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**SCOTTISH RE GROUP LIMITED**

**CONSOLIDATED FINANCIAL STATEMENTS**

**FOR THE YEAR ENDED  
DECEMBER 31, 2009**

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## Table of Contents

Summary of Results.....	2
Report of Independent Auditors.....	4
Consolidated Balance Sheets – December 31, 2009 and 2008 .....	5
Consolidated Statements of Income (Loss) – Years Ended December 31, 2009, 2008 and 2007 .....	6
Consolidated Statements of Comprehensive Income (Loss) – Years Ended December 31, 2009, 2008 and 2007 .....	8
Consolidated Statements of Shareholders’ (Deficit) Equity - Years Ended December 31, 2009, 2008 and 2007.....	9
Consolidated Statements of Cash Flows - Years Ended December 31, 2009, 2008 and 2007 .....	10
Notes to Consolidated Financial Statements.....	12

## Summary of Results

Scottish Re Group Limited (“SRGL”, the “Company”, “we”, “our” and “us”) is a holding company incorporated under the laws of the Cayman Islands with our principal executive office in Bermuda.

For the year ended December 31, 2009, SRGL reported net income attributable to ordinary shareholders of \$2,305.3 million, or \$10.56 per diluted ordinary share, as compared to a net loss attributable to ordinary shareholders of \$2,710.3 million, or (\$39.63) per diluted ordinary share, for the prior year period.

The \$2,305.3 million of net income attributable to ordinary shareholders in 2009 was driven by the following significant events:

### ***Sale of the Company’s ING individual life reinsurance business to Hannover Re***

The sale to Hannover Life Reassurance Company of America (“Hannover (America)”) and its affiliate Hannover Life Reassurance (Ireland) Limited (“Hannover (Ireland)”) and, together with Hannover (America), “Hannover Re”) of the block of individual life reinsurance business acquired by the Company in 2004 from Security Life of Denver Insurance Company (“SLD”) and Security Life of Denver International Limited (“SLDI” and, together with SLD, the “ING Companies”) was completed on February 20, 2009, with an effective date of January 1, 2009. The gain associated with the sale was principally attributable to \$1,468.7 million of assets transferred to Hannover Re, offset by \$1,902.9 million release of reserves for future policy benefits and \$269.4 million decrease in other net liabilities. The release of liabilities in excess of assets transferred generated a pre-tax gain of \$703.6 million. We recorded an additional \$49.8 million income tax expense from an increase in our valuation allowance as a result of this transaction. The increased valuation allowance was because the remaining deferred tax liabilities did not support the full recoverability of our deferred tax assets.

### ***Discounted purchases of Stingray pass-through certificates and subsequent consolidation of the Stingray funding arrangement***

Beginning in the third quarter of 2009, the Company began purchasing, initially through privately negotiated transactions and subsequently through a cash tender offer, the 5.902% Pass-Through Certificates (the “Pass-Through Certificates”) issued by the Stingray Pass-Through Trust. As of December 31, 2009, the Company had acquired \$226.7 million of the outstanding \$325.0 Pass-Through Certificates for a total consideration of \$51.5 million.

These acquisitions represented reconsideration events under Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) Subtopic 810-10 (“FASB ASC 810-10”). The Company completed a primary beneficiary analysis and concluded that, effective October 8, 2009, it was the primary beneficiary of the Stingray funding arrangement and, therefore, was required to consolidate the arrangement under FASB ASC 810-10.

The initial consolidation of the Stingray funding arrangement, including applying fair values to the Pass-Through Certificates held by third parties and the interest rate swap associated with the Stingray funding arrangement, resulted in a gain of \$249.0 million. Subsequent acquisitions of the Pass-Through Certificates resulted in a further gain of \$4.9 million. A revaluation of the Pass-Through Certificates held by third parties at December 31, 2009 resulted in a loss of \$22.1 million.

### ***Discounted repurchases of PATS securities prior to maturity***

During the first quarter of 2009, the Company extinguished, primarily through negotiated repurchases, the \$100 million unsecured funding agreement payment obligation, due on March 12, 2009 (the “Maturity Date”), in respect of the Premium Asset Trust Series 2004-4 (“PATS”). The extinguishment of PATS securities acquired through negotiated repurchases and the settlement of the remaining funding obligation in respect of all PATS securities not repurchased prior to the Maturity Date were completed for a total consideration of \$46.5 million compared to the \$100 million par value of the PATS. Consequently, the Company recorded a gain of \$53.5 million on the extinguishment of the PATS debt.

## Summary of Results (Continued)

### *De-consolidation of Ballantyne Re*

Ballantyne Re plc (“Ballantyne Re”) is a special purpose vehicle incorporated under the laws of Ireland. Effective January 1, 2009, Ballantyne Re no longer is consolidated within the Company’s financial statements. Pursuant to the purchase agreement for the sale of the ING individual life reinsurance business, Hannover Re assumed the Company’s obligation to absorb mortality risk related to all recaptures of business from Ballantyne Re under the related reinsurance agreement. Disposal by the Company of the variable interest to absorb this mortality risk constituted a reconsideration event related to the consolidation of Ballantyne Re under FASB ASC 810-10. The Company subsequently completed a primary beneficiary analysis and concluded that it no longer was the primary beneficiary of Ballantyne Re as defined within FASB ASC 810-10 and, as a result, no longer is consolidating Ballantyne Re into the financial statements of the Company. The de-consolidation of Ballantyne Re reduced the Company’s consolidated total assets and liabilities by approximately \$885 million and \$2,035 million, respectively, and resulted in a non-cash gain on de-consolidation of \$1,150 million.

### *Net Realized and Unrealized Gains*

In addition to the one-time events highlighted above, the market value of the Company’s invested assets, which primarily consist of fixed income securities, benefited from the recovery in the global credit markets during 2009. The total net realized and unrealized gains for the year were \$243.0 million. The gains principally are reversals of prior year unrealized losses.

Excluding the significant events highlighted above and the market value increases of the Company’s invested assets, net income attributable to ordinary shareholders would have resulted in a net loss.

While most of the items giving rise to the \$2,305.3 million of net income attributable to ordinary shareholders did not generate cash flows, the unrestricted assets of SRGL and Scottish Annuity & Life Insurance Company (Cayman) Ltd. (“SALIC”) increased in 2009. The unrestricted assets of SRGL and SALIC represent assets which are not held in trust accounts. As of December 31, 2009, SRGL and SALIC had a combined \$138.8 million of unrestricted assets, compared to \$57.7 million at December 31, 2008. These assets were available at December 31, 2009 to meet the obligations of SRGL and SALIC. There can be no assurances that the amount of unrestricted assets held by SRGL and SALIC will not decrease from period to period.

## Report of Independent Auditors

### The Board of Directors and Shareholders of Scottish Re Group Limited

We have audited the accompanying consolidated balance sheets of Scottish Re Group Limited and subsidiaries as of December 31, 2009 and 2008, and the related consolidated statements of income (loss), comprehensive income (loss), shareholders' (deficit) equity, and cash flows for each of the years in the period ended December 31, 2009. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Scottish Re Group Limited and subsidiaries at December 31, 2009 and 2008, and the consolidated results of their operations and their cash flows for the each of the three years in the period ended December 31, 2009, in conformity with U.S. generally accepted accounting principles.

The accompanying financial statements have been prepared assuming that Scottish Re Group Limited will continue as a going concern. As more fully described in Note 2, the Company is operating the business under an Amended Order of Supervision with the Delaware Department of Insurance and has a shareholders' deficit at December 31, 2009. These conditions raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regards to these matters are also described in Note 2. The 2009 consolidated financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the outcome of this uncertainty.

/s/ Ernst & Young LLP

Charlotte, North Carolina  
April 30, 2010

**SCOTTISH RE GROUP LIMITED**  
**CONSOLIDATED BALANCE SHEETS**  
(Expressed in Thousands of United States Dollars, Except Share Data)

	December 31, 2009	December 31, 2008
<b>ASSETS</b>		
Fixed maturity investments, trading at fair value .....	\$ 2,988,164	\$ 3,781,104
Preferred stock, trading at fair value.....	77,410	79,767
Cash and cash equivalents .....	390,025	824,613
Other investments .....	21,482	22,772
Funds withheld at interest.....	608,500	1,748,768
Total investments.....	4,085,581	6,457,024
Accrued interest receivable .....	24,422	35,473
Reinsurance balances.....	161,977	353,579
Deferred acquisition costs .....	296,822	375,475
Amount recoverable from reinsurers .....	606,347	711,576
Present value of in-force business .....	38,316	40,105
Other assets.....	67,185	41,750
Current income tax receivable.....	12,762	8,811
Deferred tax asset .....	3,922	3,061
Total assets .....	\$ 5,297,334	\$ 8,026,854
<b>LIABILITIES</b>		
Reserves for future policy benefits.....	\$ 1,542,639	\$ 4,011,053
Interest sensitive contract liabilities .....	1,518,365	2,025,554
Collateral finance facilities.....	1,300,000	3,000,000
Accounts payable and other liabilities .....	68,921	112,273
Embedded derivatives at fair value .....	35,732	347,519
Reinsurance balances payable .....	137,597	248,065
Deferred tax liability.....	50,143	221
Long term debt at fair value .....	55,068	-
Long term debt .....	129,500	129,500
Total liabilities.....	4,837,965	9,874,185
<b>MEZZANINE EQUITY</b>		
Convertible cumulative participating preferred shares (liquidation preference \$716.2 million) Commitments and contingencies (Note 21)	555,857	555,857
<b>EQUITY</b>		
Ordinary shares, par value \$0.01:		
Issued 68,383,370 shares (2008 – 68,383,370).....	684	684
Non-cumulative perpetual preferred shares, par value \$0.01:		
Issued: 5,000,000 shares (2008 – 5,000,000).....	125,000	125,000
Additional paid-in capital .....	1,217,535	1,216,878
Retained deficit.....	(1,447,375)	(3,752,716)
Total Scottish Re Group Limited shareholders' deficit .....	(104,156)	(2,410,154)
Noncontrolling interest.....	7,668	6,966
Total deficit .....	(96,488)	(2,403,188)
Total liabilities, mezzanine equity and total deficit .....	\$ 5,297,334	\$ 8,026,854

See Accompanying Notes to Consolidated Financial Statements

**SCOTTISH RE GROUP LIMITED**  
**CONSOLIDATED STATEMENTS OF INCOME (LOSS)**  
(Expressed in Thousands of United States Dollars, Except Share Data)

	Year Ended		
	December 31, 2009	December 31, 2008	December 31, 2007
<b>Revenues</b>			
Premiums earned, net.....	\$ 451,800	\$ 1,651,106	\$ 1,773,388
Fee and other income.....	6,996	8,803	14,917
Investment income, net.....	176,923	377,304	586,329
Net realized and unrealized gains (losses).....	242,990	(1,895,895)	(972,920)
Gain on de-consolidation of collateral finance facility .....	1,150,114	-	-
Gain on consolidation of funding arrangement.....	253,824	-	-
Change in value of long term debt at fair value.....	(22,125)	-	-
Gain on extinguishment of debt.....	53,545	19,437	20,043
Change in value of embedded derivatives, net .....	311,787	(216,041)	(43,627)
Total revenues.....	<u>2,625,854</u>	<u>(55,286)</u>	<u>1,378,130</u>
<b>Benefits and expenses</b>			
Claims and other policy benefits.....	(22,926)	1,579,412	1,473,563
Interest credited to interest sensitive contract liabilities .....	59,959	75,581	135,366
Acquisition costs and other insurance expenses, net ...	133,782	559,933	359,761
Operating expenses.....	53,781	137,981	128,198
Collateral finance facilities expense .....	39,410	257,912	289,098
Interest expense .....	6,274	9,902	18,161
Total benefits and expenses .....	<u>270,280</u>	<u>2,620,721</u>	<u>2,404,147</u>
<b>Income (loss) from continuing operations before income taxes.....</b>			
	2,355,574	(2,676,007)	(1,026,017)
Income tax (expense) benefit.....	(49,531)	6,836	157,259
<b>Income (loss) from continuing operations .....</b>	<u>2,306,043</u>	<u>(2,669,171)</u>	<u>(868,758)</u>
Loss from discontinued operations, net of related taxes .....	-	(43,001)	(26,323)
<b>Consolidated income (loss) .....</b>	<u>2,306,043</u>	<u>(2,712,172)</u>	<u>(895,081)</u>
Net (income) loss attributable to noncontrolling interest.....	(702)	1,855	(661)
Dividend declared on non-cumulative perpetual preferred shares.....	-	-	(9,062)
Deemed dividend on beneficial conversion feature related to convertible cumulative participating preferred shares.....	-	-	(120,750)
<b>Net income (loss) attributable to ordinary shareholders .....</b>	<u>\$ 2,305,341</u>	<u>\$ (2,710,317)</u>	<u>\$ (1,025,554)</u>
<b>Amounts attributable to ordinary shareholders:</b>			
Income (loss) from continuing operations .....	\$ 2,305,341	\$ (2,667,316)	\$ (869,419)
Income (loss) from discontinued operations, net of related taxes .....	-	(43,001)	(26,323)
Dividend declared on non-cumulative perpetual preferred shares.....	-	-	(9,062)
Deemed dividend on beneficial conversion feature related to convertible cumulative participating preferred shares.....	-	-	(120,750)

<b>Net income (loss) attributable to ordinary shareholders</b> .....	<u>\$ 2,305,341</u>	<u>\$ (2,710,317)</u>	<u>\$ (1,025,554)</u>
<b>Income (loss) per ordinary share attributable to ordinary shareholders:</b>			
<b>Basic income (loss) per ordinary share</b>			
Income (loss) from continuing operations .....	<u>\$ 33.23</u>	<u>\$ (39.00)</u>	<u>\$ (12.92)</u>
Loss from discontinued operations .....	<u>\$ -</u>	<u>\$ (0.63)</u>	<u>\$ (0.39)</u>
Income (loss) .....	<u>\$ 33.23</u>	<u>\$ (39.63)</u>	<u>\$ (13.31)</u>
<b>Net income (loss) attributable to ordinary shareholders</b> .....	<u>\$ 33.23</u>	<u>\$ (39.63)</u>	<u>\$ (15.24)</u>
<b>Diluted income (loss) per ordinary share</b>			
Income (loss) from continuing operations .....	<u>\$ 10.56</u>	<u>\$ (39.00)</u>	<u>\$ (12.92)</u>
Loss from discontinued operations .....	<u>\$ -</u>	<u>\$ (0.63)</u>	<u>\$ (0.39)</u>
Income (loss) .....	<u>\$ 10.56</u>	<u>\$ (39.63)</u>	<u>\$ (13.31)</u>
<b>Net income (loss) attributable to ordinary shareholders</b> .....	<u>\$ 10.56</u>	<u>\$ (39.63)</u>	<u>\$ (15.24)</u>
<b>Weighted average number of ordinary shares outstanding – basic</b> .....	<u>68,383,370</u>	<u>68,383,370</u>	<u>67,303,066</u>
<b>Weighted average number of ordinary shares outstanding – diluted</b> .....	<u>218,383,370</u>	<u>68,383,370</u>	<u>67,303,066</u>

See Accompanying Notes to Consolidated Financial Statements

**SCOTTISH RE GROUP LIMITED**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**  
(Expressed in Thousands of United States Dollars)

	<b>Year Ended</b>		
	<b>December 31, 2009</b>	<b>December 31, 2008</b>	<b>December 31, 2007</b>
<b>Net income (loss) attributable to ordinary shareholders</b> .....	\$ 2,305,341	\$ (2,710,317)	\$ (895,742)
Other comprehensive income (loss):			
Unrealized depreciation on investments .....	-	-	(739,353)
Reclassification adjustment for net realized and unrealized gains (losses) included in net income (loss) .....	-	(26,514)	785,741
Net unrealized (depreciation) appreciation on investments, net of income taxes and deferred acquisition costs of \$nil, \$11,937 and \$(31,657) .....	-	(26,514)	46,388
Cumulative translation adjustment .....	-	(24,590)	1,764
Benefit plans .....	-	2,344	518
Other comprehensive (loss) income .....	-	(48,760)	48,670
Comprehensive income (loss) .....	\$ 2,305,341	\$ (2,759,077)	\$ (847,072)
Change in net unrealized appreciation (depreciation) attributable to the noncontrolling interest .....	-	204	(454)
<b>Comprehensive income (loss) attributable to ordinary shareholders</b> .....	<u>\$ 2,305,341</u>	<u>\$ (2,758,873)</u>	<u>\$ (847,526)</u>

See Accompanying Notes to Consolidated Financial Statements

**SCOTTISH RE GROUP LIMITED**  
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' (DEFICIT) EQUITY**  
(Expressed in Thousands of United States Dollars)

	Year Ended		
	December 31, 2009	December 31, 2008	December 31, 2007
<b>Share capital:</b>			
<b>Ordinary shares:</b>			
Beginning of period .....	\$ 684	\$ 684	\$ 606
Issuance to holders of HyCUs on conversion of purchase contracts.....	-	-	74
Issuance to holders of restricted stock awards .....	-	-	4
End of period .....	684	684	684
<b>Non-cumulative perpetual preferred shares:</b>			
Beginning and end of period.....	125,000	125,000	125,000
<b>Additional paid-in capital:</b>			
Beginning of period .....	1,216,878	1,214,886	1,050,860
Option and restricted stock unit expense .....	657	1,992	20,067
Issuance to holders of HyCUs on conversion of purchase contracts.....	-	-	143,675
Beneficial conversion feature related to convertible cumulative participating preferred shares.....	-	-	120,750
Accretion of beneficial conversion feature related to convertible cumulative participating preferred shares.....	-	-	(120,750)
Other .....	-	-	284
End of period .....	1,217,535	1,216,878	1,214,886
<b>Accumulated other comprehensive income (loss):</b>			
<b>Unrealized appreciation (depreciation) on investments net of income taxes and deferred acquisition costs</b>			
Beginning of period .....	-	26,514	(19,874)
Change in period.....	-	(26,514)	46,388
End of period .....	-	-	26,514
<b>Noncontrolling interest</b>			
Beginning of period .....	-	(204)	250
Change in period (net of tax) .....	-	204	(454)
End of period .....	-	-	(204)
<b>Cumulative translation adjustment</b>			
Beginning of period .....	-	24,590	22,826
Change in period (net of tax) .....	-	(24,590)	1,764
End of period .....	-	-	24,590
<b>Benefit plans</b>			
Beginning of period .....	-	(2,344)	(2,862)
Change in period (net of tax) .....	-	2,344	518
End of period .....	-	-	(2,344)
<b>Total accumulated other comprehensive income (loss)</b> .....	-	-	48,556
<b>Retained deficit:</b>			
Beginning of period .....	(3,752,716)	(1,042,399)	(119,614)
Adoption of FASB ASC 740-10 on January 1, 2007.....	-	-	(17,981)
Net income (loss).....	2,305,341	(2,710,317)	(895,742)
Dividends declared on non-cumulative perpetual preferred shares .....	-	-	(9,062)
End of period .....	(1,447,375)	(3,752,716)	(1,042,399)
<b>Total Scottish Re Group Limited shareholders' (deficit) equity</b> .....	\$ (104,156)	\$ (2,410,154)	\$ 346,727
<b>Noncontrolling interest:</b>			
Beginning of period .....	6,966	9,025	7,910
Net income (loss).....	702	(1,855)	661
Unrealized (depreciation) appreciation - change in period (net of tax).....	-	(204)	454
End of period .....	7,668	6,966	9,025
<b>Total shareholders' (deficit) equity</b> .....	\$ (96,488)	\$ (2,403,188)	\$ 355,752

