**TIG Reinsurance Company**

**Audited Financial Statements**
**Statutory-Basis**

*Years ended December 31, 1998 and 1997*
*With Report of Independent Auditors*

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**Audited Financial Statements--Statutory-Basis**

Years ended December 31, 1998 and 1997

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**ERNST & YOUNG LLP**

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Board of Directors
TIG Reinsurance Company

We have audited, in accordance with generally accepted auditing standards, the statutory-basis financial statements of TIG Reinsurance Company (the "Company") as of December 31, 1998 and 1997 and for the years then ended, and have issued our report thereon dated January 29, 1999. In connection with that report, we advise you as follows:

We are independent certified public accountants with respect to the Company and conform to the standards of the accounting profession as contained in the Code of Professional Conduct and pronouncements of the American Institute of Certified Public Accountants, and the Rules of Professional Conduct of the Connecticut Board of Public Accountancy.

The engagement partner and engagement manager, who are both certified public accountants, have 14 years and 5 years, respectively, of experience in public accounting and are experienced in auditing insurance enterprises. Members of the engagement team, most of whom have had experience in auditing insurance enterprises and 50% of whom are certified public accountants, were assigned to perform tasks commensurate with their training and experience.

We understand that the Company intends to file its audited statutory-basis financial statements and our report thereon with the Connecticut Insurance Department and other state insurance departments in states in which the Company is licensed and that the insurance commissioners of those states will be relying on that information in monitoring and regulating the statutory-basis financial condition of the Company.

Although we understand that an objective of issuing a report on the statutory-basis financial statements is to satisfy regulatory requirements, our audit was not planned to satisfy all objectives or responsibilities of insurance regulators. In this context, the Company and insurance department personnel should understand that the objectives of an audit of statutory-basis financial statements in accordance with generally accepted auditing standards is to form an opinion and issue a report on whether the statutory-basis financial statements present fairly, in all material respects, the admitted assets, liabilities, and capital and surplus, results of operations, and cash flow in conformity with accounting practices prescribed or permitted by the Connecticut Insurance Department. Consequently, under generally accepted auditing standards, we have the responsibility, within the inherent limitations of the auditing process, to plan and perform our audit to obtain reasonable assurance about whether the statutory-basis financial statements are free of material misstatement, whether caused by error or fraud, and to exercise due professional care in the conduct of the audit. The concept of selective testing of the data being audited, which involves judgment both as to the number of transactions to be audited and the areas to be tested, has been generally accepted as a valid and sufficient basis for an auditor to express an opinion on financial statements. Audit procedures that are effective for detecting errors, if they exist, may be ineffective for detecting misstatements resulting from fraud. Because of the characteristics of fraud, particularly those involving concealment and falsified documentation (including forgery), a properly planned and performed audit may not detect a material misstatement resulting from fraud. In addition, an audit does not address the possibility that material errors or misstatements caused by fraud may occur in the future. Also, our use of professional judgment and the assessment of materiality for the purpose of our audit means that matters may exist that would have been assessed differently by insurance commissioners.

It is the responsibility of the management of the Company to adopt sound accounting policies, to maintain an adequate and effective system of accounts, and to establish and maintain internal control that will, among other things, provide reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in conformity with accounting practices prescribed or permitted by the Connecticut Insurance Department.

The Connecticut Insurance Department personnel and other state insurance commissioners should exercise due diligence to obtain whatever other information that may be necessary for the purpose of monitoring and regulating the statutory-basis financial position of insurers and should not rely solely upon our report.

We will retain the workpapers prepared in the conduct of our audit until the Connecticut Insurance Department has filed a Report of Examination covering 1998, but not longer than seven years. After notification to the Company, we will make the workpapers available for review by the Connecticut Insurance Department at the offices of the insurer, at our offices, at the Insurance Department or at any other reasonable place designated by the Insurance Commissioner. Furthermore, in the conduct of the aforementioned periodic review by the Connecticut Insurance Department, photocopies of pertinent audit workpapers may be made under our control and such copies may be retained by the Connecticut Insurance Department.

The engagement partner has served in that capacity with respect to the Company since 1997, is licensed by the Connecticut and New York Board of Public Accountancy, and is a member in good standing of the American Institute of Certified Public Accountants.

To the best of our knowledge and belief, we are in compliance with the requirements of Section 7 of the NAIC's *Model Rule (Regulation) Requiring Annual Audited Financial Reports* regarding qualifications of independent certified public accountants.

This letter is furnished solely for filing with the Connecticut Insurance Department and other state insurance departments and should not be used for any other purpose.

Ernst + Young LLP

January 29, 1999

ERNST & YOUNG LLP
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# Report on Internal Control

Board of Directors
TIG Reinsurance Company

In planning and performing our audit of the statutory-basis financial statements of TIG Reinsurance Company (the "Company") for the year ended December 31, 1998, we considered its internal control to determine our auditing procedures for the purpose of expressing our opinion on the Company's financial statements and not to provide assurance on internal control. Our consideration of internal control would not necessarily disclose all matters in internal control that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving the Company's internal control and its operation that we consider to be material weaknesses as defined above.

