# MML Bay State Life Insurance Company
# Management's Discussion and Analysis
## Of the 2007 Financial Condition and Results of Operations

## General

Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the Audited Statutory Financial Statements, Notes to Statutory Financial Statements, and Statutory Annual Statements. This Management's Discussion and Analysis reviews the financial condition of MML Bay State Life Insurance Company **("MML Bay State," "the Company," "us," "we" or "our")** as of December 31, 2007 and 2006, our results of operations for the past two years and, where appropriate, factors that may affect our future financial performance.

Together with our parent, C.M. Life Insurance Company **("C.M. Life")** and its parent, Massachusetts Mutual Life Insurance Company **("MassMutual")** and its subsidiaries, we comprise a growth-oriented, diversified financial services company that seeks to provide superior value for policyholders and other customers by achieving exceptional results. We are in the business of helping our customers achieve financial success while protecting their families and businesses. We are committed to maintaining a position of preeminent financial strength by achieving consistent and long-term profitable growth.

This will be accomplished by developing and distributing a broad and superior portfolio of innovative financial products and services, sophisticated asset/liability management, rigorous expense control, prudent underwriting standards, continued efforts to improve persistency and retention levels, and continued commitment to the high credit quality and disciplined diversification of our general account investment portfolio.

Our statutory net income was $11 million in 2007 and $37 million in 2006. As of and for the year ended December 31, 2007, we had $298 million in general account statutory assets, $4.6 billion in total statutory assets, over 53,600 individual policies in force and $19.2 billion of life insurance in force. Our total adjusted capital, as defined by the National Association of Insurance Commissioners **(**the "**NAIC**"**)**, was $185 million as of December 31, 2007 and $215 million as of December 31, 2006.

The following table sets forth the calculation of total adjusted capital:

| | December 31, | |
|---|---|---|
| | 2007 | 2006 |
| | (In Millions) | |
| Surplus | $ 183 | $ 212 |
| Asset valuation reserves | 2 | 3 |
| One-half of the apportioned dividend liability | - | - |
| Total adjusted capital [1] | $ 185 | $ 215 |

[1] Defined by the NAIC as surplus plus consolidated asset valuation reserve **("AVR")** and one-half of the consolidated apportioned dividend liability.

Our financial strength ratings as of December 31, 2007 for MML Bay State, C.M. Life and MassMutual are AAA (Extremely Strong) from Standard & Poor's, A++ (Superior) from A.M. Best Company, AAA (Exceptionally Strong) from Fitch Ratings, and Aa1 (Excellent) from Moody's Investors Service. Each rating agency independently assigns a rating based on its own separate review and takes into account a variety of factors in making its decision. Accordingly, there can be no assurance of the ratings that will be afforded to us in the future.

Financial strength ratings are assigned to us based on a number of factors, including our financial strength and the industry in which we operate. A rating trigger refers to a contractual clause requiring action by us or resulting in financial consequences in the event of a downgrade of our and/or MassMutual's financial strength rating below a specified level. As of December 31, 2007, two group life insurance contracts with combined account values of $301 million contained rating triggers. If MassMutual's or MML Bay State's financial strength ratings fall significantly, we are required to pursue the transfer of the risks of the contracts to another company.

As of December 31, 2007, there were no significant statutory or regulatory issues which would impair our financial position or liquidity, but there can be no assurance that such issues will not arise in the future. To the best of management's knowledge, we are not included on any regulatory or similar "watch list."

## Forward-Looking Information

The Private Securities Litigation Reform Act of 1995 provides a "safe harbor" for forward-looking statements, which are identified as such and are accompanied by the identification of important factors, which could cause a material difference from the forward-looking statements.

Certain information contained in this discussion is or may be considered forward-looking. Forward-looking statements are those not based on historical information, but rather, relate to future operations, strategies, financial results or other developments, and contain terms such as "may," "expects," "should," "believes," "anticipates," "intends," "estimates," "projects," "goals," "objectives" or similar expressions.

Forward-looking statements are based upon estimates and assumptions. These statements may change due to business uncertainties, economic uncertainties, competitive uncertainties, and other factors, many of which are beyond our control. Additionally, our business decisions are also subject to change. We do not publicly update or revise any forward-looking statements as a result of new information, future developments or otherwise.

## Results of Operations

The following table sets forth the components of statutory net income, which are supported by the Annual Statement:

| | Years Ended December 31, | | | | |
|---|---|---|---|---|---|
| | **2007** | **2006** | **2005** | **% Change 07 vs. 06** | **% Change 06 vs. 05** |
| | | **($ In Millions)** | | | |
| **Revenue:** | | | | | |
| Premium income | $ 51 | $ 66 | $ 76 | (23)% | (13)% |
| Net investment income | 16 | 16 | 14 | - | 14 |
| Fees and other income | 77 | 73 | 77 | 5 | (5) |
| Total revenue | 144 | 155 | 167 | (7) | (7) |
| **Benefits and expenses:** | | | | | |
| Policyholders' benefits | 127 | 131 | 132 | (3) | (1) |
| Change in policyholders' reserves | (33) | (36) | (23) | 8 | (57) |
| General insurance expenses | 10 | 14 | 12 | (29) | 17 |
| Commissions | 5 | 5 | 6 | - | (17) |
| State taxes, licenses and fees | 2 | 2 | 2 | - | - |
| Total benefits and expenses | 111 | 116 | 129 | (4) | (10) |
| Net gain from operations before federal income taxes | 33 | 39 | 38 | (15) | 3 |
| Federal income tax expense (benefit) | 19 | 2 | (6) | 850 | 133 |
| Net gain from operations | 14 | 37 | 44 | (62) | (16) |
| Net realized capital losses, after tax and transfer to interest maintenance reserve | (3) | - | - | NM | - |
| **Net income** | **$ 11** | **$ 37** | **$ 44** | **(70)%** | **(16)%** |

