LUMBERMENS MUTUAL CASUALTY COMPANY

Statutory Financial Statements and Schedules

December 31, 2005 and 2004

(With Independent Auditors' Report Thereon)

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

Independent Auditors' Report

The Board of Directors
Lumbermens Mutual Casualty Company:

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of Lumbermens Mutual Casualty Company (the Company) as of December 31, 2005 and 2004, and the related statutory statements of operations, surplus, and cash flow for the years then ended. These statutory financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these statutory financial statements based on our audits.

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

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

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the statutory financial statements referred to above do not present fairly, in conformity with U.S. generally accepted accounting principles, the financial position of Lumbermens Mutual Casualty Company as of December 31, 2005 and 2004, or the results of its operations or its cash flows for the years then ended.

Also, in our opinion, the statutory financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of Lumbermens Mutual Casualty Company as of December 31, 2005 and 2004, and the results of its operations and its cash flow for the years then ended, on the basis of accounting described in note 1.

As discussed in note 1 to the statutory financial statements, the Division of Insurance has prescribed certain accounting practices under a Corrective Order which result in an increase to policyholder surplus of $562 million and $666 million as of December 31, 2005 and 2004, respectively. These accounting practices differ from the National Association of Insurance Commissioners *Accounting Practices and Procedures Manual.*

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

The accompanying statutory financial statements and supplementary information have been prepared assuming that the Company will continue as a going concern. As discussed in note 8 to the statutory financial statements, the Division of Insurance imposes risk-based capital (RBC) requirements on insurance enterprises, including the Company. As of December 31, 2005, the Company's total adjusted capital, as reported in the 2005 Annual Statement filed with the Division of Insurance, is at the "mandatory control level," based on the RBC calculation required by the Division of Insurance. At this level, the Division of Insurance has substantial authority to exercise control over the Company, its subsidiaries and affiliates. The Division of Insurance is mandated to place a company at this level under its control, except where, as is the case with the Company, such Company is a property and casualty insurance company that is no longer writing new business and is running off its existing business, in which case the Director of the Division of Insurance has discretion to allow the continued run-off. In the first half of 2003, as a result of a combination of various business factors including certain ratings downgrades and the Company's deteriorating statutory surplus, the Company substantially ceased underwriting activities. Since July 2003, the Company and most of its subsidiaries and affiliates have been subject to a Corrective Order by the Division of Insurance not to write any new or renewal business except as necessary to comply with contractual commitments or as expressly permitted by the Division of Insurance. On March 19, 2004, the Company submitted to the Division of Insurance its commercial run-off plan which was approved on June 9, 2004.

The Division of Insurance could seek to place the Company in formal proceeding (receivership, rehabilitation, or other) at any time based on the Company's financial condition or operating performance. This risk of a proceeding would be further increased if the Company fails to execute successfully on its commercial run-off plan, if the Company fails to have sufficient liquid assets to meet its current obligations, or if the Company's reported statutory liabilities at any time would exceed its reported statutory assets as discussed in note 9 to the statutory financial statements.

There are a number of factors that could adversely affect the Company's surplus and liquidity position and its adequacy through future years. There can be no assurance that the Company will be successful to the extent necessary to avoid a negative surplus in future years. In addition, the Company has approximately $1.1 billion of invested assets that are encumbered by being on deposit or held in trust or escrow arrangements and access to these amounts is subject to certain limitations.

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

KPMG LLP

May 30, 2006

LUMBERMENS MUTUAL CASUALTY COMPANY

Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2005 and 2004

Admitted Assets		**2005**	**2004**
Cash, cash equivalents and short-term investments	$	308,270,902	908,597,084
Common stocks:			
Affiliated		91,424,689	96,246,251
Nonaffiliated		2,436,585	2,464,446
Preferred stocks		—	68,030
Bonds		1,551,961,871	1,583,567,169
Mortgage loans on real estate		804,176	1,835,467
Real estate held for sale		4,241,182	34,965,386
Receivable for securities sold		32,476,418	2,405,798
Other invested assets		28,686,507	49,908,335
Total cash and invested assets		2,020,302,330	2,680,057,966
Reinsurance recoverable on paid losses and loss adjustment expenses		301,210,228	368,821,781
Agents' balances and uncollected premiums, net		122,546,254	197,709,648
Other admitted assets		90,573,898	136,849,284
Accrued retrospective premiums		58,656,689	107,837,509
Receivable from subsidiaries and affiliates		—	59,672,555
Amounts billed and receivable under high deductible policies		32,433,674	55,053,097
Reinsurance accounted for as a deposit		20,053,594	43,011,255
Funds held by claim service provider		16,548,677	21,273,837
Investment income due and accrued		15,771,735	15,581,714
Equities and deposits in pools and associations		11,159,766	25,384,230
Funds held by or deposited with reinsured companies		10,558,018	16,561,259
Electronic data processing equipment		—	2,174,949
Total admitted assets	$	2,699,814,863	3,729,989,084

See accompanying notes to statutory financial statements.

Liabilities and Surplus	2005	2004
Liabilities:		
Losses and loss adjustment expenses	$ 1,974,312,431	2,819,780,013
Amounts withheld for others	183,081,209	252,686,725
Accounts payable and other liabilities	164,401,923	191,340,672
Taxes, licenses and fees payable	48,881,275	57,331,110
Reinsurance payable on paid losses and loss adjustment expenses	36,560,978	82,963,829
Other expenses payable	21,309,938	31,207,385
Unearned premium	19,045,951	43,108,518
Ceded reinsurance premiums payable, net	19,035,927	57,359,770
Reinsurance funds held related to retroactive reinsurance	14,253,055	38,950,767
Payable to subsidiaries	13,191,661	—
Remittances and items not allocated	12,222,013	29,297,811
Funds held under reinsurance treaties	10,619,735	17,114,358
Federal and foreign income taxes	8,256,345	29,742,368
Minimum pension liability	—	7,940,399
Net adjustments in assets and liabilities due to foreign exchange rates	5,339,676	5,519,042
Commissions payable	989,595	3,612,040
Payable for securities purchased	—	50,283
Total liabilities	2,531,501,712	3,668,005,090
Guaranty fund	1,500,000	1,500,000
Surplus notes	698,355,598	698,355,598
Unassigned deficit	(531,542,447)	(637,871,604)
Total surplus	168,313,151	61,983,994
Total liabilities and surplus	$ 2,699,814,863	3,729,989,084

LUMBERMENS MUTUAL CASUALTY COMPANY

Statutory Statements of Operations

Years ended December 31, 2005 and 2004

	2005	2004
Underwriting:		
Premiums earned	$ 61,388,934	48,410,809
Losses and expenses incurred:		
Losses	8,107,292	(112,061,559)
Loss adjustment expenses	81,151,050	354,887,855
Underwriting expenses	91,253,142	77,766,222
Change in premium deficiency reserve	540,492	(3,428,954)
Total underwriting deductions	181,051,976	317,163,564
Net underwriting loss	(119,663,042)	(268,752,755)
Investment income:		
Net investment income	73,925,822	96,109,930
Net realized capital (losses) gains on investments	(2,495,630)	10,415,852
Net investment income	71,430,192	106,525,782
Other income:		
Retroactive gain on reinsurance	—	838,570
Other income	37,798,291	13,959,325
Other income, net	37,798,291	14,797,895
Loss before dividends to policyholders and Federal and foreign income taxes	(10,434,559)	(147,429,078)
Dividends (to) recovered from policyholders	(7,127,581)	26,131,358
Loss before Federal and foreign income taxes	(17,562,140)	(121,297,720)
Federal and foreign income tax benefit (expense)	24,410,660	(12,317,644)
Net income (loss)	$ 6,848,520	(133,615,364)

See accompanying notes to statutory financial statements.

LUMBERMENS MUTUAL CASUALTY COMPANY

Statutory Statements of Surplus

Years ended December 31, 2005 and 2004

	2005	2004
Surplus at beginning of year	$ 61,983,994	202,425,965
Correction of errors	262,083	(41,063,947)
Net income (loss)	6,848,520	(133,615,364)
Other increases (decreases) in surplus:		
Net unrealized capital gains (losses)	11,964,351	(31,843,586)
Changes in:		
Nonadmitted assets	35,343,874	(91,871,938)
Minimum pension liability	—	107,057,685
Net deferred income taxes	31,116,277	115,524,244
Net adjustments due to foreign exchange rates	179,366	7,243,566
Provision for uncollectible reinsurance	20,614,686	(71,872,631)
Net increase (decrease) in surplus	106,329,157	(140,441,971)
Surplus at end of year	$ 168,313,151	61,983,994

See accompanying notes to statutory financial statements.

LUMBERMENS MUTUAL CASUALTY COMPANY

Statutory Statements of Cash Flow

Years ended December 31, 2005 and 2004

		2005	2004
Cash flows from operations:			
Premiums collected, net of reinsurance	$	176,988,849	119,692,496
Losses and loss adjustment expenses paid		(644,491,493)	(985,807,056)
Underwriting expenses paid		(343,068,059)	(511,098,446)
Net investment income		75,134,726	101,328,232
Other miscellaneous items		43,801,532	17,654,792
Dividends recovered from policyholders		21,429,907	103,300,716
Federal and foreign income taxes recovered (paid)		2,924,637	(5,378,382)
Net cash used in operations		(667,279,901)	(1,160,307,648)
Cash flows from investing activity:			
Proceeds from investments sold, matured or repaid:			
Bonds		726,689,492	691,743,477
Stocks, including affiliates		60,868,816	284,985,793
Mortgage loans		1,301,825	17,519,311
Real estate		32,137,952	—
Other invested assets		21,949,623	62,160,014
Net losses on short-term investments and other		(22,340)	(183,121)
Miscellaneous proceeds		427,801	939,777
Cost of investments acquired:			
Bonds		(699,567,760)	(608,850,613)
Stocks, including affiliates		(49,401,466)	(121,346,233)
Other invested assets		—	(27,206,632)
Miscellaneous applications		(30,120,903)	—
Net cash provided by investing		64,263,040	299,761,773
Cash flows from financing and miscellaneous sources:			
Other cash provided (used)		2,690,679	(101,430,772)
Net cash provided by (used in) financing and miscellaneous sources		2,690,679	(101,430,772)
Net change in cash, cash equivalents and short-term investments		(600,326,182)	(961,976,647)
Cash, cash equivalents and short-term investments:			
Beginning of year		908,597,084	1,870,573,731
End of year	$	308,270,902	908,597,084

See accompanying notes to statutory financial statements.

(1) Business Operations and Summary of Significant Accounting Policies

Basis of Presentation

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

As further discussed in note 8, the Company's risk-based capital (RBC) ratio, as filed, fell below the "authorized control level" as of December 31, 2002, and is at the "mandatory control level" at December 31, 2005 and 2004. The Company's RBC ratio and the reduction of the Company's ratings have had and will continue to have a significant impact on the Company's operations.

Accounting Policies

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

- the costs related to acquiring business are charged to income when incurred rather than deferred and amortized over the life of the related insurance policy;
- investments in bonds are generally carried at amortized cost, while under GAAP, such fixed maturity investments are designated at purchase as held-to-maturity, available-for-sale, or trading. Held-to-maturity investments are reported at amortized cost. Available-for-sale and trading investments are reported at fair value with unrealized gains and losses reported in operations for those designated as trading and as a separate component of stockholder's equity, net of applicable deferred income taxes, for those designated as available-for-sale;
- assets are included in the statutory statement of admitted assets, liabilities, and surplus (the "statutory balance sheet") at admitted asset value, and nonadmitted assets are excluded through a direct charge against surplus, while under GAAP, such assets would be recognized at the lower of cost or net realizable value;
- majority owned subsidiaries are carried under the equity method and are not consolidated, and adjustments reflecting the equity in earnings of affiliated companies are credited or charged directly to surplus as net unrealized capital gains or losses rather than being recorded through income;
- surplus notes are reflected as a component of surplus rather than as a liability as would be reported under GAAP, and interest on such notes is not recorded as a liability or expense until payment has been approved by the Division of Insurance;
- the realizability of deferred tax assets under GAAP is evaluated utilizing a "more likely than not" standard. A valuation allowance is established for deferred tax assets deemed not realizable using

this standard. Under statutory accounting principles, the realizability of deferred tax assets is determined utilizing an admissibility test outlined in Statement of Statutory Accounting Principles (SSAP) No. 10 – *Income Taxes*. Any gross deferred tax assets determined not to be realizable are nonadmitted for statutory accounting purposes. Additionally, changes in the balances of deferred tax assets and liabilities result in increases or decreases in net income under GAAP, whereas under statutory accounting principles, these changes are charged or credited to surplus;

- ceded reinsurance balances are netted against direct and assumed balances on the statutory balance sheet rather than shown gross under GAAP;
- liabilities for losses and loss adjustment expenses (LAE) are discounted using discount rates prescribed by the Division of Insurance;
- certain assets and liabilities originated in foreign currency are adjusted to U.S. dollars through a direct charge to surplus;
- the estimated rental cost of office facilities owned is presented in the statutory statements of operations as both income and expense;
- the correction of errors related to previously issued financial statements is charged directly to surplus rather than restating prior period results;
- the statutory statements of cash flow are presented in a specified format which differs from the formats prescribed by Statement of Financial Accounting Standards No. 95, *Statement of Cash Flows*; and
- comprehensive income is not determined for statutory reporting purposes.

