.6% of invested assets.

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Of the \$2,097 and \$1,608 of common stock as of December 31, 2012 and 2011, respectively, \$315 and \$271, respectively, related to securities associated with non-guaranteed unit linked products where the policyholder bears the investment risk.

As of December 31, 2012 and 2011, securities carried at \$4,292 and \$4,386, respectively, were on deposit with regulatory authorities as required by law.

As of December 31, 2012 and 2011, the fair values of fixed maturities loaned were approximately \$901 and \$1,296, respectively. Cash and short-term investments received as collateral in connection with the loaned securities were approximately \$824 and \$1,310 as of December 31, 2012 and 2011, respectively. Other investments received as collateral in connection with the loaned securities was approximately \$105 and \$24 as of December 31, 2012 and 2011, respectively.

The amortized cost and fair value of fixed maturities as of December 31, 2012, by contractual maturity are as follows:

	<b>Amortized Cost</b>	<b>Fair Value</b>
Due to mature:		
One year or less	\$3,294	\$3,337
Over one year through five years	18,193	19,275
Over five years through ten years	14,528	15,808
Over ten years	11,111	12,677
MBS and ABS of government and corporate agencies	12,240	12,997
Total fixed maturities	<u>\$59,366</u>	<u>\$64,094</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, 2012 and 2011 that are not deemed to be other-than-temporarily impaired.

**December 31, 2012**

	<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	\$(1)	\$405	\$ -	\$ -
Residential MBS	(1)	135	(3)	49
Commercial MBS	-	45	(1)	20
Other MBS and ABS	-	34	(1)	8
U.S. state and municipal	(9)	654	(10)	69
Corporate and other	(19)	1,250	(34)	417
Foreign government securities	(7)	439	(41)	438
Total fixed maturities	(37)	2,962	(90)	1,001
Common stock	(33)	354	(30)	215
Preferred stock	-	-	(49)	268
Total equities	(33)	354	(79)	483
Total	<u>\$(70)</u>	<u>\$3,316</u>	<u>\$(169)</u>	<u>\$1,484</u>

**December 31, 2011**

	<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	(205)	4,489	(283)	2,037
Common stock	(104)	513	(33)	124
Preferred stock	(2)	12	(101)	224
Total equities	(106)	525	(134)	348
Total	<u>\$(311)</u>	<u>\$5,014</u>	<u>\$(417)</u>	<u>\$2,385</u>

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Unrealized losses decreased from \$728 as of December 31, 2011 to \$239 as of December 31, 2012 primarily due to declining interest rates, the tightening of credit spreads and improvement in the equity markets. As of December 31, 2012, there were 921 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 fixed maturity 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 maturity 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, 2012, 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 is immaterial to the Company. As of December 31, 2011, the Company determined that it was the primary beneficiary of one VIE in the energy investment sector, and as such, this VIE was consolidated in the Company's financial statements. As of December 31, 2012, this entity is no longer deemed a VIE and therefore no longer consolidated.

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 net carrying value of non-consolidated VIEs in which the Company has a significant variable interest was \$282 and \$250 as of December 31, 2012 and December 31, 2011, respectively and the Company's maximum exposure to loss was \$340 and \$309 as of December 31, 2012 and December 31, 2011, 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 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 Commercial Mortgage Loans**

As of December 31, 2012 and 2011, the carrying values of commercial mortgage loans were \$1,335 and \$1,196, respectively. The carrying values reflect allowances of \$22 and \$18 as of December 31, 2012 and 2011, 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, 2012, 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 3,272 as of December 31, 2011, to 3,679 as of December 31, 2012. Approximately 93% of the loans are full or partial recourse to borrowers.

### **(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,		
	2012	2011	2010
Balance at beginning of year	\$2,391	\$2,403	\$2,636
Cumulative effect of adoption of ASU 2010-26 at January 1, 2010 (Note 1)	-	-	(385)
Acquisition costs deferred and other	4,613	4,121	4,187
Amortization charged to income	(4,272)	(4,133)	(4,035)
Balance at end of year	\$2,732	\$2,391	\$2,403

### **(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); incurred but not reported claims reserves ("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

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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 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, 2012, 2011, and 2010 were \$1,880, \$2,699, and \$1,253, respectively.

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

	<b>2012</b>	<b>2011</b>	<b>2010</b>
Balance as of January 1	\$50,228	\$48,059	\$48,355
Less: unpaid reinsurance recoverables <sup>(1)</sup>	11,147	11,526	12,052
Net balance as of January 1	39,081	36,533	36,303
Balance attributable to acquisitions <sup>(2)</sup>	97	1,021	-
Incurred attributable to:			
Current year	22,874	22,589	20,033
Prior years <sup>(3)</sup>	341	96	(373)
Discount accretion attributable to prior years	125	121	128
Total incurred	23,340	22,806	19,788
Paid attributable to:			
Current year	11,625	11,776	10,205
Prior years	10,114	9,471	9,138
Total paid	21,739	21,247	19,343
Amortization of deferred retroactive reinsurance gain <sup>(4)</sup>	29	134	54
Net adjustment due to foreign exchange	(51)	(166)	(269)
Add: unpaid reinsurance recoverables <sup>(1)</sup>	11,128	11,147	11,526
Balance as of December 31	<u>\$51,885</u>	<u>\$50,228</u>	<u>\$48,059</u>

<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 \$1,201, \$1,258, and \$1,992 as of December 31, 2012, 2011, and 2010, respectively.

