**TRAVELERS REINSURANCE POOL**
**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**
**DECEMBER 31, 2008**

**Organization:**
The Travelers Reinsurance Pool (the Pool) consists of 35 property-casualty insurance companies. Seven additional property-casualty companies cede 100% of their business to the Pool. At December 31, 2008 these U.S.-domiciled companies were direct or indirect wholly-owned subsidiaries of The Travelers Companies, Inc., a publicly traded holding company.

The Pool provides a wide range of property-casualty insurance products and services to businesses, government units, associations and individuals, primarily in the United States. Management's Discussion & Analysis for the Pool has been prepared on a comparative combined basis for the 2008 and 2007 reporting years.

The Travelers Indemnity Company (Indemnity) is the lead company of the Pool. Under the terms of the intercompany pooling arrangement, the property-casualty underwriting risks for substantially all lines of business of the intercompany pool participants are reinsured with Indemnity. The pool of net underwriting risks remaining after reinsurance is transacted with third parties by Indemnity is then retroceded to the pool participants based on pool percentages. The provision for reinsurance and the write-off of uncollectible reinsurance are reported in the statutory financial statements of Indemnity and are not allocated to the other pool participants.

The names, National Association of Insurance Commissioners (NAIC) company codes and intercompany pool percentages of the companies participating in the Pool are as follows:

| Pool Participant | NAIC Company Code | Pool Participation Percentage |
|---|---|---|
| St. Paul Fire and Marine Insurance Company | 24767 | 24.79 |
| The Travelers Indemnity Company | 25658 | 23.29 |
| Travelers Casualty and Surety Company | 19038 | 20.36 |
| The Phoenix Insurance Company | 25623 | 5.00 |
| The Standard Fire Insurance Company | 19070 | 4.84 |
| United States Fidelity and Guaranty Company | 25887 | 4.41 |
| Travelers Casualty Insurance Company of America | 19046 | 2.73 |
| Farmington Casualty Company | 41483 | 1.48 |
| The Automobile Insurance Company of Hartford, CT | 19062 | 1.37 |
| The Travelers Indemnity Company of Connecticut | 25682 | 1.37 |
| The Charter Oak Fire Insurance Company | 25615 | 1.27 |
| Northland Insurance Company | 24015 | 1.22 |
| St. Paul Surplus Lines Insurance Company | 30481 | 0.88 |
| The Travelers Indemnity Company of America | 25666 | 0.77 |
| St. Paul Protective Insurance Company | 19224 | 0.58 |
| Northfield Insurance Company | 27987 | 0.52 |
| Travelers Casualty Company of Connecticut | 36170 | 0.47 |
| Travelers Commercial Casualty Company | 40282 | 0.47 |
| Travelers Commercial Insurance Company | 36137 | 0.47 |
| St. Paul Mercury Insurance Company | 24791 | 0.40 |
| Travelers Property Casualty Company of America | 25674 | 0.36 |
| Travelers Property Casualty Insurance Company | 36161 | 0.30 |
| Athena Assurance Company | 41769 | 0.29 |
| St. Paul Medical Liability Insurance Company | 41750 | 0.29 |
| TravCo Insurance Company | 28188 | 0.27 |
| Travelers Excess and Surplus Lines Company | 29696 | 0.27 |
| The Travelers Home and Marine Insurance Company | 27998 | 0.27 |
| Travelers Personal Security Insurance Company | 36145 | 0.27 |
| Travelers Personal Insurance Company | 38130 | 0.27 |
| Discover Property & Casualty Insurance Company | 36463 | 0.14 |
| Discover Specialty Insurance Company | 10213 | 0.14 |
| Northland Casualty Company | 24031 | 0.14 |
| American Equity Specialty Insurance Company | 10819 | 0.10 |
| Fidelity and Guaranty Insurance Underwriters, Inc. | 25879 | 0.10 |
| St. Paul Guardian Insurance Company | 24775 | 0.10 |
| Total | | 100.00 |

The following companies cede 100% of their direct and assumed business to one of the above Pool participants:

| | | |
|---|---|---|
| American Equity Insurance Company | 43117 | — |
| Fidelity and Guaranty Insurance Company | 35386 | — |
| Gulf Underwriters Insurance Company | 42811 | — |
| The Travelers Lloyd's Insurance Company | 41262 | — |
| Travelers Lloyd's of Texas Insurance Company | 41564 | — |

At December 31, 2008, Seaboard Surety Company, an affiliated company, ceded 90% of its business to a member of the Pool. Effective January 1, 2009, Seaboard Surety Company was merged into Travelers Casualty and Surety Company of America.

The Pool is licensed to write business, personal and financial coverages in 50 states, the District of Columbia, Guam, Puerto Rico, the Virgin Islands, Northern Mariana Islands, Canada, and the Bahamas.

On December 31, 2008, Indemnity completed the sale of Atlantic Insurance Company (AIC) to Scottsdale Insurance Company, an unaffiliated property-casualty insurer. To facilitate this sale, Indemnity and AIC entered into a "Transfer and Assumption Agreement" and AIC transferred all of its assets, other than certain "Retained Assets" as defined in the "Transfer and Assumption Agreement" as well as all of its liabilities, to Indemnity prior to the sale. The sale was not material to the Pool's results of operations or financial position.

In December 2008, St. Paul Fire and Marine Insurance Company sold its subsidiary Unionamarica, which comprised its United Kingdom-based runoff insurance and reinsurance businesses, to Royston Run-Off Limited, an unaffiliated entity. Included in the claim and claim adjustment expense reserves transferred to the purchaser were gross and net asbestos reserves of $330 million and $232 million, respectively, and gross and net environmental reserves of $40 million and $33 million, respectively. The sale was not material to the Pool's results of operations or financial position.

On October 21, 2008, Indemnity acquired an aircraft and certain aviation assets valued at $15.4 million from St. Paul Aviation, Inc. (Aviation), a non insurance affiliate, in exchange for 207 shares of its common stock. This distribution qualified as a tax-free transfer under Sections 351 and 361 of the Internal Revenue Code. Following this transaction, Aviation merged with and into Indemnity's parent, Travelers Insurance Group Holdings, Inc. (TIGHI), with TIGHI being the surviving corporation. As a result of this merger, TIGHI continues to own 100% of the issued and outstanding common stock of Indemnity.

The Northland Company, a wholly owned non-insurance subsidiary of Indemnity, was dissolved effective May 1, 2008. As a result of this dissolution, Commercial Guaranty Casualty Insurance Company (CGCIC) and Jupiter Holdings, Inc. became direct subsidiaries of Indemnity.

On October 14, 2008, St. Paul Fire and Marine Insurance Company entered into an "Agreement and Plan of Restructuring" with the following affiliates: Seaboard Surety Company (Seaboard), Travelers Casualty and Surety Company of America (America), Travelers Casualty and Surety Company (TCS), The Travelers Companies, Inc. (TRV), Travelers Property Casualty Corp. (TPC) and Travelers Insurance Group Holdings, Inc. (TIGHI), intended to reorganize the corporate structure of certain TRV companies in order to merge Seaboard with and into America. On January 2, 2009, in accordance with the "Agreement and Plan of Restructuring," Seaboard merged with and into America, with America being the surviving corporation. At the time of the merger, Seaboard had a statutory carrying value of $138.7 million.

On June 2, 2008, Indemnity completed the sale of CGCIC to Max Specialty Insurance Company, an unaffiliated entity. Prior to the sale, CGCIC entered into a "Transfer and Assumption Agreement" and transferred all of its assets over and above certain "Retained Assets" as defined in the "Transfer and Assumption Agreement" as well as all of their liabilities to Indemnity. The "Transfer and Assumption Agreement" has an effective date of January 1, 2008. To properly report 2008 underwriting activity in the underwriting exhibits, the December 31, 2007 loss and LAE reserves of Indemnity as reported in the underwriting exhibits were adjusted to include the loss and LAE reserves of CGCIC. The amount of loss and LAE reserves reported in the financial statements as of December 31, 2007, however, were unaffected.

As a result of this sale, Commercial Guaranty Insurance Company (CGI) became a direct subsidiary of Indemnity.

On November 26, 2007, following a series of capital contributions, as approved by the Board of Directors of TPC and TIGHI, The Travelers Asset Funding Corporation (TAFC) with a statutory carrying value of $51.5 million became a wholly-owned subsidiary of Indemnity. Also effective November 26, 2007 Indemnity proceeded to dissolve TAFC pursuant to a Plan of Liquidation and Dissolution (the Plan) entered into by Indemnity and TAFC. In accordance with the Plan, Indemnity and TAFC entered into an Assumption Agreement whereby Indemnity assumes all obligations and liabilities of TAFC not otherwise discharged by the Plan. The impact of the above capital contribution and resulting increase in nonadmitted assets was not material to Indemnity's surplus. The State of Connecticut Insurance Department approved the contribution of TAFC to Indemnity, the Plan and the Assumption Agreement.