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

Prescribed Practices

The Company’s reported surplus at December 31, 2005 and 2004 reflects increases of approximately $562 million and $666 million, respectively, over what would have reported without accounting practices prescribed by the Division of Insurance. The Company’s reported net income (loss) at December 31, 2005 and 2004 reflects decreases of approximately $130 million and $449 million, respectively, over what would have reported without accounting practices prescribed by the Division of Insurance.

Pursuant to the prescribed practices in 2005 and 2004, the Company:

1. Discounted all its loss and LAE liabilities at 4.2%. The 4.2% discount rate exceeds the Company’s current investment portfolio yield;
2. Reflected as admitted assets the amounts that the Company has prepaid for claim handling services to two third-party administrators related to unallocated LAE (ULAE);
3. Established a general provision for uncollectible reinsurance, net of discount. This provision has been established using the same 4.2% discount rate as used for the Company’s discounted underlying loss and LAE liabilities;

4. Recognized amounts due from National Fidelity Life Insurance Company as a contra liability for the amount due to the extent of direct claim liabilities and the remaining balance as an admitted receivable to reflect the "economic basis" of the reinsurance annuity contracts;
5. Decreased a liability related to a loan due to a subsidiary which had been previously charged as a reduction to surplus on the statutory financial statements of the subsidiary;
6. Discounted the premium deficiency liability at 4.2%;
7. Discounted the liability for loss-based assessments at 4.2%;
8. Admitted the California Guarantee Association refund (CIGA) as a receivable;
9. Changed the applicable interest rate assumption for calculating the accumulated benefit obligation (ABO) liability under the qualified Kemper Retirement Plan and the unqualified Kemper Supplemental Retirement Plan from 6.25% to 7.5%; and
10. Amended its post-retirement benefit plans to reduce benefits. The economic effect of the entire reduction in liability was recorded immediately in 2004 rather than as a gradual reduction of the liability over the average life span of the retirees as that time.

The accompanying table details the effects on surplus and operations as of December 31, 2005 and 2004 of the prescribed practices as described above.

	Surplus		Net income (loss)	
	2005	**2004**	**2005**	**2004**
	(In millions)			
As reported herein	$ 168	62	7	(134)
Increase (decrease) as a result of prescribed practices:				
Discount liability for loss and LAE	(468)	(577)	109	274
Prepaid ULAE	(45)	(66)	21	39
Provision for uncollectible reinsurance	(4)	4	—	—
Annuity reinsurance contracts	(12)	—	(12)	—
Subsidiary loan	—	(5)	5	(5)
Discount loss-based assessment and premium deficiency liability	(17)	(22)	7	(9)
CIGA admitted asset	(16)	—	—	—
Pension plan discount rate	—	—	—	118
Post-retirement benefit obligation	—	—	—	32
Total prescribed practices	(562)	(666)	130	449
Manual basis	$ (394)	(604)	137	315

Permitted Practices

The Division of Insurance has also granted the Company three permitted practices as of December 31, 2005, as follows:

1. The Company is permitted to account for certain reinsurance contracts that meet the definition of retroactive reinsurance agreements as prospective reinsurance agreement. This permitted practice has no impact on total surplus.
2. The Company is permitted to forego the requirement to obtain financial statements prepared on the basis of GAAP for the Company's four overseas insurance subsidiaries and three U.S. non insurance company subsidiaries. This permitted practice increased surplus as of December 31, 2005 by $9.3 million.
3. As more fully described in note 12, the Company is permitted to record through the 2005 Annual Statement statutory statement of operations the correction of errors related to 2004 and identified subsequent to the 2004 Annual Statement filing. This permitted practice has no impact on these statutory financial statements.

Correction of Errors

In accordance with SSAP No. 3, *Accounting for Changes and Corrections of Errors*, the Company has reflected as a direct benefit (charge) to surplus corrections of errors of $262 thousand and $(41.0) million, as of December 31, 2005 and 2004, respectively, which related to transactions which occurred in prior periods.

The errors are described as follows:

During 2005, the Company reversed certain expenses of American Manufacturers Mutual Insurance Company (AMM) that had been incurred and paid by the Company in 2004.

During 2004, the Company determined that:

1. The realized loss recorded in 2003 on the sale of a subsidiary was overstated;
2. Its calculation for accrued retrospective premiums (dividend recalls) contained certain errors that existed at December 31, 2003;
3. The adjustment it made to liabilities for losses and LAE in 2003 relating to the change in discount rate from 3.5% to 4.2% was overstated;
4. Certain insurance policies related to a guaranteed cost program were recorded to premium incorrectly in prior years;
5. Certain facts related to its various reinsurance programs were misapplied by way of either over-ceding losses or under-accruing ceded premiums; and
6. Certain facts related to its reinsurance annuities were misapplied by overvaluing the amount of expected reinsurance recoveries.

The following table details the effects on surplus as of December 31, 2005 and 2004 of the corrections of errors described above:

	Surplus	
	2005	2004
	(In millions)	
Increase (decrease) to surplus as a result of the corrections of errors:		
AMM expenses	$ 0.3	—
Realized loss – sale of subsidiary	—	36.8
Dividend recalls	—	(11.5)
Discount rate adjustment	—	(16.9)
Guaranteed cost programs	—	(3.8)
Reinsurance programs – cession adjustments	—	(29.0)
Reinsurance annuities	—	(16.6)
Total corrections of errors	$ 0.3	(41.0)

Invested Assets and Related Income

Bonds, cash equivalents, and short-term investments are valued generally at amortized cost; however, bonds rated NAIC 3 or below are carried at the lower of amortized cost or fair value. The amortized cost of bonds is adjusted for amortization of premiums and accretion of discounts using a level effective yield method to maturity, or in the case of mortgage-backed and asset-backed securities, over the estimated life of the security. Such amortization is included in investment income. Amortization of the discount or premium from mortgage-backed and asset-backed securities is recognized based on the estimated timing and amount of prepayments of the underlying assets and is adjusted to reflect differences which arise between the prepayments originally anticipated and the actual prepayments received and currently anticipated. To the extent the estimated lives of such securities change as a result of changes in prepayment rates, the adjustment is also included in investment income. Prepayment assumptions used for mortgage-backed and asset-backed securities were obtained from an external securities information service and are consistent with the current interest rate and economic environment.

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

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

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

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

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

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

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

Premiums and Policy Acquisition Costs

Premiums are earned on a daily pro-rata basis over the term of the policies and are net of reinsurance placed with reinsurers. Unearned premiums are also stated after deduction for premiums ceded to reinsurers. Premiums received in advance are recorded as a liability and are not considered income until due. Agents' balances and uncollected premiums receivable are recorded at the effective date of the underlying contract or in the case of audit premiums in accordance with the terms of the underlying contracts. Such receivables are recorded net of balances over 90-days past due and such other balances as required by the Manual. The Company evaluates the collectibility of all receivables for possible impairment. When the Company determines it is probable a receivable balance will not be collected, such amounts are written off and charged to operations. Policy acquisition costs such as commissions, premium taxes, and other underwriting and agency expenses are charged to income as incurred. The Company anticipates investment income as a factor in determining the premium deficiency liability. As of December 31, 2005 and 2004, the Company recorded an ending premium deficiency liability of $5.6 million and $5.0 million, respectively.

Liability for Losses and Loss Adjustment Expenses

The Company records liabilities for unpaid claims, losses, and related loss expenses based upon management's best estimate of aggregate case-basis estimates for losses reported, estimates received from ceding reinsurers, and estimates of incurred but not reported (IBNR) losses related to direct and assumed business, less amounts ceded to reinsurers. Liabilities for unreported losses are established using various statistical and actuarial techniques reflecting historical patterns of development of paid and reported losses adjusted for current trends.

The Division of Insurance has prescribed an accounting practice under a Corrective Order pursuant to which the Company discounts all its loss and LAE liabilities at 4.2% in the accompanying financial statements as of December 31, 2005 and 2004. At December 31, 2005 and 2004, the total amount of the discount related to this prescribed practice included in the accompanying financial statements is $468 million and $577 million, respectively.

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

The Company reflects its liability for losses net of anticipated salvage and subrogation recoveries. Those recoveries were $64.8 million and $71.0 million at December 31, 2005 and 2004, respectively. Salvage and subrogation received and changes in estimates of future recoveries are reflected in current year underwriting results.

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

Federal and Foreign Income Taxes

The Company files a consolidated federal income tax return with its subsidiaries. Federal and foreign income taxes are charged to operations based on income that is currently taxable. The Company provides, as a component of surplus, an estimate of deferred income tax assets and liabilities which reflect the expected future tax consequences of unrealized capital gains or losses and the temporary differences generated between statutory accounting and the tax bases of assets and liabilities that are anticipated to reverse within one year or can be recovered through loss carrybacks.

The Company has a tax allocation agreement which provides that current federal income taxes will generally be paid to or recovered from the Company on the basis of each subsidiary companies' taxable income or taxable loss as if the subsidiary were filing a separate federal income tax return. In the event of a federal income tax benefit on a separate return basis which is greater than the subsidiary companies' actual amount recoverable on a consolidated return basis, the amount recoverable will be apportioned among all such companies entitled to a recovery on a pro rata basis. Settlement among the companies occurs within a reasonable time period following the filing of the consolidated federal tax return. Based upon the Company's current financial position, all settlements of inter-company tax balances are subject to approval by the Division of Insurance.

Nonadmitted Assets

Assets included in the statutory balance sheet are at admitted asset value. Certain assets designated as “nonadmitted assets” are excluded from the statements of admitted assets, liabilities and surplus and are charged to unassigned surplus at December 31, 2005 and 2004 as follows:

		2005	**2004**
		(In millions)	
Other assets nonadmitted	$	46.6	35.5
Premiums receivable		60.6	138.2
Deferred tax assets		760.0	728.8
Total nonadmitted assets	$	867.2	902.5

The Company’s investment in computer hardware and equipment as of December 31, 2005 and 2004 was as follows:

		2005	**2004**
		(In thousands)	
Computer hardware and equipment	$	—	3,728
Less accumulated depreciation		—	(1,553)
Net computer hardware and equipment	$	—	2,175

Computer hardware and equipment were depreciated over three years, and total depreciation expense amounted to $2.2 million and $2.3 million in 2005 and 2004, respectively.

Provision for Uncollectible Reinsurance

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

The general provision for uncollectible reinsurance, net of discount, was $121.6 million and $150.1 million at December 31, 2005 and 2004, respectively. The Schedule F penalty otherwise prescribed would have been $125.9 million and $146.2 million at December 31, 2005 and 2004, respectively.

Use of Estimates

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

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

Renewal Rights Transactions

In 2003 and 2002, the Company had entered into various renewal rights transactions pursuant to which the Company and its affiliates were to receive then current and/or future commissions in return for the purchasing companies' acquisitions of the rights and information necessary to renew business that the Company and its affiliates could no longer write due to various business factors, including ratings, deteriorating financial condition, and regulatory concerns. Renewal rights revenue earned by the Company in 2005 and 2004 totaled $381 thousand and $44.6 million, respectively.

Of the $17.6 million carried on the Company's December 31, 2004 balance sheet as a receivable from the St. Paul Travelers Companies in connection with the purchase from the Company of renewal rights to certain lines of business in 2003, the St. Paul Travelers Companies paid to the Company approximately $16.7 million in June 2005, following resolution of unrelated disputes.

The 2004 renewal rights revenue also included $35.4 million received from Unitrin, Inc. (Unitrin), and its subsidiary, Trinity Universal Insurance Company (Trinity), in connection with the sale in 2002 of the Company's and its affiliates' U.S. personal lines business.

In connection with the sale to Unitrin in 2002, the Company and Unitrin entered into administrative service agreements whereby Unitrin continues to monitor and service the run-off of the Company's retained personal lines policies. Unitrin did not acquire renewal rights to policies issued in Alaska, Michigan, Delaware, or Arkansas or to policies produced by independent agents whose authority to write new business had been terminated prior to April 19, 2002. The Company and certain of its affiliates agreed to front for Trinity during a transition period in those states where Trinity (or an affiliate) was seeking licenses and making form and rate filings necessary for the issuance of policies in place of renewals of policies originally issued by the Company or its affiliates. Unitrin substantially completed that transition process in 2004. As of December 31, 2005, approximately $49 million of the Company's gross liabilities for losses and LAE are policies that are 100% reinsured by Trinity. Not only are the reinsured policies fully administered (including claims handled) by the Unitrin subsidiaries, the policies are covered by a cut-through provision allowing the insureds to seek direct recourse from Trinity in the event of any insolvency of the Company.

(2) Invested Assets and Investments in Subsidiaries

Bonds

The fair values of the Company's bonds have been determined using prices provided by the SVO, or when such values are not available from the SVO, using prices from independent pricing services that use market quotations, prices provided by brokers or estimates of fair values obtained from yield data relating to instruments or securities with similar characteristics or prices determined in good faith by the Company's engaged portfolio manager. Such values are referred to in the accompanying tables as "NAIC fair value."

The statement value and NAIC fair value of bonds at December 31, 2005 and 2004 were as follows:

	2005			
	Statement value	**Gross unrealized gains**	**Gross unrealized losses**	**NAIC fair value**
	(In thousands)			
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	$ 860,816	220	(18,002)	843,034
State, political subdivision, and special revenue obligations	71,679	2,171	(306)	73,544
Debt securities issued by foreign governments	76	3	—	79
Corporate securities	428,042	1,192	(36,594)	392,640
Asset-backed securities	134,576	448	(143)	134,881
Mortgage-backed securities	56,773	74	(472)	56,375
Total bonds	$ 1,551,962	4,108	(55,517)	1,500,553

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

Bonds in an unrealized loss position are regularly reviewed for other-than-temporary declines in value. Factors considered in determining whether a decline is other-than-temporary include the length of time a bond has been in an unrealized loss position and the reasons for the decline in value. Assessments include judgments about an obligor's current and projected financial position, an issuer's current and projected ability to service and repay its debt obligations, the existence of, and realizable value for, any collateral backing obligations, and the macro-economic and micro-economic outlooks for specific industries and issuers. Assessing the duration of loan-backed securities can also involve assumptions regarding underlying collateral such as prepayment rates, default and recovery rates, and third-party servicing abilities.