<sup>(2)</sup> The balance attributable to acquisitions represents the 2012 acquisitions of KIT Finance Insurance and Liberty Ecuador, and the 2011 acquisition of Quinn Insurance Limited (See Note 2 for further discussion).

<sup>(3)</sup> Gross of offsetting allowance due to prior year development of \$(47), \$(38), and \$(45) as of December 31, 2012, 2011, and 2010, respectively.

<sup>(4)</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.)

In 2012, incurred attributable to prior years, excluding asbestos and environmental, is primarily attributable to LIU reinsurance, LIU third party and workers compensation lines of business, partially offset by Surety and Personal lines of business. The LIU reinsurance unfavorable development is driven by worse than expected severity of large loss events. The LIU third party unfavorable development is driven by worse than expected severity trends. The workers compensation unfavorable development is driven by worse than expected frequency and severity trends. In 2011, the Company experienced unfavorable development in asbestos and environmental liabilities, as discussed below. For other lines of business, the Company experienced favorable incurred attributable to prior years, excluding amortization of deferred retroactive gain, primarily related 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.

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, 2012 and 2011, the Company held \$3,705 and \$3,681, respectively, of unpaid claims and claim adjustment expenses related to experience-rated contracts. Premiums receivable included accrued retrospective and unbilled audit premiums of

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\$341 and \$461 as of December 31, 2012 and 2011, respectively. For the years ended December 31, 2012, 2011, and 2010, the Company recognized an increase (decrease) of premium income of \$56, \$(26), and \$(64), respectively, relating to prior years.

Unpaid claims and claim adjustment expenses are recorded net of anticipated salvage and subrogation of \$1,291 and \$1,166 as of December 31, 2012 and 2011, respectively.

As of December 31, 2012 and 2011, the reserve for unpaid claim reserves was reduced by \$5,580 and \$5,429, respectively, for large dollar deductibles. Large dollar deductibles billed and recoverable were \$217 and \$203 as of December 31, 2012 and 2011, 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-1980s. 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 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 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 third quarter of 2011, 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 \$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, 2012 and 2011, the Company's unpaid claims and claim adjustment expense reserves, net of associated reinsurance recoverables included \$1,215 and \$1,332 respectively, for asbestos and environmental-related claims.



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Net asbestos losses paid in 2012, 2011, and 2010 were \$229, \$166, and \$235, respectively. The Company incurred \$63, \$307, and \$(46) of asbestos reserves, net of change in allowance for doubtful accounts during the years ended December 31, 2012, 2011, and 2010, respectively.

Net environmental losses paid in 2012, 2011, and 2010 were \$37, \$53, and \$45, respectively. The Company incurred \$(2), \$44, and \$(4) of environmental reserves, net of change in allowance for doubtful accounts during the years ended December 31, 2012, 2011, and 2010, respectively.

**(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	2012		2011		2010	
	Written	Earned	Written	Earned	Written	Earned
Direct	\$36,022	\$34,824	\$33,551	\$32,432	\$31,222	\$30,751
Assumed	2,025	1,923	1,747	1,660	1,486	1,403
Ceded	5,765	5,847	5,338	5,206	4,567	4,503
Net premiums	<u>\$32,282</u>	<u>\$30,900</u>	<u>\$29,960</u>	<u>\$28,886</u>	<u>\$28,141</u>	<u>\$27,651</u>

Life & Annuity	2012		2011		2010	
	Written	Earned	Written	Earned	Written	Earned
Direct	\$1,354	\$1,346	\$1,309	\$1,307	\$1,124	\$1,122
Assumed	-	-	-	-	-	-
Ceded	81	81	74	74	74	74
Net premiums	<u>\$1,273</u>	<u>\$1,265</u>	<u>\$1,235</u>	<u>\$1,233</u>	<u>\$1,050</u>	<u>\$1,048</u>

The Company reported reinsurance recoverables of \$13,232 and \$13,272 as of December 31, 2012 and 2011, respectively, net of allowance for doubtful accounts of \$275 and \$326, 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, 2012.

S&P Rating	Reinsurance Recoverables	Collateral Held	Net Recoverables <sup>(1)</sup>
AAA	\$1	\$ -	\$1
AA+, AA, AA-	3,992	1,488	2,659
A+, A, A-	4,210	697	3,622
BBB+, BBB, BBB-	41	7	35
BB+ or below	21	4	17
Involuntary pools	2,615	1	2,614
Voluntary pools	340	69	298
Other <sup>(2)</sup>	2,287	2,572	582
Gross recoverables <sup>(3)</sup>	<u>\$13,507</u>	<u>\$4,838</u>	<u>\$9,828</u>
Less: allowance	275	-	-
Net recoverables	<u>\$13,232</u>	<u>\$4,838</u>	<u>\$9,828</u>

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

<sup>(2)</sup> Includes \$653 and \$1,634 of reinsurance recoverables from non-rated reinsurers and captive and program business, respectively.

<sup>(3)</sup> Includes \$905 and \$12,602 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 \$1,553 and \$1,507 as of December 31, 2012 and 2011, 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 Re Group, Munich Re Group, Everest Re Group and Alleghany Corporation totaling \$1,339, \$543, \$390, and \$310, respectively, as of December 31, 2012, net of offsetting collateral under the contracts.