On October 1, 2007, effective January 1, 2007, after receiving all required regulatory approvals, the Pool was amended to include four former members of the Northland Pool (American Equity Specialty Insurance Company, Northland Insurance Company, Northfield Insurance Company, Northland Casualty Company), and three additional participants, Fidelity and Guaranty Insurance Underwriters, Inc. (FGIU), St. Paul Guardian Insurance Company (Guardian), and St. Paul Mercury Insurance Company (Mercury). Prior to this amendment FGIU, Guardian, and Mercury ceded 100% of their business to a member of the Pool.

On October 1, 2007, in accordance with a "Plan of Merger" and in connection with and as part of a series of related transactions as contemplated by and described in the "Agreement and Plan of Restructuring" dated June 20, 2007, Indemnity merged with Discover Reinsurance Company (Discover Re), with Indemnity being the surviving entity. At the time of this merger Discover Re had a statutory carrying value of $576.2 million.

As part of these transactions, Discover Re Managers, Inc. distributed 100% of the common shares of Discover Re to its parent, United States Fidelity and Guaranty Company (USF&G). USF&G then distributed 100% of the common shares of Discover Re to its sole shareholder and parent St. Paul Fire and Marine Insurance Company (Fire and Marine). Fire and Marine then distributed 100% of the common shares of Discover Re to its sole shareholder and parent TRV. Each of these transactions qualified as a tax-free spin-off distribution under Section 355 of the Internal Revenue Code and was reported as a return of capital/decrease in surplus in USF&G's and Fire and Marine's Annual Statement. In accordance with the "Plan of Merger", Discover Re then merged with and into Indemnity at which time all issued and outstanding shares of Discover Re were exchanged for 7,700 shares of Indemnity. TRV then contributed the 7,700 shares as a capital contribution to Travelers Property Casualty Corp. (TPC) which in turn contributed the 7,700 shares to Travelers Insurance Group Holdings, Inc. (TIGHI). As a result TIGHI continues to own all issued and outstanding shares of Indemnity. The statutory merger method was utilized in merging the two entities, of which Indemnity was the surviving entity.

All required regulatory approvals were obtained by Indemnity and its affiliates in connection with the "Plan of Merger" dated September 21, 2007 and the "Agreement and Plan of Restructuring" dated June 20, 2007.

# MANAGEMENT'S DISCUSSION AND ANALYSIS

**Nature of Operations:**
The Pool's operations are organized into three business segments: Business Insurance, Personal Insurance, and Financial, Professional & International Insurance (FPII) (only a portion of FPII written in U.S. companies is included in the Pool).
The specific business segments are as follows:

**Business Insurance**

The Business Insurance segment offers a broad array of property-casualty insurance and insurance-related services to its clients primarily in the United States. Business Insurance is organized into the following six groups, which collectively comprise Business Insurance Core operations:

- *Select Accounts* serves small businesses for property and casualty products, including commercial multi-peril, property, general liability, commercial auto and workers' compensation insurance.

- *Commercial Accounts* serves mid-sized businesses for property and casualty products, including property, general liability, commercial multi-peril, commercial auto and workers' compensation insurance.

- *National Accounts* provides casualty products and services to large companies, with particular emphasis on workers' compensation, general liability and automobile liability, generally utilizing loss-sensitive products such as collateralized deductibles or self-insured programs. In addition, National Accounts includes the commercial residual market business, which primarily offers workers' compensation products and services to the involuntary market.

- *Industry-Focused Underwriting.* The following units serve targeted industries with differentiated combinations of insurance coverage, risk management, claims handling and other services:

  - *Construction* serves a broad range of construction businesses, offering guaranteed cost products for small to mid-sized policyholders and loss sensitive programs for larger accounts. For the larger accounts, the customer and the Pool work together in actively managing and controlling exposure and claims and they share risk through policy features such as deductibles or retrospective rating. Products offered include workers' compensation, general liability, umbrella, commercial auto, property and inland marine coverages, and other risk management solutions.

  - *Technology* serves small to large companies involved in telecommunications, information technology, medical technology and electronics manufacturing, offering a comprehensive portfolio of products and services. These products include property, commercial auto, general liability, workers' compensation, umbrella, internet liability, technology errors and omissions coverages and global companion products.

  - *Public Sector Services* markets insurance products and services to public entities including municipalities, counties, Indian Nation gaming and selected special government districts such as water and sewer utilities. The policies written by this unit typically cover property, commercial auto, general liability and errors and omissions exposures.

  - *Oil & Gas* provides specialized property and liability products and services for customers involved in the exploration and production of oil and natural gas, including operators and drilling contractors, as well as various service and supply companies and manufacturers that support upstream operations. The policies written by this business group cover risks including physical damage, liability and business interruption.

  - *Agribusiness* serves small to medium-sized agricultural businesses, including farms, ranches, wineries and related operations, offering property and liability coverages other than workers' compensation.

- *Target Risk Underwriting.* The following units serve commercial businesses requiring specialized product underwriting, claims handling and risk management services:

  - *National Property* provides traditional and customized property insurance programs to large and mid-sized customers, including office building owners, manufacturers, municipalities and schools, retailers, and service businesses. These insurance programs cover losses on buildings, business assets, personal property and business interruption exposures.

  - *Inland Marine* provides insurance for goods in transit and movable objects for customers such as jewelers, museums, contractors and the transportation industry. Builders' risk insurance is also offered to customers during the construction, renovation or repair of buildings and other structures.

  - *Ocean Marine* serves the marine transportation industry and related services, as well as other businesses involved in international trade. The Pool's product offerings in this unit fall under six main coverage categories: marine liability, cargo, hull and machinery, protection and indemnity, pleasure craft, and marine property and liability.

  - *Excess Casualty* serves small to mid-sized commercial businesses, offering mono-line umbrella and excess coverage where the Pool typically does not write the primary casualty coverage, or where other business units within the Pool prefer to access the underwriting expertise and/or limit capacity of the Excess Casualty business unit.

  - *Boiler & Machinery* serves small to large companies, offering comprehensive breakdown coverages for equipment, including property and business interruption coverages. Through the BoilerRe unit, Boiler & Machinery also serves other property casualty carriers that do not have in-house expertise with reinsurance, underwriting, engineering, claim handling and risk management services for this type of coverage.

  - *Global Accounts* provides insurance to U.S. companies with foreign property and liability exposures (home-foreign), and foreign organizations with property and liability exposures located in the United States (reverse-flow), as part of a global program.

- *Specialized Distribution.* The following units market and underwrite their products to customers predominantly through licensed wholesale, general and program agents that manage customers' unique insurance requirements:

  - *Northland* provides insurance coverage for the commercial transportation industry, as well as commercial liability and package policies for small, difficult to place specialty classes of commercial business on an admitted or excess and surplus lines basis.

  - *National Programs* offers tailored property and casualty programs on an admitted basis for customers with common risk characteristics or coverage requirements. Programs available include those for entertainment, architects and engineers, equipment rental and golf services.

Business Insurance also includes the Special Liability Group (which manages the Pool's asbestos and environmental liabilities); the assumed reinsurance, health care, and certain international and other runoff operations; and policies written by the Pool's Gulf operation (Gulf), which is in runoff. These are collectively referred to as Business Insurance Other. In December 2008, the Pool completed the sale of Unionamerica Holdings Limited (Unionamerica), which comprised its United Kingdom-based runoff insurance and reinsurance businesses. The sale was not material to the Pool's results of operations or financial position.

**Personal Insurance**

The Personal Insurance segment writes virtually all types of property and casualty insurance covering personal risks. The primary coverages in Personal Insurance are automobile and homeowners insurance sold to individuals. These products are distributed through independent agents, sponsoring organizations such as employee and affinity groups, joint marketing arrangements with other insurers and direct marketing.

Automobile policies provide coverage for liability to others for both bodily injury and property damage, and for physical damage to an insured's own vehicle from collision and various other perils. In addition, many states require policies to provide first-party personal injury protection, frequently referred to as no-fault coverage.

Homeowners policies are available for dwellings, condominiums, mobile homes and rental property contents. Protection against losses to dwellings and contents from a wide variety of perils (excluding flooding) is included in these policies, as well as coverage for liability arising from ownership or occupancy. The Personal Insurance segment also writes coverage for personal watercraft, personal articles such as jewelry, and umbrella liability protection.

**Financial, Professional & International Insurance**

The Financial, Professional & International Insurance segment includes surety and financial liability coverages, which primarily use credit-based underwriting processes. This segment's Pool business is underwritten by the *Bond & Financial Products* group:

- *Bond & Financial Products* provides a wide range of customers with bond and insurance products and risk management services. The range of coverages includes surety and fidelity bonds for construction and general commercial enterprises; professional liability and management liability for public corporations, private companies and not-for-profit organizations for losses caused by the negligence or misconduct of named directors and officers; professional liability for a variety of professionals, such as lawyers, design professionals and real estate agents for liability from errors and omissions committed in the course of professional conduct or practice; and a full range of property, auto, liability, fidelity and professional/management liability insurance for financial institutions, with a special focus on community banks.