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

The bonds shown in the below table are subject to normal market fluctuations. The Company intends to hold them until they mature or recover in value. However, if the specific facts and circumstances surrounding a bond, or the outlook for its industry sector or the economy change, the Company may sell the bond and realize a loss.

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

As of December 31, 2005 and 2004, the gross unrealized losses that were in that position for more than twelve months and for less than twelve months were as follows:

	2005			2004		
	Number of issues	**Gross unrealized losses**	**NAIC fair value**	**Number of issues**	**Gross unrealized losses**	**NAIC fair value**
			(In thousands)			
Bonds in a loss position more than 12 months:						
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	18	$ (12,761)	501,105	8	$ (3,216)	155,520
State, political subdivision, and special revenue obligations	4	(210)	11,251	2	(164)	9,927
Corporate securities	18	(35,610)	257,394	10	(467)	27,389
Mortgage-backed securities	5	(49)	11,440	5	(173)	6,862
	45	(48,630)	781,190	25	(4,020)	199,698
Bonds in a loss position less than 12 months:						
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	25	(5,241)	295,939	24	(3,802)	591,308
State, political subdivision, and special revenue obligations	3	(96)	23,215	3	(11)	1,454
Debt securities issued by foreign governments	—	—	—	2	(23)	4,298
Corporate securities	12	(984)	56,622	23	(30,796)	277,552
Asset-backed securities	14	(143)	107,682	—	—	—
Mortgage-backed securities	53	(423)	28,769	39	(440)	62,323
	107	(6,887)	512,227	91	(35,072)	936,935
Total bonds	152	$ (55,517)	1,293,417	116	$ (39,092)	1,136,633

The following table sets forth the maturity aging schedule of bonds at December 31, 2005. The actual maturities may differ from the contractual maturities because debtors may have the right to call or prepay obligations with or without call or prepayment penalties.

		Statement value	NAIC fair value
		(In thousands)	
One year or less	$	208,058	204,958
Over one year through five years		571,877	562,117
Over five years through ten years		306,206	300,703
Over ten years		318,454	285,450
Securities not due at a single maturity date		147,367	147,325
Total bonds	$	1,551,962	1,500,553

At December 31, 2005 and 2004, cash, short-term investments and bonds carried at $745.2 million and $1.1 billion, respectively, were on deposit with government authorities as required by law. The Company's cash and invested assets were also encumbered at December 31, 2005 and 2004, by $327.5 million and $460.1 million, respectively, related to various collateral requirements.

Proceeds from sales of investments in bonds prior to maturity during 2005 and 2004 were $304.0 million and $374.9 million, respectively. Gross gains of $1.5 million and gross losses of $2.8 million were realized on those sales during 2005. Gross gains of $7.8 million and gross losses of $434 thousand were realized on those sales during 2004.

Equity Securities

Gross unrealized gains on equity securities (common stocks and preferred stocks), excluding affiliated companies, at December 31, 2005 and 2004 amounted to $59 thousand and $64 thousand, respectively. Gross unrealized losses on equity securities at December 31, 2005 and 2004 amounted to $11 thousand and $35 thousand, respectively. The cost of equity securities held at December 31, 2005 and 2004, excluding affiliated companies, was $2.4 million and $2.5 million, respectively. Consideration on sales of unaffiliated equity securities totaled $53 thousand with related net losses of $46 thousand in 2005 and for 2004 totaled $17.9 million including net gains of $5.5 million.

(Continued)

Investments in Affiliated Companies

The Company's investments in common stocks of affiliated companies at December 31, 2005 and 2004 are summarized below:

	2005		2004	
	Cost	Statement value	Cost	Statement value
	(In thousands)			
American Motorists Insurance Co.	$ —	30,372	—	30,819
Specialty Surplus Insurance Co.	26,895	29,307	—	—
Kemper Casualty Insurance Co.	22,506	22,448	—	—
Kemper International Corp.	6,998	6,998	21,204	15,749
Kemper Casualty Inc.	—	—	22,506	22,126
Kempes Inc.	—	—	26,895	25,071
All other	1,938	2,300	1,939	2,481
	$ 58,337	91,425	72,544	96,246

Significant Transactions involving Affiliates

Subsidiary Mergers and Dissolutions

During 2005, the Company voluntarily dissolved 20 of its direct and indirect non-insurance company subsidiaries, primarily non-operating holding companies and insurance agencies that no longer served a purpose since the Company is in run-off. These actions simplified the Company's organization chart and reduced certain operating expenses. As a result of these transactions, the cost basis of Specialty Surplus Insurance Company (SSIC) and Kemper Casualty Insurance Company (KCIC) carried over from the investment in the previously held holding company. The Company completed the voluntary liquidation of its Singapore subsidiary in the first half of 2006 and is in the process of voluntarily liquidating its Bermuda insurance company subsidiary.

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

International Operations

The Company has had seven international insurance operations in six countries. These operations consist of a branch of the Company in Canada, another branch in Japan, a branch of AMICO (formerly a branch of SNIC) in Canada, and four insurance company subsidiaries, one in each of Australia, Belgium, Bermuda, and Singapore. These operations accounted for approximately $46.5 million of the Company's surplus at December 31, 2005. Total surplus of the non-Canadian affiliates is $7 million at December 31, 2005.

As of both December 31, 2005 and 2004, the two Canadian branches together have more than $40.4 million of assets in excess of recorded liabilities. Approximately $47 million of the $48 million of cash and invested assets in Canada at December 31, 2005 are encumbered in trust. The trust is required by Canadian regulators who must approve any releases of the vested assets from the trust, including releases to pay claims, and who are currently approving payments of the branches' liabilities from vested trust assets. In 2005, using vested assets, the Company settled a $21 million liability related to the 2001 sale of its personal lines business in Canada, and as a result of the 2005 settlement, the Company, and its Canadian branch, recorded a benefit directly to surplus of approximately $3 million.

The AMICO branch in Canada is currently the subject of an assumption reinsurance transaction designed to repatriate to the U.S. approximately $5.5 million in 2006, as a direct charge to surplus, recorded as of December 31, 2005, of approximately $500 thousand. In connection with this pending Canadian transaction, at year-end 2005, the Company commuted certain non-Canadian reinsurance contracts, resulting in a benefit to the Company operations of $4.6 million.

In 2005, the Company repatriated net assets of approximately $2.2 million and $4.0 million from its Japanese branch and Singapore subsidiary, respectively. There was no impact on operations or surplus from these repatriations.

In the second half of 2005, the Company's Bermuda subsidiary, the Seven Continents Insurance Company, paid the Company $5.9 million pursuant to, and in connection with, the commutation of its separate cell reinsurance agreement; entered formal voluntary liquidation proceedings; and distributed to its shareholders all its assets other than approximately $63 thousand to cover final closure expenses anticipated in the second quarter of 2006. The Company received from this distribution net reinsurance recoverables valued at approximately $500 thousand and cash of $2.4 million at December 31, 2005. The distribution did not impact operations nor surplus.

The Company is exploring reinsurance and/or sale alternatives for its Australian and Belgium subsidiaries; however, the Company has not entered into any agreements with respect to divesting these subsidiaries. The Company has guaranteed the obligations under policies issued on or after January 1, 2002 by its Belgium subsidiary, Kemper, S.A. (Societe Anonyme), and obligations under policies issued by its Australian subsidiary, Kemper Insurance Company Limited. Most of those Belgium and Australian policies are also reinsured by the Company under excess of loss reinsurance agreements for any net losses in excess of $50 thousand.

On April 30, 2004, the Company closed the sale of 100% of the stock of Kemper de Mexico, Compania de Seguros, S.A., for $9.25 million. The sale resulted in no gain or loss in 2004.

UBIC Surety Bonds

Universal Bonding Insurance Company (UBIC) is a wholly owned subsidiary of the Company domiciled in New Jersey. In connection with certain surety bonds fronted by the Company for UBIC prior to 2003, the Company realized cumulative losses of approximately $107 million through 2005, primarily prior to 2004. The losses arose primarily in connection with a series of unauthorized bond programs implemented by UBIC, then 80% owned by the Company, the true nature of which was not fully disclosed to certain members of UBIC's management or to the Company prior to mid-2002. At that time, the Company began pursuing an investigation into the validity, available defenses, and potential recoveries of such unauthorized bonds, and UBIC entered run-off status and discontinued issuing any further bonds, except those bonds which UBIC was statutorily obligated to renew. As of December 31, 2005 and 2004, the Company carries its investment in UBIC at zero. UBIC has no employees, and the Company provides certain administrative and claim services for the subsidiary.

Affiliate Support for D&O Insurance

In connection with a portion of the Company's and its affiliates' corporate insurance program, a wholly owned subsidiary of the Company, SSIC, entered into a reinsurance agreement, effective January 1, 2005 for a three-year period ending December 31, 2007, facultatively reinsuring a corresponding three-year management liability policy issued by an unaffiliated third-party to the Company and AMM. In 2005, SSIC deposited the $15.0 million reinsurance premium it received into trust for the benefit of the third-party insurer to collateralize the reinsurance obligation.

Impairment Write-downs

The Company recognized impairment write-downs as realized capital losses for the following investments in subsidiaries during 2005 and 2004:

Company	**2005**	**2004**
	(In thousands)	
Kemper International Corporation	$ 1,776	—
LGA-3, Inc.	—	26
Kemper Employers Group, Inc.	—	5,166
	$ 1,776	5,192

The write-downs were based upon the Company's view that the unrealized losses related to such subsidiaries were impaired on an other-than-temporary basis.

Other Affiliate Transactions

During 2005, the Company did not make any contributions to subsidiaries. During 2004, the Company made additional capital contributions to Kemper International Corporation of $1.6 million and LGA-3, Inc. of $26 thousand primarily to fund cash flow operating needs.

The Company recorded an ordinary dividend of $33.8 million from AMICO during 2004.

Real Estate Held for Sale

During 2003, the Company reclassified all of its remaining real estate owned from company-occupied to held for sale and obtained appraisals for properties not sold. In 2004, the Company signed a definitive agreement to sell its home office complex in Long Grove, Illinois, and to lease back a portion of that office space for the Company's current operations. In anticipation of the proposed sale, the Company recorded an impairment write-down on the property of $5.9 million in 2004. The Company received net proceeds of $29.8 million at closing in the first quarter of 2005, and recorded a realized gain on the sale of $295 thousand.

Other Invested Assets

Other invested assets, consisted of the following as of December 31, 2005 and 2004:

		2005	2004
		(In thousands)	
Real estate joint venture	$	5,853	5,982
Kemper Lloyds Insurance Co. joint venture		21,585	21,113
Other notes receivable and equity investments		1,249	22,813
Other invested assets	$	28,687	49,908

The Company has a real estate joint venture, which is accounted for as a real estate ADC arrangement, through a master limited partnership between a subsidiary of the Company and subsidiaries of a former affiliate, which amounted to $5.9 million, or 20% of the Company's total other invested assets, at December 31, 2005. The partnership's underlying investment consisted primarily of a water development project located in California's Sacramento River Valley. During 2003, the Company abandoned its plans for the water development project and has actively sought an exit from this investment. The Company recorded impairment write-downs based on the fair value of the undeveloped land net of anticipated costs to sell of $129 thousand and $1.8 million during 2005 and 2004, respectively.

Domiciled in the state of Texas, Kemper Lloyds Insurance Company (Lloyds) is organized and licensed under Texas statutory provisions for Lloyds Plan operations. Historically controlled by officers and employees of the Company, Lloyds cedes 100% of its premiums, losses, and underwriting expenses to the Company.

During 2005, other notes receivable collections approximated $18 million. Of the balances remaining, the Company had one and two notes receivable totaling $840 thousand and $18.7 million on nonaccrual status as of December 31, 2005 and 2004, respectively.

Net Realized Capital Gains/Losses

Net realized capital gains (losses) by category for the years ended December 31, 2005 and 2004 were as follows:

		2005	2004
		(In thousands)	
Cash, cash equivalents and short-term investments	$	(22)	(183)
Common stocks:			
Affiliate write-downs		(1,776)	(5,192)
Sale of NATLSCO		3,638	(5,000)
Extraordinary distribution from AMICO		—	8,461
Other affiliate transactions		(4,655)	11,463
Unaffiliated		(62)	4,482
Bonds		(1,266)	5,253
Real estate owned and mortgages		1,684	(3,683)
Other invested assets		(37)	(5,185)
Net realized capital (losses) gains	$	(2,496)	10,416

During 2005, the Company recorded realized losses related to other-than-temporary declines in fair values of $48 thousand related to bonds; $16 thousand related to equity securities, excluding affiliated companies; $49 thousand related to mortgages; and $129 thousand related to other invested assets. During 2004, the Company recorded realized losses related to other-than-temporary declines in fair values of $3.7 million related to bonds, $1.0 million related to equity securities, excluding affiliated companies, $900 thousand related to venture capital partnerships, $1.8 million related to a real estate joint venture, $7.4 million related to real estate owned and mortgages, and $3.3 million related to notes receivable included in other invested assets. The determination of fair value for such write-downs is based upon estimated fair value.