See Accompanying Notes to Consolidated Financial Statements

**SCOTTISH RE GROUP LIMITED**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Expressed in Thousands of United States Dollars)

	Year Ended		
	December 31, 2009	December 31, 2008	December 31, 2007
<b>Operating activities</b>			
Net income (loss) attributable to ordinary shareholders .....	\$ 2,305,341	\$ (2,710,317)	\$ (895,742)
Adjustments to reconcile net income (loss) to net cash used by operating activities:			
Net realized and unrealized (gains) losses .....	(242,990)	1,894,033	979,343
Gain on de-consolidation of collateral finance facility .....	(1,150,114)	-	-
Gain on consolidation of funding arrangement.....	(253,824)	-	-
Change in value of long term debt at fair value .....	22,125	-	-
Gain on extinguishment of debt.....	(53,545)	(19,437)	(20,043)
Changes in value of embedded derivatives, net.....	(311,787)	216,041	43,627
Amortization of discount on fixed maturity investments and preferred stock .....	-	281	13,021
Amortization of deferred acquisition costs .....	79,848	209,577	76,493
Amortization and write down of present value of in-force business.....	1,789	5,455	3,219
Write-off of fixed assets.....	6,021	-	-
Amortization of deferred transaction costs .....	2,646	49,170	13,309
Depreciation of fixed assets .....	1,126	7,989	11,045
Option expense .....	657	1,992	20,067
Net income (loss) attributable to noncontrolling interest.....	702	(1,855)	661
Changes in assets and liabilities:			
Accrued interest receivable .....	4,665	22,335	(101)
Reinsurance balances and risk fees receivable.....	138,180	197,213	(65,266)
Deferred acquisition costs .....	(1,906)	41,155	(87,214)
Deferred tax asset and liability.....	49,060	10,478	(192,697)
Other assets .....	(243,111)	18,944	25,941
Current income tax receivable and payable .....	(3,951)	2,258	(10,874)
Reserves for future policy benefits, net of amounts recoverable from reinsurers.....	(2,121,249)	(209,887)	325,780
Funds withheld at interest .....	1,140,268	(151,432)	344,743
Interest sensitive contract liabilities .....	(13,813)	(41,504)	(231,791)
Accounts payable and other liabilities .....	(318,067)	174,446	100,928
Embedded derivatives at fair value.....	311,787	(216,041)	(43,627)
Net cash (used in) provided by operating activities .....	(650,142)	(499,106)	410,822
<b>Investing activities</b>			
Purchase of fixed maturity investments.....	(778,910)	(316,809)	(1,331,162)
Proceeds from sales of fixed maturity investments .....	702,874	1,663,232	270,403
Proceeds from maturity and return of capital of fixed maturity investments.....	399,328	588,154	596,040
Purchase of preferred stock .....	(80)	(2,285)	-
Proceeds from sale and maturity of preferred stock .....	12,438	3,167	19,878
Purchase of and proceeds from other investments, net.....	299	36,401	(344)
Proceeds from sale (purchase) of fixed assets, net.....	64	4,117	(2,764)
Net cash provided by (used in) investing activities .....	336,013	1,975,977	(447,949)
<b>Financing activities</b>			
Deposits to interest sensitive contract liabilities .....	-	1,033	2,382
Withdrawals from interest sensitive contract liabilities .....	(73,845)	(837,934)	(289,798)
Proceeds from issuance of convertible cumulative participating preferred shares .....	-	-	555,857
Proceeds from issuance to holders of HyCUs on conversion of purchase contracts ..	-	-	7,338
Redemption of convertible preferred shares .....	-	-	(7,338)
Dividends paid on redemption of convertible preferred shares .....	-	-	(222)
Proceeds from collateral finance facilities.....	-	-	411,471
Payments on collateral finance facilities.....	-	(960,942)	(168,484)
Proceeds from (repayment on) drawdown of funding arrangement .....	-	325,000	(265,000)

Proceeds from issuance of ordinary shares .....	-	-	78
Dividends paid on non-cumulative perpetual preferred shares .....	-	(2,266)	(9,062)
Extinguishment of debt.....	(46,614)	-	-
Dividends paid on ordinary shares.....	-	-	-
Net cash (used in) provided by financing activities .....	<u>(120,459)</u>	<u>(1,475,109)</u>	<u>237,222</u>
Net change in cash and cash equivalents.....	(434,588)	1,762	200,095
Cash and cash equivalents, beginning of period.....	824,613	822,851	622,756
Cash and cash equivalents, end of period.....	<u>\$ 390,025</u>	<u>\$ 824,613</u>	<u>\$ 822,851</u>
Interest paid .....	<u>\$ 381</u>	<u>\$ 28,350</u>	<u>\$ 2,998</u>
Taxes (refunded) paid.....	<u>\$ (3,397)</u>	<u>\$ (4,815)</u>	<u>\$ 16,095</u>

See Accompanying Notes to Consolidated Financial Statements

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 1. Organization and Business

##### *Organization*

SRGL is a holding company incorporated under the laws of the Cayman Islands with our principal executive office in Bermuda. Through our operating subsidiaries, we are principally engaged in the reinsurance of life insurance, annuities and annuity-type products. We have principal operating companies in Bermuda, the Cayman Islands, Ireland, and the United States.

##### *Run Off Strategy*

In 2008, we ceased writing new business and notified our existing clients that we would not be accepting any new reinsurance risks under existing reinsurance treaties, thereby placing our remaining treaties into run-off. We expect to continue to pursue a run-off strategy for the remaining business, whereby we continue to receive premiums, pay claims and perform key activities under our remaining reinsurance treaties. Through prudent management of investments, reinsurance cash flows and operating expenses, our goal is to continue to satisfy our reinsurance and other obligations and to maintain a risk based capital ratio above the company action level prescribed by Delaware law and above any risk based capital-based recapture thresholds in our reinsurance agreements with ceding companies. No assurances can be given that we will be successful in implementing this strategy.

While pursuing our run-off strategy, we may from time to time, if opportunities arise, purchase in privately negotiated transactions, open market purchases or by means of general solicitations, tender offers or otherwise, additional amounts of our outstanding debt, non-voting preferred securities, and other liabilities. Any such purchases will depend on a variety of factors including but not limited to available corporate liquidity, capital requirements and indicative pricing levels. The amounts involved in any such transactions, individually or in the aggregate, may be material. For further discussion on our outstanding securities, see Note 11, "Debt Obligations and Other Funding Arrangements", Note 13, "Shareholders' Deficit", Note 23, "Related Party Transactions" and Note 25, "Subsequent Events".

##### *Regulatory Considerations*

We currently operate with certain regulatory considerations in respect of Scottish Re (U.S.), Inc. ("SRUS"), our primary U.S. reinsurance subsidiary. In connection with the receipt by SRUS in late 2008 of a permitted statutory accounting practice related to the reduction from liability for reinsurance ceded to an unauthorized assuming insurer (the "Permitted Practice"), SRUS consented to the issuance by the Delaware Department of Insurance (the "Department") on January 5, 2009, of an Order of Supervision against SRUS (the "Order of Supervision"), in accordance with 18 Del. C. §5942. The Order of Supervision required, among other things, the Department's consent to any transaction by SRUS outside the ordinary course of business and any transaction with or any distribution or payment to its affiliates. The original Order of Supervision subsequently was amended and replaced with an Extended and Amended Order of Supervision, dated April 3, 2009 (the "Amended Order of Supervision"), which amends and clarifies certain matters contained within the original Order of Supervision. See Note 22, "Statutory Requirements and Dividend Restrictions".

##### *Business*

We have written reinsurance business that is wholly or partially retained in one or more of our reinsurance subsidiaries. With the sale of the Wealth Management business and Life Reinsurance International Segment in 2008, together with the sale of the Acquired Business in our Life Reinsurance North America Segment in the first quarter of 2009, operating decisions and performance assessment of the Company is now performed without reference to any separate segments. Accordingly, we do not present information about distinct operating segments for periods after January 1, 2009.

# SCOTTISH RE GROUP LIMITED

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

### 1. Organization and Business (continued)

We have assumed risks associated with primary life insurance, annuities and annuity-type policies. We reinsure mortality, investment, persistency and expense risks of United States life insurance and reinsurance companies. Most of the reinsurance assumed is through automatic treaties, but in 2006 we also began assuming risks on a facultative basis. We suspended bidding for new business on March 3, 2008, and at that time, we began issuing notices cancelling the acceptance of new reinsurance risks for all open reinsurance treaties. The business we historically have written falls into two categories: Traditional Solutions and Financial Solutions, as detailed below.

*Traditional Solutions:* We reinsure the mortality risk on life insurance policies written by primary insurers. The business often is referred to as traditional life reinsurance. We wrote our Traditional Solutions business predominantly on an automatic basis. This means that we automatically reinsured all policies written by a ceding company that met the underwriting criteria specified in the treaty with the ceding company. As discussed herein, we completed in 2009 the sale to Hannover Re of the Acquired Business (as more fully defined in Note 14, the “Acquired Business”), which business generally was a part of our Traditional Solutions business.

*Financial Solutions:* Financial Solutions include contracts under which we assumed the investment and persistency risks of existing, as well as newly written, blocks of business that improve the financial position of our clients by increasing their capital availability and statutory surplus. The products reinsured include annuities and annuity-type products, cash value life insurance and, to a lesser extent, disability products that are in a pay-out phase. This line of business includes acquired solutions products in which we provided our clients with exit strategies for discontinued lines of business, closed blocks of business, or lines of business not providing a good fit for a client’s growth strategies.

Life insurance products that we reinsure include yearly renewable term, term with multi-year guarantees, ordinary life and variable life. Retail annuity products that we reinsure include fixed deferred annuities and variable annuities.

For these products, we wrote reinsurance generally in the form of yearly renewable term, coinsurance or modified coinsurance. Under yearly renewable term, we share only in the mortality risk for which we receive a premium. In a coinsurance or modified coinsurance arrangement, we generally share proportionately in all material risks inherent in the underlying policies, including mortality, lapses and investments. Under such agreements, we agree to indemnify the primary insurer for all or a portion of the risks associated with the underlying insurance policy in exchange for a proportionate share of premiums. Coinsurance differs from modified coinsurance with respect to the ownership of the assets supporting the reserves. Under our coinsurance arrangements, ownership of these assets is transferred to us, whereas in modified coinsurance arrangements, the ceding company retains ownership of these assets, but we share in the investment income and risk associated with the assets.

As discussed above, however, we have ceased writing new reinsurance treaties and no longer are accepting any new reinsurance risks under existing treaties or contracts with ceding companies.

### 2. Summary of Significant Accounting Policies

#### *Basis of Presentation*

Accounting Principles - Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”). Certain items in the prior period financial statements have been reclassified to conform to the current period presentation.

Going Concern – These consolidated financial statements have been prepared using accounting principles applicable to a going concern, which contemplates the realization of assets and the satisfaction of liabilities and commitments in the normal course of business. Our ability to continue as a going concern is dependent upon our ability to successfully meet our obligations in a manner that addresses ongoing regulatory requirements and capital,

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 2. Summary of Significant Accounting Policies (continued)

liquidity and collateral needs. There can be no assurance that any of the actions we have taken or plan to take will be successful in supplying funds in amounts and at times necessary to meet our liquidity or capital requirements in future periods. These consolidated financial statements do not give effect to any adjustments to recorded amounts and their classification which would be necessary if we were unable to continue as a going concern. We have a shareholders' deficit of \$104.2 million as of December 31, 2009.

In the event that for any reason, we fail to comply with the Department's Amended Order of Supervision, or in the event the financial condition of SRUS materially was to deteriorate, the Department may take action to seize control of SRUS under applicable insurance law. Such a seizure would place control of all management decisions of SRUS with the Department, including with respect to controlling cash flows, settling claims and paying obligations. The primary objective of the Department would be to protect the interests of the policyholders and ceding insurers with whom SRUS has contracted and would not be to protect the interests of SRGL, SALIC, the shareholders or any other stakeholders of the Company. A seizure of SRUS would have numerous consequences, including potentially triggering ceding company recapture rights on reinsurance agreements with us. Such seizure may also lead to the need for SALIC and SRGL to seek bankruptcy protection.

Consolidation - The consolidated financial statements include the assets, liabilities and results of operations of SRGL and its subsidiaries and all variable interest entities for which we are the primary beneficiary as defined in Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Subtopic 810-10, Consolidation - Overall ("FASB ASC 810-10"). All significant inter-company transactions and balances have been eliminated on consolidation. As at December 31, 2009, we consolidate two non-recourse securitizations: Orkney Re and Orkney Re II (each of the foregoing as more fully defined in Note 10). In addition, we have also consolidated the Stingray Pass-Through Trust and the Stingray Investor Trust, effective October 8, 2009. See Note 11, "Debt Obligations and Other Funding Arrangements". Effective January 1, 2009, we no longer consolidated Ballantyne Re plc ("Ballantyne Re"). See Note 10, "Collateral Finance Facilities and Securitization Structures".

Estimates, Risks and Uncertainties - The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ materially from those estimates and assumptions used by management. Our most significant assumptions are for:

- investment valuation and impairments;
- accounting for derivative instruments;
- assessment of risk transfer for structured insurance and reinsurance contracts;
- estimates of premiums;
- valuation of present value of in-force business;
- establishment of reserves for future policy benefits;
- amortization of deferred acquisition costs;
- retrocession arrangements and amounts recoverable from reinsurers;
- interest sensitive contract liabilities;
- long term debt at fair value; and
- income taxes, deferred taxes and determination of the valuation allowance.

We review and revise these estimates as appropriate. Any adjustments made to these estimates are reflected in the period the estimates are revised.

All tabular amounts are reported in thousands of United States dollars, or as otherwise noted.

# SCOTTISH RE GROUP LIMITED

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

### 2. Summary of Significant Accounting Policies (continued)

#### *Fixed Maturity Investments, Preferred Stock, Other Investments and Cash and Cash Equivalents*

Effective January 1, 2008, we reclassified our available for sale securities to trading. Accordingly, as of January 1, 2008, the balance of unrealized appreciation on investments of \$38.5 million, which was previously included in accumulated other comprehensive income (loss), was reclassified and recorded in the Consolidated Statements of Income (Loss) caption "Net realized and unrealized gains (losses)".

We carry securities at fair value on our Consolidated Balance Sheets. We maximize the use of observable inputs and minimize the use of non-observable inputs when measuring fair value. The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value of fixed maturity investments is calculated using independent pricing sources which utilize brokerage quotes, proprietary models and market based information. The actual value at which such financial instruments actually could be sold or settled with a willing buyer may differ from such estimated fair values. Unrealized holding gains and losses on trading investments are included in earnings. Interest is recorded on the accrual basis based upon the stated coupon rate as a component of net investment income. For securities with uncertain cash flow, the investments are accounted for under the cost recovery method, whereby all principal and coupon payments received are applied as a reduction of the carrying value. Cash flows for trading securities are classified in Investing Activities on the Consolidated Statements of Cash Flows based on the nature and purpose for which the related securities were acquired. Investment transactions are recorded on the trade date with balances pending settlement reflected in the Consolidated Balance Sheets as a component of cash and cash equivalents.

Realized gains and losses arising on the sale of securities are determined on a specific identification method. Realized gains and losses are stated net of associated deferred acquisition costs and income taxes.

Other investments include equity securities and structured loans, which are generally accounted for at fair value. Other investments represented approximately 0.5% and 0.4% of our investments as of December 31, 2009 and 2008, respectively.

Cash and cash equivalents include cash and fixed deposits with an original maturity, when purchased, of three months or less. Cash and cash equivalents are recorded at face value, which approximates fair value.

#### *Statement of Cash Flows*

In accordance with FASB ASC Topic 360, Property, Plant and Equipment ("FASB ASC 360"), formerly SFAS No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144"), certain items in the prior years in the Consolidated Statements of Income (Loss) and the assets and liabilities in the Consolidated Balance Sheets have been restated to exclude the results of our discontinued operations, namely the Life Reinsurance International Segment and the Wealth Management business. As permitted by FASB ASC 360, the Consolidated Statements of Comprehensive Income, Shareholders' Deficit and Cash Flows remain unchanged.

We included the change in funds withheld at interest in our modified coinsurance arrangements as change in operating activities in the Consolidated Statements of Cash Flows. The related interest and change in fair value of embedded derivatives is also included in cash flows from operating activities.

#### *Derivatives*

All derivative instruments are recognized either as assets or liabilities in the Consolidated Balance Sheets at fair value as required by FASB ASC Topic 815, Derivatives and Hedging ("FASB ASC 815"), formerly SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities" ("SFAS No. 133"). The accounting for changes in

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 2. Summary of Significant Accounting Policies (continued)

the fair value of stand alone derivatives that have not been designated as a hedge are included in net realized and unrealized losses in the Consolidated Statements of Income (Loss).

Our funds withheld at interest arise on modified coinsurance and funds withheld coinsurance agreements. FASB ASC Section 815-15-55, Derivatives and Hedging – Embedded Derivatives – Implementation Guidelines and Illustrations (“FASB ASC 815-15-55”), which incorporates Derivatives Implementation Group Issue No. B36 “Embedded Derivatives: Bifurcation of a Debt Instrument that Incorporates Both Interest Rate and Credit Rate Risk Exposures that are Unrelated or Only Partially Related to the Creditworthiness of the Issuer of that Instrument”, indicates that these transactions contain embedded derivatives. The embedded derivative feature in our funds withheld treaties is similar to a fixed-rate total return swap on the assets held by the ceding companies.

During the year ended December 31, 2008, we reinsured equity-indexed annuity reinsurance contracts, with account values credited with a return indexed to an equity index rather than established interest rates. Under FASB ASC 815-15-55, which now incorporates Derivatives Implementation Group Issue No. B10 “Embedded Derivatives: Equity-Indexed Life Insurance Contracts”, these transactions contained embedded derivatives. These contracts were recaptured in 2008, eliminating the associated embedded derivative balance of \$81.4 million and resulting in a pre-tax gain of \$35.2 million.

The fair value of these embedded derivatives at December 31, 2009, was a liability of \$35.7 million compared to a liability of \$347.5 million at December 31, 2008, and is included in embedded derivatives at fair value on the Consolidated Balance Sheets. This represents a reclassification from prior years where these embedded derivatives were included in accounts payable and other liabilities. The reclassification provides better disclosure for our liabilities held at fair value. See Note 5 “Fair Value Measurements”. The change in fair value of embedded derivatives is reported in the Consolidated Statements of Income (Loss) under the caption “Change in value of embedded derivatives, net”.