*Catastrophe Reinsurance*
The Pool has geographic exposure to catastrophe losses in certain areas of the country. Catastrophes can be caused by various natural events, including, among others, hurricanes, windstorms, earthquakes, hail, severe winter weather, wildfires and volcanic eruptions. Catastrophes can also be man-made, such as a terrorist attack (including those involving nuclear, biological, chemical or radiological events) or a consequence of war or political instability. The incidence and severity of catastrophes are inherently unpredictable. The extent of losses from a catastrophe is a function of both the total amount of insured exposure in the area affected by the event and the severity of the event. Most catastrophes are restricted to small geographic areas; however, hurricanes and earthquakes may produce significant damage in larger areas, especially those that are heavily populated. The Pool generally seeks to manage its exposure to catastrophes through individual risk selection and the purchase of catastrophe reinsurance. The Pool utilizes a general catastrophe reinsurance treaty with unaffiliated reinsurers to manage its exposure to losses resulting from catastrophes. In addition to the coverage provided under this treaty, the Pool also utilizes a catastrophe bond program, as well as a Northeast catastrophe reinsurance treaty, to protect against losses resulting from catastrophes in the Northeastern United States.

**Assets:**
The primary purpose of the investment portfolio is to fund future claim payments; as a result, the Pool employs a conservative investment philosophy. A significant majority of funds available for investment are deployed in a widely diversified portfolio of high quality, liquid intermediate-term taxable U.S. government bonds, tax-exempt U.S. municipal bonds, and taxable corporate and U.S. agency mortgage-backed bonds. To minimize risk, the Pool continues to primarily invest in securities rated NAIC Class 1 or 2. The investment strategy has also focused on limiting surplus volatility.

The Pool's cash and invested assets at statutory carrying values were as follows:

| (at December 31, in millions) | 2008 | 2007 |
|---|---|---|
| Bonds | **$ 52,771** | $ 53,533 |
| Preferred stocks | **243** | 342 |
| Common stocks – affiliated | **3,655** | 3,802 |
| Common stocks – non-affiliated | **254** | 246 |
| Mortgage loans | **94** | 45 |
| Real estate | **923** | 933 |
| Cash and short-term investments | **1,765** | 1,959 |
| Other invested assets | **2,235** | 2,738 |

The primary goals of the Pool's asset/liability management process are to satisfy the insurance liabilities, manage the interest rate risk embedded in those insurance liabilities and maintain sufficient liquidity to cover fluctuations in projected liability cash flows. Generally, the expected principal and interest payments produced by the Pool's fixed maturity portfolio adequately fund the estimated runoff of the Pool's insurance reserves. Although this is not an exact cash flow match in each period, the substantial degree by which the market value of the fixed maturity portfolio exceeds the expected present value of the net insurance liabilities, as well as the positive cash flow from newly sold policies and the large amount of high quality liquid bonds, provide assurance of the Pool's ability to fund the payment of claims without having to sell illiquid assets or access credit facilities. However, as the Pool's investment strategy focuses on asset and liability durations, and not specific cash flows, asset sales may be required to satisfy obligations and/or rebalance asset portfolios.

The Pool also invests much smaller amounts in equity securities, private equity limited partnerships, hedge funds, real estate partnerships, joint ventures, non-public common and preferred equities, mortgage loans and trading securities. These investment classes have the potential for higher returns but also involve varying degrees of risk, including less stable rates of return and less liquidity.

At December 31, 2008, the carrying value of the Pool's total bond portfolio, including short-term investments, was $54.94 billion compared with $55.98 billion at December 31, 2007. The majority of the Pool's long-term bonds are carried at amortized cost, which was $52.77 billion and $53.53 billion at December 31, 2008 and 2007, respectively. The fair value of these long-term bonds was $52.85 billion and $54.38 billion at December 31, 2008 and 2007, respectively. The quality of the Pool's bond portfolio remains very high. Bond issues are rated in accordance with Securities Valuation Office (SVO) guidelines. At December 31, 2008 and 2007, 98% and 97%, respectively, of the Pool's bond portfolio was comprised of NAIC Class 1 and 2 securities.

The Pool makes investments in residential collateralized mortgage obligations (CMOs) that typically have high credit quality, offer good liquidity and are expected to provide an advantage in yield compared to U.S. Treasury securities. The Pool's investment strategy is to purchase CMO tranches which offer the most favorable return given the risks involved. One significant risk evaluated is prepayment sensitivity. While prepayment risk (either shortening or lengthening of duration) and its effect on total return cannot be fully controlled, particularly when interest rates move dramatically, the investment process generally favors securities that control this risk within expected interest rate ranges. The Pool does invest in other types of CMO tranches if a careful assessment indicates a favorable risk/return tradeoff. The Pool does not purchase residual interests in CMOs.

The Pool's preferred stock holdings of $243 million at December 31, 2008 decreased by $99 million, or 29%, from December 31, 2007, primarily reflecting the sale of securities. Redeemable issues that were called totaled $8 million in 2008.

The Pool's investments in affiliated common stocks totaled $3.66 billion, a decrease of $79 million from December 31, 2007. The value of non-pool U.S. property-casualty insurance subsidiaries at December 31, 2008 increased by $442 million over year-end 2007, driven by an increase of $444 million in the surplus of Travelers Casualty and Surety Company of America (TC&S of America). During 2008, TC&S of America recorded net income of $512 million while paying dividends of $50 million. This increase was offset by the Pool's sale of Unionamerica in December 2008, which had a carrying value of $442 million at the date of sale.

Cash and short-term investments of $1.77 billion at December 31, 2008 decreased $194 million from December 31, 2007. The decline in 2008 reflected a lower level of cash provided from operations coupled with an increase in dividends paid to stockholders. Cash flows from operations in 2008 reflected a higher level of loss and loss adjustment expenses paid, primarily resulting from catastrophe losses incurred, as well as lower levels of collected premiums and net investment income.

Other invested assets of $2.24 billion at December 31, 2008 declined $503 million from December 31, 2007, primarily reflecting a significant decrease in the unrealized appreciation on these investments. The market disruptions that occurred in the second half of 2008 resulted in increased unrealized losses compared with previous years. The Pool continually evaluates current developments in the market that have the potential to affect the valuation of the Pool's investments.

Receivables related to federal and foreign income tax increased $42 million during 2008, primarily due to the settlement of prior year audits and the timing of tax payments.

The Pool's reinsurance recoverable on paid losses totaled $820 million at December 31, 2008, a decline of $138 million from year-end 2007. This decrease reflected various commutation agreements and collections on reinsurance recoverables, including those related to prior years' hurricane losses.

TRV maintains a private short-term investment pool, known as the Travelers Money Market Liquidity Pool (TRVMMLP), in which affiliated companies may participate. The TRVMMLP is managed by Indemnity and each company may convert its position in the TRVMMLP into cash at any time and may also use its position in the TRVMMLP to settle transactions with other affiliated participants in the TRVMMLP. The position of each company in the TRVMMLP is calculated and adjusted daily. Each participating insurance company carries its share of the TRVMMLP as a short-term investment in Schedule DA. At December 31, 2008, the TRVMMLP totaled $4.93 billion. At December 31, 2008, the Pool had $148,000 receivable from affiliates. Accounts between and among the Pool and its affiliates are settled at least monthly through the TRVMMLP or cash. Any balances remaining outstanding at the end of the month are settled in the following month.

**Liabilities:**

The majority of the Pool's liabilities consist of reserves for losses and loss adjustment expenses (LAE). Loss and LAE reserves totaled $37.64 billion and $38.36 billion at December 31, 2008 and 2007, respectively. The $720 million decrease in loss and LAE reserves primarily reflected favorable prior year reserve development during 2008 in each of the Pool's business segments, and payments related to operations in runoff (including asbestos and environmental payments), partially offset by catastrophe losses incurred. Asbestos and environmental reserves are described in more detail in the discussion that follows. Please refer to the Statement of Actuarial Opinion attached to each of the Pool participants' 2008 Annual Statement for more discussion concerning the Pool's reserves for losses and loss adjustment expenses.

**Asbestos and Environmental Claims**

Asbestos and environmental claims are segregated from other claims and are handled by the Pool's Special Liability Group, a separate unit staffed by dedicated legal, claim, finance and engineering professionals. For quantification of environmental and asbestos claims, please see the tables included in Note 32 of the Notes to Financial Statements in any of the Pool participants' 2008 Annual Statement.

*Asbestos Claims*

Exposure for asbestos losses arises from liability coverage written many years ago. The exposures include bodily injury and property damage losses.

With respect to reserving procedures, staff in the Special Liability Group reviews pending claim activities and anticipated development on a daily basis. The Pool also conducts quarterly asbestos reviews with representatives of the claim, legal, reinsurance, finance and actuarial areas to review asbestos trends and other relevant factors. Based on these reviews, asbestos reserves are established for the Pool's future exposure. Beginning in 2007, the Pool supplemented the existing annual in-depth asbestos claim review and the existing quarterly asbestos reserve review with additional aggregate quarterly reserve analyses. These additional analyses provide the Pool with an increased ability to detect and respond to emerging trends in its quarterly reserve estimates.