*NM = Not Meaningful*

Net income decreased $26 million in 2007 primarily due to a $15 million decrease in premium income, a $17 million increase in federal income tax expense and a $3 million increase in the change in policyholders' reserves, partially offset by a $4 million increase in fees and other income, a $4 million decrease in policyholders' benefits and a $4 million decrease in general insurance expenses.

The decrease in net income in 2006 was primarily due to a $10 million decrease in premium income and an $8 million increase in federal income tax expense, partially offset by a $13 million decrease to the change in policyholders' reserves.

Premium income includes premium and annuity considerations on life contracts and bank-owned life insurance deposits. Premium income decreased $15 million in 2007 primarily due to a decrease in variable life insurance premium and lower premium from experience rated contracts. Premium income decreased $10 million in 2006 primarily due to a decline in variable life insurance premium as we no longer sell this product.

We calculate the yield before federal income taxes as (a) gross investment income divided by (b) the monthly average of invested assets plus investment income due and accrued, net of foreign exchange adjustments, unrealized gains and losses, and investment-related liabilities, less half the gross investment income. After deducting all investment expenses and including separate account net gains and interest maintenance reserve **("IMR")** amortization, the net annualized yields were 5.6% for the year ended December 31, 2007 and 5.5% for the year ended December 31, 2006. In 2007, yields on mortgage loans and long and short-term bonds increased while policy loans remained the same.

In 2007, net investment income, including the amortization of the IMR, remained level at $16 million. Current year income is primarily due to bonds of $10 million and policy loans of $5 million. In 2006, net investment income increased $2 million primarily due to an increase in bond and short-term investment earnings.

In 2007, fees and other income, which includes miscellaneous income, commissions and expense allowances on reinsurance ceded and reserve adjustments on reinsurance, increased $4 million. The increase was primarily from growth in fees due to market appreciation on separate account assets, partially offset by a decrease in reserve adjustments on reinsurance. In 2006, fees and other income decreased $4 million primarily due to a decrease in fees from separate accounts caused by a decline in the number of contract holders.

Policyholders' benefits, which includes supplemental contract payments, death, annuity, and surrender benefits, and interest and adjustments on contract or deposit-type contract funds, decreased $4 million in 2007 due to lower surrender benefits. The decrease in surrender benefits was due in part to the surrender of a large contract in 2006. In 2006, policyholders' benefits decreased $1 million as a decrease in death benefits of $8 million was partially offset by an increase in surrender benefits of $7 million.

The life insurance lapse rate, which is based on the amount of life insurance in force, was 5.7% in 2007 and 5.5% in 2006.

Change in policyholders' reserves, which includes transfers to and from separate accounts based upon policyholder elections and the change in general account reserves, increased $3 million in 2007. The increase in the change in policyholders' reserves in 2007 was driven by lower surrender activity. The 2006 decrease of $13 million was primarily due to a decline in premium income and increased surrender benefits, partially offset by a decrease in death benefits.

General insurance expenses decreased $4 million compared to 2006. Expenses were favorably impacted by $1 million from refinements in the Global Settlement reserve. Additionally, no new products are being issued from MML Bay State resulting in lower expenses. General insurance expenses were relatively unchanged from 2005 to 2006.

Federal income tax expense increased $17 million in 2007 primarily due to a $14 million increase in expenses associated with IRS settlements upon completion of the 2001-2003 audit. Federal income tax expense increased $8 million in 2006 primarily due to a $7 million tax benefit in 2005 arising from a favorable IRS decision.

Net realized capital losses after taxes and IMR deferrals increased to a $3 million loss through December 31, 2007 from no gain or loss through December 31, 2006. The losses are driven by bond other-than-temporary impairments of $3 million which are primarily attributed to the decline in the residential mortgage-backed securities market.

The book values of investments are written down when a decline in value is considered to be other-than-temporary. Through December 31, 2007, we recognized $3 million of other-than-temporary impairment losses. We employ a systematic methodology to evaluate other-than-temporary impairments. The methodology to evaluate declines in value utilizes a quantitative and qualitative process ensuring that available evidence concerning the declines is evaluated in a disciplined manner.