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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 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, 2012 and 2011, deferred gains related to these reinsurance arrangements were \$296 and \$315, 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, 2012, 2011, and 2010 was \$83, \$105, and \$118, respectively. Deferred gain amortization was \$29, \$129, and \$54 for the years ended December 31, 2012, 2011, and 2010, respectively. Reinsurance recoverables related to these transactions, including experience related profit accruals, were \$1,165 and \$1,217 as of December 31, 2012 and 2011, 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 Insurance's 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. Additional premium and loss activity on these retroactive and prospective contracts was immaterial in 2012 and 2010. For the year ended December 31, 2011 approximately \$17 and \$10 of additional losses were ceded to these retroactive and prospective contracts, respectively, with additional premium of \$11 and \$7, respectively. 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.

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 million 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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### 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."

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 (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 \$1,746 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.

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**(7) DEBT OUTSTANDING**

Debt outstanding as of December 31, 2012 and 2011 includes the following:

*Current maturities of long-term debt:*

	2012	2011
Current maturities of long-term debt	\$ 286	\$205

*Long-term debt:*

	2012	2011
7.86% Medium Term Notes, due 2013	\$ -	\$25
8.00% Notes, due 2013	-	260
5.75% Notes, due 2014	239	500
7.30% Notes, due 2014	104	200
5.588% Mortgage Loan due 2015	47	48
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	600
4.95% Notes, due 2022	750	-
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% Term Loan, due 2032	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 <sup>2</sup>	700	700
10.75% Junior Subordinated Notes, due 2088 <sup>3</sup>	620	981
6.50% Notes, due 2042	750	-
7.697% Surplus Notes, due 2097	260	435
	6,010	5,389
Unamortized discount	(20)	(48)
Total long-term debt	\$5,990	\$5,341

<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.

**Debt Transactions and In-Force Credit Facilities**

On December 20, 2012, Liberty Mutual Insurance Company (“LMIC”) entered into a three-year \$1,000 repurchase agreement which terminates on December 20, 2015. To date, no funds have been borrowed under the facility. In connection with the new facility, the Company terminated its \$1,000 three-year repurchase agreements dated March 26, 2010.

On May 4, 2012 and August 17, 2012, Liberty Mutual Group Inc. (“LMGI”) issued \$500 and \$250 of Senior Notes due 2022 (the “2022 Notes”), respectively. Also, on May 4, 2012 and August 17, 2012, LMGI issued \$500 and \$250 of Senior Notes due 2042 (the “2042 Notes”), respectively. Interest is payable semi-annually at a fixed rate of 4.95% for the 2022 Notes and 6.50% for the 2042 Notes. The 2022 Notes mature on May 1, 2022 and the 2042 Notes mature on May 1, 2042.

On April 18, 2012, the Company announced the commencement of two tender offers. The first offer was a cash tender offer to purchase up to \$350, subject to increase, of the aggregate principal amount of (i) LMGI’s 10.75% Series C Junior Subordinated Notes due 2088 by LMGI and (ii) LMIC’s 7.697% Surplus Notes due 2097 by LMIC, each at a purchase price determined in accordance with the procedures of a modified “Dutch Auction” (the “Dutch Auction Offer”). The second offer was a cash tender offer by LMGI to purchase up to \$350, subject to increase, of the aggregate principal amount of its 5.75% Senior Notes due 2014 and its 7.30% Senior Notes due 2014, each at a price determined by reference to a fixed spread above the bid-side yield on the applicable reference security and accepted in accordance with the acceptance priority level set forth in the tender documents (the “Waterfall Offer”). The Waterfall Offer was conditioned on LMGI issuing at least \$350 aggregate principal amount of new senior notes. The Waterfall Offer was increased to include all notes tendered in the Waterfall Offer. The Dutch Auction Offer was increased by up to \$175 in aggregate principal amount to permit the additional purchase of the applicable notes tendered at the full tender offer

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consideration. The tender offers expired on May 15, 2012 and the Company paid in aggregate approximately \$949 in connection with such tender offers, including approximately \$17 in accrued and unpaid interest, to holders of the Notes involved in the tender offers. As a result of these transactions, the Company recorded pre-tax losses of \$147 that are included in loss on extinguishment of debt in the accompanying consolidated statements of income. After completion of the tender offers, the following principal amounts remained outstanding for such notes: \$676 of the 10.75% Series C Junior Subordinated Notes due 2088, \$260 of the 7.697% Surplus Notes due 2097, \$239 of the 5.75% Senior Notes due 2014 and \$104 of the 7.30% Senior Notes due 2014.

Additionally, during the years ended December 31, 2012 and 2011, the Company repurchased \$97 and \$269, respectively, of the 10.75% Junior Subordinated Notes due 2088. Pre-tax losses of \$46 and \$70, respectively, were recorded on these transactions and are included in loss on extinguishment of debt in the accompanying consolidated statements of income.

LMIC, Peerless Insurance Company ("PIC"), Liberty Life Assurance Company of Boston ("LLAC"), Liberty Mutual Fire Insurance Company ("LMFIC"), and EICOW are members of the Federal Home Loan Bank. On March 21, 2012, 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 December 31, 2012, all of the outstanding Federal Home Loan Bank borrowings are fully collateralized.

On January 20, 2012, LMGI entered into two interest rate swap transactions with an aggregate notional amount of \$300 with respect to LMGI's \$300 7% 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.

As of December 31, 2012, 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.

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

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, 2012, 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 \$40 pre-tax loss which is included in loss on extinguishment of debt in the accompanying consolidated statement of income. After completion of the tender offer and subsequent open market purchase, \$19 aggregate principal amount of the 2036 Notes remains outstanding.