#### *Assessment of Risk Transfer for Structured Insurance and Reinsurance Contracts*

For both ceded and assumed reinsurance, risk transfer requirements must be met in order to obtain reinsurance status for accounting purposes, principally resulting in the recognition of cash flows under the contract as premiums and losses. To meet risk transfer requirements, a reinsurance contract must include insurance risk, consisting of both underwriting and timing risk, and a reasonable possibility of a significant loss for the assuming entity. To assess risk transfer for certain contracts, we generally develop expected discounted cash flow analyses at contract inception. If risk transfer requirements are not met, a contract is accounted for using the deposit method. Deposit accounting requires that consideration received or paid be recorded in the Consolidated Balance Sheets as opposed to premiums written or losses incurred in the Consolidated Statements of Income (Loss) and any non-refundable fees earned based on the terms of the contract.

For each of our reinsurance contracts, the Company must determine if the contract provides indemnification against loss or liability relating to insurance risk, in accordance with applicable accounting standards. We must review all contractual features, particularly those that may limit the amount of insurance risk to which we are subject or features that delay the timely reimbursement of claims. If we determine that a contract does not expose us to a reasonable possibility of a significant loss from insurance risk, we record the contract on a deposit method of accounting with the net amount payable/receivable reflected in other reinsurance assets or liabilities on the Consolidated Balance Sheets. Fees earned on the contracts are reflected as other revenues, as opposed to premiums, on the Consolidated Statements of Income (Loss).

#### *Revenue Recognition*

- (i) Reinsurance premiums from traditional life policies and annuity policies with life contingencies generally are recognized as revenue when due from policyholders and reported net of amounts

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 2. Summary of Significant Accounting Policies (continued)

retroceded. Traditional life policies include those contracts with fixed and guaranteed premiums and benefits, and principally consist of whole life and term insurance policies.

- (ii) Benefits and expenses, net of amounts retroceded, are matched with net earned premiums so as to result in the recognition of profits over the life of the contracts. This is achieved by means of the provision for liabilities for future policy benefits and deferral and subsequent amortization of deferred acquisition costs.
- (iii) Reinsurance assumed for interest sensitive and investment type products does not generate premium but generates investment income on the assets we receive from ceding companies less policy charges for the cost of insurance, policy administration, and surrenders that have been assessed against policy account balances during the period.
- (iv) Fee income is recorded on an accrual basis.
- (v) Net investment income includes interest and dividend income together with amortization of market premium and discounts and is net of investment management and custody fees.

#### *Present Value of In-force Business*

The present value of in-force business is established upon the acquisition of a book of business and is amortized over the expected life of the business as determined at acquisition. The amortization each year is a function of the ratio of annual gross profits or revenues to total anticipated gross profits or revenues expected over the life of the business, discounted at the assumed net credit rate (4.9% for 2009, 2008 and 2007). The carrying value is reviewed for premium deficiency at least annually for indicators of impairment in value.

#### *Reserves for Future Policy Benefits*

FASB ASC Topic 944, Financial Services – Insurance (“FASB ASC 944”), formerly SFAS No. 60 “Accounting and Reporting by Insurance Enterprises” (“SFAS No. 60”), applies to our traditional life policies with continuing premiums. For these policies, reserves for future policy benefits are computed based upon expected mortality rates, lapse rates, investment yields, expenses and other assumptions established at policy issue, including a margin for adverse deviation. Once these assumptions are made for a given treaty or group of treaties, they will not be changed over the life of the treaty. We periodically review actual historical experience and relative anticipated experience compared to the assumptions used to establish reserves for future policy benefits. Further, we determine whether actual and anticipated experience indicates that existing policy reserves, together with the present value of future gross premiums are sufficient to cover the present value of future benefits, settlement and maintenance costs and to recover unamortized acquisition costs. Significant changes in experience or assumptions may require us to provide for expected losses on a group of treaties by establishing additional net reserves. Because of the many assumptions and estimates used in establishing reserves and the long-term nature of the reinsurance contracts, the reserving process, while based on actuarial science, is inherently uncertain.

On certain lines of business, policy benefit reserves include an estimate of claims payable for incurred but not reported (“IBNR”) losses. Those IBNR loss estimates are determined using some or all of the following: studies of actual claim lag experience, best estimates of expected incurred claims in a period, actual reported claims, and best estimates of IBNR losses as a percentage of current in-force.

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 2. Summary of Significant Accounting Policies (continued)

##### *Deferred Acquisition Costs*

Costs of acquiring new business, which vary with and primarily are related to the production of new business, have been deferred to the extent that such costs are deemed recoverable from future gross profits. Such costs include commissions and allowances as well as certain costs of policy issuance and underwriting. We perform periodic tests to determine that the cost of business acquired remains recoverable, and if financial performance significantly deteriorates to the point where a premium deficiency exists, the cumulative amortization is re-estimated and adjusted by a cumulative charge to current operations.

Deferred acquisition costs ("DAC") related to traditional life insurance contracts, substantially all of which relate to long-duration contracts, are amortized in proportion to the ratio of individual period premium revenues to total anticipated premium revenues over the life of the policy. Such anticipated premium revenues are estimated using the same assumptions used for computing liabilities for future policy benefits. The deferral of acquisition costs are established for limited premium policies under the same practices as used for traditional life policies with the exception that any gross premium in excess of the net premium is deferred and recognized into income as a constant percentage of insurance in-force.

DAC related to interest-sensitive life and investment-type policies are deferred and amortized over the lives of the policies, in relation to the present value of estimated gross profits from mortality and investment income, less interest credited and expense margins without provision for adverse deviation. Each reporting period, we update the estimated gross profits with the actual gross profits for that period. When actual gross profits change from previously estimated gross profits, the cumulative DAC amortization is recalculated and adjusted by a cumulative charge or credit to current operations. When actual gross profits exceed those previously estimated, the DAC amortization will increase, resulting in a current period charge to earnings. The opposite result occurs when the actual gross profits are below the previously estimated gross profits. In circumstances where calculated gross profits are negative, we record the actual gross profits at zero. This is necessitated by the declining level of asset market values, which now flow through earnings under the trading classification.

In addition, we review the future estimated gross profit for each block of business to determine the recoverability of DAC balances based on future expectations. Changes in the assumptions for mortality, persistency, maintenance expense and interest could result in material changes to the financial statements. When expected future gross profits are below those previously estimated, the DAC amortization will increase, resulting in a current period charge to earnings. The opposite result occurs when the expected future gross profits are above the previously estimated future gross profits.

Total DAC amortization during a particular period may increase or decrease depending upon the relative size of the amortization change resulting from the adjustment to DAC for the update of actual gross profits and the re-estimation of expected future gross profits.

Modifications or exchanges of contracts that constitute a substantial contract change are accounted for as an extinguishment of the replaced contract resulting in a release of unamortized deferred acquisition costs, unearned revenue and deferred sales inducements associated with the replaced contract.

The development and amortization of deferred acquisition costs for our products requires management to make estimates and assumptions. Actual results could differ materially from those estimates. Management monitors actual experience, and should circumstances warrant, will revise its assumptions and the related estimates.

##### *Retrocession Arrangements and Amounts Recoverable from Reinsurers*

In the ordinary course of business, our reinsurance subsidiaries cede reinsurance to other reinsurance companies. These agreements provide greater diversification of business and minimize the net loss potential arising

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 2. Summary of Significant Accounting Policies (continued)

from large risks. Ceded reinsurance contracts do not relieve us of our obligation to the direct writing companies. The cost of reinsurance related to long duration contracts is recognized over the terms of the reinsured policies on a basis consistent with the reporting of those policies.

In the normal course of business, we seek to limit our exposure to losses on any single insured and to recover a portion of benefits paid by ceding reinsurance to other insurance enterprises or reinsurers under excess coverage and quota share contracts. In order to manage short term volatility in our earnings and diversify our mortality exposure, we limit our exposure on any given life.

Our initial North American retention limit was set at \$500,000 per life. With the acquisition of ERC Life Reinsurance Corporation in December 2003 (subsequently renamed Scottish Re Life Corporation (“SRLC”)), we set retention for that block of business at \$1,000,000 per life, effective July 1, 2004. On December 31, 2004, we acquired the former individual life business of ING Re which had managed a per life retention up to \$5,000,000. Effective January 1, 2005, we established a per life retention on the ING Re acquired business of \$2,000,000, while raising retention for new issues to \$1,000,000. This organic new business retention was increased to \$2,000,000 per life for 2007. In 2009, the former individual life business of ING Re was purchased by Hannover Re as part of the Acquired Business. See Note 14, “Reinsurance-Sale of a Block of Life Reinsurance North America Business”.

In May 2006, we entered into an agreement that provided \$155 million of collateralized catastrophe protection with Tartan Capital Management (“Tartan”), a special purpose Cayman Islands company funded by a catastrophe bond transaction, for terrorism, nuclear, biological and chemical risks on our entire retained life reinsurance business. The coverage period ran from January 1, 2006 to December 31, 2008, and provided SALIC with protection from losses arising from higher than normal mortality levels within the United States, as reported by the U.S. Center for Disease Control and Prevention or other designated reporting agency. This coverage was based on a mortality index, which in turn was based on age and gender weighted mortality rates for the United States constructed from publicly available data sources, as defined at inception of the transaction, and which compared the mortality rates over consecutive two year periods to a reference index value. We have not renewed this cover due to the reduced size of our retained business.

Amounts recoverable from reinsurers includes the balances due from reinsurance companies for claims and policy benefits that will be recovered from reinsurers, based on contracts in-force, and are presented net of a reserve for uncollectible reinsurance that has been determined based upon a review of the financial condition of the reinsurers and other factors. The method for determining the reinsurance recoverable involves actuarial estimates as well as a determination of our ability to cede claims and policy benefits under our existing reinsurance contracts. The reserve for uncollectible reinsurance is based on an estimate of the amount of the reinsurance recoverable balance that we will ultimately be unable to recover due to reinsurer insolvency, a contractual dispute or any other reason.

The methods used to determine the reinsurance recoverable balance, and related bad debt provision, continually are reviewed and updated and any resulting adjustments are reflected in earnings in the period identified. At December 31, 2009 and 2008, we had a reserve for uncollectible reinsurance of \$5.0 million and \$4.5 million, respectively.

#### *Interest Sensitive Contract Liabilities*

The liabilities for interest sensitive contract liabilities equal the accumulated account values of the policies or contracts as of the valuation date and include funds received plus interest credited less funds withdrawn and interest paid. Benefit liabilities for fixed annuities during the accumulation period equal their account values; after annuitization, they equal the discounted present value of expected future payments.

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 2. Summary of Significant Accounting Policies (continued)

FASB ASC 944, which incorporates SFAS No. 97 “Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments” (“SFAS No. 97”), applies to investment contracts, limited premium contracts, and universal life-type contracts. For investment and universal life-type contracts, future benefit liabilities are held using the retrospective deposit method, increased for amounts representing unearned revenue or refundable policy charges. Should the liabilities for future policy benefits plus the present value of expected future gross premiums for a product be insufficient to provide for expected future benefits and expenses for that product, deferred acquisition costs will be written off and thereafter, if required, a premium deficiency reserve will be established by a charge to income.

#### *Income Taxes*

Income taxes are recorded in accordance with FASB ASC Topic 740, Income Taxes (“FASB ASC 740”), formerly SFAS No. 109, “Accounting for Income Taxes” (“SFAS No. 109”). In accordance with FASB ASC 740, for all years presented we use the asset and liability method to record deferred income taxes. Accordingly, deferred income tax assets and liabilities are recognized that reflect the net tax effect of the temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes, using enacted tax rates. Such temporary differences are primarily due to tax basis of reserves, DACs, unrealized investment losses and net operating loss carry forwards. A valuation allowance is applied to deferred tax assets if it is more likely than not that all, or some portion, of the benefits related to the deferred tax assets will not be realized.

#### *Stock-based Compensation*

We account for our stock-based compensation in accordance with FASB ASC Topic 718, Compensation – Stock Compensation (“FASB ASC 718”), formerly SFAS No.123(R) “Share Based Payment” (“SFAS No. 123(R)”), using the modified-prospective transition method.

#### *Funds Withheld at Interest*

Funds withheld at interest are funds held by ceding companies under modified coinsurance and funds withheld coinsurance agreements whereby we receive the interest income earned on the funds. The balance of funds held represents the statutory reserves of the ceding companies with the assets supporting these reserves retained by the ceding company and managed for our account. Interest accrues to these assets at rates defined by the treaty terms. These agreements are considered to include embedded derivatives as further discussed in this Note. In addition to our modified coinsurance and funds withheld coinsurance agreements, we have entered into various financial reinsurance treaties that, although considered funds withheld, do not transfer significant insurance risk and are recorded on a deposit method of accounting.

#### *Other Assets*

Other assets primarily include unamortized debt issuance costs, interest rate swap derivative, collateral finance facility costs, certain deferred transaction costs, funds on deposit as security for certain collateral finance facilities, and fixed assets

As of December 31, 2009 and 2008, we had unamortized collateral finance facilities costs and debt issuance costs of approximately \$21.8 million and \$24.5 million, respectively. During 2009, 2008 and 2007, we amortized collateral finance facilities costs and debt issuance costs of \$2.6 million, \$6.8 million and \$11.9 million, respectively. Debt issuance costs relating to our long term debt were fully amortized in 2009. In 2008, we wrote off collateral finance facilities costs related to Ballantyne Re (\$21.3 million), Clearwater Re (as defined in Note 10, “Collateral Finance Facilities and Securitization Structures-*Clearwater Re*”) (\$10.3 million), HSBC II (as defined in Note 10, “Collateral Finance Facilities and Securitization Structures-*HSBC II*”) (\$4.8 million) and our reinsurance

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 2. Summary of Significant Accounting Policies (continued)

facility (\$4.6 million). There were no write offs of collateral finance facilities costs in 2007. Deferred costs relating to the collateralized catastrophe protection with Tartan were fully amortized in 2008. During 2008 and 2007, we amortized \$1.4 million and \$1.4 million of these deferred costs respectively.

#### *Other Liabilities*

Other liabilities primarily relate to collateral facility accrued interest, deferred guarantee fees and uncertain income tax liabilities (FASB ASC 740-10, formerly FIN 48).

#### *Long Term Debt at Fair Value*

Long term debt at fair value relates to amounts outstanding on the Pass-Through Certificates. See Note 11, "Debt Obligations and Other Funding Arrangements".

#### *Earnings per Share*

In accordance with FASB ASC Topic 260, Earnings per Share ("FASB ASC 260"), formerly SFAS Statement No. 128 "Earnings Per Share" ("SFAS No. 128"), and EITF No. 03-06, "Participating Securities and the Two-Class Method under FASB Statement No. 128", basic earnings per share is computed based on the weighted average number of ordinary shares outstanding and assumes an allocation of net income to the Convertible Cumulative Participating Preferred Shares for the period or portion of the period that this security is outstanding. During the year ended December 31, 2007, we determined that in accordance with FASB ASC Subtopic 470-20, Debt – Debt with Conversion and Other Options ("FASB ASC 470-20"), which incorporates EITF 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios", and EITF 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments", the non-cash beneficial conversion feature recorded on issue of the Convertible Cumulative Participating Preferred Shares amounting to \$120.8 million should be treated as a deemed dividend and deducted from the net loss attributable to ordinary shareholders for the purposes of calculating earnings per share.

Under the provisions of FASB ASC 260, formerly SFAS No. 128, basic earnings per share are computed by dividing the net loss attributable to ordinary shareholders by the weighted average number of shares of our ordinary shares outstanding for the period. Diluted earnings per share is calculated based on the weighted average number of shares of ordinary shares outstanding plus the diluted effect of potential ordinary shares in accordance with the if-converted method.

#### 3. Recent Accounting Pronouncements

#### *FASB ASC Consolidation Section 810-10-65, Consolidation – Overall – Transition and Open Effective Date Information (formerly FASB Statement No. 160, Noncontrolling Interest in Consolidated Financial Statements)*

In December 2007, the FASB issued FASB ASC Consolidation Section 810-10-65, Consolidation – Overall – Transition and Open Effective Date Information ("FASB ASC 810-10-65") formerly SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements — an amendment of Accounting Research Bulletin ("ARB") No. 51" ("SFAS No. 160"), which aims to improve the relevance, comparability and transparency of the financial information that a reporting entity provides in its consolidated financial statements by establishing accounting and reporting standards surrounding noncontrolling interests, or minority interests, which are the portions of equity in a subsidiary not attributable, directly or indirectly, to a parent. The ownership interests in subsidiaries held by parties other than the parent shall be clearly identified, labeled and presented in the Consolidated Statement of Financial Position within equity, but separate from the parent's equity. The amount of consolidated net income attributable to the parent and to the noncontrolling interest must be clearly identified and presented on the face of the Consolidated Statements of Income (Loss). Changes in a parent's ownership interest

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 3. Recent Accounting Pronouncements (continued)

while the parent retains its controlling financial interest in its subsidiary must be accounted for consistently as equity transactions. A parent's ownership interest in a subsidiary changes if the parent purchases additional ownership interests in its subsidiary, sells some of its ownership interests in its subsidiary, the subsidiary reacquires some of its ownership interests or the subsidiary issues additional ownership interests. When a subsidiary is deconsolidated, any retained noncontrolling equity investment in the former subsidiary must be initially measured at fair value. The gain or loss on the de-consolidation of the subsidiary is measured using the fair value of any noncontrolling equity investment rather than the carrying amount of that retained investment. Entities must provide sufficient disclosures that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. FASB ASC 810-10-65 was effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. We included the enhanced disclosures required by FASB ASC 810-10-65 in our consolidated financial statements.

#### ***FASB ASC Topic 820, Fair Value Measurements and Disclosures (formerly FASB Statement No. 157, Fair Value Measurements)***

As of January 1, 2008, we adopted FASB ASC Topic 820, Fair Value Measurements and Disclosures ("FASB ASC 820"), formerly SFAS No. 157 "*Fair Value Measurements*" ("SFAS No. 157"). This statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. The adoption of FASB ASC 820 did not have a material impact on our consolidated financial statements.

#### ***FASB ASC Section 815-10-65, Derivatives and Hedging – Overall – Transition and Open Effective Date Information (formerly FASB Statement No. 161, Disclosures about Derivative Instruments and Hedging Activities)***

In March 2008, the FASB issued FASB ASC Section 815-10-65, Derivatives and Hedging – Overall – Transition and Open Effective Date Information ("FASB ASC 815-10-65"), formerly SFAS No. 161 "*Disclosures About Derivative Instruments and Hedging Activities*" ("SFAS No. 161"). FASB ASC 815-10-65 establishes reporting standards that require enhanced disclosures about how and why derivative instruments are used, how derivative instruments are accounted for under FASB ASC Topic 815, Derivatives and Hedging, and how derivative instruments affect an entity's financial condition, financial performance, and cash flows. FASB ASC 815-10-65 was effective for fiscal years, and interim periods within those fiscal years, beginning on or after November 15, 2008. The adoption of FASB ASC 815-10-65 did not have a material effect on our consolidated financial statements.