Because each policyholder presents different liability and coverage issues, the Pool generally reviews the exposure presented by each policyholder at least annually. In the course of this review, the Pool considers, among other factors: available insurance coverage, including the role of any umbrella or excess insurance the Pool has issued to the policyholder; limits and deductibles; an analysis of each policyholder's potential liability; the jurisdictions involved; past and anticipated future claim activity and loss development on pending claims; past settlement values of similar claims; allocated claim adjustment expense; potential role of other insurance; the role, if any, of non-asbestos claims or potential non-asbestos claims in any resolution process; and applicable coverage defenses or determinations, if any, including the determination as to whether or not an asbestos claim is a products/completed operation claim subject to an aggregate limit and the available coverage, if any, for that claim. For certain policyholders an estimate of the gross ultimate exposure for indemnity and related claim adjustment expense is determined, and for those policyholders the Pool calculates, by each policy year, a ceded reinsurance projection based on any applicable facultative and treaty reinsurance, past ceded experience and reinsurance collections. Conventional actuarial methods are not utilized to establish asbestos reserves nor have the Pool's evaluations resulted in any way of determining a meaningful average asbestos defense or indemnity payment.

On July 6, 2007, TRV announced that it entered into a settlement to resolve fully all current and future asbestos-related coverage claims relating to ACandS, Inc. (ACandS), formerly a national distributor and installer of products containing asbestos. Pursuant to that agreement, the Pool placed $449 million into escrow in 2007, which was reported in each Pool participants' 2007 Annual Statement (Schedule E – Part 3 – Special Deposits). The settlement was subject to a number of contingencies, all of which were fulfilled. On August 6, 2008, the $449 million settlement payment was released from the escrow to the ACandS Trust. This transaction was recorded as a paid claim and reduction in claim reserves, and accordingly, there was no effect on the Pool's results of operations.

*Environmental Claims*

Exposure for environmental losses arises from liability coverage written many years ago. The exposures include bodily injury and property damage losses.

In establishing environmental reserves, the Pool evaluates the exposure presented by each policyholder and the anticipated cost of resolution, if any. In the course of this analysis, the Pool generally considers the probable liability, available coverage, relevant judicial interpretations and historical value of similar exposures. In addition, the Pool considers the many variables presented, such as the nature of the alleged activities of the policyholder at each site; the allegations of environmental harm at each site; the number of sites; the total number of potentially responsible parties at each site; the nature of environmental harm and the corresponding remedy at each site; the nature of government enforcement activities at each site; the ownership and general use of each site; the overall nature of the insurance relationship between the Pool and the policyholder, including the role of any umbrella or excess insurance the Pool has issued to the policyholder; the involvement of other insurers; the potential for other available coverage, including the number of years of coverage; the role, if any, of non-environmental claims or potential non-environmental claims in any resolution process; and the applicable law in each jurisdiction. Conventional actuarial techniques are not used to estimate these reserves.

The Pool's reserves for environmental claims are not established on a claim-by-claim basis. The Pool carries an aggregate bulk reserve for all of the Pool's environmental claims that are in dispute, until the dispute is resolved. This bulk reserve is established and adjusted based upon the aggregate volume of in-process environmental claims and the Pool's experience in resolving those claims and includes unresolved and incurred but not reported environmental claims for which the Pool has not received any specific claims as well as for the anticipated cost of coverage litigation disputes relating to these claims. Case reserves are established solely for resolved claims.

The resolution of environmental exposures by the Pool generally occurs by settlement on a policyholder-by-policyholder basis as opposed to a claim-by-claim basis. Generally, the Pool strives to extinguish any obligations it may have under any policy issued to the policyholder for past, present and future environmental liabilities and extinguish any pending coverage litigation dispute with the policyholder. This form of settlement is commonly referred to as a "buy-back" of policies for future environmental liability. In addition, many of the agreements have also extinguished any insurance obligation which the Pool may have for other claims, including but not limited to asbestos and other cumulative injury claims. The Pool and its policyholders may also agree to settlements which extinguish any liability arising from known specified sites or claims. These agreements also include appropriate indemnities and hold harmless provisions to protect the Pool. The Pool's general purpose in executing these agreements is to reduce the Pool's potential environmental exposure and eliminate the risks presented by coverage litigation with the policyholder and related costs.

*Uncertainty Regarding Adequacy of Asbestos and Environmental Reserves*

As a result of the processes and procedures described above, management believes that the reserves carried for asbestos and environmental claims at December 31, 2008 are appropriately established based upon known facts, current law and management's judgment. However, the uncertainties surrounding the final resolution of these claims continue, and it is difficult to determine the ultimate exposure for asbestos and environmental claims and related litigation. As a result, these reserves are subject to revision as new information becomes available and as claims develop. The continuing uncertainties include, without limitation, the risks and lack of predictability inherent in complex litigation, any impact from the bankruptcy protection sought by various asbestos producers and other asbestos defendants, a further increase or decrease in asbestos and environmental claims beyond that which is anticipated, the role of any umbrella or excess policies the Pool has issued, the resolution or adjudication of disputes pertaining to the amount of available coverage for asbestos and environmental claims in a manner inconsistent with the Pool's previous assessment of these claims, the number and outcome of direct actions against the Pool, future developments pertaining to the Pool's ability to recover reinsurance for asbestos and environmental claims and the unavailability of other insurance sources potentially available to policyholders, whether through exhaustion of policy limits or through the insolvency of other participating insurers. In addition, uncertainties arise from the insolvency or bankruptcy of policyholders and other defendants, although in recent years the Pool has noted a decrease in the number and volatility of asbestos-related bankruptcies. It is also not possible to predict

changes in the legal, regulatory and legislative environment and their impact on the future development of asbestos and environmental claims. This development will be affected by future court and regulatory decisions and interpretations, as well as changes in applicable legislation. It is also difficult to predict the ultimate outcome of complex coverage disputes until settlement negotiations near completion and significant legal questions are resolved or, failing settlement, until the dispute is adjudicated. This is particularly the case with policyholders in bankruptcy where negotiations often involve a large number of claimants and other parties and require court approval to be effective. As part of its continuing analysis of asbestos and environmental reserves, the Company continues to study the implications of these and other developments.

Because of the uncertainties set forth above, additional liabilities may arise for amounts in excess of the current related reserves. In addition, the Pool's estimate of claims and claim adjustment expenses may change. These additional liabilities or increases in estimates, or a range of either, cannot now be reasonably estimated and could result in income statement charges that could be material to the Pool's operating results in future periods.

*Other Liabilities*

Unearned premiums at December 31, 2008 totaled $8.20 billion, an increase of $42 million, or less than 1%, over the year-end 2007 total of $8.15 billion. This increase is consistent with the 1% growth in net written premiums in 2008.

The payable for securities balance of $33 million at December 31, 2008 was $32 million lower than the December 31, 2007 balance of $65 million. This balance fluctuates based on purchase activity and unsettled transactions prior to the statement date; the decrease in this balance was due to a lower volume of securities traded at the end of 2008 which settled in early 2009.

Amounts withheld or retained for account of others totaled $1.17 billion at December 31, 2008, an increase of $111 million, or 10%, over the December 31, 2007 total of $1.06 billion. This increase was primarily attributable to a rise in the Pool's cash collateral held. Cash collateral is generally held to secure reimbursements due from policyholders under the Pool's retrospectively rated and high deductible programs.

The Pool's provision for reinsurance of $289 million at December 31, 2008 decreased by $75 million from the December 31, 2007 total of $364 million. The Pool's provision for reinsurance related to authorized reinsurers declined by $87 million, while the provision for reinsurance attributable to unauthorized reinsurers increased by $12 million during 2008. Total reinsurance recoverables at December 31, 2008 declined by $1.83 billion from the same date in 2007, primarily reflecting significant collections on reinsurance recoverables, including those related to prior year hurricane losses, operations in runoff and various commutation agreements.

Aggregate write-ins for liabilities increased by $95 million compared with year-end 2007, reflecting a change in the timing of the reclassification of negative cash balances to an escheat liability, and an increase in retrospective premium reserves. Included in the write-ins for liabilities are balances associated with agreements that have been accounted for as deposits (SSAP No. 75). Cash payments related to those contracts reduced this liability by $121 million in 2008.

**Capital and Surplus:**

Total capital and surplus was $20.86 billion and $22.18 billion at December 31, 2008 and 2007, respectively. The $1.32 billion decrease in surplus in 2008 primarily reflected dividends of $3.70 billion paid to Travelers Insurance Group Holdings, Inc., ($1.19 billion from Indemnity, $1.14 billion from Travelers Casualty and Surety Company, $275 million from The Standard Fire Insurance Company) and TRV ($1.10 billion from St. Paul Fire and Marine Insurance Company), a $542 million increase in non-admitted assets and a $410 million decline in net unrealized capital gains, partially offset by net income of $3.38 billion. The increase in non-admitted assets primarily reflected a $376 million increase in non-admitted deferred tax assets.