This report is intended solely for the information and use of the Board of Directors and management of the Company and state insurance departments to whose jurisdiction the Company is subject and is not intended to be and should not be used by anyone other than these specified parties.

Ernst + Young LLP

January 29, 1999

ERNST & YOUNG LLP

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Stamford, Connecticut 06905

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# Report of Independent Auditors

Board of Directors
TIG Reinsurance Company

We have audited the accompanying statutory-basis statements of admitted assets, liabilities, and capital and surplus of TIG Reinsurance Company as of December 31, 1998 and 1997, and the related statutory-basis statements of operations and capital and surplus, and cash flow for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

As described in Note 2, the accompanying financial statements have been prepared in conformity with accounting practices prescribed or permitted by the Connecticut Insurance Department, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of TIG Reinsurance Company at December 31, 1998 and 1997, and the results of its operations and its cash flow for the years then ended, in conformity with accounting practices prescribed or permitted by the Connecticut Insurance Department.

This report is intended solely for the use of the Company and state insurance departments to whose jurisdiction the Company is subject and is not intended to be and should not be used by anyone other than these specified parties.

Ernst + Young LLP

January 29, 1999

**TIG REINSURANCE COMPANY**

STATUTORY-BASIS STATEMENTS OF ADMITTED ASSETS, LIABILITIES, AND CAPITAL AND SURPLUS

| | December 31, 1998 | December 31, 1997 |
|---|---|---|
| | *(Dollars in thousands, Except share amounts)* | |
| ADMITTED ASSETS | | |
| CASH AND INVESTED ASSETS | | |
| Bonds | $ 1,631,874 | $ 1,629,092 |
| Common stocks | 131,385 | 131,950 |
| Cash and short-term investments | 104,033 | 119,862 |
| Receivable for securities sold | 6,941 | 362 |
| Other invested assets | 33,236 | 500 |
| Total cash and invested assets | 1,907,469 | 1,881,766 |
| OTHER ADMITTED ASSETS | | |
| Agents' balances and uncollected premiums | 136,970 | 173,690 |
| Accrued investment income | 25,640 | 27,058 |
| Funds deposited with reinsurance companies | 17,629 | 16,688 |
| Federal income taxes receivable from parent | - | 17,583 |
| Receivable from parent and affiliates | 4,910 | 70,009 |
| Other admitted assets | 8,769 | 9,136 |
| TOTAL ADMITTED ASSETS | $ 2,101,387 | $ 2,195,930 |
| LIABILITIES AND CAPITAL AND SURPLUS | | |
| LIABILITIES | | |
| Losses | $ 1,051,964 | $ 1,184,227 |
| Loss adjustment expenses | 98,094 | 102,139 |
| Unearned premiums | 138,794 | 216,065 |
| Reinsurance balances | 236,964 | 161,537 |
| Accounts payable and accrued expenses | 24,550 | 17,908 |
| Federal income taxes payable to parent | 3,326 | - |
| Provision for reinsurance | 685 | 503 |
| Payable for securities purchased | 167 | 5,193 |
| Total liabilities | 1,554,544 | 1,687,572 |
| CAPITAL AND SURPLUS | | |
| Common Stock, $300 par value; 33,500 shares authorized, 16,700 issued and outstanding | 5,010 | 5,010 |
| Additional paid-in capital | 383,800 | 383,800 |
| Unassigned surplus | 158,033 | 119,548 |
| Total capital and surplus | 546,843 | 508,358 |
| TOTAL LIABILITIES AND CAPITAL AND SURPLUS | $ 2,101,387 | $ 2,195,930 |

*See notes to statutory-basis financial statements.*

**TIG REINSURANCE COMPANY**

STATUTORY-BASIS STATEMENTS OF OPERATIONS AND CAPITAL AND SURPLUS

| | Year ended December 31, 1998 | 1997 |
|---|---|---|
| | *(Dollars in thousands)* | |
| UNDERWRITING OPERATIONS | | |
| Premiums earned | $ 472,878 | $ 521,297 |
| Losses incurred | 270,560 | 428,294 |
| Loss adjustment expenses incurred | 48,393 | 84,831 |
| Other underwriting expenses incurred | 157,627 | 171,135 |
| Underwriting loss | (3,702) | (162,963) |
| INVESTMENT INCOME | | |
| Net investment income | 122,339 | 128,938 |
| Net realized investment (losses) gains | (3,018) | 10,817 |
| Total investment income | 119,321 | 139,755 |
| INCOME (LOSS) BEFORE FEDERAL INCOME TAXES | 115,619 | (23,208) |
| FEDERAL INCOME TAX EXPENSE (BENEFIT) | 22,229 | (1,639) |
| NET INCOME (LOSS) | 93,390 | (21,569) |
| OTHER CREDITS (CHARGES) TO CAPITAL AND SURPLUS | | |
| Additional paid-in surplus | - | 70,000 |
| Net unrealized capital gains (losses) | 566 | (13,598) |
| Increase in nonadmitted assets | (4,390) | (1,866) |
| Dividend to stockholder | (50,000) | (40,000) |
| Change in foreign exchange adjustment | (899) | - |
| (Increase) decrease in provision for reinsurance | (182) | 247 |
| Net change in capital and surplus | 38,485 | (6,786) |
| CAPITAL AND SURPLUS AT BEGINNING OF YEAR | 508,358 | 515,144 |
| CAPITAL AND SURPLUS AT END OF YEAR | $ 546,843 | $ 508,358 |