*Residential mortgage-backed securities*

As of December 31, 2007, we had $57 million of residential mortgage-backed securities **("RMBS")** of which $17 million was prime, $10 million was Federal Housing Administration **("FHA**") insured or Veterans' Administration **("VA"**) guaranteed, $16 million was Alt-A and $14 million was subprime. The majority of these investments are included in bonds. The mortgages in these pools have varying risk characteristics and are commonly categorized as being of U.S. Government agency and non-agency prime, Alt-A and subprime borrower quality. The mortgage collateral classified as U.S. Government agency is considered of lowest relative risk while those classified as subprime are of the highest relative risk. The Alt-A category includes option adjustable rate mortgages and subprime investments include "scratch and dent" pools, high loan to value pools, and pools where the borrowers have very impaired credit but the average loan to value is low, typically 70% or below. In identifying Alt-A and subprime exposure, management utilized a combination of qualitative and quantitative factors, including FICO scores and loan to value ratios.

In 2007, market conditions for subprime and Alt-A investments deteriorated due to higher delinquencies, reduced home prices, and reduced refinancing opportunities. This market turbulence has spread to other credit markets. It is unclear how long it will take for a return to more normal market conditions. Over the second half of 2007, there were a large number of credit downgrades by rating agencies for residential mortgage-backed investments. Subsequent to year end there were additional credit downgrades for securities backed by residential mortgage pools which were held by us, however such downgrades did not significantly change the overall credit quality mix of our RMBS portfolio.

The actual cost, adjusted carrying value, fair value, and related gross realized losses from other-than-temporary impairments of our investments in residential mortgage-backed securities with significant subprime and Alt-A exposure were as follows:

| | December 31, 2007 | | | |
|---|---|---|---|---|
| | Actual Cost | Adjusted Carrying Value | Fair Value | Other-Than-Temporary Impairments |
| | (In Millions) | | | |
| Subprime bonds | $ 15 | $ 14 | $ 13 | $ 1 |
| Alt-A bonds | 17 | 16 | 16 | 1 |

The following table shows the percentage by statement value of subprime and Alt-A bonds by vintage (representing the year the pool of loans was originated) and credit quality as of December 31, 2007.

| Year | AAA | AA | A | BBB | BB & Below | Total |
|---|---|---|---|---|---|---|
| 2007 | 10.0% | 3.3% | -% | -% | -% | 13.3% |
| 2006 | 16.7 | 3.3 | - | - | - | 20.0 |
| 2005 & prior | 53.4 | 13.3 | - | - | - | 66.7 |
| **Total** | **80.1%** | **19.9%** | **-%** | **-%** | **-%** | **100.0%** |

Management's judgment regarding fair value, including the difficulty of obtaining readily determinable prices for residential mortgage-backed investments and other investments impacted by the current illiquid credit market environment, depends upon evolving conditions that can alter the anticipated cash flows realized by investors. Further deterioration of market conditions and related management judgments of fair value could negatively impact our statement of operations and fair value disclosures in future periods.

Realized capital losses do not reflect the changes in the AVR and other investment reserves, which are recorded as a change in surplus.

Fluctuations in market conditions will impact future investment results.

## Statement of Financial Position

The following table sets forth MML Bay State's assets, liabilities and shareholder's equity:

| | December 31, 2007 | December 31, 2006 | % Change 07 vs. 06 |
|---|---|---|---|
| | ($ In Millions) | | |
| **Assets:** | | | |
| Bonds | $ 175 | $ 186 | (6)% |
| Mortgage loans | 10 | 8 | 25 |
| Policy loans | 90 | 80 | 13 |
| Derivatives and other invested assets | (1) | - | NM |
| Cash, cash equivalents and short-term investments | (6) | 5 | (220) |
| Total invested assets | 268 | 279 | (4) |
| Investment income due and accrued | 3 | 3 | - |
| Insurance amounts receivable | 6 | 5 | 20 |
| Current and deferred income taxes | 21 | 13 | 62 |
| Total assets excluding separate accounts | 298 | 300 | (1) |
| Separate account assets | 4,339 | 4,250 | 2 |
| **Total assets** | **$ 4,637** | **$ 4,550** | **2%** |
| **Liabilities and shareholder's equity:** | | | |
| Policyholders' reserves | $ 99 | $ 88 | 13% |
| Liabilities for deposit–type contracts | 1 | 2 | (50) |
| Contract claims and other benefits | 21 | 14 | 50 |
| General expenses due or accrued | 4 | 5 | (20) |
| Transfers due from separate accounts | (25) | (36) | 31 |
| Payable to affiliate | 3 | 3 | - |
| Asset valuation reserve | 2 | 4 | (50) |
| Other liabilities | 10 | 8 | 25 |
| Total liabilities excluding separate accounts | 115 | 88 | 31 |
| Separate account liabilities | 4,339 | 4,250 | 2 |
| Total liabilities | 4,454 | 4,338 | 3 |
| Shareholder's equity | 183 | 212 | (14) |
| **Total liabilities and shareholder's equity** | **$ 4,637** | **$ 4,550** | **2%** |

*NM = Not Meaningful*

### Assets

Total assets increased $87 million, or 2%, in 2007 primarily due to an increase in separate account assets of $89 million.