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, 2012 and 2011 were \$88 and \$171, respectively, and are included in other liabilities in the accompanying consolidated balance sheets. Amortization of the lease obligation was \$40 and \$36 for the years ended December 31, 2012 and 2011, 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 3.46%. The transactions are accounted for as capital leases. As of December 31, 2012, the Company's amortization of the lease obligations under the sale-leaseback agreements through maturity is approximately \$33 for 2013, \$17 for 2014, and \$16 for 2015.

#### **Interest**

The Company paid \$431, \$454, \$461 of interest in 2012, 2011, and 2010, respectively.

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**(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.

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

<b>Years ended December 31,</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>
Current tax (benefit) expense:			
United States Federal	\$(61)	\$(63)	\$121
United States Federal benefit of net operating losses	-	-	(8)
State	2	1	5
Foreign	243	219	201
Total current tax expense	184	157	319
Deferred tax (benefit) expense:			
United States Federal	(87)	(137)	304
Foreign	(7)	(95)	24
Total deferred tax (benefit) expense	(94)	(232)	328
Total United States Federal, state and foreign income tax expense (benefit)	\$90	\$(75)	\$647

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

<b>Years ended December 31,</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>
Expected Federal income tax expense	\$331	\$100	\$822
Tax effect of:			
Nontaxable investment income	(138)	(147)	(168)
Change in valuation allowance	51	(1)	(11)
Goodwill	(15)	(15)	(15)
Revision to estimates	(14)	9	(21)
Medicare legislative change	-	-	55
General business credits	(27)	(11)	(3)
Audit settlement	(38)	(3)	-
State	2	1	5
Foreign	(53)	(18)	(69)
Other	(9)	10	52
Actual income tax expense (benefit)	\$90	\$(75)	\$647

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The significant components of the deferred income tax assets and liabilities are summarized as follows:

<b>Years ended December 31,</b>	<b>2012</b>	<b>2011</b>
Deferred tax assets:		
Unpaid claims discount	\$604	\$662
Unearned premium reserves	865	817
Net operating losses	1,178	710
Employee benefits	853	623
Retroactive reinsurance deferred gain	133	143
Credits	186	144
Other accrued expenses	181	190
Other	730	627
	<u>4,730</u>	<u>3,916</u>
Less: valuation allowance	(185)	(136)
Total deferred tax assets	<u>4,545</u>	<u>3,780</u>
Deferred tax liabilities:		
Deferred acquisition costs	706	643
Net unrealized gains	1,742	1,360
Intangibles	392	410
Depreciation/amortization	262	218
Other	341	197
	<u>3,443</u>	<u>2,828</u>
Total deferred tax liabilities	<u>3,443</u>	<u>2,828</u>
Net deferred tax assets	<u>\$1,102</u>	<u>\$952</u>

The overall increase in the valuation allowance is primarily due to net operating losses generated in certain foreign subsidiaries where there is uncertainty in the timing and amount of the realization of these losses. 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.

The Company's subsidiaries have foreign tax credit carry forwards of \$58, general business credit carry forwards of \$33, alternative minimum tax credit carry forwards of \$94, other foreign credits of \$1, and net operating loss carry forwards of \$3,464 as of December 31, 2012. 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:

2013	\$36
2014	31
2015	50
2016	40
2017	49
Thereafter	<u>3,258</u>
Total	<u>\$3,464</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, 2012, unremitted earnings of foreign subsidiaries were \$2,424. 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 determination of the amount of the unrecognized deferred tax liability related to the undistributed earnings is not practicable.

The IRS has completed its review of the Company's federal income tax returns through the 2001 tax year and is currently reviewing income tax returns for the 2002 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.

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

Balance as of December 31, 2010	\$321
Additions based on tax positions related to 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	\$332
Additions based on tax positions related to current year	23
Reductions based on tax positions related to current year	(31)
Additions for tax positions of prior years	81
Reductions for tax positions of prior years	(47)
Settlements	(2)
Balance as of December 31, 2012	\$356

Included in the tabular roll forward of unrecognized tax benefits are interest and penalties in the amount of \$102 and \$78 as of December 31, 2012 and 2011, respectively.

Included in the balance at December 31, 2012 is \$188 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, 2012, 2011, and 2010, the Company recognized approximately \$15, \$2, and \$(2) in interest and penalties, respectively. The Company had approximately \$106 and \$82 of interest and penalties accrued as of December 31, 2012 and 2011, 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 for selected highly compensated employees to restore the pension benefits they would be entitled to 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. The postretirement plan is unfunded.

Assets of the U.S. tax-qualified, defined benefit pension plans consist primarily of investments held in a master trust with The Bank of New York Mellon. During 2012, the Company began transferring a majority of the assets previously held in separate accounts established under a group annuity contract issued by a subsidiary life insurance company to The Bank of New York Mellon. The transition of assets from the group annuity contract to the master trust is expected to be completed in 2013. Assets of the plan are invested primarily in fixed income securities and in diversified public equities. As of December 31, 2012 and 2011, assets of the plans totaling \$250 and \$3,933, 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 eligibility requirements. During 2012, 2011, and 2010, 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 2012, 2011, and 2010, the Company made matching contributions of \$122, \$139, and \$148, 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 \$480, \$372, and \$406 for the years ended December 31, 2012, 2011, and 2010, 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, 2012 and 2011, and accompanying consolidated statements of income for the years ended December 31, 2012, 2011, and 2010.