*See notes to statutory-basis financial statements.*

**TIG REINSURANCE COMPANY**

STATUTORY-BASIS STATEMENTS OF CASH FLOW

| | Year ended December 31, 1998 | 1997 |
|---|---|---|
| | (Dollars in thousands) | |
| OPERATING ACTIVITES | | |
| Premiums collected | $ 427,327 | $ 504,336 |
| Losses and loss adjustment expenses paid | (442,813) | (355,283) |
| Underwriting expenses paid | (156,985) | (170,258) |
| Net investment income received | 123,064 | 127,641 |
| Change in funds held | 74,074 | 14,394 |
| Other | 969 | 4,274 |
| Federal income taxes paid to parent | (1,319) | (21,329) |
| Net cash provided by operating activities | 24,317 | 103,775 |
| INVESTING ACTIVITIES | | |
| Sales and maturities of investments | 2,257,417 | 1,288,809 |
| Purchases of investments | (2,294,111) | (1,280,509) |
| Change in unsettled securities | (11,603) | 5,107 |
| Net cash (used in) provided by investing activities | (48,297) | 13,407 |
| FINANCING ACTIVITIES | | |
| Capital contribution | - | 70,000 |
| Dividend to stockholder | (50,000) | (40,000) |
| Net transfers from (to) affiliates | 67,793 | (72,451) |
| Change in deposits | - | 14,418 |
| Other | (9,642) | (2,457) |
| Net cash provided by (used in) financing activities | 8,151 | (30,490) |
| NET (DECREASE) INCREASE IN CASH AND SHORT-TERM INVESTMENTS | (15,829) | 86,692 |
| CASH AND SHORT-TERM INVESTMENTS AT BEGINNING OF YEAR | 119,862 | 33,170 |
| CASH AND SHORT-TERM INVESTMENTS AT END OF YEAR | $ 104,033 | $ 119,862 |

*See notes to statutory-basis financial statements*

## 1. ORGANIZATION

TIG Reinsurance Company (the "Company") is in the business of providing property and casualty reinsurance. Reinsurance is a form of insurance whereby the reinsurer (e.g., the Company) agrees to indemnify another insurance organization for all or a portion of the insurance risks underwritten by the other insurance organization under an insurance policy or policies. Reinsurance coverage is typically provided through excess of loss or pro-rata reinsurance contracts. The Company writes property and casualty business on a treaty and facultative basis. The Company's predominant source of business is through reinsurance intermediaries.

The Company is wholly-owned subsidiary of TIG Insurance Company whose ultimate parent is TIG Holdings, Inc. ("TIG Holdings"). TIG Holdings is a holding company organized in 1993 as a Delaware corporation. Prior to April 27, 1993, TIG Holdings was wholly-owned by Transamerica Corporation. Transamerica Corporation subsequently sold 100% of its ownership interest through an initial public offering on April 27, 1993 and a secondary offering in December 1993.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

***Basis of Presentation*** - The accompanying financial statements have been prepared in conformity with statutory accounting practices prescribed for insurance companies by the State of Connecticut Insurance Department. These accounting practices differ from generally accepted accounting principles ("GAAP"). The most significant effects of the differences on the Company's financial statements are summarized in the following table and described in the subsequent narratives:

| | Net Income (Loss) for year ended December 31, | | Capital and Surplus at December 31, | |
|---|---|---|---|---|
| | 1998 | 1997 | 1998 | 1997 |
| Amounts reported to regulatory authorities | $93,390 | $(21,569) | $546,843 | $508,358 |
| Add (deduct): | | | | |
| Deferred policy acquisition costs | (17,957) | 2,370 | 43,249 | 61,207 |
| Realized capital loss on investments | - | (6,000) | - | - |
| Non-consolidated investment in foreign subsidiary | (1,188) | (1,623) | - | - |
| Income taxes | (2,609) | 14,862 | 57,565 | 59,602 |
| Unrealized capital gain, net of tax | - | - | 38,745 | 43,731 |
| Deferred charge | (1,036) | (1,036) | 2,830 | 3,866 |
| Reserve for uncollectible premiums | (5,000) | - | - | - |
| Nonadmitted assets | - | - | 7,544 | 5,356 |
| Other – net | (409) | 103 | (597) | 4,916 |
| Amounts in conformity with GAAP | $65,191 | $(12,893) | $696,179 | $687,036 |

Preparation of financial statements requires the use of management's estimates. Actual results may differ from these estimates. Certain reclassifications of prior years' amounts have been made to conform to the 1998 presentation.