Bonds decreased $11 million in 2007, as mortgage loan spreads were favorable over the first half of the year when compared to those of corporate bonds. Bond other-than-temporary impairments were $3 million. Bonds in NAIC Classes 1 and 2 were 63% and 65% of total invested general assets as of December 31, 2007 and 2006, respectively. The percentage of total invested assets representing bond investments in NAIC Classes 3 and 4 was 2% as of December 31, 2007 and 2006. There were no bonds in NAIC classes 5 and 6 as of December 31, 2007 or 2006. See "Investments" for more discussion of NAIC investment classes.

Mortgage loans increased $2 million, or 25%, in 2007. This increase is primarily due to mortgage loan originations of $3 million, partially offset by $1 million in paydowns. Mortgage loans were a favored investment as spreads were favorable compared to other long-term investments during the first half of 2007. This situation reversed in the third quarter as mortgage spreads tightened and bond spreads presented a more attractive opportunity.

Policy loans increased $10 million, or 13%, in 2007 due to normal growth.

Cash, cash equivalents and short-term investments decreased $11 million in 2007 to $(6) million due to a $20 million tax payment made in late December. Net acquisitions of short-term investments consisted of $825 million of acquisitions and $821 million of dispositions, including a $37 million dividend payment to C.M. Life.

The increase in current and deferred income taxes is primarily due to payments made upon completion of the 2001-2003 IRS audit and estimated tax payments for 2007, partially offset by accrual of the current tax expense.

Separate account assets increased $89 million, or 2%, primarily due to market appreciation of $237 million, partially offset by $148 million of negative net cash flows.

### Liabilities

Total liabilities increased $116 million, or 3%, in 2007 primarily due to an increase in separate account liabilities of $89 million, an increase in policyholders' reserves of $11 million and a decrease in transfers due from separate accounts of $11 million.

Our policyholders' reserves increased $11 million in 2007 primarily due to net growth of variable life reserves on an aging block.

Contract claims and other benefits increased $7 million primarily due to an increase in the provision for experience rating refunds.

Transfers due from separate accounts decreased $11 million to $25 million in 2007 primarily due to a decrease in the surrender charge receivable.

The AVR decreased $2 million, or 50%, in 2007 to $2 million from $4 million in 2006. The decrease is primarily related to a decrease in statement values of bonds and $3 million of net realized losses related to other-than-temporary impairments.

### Shareholder's Equity ("Surplus")

The decrease in surplus of $29 million in 2007 was primarily attributable to a $37 million dividend paid to our parent, C.M. Life and an $11 million increase in non-admitted assets, partially offset by net income of $11 million and the change in deferred income taxes of $7 million.

## Liquidity and Capital Resources

### Liquidity

We manage our liquidity position by matching our exposure to cash demands with adequate sources of cash and other liquid assets. Our principal sources of liquidity are operating cash flow and holdings of cash, cash equivalents and other readily marketable assets. Our primary cash flow sources include investment income, principal repayments on invested assets and life insurance premium.

Cash, cash equivalents and short-term investments decreased $11 million in 2007 primarily due to a $20 million tax payment made in late December. Cash, cash equivalents and short-term investments decreased $20 million in 2006 primarily due to an increase in bonds.

Net cash from operations decreased $14 million in 2007 primarily due to a $24 million increase in federal income taxes paid, partially offset by a $7 million increase in net transfers from separate accounts. Net cash from operations decreased $1 million in 2006 primarily due to a $13 million decrease in premium and other income collected and a $5 million increase in benefit payments, partially offset by an $18 million increase in net transfers from separate accounts.

Net cash from investments remained an outflow in 2007, but less than in 2006 by $19 million. Purchases of investments and the net increase in policy loans were $58 million in 2007 while sales and maturities of investments and receipts from repayments of loans were $54 million, resulting in a net cash outflow of $4 million. In 2006, purchases of investments and the net increase in policy loans were $55 million while sales and maturities of investments and receipts from repayments of loans were $32 million, resulting in a net cash outflow of $23 million.

The decrease in net cash applied from financing and other sources of $4 million in 2007 was primarily due to a decrease in dividends paid to C.M. Life of $7 million. The decrease in net cash applied from financing and other sources of $2 million in 2006 was primarily due to a decrease in dividends paid to C.M. Life of $3 million.

Our investment portfolio is structured to ensure a strong liquidity position in order to permit timely payment of policy and contract benefits without requiring an uneconomic sale of assets. In general, liquid assets include cash and cash equivalents and public bonds, all of which generally have ready markets with large numbers of buyers. The statement value of these assets as of December 31, 2007 was approximately $133 million. While the investment portfolio does contain assets (primarily mortgage loans, other invested assets and private bonds) which are generally considered illiquid for liquidity monitoring purposes, there is some ability to raise cash from these assets if needed.

We utilize sophisticated asset/liability analysis techniques in the management of the investments supporting our liabilities. Additionally, we test the adequacy of the projected cash flow provided by assets to meet all of our future policyholder and other obligations. We perform these studies using stress tests regarding future credit and other asset losses, market interest rate fluctuations, claim losses, and other considerations. The result is a complete picture of the adequacy of our underlying assets, reserves, and capital. We analyze a variety of scenarios modeling potential demands on liquidity, taking into account the provisions of our policies and contracts in force, our cash flow position, and the volume of cash and readily marketable securities in our portfolio. We proactively manage our liquidity position on an ongoing basis to meet cash needs while minimizing adverse impacts on investment returns.