#### ***FASB ASC Subtopic 860-40, Transfers and Servicing – Transfers to Qualifying Special Purpose Entities (which incorporate FSP FAS No. 140-4 and FIN 46(R)-8, Enhanced Disclosure Requirements Related to Transfers of Financial Assets and Variable Interest Entities)***

In December 2008, the FASB issued FSP FAS 140-4 and FIN 46(R)-8, "*Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities*" ("FSP 140-4"), which are now incorporated in FASB ASC Subtopic 860-40, Transfers and Servicing – Transfers to Qualifying Special Purpose Entities ("FASB ASC 860-40"). FASB ASC 860-40 amends FASB Statement No. 140 "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" ("SFAS No. 140") to require additional disclosures regarding a transferor's continuing involvement with transferred financial assets in a securitization or asset-backed financing arrangement. FASB ASC 860-40 also amends FIN 46 (revised December 2003) "Consolidation of Variable Interest Entities," to expand the disclosure requirements for variable interest entities ("VIEs") to include information regarding the decision to consolidate the VIE, the nature of and changes in risks related to a VIE, and the impact on the entity's financial statements due to the involvement with a VIE. Those variable interests required to comply with the guidance in FASB ASC 860-40 include the primary beneficiary of the VIE, the holder of a significant variable interest and a sponsor that holds a variable interest. Further, FASB ASC 860-40 requires enhanced disclosures for certain sponsors and holders of a significant variable interest in a qualifying special purpose entity. The provisions of FASB ASC 860-40 were effective for the first reporting period

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 3. Recent Accounting Pronouncements (continued)

ending after December 15, 2008, and comparative disclosures were not required. We included the enhanced disclosures required by FASB ASC 860-40 in the notes to the consolidated financial statements beginning in the reporting period ended December 31, 2008, and there have been no significant changes to disclose in 2009.

See Note 10, "Collateral Finance Facilities and Securitization Structures" for more information regarding our involvement with VIEs.

#### ***FASB ASC Section 820-10-65, Fair Value Measurements and Disclosures – Overall – Transition and Open Effective Date Information (formerly FSP FAS No. 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly)***

In April 2009, the FASB issued FASB ASC Section 820-10-65, Fair Value Measurements and Disclosures – Overall – Transition and Open Effective Date Information ("FASB ASC 820-10-65"), formerly FSP FAS No. 157-4, "Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly" ("FSP No. 157-4"). FASB ASC 820-10-65 provides additional guidance for estimating fair value in accordance with SFAS No. 157, emphasizing that even if there has been significant decrease in the volume and level of activity for the asset or liability and regardless of valuation technique(s) used, the objective of a fair value measurement remains the same. FASB ASC 820-10-65 shall be effective for interim and annual reporting periods ending after June 15, 2009 and shall be applied prospectively. Early adoption is permitted for periods ending after March 15, 2009. Earlier adoption for periods ending before March 15, 2009 is not permitted. The adoption of FASB ASC 820-10-65 did not have a material effect on our consolidated financial statements.

#### ***FASB ASC Section 825-10-65, Financial Instruments – Overall – Transition and Open Effective Date Information (formerly FSP FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments)***

In April 2009, the FASB issued FASB ASC Section 825-10-65, Financial Instruments – Overall – Transition and Open Effective Date Information ("FASB ASC 825-10-65"), formerly FSP FAS No. 107-1 and APB No. 28-1. "Interim Disclosures about Fair Value of Financial Instruments" (FSP No. 107-1 and APB No. 28-1"). FASB ASC 825-10-65 was issued to require disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements, and for those disclosures at interim reporting periods to be in a format that summarized financial information. FASB ASC 825-10-65 shall be effective for interim reporting periods ending after June 15, 2009, with early adoption permitted ending after March 15, 2009. We included the annual summarized financial information disclosure required by FASB ASC 825-10-65 in Note 6, "Fair Value of Financial Instruments" of the consolidated financial statements.

#### ***FASB ASC Topic 855, Subsequent Events (formerly FASB Statement No. 165, Subsequent Events)***

In May 2009, the FASB issued FASB ASC Topic 855, Subsequent Events ("FASB ASC 855"), formerly SFAS No. 165, "Subsequent Events" ("SFAS No. 165"). This statement is intended to establish general standards of accounting for and disclosure of events that occur after the balance sheet date, but before the financial statements are issued or are available to be issued. FASB ASC 855 requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for the date – that is, whether that date represents the date the financial statements were issued or were available to be issued. This disclosure should alert all users of financial statements that an entity has not evaluated subsequent events after the date in the set of financial statements being presented. The Company adopted FASB ASC 855 during the second quarter of 2009 and evaluates subsequent events through the date its financial statements are filed. The adoption of this standard did not have an impact on our consolidated financial statements.

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 3. Recent Accounting Pronouncements (continued)

##### ***FASB ASC Topic 105, Generally Accepted Accounting Principles (formerly FASB Statement No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles-a replacement of FASB Statement No. 162)***

In June 2009, the FASB issued FASB ASC Topic 105, Generally Accepted Accounting Principles (“FASB ASC 105”), formerly SFAS No. 168, “*The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles-a replacement of FASB Statement No. 162*” (“FASB No. 168”). This statement is a replacement of SFAS No. 162 “*The Hierarchy of Generally Accepted Accounting Principles*” and aims to establish the FASB ASC as the source of authoritative accounting principles and the framework for selecting the principles used in the preparation of financial statements of non-governmental entities that are presented in conformity with U.S. GAAP. FASB ASC 105 is effective for financial statements for interim or annual periods ending on or after September 15, 2009. FASB ASC 105 will have no impact on our consolidated financial statements as it only changes the referencing of financial accounting standards and does not change or alter existing U.S. GAAP.

##### ***Accounting Standards Update No. 2009-05, Fair Value Measurements and Disclosures (Topic 820) – Measuring Liabilities at Fair Value***

In August 2009, the FASB issued Accounting Standards Update No. 2009-05, Fair Value Measurements and Disclosures (Topic 820) – Measuring Liabilities at Fair Value (“ASU No. 2009-05”). This update provides amendments to FASB ASC Subtopic 820-10, Fair Value Measurement and Disclosures-Overall, for the fair value measurement of liabilities. ASU No. 2009-05 provides clarification in using valuation techniques for measuring fair value of liabilities, estimating the fair value of a liability and also clarifies Level 1 fair value measurements of a liability. ASU No. 2009-05 is effective for the first reporting period (including interim periods) beginning after its August 2009 issuance. The adoption of ASU No. 2009-05 did not have a material impact on our consolidated financial statements.

##### ***Accounting Standards Update No. 2009-17, Consolidations (Topic 810) – Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities***

In December 2009, the FASB issued Accounting Standards Update No. 2009-17, Consolidations (Topic 810) – Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities (“ASU No. 2009-17”). ASU No. 2009-17 replaces the quantitative-based risks and rewards calculation for determining which reporting entity, if any, has a controlling financial interest in a variable interest entity with an approach focused on identifying which reporting entity has the power to direct the activities of a variable interest entity that most significantly impact the entity’s economic performance and the obligation to absorb losses of, and the right to receive benefits from, the entity. This update also requires additional disclosures about a reporting entity’s involvement in variable interest entities which will enhance the information provided to users of financial statements. ASU No. 2009-17 is effective as of the beginning of each reporting entity’s first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. Earlier application is prohibited. We are currently reviewing ASU No. 2009-17 to determine whether this will have an impact on our consolidated financial statements.

##### ***Accounting Standards Update No. 2010-02, Consolidation (Topic 810) - Accounting and Reporting for Decreases in Ownership of a Subsidiary – A Scope Clarification***

In January 2010, the FASB issued Accounting Standards Update No. 2010-02, Consolidation (Topic 810) - Accounting and Reporting for Decreases in Ownership of a Subsidiary – A Scope Clarification (“ASU No. 2010-02”). ASU No. 2010-02 provides amendments to Subtopic 810-10 and related guidance within U.S. GAAP to clarify the scope of the decrease in ownership provisions of the Subtopic related guidance. It also clarifies that the decrease in ownership guidance does not apply to certain transactions even if they involve businesses. ASU No. 2010-02 is

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 3. Recent Accounting Pronouncements (continued)

effective beginning in the period that an entity adopts SFAS No. 160 (now included in Subtopic 810-10). If an entity has previously adopted SFAS No. 160 as of the date the amendments in this update are included in the ASC, ASU No. 2010-02 is effective in the first interim or annual reporting period ending on or after December 15, 2009 and applied retrospectively to the first period that an entity adopted SFAS No. 160. The adoption of ASU No. 2010-02 did not have an impact on our consolidated financial statements.

#### *Accounting Standards Update No. 2010-06, Fair Value Measurements and Disclosures (Topic 820) – Improving Disclosures about Fair Value Measurements*

In January 2010, the FASB issued Accounting Standards Update No. 2010-06, Fair Value Measurements and Disclosures (Topic 820) – Improving Disclosures about Fair Value Measurements (“ASU No. 2010-06”). ASU No. 2010-06 provides more robust disclosures about the different classes of assets and liabilities measured at fair value, the valuation techniques and inputs used, the activity in Level 3 fair value measurements and the transfers between Levels 1, 2 and 3. ASU No. 2010-06 is effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances and settlements in the roll forward of activity in Level 3 fair value measurements. These disclosures are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. We are currently evaluating the potential impact of the adoption of ASU No. 2010-06 on our consolidated financial statements.

#### *Accounting Standards Update No. 2010-09, Subsequent Events (Topic 855) – Amendments to Certain Recognition and Disclosure Requirements*

In February 2010, the FASB issued Accounting Standards Update No. 2010-09, Subsequent Events (Topic 855) – Amendments to Certain Recognition and Disclosure Requirements (“ASU No. 2010-09”). ASU No. 2010-09 addresses both the interaction of the requirements of FASB ASC 855 with the SEC’s reporting requirements and the intended breadth of the reissuance disclosures provision related to subsequent events. It also has the potential to change reporting by both private and public entities, however, the nature of the change may vary depending on facts and circumstances. ASU No. 2010-09 is effective upon issuance of the final update, except for the use of the issued date for conduit debt obligors which is effective for interim or annual periods ending after June 15, 2010. As we are not an SEC filer, ASU No. 2010-09 did not have a material impact on our consolidated financial statements.

#### 4. Investments

Effective January 1, 2008, our invested assets were classified as trading and the balances in fixed maturity investments - available-for-sale and preferred stock – available-for-sale were transferred to trading securities. Additionally, as of January 1, 2008, the balance of unrealized appreciation on investments, which previously was included in accumulated other comprehensive income (loss), was reclassified and recorded in the Consolidated Statement of Income (Losses) caption “Net realized and unrealized (gains) losses”.

Trading investments are recorded at fair market value. Unrealized holding gains and losses on trading investments are included in earnings. Interest is recorded based upon the stated coupon rate as a component of net investment income. For securities with uncertain cash flow, the investments are accounted for under the cost recovery method, whereby all principal and coupon payments received are applied as a reduction of the carrying value. Cash flows for trading securities are classified in Investing Activities on the Consolidated Statements of Cash Flows based on the nature and purpose for which the related securities were acquired.

The portion of net unrealized gains and losses for the year ended December 31, 2009 and 2008, that relates to trading securities still held at the reporting date is \$140.6 million gains and \$1,874.8 million losses, respectively.

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**4. Investments (continued)**

The portion of net unrealized losses in respect of trading securities still held at the reporting date using Level 3 measurements (for more information on Level 3, see Note 5 – “Fair Value Measurements”) for the year ended December 31, 2009 and 2008, is \$65.7 million and \$1,492.9 million, respectively.

The estimated fair values of our held for trading fixed maturity investments and preferred stock at December 31, 2009 and 2008 are as follows:

<b>(U.S. dollars in thousands)</b>	<b>December 31, 2009</b>	<b>December 31, 2008</b>
U.S. Treasury securities and U.S. government agency obligations.....	\$ 104,643	\$ 109,795
Corporate securities .....	1,166,251	1,593,499
Municipal bonds .....	43,803	49,549
Mortgage and asset backed securities .....	1,673,467	2,028,261
Preferred stock .....	77,410	79,767
<b>Total.....</b>	<b>\$ 3,065,574</b>	<b>\$ 3,860,871</b>

The contractual maturities of the held for trading fixed maturities and preferred stock at December 31, 2009 and 2008 are as follows (actual maturities may differ as a result of calls and prepayments):

<b>(U.S. dollars in thousands)</b>	<b>Estimated Fair Value December 31, 2009</b>	<b>Estimated Fair Value December 31, 2008</b>
Due in one year or less .....	\$ 177,986	\$ 155,369
Due after one year through five years.....	519,981	514,226
Due after five years through ten years .....	302,329	455,511
Due after ten years.....	391,811	707,504
	1,392,107	1,832,610
Mortgage and asset backed securities .....	1,673,467	2,028,261
<b>Total.....</b>	<b>\$ 3,065,574</b>	<b>\$ 3,860,871</b>

During the year ended December 31, 2007, we reviewed available-for-sale securities with material unrealized losses and tested for other-than-temporary impairments on a quarterly basis. Factors involved in the determination of potential impairment include fair value as compared to cost, length of time the fair value has been below cost, credit worthiness and forecasted financial performance of the issuer, position of the security in the issuer’s capital structure, the presence and estimated value of collateral or other credit enhancement, length of time to maturity, the level and volatility of interest rates and our intent and ability to hold the security until the estimated fair value recovers. When a decline is considered to be “other-than-temporary”, the cost basis of the impaired asset is adjusted to its fair value and a corresponding realized investment loss recognized in the Consolidated Statements of Income (Loss).

U.S. GAAP required that we evaluate for each impaired security in respect of which the estimated fair value is less than its amortized cost whether we have the intent and ability to hold the security for a reasonable time for a forecasted recovery of the fair value up to the amortized cost of the investment. This required us to consider our capital and liquidity requirements, any contractual or regulatory obligations, and the implications of our strategic initiatives that might indicate that securities may need to be sold before the forecasted recovery of fair value occurs.

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**4. Investments (continued)**

We did not meet the necessary conditions to assert the intent and ability to hold securities with unrealized losses for a period of time sufficient to allow for a recovery in their value as of December 31, 2007. In accordance with FASB ASC Topic 320, Investments – Debt and Equity Securities (“FASB ASC 320”), we recorded \$777.1 million as part of net realized investment losses in the Consolidated Statements of Income (Loss) during 2007 to recognize other-than-temporary impairments in securities that we no longer could positively assert our intent and ability to hold to recovery of fair value.

During the year ended December 31, 2007, fixed maturity investments and preferred stock available-for-sale securities with a fair value at the date of sale of \$290.3 million were sold.

During the year ended December 31, 2007, fixed maturity investments and preferred stock available-for-sale securities which were below amortized cost were sold at losses of \$12.6 million.

At December 31, 2007, our available-for-sale fixed income portfolio had 11,053 positions. Of these positions, there were none trading at an unrealized loss.

Due to other-than-temporary impairment charges recognized by us in the year ended December 31, 2007, there were no fixed maturity investments or preferred stock that have estimated fair values below amortized cost or cost as of December 31, 2007.

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**4. Investments (continued)**

The analysis of realized and unrealized gains (losses) and the change in net unrealized (depreciation) appreciation on investments and other balances for the years ended December 31, 2009, 2008 and 2007 are as follows:

<b>(U.S. dollars in thousands)</b>	<b>Year Ended December 31, 2009</b>	<b>Year Ended December 31, 2008</b>	<b>Year Ended December 31, 2007</b>
<b>Gross realized and unrealized gains (losses)</b>			
<b>Fixed maturities</b>			
Gross realized gains.....	\$ 118,234	\$ 37,257	\$ 2,911
Gross realized (losses) .....	(8,888)	(33,863)	(13,149)
Net unrealized gains (losses) .....	132,295	(1,866,490)	-
Other-than-temporary impairments .....	-	-	(952,315)
	<u>241,641</u>	<u>(1,863,096)</u>	<u>(962,553)</u>
<b>Preferred stock</b>			
Gross realized gains.....	2,687	138	1
Gross realized (losses) .....	(270)	(87)	(1,732)
Net unrealized gains (losses) .....	8,306	(8,324)	-
Other-than-temporary impairments .....	-	-	(9,441)
	<u>10,723</u>	<u>(8,273)</u>	<u>(11,172)</u>
<b>Other</b>			
Foreign currency (losses).....	(360)	(149)	(356)
Deferred acquisition costs.....	-	-	5,112
Change in value of interest rate swap .....	(6,907)	-	-
Interest rate swap investment income .....	3,180	-	-
Realized losses on modco treaties .....	(5,628)	(19,374)	(2,582)
Other .....	341	(5,003)	(1,369)
Net realized and unrealized gains (losses) .....	<u>242,990</u>	<u>(1,895,895)</u>	<u>(972,920)</u>
<b>Change in net unrealized (depreciation) appreciation on investments</b>			
Fixed maturities .....	-	(38,392)	75,252
Preferred stock.....	-	(59)	2,793
Change in deferred acquisition costs .....	-	5,442	(14,428)
Change in deferred income taxes.....	-	6,495	(17,229)
Change in net unrealized (depreciation) appreciation on investments .....	<u>-</u>	<u>(26,514)</u>	<u>46,388</u>
Change in net unrealized appreciation (depreciation) attributable to noncontrolling interest .....	<u>-</u>	<u>204</u>	<u>(454)</u>
Total net realized and unrealized gains (losses) and change in net unrealized (depreciation) appreciation on investments and other balances .....	<u>\$ 242,990</u>	<u>\$ (1,922,205)</u>	<u>\$ (926,986)</u>

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**4. Investments (continued)**

Net investment income for the years ended December 31, 2009, 2008 and 2007 was derived from the following sources:

<b>(U.S. dollars in thousands)</b>	<b>Year Ended December 31, 2009</b>	<b>Year Ended December 31, 2008</b>	<b>Year Ended December 31, 2007</b>
Fixed maturities .....	\$ 138,971	\$ 288,877	\$ 443,943
Preferred stock .....	5,250	5,618	6,564
Funds withheld at interest .....	34,694	73,747	104,055
Other investments .....	3,300	16,881	43,056
Investment expenses .....	(5,292)	(7,819)	(11,289)
Net investment income .....	<u>\$ 176,923</u>	<u>\$ 377,304</u>	<u>\$ 586,329</u>

We are required to maintain assets on deposit with various regulatory authorities to support our insurance and reinsurance operations. These requirements are promulgated in the statutory regulations of the individual jurisdictions. The assets on deposit are available to settle insurance and reinsurance liabilities. We also utilize trust funds in certain transactions where the trust funds are established for the benefit of the ceding companies and generally take the place of letter of credit (“LOC”) requirements. At December 31, 2009 and 2008, such assets included fixed maturities at the estimated fair value of \$2,349 million and \$3,537 million, respectively, and cash and cash equivalents of \$219 million and \$616 million, respectively. This includes controlled assets within collateral finance facilities that we consolidate. See Note 10, “Collateral Finance Facilities and Securitization Structures”. The estimated fair value of these assets, as at December 31, 2009, total \$1,001 million of investments compared to \$1,776 million at December 31, 2008, and \$115 million of cash and cash equivalents compared to \$452 million in the prior year. These assets are held for the contractual obligations of these structures and for the regulatory obligations of our reinsurance operations and are not available for general corporate purposes.