**Results of Operations:**

| (for the year ended December 31, in millions) | 2008 | 2007 |
|---|---|---|
| Earned premiums | **$ 18,270** | $ 18,159 |
| Losses incurred | **(8,830)** | (8,462) |
| Loss adjustment expenses incurred | **(2,390)** | (2,198) |
| Other underwriting expenses | **(5,736)** | (5,529) |
| **Net underwriting gain** | **1,314** | $ 1,970 |
| | | |
| Net investment income | **3,380** | $ 3,591 |
| Net after-tax realized capital losses | **(412)** | (82) |
| Net income | **3,383** | 4,398 |

***Overview***

The Pool's net underwriting gain of $1.31 billion in 2008 was $656 million, or 33%, lower than the 2007 net underwriting gain. Losses incurred and LAE incurred in 2008 increased by $368 million and $192 million, respectively, over 2007, primarily due to a significant increase in catastrophe losses in 2008, an increase in non-catastrophe related weather losses and the impact of loss cost trends. These factors were partially offset by a higher level of net favorable prior year reserve development in 2008 compared to 2007. Net favorable prior year reserve development totaled $1.38 billion in 2008, compared with net favorable prior year reserve development of $364 million in 2007.

The cost of catastrophes (including hurricane-related assessments) in 2008 for the Pool totaled $1.34 billion, $1.21 billion higher than the 2007 total of $136 million. Catastrophe losses in 2008 were primarily the result of Hurricanes Ike and Gustav, as well as wind, rain and hail storms in several regions of the United States throughout the year, whereas the 2007 total was driven by wildfires in California and several storms throughout the United States.

***Premiums Earned***

Earned premiums in 2008 totaled $18.27 billion, an increase of $111 million, or 1%, over the 2007 total of $18.16 billion. In the Business Insurance segment, earned premiums in 2008 declined 1% from 2007 despite continued strong business retention rates, reflecting the impact of competitive market conditions on pricing and new business. In the Personal Insurance segment, earned premium growth of 5% in 2008 reflected continued strong business retention rates and new business volume, coupled with continued renewal price increases. In the Bond & Financial Products group of the Financial, Professional & International Insurance segment, earned premium growth in 2008 was concentrated in the Construction Services business unit, due to changes in the terms of certain reinsurance treaties that resulted in a higher level of business retained.

***Net Investment Income***

Net investment income totaled $3.38 billion in 2008, a decrease of $211 million, or 6%, from 2007 net investment income of $3.59 billion, primarily due to a $190 million decrease in dividends received by the Pool from its affiliated insurance subsidiaries in 2008 compared to 2007. In addition, lower returns from non-fixed maturity investments, which were negative in 2008, compared with strong positive returns in 2007, contributed to the decline in net investment income in 2008. The decline in net investment income from these investments in 2008 reflected market conditions, which resulted in a lower level of transactions and lower market values compared to those at December 31, 2007. Net investment income from the Pool's fixed maturity portfolio in 2008 also declined from 2007, primarily due to a significant decline in short-term interest rates.

***Pretax Net Realized Capital Gains/(Losses)***

Net pretax realized capital losses in 2008 totaled $505 million, compared with net pretax capital losses of $108 million in 2007. Net pretax realized capital losses in 2008 included impairment losses of $301 million, which were concentrated in the fixed maturity portfolio. The majority of fixed maturity impairments related to the deteriorated financial position of various issuers. In addition, a portion was related to externally managed securities whereby the Pool does not place purchase and sale constraints on the external manager and therefore assumes the intent to sell for these securities.

Net pretax realized capital losses in 2007 included losses of $39 million from impairments on fourteen of the Pool's partnership investments and one limited liability company. In addition, the Pool realized a $16 million loss on the sale of its Mexican insurance subsidiary, Afianzadora Insurgentes, S.A. de C.V. and a $53 million realized loss on its subsidiary Discover Re Managers Inc. following the distribution of Discover Reinsurance Company (Discover Re) in connection with an "Agreement and Plan of Restructuring" and "Plan of Merger" whereby Discover Re ultimately merged with and into Indemnity.

## *Written Premiums*

Direct written premiums of $19.65 billion in 2008 declined by 1% from the 2007 total of $19.83 billion, whereas net written premiums of $18.36 billion in 2008 increased 1% over the 2007 total of $18.21 billion. In the Pool's Business Insurance segment, net written premiums decreased by 1% from 2007, despite strong business retention rates. Premium growth in the Industry-Focused Underwriting, Select Accounts and Commercial Accounts markets in 2008, which was generally driven by strong business retention rates and new business volume, was more than offset by premium declines in the National Accounts, Target Risk Underwriting and Specialized Distribution markets, which primarily resulted from declines in renewal price changes. In the Personal Insurance segment, net written premiums in 2008 increased 4% over 2007, reflecting continued strong retention rates, renewal price increases and growth in new business levels. Net written premiums in the Bond & Financial Products group in the Financial, Professional & International Insurance segment in 2008 were level with 2007.

***Loss and LAE***

Losses and LAE incurred totaled $11.22 billion in 2008, an increase of $560 million, or 5%, over the 2007 total of $10.66 billion. The 2008 total included $1.20 billion of catastrophe losses and $1.38 billion of net favorable prior year reserve development, whereas the 2007 total included $136 million of catastrophe losses and $364 million of net favorable prior year reserve development.

In the Business Insurance segment, net favorable prior year development in 2008 was driven by better than expected loss results primarily concentrated in the general liability and commercial multi-peril product lines, an increase in anticipated ceded recoveries for older accident years in the general liability product line and better than anticipated loss development in the commercial property and commercial automobile product lines. The net favorable prior year reserve development in the general liability and commercial multi-peril lines was attributable to several factors, including improved legal and judicial environments, as well as enhanced risk control, underwriting and claim process initiatives. The commercial property product line improvement occurred primarily in the 2007 accident year as a result of better than expected loss development for certain large national property, national programs, and ocean marine claim exposures and lower than expected weather-related losses during the last half of 2007, as well as favorable loss development in certain large inland marine claim exposures and in ceded recoveries for commercial property large claims. In addition, the commercial multi-peril and property product lines' 2005 accident year results experienced improvement due to the litigation environment relating to, and ongoing claim settlements for, Hurricane Katrina. The commercial automobile product line improvement was attributable to several factors, including improved legal and judicial environments, as well as enhanced risk control, underwriting and claim process initiatives. The net favorable prior year reserve development in the foregoing product lines in 2008 was partially offset by net unfavorable prior year reserve development in the workers' compensation product line, primarily driven by higher than anticipated medical costs related to 2004 and prior accident years, and by $36 million and $80 million increases to asbestos and environmental reserves, respectively.

In the Personal Insurance segment, net favorable prior year reserve development in 2008 was primarily driven by favorable loss experience related to Hurricane Katrina, and better than expected loss experience from recent accident years for the Homeowners and Other product line. This improvement was driven in part by claim initiatives as well as better than expected outcomes on 2007 catastrophe-related claims. In addition, the Homeowners and Other product line experienced improvement in older accident years for the umbrella line as well as favorable experience from accident year 2007 for allied coverages due to less than expected claim activity.

In the Bond & Financial Products group of the Financial, Professional & International Insurance segment, better than expected loss experience for the contract surety business within the fidelity and surety product line, resulting from favorable settlements on large claims (primarily from accident years prior to 2005), resulted in net favorable prior year reserve development in 2008.

In 2007, net favorable prior year reserve development in the Business Insurance segment was primarily driven by better than expected loss development for recent accident years in the commercial multi-peril, general liability, commercial automobile and property product lines. The commercial multi-peril and general liability product lines experienced better than anticipated loss development that was attributable to several factors, including improved legal and judicial environments, as well as enhanced risk control, underwriting and claim process initiatives. The

commercial automobile product line experienced better than expected loss development due to more favorable legal and judicial environments, claim handling initiatives focused on the automobile line of insurance and improvements in auto safety technology. The property product line experienced fewer than expected late reported claims related to non-catastrophe weather events that occurred late in 2006, as well as better than expected frequency and severity due in part to changes in the marketplace, such as higher deductibles and lower policy limits. In addition, the property product line experienced better than expected large loss outcomes which were partially attributable to favorable litigation resolutions. Net total prior year reserve development in 2007 included a $185 million increase to environmental reserves. The Pool's completion of its annual in-depth asbestos claim review in the third quarter of 2007 and its quarterly asbestos reserve reviews throughout the year resulted in no change to the Pool's asbestos reserves in 2007.

In the Personal Insurance segment, net favorable prior year reserve development in 2007 was driven by better than expected automobile loss experience due in part to claim initiatives and fewer than expected late reported homeowners' claims related to non-catastrophe weather events that occurred in the fourth quarter of 2006. In addition, a portion of net favorable prior year reserve development in the Homeowners and Other line of business in 2007 was attributable to a decrease in the number of claims due to changes in the marketplace, including higher deductibles and fewer small-dollar claims.