### Capital Resources

As of December 31, 2007 and 2006, our total adjusted capital as defined by the NAIC was $185 million and $215 million, respectively. The NAIC has a Risk Based Capital **("RBC")** model to compare total adjusted capital with a standard design in order to reflect an insurance company's risk profile. Although we believe that there is no single appropriate means of measuring RBC needs, we feel that the NAIC approach to RBC measurement is reasonable, and we manage our capital position with significant attention to maintaining adequate total adjusted capital relative to RBC. We believe that we enjoy a strong capital position in light of our risks and that we are well positioned to meet policyholder and other obligations.

## Investments

### General

As directed by our policyholders, approximately 94% of our assets as of December 31, 2007 are separate account assets. Separate account assets consist principally of marketable securities reported at fair value and are not available to satisfy liabilities that arise from any other business of the Company. The following discussion focuses on the general investment account portfolio, which does not include our separate account assets.

As of December 31, 2007 and 2006, we had $268 million and $279 million, respectively, of invested assets in our general investment account. We manage the portfolio of invested assets to support the general account liabilities of the business in light of yield, liquidity and diversification considerations.

The following table sets forth our invested assets in the general account:

| | December 31, 2007 Carrying Value | 2007 % of Total | December 31, 2006 Carrying Value | 2006 % of Total |
|---|---|---|---|---|
| | ($ in Millions) | | | |
| Bonds | $ 175 | 65% | $ 186 | 67% |
| Mortgage loans | 10 | 4 | 8 | 3 |
| Policy loans | 90 | 33 | 80 | 28 |
| Derivatives and other invested assets | (1) | NM | - | NM |
| Cash, cash equivalents and short-term investments | (6) | (2) | 5 | 2 |
| **Total investments** | $ 268 | 100% | $ 279 | 100% |

*NM =Not Meaningful*

The following table is a management view of the general investment account's earnings yields by asset type:

| | December 31, 2007 | 2006 |
|---|---|---|
| Long and short-term bonds | 5.6% | 5.5% |
| Mortgage loans | 6.2 | 5.9 |
| Policy loans | 5.7 | 5.7 |
| Derivatives | NM | NM |
| **Total Portfolio** | **5.6%** | **5.5%** |

*NM = Not Meaningful*

## Bonds, Cash Equivalents and Short-Term Investments

Bonds consist primarily of government securities, mortgage-backed securities and high quality marketable corporate debt securities. We invest a significant portion of our investment funds in high quality publicly traded bonds in order to maintain and manage liquidity and reduce the risk of default in the portfolio.

The NAIC Securities Valuation Office **("SVO")** rates investment credit risk based upon the issuer's credit profile. NAIC rating designations range from 1 to 6. An NAIC designation of 1 denotes obligations of the highest quality in which credit risk is at its lowest and the issuer's credit profile is stable, whereas an NAIC designation of 6 is assigned to obligations that are in or near default. Classes 1 and 2 are investment grade, Class 3 is medium quality and Classes 4, 5 and 6 are non-investment grade.

The following table sets forth the SVO ratings for our portfolio along with what we believe are the equivalent rating agency designations. Our presentation consists of long-term bonds, short-term securities and cash equivalents. The tables below also set forth the NAIC SVO ratings for our publicly traded and privately placed portfolios.

**Total Portfolio Credit Quality**

| NAIC Classes | Rating Agency Equivalent Designation | December 31, 2007 Carrying Value | 2007 % of Total | December 31, 2006 Carrying Value | 2006 % of Total |
|---|---|---|---|---|---|
| | | ($ In Millions) | | | |
| 1 | Aaa/Aa/A | $ 109 | 59% | $ 125 | 64% |
| 2 | Baa | 71 | 38 | 64 | 33 |
| 3 | Ba | 5 | 3 | 4 | 2 |
| 4 | B | 1 | - | 1 | 1 |
| | **Total** | $ 186 | 100% | $ 194 | 100% |

**Publicly Traded Credit Quality**

| NAIC Classes | Rating Agency Equivalent Designation | December 31, 2007 Carrying Value | 2007 % of Total | 2006 Carrying Value | 2006 % of Total |
|---|---|---|---|---|---|
| | | ($ In Millions) | | | |
| 1 | Aaa/Aa/A | $ 89 | 65% | $ 107 | 70% |
| 2 | Baa | 45 | 32 | 42 | 28 |
| 3 | Ba | 4 | 3 | 3 | 2 |
| 4 | B | 1 | - | 1 | - |
| | **Total** | **$ 139** | **100%** | **$ 153** | **100%** |

**Privately Placed Credit Quality**

| NAIC Classes | Rating Agency Equivalent Designation | December 31, 2007 Carrying Value | 2007 % of Total | 2006 Carrying Value | 2006 % of Total |
|---|---|---|---|---|---|
| | | ($ In Millions) | | | |
| 1 | Aaa/Aa/A | $ 20 | 43% | $ 18 | 44% |
| 2 | Baa | 26 | 55 | 22 | 54 |
| 3 | Ba | 1 | 2 | 1 | 2 |
| | **Total** | **$ 47** | **100%** | **$ 41** | **100%** |

We utilize our investments in the privately placed portfolio to enhance the value of the overall portfolio, increase diversification, and obtain higher yields than can be earned by investing in comparable quality public market securities. To control risk when utilizing privately placed securities, we rely upon broader access to management information, stronger negotiated protective covenants, call protection features, and a higher level of collateralization than can customarily be achieved in the public market. The strength of the privately placed portfolio is demonstrated by the predominance of NAIC Class 1 and 2 securities.