***Investments*** - The Company's investments are reflected in accordance with valuation methods established by the National Association of Insurance Commissioners ("NAIC"): Issuer obligations are stated at amortized cost using the interest method. Mortgage-backed, asset backed and multi-class securities are stated at amortized cost using the interest method including anticipated pre-payments at the date of purchase, with significant changes in estimated cash flows from the original purchase assumptions accounted for using the retrospective method. Pre-payment assumptions for mortgage-backed, asset backed and multi-class securities were obtained from external financial information services and are consistent with the current interest rate and economic environment. In accordance with the NAIC Valuations of Securities manual, fixed maturity securities with a designation of 3 or higher are stated at the lower cost or market. Under GAAP, the bond portfolio would be classified as available-for-sale and carried at fair value with any unrealized gain or loss reported as a component of shareholder's equity, net of tax.

Short-term investments are reported at cost which approximates market. Investments in limited partnerships are stated at the amount invested plus the Company's share of the partnership's undistributed operating results. Equity securities of non-affiliated issuers (which includes common stocks, preferred stocks and common stock warrants) are stated at their fair value.

Common stocks principally include the investments in three wholly-owned Treasury subsidiaries whose net assets are comprised entirely of 30-year U.S. Treasury Bonds due to mature in 2022. These common stocks are recorded at the amortized cost of the underlying bonds. The market value of the underlying bonds was $162.7 million and $151.0 million at December 31, 1998 and 1997 reflecting gross unrealized gains of $31.4 million and $19.7 million, respectively. Common stocks also include the Company's investment in a United Kingdom downstream holding company valued at GAAP equity. For GAAP purposes, the balance sheet amounts and operations of the downstream holding company determined in accordance with GAAP, are consolidated with those of the Company.

Realized gains and losses on the sale of investments are recognized in net income generally on the first-in, first-out basis and are included in income on the trade date.

***Premium Recognition*** - Premiums, net of reinsurance ceded, are recognized as income ratably during the terms of the related reinsurance contracts. Unearned premium reserves are established to cover the unexpired portion of premiums written. The liability for unearned premiums is reported net of amounts ceded. Under GAAP, such amounts are reported on a gross basis.

The Company estimates and accrues for the unreported premiums and losses as well as premiums and commission adjustments on retrospectively rated or other experience rated reinsurance contracts. These estimates are based on statistical data with subsequent adjustments, if any, recorded in the period in which they are determined. The Company has evaluated the collectibility and related non-admitted amount based upon several factors including available contractual offsets and the credit worthiness of ceding companies.

***Acquisition Costs*** - Acquisition costs related to premiums written are charged to income at the time the premiums are written. Under GAAP, acquisition costs are capitalized and amortized over the terms of the related treaties.

***Loss and Loss Adjustment Expenses*** – The liability for losses and loss adjustment expenses is based on reports and individual case estimates received from ceding companies and additional estimates provided by the Company's claims department. The liability also includes an amount for losses incurred but not reported based on past experience of the Company and the reinsurance industry. The liability for loss and loss adjustment expenses is reported net of amounts ceded. Under GAAP, such amounts are reported on a gross basis. These estimates are regularly reviewed and, as new information becomes known, the liability is adjusted as necessary. Such adjustments, if any, are charged to income in the period in which they become known. While there can be no assurance that the reserves at any given date are adequate to meet the Company's obligations, the amounts reported in the balance sheet are management's best estimate of that amount.

The Company uses tabular reserving for workers' compensation indemnity reserves and discounts such reserves using an interest rate of 3.5%. Losses have been discounted using the Life Table for Total Population: United States, 1979-1981. Reserves reported at present value were approximately $223.2 million and $200.4 million at December 31, 1998 and 1997, respectively. The amount of case reserve discount was $23.2 million and $20.0 million at December 31, 1998 and 1997, respectively. The amount of IBNR reserve discount was $16.6 million and $11.3 million at December 31, 1998 and 1997, respectively.

***Nonadmitted Assets*** – Certain assets designated as "nonadmitted" are excluded from the statutory statement of admitted assets, liabilities and capital and surplus, and changes in such amounts are charged or credited directly to unassigned surplus.

***Reinsurance Assumed and Ceded*** – All reinsurance contracts covering losses that have occurred prior to the inception of the contract have been accounted for in conformity with the instructions contained in the NAIC accounting procedures manual, Chapter 22, "Reinsurance". Contracts for which risk transfer guidelines have not been met have been accounted for under deposit accounting.

***Income Taxes*** – Income tax expense is based upon an estimate of taxes due on the separate return of the Company. Under GAAP, deferred taxes are provided for differences between the tax bases of assets and liabilities, and their reported amounts in the financial statements.

***Permitted Statutory Accounting Practices*** - Reinsurance enterprises are required to prepare their statutory-basis financial statements in accordance with accounting principles and practices prescribed or permitted by their domiciliary state insurance department. Prescribed statutory accounting practices include state laws, regulations, and general administrative rules, as well as a variety of publications of the NAIC. Permitted statutory accounting practices encompass all accounting practices that are not prescribed; such practices differ from state to state, may differ from company to company within a state, and may change in the future. In 1998, the NAIC adopted codified statutory accounting principles ("Codification"). Codification will likely change, to some extent, prescribed statutory accounting practices and may result in changes to the accounting practices that the Company uses to prepare its statutory-basis financial statements.