Net Investment Income

The sources of the Company's net investment income as of December 31, 2005 and 2004 were as follows:

		2005	2004
		(In thousands)	
Bonds	$	60,426	51,854
Common stocks:			
Affiliated		—	33,793
Unaffiliated		13	702
Cash, cash equivalents and short-term investments		13,450	13,320
Real estate owned		1,460	5,523
Mortgage loans on real estate		85	649
Other invested assets		2,919	3,173
Gross investment income		78,353	109,014
Less:			
Interest expense		(65)	(299)
Investment expenses		(4,362)	(12,605)
Total investment expense		(4,427)	(12,904)
Net investment income	$	73,926	96,110

(3) Losses and Loss Adjustment Expenses

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

(Continued)

Activity in the liability for losses and LAE is summarized as follows:

		2005	2004
		(In thousands)	
Balance as of January 1, net of reinsurance recoverables of of $3,041,424 in 2005 and $4,045,750 in 2004	$	2,819,780	3,823,969
Incurred related to:			
Current accident year		37,400	99,461
Prior accident years		51,858	143,366
Total incurred		89,258	242,827
Correction of errors		—	33,541
Received related to:			
Current accident year		(22,383)	(48,617)
Prior accident years		(912,343)	(1,231,940)
Total received		(934,726)	(1,280,557)
Balance as of December 31, net of reinsurance recoverables of $2,116,280 in 2005 and $3,041,424 in 2004	$	1,974,312	2,819,780

The incurred losses and LAE related to prior accident years increased on a net basis by $51.9 million in 2005 and increased by $143.4 million in 2004. The adverse development on prior accident years in 2005 of $51.9 million is comprised of $70.0 million of favorable development related to commutation, novation, and buyback activity with the remaining $121.9 million of adverse development including an expected amortization of discount of $102.0 million.

During 2004, the Company determined that the adjustment it made to liability for losses in 2003 relating to the change in discount rate from 3.5% to 4.2% was overstated by $16.9 million. Also, during 2004, the Company determined that an adjustment made to ceded reinsurance annuity liability in 2003 was overstated by $16.6 million.

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

Asbestos Related Losses

The asbestos related losses including coverage dispute costs, and LAE as of December 31, 2005 and 2004, gross of reinsurance, were as follows:

		2005	**2004**
		(In thousands)	
Beginning liability	$	587,032	799,587
Incurred losses and LAE		2,484	(111,910)
Calendar year payments for losses and LAE		(99,483)	(100,645)
Ending liability	$	490,033	587,032

The asbestos related losses, including coverage dispute costs, and LAE as of December 31, 2005 and 2004, net of reinsurance, were as follows:

		2005	**2004**
		(In thousands)	
Beginning liability	$	274,800	443,809
Incurred losses and LAE		4,838	(86,693)
Calendar year payments for losses and LAE		(64,140)	(82,316)
Ending liability	$	215,498	274,800

The total asbestos liability for losses and LAE at December 31, 2005 and 2004 includes IBNR liabilities in the amount of $93.2 million and $98.3 million gross of reinsurance and $47.9 million and $43.9 million net of reinsurance, respectively. These IBNR liabilities and the comparable amounts for prior years cover both losses and defense and cost containment expenses. The Company also includes adjusting and other expenses in the amounts shown above.

Pursuant to a prescribed accounting practice, the amount of the discount on asbestos liabilities at December 31, 2005 and 2004 is $44.5 million and $94.2 million net of reinsurance, respectively.

Environmental Related Losses

The environmental related losses (including coverage dispute costs) as of December 31, 2005 and 2004, gross of reinsurance, were as follows:

		2005	2004
		(In thousands)	
Beginning liability	$	103,892	147,011
Incurred losses and LAE		10,442	3,979
Calendar year payments for losses and LAE		(19,886)	(47,098)
Ending liability	$	94,448	103,892

The environmental related losses, including coverage dispute costs, and LAE as of December 31, 2005 and 2004, net of reinsurance, were as follows:

		2005	2004
		(In thousands)	
Beginning liability	$	88,310	125,862
Incurred losses and LAE		(3,202)	(6,290)
Calendar year payments for losses and LAE		(10,736)	(31,262)
Ending liability	$	74,372	88,310

The total environmental liability for losses and LAE at December 31, 2005 and 2004 includes IBNR liabilities in the amount of $11.6 million and $43.8 million gross of reinsurance and $5.7 million and $47.6 million net of reinsurance, respectively. These IBNR liabilities and the comparable amounts for prior years cover both losses and defense and cost containment expenses. The Company also includes adjusting and other expenses in the amounts shown above.

Pursuant to a prescribed accounting practice, the amount of the discount on environmental liabilities at December 31, 2005 and 2004 is $5.7 million and $16.8 million net of reinsurance, respectively.

Discounting of Losses and LAE

The Company discounts its liability for losses and LAE for all lines of business pursuant to a prescribed accounting practice. The Company utilizes a cash-flow methodology approach in determining the amount of this discount which is based on the underlying payout patterns for each line of business. The Company segregates a portion of the discount that is associated with permanent total indemnity benefits. This amount is identified as tabular discount. The discount for these claims is based on industry tabular factors and statutory interest rates. Any supplemental discount associated with the Company’s higher interest rate assumption is treated as non-tabular discount. The Company’s tabular and non-tabular discounts by line of business as of December 31, 2005 and 2004 were as follows:

(Continued)

(In thousands)

		2005 *Case and IBNR	2004 *Case and IBNR
Tabular Discount			
Workers' compensation	$	157,535	187,535
Non-Tabular Discount			
Homeowners/farmowners		414	773
Private passenger auto/truck liability/medical		3,820	6,746
Commercial auto/truck liability/medical		15,693	16,513
Workers' compensation		286,858	332,876
Commercial multi peril		31,808	41,315
Medical malpractice:			
Claims-made		8	421
Occurrence		537	3
Specialty liability		939	1,497
Other liability – claims made		94,030	13,443
Other liability – occurrence		9,468	123,186
Special property		285	1,247
Auto physical damage		(8)	(9)
Fidelity/surety		3,859	3,950
Other (including credit, A&H)		89	3,129
Reinsurance nonproportional assumed liability		22,548	34,311
Product liability – claims made		(2,071)	(5)
Products liability – occurrence		4	(2,824)
Total		468,281	576,572
Grand total	$	625,816	764,107

*Includes liabilities for losses and loss adjustment expenses.

(4) Reinsurance

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

The Company's aggregate excess of loss reinsurance treaties relate to the 1998 through 2002 accident years, and they cover substantially all of the Company's lines of business. Recoveries under the treaties are payable when the paid covered net losses, as defined in the contracts, exceed the retention. Under the aggregate excess of loss reinsurance treaties, interest expense generally accrues on the funds withheld account at a rate of approximately 7% per annum. There were no ceded premiums under contracts accounted for as prospective reinsurance, net of ceding commission. Additional premiums may also be payable under the terms of certain treaties in future years.

Berkshire Hathaway Insurance Group and Kemper Commercial Insurance Company

In early 2003, shortly after the Kemper Insurance Companies were downgraded to below an "A" level, National Indemnity Company (NICO), a member of the "AAA" rated Berkshire Hathaway Group (Berkshire), provided the Company and its affiliates with immediate access to cut-through agreements issued by NICO. The cut-through agreements were applied to certain standard commercial and specialty lines policies of insurance in-force as of December 23, 2002 and to certain new policies issued by certain of the Kemper Insurance Companies on and after December 23, 2002 until September 30, 2003. With respect to each policy to which the NICO cut-through agreement applies, the cut-through allows a Kemper insured to directly submit claims to NICO in the event the respective Kemper Insurance Company (as the issuer of the policy) is unable to pay such claims as a result of its insolvency or a court or regulatory order prohibiting claim payments due to the issuing company's financial condition. From inception of the use of the cut-throughs in late December 2002 through 2005, Kemper incurred net cut-through agreement fees of approximately $15 million, substantially all of which was incurred by the Company during 2003 and prior.

As an agreed condition for NICO to provide the cut-through agreements, the Company and its affiliates immediately provided collateral available to NICO if and to the extent NICO makes any payments under any cut-through agreements. The collateral includes offset rights granted to NICO for reinsurance proceeds payable by either NICO or its affiliate, National Fire & Marine Insurance Company (National Fire), to the Company or its affiliates; a collateral trust initially in an amount of $251.1 million as of the end of June 2003, which amount has been and is subject to quarterly reductions by payments of losses and LAE and mid-term cancellations of policies (the trust amount has decreased to $22.4 million and $98.8 million at December 31, 2005 and 2004, respectively); and an investment of $257.3 million in Berkshire corporate obligations (Schedule D admitted assets) which the Company and AMM purchased from (and pledged as security to) Berkshire in 2003. In accordance with existing agreements, the investment was reduced to $246.9 million in December 2005 with cash and securities in the amount of the reduction being released to the Company. If NICO makes no payments under the cut-through agreements, then of the $246.9 million of pledged obligations, $100.0 million matures in March 2025, while the remaining $146.9 million is subject to mandatory redemption annually as the Company pays claims on policies covered by the cut-through agreements following exhaustion of the assets in the aforementioned collateral trust which must first be applied to such claim payments. Because the Berkshire corporate obligations have been pledged as collateral to Berkshire, the Company does not have the intent or, in the absence of a voluntary agreement from Berkshire, the ability to dispose of the obligations prior to maturity or redemption. At current claim payment rates, the trust assets will be reduced to zero by mid 2006. At December 31, 2005, $154.2 million of the Company's gross policy liabilities are protected by the NICO cut-through. Overall, the Company cedes to the Berkshire Hathaway Group liabilities totaling $261.6 million at December 31, 2005. Most of that amount also serves as security for any payments that may be made under any NICO cut-through agreements.

NICO also provides, for initial and annual fees, an appeals bond facility that the Company and its affiliates use primarily in connection with litigated claims. The Company fully collateralizes the appeal bonds with an investment in a Berkshire corporate obligation purchased from and pledged to Berkshire. At December 31, 2005, the Company has pledged $42.5 million of its assets as collateral for this purpose.

In connection with a 2001 commuted reinsurance arrangement, the Company entered into a long-term claim administration agreement with National Fire for the servicing of most of the Company's and its affiliates' existing asbestos and environmental claims. The Company paid $27.5 million in advance for the future servicing of such claims. In accordance with the prescribed accounting practice more fully described in note 1, the Company reflects as an admitted asset the remaining prepaid amount for claim handling services of approximately $12.2 million and $16.4 million as of December 31, 2005 and 2004, respectively.

Affiliate Assumed Reinsurance

The significant majority of the business written by members of the Kemper Insurance Companies has historically been ceded to the Company through quota share reinsurance agreements with some Company subsidiaries retaining a portion of the business written and through a quota share pooling agreement by and among the Company, AMICO, and AMM.

AMM is an affiliated mutual insurance company that shares with the Company common management and a substantially overlapping board of directors. AMM has been one of the Kemper Insurance Companies for over 50 years. The Company assumed most of AMM's liabilities, agreed to perform for AMM all insurance policy-related obligations including handling and paying claims, and issued a Company policy to each holder of a policy ever issued by AMM, including any policy no longer in force but excluding any policy that is cut-through reinsured by Unitrin (see "Renewal Rights Transactions" in note 1). The additional Company policy is substantively identical to the policy previously issued by AMM, although the Company policy is non-participating and non-voting with respect to the Company's corporate governance. The additional Company policy assures affected AMM policyholders that their claims will be treated equally with the claims of other Company policyholders not only in the event of a managed run-off of the Company and AMM, but also in the event of any insolvency proceedings with respect to the two companies. AMM remains liable for its policy liabilities in the event the Company does not comply with all the terms of the affected policies. AMM has approximately $435 million in reinsurance due from the Company as of December 31, 2005.

Other Reinsurance Disclosures

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

		Assumed	Ceded
		(In thousands)	
2005:			
Written premiums	$	1,472	32,911
Unearned premiums		8,980	15,280
Outstanding losses and LAE (including IBNR)		427,661	2,111,270
Paid losses		158,697	782,461
2004:			
Written premiums	$	28,123	60,083
Unearned premiums		15,271	24,229
Outstanding losses and LAE (including IBNR)		735,197	3,015,526
Paid losses		568,477	1,123,421

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

		Assumed	Ceded
		(In thousands)	
2005:			
Written premiums	$	25,151	671
Unearned premiums		19,369	—
Outstanding losses and LAE (including IBNR)		2,068,614	5,010
Paid losses		811,920	15,716
2004:			
Written premiums	$	(9,821)	5,255
Unearned premiums		37,098	—
Outstanding losses and LAE (including IBNR)		2,724,663	25,898
Paid losses		119,088	(830,174)

The Company historically has reinsured portions of the risks it underwrote in an effort to control its exposure to losses and protect surplus. The Company ceded to reinsurers a portion of these risks and paid premiums based upon the risk and exposure of the policies subject to such reinsurance. Reinsurance is subject to collectibility in all cases and to aggregate loss limits in certain cases. Although the reinsurer is liable to the extent of the reinsurance limits purchased, the Company remains primarily liable as the direct insurer on all risks reinsured. The Company also holds collateral, including escrow funds, letters of credit, and trust funds, under certain reinsurance agreements. The Company monitors the financial condition of reinsurers on an ongoing basis, and reviews its reinsurance arrangements periodically.