The following table sets forth by industry category the total bond portfolio, including short-term securities and cash equivalents, as of December 31, 2007:

**Portfolio by Industry**
**December 31, 2007**

| | Public | | Private | | Total | |
|---|---|---|---|---|---|---|
| **Industry Category** | **Carrying Value** | **% of Total** | **Carrying Value** | **% of Total** | **Carrying Value** | **% of Total** |
| | | | ($ In Millions) | | | |
| Mortgage-backed securities | $ 56 | 40% | $ 1 | 2% | $ 57 | 31 |
| Utilities | 13 | 9 | 8 | 17 | 21 | 11 |
| Asset-backed securities | 12 | 9 | 7 | 15 | 19 | 10 |
| Finance | 10 | 7 | 7 | 15 | 17 | 9 |
| Consumer services | 9 | 6 | 6 | 13 | 15 | 8 |
| Capital goods | 5 | 4 | 9 | 19 | 14 | 6 |
| Cash equivalent and short-term inv. | 11 | 8 | - | - | 11 | 6 |
| Media | 6 | 4 | 1 | 2 | 7 | 4 |
| Natural resources | 3 | 3 | 2 | 4 | 5 | 3 |
| Government | 5 | 4 | - | - | 5 | 3 |
| Technology | 3 | 2 | - | - | 3 | 2 |
| Consumer goods | 2 | 1 | 1 | 2 | 3 | 2 |
| Healthcare | 2 | 1 | 1 | 2 | 3 | 2 |
| Transportation | - | - | 3 | 7 | 3 | 2 |
| Retail | 1 | 1 | 1 | 2 | 2 | 1 |
| Telecommunications | 1 | 1 | - | - | 1 | - |
| **Total** | $ 139 | 100% | $ 47 | 100% | $ 186 | 100% |

Mortgage-backed securities consist mainly of residential mortgage-backed securities and collateralized mortgage obligations. We do not originate any residential mortgages but invest in residential mortgage loan pools which may contain mortgages of subprime credit quality. We purchase seasoned loan pools, most of which are Federal Housing Administration **("FHA")** insured and Veterans Administration **("VA")** guaranteed. As of December 31, 2007, we had no direct subprime exposure through the origination of residential mortgage loans or purchases of unsecuritized whole-loan pools. As of December 31, 2007, we had mortgages with residential mortgage-backed exposure with a carrying value of $10 million which were FHA insured or VA guaranteed.

Only one other industry group, utilities, exceeds 10% of the total bond portfolio.

## Bond Portfolio Surveillance and Under-Performing Investments

Generally, bonds are valued at amortized cost using the constant yield interest method. Bond transactions are recorded on a trade date basis, except for private placement bonds which are recorded on the funding date.

The fair value of bonds is based on values provided by the NAIC's SVO when available. If SVO values are not available, quoted market values provided by other third-party organizations are used. If quoted market values are unavailable, fair value is estimated by discounting expected future cash flows using current market rates applicable to yield, credit quality and maturity of the investment or using quoted market values for comparable investments.

To identify under-performing investments, we conduct a quarterly management review of all bonds including those in default, not-in-good standing, or valued below 80% of cost. We consider the following factors in the evaluation of whether a non-interest related decline in value is other-than-temporary: (a) the financial condition and near-term prospects of the issuer; (b) the likelihood that we will be able to collect all amounts due according to the contractual terms of a debt security in effect at the date of acquisition; (c) our ability and intent to hold the investment for a period of time sufficient to allow for an anticipated recovery in value; and (d) the period and degree to which the market value has been below cost. We consider the following factors in the evaluation of whether an interest related decline in value is other-than-temporary: (a) our near-term intent to sell; (b) our contractual and regulatory obligations; and (c) our ability to hold the investment until anticipated recovery of the cost of the investment.

Additionally, we consider qualitative and quantitative factors such as material declines in issuer revenues or margins, significant uncertainty regarding the issuer's industry, debt service coverage or cash flow ratios that fall below industry-specific thresholds, violation of financial covenants, trading of public securities at a substantial discount due to specific credit concerns, and other subjective factors that relate to the issuer.

We actively review the bond portfolio to estimate the likelihood and amount of financial defaults or write-downs in the portfolio and to make timely decisions as to the potential sale or renegotiation of terms of specific investments.

The NAIC defines under-performing bonds as those whose deferral of interest and/or principal payments are deemed to be caused by the inability of the obligor to make such payments as called for in the bond contract.