Codification will require adoption by the various states before it becomes the prescribed statutory basis of accounting for insurance companies domesticated within those states. Accordingly, before Codification becomes effective for the Company, the State of Connecticut Insurance Department must adopt Codification as the prescribed basis of accounting on which domestic insurers must report their statutory-basis results to the Insurance Department. Based upon current guidance, management believes that the impact of Codification will not be material to the Company's statutory-basis financial statements.

As of December 31, 1998 and 1997, all statutory accounting practices utilized by the Company in the preparation of its statutory-basis financial statements were prescribed in nature.

***Risk-Based Capital*** – During 1993, the NAIC approved certain Risk-Based Capital ("RBC") requirements for property and casualty companies. Those requirements were effective in 1994, and require that the amount of capital maintained by an insurance or reinsurance company be determined based upon the various risk factors related to it. At December 31, 1998 and 1997, the Company exceeded the RBC requirements.

## 3. INVESTMENTS

The amortized cost and the NAIC market values of investments in bonds are summarized as follows (in thousands):

| | December 31, 1998 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | NAIC Market Values |
| U.S Treasury securities and obligations of U.S. Government authorities and agencies | $ 557,179 | $ 9,425 | $ - | $ 566,604 |
| Obligations of states and political subdivisions | 403,987 | 28,191 | - | 432,178 |
| Corporate securities | 395,338 | 4,160 | (12,891) | 386,607 |
| Loan-backed securities | 264,925 | 1,054 | (179) | 265,800 |
| Foreign Governments | 10,445 | 104 | - | 10,549 |
| Total Bonds | $ 1,631,874 | $ 42,934 | $ (13,070) | $ 1,661,738 |

| | December 31, 1997 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | NAIC Market Values |
| U.S Treasury securities and obligations of U.S. Government authorities and agencies | $ 224,420 | $ 6,263 | $ - | $ 230,683 |
| Obligations of states and political subdivisions | 412,696 | 26,327 | - | 439,023 |
| Corporate securities | 515,025 | 8,355 | (883) | 522,497 |
| Loan-backed securities | 414,305 | - | - | 414,305 |
| Foreign Governments | 44,154 | - | - | 44,154 |
| Public Utilities | 18,492 | - | - | 18,492 |
| Total Bonds | $ 1,629,092 | $ 40,945 | $ (883) | $ 1,669,154 |

A summary of the amortized cost and NAIC market values of bonds at December 31, 1998, by contractual maturity, is as follows (in thousands):

| | Amortized Cost | NAIC Market Values |
|---|---|---|
| Due in one year or less | $ 14,621 | $ 14,621 |
| Due after one year through five years | 127,009 | 128,109 |
| Due after five years through ten years | 668,769 | 667,389 |
| Due after ten years | 556,550 | 585,819 |
| Mortgage-backed securities | 264,925 | 265,800 |
| | $ 1,631,874 | $ 1,661,738 |

The expected maturities in the foregoing table may differ from contractual maturities because certain borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

Securities of the Company, carried at $86.8 million at December 31, 1998, were on deposit with government agencies and foreign jurisdictions as required by law in various states and jurisdictions in which the Company conducts business.

Net investment income by major category of investments is summarized as follows (in thousands):

| | Year ended December 31, 1998 | Year ended December 31, 1997 |
|---|---|---|
| Bonds | $ 132,017 | $ 134,706 |
| Short-term investments | 4,370 | 5,314 |
| Other invested assets | 384 | - |
| | 136,771 | 140,020 |
| Interest expense on funds withheld | (12,922) | (9,668) |
| Other investment expenses | (1,510) | (1,414) |
| Net investment income | $ 122,339 | $ 128,938 |

Proceeds from the sale of debt securities (excluding security paydowns and calls) during 1998 and 1997 were $2,138.6 million and $1,213.9 million, respectively. Gross gains of $37.2 million and $16.6 million in 1998 and 1997, respectively, and gross losses of $40.5 million and $5.8 million in 1998 and 1997, respectively, were realized from sales of bonds.

The Company routinely enters into commitments to purchase securities on a "To Be Announced" ("TBA") basis for which the interest rate risk remains with the Company until the date of delivery and payment. Delivery and payment of securities purchased on a TBA basis can take place a month or more after the date of the transaction. These securities are subject to market fluctuation during this period and it is the Company's policy to recognize any gains and losses only when they are realized. The Company maintains cash and invested assets with a fair value exceeding the amount of its TBA purchase commitments. As of December 31, 1998 and 1997, there were no TBA purchase commitments.

## 4. FEDERAL INCOME TAXES

The Company is included in the consolidated Federal income tax return filed by TIG Holdings. Pursuant to a tax sharing agreement, tax payments are made to, or refunds received from, TIG Holdings in amounts which would result from filing separate tax returns for the Company and its subsidiaries with Federal taxing authorities. Carryback and carryforward of losses is calculated on a separate return basis.