The components of the estimated fair value of the total consolidated invested restricted assets at December 31, 2009 and 2008 are as follows:

<b>(U.S. dollars in thousands)</b>	<b>December 31, 2009</b>	<b>December 31, 2008</b>
Deposits with U.S. regulatory authorities .....	\$ 15,863	\$ 15,267
Trust funds .....	2,552,590	4,137,617
	<u>\$ 2,568,453</u>	<u>\$ 4,152,884</u>

**5. Fair Value Measurements**

We adopted FASB ASC 820 as of January 1, 2008. FASB ASC 820 establishes a framework for measuring fair value, establishes a fair value hierarchy based on the quality of inputs used to measure fair value, and enhances disclosure requirements for fair value measurements.

The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under FASB ASC 820 are described below:

Level 1 – Quoted prices for identical instruments in active markets.

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 5. Fair Value Measurements (continued)

Level 2 – Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets.

Level 3 – Model derived valuations in which one or more significant inputs or significant value drivers are unobservable.

As required by FASB ASC 820, when the inputs used to measure fair value fall within different levels of the hierarchy, the level within which the fair value measurement is categorized is based on the lowest level input that is significant to the fair value measurement in its entirety. Thus, a Level 3 fair value measurement may include inputs that are observable (Level 1 and 2) and unobservable (Level 3).

Level 1 primarily consists of financial instruments whose value is based on quoted market prices such as stocks and actively traded mutual fund investments.

Level 2 includes those financial instruments that are valued by independent pricing services or valued using models or other valuation methodologies. These models primarily are industry-standard models that consider various inputs, such as interest rate, credit spread and foreign exchange rates for the underlying financial instruments. All significant inputs are observable, or derived from observable, information in the marketplace or are supported by observable levels at which transactions are executed in the marketplace. Financial instruments in this category primarily include: certain public and private corporate fixed maturity and equity securities; government or agency securities; certain mortgage and asset-backed securities; and securities held as collateral.

Level 3 is comprised of financial instruments whose fair value is estimated based on non-binding brokerage prices or internally developed models or methodologies utilizing significant inputs not based on, or corroborated by, readily available market information. This category primarily consists of certain less liquid fixed maturity and equity securities where we cannot corroborate the significant valuation inputs with market observable data. Additionally, our embedded derivatives, all of which are associated with reinsurance treaties, are classified in Level 3 since their values include significant unobservable inputs associated with actuarial assumptions regarding policyholder behavior. Embedded derivatives are reported with the host instruments in the Consolidated Balance Sheets.

At each reporting period, all assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. Our assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability, such as the relative impact on the fair value as a result of including a particular input.

The majority of our fixed maturity and equity securities use Level 2 inputs for the determination of fair value. These fair values are obtained primarily from independent pricing services, when available, utilizing Level 2 inputs. Where pricing services do not provide fair values, the pricing services utilize proprietary pricing models to produce estimates of fair value primarily utilizing Level 2 inputs along with certain Level 3 inputs.

The proprietary pricing models include matrix pricing where we discount expected cash flows utilizing market interest rates obtained from third-party sources based on the credit quality and duration of the instrument to determine fair value. For securities that may not be reliably priced using internally developed pricing models, broker quotes are obtained. These broker quotes represent an exit price but the assumptions used to establish the fair value may not be observable and represent Level 3 inputs.

Long term debt at fair value has been valued using Level 2 input for the determination of fair value. The fair value was derived with reference to traded prices for identical liabilities.

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**5. Fair Value Measurements (continued)**

The interest rate swap derivative has been valued using Level 2 inputs including forward interest rates derived from observable information in the market place.

The embedded derivatives results from assumed modified coinsurance (“modco”) or coinsurance funds withheld reinsurance arrangements. These values are based upon the difference between the fair value of the underlying assets backing the modco or funds withheld receivable and the fair value of the underlying liabilities.

The fair value of the assets generally is based upon observable market data using valuation methods similar to those used for assets held directly by us. The fair value of the liabilities is determined by using market observable swap rates as well as some unobservable inputs such as actuarial assumptions regarding policyholder behavior. These assumptions require significant management judgment.

The fair value is determined by using the Income Approach as characterized by FASB ASC 820. This method estimates the value of future equity purchases using certain actuarial assumptions and margins. The actuarial assumptions include factors that generally are not observable such as policyholder behavior, explicit risk margins related to non-capital market inputs, and future interest margins. These assumptions require significant management judgment.

The following tables set forth our assets and liabilities that are measured at fair value on a recurring basis as of the date indicated:

(U.S. dollars in millions)	December 31, 2009			
	Total	Level 1	Level 2	Level 3
Investments .....				
Government securities .....	\$ 104.6	\$ -	\$ 104.4	\$ 0.2
Corporate securities .....	1,166.3	-	1,033.0	133.3
Municipal bonds .....	43.8	-	43.8	-
Mortgage and asset backed securities .....	1,673.5	-	1,200.7	472.8
Preferred stock .....	77.4	-	24.0	53.4
Equity .....	3.7	3.7	-	-
Derivatives – interest rate swap .....	25.9	-	25.9	-
Total assets at fair value .....	\$ 3,095.2	\$ 3.7	\$ 2,431.8	\$ 659.7
Embedded derivatives .....	(35.7)	-	-	(35.7)
Long term debt at fair value .....	(55.1)	-	(55.1)	-
Total liabilities at fair value .....	\$ (90.8)	\$ -	\$ (55.1)	\$ (35.7)

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**5. Fair Value Measurements (continued)**

	<b>December 31, 2008</b>			
<b>(U.S. dollars in millions)</b>	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
Investments .....				
Government securities .....	\$ 109.8	\$ -	\$ 103.1	\$ 6.7
Corporate securities .....	1,593.5	-	1,452.2	141.3
Municipal bonds .....	49.6	-	49.6	-
Mortgage and asset backed securities .....	2,028.2	-	1,303.2	725.0
Preferred stock .....	79.8	-	31.2	48.6
Total assets at fair value .....	<u>\$ 3,860.9</u>	<u>\$ -</u>	<u>\$ 2,939.3</u>	<u>\$ 921.6</u>
Embedded derivatives .....	(347.5)	-	-	(347.5)
Total liabilities at fair value .....	<u>\$ (347.5)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ (347.5)</u>

The following table presents additional information about assets measured at fair value on a recurring basis and for which we have utilized significant unobservable (Level 3) inputs to determine fair value:

**Fair Value Measurements Using Significant Unobservable Inputs  
(Level 3)**

<b>(U.S. dollars in millions)</b>	<b>Fixed Maturities &amp; Preferred Stock</b>	<b>Other Liabilities at Fair Value – Embedded Derivatives</b>	<b>Total</b>
Beginning balance at January 1, 2009 .....	\$ 921.6	\$ (347.5)	\$ 574.1
Transfers attributable to deconsolidation of Ballantyne Re .....	(108.6)	-	(108.6)
Total realized and unrealized gains (losses) included in net income .....	(16.9)	311.8	294.9
Purchases, issuances and settlements .....	(43.8)	-	(43.8)
Transfers in and/or out of Level 3 .....	(92.6)	-	(92.6)
Ending balance at December 31, 2009 .....	<u>\$ 659.7</u>	<u>\$ (35.7)</u>	<u>\$ 624.0</u>

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**5. Fair Value Measurements (continued)**

**Fair Value Measurements Using Significant Unobservable Inputs  
(Level 3)**

<b>(U.S. dollars in millions)</b>	<b>Fixed Maturities &amp; Preferred Stock</b>	<b>Other Liabilities at Fair Value – Embedded Derivatives</b>	<b>Interest Sensitive Contract Liabilities – Embedded Derivatives</b>	<b>Total</b>
Beginning balance at January 1, 2008 .....	\$ 2,552.6	\$ (38.5)	\$ (93.0)	\$ 2,421.1
Total realized and unrealized gains (losses) included in net loss .....	(1,472.6)	(309.0)	11.6	(1,770.0)
Purchases, issuances and settlements .....	(125.7)	-	81.4	(44.3)
Transfers in and/or out of Level 3 .....	(32.7)	-	-	(32.7)
Ending balance at December 31, 2008 .....	<u>\$ 921.6</u>	<u>\$ (347.5)</u>	<u>\$ -</u>	<u>\$ 574.1</u>

We review the fair value hierarchy classifications quarterly. Changes in the observability of the valuation attributes may result in a reclassification of certain financial assets or liabilities. Such reclassifications are reported as transfers in and out of Level 3 at the beginning fair value for the reporting period in which the changes occur.

**6. Fair Value of Financial Instruments**

As discussed above, fair value of financial assets and liabilities is estimated under FASB ASC 820 using the following methods and assumptions:

(i) Fixed maturity investments and preferred stock are carried at fair value. See Note 5, “Fair Value Measurements” for a description of the methodologies and assumptions used to determine the fair value of financial instruments carried at fair value.

(ii) Other investments carrying value approximates fair value.

(iii) Funds withheld at interest represent fixed maturity investments held by ceding companies and the fair values are consistent with the methodologies and assumptions used to determine the fair value of fixed maturities carried at fair value.

(iv) Fair values for collateral finance facilities prioritize the utilization of market value observable inputs. For any notes issued by the collateral finance facilities that are wrapped by guarantors, we defined the unit of value as the combination of the issued note and guarantee. As a result, the fair value of the collateral finance facilities incorporates the value of the guarantee, including consideration of the non-performance risk of the guarantors.

(v) Fair value of the interest rate swap derivative has been calculated with reference to observable market inputs. See Note 5, “Fair Value Measurements” for a description of the methodologies and assumptions used to determine the fair value of financial instruments carried at fair value.

(vi) Long term debt at fair value (“i.e. outstanding Pass-Through Certificates [held by third parties]”) have been derived with reference to traded prices for identical liabilities. See Note 5, Fair Value Measurements” for a description of the methodologies and assumptions used to determine the fair value of financial instruments carried at fair value.

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**6. Fair Value of Financial Instruments (continued)**

(vii) Fair values for our long term debt of trust preferred securities were determined with reference to similar quoted securities and settlements of other Company long term debt during 2009. In 2008, the fair values for our long term debt were determined by a third party service provider.

(viii) Interest sensitive contract liabilities include amounts payable under funding agreements and investment contracts. The fair value for amounts payable under funding agreements was determined by a third party service provider with reference to similar quoted securities. The fair value of investment contracts, which exclude significant mortality risk, is based on the cash surrender value of the liabilities as an approximation of the exit market.

(ix) Embedded derivatives are carried at fair value. See Note 5, "Fair Value Measurements" for a description of the methodologies and assumptions used to determine the fair value of financial instruments carried at fair value.

(U.S. dollars in thousands)	December 31, 2009		December 31, 2008	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
<b>Assets</b>				
Fixed maturity investments.....	\$ 2,988,164	\$ 2,988,164	\$ 3,781,104	\$ 3,781,104
Preferred stock .....	77,410	77,410	79,767	79,767
Other investments .....	21,482	21,482	18,112	18,112
Funds withheld at interest (excluding cash).....	608,500	513,419	1,748,768	1,474,183
Derivatives – interest rate swap .....	25,924	25,924	-	-
<b>Liabilities</b>				
Collateral finance facilities .....	\$ 1,300,000	\$ 907,710	\$ 3,000,000	\$ 1,861,229
Long term debt at fair value .....	55,068	55,068	-	-
Long term debt.....	129,500	32,375	129,500	62,000
Amounts payable under funding agreements.....	-	-	425,159	185,000
Investment contracts .....	1,518,365	1,485,554	1,600,395	1,554,817
Embedded derivatives.....	35,732	35,732	347,519	347,519

**7. Funds Withheld at Interest**

For agreements written on a modco basis and certain agreements written on a funds withheld coinsurance basis, asset values recorded in the Consolidated Balance Sheets are equal to the net statutory reserve fund balances with the assets backing the reserves retained by the ceding company and managed for our account, including the reporting of amortized costs and fair value on the portfolio. The amounts in the funding accounts are adjusted quarterly to equal the net statutory reserve balances.

At December 31, 2009 and 2008, funds withheld at interest were in respect of six contracts with four ceding companies. At December 31, 2009, we had three contracts with two companies within the Lincoln Financial Group (two contracts with Lincoln National Life Insurance Company and one contract with Lincoln Life & Annuity Company of New York) that accounted for \$501 million (2008 - \$535 million) or 82% (2008 – 31%) of the funds withheld balances. Additionally, we had one contract with Inviva that accounted for \$70 million or 12% of the funds withheld balances. In 2008, we had one contract with SLDI that accounted for \$1,165 million or 67% of the funds

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**7. Funds Withheld at Interest (continued)**

withheld balances. This is now with Hannover Re as part of the Acquired Business transaction, effective January 1, 2009. See Note 14, "Reinsurance-Sale of a Block of Life Reinsurance North America Business". The remaining contracts were with Illinois Mutual Life Company and American Founders Life Insurance Company. Lincoln National Life Insurance Company has a financial strength rating of "A+" from A.M. Best and Lincoln Life & Annuity Company of New York has a financial strength rating of "NR-5" from A.M. Best, both as at December 31, 2009. In the event of insolvency of the ceding companies on these arrangements, we would need to make a claim on the assets supporting the contract liabilities. However, the risk of loss is mitigated by our ability to offset amounts owed to the ceding company with the amounts owed to us by the ceding company. Reserves for future policy benefits and interest sensitive contract liabilities relating to these contracts amounted to \$608 million and \$1,749 million at December 31, 2009 and 2008, respectively.

**8. Deferred Acquisition Costs**

The following reflects the amounts of policy acquisition costs deferred and amortized:

<b>(U.S. dollars in thousands)</b>	<b>December 31, 2009</b>	<b>December 31, 2008</b>
Balance beginning of year .....	\$ 375,475	\$ 581,131
Deferred acquisition costs associated with Ballantyne Re no longer included in the financial statements of SRGL due to de-consolidation	(711)	-
Expenses deferred .....	1,906	16,677
Amortization expense .....	(79,848)	(227,775)
Deferred acquisition costs on unrealized gains and losses .....	-	5,442
Deferred acquisition costs on realized losses .....	-	-
Balance at end of year .....	<u>\$ 296,822</u>	<u>\$ 375,475</u>

The amortization expenses in 2009 include negative amounts of \$24.9 million attributable to the recaptures made in 2009 on a portion of the Acquired Business sold to Hannover Re, in addition to accelerated DAC unlocking of \$15.5 million on the Financial Solutions business associated with realized gains incurred in the year.

Included in the 2008 amortization expense is the aggregate write-off of deferred acquisition costs on two significant recaptures of \$76 million and the retrocession of the Clearwater Re business of \$75 million.

**9. Present Value of In-force Business**

A reconciliation of the present value of in-force business is as follows:

<b>(U.S. dollars in thousands)</b>	<b>December 31, 2009</b>	<b>December 31, 2008</b>
Balance at beginning of year .....	\$ 40,105	\$ 41,859
Amortization .....	(1,789)	(1,754)
Balance at end of year .....	<u>\$ 38,316</u>	<u>\$ 40,105</u>

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**9. Present Value of In-force Business (continued)**

A reconciliation of the gross amount of present value of in-force business and the accumulated amount of amortization, in total, is as follows:

<b>(U.S. dollars in thousands)</b>	<b>December 31, 2009</b>
Gross amount of present value of in-force business .....	\$ 56,272
Accumulated amortization.....	(17,956)
Net amount of present value of in-force business .....	<u>\$ 38,316</u>

Future estimated amortization of the present value of in-force business is as follows:

<b>(U.S. dollars in thousands)</b>	
<b>Year ending December 31</b>	
2010 .....	\$ 3,256
2011 .....	2,980
2012 .....	2,512
2013 .....	2,338
2014 .....	2,064
Thereafter.....	25,166
	<u>\$ 38,316</u>

**10. Collateral Finance Facilities and Securitization Structures**

***Orkney Re, Inc.***

On February 11, 2005, Orkney Holdings, LLC, a Delaware limited liability company (“Orkney I”), issued and sold in a private offering an aggregate of \$850 million Series A Floating Rate Insured Notes due February 11, 2035 (the “Orkney Notes”). Orkney I was organized for the limited purpose of issuing the Orkney Notes and holding the stock of Orkney Re, Inc., originally a South Carolina special purpose financial captive insurance company, now a Delaware special purpose captive insurance company (“Orkney Re”). SRUS holds all of the limited liability company interest in Orkney I, and has contributed capital to Orkney I in the amount of \$268.5 million. Proceeds from this offering were used to fund the Valuation of Life Insurance Policies Model Regulation (“Regulation XXX”) reserve requirements for a defined block of level premium term life insurance policies issued by direct ceding companies between January 1, 2000 and December 31, 2003, and reinsured by SRUS to Orkney Re. Proceeds from the Orkney Notes have been deposited into a series of accounts that collateralize the notes and the reserve obligations of SRUS.

The holders of the Orkney Notes have no recourse against us or any of our subsidiaries, other than Orkney I. The timely payment of interest and ultimate payment of principal for the Orkney Notes are guaranteed by MBIA Insurance Corporation (“MBIA”).

Interest on the principal amount of the Orkney Notes is payable quarterly at a rate equivalent to three-month LIBOR plus 0.53%. At December 31, 2009, the interest rate was 0.80% (compared to 2.82% at December 31, 2008). Any payment of principal, including by redemption, or interest on the Orkney Notes is sourced from dividends from Orkney Re, and the balances available in a series of trust accounts generally excluding amounts on deposit in a reinsurance trust account supporting the associated reserve requirements of SRUS. Dividends only may be made after filing with the Commissioner in accordance with the terms of Orkney Re’s licensing order and in

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 10. Collateral Finance Facilities and Securitization Structures (continued)

accordance with applicable law. The Orkney Notes also contain a customary limitation on lien provisions and customary events of default provisions, which, if breached, could result in the accelerated maturity of the Orkney Notes. Orkney I has the option to redeem all or a portion of the Orkney Notes prior to and on or after February 11, 2010, subject to certain call premiums.

In accordance with FASB ASC 810-10, Orkney I is considered to be a variable interest entity and we are considered to hold the primary beneficial interest following a quantitative analysis whereby it was determined that we would absorb a majority of the expected losses. As a result, Orkney I is consolidated in our financial statements. The assets of Orkney I have been recorded as fixed maturity investments and cash and cash equivalents. Our Consolidated Statements of Income (Loss) shows the investment return of Orkney I as investment income and the cost of the facility is reflected in collateral finance facilities expense. Funds in the securitization structure are used for the sole purpose of the securitization structure and hence not available for general corporate purposes. See Note 4, "Investments".