As of December 31, 2005, the Company had unsecured aggregate recoverables from outside reinsurers for losses paid, losses unpaid, LAE, and unearned premium that exceed 3% of the Company's total surplus with the following reinsurers (and related group members):

Reinsurer	FEIN Code	NAIC Group #	NAIC Code		Net recoverable
					(In thousands)
Allstate Insurance Co.	36-0719665	8	19232	$	9,770
		8 Total		$	9,770
American Home Assurance Co.	13-5124990	12	19380	$	449
Hartford Steam Boil Inspection & Insurance Co.	06-0384680	12	11452		503
Insurance Co. of the State of Pennsylvania	13-5540698	12	19429		1,769
National Union Fire Insurance Co. of Pittsburgh	25-0687550	12	19445		1,370
Transatlantic Reinsurance Co.	13-5616275	12	19453		26,651
		12 Total		$	30,742
Cologne Reinsurance Co. of America	06-0949141	31	33197	$	1
General Reinsurance Corp.	13-2673100	31	22039		113,240
National Fire & Marine Insurance Co.	47-6021331	31	20079		147,829
National Reinsurance Corp.	13-1988169	31	34835		507
North Star Reinsurance Corp.	13-2930109	31	22047		18
		31 Total		$	261,595
Motors Insurance Co.	38-0855585	79	22012	$	5,472
		79 Total		$	5,472
Hartford Fire Insurance Co.	06-0383750	91	19682	$	9,024
		91 Total		$	9,024
Berkley Insurance Co.	47-0574325	98	32603	$	31,943
Firemen's Insurance Co. of Washington D.C.	53-0067060	98	21784		626
Tri State Insurance Co. of Minnesota	41-1232071	98	31003		630
		98 Total		$	33,199
Employers Insurance of Wausau	39-0264050	111	21458	$	6,013
Liberty Mutual Insurance Co.	04-1543470	111	23043		623
		111 Total		$	6,636
Clearwater Insurance Co.	13-2781282	158	25070	$	25,392
Clearwater Select Insurance Co.	23-2745904	158	10019		8,690
North River Insurance Co.	22-1964135	158	21105		2
Odyssey America Reinsurance Co.	47-0698507	158	23680		5,737
Old Lyme Insurance Co. of RI Inc.	13-3306163	158	19160		361
		158 Total		$	40,182
Swiss Reinsurance Life & Health America Inc.	06-0839705	181	82627	$	6,541
Swiss Reinsurance America Corp.	13-1675535	181	25364		188,215
		181 Total		$	194,756

(Continued)

Reinsurer	FEIN Code	NAIC Group #	NAIC Code		Net recoverable
					(In thousands)
Trinity Universal Insurance Co.	75-0620550	215	19887	$	52,767
Unitrin Preferred Insurance Co.	13-5460208	215	25909		(12)
		215 Total		$	52,755
Continental Casualty Co.	36-2114545	218	20443	$	20,472
Continental Insurance Co.	13-5010440	218	35289		10
Encompass Insurance Co. of America	36-3976913	218	10071		564
		218 Total		$	21,046
Philadelphia Reins. Corp.	23-1620930	229	12319	$	433
Reliastar Life Insurance Co.	41-0451140	229	67105		75,984
		229 Total		$	76,417
Employers Reinsurance Corp.	48-0921045	350	39845	$	56,975
GE Reinsurance Corp.	36-2667627	350	22969		180,447
Westport Insurance Corp.	13-1941868	350	34207		902
		350 Total		$	238,324
American Reinsurance Co.	13-4924125	361	10227	$	221,919
		361 Total		$	221,919
American National Insurance Co.	74-0484030	408	60739	$	6,641
		408 Total		$	6,641
RSUI Indemnity Co.	16-0366830	501	22314	$	17,536
		501 Total		$	17,536
Gerling Global Reinsurance Corp. of America	13-5009848	604	21032	$	12,967
Global Reinsurance Corp. U.S. Branch	13-6107326	604	11266		1
		604 Total		$	12,968
Ace American Reinsurance Co.	23-1740414	626	22705	$	156
Ace American Insurance Co.	95-2371728	626	22667		3,683
Ace Property & Casualty Insurance Co.	06-0237820	626	20699		5,240
Insurance Co. of North America	23-0723970	626	22713		5,931
Westchester Fire Insurance Co.	13-5481330	626	21121		65
		626 Total		$	15,075
General Security National Insurance Co.	13-3029255	749	39322	$	4,967
Scor Reinsurance Co.	75-1444207	749	30058		35,360
		749 Total		$	40,327
Pennsylvania Manufacturers Assn. Insurance Co.	23-1642962	767	12262	$	257
PMA Capital Insurance Co.	23-2153760	767	39675		5,130
		767 Total		$	5,387
Everest Reinsurance Co.	22-2005057	1120	26921	$	12,449
		1120 Total		$	12,449

(Continued)

Reinsurer	FEIN Code	NAIC Group #	NAIC Code		Net recoverable
					(In thousands)
American Employers Insurance Co.	04-1027270	1129	20613	$	320
Folksamerica Reinsurance Co.	13-2997499	1129	38776		12,719
		1129 Total		$	13,039
X.L. Reinsurance America Inc.	13-1290712	1285	20583	$	10,332
		1285 Total		$	10,332
Insurance Corp. of NY	13-5339725	1314	18341	$	454
Trenwick America Reinsurance Corp.	06-1117063	1314	34894		68,368
		1314 Total		$	68,822
Alea North American Specialty Insurance Co.	51-0335732	1325	44776	$	1,792
Alea North America Insurance Co.	06-1022232	1325	24899		12,420
		1325 Total		$	14,212
Converium Reinsurance North America Inc.	06-1325038	3018	39136	$	161,751
		3018 Total		$	161,751
Partner Reinsurance Co. of the U.S.	13-3031176	3483	38636	$	5,919
PartnerRe Insurance Co. of New York	13-3531373	3483	10006		257
		3483 Total		$	6,176
Discover Prop & Cas Insurance Co.	36-2999370	3548	36463	$	130
Fidelity & Guaranty Insurance Co.	42-1091525	3548	35386		(15)
Gulf Insurance Co.	43-6028696	3548	22217		4,207
Northland Insurance Co.	41-6009967	3548	24015		1,790
St. Paul Fire & Marine Insurance Co.	41-0406690	3548	24767		17,668
Travelers Indemnity. Co.	06-0566050	3548	25658		1,237
US Fidelity & Guaranty Co.	52-0515280	3548	25887		1,761
		3548 Total		$	26,778
Associated Aviation Underwriters	AA-9995013			$	115,347
Commercial Risk Re-Insurance Co.	03-0331391		27955		9,484
Excess and Casualty Reinsurance Assn.	AA-9995022				10,106
Hannover Ruckversicherungs AG	AA-1340125				7,072
Lloyds of London	AA-1122000				19,276
Lloyd's Syndicate Number 2020	AA-1128020				6,041
Patriot Insurance Co. Ltd.	AA-3190450				24,970
Texas Workes Compensation	AA-9991444				26,173
TOA-Reinsurance Co. of America	13-2918573		42439		5,218
Workers Compensation Reinsurance Assn.	41-1357750		10181		9,092
Grand Total				$	1,846,109

Uncollectible Reinsurance

During 2005 and 2004, the Company wrote off $8.3 million and $3.7 million, respectively, related to reinsurance paid loss recoverable balances with reinsurers deemed no longer collectable.

Reinsurance Assumed and Ceded

The estimated maximum amount of return commission due reinsurers if all of the Company's reinsurance was canceled as of December 31, 2005 is as follows:

	Assumed reinsurance		Ceded reinsurance		Net	
	Unearned premium liability	Commission equity	Unearned premium liability	Commission equity	Unearned premium liability	Commission equity
Affiliates	$ 19,368,578	(1,297,379)	—	—	19,368,578	(1,297,379)
All other	8,980,189	11,795,755	15,279,743	1,389,412	(6,299,554)	10,406,343
Total	$ 28,348,767	10,498,376	15,279,743	1,389,412	13,069,024	9,108,964

Commutation of Ceded Reinsurance

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

Agreement	Reinsurer	FEIN Code	Amount	Reflected As
Commutation #1	Affiliated Chemical Group Ltd.	AA-3191085	$ (35,040)	Losses incurred
Commutation #2	Alea Bermuda Ltd.	AA-3190800	58,559,176	Losses incurred
Commutation #3 A	GE Reinsurance Co.	36-2667627	712,837	Losses incurred
Commutation #3 B	GE Reinsurance Co.	36-2667627	7,639	Miscellaneous income
Commutation #4	Seven Continents Insurance Co., Ltd.	AA-3190196	(727,000)	Losses incurred
Commutation #5	Trenwick America Reinsurance Corp.	06-1117063	10,238,380	Other
Total			$ 68,755,992	

Reinsurance Recoverable in Dispute

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

Name of reinsurer	Total amount in dispute (including IBNR)	Notification	Arbitration	Litigation
Patriot Insurance Co. Ltd.	$ 30,371,053	—	—	30,371,053
Front Range Insurance Co.	9,740,877	—	—	9,740,877
X.L. Reinsurance America Inc.	6,189,632	6,189,632	—	—
American Re-insurance Co.	5,309,334	5,309,334	—	—
Clearwater Insurance Co. (FKA Odyssey Re)	5,250,915	—	5,250,915	—
Swiss Reinsurance Life & Health America, Inc.	5,035,449	5,035,449	—	—
Q.B.E. Internation Insurance Ltd.	4,519,617	—	4,519,617	—
Canadian Reinsurance Co. (FKA Swiss Re Canada)	3,550,945	3,550,945	—	—
Hannover Ruckversicherungs AG.	3,477,031	3,477,031	—	—
Lloyd's Syndicate Number 2020	3,100,068	246	3,099,822	—
Arch Reinsurance Co.	2,660,891	2,660,891	—	—
Ace American Insurance/Cigna				—
Insurance Co.	2,552,865	2,552,865	—	—
Employers Insurance of Wausau A Mutual Co.	2,193,845	453,003	1,740,842	—
Employers Reinsurance Corp.	2,070,248	2,070,248	—	—
Royal & Sun Alliance PLC	1,920,822	—	1,920,822	—
General Reinsurance Corp.	1,867,299	1,867,299	—	—
Transatlantic Reinsurance Co.	1,813,593	25,432	1,788,161	—
Folksamerica Reinsurance Co.	1,470,727	1,470,727	—	—
Argonaut Insurance Co.	1,419,095	1,419,095	—	—
Insurance Co. of North America	1,283,687	1,283,687	—	—
Lloyd's Syndicate Number 1212	1,247,441	—	1,247,441	—
Excess and Casualty Reinsurance Assn. (ECRA)	1,054,732	1,054,732	—	—
National Casualty Co.	1,016,370	216,309	800,061	—
Lloyd's Syndicate Number 1241	945,713	—	945,713	—
TOA-Reinsurance Co. of America	924,051	—	924,051	—
Liberty Mutual Insurance Co. (Massachusetts) Ltd.	891,426	—	891,426	—
Scor Reinsurance Co.	832,549	832,549	—	—
Lloyd's Syndicate Number 183	750,000	—	750,000	—
Lloyd's Syndicate Number 250	742,322	—	742,322	—
Swiss Reinsurance America Corp.	705,737	705,737	—	—
Continental Casualty Co.	574,106	574,106	—	—

Name of reinsurer		Total amount in dispute (including IBNR)	Notification	Arbitration	Litigation
Lloyd's Syndicate Number 510	$	546,609	—	546,609	—
Endurance Specialty Insurance Ltd.		500,428	500,428	—	—
Mutual Reinsurance Bureau		459,399	459,399	—	—
Excess Insurance Co. Ltd.		311,278	311,278	—	—
Odyssey Reinsurance Corp.		308,183	308,183	—	—
Ace American Reinsurance Co.				—	—
(FKA Cigna Reinsurance Co.)		292,083	292,083	—	—
American States Insurance Co.		255,545	255,545	—	—
Factory Mutual Insurance Co.		251,696	251,696	—	—
Allstate Insurance Co.		233,799	—	233,799	—
Partner Reinsurance New York		207,341	207,341	—	—
GE Reinsurance Corp.		192,203	192,203	—	—
Seguros Monterrey Aetna, S.A.		190,952	190,952	—	—
Partner Reinsurance Co. of the U.S.		182,574	182,574	—	—
Lloyd's Syndicate Number 138		149,103	—	149,103	—
Lloyd's Syndicate Number 727		149,103	—	149,103	—
Great American Insurance Co.		96,774	96,774	—	—
Lloyd's Syndicate Number 2791		74,544	—	74,544	—
Underwriters Reinsurance Co.		63,925	63,925	—	—
Arkwright Mutual Insurance Co.		62,774	62,774	—	—
Travelers Indemnity Co.		55,389	55,389	—	—
Nationwide Mutual Insurance Co.		26,939	26,939	—	—
Odyssey America Reinsurance Co.		15,202	15,202	—	—
American Employers Insurance Co.		4,711	4,711	—	—
Gothaer Versicherungsbank VAG		440	440	—	—
St. Paul Fire & Marine Insurance Co.		402	—	402	—
Total	$	110,113,836	44,227,153	25,774,753	40,111,930

(Continued)

Events of September 11, 2001

As of December 31, 2005 and 2004, the Company's total inception to date incurred losses and LAE related to the September 11 events were as follows:

		2005	**2004**
		(In thousands)	
Gross losses and LAE incurred	$	219,473	226,263
Reinsurance losses and LAE ceded		(178,783)	(174,612)
Net losses and LAE incurred	$	40,690	51,651

The incurred losses were primarily attributable to the commercial multiple peril and other liability lines of business. As of December 31, 2005 and 2004, the Company has recovered a total of $155.2 million and $148.0 from its reinsurers, against $191.1 million and $182.8 in total claim payments, respectively.