The difference between the Federal income tax rate and effective tax rate as reflected in the accompanying statutory statement of income and capital and surplus on income before Federal income taxes is as follows (in thousands):

| | Year ended December 31, | | | |
|---|---|---|---|---|
| | 1998 | | 1997 | |
| | Amount | Percent | Amount | Percent |
| Federal income tax expense (benefit) at statutory rate | $ 40,466 | 35.0% | $ (8,123) | 35.0% |
| Add (deduct): | | | | |
| Nontaxable investment income | (6,798) | -5.9 | (6,412) | 27.6 |
| Loss reserve discounting | 10,823 | 9.4 | 17,519 | -75.5 |
| Unearned premium reserve adjustment | (5,409) | -4.7 | (422) | 1.8 |
| Basis adjustments under 338(h)(10): | | | | |
| Amortization of business in force | (6,533) | -5.7 | (6,533) | 28.1 |
| Investment portfolio adjustments | 4,191 | 3.6 | (1,607) | 6.9 |
| Agents' balances and adjustments | 134 | 0.1 | (139) | 0.6 |
| Net operating loss carryback | - | - | 9,123 | -39.3 |
| Alternative minimum tax | (10,058) | -8.7 | - | - |
| Alternative minimum tax NOL carryback | - | - | (2,272) | 9.8 |
| Other | (4,587) | -3.9 | (2,773) | 12.1 |
| | $ 22,229 | 19.2% | $ (1,639) | 7.1% |

The amount of AMT taxes paid and available to offset a future regular income tax liability is approximately $2.9 million. The amount of federal income taxes incurred and available for recoupment in the event of future net losses is $27.3 million in the current year, $0 million in the first preceding year, and $19.7 million in the second preceding year.

## 5. REINSURANCE

The Company utilizes retrocessional agreements principally to limit its exposure and spread the risk of loss on reinsurance underwritten which includes retrocessions that limit the aggregate amount of accident year losses. In addition, the Company maintains catastrophe retrocessional programs for the purpose of limiting its exposure to multiple claims arising from a single occurrence or event. The table below shows the effect on premiums and losses of all reinsurance transactions (in thousands):

| | Year ended December 31, 1998 | Year ended December 31, 1997 |
|---|---|---|
| Written Premium: | | |
| Direct | $ 921 | $ (54) |
| Assumed | 516,841 | 575,728 |
| Ceded | (122,155) | (60,408) |
| Net | $ 395,607 | $ 515,266 |
| Earned Premium: | | |
| Direct | $ 2,483 | $ 4,597 |
| Assumed | 571,857 | 577,488 |
| Ceded | (101,462) | (60,788) |
| Net | $ 472,878 | $ 521,297 |
| Incurred losses and LAE: | | |
| Direct | $ 3,990 | $ 3,217 |
| Assumed | 340,079 | 691,681 |
| Ceded | (25,116) | (181,773) |
| Net | $ 318,953 | $ 513,125 |

The Company remains obligated for amounts ceded regardless of whether the reinsurers meet their obligations. The amounts deducted from reserves for unpaid losses and loss adjustment expenses and unearned premiums are as follows (in thousands):

| | December 31, 1998 | December 31, 1997 |
|---|---|---|
| Reduction in gross unpaid loss and loss adjustment expenses | $ 336,580 | $ 362,919 |
| Reduction in unearned premiums | 24,481 | 3,771 |

The maximum amount of return commission that would have been due the Company's reinsurers with the return of unearned premiums reserve if all of the Company's ceded reinsurance had been cancelled amounted to approximately $6.6 million and $1.0 million as of December 31, 1998 and 1997, respectively.

Additional or return commission predicated on loss experience or any form of profit sharing arrangements, as a result of existing contractual arrangements were as follows (in thousands):

| | December 31, | |
|---|---|---|
| | **1998** | **1997** |
| Contigent commission | $ 4,108 | $ 5,734 |
| Sliding scale adjustments | (4,012) | (3,224) |
| Total | $ 96 | $ 2,510 |

At December 31, 1998, the Company has unsecured reinsurance recoverable in excess of 3% of policyholders' surplus from one ceding company. The amount of unsecured recoverable at December 31, 1998, and the most recent A.M. Best rating for the reinsurer is as follows (in thousands):

| | **Unsecured *Recoverable*** | **A.M. Best *Rating*** |
|---|---|---|
| Underwriters Reinsurance Co. | $ 54,898 | A+ |

## 6. DEFERRED COMPENSATION AND RETIREMENT PLANS

The Company has no defined benefit pension plan. Participants in the Transamerica Corporation defined benefit plan were fully vested at the IPO date.

TIG Holdings' employee benefit plans include the Diversified Savings and Profit Sharing Plan (in which the Diversified Savings Plan and Profit Sharing Plan were combined effective January 1, 1997), and the Employee Stock Ownership Plan ("ESOP") for which substantially all employees are eligible. In addition, certain members of management are eligible for the TIG Holdings Long Term Incentive Plan, the ESOP and Profit Restoration Plan and the Diversified Savings and Profit Sharing Restoration Plan.