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	Pension		Supplemental Pension		Postretirement	
	2012	2011	2012	2011	2012	2011
<b>Change in benefit obligations:</b>						
Benefit obligation at beginning of year	\$4,865	\$4,496	\$364	\$321	\$699	\$719
Service costs	121	111	6	6	18	17
Interest costs	293	288	22	20	43	43
Amendments	7	(37)	(16)	(2)	-	9
Curtailment	(6)	(17)	-	-	-	-
Actuarial losses (gains)	1,224	215	80	49	185	(54)
Currency exchange rate change	6	(9)	-	-	-	-
Benefits paid	(365)	(192)	(27)	(30)	(38)	(35)
Employee contributions	1	1	-	-	-	-
Other	-	9	-	-	-	-
<b>Benefit obligations at end of year</b>	<b>\$6,146</b>	<b>\$4,865</b>	<b>\$429</b>	<b>\$364</b>	<b>\$907</b>	<b>\$699</b>
<b>Accumulated benefit obligations</b>	<b>5,529</b>	<b>\$4,517</b>	<b>\$399</b>	<b>\$329</b>	<b>\$907</b>	<b>\$699</b>
<b>Change in plan assets:</b>						
Fair value of plan assets at beginning of year	\$4,108	\$3,900	\$ -	\$ -	\$ -	\$ -
Actual return on plan assets	409	99	-	-	-	-
Currency exchange rate change	5	(4)	-	-	-	-
Employer contribution	647	304	-	-	-	-
Benefits paid	(365)	(192)	-	-	-	-
Other	1	1	-	-	-	-
<b>Fair value of plan assets at end of year</b>	<b>\$4,805</b>	<b>\$4,108</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>
<b>Funded status of Plan</b>	<b>\$(1,341)</b>	<b>\$(757)</b>	<b>\$(429)</b>	<b>\$(364)</b>	<b>\$(907)</b>	<b>\$(699)</b>

**Amounts recognized in the Balance**

**Sheets:**

Assets	\$6	\$4	\$ -	\$ -	\$ -	\$ -
Liabilities	(1,347)	(761)	(429)	(364)	(907)	(699)
<b>Net liability at end of year</b>	<b>\$(1,341)</b>	<b>\$(757)</b>	<b>\$(429)</b>	<b>\$(364)</b>	<b>\$(907)</b>	<b>\$(699)</b>

**Amounts recognized in Accumulated Other Comprehensive Loss (Income):**

Net loss (gain)	\$2,016	\$949	\$201	\$133	\$43	\$(149)
Prior service costs	1	(16)	(16)	-	(16)	(18)
Net transition (asset) liability	(3)	3	-	-	-	-
<b>Total</b>	<b>\$2,014</b>	<b>\$936</b>	<b>\$185</b>	<b>\$133</b>	<b>\$27</b>	<b>\$(167)</b>

**Other changes in Plan assets and projected benefit obligation recognized in Other Comprehensive Loss (Income):**

Net actuarial loss (gain)	\$1,104	\$393	\$80	\$49	\$185	\$(54)
Currency exchange rate change	-	(1)	-	-	-	-
Amortization of net actuarial (gain) loss	(37)	(7)	(12)	(9)	7	6
Prior service costs	7	(36)	(16)	(2)	-	9
Amortization of prior service cost	10	(6)	-	(1)	2	3
Transition obligation	-	-	-	-	-	-
Amortization of transition obligation	(6)	5	-	-	-	-
<b>Total</b>	<b>\$1,078</b>	<b>\$348</b>	<b>\$52</b>	<b>\$37</b>	<b>\$194</b>	<b>\$(36)</b>

The estimated net actuarial loss, prior service cost, and transition obligation for the pension, supplemental pension and postretirement plan that will be amortized from accumulated other comprehensive income into net periodic benefit cost during the 2013 fiscal year are \$154, \$(1), and \$(1) for pension plans, \$18, \$(2), and \$0 for supplemental pension plans, and \$5, \$(3), and \$0 for postretirement plans.

The net benefit costs for the years ended December 31, 2012, 2011, and 2010, include the following components:

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<b>December 31, 2012</b>	<b>Pension</b>	<b>Supplemental Pension</b>	<b>Postretirement</b>
Components of net periodic benefit costs:			
Service costs	\$121	\$6	\$18
Interest costs	293	22	43
Expected return on plan assets	(289)	-	-
Settlement charge/curtailment (gain)	(2)	-	-
Amortization of unrecognized:			
Net loss (gain)	37	12	(7)
Prior service cost	(7)	-	(2)
Net transition assets	-	-	-
<b>Net periodic benefit costs</b>	<b>\$153</b>	<b>\$40</b>	<b>\$52</b>

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

<b>December 31, 2010</b>	<b>Pension</b>	<b>Supplemental Pension</b>	<b>Postretirement</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>

The measurement date used to determine pension and other postretirement is December 31, 2012.

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

<b>December 31,</b>	<b>2012</b>	<b>2011</b>
<b>Pension</b>		
Discount rate	4.80%	6.30%
Rate of compensation increase	3.70%	3.70%
<b>Supplemental Pension</b>		
Discount rate	4.80%	6.30%
Rate of compensation increase	3.90%	3.90%
<b>Postretirement</b>		
Discount rate	4.80%	6.30%

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

<b>December 31,</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>
<b>Pension</b>			
Discount rate	6.30%	6.50%	6.15%
Expected return on plan assets	6.75%	6.75%	6.75%
Rate of compensation increase	3.70%	3.70%	4.70%
<b>Supplemental Pension</b>			
Discount rate	6.30%	6.50%	6.15%
Rate of compensation increase	3.90%	3.90%	4.90%
<b>Postretirement</b>			
Discount rate	6.30%	6.50%	5.98%

The discount rate assumption used to determine the benefit obligations was based on a yield curve approach where the cash flows related to the benefit plans' liability stream was discounted at an interest rate specifically applicable to the timing of the cash flows. 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.