Reinsurance Accounted for as a Deposit

The Company entered into various reinsurance agreements in previous years which were determined to be of a deposit type nature. As of December 31, 2005, the Company had a total remaining deposit balance of $20.6 million after taking into account interest income deposits and cash recoveries, as follows (amounts in thousands):

	Contract #1	Contract #2	Contract #3	Contract #4	Total
Effective yield	7.54%	14.11%	(14.02)%	(6.39)%	
2000:					
Initial payment	$ 22,007	—	—	—	22,007
Cash deposits	—	—	—	—	—
Interest income	124	—	—	—	124
Cash recoveries	(29)	—	—	—	(29)
Deposit balance	22,102	—	—	—	22,102
2001:					
Initial payment	—	—	—	2,614	2,614
Cash deposits	20,976	3,887	—	—	24,863
Interest income	618	240	—	(1,114)	(256)
Cash recoveries	(1,538)	(1,454)	—	(4)	(2,996)
Deposit balance	42,158	2,673	—	1,496	46,327
2002:					
Initial payment	—	—	2,823	—	2,823
Cash deposits	22,411	—	—	112	22,523
Interest income	1,047	290	(1,698)	—	(361)
Cash recoveries	(6,235)	(967)	(10)	(541)	(7,753)
Deposit balance	59,381	1,996	1,115	1,067	63,559
2003:					
Initial payment	—	—	—	—	—
Cash deposits	765	—	(71)	(24)	670
Interest income	7,342	114	—	—	7,456
Cash recoveries	(13,870)	(538)	(361)	(384)	(15,153)
Deposit balance	53,618	1,572	683	659	56,532
2004:					
Initial payment	—	—	—	—	—
Cash deposits	206	—	(1)	(1)	204
Interest income	1,954	—	—	—	1,954
Cash recoveries	(14,339)	—	(366)	(490)	(15,195)
Deposit balance	41,439	1,572	316	168	43,495
2005:					
Initial payment	—	—	—	—	—
Cash deposits	—	—	—	—	—
Interest income	4,322	415	586	539	5,862
Cash recoveries	(26,838)	(1,532)	(226)	(152)	(28,748)
Deposit balance	$ 18,923	455	676	555	20,609

(5) Federal and Foreign Income Taxes

The components of the Company's net deferred tax asset as of December 31, 2005 and 2004 were as follows:

		2005	2004
		(In thousands)	
Total of gross deferred tax assets	$	763,361	732,431
Total of gross deferred tax liabilities		(3,393)	(3,579)
Net deferred tax asset		759,968	728,852
Deferred tax asset nonadmitted		(759,968)	(728,852)
Net admitted deferred tax asset	$	—	—
Increase in nonadmitted asset	$	(31,116)	(115,524)

The Company's income tax benefit (expense) for the years ended December 31, 2005 and 2004 consisted of the following major components:

		2005	2004
		(In thousands)	
Federal	$	22,769	(14,496)
Foreign		1,642	2,178
Federal and foreign income tax benefit (expense)	$	24,411	(12,318)

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities as of December 31, 2005 and 2004 were as follows:

		2005	2004
		(In thousands)	
Deferred tax assets:			
Loss carryforwards	$	544,404	423,049
Accrued liabilities		24,402	35,526
Reserves		24,834	48,448
Investments		58,938	73,233
Receivables		83,627	106,889
Reinsurance adjustments		—	30,465
Section 197 intangibles		12,088	—
Other		15,068	14,821
Total deferred tax assets		763,361	732,431
Nonadmitted deferred tax assets		(759,968)	(728,852)
Admitted deferred tax assets		3,393	3,579
Deferred tax liabilities:			
Salvage and subrogation		(2,281)	(3,441)
Investments		(1,112)	(138)
Total deferred tax liabilities		(3,393)	(3,579)
Net admitted deferred tax asset	$	—	—

The change in net deferred income taxes as of December 31, 2005 and 2004 was comprised of the following:

		2005	2004		Change
			(In thousands)		
Total deferred tax assets	$	763,361	732,431		30,930
Total deferred tax liabilities		(3,393)	(3,579)		186
Net deferred tax asset	$	759,968	728,852		31,116
Tax effect of unrealized gains or losses					—
Increase in net deferred income tax in surplus				$	31,116

The actual federal and foreign income tax benefit (expense) as of December 31, 2005 and 2004 differed from "expected" tax benefit (expense) (expected tax is computed by applying the corporate tax rate of 35% to income before federal and foreign income taxes) as follows:

		2005	**2004**
		(In thousands)	
Computed "expected" tax benefit	$	6,147	42,454
Capital gain adjustment		11,617	24,687
Operating loss carryforward adjustment		(60,334)	(134,145)
Accrued liabilities		14,947	46,360
Prior year tax adjustments		20,244	(15,079)
Reinsurance adjustments		26,203	(21,275)
Policyholder dividends		—	4,015
Tax-exempt investment income		—	11,978
Depreciation		1,036	5,772
Foreign income taxes		1,642	2,178
Accrued income		(3,351)	(3,567)
Reserves		14,585	24,639
Other, net		(8,325)	(335)
Federal and foreign income tax benefit (expense)	$	24,411	(12,318)

Provision computed at statutory rate	$	6,147	42,454
Investments		(7,003)	(40)
Accrued liabilities		3,823	(27,149)
Tax-exempt investment income		—	11,978
Prior period adjustments		20,244	(12,900)
Reinsurance adjustments		(4,262)	10,165
Receivables		(23,266)	24,300
Reserves		(9,029)	24,957
Loss carryforwards		61,021	—
Section 197 intangibles		13,207	—
Subsidiary mergers		—	32,092
Other, net		(5,355)	(2,651)
Total statutory income taxes	$	55,527	103,206
Federal and foreign income taxes incurred	$	24,411	(12,318)
Change in net deferred income taxes		31,116	115,524
Total statutory income taxes	$	55,527	103,206

(Continued)

At December 31, 2005, the Company had $1.5 billion of operating loss carryforward which originated and expires as follows:

Origination year	Expiration year	Amount (In thousands)
2000	2020	$ 182,176
2001	2021	405,592
2002	2022	152,661
2003	2023	211,668
2004	2024	399,427
2005	2025	172,382
		$ 1,523,906

There were no income taxes incurred in the current and prior year that will be available for recoupment in the event of future net losses.

Tax returns for the years through 2001 are closed for IRS examination. The Company is not currently under examination by the Internal Revenue Service for any open tax years.

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

(6) Transactions with Affiliates and Related Parties

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

(7) Employee Benefit Plans

Pension Plan

The Company had a noncontributory defined benefit pension plan in which all of its full-time employees with one year of service participated and became fully vested after five years of service. The Company also had a nonqualified supplemental plan which provided additional pension benefits to certain key employees and officers. Effective January 15, 2004, the Company adopted an amendment to freeze both the qualified and nonqualified noncontributory defined benefit pension plans.

During 2004, the Company funded and accrued a total of $21.5 million into its noncontributory qualified defined benefit pension plans.

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

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

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

Savings and Profit Sharing Plans

The Company's Savings and Profit Sharing Plan is qualified under Section 401(a) of the Internal Revenue Code. For the year ended December 31, 2005, employee contributions were $2.2 million, while for 2004, employer and employee contributions were $1.5 million and $3.3 million, respectively.

In 2004, the Company announced that it would cease matching contributions to the Company's 401(k) plan beginning in 2005. The Company had previously terminated any discretionary profit sharing; this announcement reflected a further amendment to the profit sharing plan to eliminate a previously mandatory feature pursuant to which the Company had matched each participating employee's contributions up to 4% of the employee's salary.

Retention Plan

The Company's workforce decreased to approximately 284 employees at December 31, 2005 from 340 employees at December 31, 2004. During 2004, to help stabilize the workforce, the Company implemented among other things, a retention plan providing for scheduled quarterly payments. The retention payments for 2005 and 2004 totaled $5.3 million and $2.6 million, respectively.

Incentive Program

In the third quarter of 2004, the Company also implemented, in lieu of any other annual short-term bonus plan, two incentive programs linked to successfully achieving or exceeding certain targets as anticipated in the Company's approved run-off plan and policy buyback activity. The programs took into account payments under the aforementioned employment agreements and retention plan. Payments under these programs in the first quarter of 2006 totaled approximately $4.4 million (of which $4.7 million was accrued at December 31, 2005).

Restricted Stock and Stock Option Plans

Certain of the Company's stock company affiliates have had restricted stock and variable stock option incentive plans available to certain key officers and employees of both the Company and the affiliates. The value of such incentives, which has been subject to Board approval, was determined using an adjusted book value calculation. The value of the restricted stock, which was determined at the date of the grant, and changes in the value of the stock option plans from the original grant price were accrued as compensation expense using the vesting periods contained in the stock plans. The restricted stock and stock option compensation expense was charged to surplus as a component of net unrealized capital losses. In February of 2003, the Board terminated the restricted stock and stock option programs. As of September 30, 2004, certain of the Company's subsidiaries had accrued liabilities related to stock option plans totaling $2.2 million, consisting of $1.5 million previously accrued at December 31, 2003 plus amounts that vested in early 2004. In the fourth quarter of 2004, the Company paid $200 thousand to settle those liabilities, which resulted in a reduction of expense of approximately $2.0 million as of December 31, 2004. The Company continues to carry deferred compensation liabilities of approximately $1.2 million at December 31, 2005.

Other Post-retirement Benefits Other than Pensions

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

Other Benefit Plans

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

Certain coverages of the Plan require both employer and employee contributions, while others require either an employer or employee contribution. The Company and its employees make specified monthly contributions for the coverages selected. The contribution rates for both the employer and employee are determined annually by the Company. In accordance with provisions of the Plan, eligible employees, and eligible dependents of employees of the Company who incur claims are entitled to receive benefits under the Plan.

Employer and employee contributions for 2005 were $5 million and $1.9 million, respectively, while 2004 employer and employee contributions were $13.0 million and $10.3 million, respectively. For 2005 and 2004, total benefit payments under the Plan were $6.8 million and $22.4 million, respectively.

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

(8) Risk-based Capital

The NAIC utilizes a RBC formula intended for regulatory monitoring of property-casualty insurers. Under RBC rules in Illinois, state regulators may mandate remedial action for inadequately capitalized companies. The focus of the capital rules is a risk-based formula that applies prescribed factors to various risk elements in an insurer's business and investments to develop a minimum capital requirement designed to be proportional to the amount of risk assumed by the insurer. For the last three years, the Company's level of capital and surplus has been at the "mandatory control level" under the RBC rules. At this level, the Division of Insurance has substantial authority to exercise control over the Company and its affiliates. The Division of Insurance is mandated to place a company at this level under its control, except where, as is the case with the Company, such company is a property and casualty insurance company that is no longer writing new business and is running off its existing business, in which case the Director of the Division of Insurance (the Director) has discretion to allow the continued run-off. Exercising its supervisory authority, the Division of Insurance has issued Corrective Orders.

On March 19, 2004, the Company and the other Illinois-domiciled Kemper Insurance Companies filed a commercial run-off plan with the Division of Insurance. On June 9, 2004, the Division of Insurance gave the Kemper Insurance Companies permission to proceed with the run-off plan as submitted. The Company updates the plan based on current information from time to time. Details of the plan are confidential, pursuant to the state's RBC statute. The plan is designed to help Kemper meet its goal of resolving, to the maximum extent possible, all valid policyholder claims. The Company prepared and filed a supplement to the run-off plan on April 13, 2006 and April 15, 2005.

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

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

Having entered into voluntary run-off in the first half of 2003, the Company has been operating under guidance provided within certain agreed to Corrective Orders with the Division of Insurance, pursuant to which the Company has ceased to write virtually all insurance business and is settling its liabilities under the administrative supervision of the Division of Insurance. The Company has also entered into consent agreements with certain states under which the Company agreed to cease writing business in those jurisdictions. In addition, the Company has voluntarily agreed for its license to be suspended in Florida and Tennessee, with the Company permitted to maintain its license but not permitted to write any new business.

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

Ratings

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

The downgrades to below A- effectively ended the Company's and its affiliates' ability to write most new commercial lines of business or retain existing policyholders. In the first half of 2003, as a result of a combination of various business factors including the ratings downgrades and the Company's deteriorating statutory surplus, the Company has substantially ceased underwriting activities other than as required by contract or law. The Company and most of its affiliates have been subject to Corrective Orders by the Division of Insurance not to write any new or renewal business except as necessary to comply with contractual commitments or as expressly permitted by the Division of Insurance.

Liquidity

The Company's net cash outflows, consisting principally of claim payments (net of reinsurance collections and releases of encumbered assets), exceed substantially its cash inflows resulting from investment income and the limited premium income the Company continues to receive. There are a number of factors that could adversely affect the Company's liquidity position and its adequacy in the future. Accelerated claim payments or imposition of requirements to secure future maturing obligations by court order or otherwise, deterioration of reinsurance collections, increases in operating expenses, and other unanticipated strains on liquidity could cause the Company to have insufficient liquid and unencumbered assets to continue to pay obligations as they mature. As liquidity declines, there can be no assurance that formal proceedings would not be initiated by the Division of Insurance significantly before the Company's projected liquidity would reach zero. The Company's reported approximately $947 million of unencumbered assets at December 31, 2005 includes approximately $200 million that, although unencumbered, are not necessarily immediately available funds, as this amount consists of such items as assets held in subsidiaries and working capital requirements.