To the extent that we continue to experience fair value declines in our investment portfolio, we may need to recapture a pro-rata portion of the underlying business in Orkney I and find alternative collateral support for the recaptured business. No assurances can be given that we would be successful in securing alternative collateral support.

#### *Orkney Re, Inc. Notices of Default*

On February 9, 2009, MBIA served Orkney Re, Orkney I and SRUS with notices of default under each of the Orkney I indenture and the insurance and indemnity agreement (the "Orkney Insurance Agreement"), alleging failure by the parties to provide certain required financial statements and improper withdrawals by the parties from Orkney I tax accounts. SRUS cured such alleged defaults within the cure periods set forth in the indenture and the Orkney Insurance Agreement.

On September 21, 2009, MBIA served Orkney Re, Orkney I and SRUS with a notice of default under the restructuring agreement executed at the time of Orkney Re's redomestication from South Carolina to Delaware, alleging failure by the parties to provide MBIA with an actuarial review in accordance with the requirements set forth in the restructuring agreement. SRUS, Orkney I and Orkney Re disagree with such contention. However, in the event such alleged failure to provide an actuarial review ultimately were determined to be a default, and because not cured within five (5) business days of the September 21, 2009 notice, then such default would constitute an event of default under the Orkney Insurance Agreement, which in turn would provide certain enhanced contractual rights to MBIA under the Orkney Insurance Agreement, including the right to recover from Orkney I any actual losses, costs and expenses incurred by MBIA in connection with the event of default and the receipt of certain penalty fees. Pursuant to the terms of a letter agreement put in place between SRUS and MBIA at the time of the Orkney I transaction, SRUS then would be obligated to pay on behalf of Orkney I certain of the foregoing fees and expenses to the extent due from Orkney I. As of December 31, 2009, MBIA, Orkney Re, Orkney I and SRUS were engaged in negotiations related to such actuarial review and alleged default.

For further discussion on notices of default related to Orkney Re and Orkney I, see Note 25, "Subsequent Events".

#### **Orkney Re II plc**

On December 21, 2005, Orkney Re II plc, a special purpose vehicle incorporated under the laws of Ireland ("Orkney Re II"), whose issued ordinary shares are held by a share trustee and its nominees in trust for charitable purposes, issued in a private offering \$450 million of debt to external investors. The debt consisted of \$382.5

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 10. Collateral Finance Facilities and Securitization Structures (continued)

million of Series A-1 Floating Rate Guaranteed Notes (the "Series A-1 Notes"), \$42.5 million of Series A-2 Floating Rate Notes (the "Series A-2 Notes"), and \$25 million of Series B Floating Rate Notes (the "Series B Notes"), all due December 31, 2035 (collectively, the "Orkney Re II Notes"). The Orkney Re II Notes are listed on the Irish Stock Exchange. Proceeds from this offering were used to fund the Regulation XXX reserve requirements for a defined block of level premium term life insurance policies issued between January 1, 2004 and December 31, 2004 reinsured by SRUS to Orkney Re II. Proceeds from the Orkney Re II Notes have been deposited into a series of accounts that collateralize the notes and the reserve obligations of SRUS.

The holders of the Orkney Re II Notes have no recourse against us or any of our subsidiaries. Assured Guaranty (UK) Ltd. ("Assured") has guaranteed the timely payment of the scheduled interest payments and the principal on the maturity date of the Series A-1 Notes.

The debt issued to SALIC consisted of \$30 million of Series C Floating Rate Notes ("Series C Notes") due December 21, 2036, and \$5 million of Series B Notes. These Series C Notes accrue interest only until the Orkney Re II Notes are fully repaid. SRGL owns \$0.5 million Series D Convertible Notes due December 21, 2036, and 76,190,000 Preference Shares of \$1.00 each in capital.

Interest on the principal amount of the Orkney Re II Notes is payable quarterly at a rate equivalent to three-month LIBOR plus 0.425% for the Series A-1 Notes, three-month LIBOR plus 0.73% for the Series A-2 Notes, and three-month LIBOR plus 3.0% for the Series B Notes. At December 31, 2009, the interest rate on the Series A-1 Notes was 0.70% (compared to 2.72% at December 31, 2008), Series A-2 Notes was 1.00% (compared to 3.02% at December 31, 2008), and Series B Notes was 3.27% (compared to 5.29% at December 31, 2008). The Orkney Re II Notes also contain customary limitation on lien provisions and customary events of default provisions, which, if breached, could result in the accelerated maturity of the Orkney Re II Notes. Orkney Re II has the option to redeem all or a portion of the Orkney Re II Notes, subject to certain call premiums and available (unencumbered) funds.

In accordance with FASB ASC 810-10, Orkney Re II is considered to be a variable interest entity and we are considered to hold the primary beneficial interest following a quantitative analysis whereby it was determined that we would absorb a majority of the expected losses. As a result, Orkney Re II is consolidated in our financial statements. The assets of Orkney Re II have been recorded as fixed maturity investments and cash and cash equivalents. Our Consolidated Statements of Income (Loss) shows the investment return of Orkney Re II as investment income and the cost of the securitization structure is reflected in collateral finance facilities expense. Funds in the securitizations are primarily used for the purpose of the securitizations and hence not available for general corporate purposes. See Note 4, "Investments".

In May 2008, we executed amendments to certain transaction documents to give us flexibility in dealing with additional near term estimated fair value declines in the sub-prime and Alt-A securities held by Orkney Re II. The amendments eliminate certain priority of payment limitations and provide us greater flexibility to recapture business from Orkney Re II.

To the extent that we continue to experience fair value declines in our investment portfolio, we may need to recapture a pro-rata portion of the underlying business in Orkney Re II and find alternative collateral support for the recaptured business. No assurances can be given that we would be successful in securing alternative collateral support.

#### *Orkney Re II Event of Default, Acceleration and Foreclosure*

On the scheduled interest payment date on May 11, 2009, Orkney Re II was unable to make scheduled interest payments on the Series A-1 Notes. Failure to make such payments in full when due constitutes an event of default under the Orkney Re II indenture ("Orkney EOD"). Assured, in its capacity as financial guarantor of the Series A-1 Notes, made guarantee payments on the Series A-1 Notes in the amount of \$1.2 million. As a result of the Orkney

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 10. Collateral Finance Facilities and Securitization Structures (continued)

EOD, Assured obtained, and will continue to have, certain enhanced contractual rights under the transaction documents and additional fees will be accrued for the guarantee coverage.

Among Assured's enhanced contractual rights are (a) the right to instruct the trustee to declare the principal of and the interest on all the Notes to be due and payable immediately and (b) the right to foreclose upon the Collateral (as defined in the related indenture). On June 1, 2009, Assured instructed the trustee to accelerate the Notes and the trustee delivered a notice of acceleration to Orkney Re II on June 18, 2009. On June 19, 2009, Assured notified Orkney Re II and the trustee that it was electing to foreclose upon the Collateral.

Following these actions, on June 26, 2009, SRUS exercised its contractual right under its agreements with Orkney Re II to withdraw all assets from the reserve credit trust established by Orkney Re II for the benefit of SRUS. The withdrawn assets were deposited into SRUS segregated accounts pursuant to the terms of the reinsurance agreement between SRUS and Orkney Re II (the "Orkney Re II Reinsurance Agreement") where they are held in order to provide reserve credit to SRUS for the reinsurance liabilities that continue to be ceded to Orkney Re II and for certain other permissible uses under the Orkney Re II Reinsurance Agreement. The transfer of assets had no impact on our consolidated financial statements.

On the scheduled interest payment dates of August 11, 2009 and November 12, 2009, Orkney Re II was unable to make scheduled interest payments on the Series A-1 Notes. Assured made guarantee payments on the Series A-1 Notes in the amount of \$1.4 million and \$0.9 million, for August 11, 2009 and November 12, 2009, respectively.

For further discussion on the Orkney Re II scheduled interest payments on the Series A-1 Notes, see Note 25, "Subsequent Events".

#### **HSBC II**

On December 22, 2005, we entered into an agreement with HSBC for a 20 year collateral finance facility ("HSBC II") that provided up to \$934 million of financing for the purpose of collateralizing intercompany reinsurance obligations on a portion of the business acquired from the ING Companies subject to Regulation XXX reserve requirements. Simultaneously, we entered into a total return swap with HSBC under which we were entitled to the total return of the investment portfolio of the trust established for this facility. In accordance with FASB ASC 810-10, the trust associated with this facility was considered to be a variable interest entity and we were deemed to hold the primary beneficial interest in the trust following a quantitative analysis whereby it was determined that we would absorb a majority of the expected losses. As a result, the trust was consolidated in our financial statements. The total return swap represents a variable interest in the underlying trust, and therefore all fair value movements eliminate upon consolidation. Our Consolidated Statements of Income (Loss) showed the investment return of the trust as investment income and the cost of the facility was reflected in collateral finance facilities expense. Funds in this facility were used solely for the purpose of the facility and hence not available for general corporate purposes.

On June 30, 2008, we executed a forbearance agreement with HSBC in respect to the HSBC II facility as previously disclosed whereby HSBC agreed to forbear taking action until December 15, 2008. In order to achieve forbearance, we agreed to certain economic and non-economic terms, including forbearance payments to HSBC, the contribution by SALIC of additional collateral to the transaction, limitations on future fundings by HSBC under the facility, and the requirement to achieve certain milestones set by HSBC related to, among other things, the sale of our Life Reinsurance North America Segment, all of which significantly increased constraints on our available capital and liquidity.

In connection with the HSBC II facility, on September 30, 2008, we entered into a binding letter of intent (the "HSBC II LOI") with ING and the ING Companies. Pursuant to the HSBC II LOI, SLD consented to the recapture by SRUS of the business (such recaptured business, the "HSBC II Recaptured Business") that had been ceded by SRUS to Scottish Re (Dublin) Limited ("SRD") for the purpose of collateralizing (with financing provided by the

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 10. Collateral Finance Facilities and Securitization Structures (continued)

HSBC II collateral finance facility) the Regulation XXX reserve requirements for a portion of the business originally acquired by us from the ING Companies at the end of 2004 (such portion related to the HSBC II collateral finance facility, the “HSBC II Business”) effective as of September 30, 2008 (the “HSBC II Recapture”).

On October 15, 2008, we and certain of our subsidiaries entered into a series of transactions with an effective date of September 30, 2008 to unwind the HSBC II facility. In connection with the unwind transactions, HSBC was repaid in full from assets within the collateral finance facility that secured the obligations to HSBC. We also paid a \$6 million fee pursuant to the related forbearance agreement and paid a make-whole fee of \$4 million (reduced from the amount contractually owed to HSBC), and the facility and the forbearance agreement and its terms were terminated. Following the consummation of the HSBC II Recapture, SLD recaptured the HSBC II Recaptured Business from SRUS and then ceded the HSBC II Recaptured Business to SLDI, which ceded the HSBC II Recaptured Business to Scottish Re Life (Bermuda) Limited (“SRLB”).

SLDI agreed to provide, or cause the provision of, one or more letters of credit (“LOCs”) in order to provide SLD with statutory financial statement credit for the excess reserves associated with the HSBC II Recaptured Business over the economic reserves held in an account related thereto. In conjunction with the HSBC II Recaptured Business, the ING Companies initially provided approximately \$650 million of LOCs, with an obligation to provide additional LOCs as needed. As consideration, we agreed to bear the costs of the LOCs by paying to SLD a facility fee based on the face amount of such LOCs outstanding as of the end of the preceding calendar quarter. Upon closing the transactions contemplated by the Purchase Agreement (as defined herein) for the Acquired Business, the obligation to pay these LOC fees transferred to Hannover Re. The recapture transaction recorded during the period ended September 30, 2008, based on the HSBC II LOI, resulted in no impact to the Consolidated Balance Sheets or Consolidated Statements of Income (Loss) on a consolidated GAAP basis. On October 15, 2008, when the HSBC II collateral facility was unwound, we returned to HSBC \$558.5 million to relieve the liabilities and fees associated with the facility. This resulted in a pre-tax loss of \$10.3 million. Both the unwind and the related GAAP loss were recorded as components of fourth quarter 2008 results because the unwind was not effectuated until October 2008.

On December 19, 2008, the final phase of the unwind was effected through the retrocession by SLDI of the recaptured business to SRLB. The HSBC II Recaptured Business and related LOC payment obligations were part of the Acquired Business sold to Hannover Re. Assets returned to SRUS in conjunction with the recapture consisted primarily of assets released from the economic account of the associated Reinsurance Trust (supporting the relevant economic reserves).

#### *Ballantyne Re plc*

On May 2, 2006, Ballantyne Re plc, a special purpose vehicle incorporated under the laws of Ireland, issued in a private offering \$1.74 billion of debt to external investors and \$178 million of debt to SALIC.

Interest on the principal amount of the notes issued by Ballantyne Re (the “Ballantyne Notes”) is payable in intervals ranging from every 28 days to monthly to annually, depending on the note, initially at a rate equivalent to one-month LIBOR plus 0.61% for the Class A-1 Floating Rate Notes (and after May 2, 2022, one-month LIBOR plus 1.22%), one-month LIBOR plus 0.31% for the Class A-2 Floating Rate Guaranteed Notes Series A (and after May 2, 2027, one-month LIBOR plus 0.62%), one-month LIBOR plus 0.36% for the Class A-2 Floating Rate Guaranteed Notes Series B (and after May 2, 2027, one-month LIBOR plus 0.72%), 4.99%, 4.99%, 5.00% and 5.01% for Series A, Series B, Series C, and Series D of the Class A-3 Notes, respectively (with the rate on the Class A-3 Notes to reset every 28 days), 7.51% for the Class B-1 Subordinated Notes, one-month LIBOR plus 2.00% for the Class B-2 Subordinated Floating Rate Notes, and a variable rate based on performance of the underlying block of business for the Class C-1 Subordinated Variable Interest Rate Notes and the Class C-2 Subordinated Variable Interest Rate Notes.

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 10. Collateral Finance Facilities and Securitization Structures (continued)

The holders of the Ballantyne Notes have no recourse against us or any of our subsidiaries. The timely payment of the scheduled interest payments and the principal on the maturity date of Series A of the Class A-2 Notes and Series A, Series B, Series C, Series D and, if issued, Series E of the Class A-3 Notes has been guaranteed by Ambac Assurance UK Limited (“Ambac”). The timely payment of the scheduled interest payments and the principal on the maturity date of Series B of the Class A-2 Notes and, if issued, Series F of the Class A-3 Notes has been guaranteed by Assured. Ambac and Assured are referred to collectively in the capacity as guarantors under the Ballantyne Re facility as the “Financial Guarantors”.

Initially, in accordance with FASB ASC 810-10, Ballantyne Re was considered to be a variable interest entity and we were considered to hold the primary beneficial interest following a quantitative analysis whereby it was determined that we would absorb a majority of the expected losses. As a result, Ballantyne Re was consolidated in our financial statements through December 31, 2008. The assets of Ballantyne Re were recorded through December 31, 2008 as fixed maturity investments and cash and cash equivalents. Our Consolidated Statements of Income (Loss) include the investment return of Ballantyne Re as investment income and the cost of the securitization structure was reflected in collateral finance facilities expense through December 31, 2008.

Under the contractual terms of the Ballantyne Re indenture, Ballantyne Re is required to write-off all or a portion of the accrued interest and principal of the Class C-1 and Class C-2 Notes if the equity balance of Ballantyne Re (determined in accordance with International Financial Reporting Standards) falls below a specified amount as of September 30 of any year. In 2007, all of the Class C-2 Notes and a portion of the Class C-1 Notes were written off. As of September 30, 2008 and 2007, such equity balance remained below the specified amount primarily due to further fair market value declines on Ballantyne Re’s investment portfolio. Under the terms of the Ballantyne Re Indenture, principal and accrued interest that were written off resulted in realized gains of \$21.9 million in 2008 and \$27.1 million in 2007, comprising \$19.4 million (2007 - \$20 million) of principal, net of the associated premium and discount, and \$2.5 million (2007 - \$7.1 million) of accrued interest, on the extinguishment of third party debt in accordance with FASB ASC Topic 860, Transfers and Servicing (“FASB ASC 860”), formerly SFAS No. 140 “Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities” (“SFAS No. 140”). As at December 31, 2008, \$nil million of Class C-1 Notes were outstanding.

#### *Ballantyne Re Recaptures*

In 2008, continued erosion in asset values in the Ballantyne Re structure created significant and material market value declines on the assets in Ballantyne Re. A majority of these assets in Ballantyne Re supported the reserve credit taken by SRUS on excess reserve obligations in respect of the business ceded by SRUS to Ballantyne Re. To avoid significant reserve credit shortfalls at SRUS arising from depressed asset values and corresponding need for capital calls from SRUS under its net worth maintenance agreement from SALIC, we entered into negotiations with the ING Companies and the Financial Guarantors to relieve statutory reserve credit shortfalls from the Ballantyne Re structure and avoid future uncertainty relating to asset valuations. These negotiations led to a series of incremental recaptures from Ballantyne Re, and eventually, the full assignment to SLD of SRUS’ reserve credit exposure to the Ballantyne Re structure.

We entered into a binding letter of intent with the ING Companies, effective March 31, 2008 (the “March 31<sup>st</sup> LOI”). Under the March 31<sup>st</sup> LOI, SLD consented to a recapture, as of March 31, 2008, a pro-rata portion of the business that had been ceded by SRUS to Ballantyne Re (all such recaptured business and subsequent recaptures from Ballantyne Re discussed below, collectively, the “Recaptured Business”) for the purpose of collateralizing the Regulation XXX reserves for a portion of the business acquired by us from the ING Companies at the end of 2004 (such portion related to the Ballantyne Re transaction). On May 6, 2008, we completed this transaction and recaptured approximately 29.5% of the Ballantyne Business, effective as of March 31, 2008. Immediately following the consummation of this transaction, SLD recaptured the Recaptured Business from SRUS in exchange for an amount approximately equal to the assets released to SRUS on its recapture from Ballantyne Re, and then ceded the Recaptured Business to SLDI, which ceded the Recaptured Business to SRLB. The market value of the assets

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 10. Collateral Finance Facilities and Securitization Structures (continued)

transferred to the ING Companies in connection with this recapture was \$174.6 million and consisted of assets retained within the economic account of the Ballantyne Re trust. These assets were transferred to the ING Companies and ultimately reinsured back to us on a modified coinsurance and funds withheld basis.