The Pool writes certain directors' and officers' liability and errors and omissions policies that are impacted by subprime related losses. The following information summarizes the subprime related loss information for the Pool for the years ended December 31, 2008 and 2007:

| 2008 (in millions) | Paid Losses | Incurred Losses | Case Loss Reserves at Year-End | IBNR Loss Reserves at Year-End |
|---|---|---|---|---|
| **Total** | **$ 0.4** | **$ 76.4** | **$ 9.0** | **$ 182.6** |

| 2007 (in millions) | Paid Losses | Incurred Losses | Case Loss Reserves | IBNR Loss Reserves |
|---|---|---|---|---|
| **Total** | $ — | $ 115.8 | $ — | $ 115.8 |

***Other Underwriting Expenses***

Other underwriting expenses in 2008 totaled $5.74 billion, an increase of $207 million, or 4%, over the comparable 2007 total of $5.53 billion, reflecting hurricane-related assessments, growth in business volume and continued expenditures in 2008 to support business growth and product development. Net commission and brokerage expenses increased 2% over 2007, reflecting the growth in business volume. In addition, increases in salaries and related benefit costs and costs associated with EDP equipment and software also contributed to the growth in other underwriting expenses in 2008. State and local insurance taxes in 2008 increased 11% over 2007.

**Cash Flow and Liquidity:**

Liquidity is a measure of a company's ability to generate sufficient cash flows to meet the short- and long-term cash requirements of its business operations. The liquidity requirements of the Pool's business have been met primarily by funds generated from underwriting operations, asset maturities and income received on investments. Cash provided from these sources is used primarily for claims and claim adjustment expense payments and operating expenses. The timing and amount of catastrophe claims are inherently unpredictable. Such claims increase liquidity requirements. The timing and amount of reinsurance recoveries may be affected by reinsurer solvency and reinsurance coverage disputes. Additionally, the variability of asbestos-related claim payments, as well as the volatility of potential judgments and settlements arising out of litigation, may also result in increased liquidity requirements. It is the opinion of the Pool's management that the Pool's future liquidity needs will be adequately met from all of the above sources.

**Cash From Operations**

The Pool's net cash from operations totaled $3.43 billion and $5.33 billion in 2008 and 2007, respectively. Cash flows in 2008 reflected an increase in claim payments (including the impact of higher catastrophe losses and the $449 million asbestos settlement payment related to ACandS, Inc., which is discussed in more detail in the "Asbestos Claims" section herein) and a reduction in reinsurance recoveries compared with 2007, partially offset by a decline in federal and foreign income taxes paid.

**Cash From Investments**

Net cash flows used in investment activities totaled $395 million and $605 million in 2008 and 2007, respectively. Fixed maturity securities accounted for the majority of investment purchases in both years.

The Pool's total cash and invested assets at December 31, 2008 declined $1.35 billion from year-end 2007, primarily reflecting dividends paid to TRV and a pretax decline in the unrealized appreciation of investments since year-end 2007 (to an unrealized loss position at December 31, 2008), partially offset by investment purchases resulting from strong cash flows from operations. The net unrealized loss position at December 31, 2008 reflected the impact of rising interest rates on longer-dated fixed maturity securities primarily due to the widening of credit spreads generally.

The Pool's management of the duration of the fixed maturity investment portfolio generally produces a duration that exceeds the estimated duration of the Pool's net insurance liabilities. The average duration of fixed maturities and short-term securities was 4.2 and 4.0 at December 31, 2008 and 2007, respectively.

**Dividend Restrictions**

Since the Pool's insurance entities are subject to state insurance regulation, the amount of dividends that each entity may pay to its respective parent company is restricted. In 2009, dividend payments by the Pool are limited to approximately $3.07 billion without prior approval of the Connecticut Insurance Commissioner and Minnesota Commissioner of Commerce.

**Risk-Based Capital**

The NAIC adopted risk-based capital (RBC) requirements for property-casualty companies to be used as minimum capital requirements by the NAIC and states to identify companies that merit further regulatory action. The formulas have not been designed to differentiate among adequately capitalized companies that operate with levels of capital higher than RBC requirements. Therefore, it is inappropriate and ineffective to use the formulas to rate or to rank such companies. At December 31, 2008, all of the Pool's insurance entities had adjusted capital in excess of amounts requiring any company or regulatory action.

**Ratings**

Ratings are an important factor in setting the Pool's competitive position in the insurance marketplace. The Pool receives ratings from the following major rating agencies: A.M. Best Co. (A.M. Best), Moody's Investors Service (Moody's), Standard & Poor's Corp. (S&P) and Fitch Ratings (Fitch).

The following table summarizes the claims-paying and financial strength ratings for the Pool from various rating agencies as of February 19, 2009. The table also presents the position of each rating in the applicable agency's rating scale.

| | A.M. Best | Moody's | S&P | Fitch |
|---|---|---|---|---|
| Travelers Reinsurance Pool | A+ (2nd of 16) | Aa2 (3rd of 21) | AA- (4th of 21) | AA (3rd of 24) |

**CRITICAL ACCOUNTING ESTIMATES**

The Pool considers its most significant accounting estimates to be those applied to claims and claim adjustment expense reserves and related reinsurance recoverables, and investment valuation and impairments.

**Loss and Loss Adjustment Expense Reserves**

Claims and claim adjustment expense reserves (loss reserves) represent management's estimate of ultimate unpaid costs of losses and LAE for claims that have been reported and claims that have been incurred but not yet reported. Loss reserves do not represent an exact calculation of liability, but instead represent management estimates, generally utilizing actuarial expertise and projection techniques, at a given accounting date. These loss reserve estimates are expectations of what the ultimate settlement and administration of claims will cost upon final resolution in the future, based on the Pool's assessment of facts and circumstances then known, review of historical settlement patterns, estimates of trends in claims severity and frequency, expected interpretations of legal theories of liability and other factors. In establishing loss reserves, the Pool also takes into account estimated recoveries, reinsurance, salvage and subrogation. The loss reserves are reviewed regularly by qualified actuaries employed by the Pool.

The process of estimating loss reserves involves a high degree of judgment and is subject to a number of variables. These variables can be affected by both internal and external events, such as changes in claims handling procedures, changes in individuals involved in the reserve estimation process, economic inflation, legal trends and legislative changes, among others. The impact of many of these items on ultimate costs for claims and claim adjustment expenses is difficult to estimate. Loss reserve estimation difficulties also differ significantly by product line due to differences in claim complexity, the volume of claims, the potential severity of individual claims, the determination of occurrence date for a claim and reporting lags (the time between the occurrence of the policyholder event and when it is actually reported to the insurer). Informed judgment is applied throughout the process, including the application of various individual experiences and expertise to multiple sets of data and analyses. The Pool continually refines its loss reserve estimates in a regular ongoing process as historical loss experience develops and additional claims are reported and settled. The Pool rigorously attempts to consider all significant facts and circumstances known at the time loss reserves are established. Due to the inherent uncertainty underlying loss reserve estimates including, but not limited to, the future settlement environment, final resolution of the estimated liability for claims and claim adjustment expenses may be higher or lower than the related loss reserves at the reporting date. Therefore, actual paid losses, as claims are settled in the future, may be materially different in amount than current loss reserves—favorable or unfavorable.

Because establishment of loss reserves is an inherently uncertain process involving estimates, currently established loss reserves may change. The Pool reflects adjustments to loss reserves in the results of operations in the period the estimates are changed.

There are also additional risks which impact the estimation of ultimate costs for catastrophes. For example, the estimation of reserves related to hurricanes can be affected by the inability of the Pool and its insureds to access portions of the impacted areas, the complexity of factors contributing to the losses, the legal and regulatory uncertainties and the nature of the information available to establish the reserves. Complex factors include, but are not limited to: determining whether damage was caused by flooding versus wind; evaluating general liability and pollution exposures; estimating additional living expenses; estimating the impact of demand surge, infrastructure disruption, fraud, the effect of mold damage and business interruption costs; and reinsurance collectibility. The timing of a catastrophe, such as at or near the end of a reporting period, can also affect the information available to the Pool in estimating reserves for that reporting period. The estimates related to catastrophes are adjusted as actual claims emerge.

A portion of the Pool's gross claims and claim adjustment expense reserves are for asbestos and environmental claims and related litigation, which totaled $3.69 billion at December 31, 2008. While the ongoing review of asbestos and environmental claims and associated liabilities considers the inconsistencies of court decisions as to coverage, plaintiffs' expanded theories of liability and the risks inherent in complex litigation and other uncertainties, in the opinion of the Pool's management, it is possible that the outcome of the continued uncertainties regarding these claims could result in liability in future periods that differs from current reserves by an amount that could be material to the Pool's future operating results.

General Discussion

The process for estimating the liabilities for claims and claim expenses begins with the collection and analysis of claim data. Data on individual reported claims, both current and historical, including paid amounts and individual claim adjuster estimates, are grouped by common characteristics (components) and evaluated by actuaries in their analyses of ultimate claim liabilities by product line. Such data is occasionally supplemented with external data as available and when appropriate. The process of analyzing reserves for a component is undertaken on a regular basis, generally quarterly, in light of continually updated information.