Under the Long Term Incentive Plan, Restricted Stock Awards ("RSA") and/or Non-Qualified Stock Option grants ("NQSO") may be granted to certain employees of the Company for shares of TIG Holdings Common Stock. Option prices for NQSO's must be at least 100% of the fair market value of the Common Stock on the date of grant.

The costs allocated to the Company in 1998 and 1997 for its share of the cost of these benefit plans were not material.

TIG Holdings provides certain health care and postretirement benefits for retired employees. Employees retiring prior to December 31, 2002, are eligible for these benefits if they reach retirement age while working for the TIG Holdings group.

The Company accounts for the cost of its retirees' health care and postretirement benefit plans using the accrual method, amortizing its transition obligation as of December 31, 1992 for retirees and fully eligible or vested employees over a period of 20 years.

## 7. COMMITMENTS AND CONTINGENCIES

The Company is routinely a party to litigation incidental to its business, as well as to other litigation of a non-material nature. In the opinion of the Company, based upon information available on the date of this report, no individual item of litigation, or group of similar items of litigation, taken net of reserves established and giving effect to insurance, is likely to result in judgements for amounts material to the results of operations.

Through an indirect subsidiary of TIG Re U.K. Holdings Corporation, the Company became a limited liability participant in the Lloyd's of London ("Lloyd's") market in 1997. As a prerequisite to admittance to the Lloyd's market in 1997, the Company put in place a clean irrevocable letter of credit in favor of the Society and Council of Lloyd's. At December 31, 1998, the letter of credit was valued at £25.0 million and was collateralized by $46.2 million of the Company's investment securities, at statement value. The letter of credit effectively secures the future contingent obligations of TIG Re U.K. Holdings Corporation should the Lloyd's underwriting syndicate in which the Company participates incur net losses. The Company's contingent liability to the Society and Council of Lloyd's is limited to the amount of the letter of credit.

Future minimum rental commitments for all noncancelable operating leases are as follows: 1999 - $2.7 million; 2000 - $2.5 million; 2001 - $2.4 million; 2002 - $2.3 million; 2003 - $3.7 million; thereafter - $13.6 million. Total gross rent expense for the years ended December 31, 1998 and 1997 was $6.0 million and $2.9 million, respectively. Total sublease income for the year ended December 31, 1998 was $1.5 million. There was no sublease income for the year ended December 31, 1997. A substantial portion of the leases are for the rental of office space.

## 8. FAIR VALUE OF FINANCIAL INSTRUMENTS

The Company may use interest rate swaps to reduce market risks from changes in interest rates and to alter interest rate exposures arising from mismatches between assets and liabilities. Under interest rate swaps, the Company agrees with other parties to exchange, at specified intervals, the difference between fixed-rate and floating-rate interest amounts calculated by reference to an agreed notional principal amount. Generally, no cash is exchanged at the outset of the contract and no principal payments are made by either party. A single net payment is usually made by one counterparty at each due date. As of December 31, 1998, the Company has no such swap agreements outstanding.

## 9. LIABILITY FOR LOSSES AND LOSS ADJUSTMENT EXPENSES

The following table presents a reconciliation of beginning and ending reserve balance for the years indicated.

| | December 31, 1998 | December 31, 1997 |
|---|---|---|
| | *(in thousands)* | |
| Balance at January 1, net of reinsurance | $ 1,286,366 | $ 1,145,459 |
| Incurred related to: | | |
| Current year | 325,096 | 398,279 |
| Prior years | (6,143) | 114,846 |
| Total incurred | 318,953 | 513,125 |
| Paid related to: | | |
| Current year | 33,561 | 33,124 |
| Prior years | 421,700 | 339,094 |
| Total paid | 455,261 | 372,218 |
| Balance at December 31, net of reinsurance | $ 1,150,058 | $ 1,286,366 |

In 1997, the Company recognized a pre-tax loss reserve charge of $145.0 million of which $107.0 million was attributable to unfavorable development on old accident years and $38.0 million reflects an increase in the 1997 accident year reserves. The reserve strengthening was based upon actuarial evalutations of loss data through September 30, 1997, which incorporated enhancements to the Company's actuarial process and previously unavailable data.

## 10. CAPITAL AND SURPLUS AND SHAREHOLDER DIVIDEND RESTRICTIONS

The Company is subject to state regulatory restrictions which limit the maximum amount of dividends payable. The Company must obtain approval of the Insurance Commissioner of the State of Connecticut in order to pay, in any 12-month period, "extraordinary" dividends which are defined as the greater of 10% of statutory capital and surplus as of the prior year end or net income for such prior year. The Connecticut law further provides that (i) the Company must report to the Connecticut Commissioner, for informational purposes, all dividends and other distributions within five business days after the declaration thereof and at least ten days prior to payment and (ii) the Company may not pay any dividend or distribution in excess of its earned surplus, as reflected in its most recent statutory annual statement on file with the Connecticut Commissioner, without such Commissioner's approval. The maximum dividend payout which may be made in 1999 without prior approval is $ 93.4 million, which is net income for the year ended December 31, 1998.