The weighted-average healthcare cost trend rates are expected to be 7.8% in 2013 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:

	<b>1% point increase</b>	<b>1% point decrease</b>
Effect on Postretirement Benefit Obligation	\$95	\$(72)
Effect on total service and interest costs	\$12	\$(9)

**Plan Assets**

The assets of the domestic Plan represent approximately 97% of the total Plans' assets as of December 31, 2012 and 2011, 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 held in a trust and managed by Liberty Mutual Group Asset Management Inc., an in-house asset manager and a wholly owned subsidiary of the Company.

The target allocation for the 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 bonds and syndicated loans of companies from diversified industries, residential and commercial mortgage backed securities ("RMBS" and "CMBS"), ABS and collateralized mortgage obligations ("CMO"), U.S. Treasuries and Agencies, U.S. Municipals and Foreign Government securities. Equity securities primarily include investments in large-cap and small-cap

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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 the domestic Plan's assets is as follows:

*Fixed maturities* - Achieve superior performance against Barclays Aggregate Bond Index, Bank of America Merrill Lynch High Yield Bond Index, Credit Suisse Leveraged Loan Index, J.P. Morgan Government Bond Index and Emerging Markets Global Diversified Bond Index over a three to five year period.

*U.S. equities* - Achieve superior performance against the Russell 3000 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 LMHC Board of Directors.

The other assets represent foreign equities, currency hedges, and real estate assets that support foreign pension plans and an insurance company separate account that supports the domestic pension plan.

The following table sets forth by level, within the fair value hierarchy, the Plans' assets at fair value as of December 31, 2012 and 2011.

**Fair Value Measurements as of December 31, 2012**

<b>Asset Category</b>	<b>Total</b>	<b>Quoted Prices in Active Markets for Identical Assets Level 1<sup>1</sup></b>	<b>Significant Observable Inputs Level 2<sup>1</sup></b>	<b>Significant Unobservable Inputs Level 3<sup>1</sup></b>
Cash, cash equivalents and short-term investments	\$285	\$158	\$127	\$ -
Fixed maturities:				
U.S. government and agency securities	164	160	4	-
RMBS/CMO/ABS/CMBS	1,099	-	1,099	-
Corporate and other	1,619	-	1,619	-
Foreign government securities	39	-	39	-
U.S. large cap equities	337	337	-	-
U.S. mid and small cap equities	427	427	-	-
European equities	155	155	-	-
Asian equities	455	455	-	-
Limited partnerships	135	-	-	135
Other assets	90	59	24	7
<b>Total</b>	<b>\$4,805</b>	<b>\$1,751</b>	<b>\$2,912</b>	<b>\$142</b>

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

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(dollars in millions)

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 Using Significant Unobservable Inputs (Level 3)

	Balance January 1, 2012	Actual Return on Plan Assets Still Held	Actual Return on Plan Assets Sold	Purchases, Sales, & Settlements	Transfers In/(Out) of Level 3	Balance December 31, 2012
European equities	\$3	\$ -	\$ -	\$ -	\$(3)	-
Limited partnerships	100	(18)	30	24	(1)	135
Other assets	13	-	-	2	(8)	7
<b>Total</b>	<b>\$116</b>	<b>\$(18)</b>	<b>\$30</b>	<b>\$26</b>	<b>\$(12)</b>	<b>\$142</b>

Fair Value Measurements Using Significant Unobservable Inputs (Level 3)

	Balance January 1, 2011	Actual Return on Plan Assets Still Held	Actual Return on Plan Assets Sold	Purchases, Sales, & Settlements	Transfers In/(Out) of Level 3	Balance December 31, 2011
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>\$ -</b>	<b>\$116</b>

The Plans' investments in limited partnerships are recorded at the carrying value as reported by the external fund managers, which is believed to approximate the fair value of the investments.

# LIBERTY MUTUAL HOLDING COMPANY INC

## Notes to Consolidated Financial Statements

(dollars in millions)

### Cash Flows

#### Contributions

The Company contributed \$647 to the qualified plans, and directly funded \$27 to retirees in the supplemental pension plans in 2012. In addition, the Company directly funded \$38 to retirees in the postretirement benefit plans in 2012.

The Company expects to contribute approximately \$600 to the qualified plans, to directly fund \$96 to retirees in the supplemental pension plans, and to directly fund \$40 to the postretirement benefit plans.

#### Expected Future Benefit Payments

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

	Pension	Supplemental Pension	Postretirement Plans
2013	\$231	\$96	\$40
2014	231	24	41
2015	244	27	43
2016	258	25	45
2017	273	26	46
2018-2022	1,621	123	245

### (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 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.

# LIBERTY MUTUAL HOLDING COMPANY INC

## Notes to Consolidated Financial Statements

(dollars in millions)

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.

#### *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 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.

# LIBERTY MUTUAL HOLDING COMPANY INC

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### 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 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

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 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.

### Other liabilities

Other liabilities within Level 2 represent the Company's derivative liabilities 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.