As of December 31, 2007 and 2006, there were no bonds with NAIC Class 6 ratings.

We employ a systematic methodology to evaluate declines in fair value below book value. The methodology to evaluate declines in fair value utilizes a quantitative and qualitative process ensuring that available evidence concerning the declines is evaluated in a disciplined manner. The book values of investments are written down to fair value when a decline in value is considered to be other-than-temporary.

The following is an analysis of the gross unrealized losses aggregated by bond category and length of time that the securities were in a continuous unrealized loss position.

| | December 31, 2007 | | | | | |
|---|---|---|---|---|---|---|
| | Less than 12 months | | | 12 Months or longer | | |
| | Fair Value | Unrealized Losses | Number of Issuers | Fair Value | Unrealized Losses | Number of Issuers |
| | ($ In Millions) | | | | | |
| U. S. government | $ - | $ - | - | $ 1 | $ - | 1 |
| Special revenue | - | - | - | 4 | - | 7 |
| Public utilities | 1 | - | 5 | 6 | - | 16 |
| Industrial and miscellaneous | 36 | 2 | 86 | 43 | 1 | 82 |
| **Total** | **$ 37** | **$ 2** | **91** | **$ 54** | **$ 1** | **106** |

The following is an analysis of the gross unrealized losses aggregated by bond category, length of time that the securities have been in a continuous unrealized loss position and investment grade.

| | December 31, 2007 | | | | | |
|---|---|---|---|---|---|---|
| | Less than 12 months | | | 12 Months or longer | | |
| | Investment Grade | Below Investment Grade | Total | Investment Grade | Below Investment Grade | Total |
| | ($ in Millions) | | | | | |
| Industrial and miscellaneous | $ 2 | $ - | $ 2 | $ 1 | $ - | $ 1 |

For industrial and miscellaneous, the majority of the unrealized losses less than 12 months as of December 31, 2007 was in residential mortgage-backed securities and resulted from the widening of credit spreads and the continuing decline in the credit markets. Deterioration of underlying collateral or downgrades of credit ratings may lead to further declines in value.

Based on our policy for the evaluation of other-than-temporary impairments, we did not consider these investments to be other-than-temporarily impaired as of December 31, 2007.

## Mortgage Loans

Mortgage loans represented 4% of the total investments in the general account as of December 31, 2007. Mortgage loans consist of whole loans on commercial real estate and residential mortgage loan pools. As of December 31, 2007, we had no commercial loans in our mortgage loan portfolio.

## Residential Mortgage Loans

We do not originate any residential mortgages but invest in residential mortgage loan pools which may contain mortgages of subprime credit quality. As of December 31, 2007, we had no direct subprime exposure through the origination of residential mortgage loans or purchases of unsecuritized whole-loan pools. We purchase seasoned loan pools, most of which are Federal Housing Administration **("FHA")** insured and Veterans Administration **("VA")** guaranteed. As of December 31, 2007, we had mortgages with residential mortgage-backed exposure with a carrying value of $10 million which were FHA insured or VA guaranteed.

These investments have provided excellent loss/risk experience. We impose rigorous investment standards focusing on governmental agency guarantees and seasoning. We also apply rigorous prepayment analysis as appropriate for each of these investments.

### Mortgage Loan Portfolio Surveillance and Under-Performing Investments

We actively monitor, manage and directly service our commercial mortgage loan portfolio. We perform or review all aspects of loan origination and portfolio management, including lease analysis, property transfer analysis, economic and financial reviews, tenant analysis, and management of default and bankruptcy proceedings.

We re-value under-performing properties each year and re-inspect these properties at least every other year based on internal quality ratings. The criteria used to determine whether a current or potential problem exists includes borrower bankruptcies, major tenant bankruptcies, requests for restructuring, delinquent tax payments, late payments, loan-to-value or debt service coverage deficiencies, and overall vacancy levels.

There were no current and potential problem mortgage loans consisting of restructured mortgage loans as of December 31, 2007 or 2006, and no mortgage loans in default as of December 31, 2007 or 2006. The AVR contains a mortgage loan component, which totaled $61 thousand and $8 thousand as of December 31, 2007 and 2006, respectively. See "Investment Reserves."

### Investment Reserves

We establish and record appropriate write-downs or investment reserves in accordance with statutory practice. We determine the fair value of bonds in accordance with principles established by the SVO using criteria that include the net worth and capital structure of the borrower, the value of the collateral, the presence of additional credit support, and our evaluation of the borrower's ability to compete in a relevant market.

In compliance with regulatory requirements, we maintain an AVR. The AVR is a contingency reserve to offset potential losses of stocks, real estate investments, partnerships and limited liability companies **("LLCs")**, as well as credit-related declines in bonds, mortgage loans, and derivatives.

As of December 31, 2007, the AVR totaled $2 million, which represents a 50% decrease from December 31, 2006. This decrease is primarily due to the decrease in statement value of bonds and current year after-tax realized capital losses of $3 million related to other-than-temporary impairments.