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

Also to supplement liquidity during 2004, the Company merged five of its subsidiaries into another wholly owned subsidiary, AMICO, and during 2005 dissolved 20 other non-insurance company subsidiaries. The liquidity benefits from the mergers are due to anticipated expense reductions by eliminating the need to maintain corporate entities. The mergers also resulted in releases of certain state deposits, which releases totaled $5.3 million in 2004. AMICO cedes 100% of its policy liabilities to the Company and therefore has no net liabilities to policyholders. As a result of the mergers, the Company and AMICO obtained approval from the Division of Insurance for AMICO to declare and pay to the Company an extraordinary dividend of approximately $161.7 million on December 31, 2004.

Prompt collection of reinsurance recoverables is a primary driver of the Company's liquidity at all times. Reinsurance provided approximately $901.9 million and $1.0 billion of liquidity to the Company during 2005 and 2004, respectively. Gross reinsurance recoverables totaled $2.4 billion, net of provision of $121 million, at December 31, 2005, down from $3.3 billion, net of provision of $150 million, at December 31, 2004.

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

Subsidiary Guarantees

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

Securities on Deposit and Encumbered Assets

Approximately $1.1 billion of the Company's invested assets at December 31, 2005 are encumbered by being on deposit or held in trust or escrow arrangements, compared with $1.5 billion one year earlier.

	2005	2004
	(In millions)	
Special deposits/encumbered assets:		
State deposits	$ 693	996
NICO cut-through collateral	269	356
NICO appeal bond collateral	43	53
Canada deposits	42	63
All other	26	64
	1,073	1,532
Unencumbered assets:		
Cash, bonds, and stocks	881	1,059
Receivables for securities	32	2
Other assets	34	87
	947	1,148
Cash and invested assets	$ 2,020	2,680

The majority of the encumbrances, are deposits with state insurance departments, with California representing the majority of that amount, $538.3 million, at December 31, 2005. During 2005, the Company received releases of encumbered assets from states totaling approximately $303 million. There can be no assurance that there will be additional releases.

Where required to post court bonds, including supersedes or appeal bonds, the Company, due to its financial condition, has had to post cash or other security totaling in most cases 100% of the bond. At December 31, 2005, the Company had pledged invested and other assets of approximately $44.1 million for such bonds, most of which are issued by National Indemnity.

Approximately $269.3 million of the Company's assets at December 31, 2005 are in a collateral trust for the benefit of or are otherwise pledged to Berkshire affiliates. This amount reflects an $86.8 million reduction from a year earlier, as the majority of these encumbered assets are subject to release to the Company periodically as claim payments are made on policies to which are attached the cut-through agreements from National Indemnity and National Fire.

The Company is contingently liable to provide up to an estimated additional $26.8 million in collateral due to ratings triggers in reinsurance agreements where it is a reinsurer. Of this amount, $4.2 million has been funded with assets of an unrelated third party, Alea Bermuda Ltd. ("Alea"), for business where the Company from late 1999 to year-end 2001 fronted assumed reinsurance contracts in the U.S. for Alea. Alea's insurance ratings fell to below the "A" level in 2005, and Alea and its affiliates recently went into run-off status and are undergoing related operational changes; however, Alea's reinsurance obligations to the Company for the fronted liabilities are secured by collateral trust assets of Alea in the amount of $144.5 million at December 31, 2005. Alea also has handled claims on behalf of the Company since 1999 on both the fronted liabilities and, at December 31, 2005 and 2004, $137.3 million and $271.8, respectively, of other assumed reinsurance liabilities written by the Company from 1997 through 1999. The Company is dependent on Alea for the claim handling and its related accounting associated with the liabilities assumed under this arrangement.

Approximately $4.9 million and $4.0 million, of the Company's invested assets at December 31, 2005 and 2004, respectively, are in a collateral trust for the benefit of Seabright Insurance Company related to a reinsurance agreement.

In addition to the encumbrances applicable to the Company's cash and invested assets which are reflected in the preceding table, the Company has certain reinsurance-related assets which have been pledged or otherwise encumbered. Such encumbered assets include funds held by or deposited with reinsured companies ($19.4 million), certain reinsurance recoverables that serve as additional security for the NICO cut-through (see note 4), and reinsurance recoverables for claims paid and to be paid by certain Markel Corporation subsidiaries related to business written by companies that the Company acquired from Markel in 1998 and 1999 ($5.9 million at December 31, 2005). In addition, one of the Company's wholly owned subsidiaries, SSIC, which was a Markel subsidiary until January 2000, also has granted to a Markel entity a security interest in SSIC's reinsurance recoverables related to claims from before 2000 that Markel is responsible for handling; SSIC's related encumbered reinsurance assets totaled $148.2 million at December 31, 2005.

To discharge certain insurance claim liabilities, LMC has purchased structured settlement annuities with the claimant as payee. The aggregate December 31, 2005 and 2004 value of loss liabilities eliminated by the purchase of these annuities was approximately $138.5 million and $140.0, respectively. The Company remains contingently liable should the issuers of the annuities fail to perform.

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

Carrier	Location		Reportable amounts
SAFECO Life Insurance Co.	Seattle, WA	$	34,238,269
United Pacific Life Insurance Co.	Seattle, WA		23,461,990
First Colony Life Insurance Co.	Lynchburg, VA		23,101,713
Federal Home Life Insurance Co.	Richmond, VA		17,007,747
Metropolitan Life Insurance Co.	New York, NY		11,762,105
Prudential Life Insurance Co.	Newark, NJ		4,058,930
Transamerica Occidental Life Insurance Co.	Cedar Rapids, IA		3,456,713
Presidential Life Insurance Co.	Nyack, NY		3,029,571
Charter Security Life Insurance Company	Hartford, CT		2,056,348
Manufacturers Life of Canada	Toronto, ON		1,990,893

Litigation

As described in note 10, the Company issued $700.0 million in aggregate principal amount surplus notes in 1996 and 1997. On March 20, 2003 and November 3, 2003, the Director denied the Company's requests for payment of interest on the surplus notes then due. Subsequent payments of interest on the surplus notes have also been prohibited by the Director. Following the March 20, 2003 denial, in June and July, 2003, several lawsuits were filed in the Circuit Court of Cook County, Illinois by certain current holders of surplus notes aggregating approximately $368.0 million and naming the Company, various directors or former directors of the Company and Kemper Commercial Insurance Company, a now dissolved subsidiary of the Company, as defendants. One case was voluntarily dismissed by the plaintiff, and the other two were consolidated in 2004. This lawsuit alleges that the Company breached the agreements relating to the surplus notes by adopting a divestiture plan to sell all or substantially all of the Company's assets and ongoing businesses without requiring the acquiring entities to assume the Company's surplus notes or obtaining the consent of a majority of the holders of the surplus notes. The complaint further alleges that the directors breached their fiduciary duties and committed corporate waste, and that the Company and Kemper Commercial Insurance Company engaged in a fraudulent conveyance. The complaint, among other things, seeks a declaratory judgment of the parties' rights, an injunction against further asset sales and monetary damages. The Company had not yet been served with a consolidated amended complaint when, in May 2006, the matter was dismissed without prejudice. See note 13.

In addition to the above, in the ordinary course of business, the Company is involved in various legal actions for which it establishes liabilities where appropriate. In the opinion of the Company's management, based upon the advice of legal counsel, contingent liabilities arising from litigation, tax, and compliance matters are not expected to have a material adverse effect on the Company's statutory financial statements due to established liabilities and anticipated insurance and reinsurance recoverables, but there can be no assurance that such matters will not become material due to future developments, including any changes with respect to the financial condition of the Company.

Other Items

The Company leases office space and equipment under various noncancelable operating lease agreements. Rental expense for 2005 and 2004 was $5.1 million and $15.1 million, respectively.

At December 31, 2005, the total aggregate minimum rental payments on operating leases is $22.1 million and future minimum rental payments are as follows:

		Minimum payments (in thousands)
Year ending December 31:		
2006	$	7,413
2007		6,362
2008		5,022
2009		2,703
2010		572
2011 and thereafter		6
	$	22,078

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

The Company is liable for guaranty fund assessments related to certain unaffiliated companies that have become insolvent during the years 2005 and prior. The Company's financial statements include provisions for all known assessments that are expected to be levied against the Company as well as an estimate of amounts (net of estimated future premium tax recoveries) that the Company believes it will be assessed in the future for which the insurance industry has estimated the cost to cover losses to policyholders. The Company is also contingently liable for any future guaranty fund assessments related to insolvencies of unaffiliated insurance companies, for which the insurance industry has been unable to estimate the cost to cover losses to policyholders. No specific amount can be reasonably estimated for such insolvencies as of December 31, 2005. As of December 31, 2005, the Company has accrued a liability of approximately $4.5 million for such assessments. The Company has established a liability for premium and loss based assessments of approximately $43.0 million as of December 31, 2005, compared with $55.7 million a year earlier.

Kemper Corporation

Kemper Corporation (KC) was a former affiliate of the Company acquired by Zurich Insurance Company (Zurich) in 1996. Dating from before that acquisition, there were certain contractual tax indemnification obligations between the Company and KC related to an earlier corporate transaction and a corporate insurance indemnification owed by KC to the Company for certain reinsurance arrangements dating from decades ago. The Company and Zurich/KC fully settled those former obligations in 2005; the settlement resulted in an increase in operating results of $16.8 million in 2005.

GE Reinsurance Company

In 1998, the Company sold to GE Insurance Solutions (GEIS) the Company's professional reinsurance subsidiary, Kemper Reinsurance Company, and that former Company affiliate was then renamed GE Reinsurance Company (GE Re). Dating from before that sale, there were and are intercompany obligations between the Company and the renamed GE Re, including numerous reinsurance arrangements. Under one of those reinsurance arrangements, GE Re reinsured certain aviation pool exposures in the U.S. and Canada. In addition, the 1998 sale created certain tax indemnification obligations between the parties. In 2005, the Company and GE Re commuted the aviation reinsurance and settled all open matters relating to the tax indemnification obligations. As a result, the Company recorded an increase in operating results of $3.8 million in 2005. The Company has other reinsurance recoverables from GE Re and its affiliates totaling $238 million at December 31, 2005.

SeaBright Insurance Company

Following the September 30, 2003 sale by the Company of 100% of the capital stock of Kemper Employers Insurance Company (KEIC) to SeaBright Insurance Holdings, Inc., the purchaser renamed KEIC as SeaBright Insurance Company (Seabright). As part of the 2003 sale transaction, the Company provided a stop loss reinsurance agreement to KEIC, now SeaBright, and collateralized that reinsurance with a collateral trust initially in the amount of $1.6 million (in addition to a purchase price escrow in the amount of $4.0 million). Being subject to adjustment in the event of adverse development of pre-sale KEIC liabilities, the amount in the trust was increased by the Company adding approximately $3.2 million to the trust in 2004. The adverse development also resulted in the Company recording a $4.7 million charge ($2.7 million net of discount) to its operating results and surplus as of December 31, 2004. In the fourth quarter of 2005, $3.8 million of the $4.0 million purchase price escrow from the September 30, 2003 transaction was released back to the Company.

Broadspire

In 2003, the Company sold its NATLSCO, Inc. (NATLSCO) subsidiary and related claim service operations to Broadspire LLC (Broadspire). NATLSCO's operations included most of the assets used in the administration of the Company's general liability, workers' compensation, and employer liability claims, as well as third-party claim servicing operations. The Company booked a realized loss on the transaction of $180.8 million. In 2004, a benefit to surplus of $36.8 million was recorded related to a purchase price adjustment to the original sale price. Based on purchase price adjustment provisions in the sale contract, the Company initially asserted a claim against Broadspire. In June 2005, a binding arbitration ruling awarded the Company $23.2 million on its claim against Broadspire. Broadspire paid $19.0 million in cash and asserted an offset right to the remaining $4.2 million. The Company's operations at December 31, 2005 reflect a benefit of $5.3 million for the difference between the ruling and amounts previously recorded as due to the Company.

In connection with the 2003 transaction, the Company entered into a long-term claim administration agreement with Broadspire for the servicing of most of the Company's existing workers' compensation, general liability, and employer liability claims. The Company paid approximately $95.3 million in advance for the future servicing of such claims, of which $56.8 million was placed in trust by Broadspire to be drawn down monthly over a four-year period commencing January 1, 2004. The Company is not obligated to add any assets to the trust. The Company receives the interest on Broadspire's trust assets. In accordance with the prescribed accounting practice more fully described in note 1, the Company reflects as an admitted asset the prepaid amount for claim handling services reflected as other admitted assets in the accompanying statutory financial statements of approximately $33 million as of December 31, 2005 and $50 million as of December 31, 2004.

(10) Surplus

Surplus Notes

The Company had the following surplus notes issued and outstanding as of December 31, 2005:

Description	Interest rate	Maturity date	Par or face value	Carrying value	Interest paid in 2005 and 2004	Inception to-date interest paid	Accrued interest at December 31, 2005
					(In thousands)		
30-Year Notes	9.15%	07/01/2026	$ 400,000	399,123	—	238,612	—
40-Year Notes	8.30%	12/01/2037	200,000	199,507	—	83,461	—
100-Year Notes	8.45%	12/01/2097	100,000	99,726	—	42,485	—
			$ 700,000	698,356	—	364,558	—

The unamortized discount at issuance has been charged directly against surplus. The unamortized discount amounted to $1.6 million at December 31, 2005 and 2004.