We entered into a subsequent binding letter of intent with the ING Companies, effective June 30, 2008 (the "June 30<sup>th</sup> LOI"). The June 30<sup>th</sup> LOI related to the business that SRUS ceded to Ballantyne Re for the purpose of collateralizing the Regulation XXX reserves for a portion of the Ballantyne Business. Pursuant to the June 30<sup>th</sup> LOI, SLD consented to the recapture by SRUS of a pro-rata portion of the Ballantyne Business effective as of June 30, 2008. On August 11, 2008, we effectuated this transaction and recaptured approximately 15.5% of the Ballantyne Business. Immediately following the consummation of this transaction, SLD recaptured the Recaptured Business from SRUS in exchange for an amount approximately equal to the assets released to SRUS on its recapture from Ballantyne Re, and then ceded the Recaptured Business to SLDI, which ceded the Recaptured Business to SRLB. The market value of the assets transferred to the ING Companies in connection with this recapture was \$95 million and consisted of assets retained within the economic account of the Ballantyne Re trust. These assets were transferred to the ING Companies and ultimately reinsured back to us on a modified coinsurance and funds withheld basis.

On September 30, 2008, we entered into a binding letter of intent with the ING Companies pursuant to SLD consented to the recapture by SRUS, effective as of September 30, 2008, of a pro-rata portion of the business that had been ceded by SRUS to Ballantyne Re for the purpose of collateralizing the Regulation XXX reserves for a portion of the Ballantyne Business. On November 12, 2008, we effectuated this recapture, which comprised approximately 6.5% of the Ballantyne Business. Immediately following the consummation of this transaction, SLD recaptured the Recaptured Business from SRUS in exchange for an amount equal to approximately the assets released to SRUS on its recapture from Ballantyne Re, and then ceded it to SLDI, which in turn immediately retroceded it to SRLB, which in turn immediately retroceded to SALIC. The market value of the assets transferred to the ING Companies in connection with this recapture was \$41.1 million and consisted of assets retained within the economic account of the Ballantyne Re trust. These assets were transferred to the ING Companies and ultimately reinsured back to us on a modified coinsurance and funds withheld basis.

Effective December 31, 2008, the ING Companies recaptured on a pro-rata basis, approximately 11.4% of the original Ballantyne Business. Immediately following this recapture, and effective as of December 31, 2008, SLD ceded the Recaptured Business to SLDI, which in turn immediately retroceded it to SRLB which in turn immediately retroceded it to SALIC. The market value of the assets transferred was \$74.4 million.

As part of each of the recaptures discussed above, SLD ceded the Recaptured Business to SLDI, which ceded the Recaptured Business to SRLB which in turn ceded the Recaptured Business to either SRD or SALIC. SLDI agreed to provide, or cause the provision of, one or more LOCs in order to provide SLD with statutory financial statement credit for the excess reserves associated with the Recaptured Business. The assets released from Ballantyne Re in conjunction with each recapture, which resided in an account at the ING Companies for the benefit of SRLB, and in turn SRD or SALIC, as applicable and the related liabilities were ceded to us on a modified coinsurance and funds withheld coinsurance basis. In conjunction with the four recaptures, the ING Companies initially provided \$843 million of LOCs, with an obligation to provide additional LOCs as needed, which was expected to reach approximately \$926 million at the peak of the XXX reserve requirements. As partial consideration for each of the recaptures, we bore the costs of the LOCs by paying to SLD a facility fee based on the face amount of such LOCs outstanding. The cost of these LOCs was consistent with pricing from our 2004 acquisition agreement with the ING Companies, as amended on May 7, 2007. Upon closing the transactions contemplated by the Purchase Agreement (as defined herein) on February 20, 2009 for the Acquired Business, Hannover Re assumed the business related to the above referenced recaptures as well as the obligation to pay these LOC fees. See Note 14, "Reinsurance-Sale of a Block of Life Reinsurance North America Business" for further discussion related to the sale of the Acquired Business and the related assumption of the Recaptured Business.

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 10. Collateral Finance Facilities and Securitization Structures (continued)

##### *Ballantyne Re Assignment*

In order to permanently remove SRUS' future exposure to reserve credit shortfalls related to Ballantyne Re, we negotiated a transaction with the ING Companies and the Financial Guarantors to transfer SRUS' reinsurance exposure to Ballantyne Re. On November 19, 2008, with an effective date of October 1, 2008, SRUS assigned and novated to SLD the reinsurance agreement and reinsurance trust agreement between SRUS and Ballantyne Re (the "Assignment") as follows: (a) SRUS assigned its existing reinsurance agreement with Ballantyne Re (pursuant to which SRUS retroceded to Ballantyne Re the Ballantyne Business) (the "Pre-Assignment Reinsurance Agreement") to SLD and assigned its existing reinsurance trust agreement with Ballantyne Re to SLD, (b) immediately thereafter, SLD and Ballantyne Re amended and restated that reinsurance agreement (the "Post-Assignment Reinsurance Agreement"), pursuant to which SLD cedes directly to Ballantyne Re the remaining portion of the Ballantyne Business, and amended and restated that reinsurance trust agreement, pursuant to which SLD is the sole beneficiary of the reinsurance trust account maintained by Ballantyne Re, and (c) SLD and SRUS amended and restated their existing reinsurance agreement related to the Ballantyne Business to reflect these changes. Despite the foregoing recaptures and assignment, we have not changed our holdings in the Preferred Shares and Class D Notes in Ballantyne Re.

Following the Assignment, SRUS remains obligated to administer the Ballantyne Business consistent with its obligation to administer the business acquired from the ING Companies at the end of 2004, of which the Ballantyne Business is a part, and SRUS was obligated to provide specified administrative services to Ballantyne Re. However, the obligation to provide reinsurance administration for the Ballantyne Business and the remainder of the business acquired from the ING Companies at the end of 2004 (i.e., the Acquired Business) was transferred to Hannover Re in connection with Hannover Re's acquisition of the Acquired Business.

As part of the Assignment, we also agreed that if SLD recaptured business from Ballantyne Re following the Assignment in order to continue to receive full credit for reinsurance, SLDI would be entitled to cede the Recaptured Business to us, in which case we would bear the costs of the LOCs obtained to support that business as described above. In connection with the sale of the Acquired Business, Hannover Re assumed these obligations, and SLDI therefore has the right to cede any such Recaptured Business to Hannover Re, and Hannover Re will bear the costs of the relevant LOCs.

As discussed in the Disclosure Document, dated January 28, 2009, available on our website at [www.scottishre.com](http://www.scottishre.com), the Assignment does not relieve SRUS of liability for breaches of its representations, warranties, covenants or other obligations that relate to periods before the effective date of the Assignment, and we and SRUS will remain responsible for certain ongoing covenants made for the benefit of Ballantyne Re and the Financial Guarantors. In addition, SRUS has agreed to indemnify and hold harmless SLD and its affiliates for losses and damages incurred arising from the exercise by Ballantyne Re of any right, or from any limitation on the ability of SLD to exercise any right or recover any amount, under the Post-Assignment Reinsurance Agreement to the extent it resulted from, generally certain breaches by SRUS under the Pre-Assignment Reinsurance Agreement, any action or omission by SRUS that causes certain tax events for Ballantyne Re or otherwise causes Ballantyne Re to be in breach of its representations, warranties or covenants or any arbitration award against SRUS that SLD pays on its behalf to avoid termination of the Post-Assignment Reinsurance Agreement.

##### *De-consolidation of Ballantyne Re*

Ballantyne Re was consolidated in our December 31, 2008 and 2007 consolidated financial statements. Effective January 1, 2009, Ballantyne Re no longer is consolidated within the financial statements of SRGL. Pursuant to the Purchase Agreement (as defined herein) for the disposal of the Acquired Business, Hannover Re explicitly agreed to assume the mortality risk for all recaptures of business from Ballantyne Re. Our disposal of the variable interest to absorb mortality risk recaptured from Ballantyne Re under the reinsurance agreement constituted a reconsideration event related to the consolidation of Ballantyne Re under FASB ASC 810-10, Consolidation -

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**10. Collateral Finance Facilities and Securitization Structures (continued)**

Overall (“FASB ASC 810-10”), which incorporates FASB Interpretation No. 46R “Consolidation of Variable Interest Entities – An Interpretation of ARB No. 51” (“FIN 46R”). We subsequently completed a primary beneficiary analysis and concluded that we no longer are the primary beneficiary of Ballantyne Re as defined within FASB ASC 810-10 and, as a result, no longer are consolidating Ballantyne Re into the financial statements of SRGL. The de-consolidation of Ballantyne Re has reduced our consolidated total assets and liabilities by approximately \$885 million and \$2,035 million, respectively, resulting in a one-time non-cash de-consolidation gain of \$1,150 million which we recognized in 2009. This one-time non-cash de-consolidation gain was increased from our previous estimate of \$750 million disclosed in our December 31, 2008 consolidated financial statements primarily for consideration of elimination entries related to our original investment in Ballantyne Re. This gain has no impact on our current or future liquidity position. The following tables reflect the significant balances attributable to Ballantyne Re as at the dates indicated below:

	<u>December 31, 2009*</u>	<u>December 31, 2008**</u>
<b>(U.S. dollars in millions)</b>		
<b>Assets</b>		
Investments .....	\$ 827.9	\$ 641.8
Cash and cash equivalents.....	18.5	235.9
All other assets.....	<u>22.2</u>	<u>7.3</u>
Total assets.....	<u>\$ 868.6</u>	<u>\$ 885.0</u>
<b>Liabilities</b>		
Reserves for future policy benefits .....	\$ 226.8	\$ 241.9
Collateral finance facilities .....	1,700.5	1,700.0
All other liabilities .....	<u>80.3</u>	<u>93.2</u>
Total liabilities .....	<u>\$ 2,007.6</u>	<u>\$ 2,035.1</u>

\*Balances and statement of income (loss) are not consolidated in the consolidated financial statements as of December 31, 2009.

\*\*Balances and statement of income (loss) are consolidated in the consolidated financial statements as of December 31, 2008.

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**10. Collateral Finance Facilities and Securitization Structures (continued)**

	<b>Year Ended</b>	
	<b>December 31, 2009*</b>	<b>December 31, 2008**</b>
<b>(U.S. dollars in millions)</b>		
<b>Revenues</b>		
Premiums earned, net .....	\$ 82.9	\$ 170.0
Investment income, net.....	34.1	89.9
Net realized and unrealized gains (losses)....	50.8	(942.4)
Total revenues .....	<u>\$ 167.8</u>	<u>\$ (682.5)</u>
<b>Expenses</b>		
Claims and other policy benefits .....	\$ 69.6	\$ 59.6
Acquisition costs and other insurance expenses, net.....	21.2	41.9
Operating expenses.....	0.4	0.1
Collateral finance facilities expense .....	65.1	80.2
Total benefits and expenses .....	<u>\$ 156.3</u>	<u>\$ 181.8</u>

\*Balances and statement of income (loss) are not consolidated in the consolidated financial statements as of December 31, 2009.

\*\*Balances and statement of income (loss) are consolidated in the consolidated financial statements as of December 31, 2008.

As of December 31, 2009, we had no remaining direct loss exposure related to Ballantyne Re since our interests in the Ballantyne Re Class D Notes and Preferred Shares are valued at \$0 and are classified as trading securities on the Consolidated Balance Sheets as of December 31, 2009. The Class C Notes were contractually written-off during 2008.

Following the presentation of the de-consolidation of Ballantyne Re discussed herein, we do not intend in future periods to continue to disclose events or matters related to Ballantyne Re except if and to the extent such events have a material relevance to our financial results or condition.

*Ballantyne Re Event of Default*

Beginning with the scheduled interest payment date on January 2, 2009, and continuing until February 3, 2009, Ballantyne Re was unable to make scheduled interest payments on the Class A Notes. Failure to make such payments in full when due constitutes an event of default under the Ballantyne Re indenture (“EOD”). During this default period, Ambac made guarantee payments on the Class A-2 Notes and Class A-3 Notes in the aggregate amount of \$2.4 million and Assured made guarantee payments on the Class A-2 Notes in the aggregate amount of \$0.8 million. On February 9, 2009 a partial recapture of the business was completed by the ceding insurer, thereby lowering the reserve funding requirement and allowing for more available assets to make interest payments. On the following date, Ballantyne Re paid all deferred and accrued interest on the Class A-1 Notes in full, and repaid Ambac and Assured for all guarantee payments made during the default period (plus interest). As a result of the EOD, Ambac and Assured continue to have certain enhanced contractual rights under the transaction documents and additional fees will be accrued for the guarantee coverage.

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 10. Collateral Finance Facilities and Securitization Structures (continued)

##### *Reinsurance Facility*

On December 22, 2005, we entered into a long term reinsurance facility (“Reinsurance Facility”), with a third-party Bermuda-domiciled reinsurer that provided up to \$1 billion of collateral support for a portion of the business acquired from the ING Companies and subject to Regulation XXX reserve requirements. The Bermuda reinsurer provided reserve credit in the form of letters of credit or assets in trust equal to the U.S. statutory reserves. As of December 31, 2008, \$1 billion, compared to \$904.6 million at December 31, 2007, of collateral support was being provided. All of the business included in this Reinsurance Facility formed a part of the Acquired Business, and as such, was acquired by Hannover Re, effective January 1, 2009, in connection with Hannover Re’s acquisition of the Acquired Business. The transfer of the Reinsurance Facility to Hannover Re was accomplished through a series of novation agreements between and among the applicable Company affiliate, the ING Companies and Hannover Re. The facility is not considered a variable interest entity and consequently is not consolidated in our consolidated financial statements.

##### *Clearwater Re Limited*

On June 25, 2007, Clearwater Re Limited (“Clearwater Re”) was incorporated under the laws of Bermuda and issued in a private offering \$365.9 million of Floating Rate Variable Funding Notes due August 11, 2037 to external investors (the “Clearwater Re Notes”). Proceeds from this offering were used to fund the Regulation XXX reserve requirements for a defined block of level premium term life insurance policies issued between January 1, 2004 and December 31, 2006 and reinsured by SRUS. Clearwater Re replaced our first collateral finance facility with HSBC, which we historically referred to as “HSBC I” and which was terminated in its entirety in connection with the creation of the Clearwater Re facility. Prior to its termination, the HSBC I facility had provided \$188.5 million of Regulation XXX reserve funding. Proceeds from the Clearwater Re Notes were deposited into a reinsurance credit trust to collateralize the statutory reserve obligations of the defined block of policies noted above. External investors committed to funding up to \$555 million of the ongoing Regulation XXX collateral requirements on this block.

Payment of interest and principal under the Clearwater Re Notes on the maturity date and following an event of default by Clearwater Re and related acceleration of the Clearwater Re Notes were guaranteed by SALIC and by SRGL. Interest on the principal amount of the Clearwater Re Notes was payable quarterly at a rate equivalent to three month LIBOR plus a spread determined by SALIC’s insurance financial strength rating and SRGL’s senior unsecured credit rating.

In accordance with FASB ASC 810-10, Clearwater Re was considered to be a variable interest entity and we were deemed to hold the primary beneficial interest following a quantitative analysis whereby it was determined that we would absorb a majority of the expected losses. As a result, Clearwater Re was consolidated in our financial statements. The assets of Clearwater Re were recorded as fixed maturity investments and cash and cash equivalents. Our Consolidated Statements of Income (Loss) included the investment return of Clearwater Re as investment income and the cost of the facility was reflected in collateral finance facilities expense. Funds in the Clearwater Re facility were fully used solely for the purpose of the facility and hence not available for general corporate purposes. See Note 4, “Investments”.

On June 30, 2008, we executed forbearance agreements with the relevant bank counterparties to the Clearwater Re facility, whereby such counterparties agreed to forbear taking action until December 15, 2008. In order to achieve forbearance, we agreed to certain economic and non-economic terms, including forbearance payments to the Clearwater Re counterparties, the contribution by SALIC of additional collateral to the transactions, limitations on future fundings by the Clearwater counterparties under the facility, and the requirement to achieve certain milestones set by the counterparties related to, among other things, the sale of our Life Reinsurance North America Segment.

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 10. Collateral Finance Facilities and Securitization Structures (continued)

On August 29, 2008, we completed a full recapture, effective as of July 1, 2008, of the business ceded from SRUS to Clearwater Re and immediately retroceded the recaptured business, also effective as of July 1, 2008, from SRUS to an unaffiliated third party reinsurer which in turn has retroceded to Hannover (Ireland) (collectively, the "Clearwater Re Recapture Transaction"). Effective September 30, 2008, SRUS retroceded the remaining portion of the defined block of business that it had retained at the time of the Clearwater Re transaction to the same third party reinsurer who in turn retroceded such business to Hannover (Ireland). In connection with the Clearwater Re Recapture Transaction, the bank counterparties to the Clearwater Re facility were repaid in full with assets from within the facility, which secured the obligations owed to the bank counterparties. Such assets resided in the excess account of the associated reinsurance trust that supported the relevant excess reserves, and in a surplus account governed by an indenture. Assets returned to SRUS in conjunction with the Clearwater Re Recapture Transaction were primarily released from the economic account of the associated reinsurance trust that supported the relevant economic reserves. We also paid a \$4 million fee to the bank-counterparties and the facility, and the related forbearance agreement and its terms, were terminated. On a consolidated GAAP basis, the Clearwater Re Recapture Transaction and the subsequent retrocession of a related portion of business resulted in a reduction of total assets and total liabilities of approximately \$624 million and \$504 million, respectively, resulting in a GAAP pre-tax loss of \$119.5 million during the year ended December 31, 2008. The loss primarily was comprised of the write-off of deferred acquisition costs of \$75.1 million and a negative ceding commission of \$39.4 million. The foregoing transactions eliminated the associated reserve credit strain in SRUS.