## Quantitative and Qualitative Information about Market Risk

All non-guaranteed separate account assets and liabilities have been excluded from the following discussion since all market risks associated with those accounts are assumed by the contract holders.

Assets, such as bonds, stocks, mortgage loans, policy loans and derivatives are financial instruments, which are subject to the risk of market volatility and potential market disruptions. These risks may reduce the value of our financial instruments, or impact future cash flows and earnings from those instruments. We do not hold or issue any financial instruments for the purpose of trading.

Our primary market risk exposure is changes in interest rates, which can cause changes in the fair value, cash flows, and earnings of certain financial instruments. To manage our exposure to interest rate changes, we use sophisticated quantitative asset/liability management techniques. Through asset/liability management we match the market sensitivity of assets with the liabilities they support. If these sensitivities are closely matched, the impact of interest rate changes is effectively offset on an economic basis as the change in value of the asset is offset by a corresponding change in the value of the supported liability. In addition, we invest a significant portion of our investment funds in high quality bonds in order to maintain and manage liquidity and reduce the risk of default in the portfolio.

Based upon the information and assumptions we used in our asset/liability analysis as of December 31, 2007, we estimate that a hypothetical immediate 10% increase in the 10-year treasury rate, approximately 40 basis points, would decrease the net fair value of our financial instruments by $3 million. Whereas, a hypothetical immediate 10% decrease in the rate would increase the net fair value of our financial instruments by $3 million. A significant portion of our liabilities, such as insurance policy and claim reserves, are not considered financial instruments and are excluded from the above analysis. Because of our asset/liability management, a corresponding change in fair values of these liabilities, based on the present value of estimated cash flows, would significantly offset the net change in fair value of assets estimated above.

Revenues and profitability from variable products will vary from period to period, driven in part by changes in the capital and equity markets. Specifically, certain fees we charge for variable annuity product separate accounts are based on the separate account asset levels. Separate account asset levels change as the underlying investments' market values change. Based on our experience, management believes that a 10% change in the equity markets would change the annualized fees by less than $1 million.

The profitability of our individual variable annuity products can also vary as our obligation related to secondary guarantees changes with capital and equity market volatility. We offer secondary guarantees with substantially all new individual variable annuity products primarily in the form of guaranteed minimum death benefits **("GMDB")**. The liability for GMDB for annuity contracts was less than $1 million as of December 31, 2007. We assess the risks associated with secondary guarantees in the overall context of risk management, but do not reinsure the risks associated with secondary guarantees.

**Risks related to credit markets**

Credit risk is the risk that issuers of investments owned by us may default or that other parties may not be able to pay amounts due to us. We attempt to manage our investments to limit credit risk by diversifying our portfolio among various security types and industry sectors.

We are exposed to credit-related losses in the event of non-performance by counterparties to various financial instruments. In order to minimize credit risk, we and certain of our counterparties require collateral to be posted in the amount owed under each transaction, subject to thresholds and minimum transfer amounts that are functions of the rating on the counterparty's long-term, unsecured, unsubordinated debt.

We regularly monitor counterparty credit ratings and exposures, investment positions and valuations, and the value of collateral posted to ensure counterparties are credit-worthy and the concentration of exposure is minimized. We monitor this exposure as part of our management of our overall credit exposures.

We may use derivative financial instruments in the normal course of business to manage our investment risks, primarily to reduce interest rate and duration imbalances determined in asset/liability analyses. The investment risk is assessed on a portfolio basis and derivative financial instruments are not designated as a hedge with respect to a specific risk; therefore, the criteria for hedge accounting are not met. Our derivative hedging strategy employs a variety of instruments, including interest rate and currency swaps, options, including interest rate caps and floors, forward commitments, asset, equity and credit swaps, and financial futures.

Management did not believe that significant concentrations of credit risk existed as of and for the year ended December 31, 2006.

In 2007, the slowing of the U.S housing market, rising residential mortgage rates, and relaxed underwriting standards by residential mortgage loan originators have led to higher delinquency and loss rates, reduced credit availability and liquidity in the residential loan market. We have implemented a stringent review process for determining the fair value of securities containing these risk characteristics. Cash flows were modeled for every bond using prepayment and default assumptions that varied according to collateral attributes. Bonds with nontrivial credit exposure were modeled across a variety of prepayment and default scenarios, spanning the range of possible outcomes specific to each individual security. Resulting cash flows were discounted at spreads consistent with the residential mortgage market's weakness and the uncertainty around the magnitude and timing of cash flows. This review process provided a framework for deriving other-than-temporary impairment losses. In these analyses, data quality of loan vintage, collateral type, and investment structure are critical elements of determining fair values.

The fair value of subprime and Alt-A investments are highly sensitive to evolving conditions that can impair the cash flows realized by investors. Determining fair value is made more difficult by the lack of observable prices, uncertainty of credit ratings, and the current liquidity crisis which may continue into the foreseeable future. The ultimate emergence of losses is subject to uncertainty. A significant, unexpected credit event could change management's view of these assets. If defaults were to increase significantly above the stresses imposed in our analysis or collateral performance was much worse than expected, management would need to reassess whether such credit events have changed the underlying dynamics of the market and the expected performance of these assets.