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.



LIBERTY MUTUAL HOLDING COMPANY INC

Notes to Consolidated Financial Statements

(dollars in millions)

**Assets and Liabilities Measured at Fair Value on a Recurring Basis**

The following tables summarize the Company's assets that are measured at fair value on a recurring basis as of December 31, 2012 and December 31, 2011:

<i>Assets, at Fair Value</i>	As of December 31, 2012			
	Level 1	Level 2	Level 3	Total
U.S. government and agency securities	\$2,644	\$874	\$10	\$3,528
Residential MBS	-	8,740	45	8,785
Commercial MBS	-	1,726	-	1,726
Other MBS and ABS	-	2,444	42	2,486
U.S. state and municipal	-	14,528	38	14,566
Corporate and other	-	26,262	673	26,935
Foreign government securities	-	5,261	807	6,068
Total fixed maturities, available for sale	2,644	59,835	1,615	64,094
Common stock	2,054	-	43	2,097
Preferred stock	-	381	17	398
Total equity securities, available for sale	2,054	381	60	2,495
Short-term investments	-	203	5	208
Other investments	-	151	131	282
Separate account assets <sup>1</sup>	287	-	65	352
Other assets	10	30	31	71
Total assets	\$4,995	\$60,600	\$1,907	\$67,502
<i>Liabilities, at Fair Value</i>				
Life insurance obligations	\$ -	\$ -	\$(206)	\$(206)
Other liabilities	-	(28)	-	(28)
Total liabilities	\$ -	\$(28)	\$(206)	\$(234)

<sup>1</sup> During 2012, the Company began transferring to The Bank of New York Mellon a majority of the assets previously held in separate accounts established under a group annuity contract issued by a subsidiary life insurance company. The transition of assets from the group annuity contract to the master trust is expected to be completed in 2013.

<i>Assets, at Fair Value</i>	As of December 31, 2011			
	Level 1	Level 2	Level 3	Total
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>Liabilities, at Fair Value</i>				
Life insurance obligations	\$ -	\$ -	\$(162)	\$(162)
Total liabilities	\$ -	\$ -	\$(162)	\$(162)

The Company did not have significant transfers between Levels 1 and 2 during the year ended December 31, 2012.

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(dollars in millions)

**Changes in Level 3 Recurring Fair Value Measurements**

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, 2012	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, 2012
U.S. government and agency securities	\$16	\$ -	\$ -	\$ -	\$ -	\$(3)	\$ -	\$(3)	\$10
Residential MBS	64	-	-	109	-	(27)	1	(102)	45
Commercial MBS	5	-	1	51	-	-	-	(57)	-
Other MBS and ABS	12	-	-	64	-	(3)	3	(34)	42
U.S. state and municipal	19	-	2	10	-	(3)	17	(7)	38
Corporate and other	656	(3)	22	124	-	(101)	23	(48)	673
Foreign government securities	260	-	31	235	-	(27)	473	(165)	807
Total fixed maturities	1,032	(3)	56	593	-	(164)	517	(416)	1,615
Common stock	26	2	-	44	-	(29)	-	-	43
Preferred stock	15	-	1	2	-	-	-	(1)	17
Total equity securities	41	2	1	46	-	(29)	-	(1)	60
Short-term investments	1	-	-	5	-	(1)	2	(2)	5
Other investments	129	23	(5)	35	-	(51)	-	-	131
Separate account assets <sup>1</sup>	174	(2)	-	1	-	(108)	-	-	65
Other assets	30	1	-	-	-	-	-	-	31
Total assets	\$1,407	\$21	\$52	\$680	\$ -	\$(353)	\$519	\$(419)	\$1,907

**Liabilities, at Fair Value**

Life insurance obligations	\$(162)	\$(64)	\$ -	\$ -	\$20	\$ -	\$ -	\$ -	\$(206)
Total liabilities	\$(162)	\$(64)	\$ -	\$ -	\$20	\$ -	\$ -	\$ -	\$(206)

<sup>1</sup> During 2012, the Company began transferring to The Bank of New York Mellon a majority of the assets previously held in separate accounts established under a group annuity contract issued by a subsidiary life insurance company. The transition of assets from the group annuity contract to the master trust is expected to be completed in 2013. The \$(108) of sales and maturities in separate account assets represents this transaction.

	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)

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Notes to Consolidated Financial Statements

(dollars in millions)

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 December 31, 2012 and 2011.

**Quantitative Information about Level 3 Fair Value Measurements**

The following table provides information about the significant unobservable inputs used for recurring fair value measurements for certain material Level 3 assets and liabilities and includes only those instruments for which information about the inputs is reasonably available to the Company. As the input information with respect to certain Level 3 instruments may not be reasonably available to the Company, balances shown below may not equal total amounts reported for such Level 3 assets and liabilities.