Multiple estimation methods are available for the analysis of ultimate claim liabilities. Each estimation method has its own set of assumption variables and its own advantages and disadvantages, with no single estimation method being better than the others in all situations and no one set of assumption variables being meaningful for all product line components. The relative strengths and weaknesses of the particular estimation methods when applied to a particular group of claims can also change over time. Therefore, the actual choice of estimation method(s) can change with each evaluation. The estimation method(s) chosen are those that are believed to produce the most reliable indication at that particular evaluation date for the claim liabilities being evaluated.

In most cases, multiple estimation methods will be valid for the particular facts and circumstances of the claim liabilities being evaluated. This will result in a range of reasonable estimates for any particular claim liability. The Pool uses such range analyses to back test whether previously established estimates for reserves at the reporting segments are reasonable, given subsequent information. Reported values found to be closer to the endpoints of a range of reasonable estimates are subject to further detailed reviews. These reviews may substantiate the validity of management's recorded estimate or lead to a change in the reported estimate.

The exact boundary points of these ranges are more qualitative than quantitative in nature, as no clear line of demarcation exists to determine when the set of underlying assumptions for an estimation method switches from being reasonable to unreasonable. As a result, the Pool does not believe that the endpoints of these ranges are or would be comparable across companies. In addition, potential interactions among the different estimation assumptions for different product lines make the aggregation of individual ranges a highly judgmental and inexact process.

Property casualty insurance policies are either written on a claims-made or on an occurrence basis. Claims-made policies generally cover, subject to requirements in individual policies, claims reported during the policy period. Policies that are written on an occurrence basis require that the insured demonstrate that a loss occurred in the policy period, even if the insured reports the loss many years later.

Most general liability policies are written on an occurrence basis. These policies are subject to substantial loss development over time as facts and circumstances change in the years following the policy issuance. The occurrence form, which accounts for much of the reserve development in asbestos and environmental exposures, is also used to provide coverage for construction general liability, including construction defect. Occurrence-based forms of insurance for general liability exposures require substantial projection of various trends, including future inflation and judicial interpretations and societal litigation dynamics, among others.

A basic premise in most actuarial analyses is that past patterns demonstrated in the data will repeat themselves in the future, absent a material change in the associated risk factors discussed below. To the extent a material change affecting the ultimate claim liability is known, such change is quantified to the extent possible through an analysis of internal Pool data and, if available and when appropriate, external data. Such a measurement is specific to the facts and circumstances of the particular claim portfolio and the known change being evaluated. Significant structural changes to the available data, product mix or organization can materially impact the reserve estimation process.

Informed judgment is applied throughout the reserving process. This includes the application of various individual experiences and expertise to multiple sets of data and analyses. In addition to actuaries, experts involved with the reserving process also include underwriting and claims personnel and lawyers, as well as other Pool management. Therefore, management may have to consider varying individual viewpoints as part of its estimation of loss reserves. It is also likely that during periods of significant change, such as a merger, consistent application of informed judgment becomes even more complicated and difficult.

The variables discussed above in this general discussion have different impacts on reserve estimation uncertainty for a given product line, depending on the length of the claim tail, the reporting lag, the impact of individual claims and the complexity of the claim process for a given product line.

Product lines are generally classifiable as either long tail or short tail, based on the average length of time between the event triggering claims under a policy and the final resolution of those claims. Short tail claims are reported and settled quickly, resulting in less estimation variability. The longer the time before final claim resolution, the greater the exposure to estimation risks and hence the greater the estimation uncertainty.

A major component of the claim tail is the reporting lag. The reporting lag, which is the time between the event triggering a claim and the reporting of the claim to the insurer, makes estimating IBNR inherently more uncertain. In addition, the greater the reporting lag, the greater the proportion of IBNR to the total claim liability for the product line. Writing new products with material reporting lags can result in adding several years worth of IBNR claim exposure before the reporting lag exposure becomes clearly observable, thereby increasing the risk associated with pricing and reserving such products. The most extreme example of claim liabilities with long reporting lags are asbestos claims.

For some lines, the impact of large individual claims can be material to the analysis. These lines are generally referred to as being "low frequency/high severity," while lines without this "large claim" sensitivity are referred to as "high frequency/low severity." Estimates of claim liabilities for low frequency/high severity lines can be sensitive to the impact of a small number of potentially large claims. As a result, the role of judgment is much greater for these reserve estimates. In contrast, for high frequency/low severity lines the impact of individual claims is relatively minor and the range of reasonable reserve estimates is narrower and more stable.

Claim complexity can also greatly affect the estimation process by impacting the number of assumptions needed to produce the estimate, the potential stability of the underlying data and claim process, and the ability to gain an understanding of the data. Product lines with greater claim complexity, such as for certain surety and construction exposures, have inherently greater estimation uncertainty.

Actuaries have to exercise a considerable degree of judgment in the evaluation of all these factors in their analysis of reserves. The human element in the application of actuarial judgment is unavoidable when faced with material uncertainty. Different actuaries may choose different assumptions when faced with such uncertainty, based on their individual backgrounds, professional experiences and areas of focus. Hence, the estimates selected by the various actuaries may differ materially from each other.

Lastly, significant structural changes to the available data, product mix or organization can also materially impact the reserve estimation process. Events such as mergers increase the inherent uncertainty of reserve estimates for a period of time, until stable trends reestablish themselves within the new organization.

*Risk factors*

The major causes of material uncertainty ("risk factors") generally will vary for each product line, as well as for each separately analyzed component of the product line. In a few cases, such risk factors are explicit assumptions of the estimation method, but in most cases, they are implicit. For example, a method may explicitly assume that a certain percentage of claims will close each year, but will implicitly assume that the legal interpretation of existing contract language will remain unchanged. Actual results will likely vary from expectations for each of these

assumptions, causing actual paid losses, as claims are settled in the future, to be different in amount than the reserves being estimated currently.

Some risk factors will affect more than one product line. Examples include changes in claim department practices, changes in settlement patterns, regulatory and legislative actions, court actions, timeliness of claim reporting, state mix of claimants and degree of claimant fraud. The extent of the impact of a risk factor will also vary by components within a product line. Individual risk factors are also subject to interactions with other risk factors within product line components.

The effect of a particular risk factor on estimates of claim liabilities cannot be isolated in most cases. For example, estimates of potential claim settlements may be impacted by the risk associated with potential court rulings, but the final settlement agreement typically does not delineate how much of the settled amount is due to this and other factors.

The evaluation of data is also subject to distortion from extreme events or structural shifts, sometimes in unanticipated ways. For example, the timing of claims payments in one geographic region will be impacted if claim adjusters are temporarily reassigned from that region to help settle catastrophe claims in another region.

While some changes in the claim environment are sudden in nature (such as a new court ruling affecting the interpretation of all contracts in that jurisdiction), others are more evolutionary. Evolutionary changes can occur when multiple factors affect final claim values, with the uncertainty surrounding each factor being resolved separately, in stepwise fashion. The final impact is not known until all steps have occurred.

Sudden changes generally cause a one-time shift in claim liability estimates, although there may be some lag in reliable quantification of their impact. Evolutionary changes generally cause a series of shifts in claim liability estimates, as each component of the evolutionary change becomes evident and estimable.

*Management's estimates*

At least once per quarter, certain Pool management meets with its actuaries to review the latest claims and claim adjustment expense reserve analyses. Based on these analyses, management determines whether its ultimate claim liability estimates should be changed. In doing so, it must evaluate whether the new data provided represents credible actionable information or an anomaly that will have no effect on estimated ultimate claim liability. For example, as described above, payments may have decreased in one geographic region due to fewer claim adjusters being available to process claims. The resulting claim payment patterns would be analyzed to determine whether or not the change in payment pattern represents a change in ultimate claim liability.

Such an assessment requires considerable judgment. It is frequently not possible to determine whether a change in the data is an anomaly until sometime after the event. Even if a change is determined to be permanent, it is not always possible to reliably determine the extent of the change until sometime later. The overall detailed analyses supporting such an effort can take several months to perform. This is because the underlying causes of the trends observed need to be evaluated, which may require the gathering or assembling of data not previously available. It may also include interviews with experts involved with the underlying processes. As a result, there can be a time lag between the emergence of a change and a determination that the change should be reflected in the Pool's estimated claim liabilities. The final estimate selected by management in a reporting period is based on these various detailed analyses of past data, adjusted to reflect any new actionable information.

## OUTLOOK

The Pool's objective is to enhance its position as a consistently profitable market leader and a cost-effective provider of property and casualty insurance in the United States. A variety of factors continue to affect the property-casualty insurance market and the Pool's core business outlook for 2009, including general economic conditions, competitive conditions in the markets served by the Pool's business segments, loss cost trends, interest rate trends and the investment environment.