All surplus notes were issued pursuant to Rule 144A of the Securities Act of 1933. All surplus notes are unsecured and subordinated to all present and future indebtedness, policy claims, and prior claims of the Company. The surplus notes are not entitled to a sinking fund. As it relates to the surplus notes, the Company is not restricted from incurring any future indebtedness, policy claims, or prior claims. Under statutory accounting, the surplus notes are part of surplus for financial statement purposes. The 30-year notes and the 40-year notes may not be redeemed at the option of the Company or any holder of the notes prior to maturity. Upon the occurrence and during the continuation of certain events, as described in the Offering Circular, the Company has the right, if certain conditions are met, to shorten the maturity of the 100-year notes; or subject to the prior written approval of the Director, redeem them in whole but not in part.

Each payment of interest on and/or repayment of principal of the surplus notes may be made only with the prior approval of the Director, which approval will only be granted if, in the judgment of the Director, the financial condition of the Company warrants the making of such payments and the Company's surplus reflects sufficient funds to cover the amount of such payment. The Director has denied the Company's 2005 and 2004 requests for payment of interest on the surplus notes due on June 1 and July 1, and on December 1, and January 1. The amount of interest due and not paid plus interest that is not accrued for at December 31, 2005 is $187.0 million.

Dividend Restrictions

Dividend distributions from the Company's insurance subsidiaries to the Company are restricted by various state insurance laws. In Illinois, where most of the Company's subsidiaries are domiciled, if such dividend, together with other distributions during the 12 preceding months would exceed the greater of (a) 10% of the insurer's statutory surplus as regards policyholders as of the preceding December 31, or (b) the statutorily adjusted net income for the preceding calendar year, then such proposed dividend must be reported to the Director at least 30 days prior to be proposed payment date and may be paid only if not disapproved. The Illinois insurance laws also permit payment of dividends only out of earned surplus, exclusive of most unrealized capital gains. Pursuant to Corrective Orders, LMC cannot enter into any transaction that involves the transfer of assets to or from affiliates of LMC without the prior approval of the Director. LMC received ordinary dividends from its insurance subsidiaries of $0 and $33.8 million during 2005 and 2004, respectively.

(11) Fair Value of Financial Instruments

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

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

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

Cash equivalents, short-term investments, bonds, and unaffiliated stocks: Fair values for cash equivalents, short-term investments, bonds, and unaffiliated stocks have been determined using prices provided by the SVO, or when such values are not available from the SVO, using prices from independent pricing services that use market quotations, prices provided by brokers or estimates of fair values obtained from yield data relating to instruments or securities with similar characteristics or prices determined in good faith by the Company's engaged portfolio manager.

Cash and receivables for securities sold: The statement values reported for these instruments approximate fair value.

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

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

The statement values and estimated fair values of the Company's financial instruments at December 31, 2005 and 2004 were as follows:

	2005		2004	
	Statement value	Estimated fair value	Statement value	Estimated fair value
	(In thousands)			
Financial instruments recorded as assets:				
Bonds	$ 1,551,962	1,500,553	1,583,567	1,553,199
Cash, cash equivalents, and short-term investments	308,271	307,844	908,597	908,597
Real estate properties held for sale	4,241	4,400	34,965	36,316
Mortgage loans	804	804	1,836	1,836
Unaffiliated stocks	2,437	2,716	2,532	2,570
Other invested assets:				
Venture capital partnerships and hedge funds	409	1,158	4,075	4,818
Notes receivable	840	840	18,738	18,738
Other equity investments	27,438	27,040	27,095	27,095
Receivables for securities sold	32,476	32,476	2,406	2,406

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

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

The Division of Insurance has granted a permitted practice to the Company to record in its 2005 Annual Statement the corrections of errors through current year operations and has not required the Company to restate its 2004 Annual Statement.

The following tables reconcile the accompanying statutory net income (loss) and surplus for 2005 and 2004 to that filed in the 2005 and 2004 Annual Statement based upon certain adjustments made subsequent to filing:

		Net income (loss)	Surplus
As filed in 2005 Annual Statement	$	(83,974,339)	168,313,151
2005 adjustments based on new facts related to change in non-admitted assets		(17,265,918)	—
2004 adjustments related to:			
Market value declines identified subsequent to year end resulting in other-than-temporary impairment of securities:			
Bonds		899,611	—
Other invested assets			
Other invested assets		1,551,705	—
Other-than temporary impairments or adjustments related to new facts, circumstances or decisions made by the Company relating to reinsurance:			
Misapplication of facts related to over-cessions of losses and allocated loss adjustment expenses on certain reinsurance contracts		12,603,538	—
Misapplication of facts related to under-accrual of ceded reinsurance premiums on certain reinsurance contracts, net of related commissions and expenses		36,495,952	—
Provision for additional under-accrued reinsurance premium on certain contracts		3,075,000	—
Adjustments related to uncollectible reinsurance balances		358,322	—
Misapplication of facts related to certain reinsurance annuity contracts		13,077,503	—
Misapplication of facts related to development of certain losses and loss adjustment expenses		53,977,780	—
Other adjustments:			
Other – miscellaneous		(13,950,634)	—
Total of all adjustments		90,822,859	—
As reported herein	$	6,848,520	168,313,151

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

(13) Subsequent Event

On May 11, 2006, the Circuit Court of Cook County, Illinois entered a Stipulation and Order (the Order) whereby the lawsuit filed by certain holders of surplus notes was dismissed without prejudice with leave to reinstate. Under the Order the plaintiffs' ability to reinstate the lawsuit is tolled until no earlier than October 1, 2008.

Schedule I

LUMBERMENS MUTUAL CASUALTY COMPANY

Supplemental Schedule of Investments

December 31, 2005

The following is a summary of certain financial data as of December 31, 2005 and for the year then ended for purposes of complying with the National Association of Insurance Commissioners' Accounting Practices and Procedures Manual. Such data is included in the Company's 2005 Annual Statement as filed with the Division of Insurance.

Investment categories	Gross investment holdings Amount	Gross investment holdings Percentage	Admitted assets as reported in the annual statement Amount	Admitted assets as reported in the annual statement Percentage
Bonds:				
U.S. Treasury securities	$ 789,276,258	39.249%	$ 789,276,258	39.067%
U.S. Government agency obligations (excluding mortgage-backed securities):				
Issued by U.S. Government sponsored agencies	71,539,273	3.558	71,539,273	3.541
Foreign government (including Canada, excluding mortgage-backed securities)	76,099	0.004	76,099	0.004
Securities issued by states, territories, and possessions and political subdivisions in the U.S.:				
States, territories and possessions general obligations	20,151,660	1.002	20,151,660	0.998
Revenue and assessment obligations	51,527,415	2.562	51,527,415	2.550
Mortgage-backed securities (includes residential and commercial MBS):				
Pass-through securities:				
Issued or guaranteed by GNMA	1,879,804	0.093	1,879,804	0.093
Issued or guaranteed by FNMA and FHLMC	6,223,984	0.310	6,223,984	0.308
All other	19,290,211	0.959	19,290,211	0.955
CMOs and REMICs:				
Issued or guaranteed by GNMA, FNMA, FHLMC, or VA	29,378,938	1.461	29,378,938	1.454
Other debt and other fixed income securities (excluding short-term):				
Unaffiliated domestic securities (includes credit tenant loans rated by the SVO)	556,144,279	27.656	556,144,279	27.528
Unaffiliated foreign securities	7,313,951	0.364	7,313,951	0.362

LUMBERMENS MUTUAL CASUALTY COMPANY

Supplemental Schedule of Investments

December 31, 2005

Investment categories	Gross investment holdings Amount	Gross investment holdings Percentage	Admitted assets as reported in the annual statement Amount	Admitted assets as reported in the annual statement Percentage
Equity interests:				
Investments in mutual funds	$ 208,130	0.010%	$ 208,130	0.010%
Publicly traded equity securities (excluding preferred stocks):				
Unaffiliated	90,027	0.005	90,027	0.004
Other equity securities:				
Affiliated (a)	82,088,104	4.082	91,424,689	4.525
Unaffiliated	2,138,428	0.106	2,138,428	0.106
Other equity interests including tangible personal property under lease:				
Affiliated	27,437,526	1.364	27,437,525	1.358
Unaffiliated	408,981	0.020	408,981	0.020
Mortgage loans:				
Single family residential properties	804,176	0.040	804,176	0.040
Real estate investments:				
Property held for sale	4,241,182	0.211	4,241,182	0.210
Receivables for securities	32,476,418	1.615	32,476,418	1.608
Cash, cash equivalents and short-term investments	308,270,902	15.329	308,270,902	15.259
Total invested assets	$ 2,010,965,746	100.000%	$ 2,020,302,330	100.000%

(a) Admitted assets differ from Manual basis due to a permitted practice of the Division of Insurance. Please see note 1 to the 2005 audited statutory financial statements for further information.

See accompanying independent auditors' report.

LUMBERMENS MUTUAL CASUALTY COMPANY

Supplemental Schedule of Investment Risk Interrogatories

December 31, 2005

The following interrogatories as of December 31, 2005 and for the year then ended are for the purpose of complying with the National Association of Insurance Commissioners *Accounting Practices and Procedures Manual.*

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

1. Reporting entity's total admitted assets as reported on page 2 of the annual statement: $2,735,065,059.

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

Issuer	Description of exposure	Amount	Percentage of total admitted assets
1. Berkshire Hathaway Inc	Bond - Cat. 2.1	$ 289,378,773	10.6%
2. JP Morgan Prime MMkt Fd - Inst	Class 1 MMF - Cat. 8	74,375,385	2.7%
3. Canadian Government	ST Bond - Cat. 8 and Bond Cat. 1.3	41,949,753	1.5%
4. American Motorists Ins Co	Affiliate Common - Cat. 3.41	30,372,141	1.1%
5. Specialty Surplus Ins Co	Affiliate Common - Cat. 3.41	29,306,742	1.1%
6. General Electric Cap Corp	Bond - Cat. 2.1	25,546,004	0.9%
7. Dallas-Fort Worth TX Indl Arpt	Bond - Cat. 1.43	23,278,648	0.9%
8. Kemper Casualty Ins Co	Affiliate Common - Cat. 3.41	22,448,214	0.8%
9. Kemper Lloyds Ins Co	Affiliate Joint Venture - Cat. 3.51	21,584,952	0.8%
10. Massachusetts ST	Bond - Cat. 1.41	20,000,000	0.7%

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

Bonds	Amount	Percentage of total admitted assets	Preferred stocks	Amount	Percentage of total admitted assets
NAIC-1	$ 1,869,759,686	68.4%	P/RP-1	$ —	—%
NAIC-2	12,987,229	0.5%	P/RP-2	—	—
NAIC-3	—	—	P/RP-3	—	—
NAIC-4	—	—	P/RP-4	—	—
NAIC-5	—	—	P/RP-5	—	—
NAIC-6	3,855,060	0.1%	P/RP-6	—	—

(Continued)

LUMBERMENS MUTUAL CASUALTY COMPANY

Supplemental Schedule of Investment Risk Interrogatories

December 31, 2005

4. Assets held in foreign investments:

1.	Are assets held in foreign investments less than 2.5% of the reporting entity's total admitted assets?		Yes [X] No [ ]
2.	Total admitted assets held in foreign investments	$ 56,927,182	2.1%
3.	Foreign-currency-denominated investments	—	—%
4.	Insurance liabilities denominated in that same foreign currency	—	—%

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

5. Aggregate foreign investment exposure categorized by NAIC sovereign rating:

Not applicable.

6. Two largest foreign investment exposures in a single country, categorized by NAIC sovereign rating:

Not applicable.

7. Aggregate unhedged foreign currency exposure:

Not applicable.

8. Aggregate unhedged foreign currency exposure categorized by the country’s NAIC sovereign rating:

Not applicable.

9. Two largest unhedged foreign currency exposures to a single country, categorized by the country’s NAIC sovereign rating:

Not applicable.

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

Not applicable.

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

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

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

LUMBERMENS MUTUAL CASUALTY COMPANY

Supplemental Schedule of Investment Risk Interrogatories

December 31, 2005

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

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

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

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

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

    Yes [ ] No [X]

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

Name of issuer		Amount	Total admitted assets
1. American Motorists Insurance Co.	$	30,372,141	1.1%
2. Specialty Surplus Insurance Co.		29,306,742	1.1%
3. Kemper Casualty Insurance Co.		22,448,214	0.8%
4. Kemper Lloyds Insurance Co.		21,584,952	0.8%
5. Kemper International Corp.		6,997,675	0.3%
6. Delta Wetlands Joint Venture		5,852,574	0.2%
7. LGA-17 Inc.		1,867,937	0.1%
8. Assurex Dev Corp.		1,410,637	0.1%
9. Shorebank Corp.		727,791	0.0%
10. American Underwriting Corp.		431,980	0.0%

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

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

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

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

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

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

LUMBERMENS MUTUAL CASUALTY COMPANY

Supplemental Schedule of Investment Risk Interrogatories

December 31, 2005

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

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

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

17. Not applicable.

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

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

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

19. Amounts and percentages of the reporting entity's total admitted assets subject to securities lending agreements, repurchase and reverse repurchase agreements, and dollar repurchase and dollar reverse repurchase agreements:

    None.

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

    None.

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

    None.

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

    None.

See accompanying independent auditors' report.