	<b>Fair Value at December 31, 2012</b>	<b>Valuation Technique(s)</b>	<b>Unobservable Input<sup>(a)</sup></b>	<b>Range (Weighted Average)</b>
<b>Assets:</b>				
Corporate and other	\$598	Discounted Cash Flow Spread Model	Discount rate (a)	3%-20% (13%)
			Bond spread	32-774 (263bps)
			Yield (b)	5.2%-20.94% (7.15%)
			Discount Rate (a)	7.8%
			Credit Spread	450-1235 (569bps)
		Comparative Valuation	Credit Spread	13-193 (138bps)
			Illiquidity Premium	50-200 (193bps)
			Index Yield	5%
		Matrix Pricing	Credit Spread (c)	145-265 (230bps)
<b>Liabilities, at Fair Value</b>				
Life insurance obligations	\$206	Discounted Cash Flow	Lapse rates (d)	4.0%-5.5%
			Annuitization take-up rate (e)	0%-35.0%

- (a) An increase in the discount rate will lead to a decrease in fair value and vice versa.
- (b) An increase in yield will lead to a decrease in fair value and vice versa.
- (c) An increase in the credit spread will lead to a decrease in fair value and vice versa.
- (d) An increase in the lapse rates will lead to a decrease in fair value and vice versa.
- (e) An increase in the take-up rate will lead to an increase in fair value and vice versa.

**Fair Value Measurements on a Non-Recurring Basis**

The following tables summarize the Company's assets that are measured at fair value on a non-recurring basis at time of impairment and are not included in the tables presented above:

	<b>As of December 31, 2012</b>			
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
<b>Assets:</b>				
Oil and gas properties	\$ -	\$ -	\$30	\$30
Goodwill	-	-	1	1
Intangibles	-	-	-	-
Software	-	-	21	21
Total	\$ -	\$ -	\$52	\$52

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The following tables summarize the Company's impairment charges for assets measured at fair value on a non-recurring basis for the years ended December 31, 2012, 2011, and 2010.

	Years ended December 31,		
	2012	2011	2010
Oil and gas properties	\$26	\$34	\$26
Goodwill	1	-	-
Intangible	33	-	-
Software	13	1	-
Total	\$73	\$35	\$26

The Company's assets measured on a non-recurring basis are primarily related to direct investments in oil and gas production ventures, which are based on independent 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 greater 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. In addition to the oil and gas impairments, the Company also recognized intangible assets impairment as a result of the July 24, 2012 realignment. (Refer to Note 1 for further discussion.)

**Fair Value Option**

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.

**Financial Instruments Not Carried at Fair Value**

The fair values and carrying values of the Company's financial instruments excluded from ASC 820, *Fair Value Measurement*, as of December 31, 2012 and 2011, are as follows:

	2012		2011	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Other investments	\$4,162	\$4,162	\$3,590	\$3,590
Commercial mortgage loans	1,335	1,512	1,196	1,328
Cash and cash equivalents	5,484	5,484	5,972	5,972
Individual and group annuities	2,239	2,423	2,028	2,168
Debt	6,276	6,953	5,546	5,891

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

*Commercial 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, 2012 and 2011. Also included are variable investment-type insurance contracts, for which carrying value approximates fair value as of December 31, 2012 and 2011.

*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, 2012 and 2011.

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

# LIBERTY MUTUAL HOLDING COMPANY INC

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### (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 has been in coverage litigation with Kentile Floors, Inc., 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 as well as all other insurance carriers.

Prior to the most recent bankruptcy filing, Metex reached agreement with each of Kentile's insurance carriers. The bankruptcy court will need to approve the Settlement Agreements before they can become effective. Management believes that the ultimate liability, if any, to Metex will not be resolved for at least one year, and possibly longer. 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 operations.

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 was \$207, \$205, and \$226 for the years ended December 31, 2012, 2011, and 2010, respectively. The Company also owns certain office facilities and receives rental income from tenants under operating leases expiring in various years through 2043. Rental income was \$32, \$32, and \$35 for the years ended December 31, 2012, 2011, and 2010, 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>
2013	169	1	29	141
2014	157	1	27	131
2015	116	1	32	85
2016	104	1	19	86
2017	61	1	12	50
2018 – 2037	114	21	12	123
2038 – 2057	-	21	-	21
2058 – 2101	-	90	-	90
Total	<u>\$721</u>	<u>\$137</u>	<u>\$131</u>	<u>\$727</u>

As of December 31, 2012, the Company had unfunded commitments in traditional private equity partnerships, real estate, natural resources, and other of \$824, \$253, \$1,168 and \$257, respectively.

As of December 31, 2012, the Company had commitments to purchase various residential MBS at a cost and fair value of \$13, and various corporate and municipal securities at a cost and fair value of \$141.

As of December 31, 2012, the Company had \$261 of undrawn letters of credit outstanding secured by assets of \$302.

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, 2012 and 2011, the liability balance was \$208 and \$236, respectively. As of December 31, 2012 and 2011, included in other assets were \$8 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 \$1,155, 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, 2012.

## LIBERTY MUTUAL HOLDING COMPANY INC

### Notes to Consolidated Financial Statements

(dollars in millions)

#### (12) POLICYHOLDERS' EQUITY

##### *Statutory Surplus*

The statutory surplus of the Company's domestic insurance companies was \$16,521 and \$15,701 as of December 31, 2012 and 2011, 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 LMIC, LMPICO, LMFIC, or EICOW to a different domiciliary state. The maximum dividend payout in 2013 that may be made prior to regulatory approval is \$1,451.

#### (13) SUBSEQUENT EVENTS

Effective February 9, 2013, the Venezuelan government devalued its currency, announcing that the fixed official exchange rate would be changed to 6.3 BsF to 1 U.S. dollar rate. While it is expected that the devaluation will reduce various financial statement amounts, including net written premium and claims and claim adjustment expense reserves in 2013, the anticipated impact to consolidated policyholders' equity is not expected to be material. Had the devaluation occurred effective January 1, 2012, net written premium and claims and claim adjustment expense reserves would have been reduced by \$581 and \$181, respectively.

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