The Company paid common stock dividends to its parent, TIG Insurance Company, in December of 1998 and 1997 of $50.0 million and $40.0 million, respectively.

The Board of Directors for TIG Insurance Company declared and approved an additional surplus contribution of $70.0 million in December 1997 which was paid to the Company in February of 1998.

## 11. RELATED PARTY TRANSACTIONS

Transactions with affiliated companies in 1998 and 1997, other than those described below, were immaterial.

The Company reinsures certain risks for TIG Insurance Company and other affilates under several reinsurance treaties. Earned premiums assumed from TIG Insurance Company and other affiliates were $57.9 million and $71.6 million for 1998 and 1997, respectively, while incurred losses and loss adjustment expenses were $110.4 million and $29.9 million for 1998 and 1997, respectively. Reserves for losses and loss adjustment expenses assumed at December 31, 1998 and 1997 were $211.5 million and $158.1 million, respectively, and the unearned premium reserves at December 31, 1998 and 1997 were $11.4 million and $25.5 million, respectively.

During 1995, the Company entered into a stop loss retrocessional treaty, covering all lines of business, with TIG Insurance Company. Reserves for losses and loss adjustment expenses ceded as of December 31, 1997 were $70.0 million and there were no ceded paid losses. During 1998, the Company entered into a commutation agreement with TIG Insurance Company for this treaty. Under this agreement, TIG Insurance Company paid $35.6 million to the Company in exchange for the release of $70.0 million of reserves ceded by the Company to TIG Insurance Company.

## 12. YEAR 2000 MATTERS (UNAUDITED)

The Year 2000 issue relates to the ability or inability of systems (including computer hardware, software and embedded microprocessors) to properly interpret date information relating to the year 2000 and beyond. Many existing systems use only the last two digits to refer to a year (i.e., "98" is used for 1998). Therefore, these systems may not properly recognize a year that begins with "20" instead of "19". If not corrected, these systems could fail or create erroneous results.

Specific information technology systems that are utilized by the Company, and by third parties with whom the Company has business relationships, include policy, claim and reinsurance processing and administration, accounting, payroll, financial reporting, product development, business planning, tax, accounts receivable, accounts payable and numerous word processing and spreadsheet programs. In addition, the Company and third parties with whom the Company has a business relationship are dependent on many non-information technology based systems, such as utility, communication and security systems.

**State of Readiness.** The Company's information systems are independent from TIG Insurance Company. The Company's principal reinsurance system is 100% Year 2000 compliant. The Company believes that the other systems are more than 95% compliant and anticipates that it will be successful in its efforts to ensure full compliance of all of its mission critical systems by the Year 2000.

The Company has reviewed and replaced software and inventoried all of its' PC workstations, servers and other computing equipment. All of the Company's existing equipment has been modified or replaced to be Year 2000 compliant. The Company has reviewed its' telecommunications equipment, and discussed Year 2000 readiness issues with vendors and service providers to obtain the necessary compliance certifications.

The Company has significant business relationships with numerous third parties (other than computer software and hardware vendors discussed above) that impact virtually all aspects of the Company's business, including, without limitation, ceding companies, retrocessionaires and brokers which produce and service contracts, banks, general suppliers and facility related vendors. In the event that one or more key third parties are unable to make their systems Year 2000 compliant, the Company's operations could suffer a material adverse impact. The Company has a coordinated processes to identify key third parties, request information regarding Year 2000 compliance, assess potential risk based upon responses received, and determine any action required to mitigate potential risks. The Company expects to complete mailing requests for information to key third parties by the end of February 1999. The Company expects to complete substantially all of its initial evaluation of third party responses by May 31, 1999. Determination of any action required is expected to be completed by June 30, 1999, and the Company will continue to monitor Year 2000 issues relating to such key third parties during the remainder of 1999. Notwithstanding the efforts by the Company to assess the third party's systems, there can be no guarantee that such systems will be Year 2000 compliant.

**Costs.** The Company originally budgeted $150,000 for Year 2000 compliance. This amount included funds for testing, remediation and possible replacement of hardware and software. The Company believes that it will be within the original budgeted amount by the time that it is completely Year 2000 compliant.

All estimates of future costs related to assessing and achieving Year 2000 compliance are based on management's best estimates and there can be no guarantee that actual amounts expended will not differ from such estimates.

**Risks.** The insurance business, by its nature, is date sensitive. Proper processing of core policy, reinsurance and claims data is dependent upon correct policy effective dates, policy expiration dates, endorsement dates, premium payment dates, loss dates, loss report dates, and the like. Inaccurate date processing of policy, reinsurance, claims and other information could have a significant adverse impact on the conduct of the Company's daily business operations and the preparation of accurate financial information. During the fourth quarter of 1998, the Company has begun processing reinsurance contracts expiring in the Year 2000 and there has not been any processing disruption to date. However, some Year 2000 related problems may only become apparent over time. It is possible that future Year 2000 related problems could result in disruptions of the Company's operations in the event that the Company is unable to make its systems fully Year 2000 compliant.