*General Economic Conditions*. The United States and other countries around the world have been experiencing deteriorating economic conditions, including unprecedented financial market disruption. If this trend in economic conditions continues or deteriorates further in 2009, it could adversely affect the Pool's results in future periods. During an economic downturn, demand for the Pool's products may decrease, and credit risk associated with agents, customers, reinsurers and the Pool's investment portfolio may be adversely impacted. In addition, in an inflationary environment, loss costs may increase. Such costs may also increase in an economic downturn, due to an increase in fraudulent reporting of claims, reduced maintenance of insured property or increased frequency of small claims. Moreover, although the Pool does not anticipate needing additional capital in the near term due to the Pool's strong current financial position, financial market disruption may make it difficult for the insurance industry generally, and the Pool in particular, to raise additional capital, when needed, on acceptable terms or at all. As discussed below, losses on the Pool's investment portfolio may adversely impact the Pool's capital and surplus. As further discussed below, the interest rate environment and general economic conditions could further impact the net investment income the Pool is able to earn on both its fixed maturity investments and other invested assets.

*Competition.* The Pool expects property casualty insurance market conditions to continue to be very competitive in 2009, particularly for new business. If the current disruption in the insurance marketplace continues into 2009, there may be increased opportunity for new business, but competition for that new business may also be significant. For example, competitors that are experiencing financial difficulties may offer products at prices and on terms that are not consistent with the Pool's economic standards in an effort to maintain their business. The pricing environment for new business generally has less of an impact on underwriting profitability than renewal price changes, particularly in an environment of high retention rates, which the Pool has experienced over the past several years. In the Business Insurance and the Financial, Professional & International Insurance segments, the Pool expects renewal price changes in 2009 to be flat with or modestly increase over their 2008 levels. With regard to the components comprising renewal price changes, the potential slight improvement in rates in 2009 in some product lines is expected to be largely offset by a decline in exposures. In the Personal Insurance segment in 2009, the Pool expects that automobile and homeowners renewal price changes will increase slightly over their 2008 levels. These expectations for the pricing environment, when combined with expected modestly increased loss costs, will likely result in somewhat reduced underwriting profitability.

*Loss Cost Trends*. Loss cost trends are primarily driven by changes in claim frequency and claim severity. The industry has generally experienced unprecedented low levels of non-catastrophe-related claim frequency over the last several years. The Pool expects this level of claim frequency to continue in 2009 in certain lines of business, while claim frequency is expected to increase modestly for other lines of business. The Pool also expects severity to increase modestly for non-catastrophe-related claims. In the Business Insurance and Financial, Professional & International Insurance segments, the Company experienced a higher than anticipated level of large, non weather-related losses during 2008. In the Personal Insurance segment, the Pool experienced a higher than anticipated level of non-catastrophe weather related losses during 2008. If these are trends that continue in 2009, they could result in reduced underwriting profit.

The overall trend of increased frequency and severity of catastrophic Gulf and Atlantic Coast storms experienced in recent years may continue for the foreseeable future. Given the potential increase in frequency and severity of storms, the Pool continues to reassess its definition of, and exposure to, coastal risks. These risks are reflected in the pricing and terms and conditions it will offer in coastal areas. Due in part to the increased frequency and severity of the Gulf and Atlantic Coast storms, there has been some disruption in the market for coastal wind insurance, most significantly in personal lines, as insurers, including the Pool, have reduced capacity and increased prices. The continued disruption in market conditions, along with the potential for increased frequency and severity of coastal storms, could result in a decrease in the amount of coastal wind coverage that the Pool is able or willing to write.

In recent periods, the Pool has recorded net favorable prior year reserve development, driven by better than expected loss experience in all of the Pool's segments for prior loss years. If better than expected loss experience continues, the Pool may record additional net favorable prior year reserve development in 2009. In that case, the Pool may also concurrently revise favorably its current year loss estimates. However, better than expected loss experience may not continue or may reverse, in which case the Pool may record no favorable prior year reserve development or net unfavorable prior year reserve development in future periods. In that case, the Pool may revise current year loss estimates upward in future periods.

*Interest Rate Trends and the Investment Environment.* Changes in the general interest rate environment affect the returns available on new investments. While a rising interest rate environment enhances the returns available on new fixed maturity investments, thereby favorably impacting net investment income, it reduces the market value of existing fixed maturity investments, and therefore, shareholders' equity. A decline in interest rates reduces the returns available on new investments, thereby negatively impacting net investment income, but increases the market value of existing investments and therefore, shareholders' equity. In 2008 and 2007, short-term interest rates declined, reducing the interest income on the Pool's short-term investment portfolio. In the second half of 2008, credit spreads on other than short-term investments, which represent the difference between a risk-free yield (i.e. the yield on U.S. Treasury securities) and the actual yield on a fixed-income investment, increased significantly. This resulted in a decline in the market value of existing other than short-term fixed maturity investments, and therefore, shareholders' equity.

The market disruption that occurred in the second half of 2008 resulted in a lack of liquidity in certain sectors of the credit markets and a widening of credit spreads generally. If the market disruption continues and interest rates (inclusive of credit spreads) remain steady or rise, the amount of securities in an unrealized loss of greater than 20% may age and significant additional unrealized investment losses could occur in the portfolio. These circumstances may result in significant realized losses through sales of securities or other-than-temporary impairment charges in 2009.

At December 31, 2008, approximately 4% of the Pool's invested assets were comprised of equity securities, private equity limited partnerships, hedge funds, real estate partnerships, joint ventures, mortgage loans, venture capital investments and trading securities, which are subject to greater volatility than fixed maturity investments. General economic conditions, stock market conditions and many other factors beyond the Pool's control may affect the value of these non-fixed maturity investments and the realization of net investment income. For example, reduced liquidity in the capital markets could adversely impact the Pool's investment portfolio, particularly investments in private equity limited partnerships, real estate partnerships and hedge funds, resulting in a decline in transaction volume in these asset classes, and as a result, lower net investment income. For the year ended December 31, 2008, these non-fixed maturity investments collectively produced negative investment income. If the current unfavorable economic environment persists in 2009, the Pool may continue to experience negative returns from these investments. The Pool is not able to predict future market conditions or their impact on net investment income.

Net investment income is an important contributor to the Pool's results of operations, and the Pool expects the investment environment to remain challenging in 2009, particularly with respect to its non-fixed maturity investment portfolio.

**FORWARD-LOOKING INFORMATION**

This report contains certain forward-looking information. All statements, other than statements of historical facts, may be forward-looking statements. Specifically, the "Outlook" section of this discussion contains forward looking statements. Such information is subject to risks and uncertainties, many of which are difficult to predict and generally beyond the Pool's control, that could cause actual results to differ materially from those expressed in, or implied or projected by, the forward-looking information.

Some of the factors that could cause actual results to differ include, but are not limited to, the following: catastrophe losses could materially and adversely affect the Pool's results of operations, it's financial position and/or liquidity and could adversely impact its ratings and the availability and cost of reinsurance; if actual claims exceed the Pool's loss reserves, or if changes in the estimated level of loss reserves are necessary, the Pool's financial results could be materially and adversely affected; the Pool's business could be harmed because of its potential exposure to asbestos and environmental claims and related litigation; the Pool is exposed to, and may face adverse developments involving, mass tort claims such as those relating to exposure to potentially harmful products or substances; the effects of emerging claim and coverage issues on the Pool's business are uncertain; the Pool may not be able to collect all amounts due to it from reinsurers, and reinsurance coverage may not be available to the Pool in the future at commercially reasonable rates or at all; the intense competition that the Pool faces could harm its ability to maintain or increase its profitability and premium volume; the Pool is exposed to credit risk in certain of its business operations and in its investment portfolio; the insurance industry and the Pool are the subject of a number of investigations by state and federal authorities in the United States, and the Pool cannot predict the outcome of these investigations or their impact on its business or financial results; the Pool's businesses are heavily regulated, and changes in regulation may reduce the Pool's profitability and limit its growth; a downgrade in the Pool's claims-paying ratings could adversely impact the Pool's business volumes; the Pool's investment portfolio may suffer reduced returns or losses; deteriorating economic conditions in the United States and abroad could adversely impact the Pool's ability to grow its business profitably, and inflation or other adverse economic circumstances could result in an increase in loss costs which could negatively impact the Pool's profitability; disruptions to the Pool's relationships with its independent agents and brokers could adversely affect the Pool; the Pool could be adversely affected if its controls to ensure compliance with guidelines, policies and legal and regulatory standards are not effective; loss or significant restriction of the use of credit scoring in the pricing and underwriting of insurance products could reduce future profitability; the Pool's business success and profitability depend, in part, on effective information technology systems and on continuing to develop and implement improvements in technology; certain significant multi-year technology projects are currently in process but may not be successful; and if the Pool experiences difficulties with technology, data security and/or outsourcing relationships, the Pool's ability to conduct its business could be negatively impacted.

The Pool's forward-looking statements speak only as of the date of this report or as of the date they are made, and the Pool undertakes no obligation to update forward-looking statements.