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**10. Collateral Finance Facilities and Securitization Structures (continued)**

*Consolidated collateral finance facilities and securitization structures*

The following table reflects the significant balances attributable to the collateral finance facilities and securitization structures providing collateral support to us as at and for the year ended December 31, 2009:

<b>(U.S. dollars in millions)</b>	<b>Clearwater Re</b>	<b>Orkney I</b>	<b>Orkney Re II</b>	<b>Total</b>
<b>Assets</b>				
Fixed maturity investments	\$ -	\$ 1,001.1	\$ -	\$ 1,001.1
Funds withheld at interest	-	-	303.1	303.1
Cash and cash equivalents	0.3	113.1	1.9	115.3
All other assets .....	-	106.4	60.1	166.5
Total assets .....	<u>\$ 0.3</u>	<u>\$ 1,220.6</u>	<u>\$ 365.1</u>	<u>\$ 1,586.0</u>
<b>Liabilities</b>				
Reserves for future policy benefits	\$ -	\$ 313.0	\$ 118.0	\$ 431.0
Collateral finance facilities	-	850.0	450.0	1,300.0
All other liabilities .....	0.1	5.8	10.8	16.7
Total liabilities .....	<u>\$ 0.1</u>	<u>\$ 1,168.8</u>	<u>\$ 578.8</u>	<u>\$ 1,747.7</u>
<b>Revenues</b>				
Premiums earned, net	\$ -	\$ 96.3	\$ 50.9	\$ 147.2
Investment income, net	0.1	22.7	12.4	35.2
Net realized and unrealized gains (losses) .....	-	71.3	(32.5)	38.8
Net embedded derivative adjustments .....	-	-	19.2	19.2
Total revenues .....	<u>\$ 0.1</u>	<u>\$ 190.3</u>	<u>\$ 50.0</u>	<u>\$ 240.4</u>
<b>Expenses</b>				
Claims and other policy benefits	\$ -	\$ 84.5	\$ 31.5	\$ 116.0
Acquisition costs and other insurance expenses, net	-	22.3	10.9	33.2
Operating expenses .....	-	0.3	0.3	0.6
Collateral finance facilities expense	-	20.4	11.8	32.2
Total benefits and expenses	<u>\$ -</u>	<u>\$ 127.5</u>	<u>\$ 54.5</u>	<u>\$ 182.0</u>

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**10. Collateral Finance Facilities and Securitization Structures (continued)**

The following table reflects the significant balances attributable to the collateral finance facilities and securitization structures providing collateral support to the Company as at and for the year ended December 31, 2008:

(U.S. dollars in millions)	Clearwater Re	Ballantyne Re	Orkney I	Orkney Re II	HSBC II	Total
<b>Assets</b>						
Investments.....	\$ -	\$ 641.8	\$ 887.6	\$ 246.6	\$ -	\$ 1,776.0
Cash and cash equivalents.....	0.3	235.9	148.9	66.7	-	451.8
All other assets.....	-	7.3	117.6	61.3	-	186.2
Total assets.....	<u>\$ 0.3</u>	<u>\$ 885.0</u>	<u>\$ 1,154.1</u>	<u>\$ 374.6</u>	<u>\$ -</u>	<u>\$ 2,414.0</u>
<b>Liabilities</b>						
Reserves for future policy benefits.....	\$ -	\$ 241.9	\$ 306.7	\$ 111.3	\$ -	\$ 659.9
Collateral finance facilities.....	-	1,700.0	850.0	450.0	-	3,000.0
All other liabilities.....	0.2	93.2	8.4	4.3	-	106.1
Total liabilities.....	<u>\$ 0.2</u>	<u>\$ 2,035.1</u>	<u>\$ 1,165.1</u>	<u>\$ 565.6</u>	<u>\$ -</u>	<u>\$ 3,766.0</u>
<b>Revenues</b>						
Premiums earned, net	\$ 48.5	\$ 170.0	\$ 99.4	\$ 54.3	\$ -	\$ 372.2
Investment income, net.....	14.1	89.9	47.3	21.7	14.4	187.4
Net realized and unrealized (losses) gains.....	(12.4)	(961.8)	(239.7)	(202.3)	33.1	(1,383.1)
Gain on extinguishment of third party debt.....	-	19.4	-	-	-	19.4
Total revenues.....	<u>\$ 50.2</u>	<u>\$ (682.5)</u>	<u>\$ (93.0)</u>	<u>\$ (126.3)</u>	<u>\$ 47.5</u>	<u>\$ (804.1)</u>
<b>Expenses</b>						
Claims and other policy benefits.....	\$ 42.3	\$ 59.6	\$ 90.0	\$ 42.9	\$ -	\$ 234.8
Acquisition costs and other insurance expenses, net.....	39.6	41.9	22.2	10.7	-	114.4
Operating expenses....	0.1	0.1	0.7	-	-	0.9
Collateral finance facilities expense....	17.7	80.2	37.9	20.4	14.5	170.7
Total benefits and expenses.....	<u>\$ 99.7</u>	<u>\$ 181.8</u>	<u>\$ 150.8</u>	<u>\$ 74.0</u>	<u>\$ 14.5</u>	<u>\$ 520.8</u>

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**11. Debt Obligations and Other Funding Arrangements**

Long-term debt consists of:

<b>(U.S. dollars in thousands)</b>	<b>December 31, 2009</b>	<b>December 31, 2008</b>
Capital securities due 2032.....	\$ 17,500	\$ 17,500
Preferred trust securities due 2033 .....	20,000	20,000
Trust preferred securities due 2033 .....	10,000	10,000
Trust preferred securities due 2034 .....	32,000	32,000
Trust preferred securities due 2034 .....	50,000	50,000
Long term debt at par value.....	<u>\$ 129,500</u>	<u>\$ 129,500</u>
Outstanding Pass-Through Certificates .....	\$ 55,068	\$ -
Long term debt at fair value .....	<u>\$ 55,068</u>	<u>\$ -</u>

***Capital Securities Due 2032***

On December 4, 2002, Scottish Holdings Statutory Trust I, a Connecticut statutory business trust (“Capital Trust”) issued and sold in a private offering an aggregate of \$17.5 million Floating Rate Capital Securities (the “Capital Securities”). All of the common shares of the Capital Trust are owned by Scottish Holdings, Inc. (“SHI”), our wholly owned subsidiary.

The Capital Securities mature on December 4, 2032. They are redeemable in whole or in part at any time after December 4, 2007. Interest is payable quarterly at a rate equivalent to three-month LIBOR plus 4%. At December 31, 2009 and 2008, the interest rates were 4.25% and 5.43%, respectively. The Capital Trust may defer payment of the interest for up to 20 consecutive quarterly periods, but no later than December 4, 2032. Any deferred payments would accrue interest quarterly on a compounded basis if SHI defers interest on the Debentures due December 4, 2032 (as described below).

The sole assets of the Capital Trust consist of \$18 million principal amount of Floating Rate Debentures (the “Debentures”) issued by SHI. The Debentures mature on December 4, 2032 and interest is payable quarterly at a rate equivalent to three-month LIBOR plus 4%. At December 31, 2009 and 2008, the interest rates were 4.25% and 5.43%, respectively. SHI may defer payment of the interest for up to 20 consecutive quarterly periods, but no later than December 4, 2032. Any deferred payments would accrue interest quarterly on a compounded basis. SHI may redeem the Debentures at any time after December 4, 2007 and in the event of certain changes in tax or investment company law.

SALIC has guaranteed SHI’s obligations under the Debentures and distributions and other payments due on the Capital Securities.

***Preferred Trust Securities Due 2033***

On October 29, 2003, Scottish Holdings, Inc. Statutory Trust II, a Connecticut statutory business trust (“Capital Trust II”) issued and sold in a private offering an aggregate of \$20 million Preferred Trust Securities (the “Preferred Trust Securities”). All of the common shares of Capital Trust II are owned by SHI.

The Preferred Trust Securities mature on October 29, 2033. They are redeemable in whole or in part at any time after October 29, 2008. Interest is payable quarterly at a rate equivalent to three-month LIBOR plus 3.95%. At December 31, 2009 and 2008, the interest rates were 4.20% and 5.38%, respectively. Prior to October 29, 2008, interest cannot exceed 12.45%. Capital Trust II may defer payment of the interest for up to 20 consecutive quarterly periods, but no later than October 29, 2033. Any deferred payments would accrue interest quarterly on a

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 11. Debt Obligations and Other Funding Arrangements (continued)

compounded basis if SHI defers interest on the 2033 Floating Rate Debentures due October 29, 2033 (as described below).

The sole assets of Capital Trust II consist of \$20.6 million principal amount of Floating Rate Debentures (the "2033 Floating Rate Debentures") issued by SHI. The 2033 Floating Rate Debentures mature on October 29, 2033 and interest is payable quarterly at three-month LIBOR plus 3.95%. At December 31, 2009 and 2008, the interest rates were 4.20% and 5.38%, respectively. SHI may defer payment of the interest for up to 20 consecutive quarterly periods, but no later than October 29, 2033. Any deferred payments would accrue interest quarterly on a compounded basis. SHI may redeem the 2033 Floating Rate Debentures at any time after October 29, 2008 and in the event of certain changes in tax or investment company law.

SALIC has guaranteed SHI's obligations under the 2033 Floating Rate Debentures and distributions and other payments due on the Preferred Trust Securities.

#### *Trust Preferred Securities Due 2033*

On November 14, 2003, GPIC Holdings Inc. Statutory Trust, a Delaware statutory business trust ("GPIC Trust") issued and sold in a private offering an aggregate of \$10 million Trust Preferred Securities (the "2033 Trust Preferred Securities"). All of the common shares of GPIC Trust are owned by SHI.

The 2033 Trust Preferred Securities mature on September 30, 2033. They are redeemable in whole or in part at any time after September 30, 2008. Interest is payable quarterly at a rate equivalent to three-month LIBOR plus 3.90%. At December 31, 2009 and 2008, the interest rates were 4.15% and 5.33%, respectively. GPIC Trust may defer payment of the interest for up to 20 consecutive quarterly periods, but no later than September 30, 2033. Any deferred payments would accrue interest quarterly on a compounded basis if SHI defers interest on the Junior Subordinated Notes due September 30, 2033 (as described below).

The sole assets of GPIC Trust consist of \$10.3 million principal amount of Junior Subordinated Notes (the "Junior Subordinated Notes") issued by SHI. The Junior Subordinated Notes mature on September 30, 2033 and interest is payable quarterly at three-month LIBOR plus 3.90%. At December 31, 2009 and 2008, the interest rates were 4.15% and 5.33%, respectively. SHI may defer payment of the interest for up to 20 consecutive quarterly periods, but no later than September 30, 2033. Any deferred payments would accrue interest quarterly on a compounded basis. SHI may redeem the Junior Subordinated Notes at any time after September 30, 2008 and in the event of certain changes in tax or investment company law.

SALIC has guaranteed SHI's obligations under the Junior Subordinated Notes and distributions and other payments due on the trust preferred securities.

#### *Trust Preferred Securities Due 2034*

On May 12, 2004, Scottish Holdings, Inc. Statutory Trust III, a Connecticut statutory business trust ("Capital Trust III") issued and sold in a private offering an aggregate of \$32 million Trust Preferred Securities (the "2034 Trust Preferred Securities"). All of the common shares of Capital Trust III are owned by SHI.

The 2034 Trust Preferred Securities mature on June 17, 2034. They are redeemable in whole or in part at any time after June 17, 2009. Interest is payable quarterly at a rate equivalent to three-month LIBOR plus 3.80%. At December 31, 2009 and 2008, the interest rate was 4.05% and 5.23%, respectively. Prior to June 17, 2009, interest could not exceed 12.50%. Capital Trust III may defer payment of the interest for up to 20 consecutive quarterly periods, but no later than June 17, 2034. Any deferred payments would accrue interest quarterly on a compounded basis if SHI defers interest on the 2034 Floating Rate Debentures due June 17, 2034 (as described below).

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 11. Debt Obligations and Other Funding Arrangements (continued)

The sole assets of Capital Trust III consist of \$33 million principal amount of Floating Rate Debentures (the “2034 Floating Rate Debentures”) issued by SHI. The 2034 Floating Rate Debentures mature on June 17, 2034 and interest is payable quarterly at three-month LIBOR plus 3.80%. At December 31, 2009 and 2008 the interest rate was 4.05% and 5.23%, respectively. Prior to June 17, 2009, interest could not exceed 12.50%. SHI may defer payment of the interest for up to 20 consecutive quarterly periods, but no later than June 17, 2034. Any deferred payments would accrue interest quarterly on a compounded basis. SHI may redeem the 2034 Floating Rate Debentures at any time after June 17, 2009 and in the event of certain changes in tax or investment company law.

SALIC has guaranteed SHI’s obligations under the 2034 Floating Rate Debentures and distributions and other payments due on the 2034 Trust Preferred Securities.

#### *Trust Preferred Securities Due 2034*

On December 18, 2004, SFL Statutory Trust I, a Delaware statutory business trust (“SFL Trust I”) issued and sold in a private offering an aggregate of \$50 million Trust Preferred Securities (the “December 2034 Trust Preferred Securities”). All of the common shares of SFL Trust I are owned by Scottish Financial (Luxembourg) S.a.r.l (“SFL”).

The December 2034 Trust Preferred Securities mature on December 15, 2034. They are redeemable in whole or in part at any time after December 15, 2009. Interest is payable quarterly at a rate equivalent to three-month LIBOR plus 3.50%. At December 31, 2009, and 2008 the interest rate was 3.75% and 4.93%, respectively. Prior to December 15, 2009, interest could not exceed 12.50%. SFL Trust I may defer payment of the interest for up to 20 consecutive quarterly periods, but no later than December 15, 2034. Any deferred payments would accrue interest quarterly on a compounded basis if SFL defers interest on the 2034 Floating Rate Debentures due December 15, 2034 (as described below).

The sole assets of SFL Trust I consist of \$51.5 million principal amount of Floating Rate Debentures (the “December 2034 Floating Rate Debentures”) issued by SFL. The December 2034 Floating Rate Debentures mature on December 15, 2034 and interest is payable quarterly at three-month LIBOR plus 3.50%. At December 31, 2009 and 2008 the interest rate was 3.75% and 4.93%, respectively. Prior to December 15, 2009, interest could not exceed 12.50%. SFL may defer payment of the interest for up to 20 consecutive quarterly periods, but no later than December 15, 2034. Any deferred payments would accrue interest quarterly on a compounded basis. SFL may redeem the December 2034 Floating Rate Debentures at any time after December 15, 2009 and in the event of certain changes in tax or investment company law.

SALIC has guaranteed SFL’s obligations under the December 2034 Floating Rate Debentures and distributions and other payments due on the December 2034 Trust Preferred Securities.

#### *Stingray*

On January 12, 2005, SALIC entered into a put agreement with the Stingray Investor Trust for an aggregate value of \$325 million, which put agreement relates to \$325 million aggregate stated amount of 5.902% Pass-Through Certificates, with a final maturity of 2015, issued by the Stingray Pass-Through Trust (together with the Stingray Investor Trust, “Stingray”). Under the terms of the put agreement, we acquired an irrevocable put option to issue funding agreements to the Stingray Investor Trust in return for the assets in a portfolio of 30-day commercial paper.

Since April 14, 2008, the Stingray facility has been fully utilized and \$325 million of funding agreements have been issued to the Stingray Investor Trust and remain outstanding as of December 31, 2009. Funds drawn down on the facility were included in interest sensitive contract liabilities on our Consolidated Balance Sheets as at December 31, 2008.

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**11. Debt Obligations and Other Funding Arrangements (continued)**

On August 3, 2009, we began to acquire Pass-Through Certificates through a number of privately negotiated purchases. These purchases represented reconsideration events under FASB ASC 810-10. We used a quantitative analysis in determining that the holder of the majority of the Pass-Through Certificates would absorb the majority of the expected gains or losses of Stingray. As a result of these acquisitions, by October 8, 2009, we had acquired Pass-Through Certificates with a stated amount of \$169.4 million. This holding represented the majority of the Pass-Through Certificates; therefore at that time we determined we were the primary beneficiary of Stingray and we were required to consolidate Stingray in our consolidated financial statements. The consolidation of Stingray has been recorded in accordance with ASC 810-10, which requires us to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in Stingray at the acquisition date, measured at their fair values as of that date. We are also required to eliminate any inter-company balances and transactions. The Stingray structure included an interest rate swap, as a mechanism for charging interest to SALIC on the funding agreements at a variable interest rate and paying interest to the Pass-Through Certificate holders at a fixed rate. The interest rate swap is included in Other Assets at a fair value of \$25.9 million on our Consolidated Balance Sheets as at December 31, 2009. Movements in the fair value of the interest rate swap are included in net realized and unrealized income (losses) in the Consolidated Statements of Income (Loss). The total assets and liabilities of Stingray at initial consolidation were \$32.8 million and \$52.1 million, respectively. As a result of the initial consolidation of Stingray, we recognized a gain of \$248.9 million as follows.

**(U.S. dollars in thousands)**

Elimination of investment in Stingray Pass-Through Trust.....	\$ (56,747)
Recognition of interest rate swap at fair value.....	32,831
Recognition of outstanding Pass-Through Certificates at fair value .....	(52,128)
Elimination of liability to Stingray Investor Trust.....	325,000
	\$ 248,956

On November 16, 2009, SALIC launched a cash tender offer to purchase any and all of the remaining outstanding Pass-Through Certificates. The tender offer was made to the holders (the "Holders") of all or part of such Pass-Through Certificates not currently held by SALIC or any of our affiliates upon the terms and subject to the conditions set forth in the related Offer to Purchase and Consent Solicitation, dated November 16, 2009 (the "Offer to Purchase") and the related Consent and Letter of Transmittal, dated November 16, 2009 (the "Letter of Transmittal" and, together with the Offer to Purchase, the "Offer"). As of the date of the launch of the Offer, \$155.6 million in aggregate stated amount of Pass-Through Certificates were held by third party Holders and therefore subject to the Offer.

In conjunction with the Offer, SALIC also solicited the consent of a requisite percentage of the Holders (the "Requisite Consents") to proposed amendments to certain of the related transaction documents. The Offer was not conditional upon receipt of the Requisite Consents, and no separate consideration was offered or paid for the consents.

On December 15, 2009, the Offer was accepted by the Holders of \$57.3 million in aggregate stated amount of Pass-Through Certificates. The Requisite Consents were not received. The acquisition of Pass-Through Certificates in the Offer resulted in an additional gain on consolidation of \$4.9 million. The total gain on consolidation for the year ended December 31, 2009 was \$253.8 million.

For further discussion on purchases of Pass-Through Certificates subsequent to December 31, 2009, see Note 25, "Subsequent Events".

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 11. Debt Obligations and Other Funding Arrangements (continued)

We have elected the fair value option under FASB ASC 825 in respect of the Pass-Through Certificates to the Holders. We have elected this option as it will reflect more appropriately the value of the liability at subsequent reporting periods. The fair value as at December 31, 2009 of the outstanding Pass-Through Certificates held by third party Holders is \$55.1 million (aggregate stated amount - \$98.3 million) and is included in long term debt at fair value in our Consolidated Balance Sheets. Changes in fair value will be reflected through earnings. The change in fair value, for the year ended December 31, 2009, of the Pass-Through Certificates held by third party Holders was a loss of \$22.1 million. See Note 5, "Fair Value Measurements".

##### *Premium Asset Trust Series 2004-4*

On March 12, 2004, SALIC entered into an unsecured funding agreement with the Premium Asset Trust for an aggregate of \$100 million (the "PATS"). The funding agreement had a stated maturity of March 12, 2009 (the "PATS Maturity Date") and accrued interest at a rate of three-month LIBOR plus 0.922%, payable on a quarterly basis. The amount due under this funding agreement was included under interest sensitive contract liabilities on the Consolidated Balance Sheets.

During the first quarter of 2009, we extinguished, primarily through negotiated repurchases, SALIC's unsecured funding agreement payment obligation in respect of the PATS. The extinguishment of PATS securities acquired through negotiated repurchases and the settlement of the remaining funding obligation in respect of all PATS securities not repurchased prior to the Maturity Date were completed for a total consideration of \$46.5 million compared to the \$100 million par value of the PATS. Consequently, in accordance with FASB ASC Topic 860, Transfers and Servicing, which now incorporates SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Liabilities – A Replacement of FASB Statement 125," we recorded a gain on the extinguishment of the PATS debt of \$53.5 million in the first quarter of 2009. The funding agreements were included in interest sensitive contract liabilities in the accompanying Consolidated Balance Sheets at December 31, 2008.

##### *Deferral of Interest Payments on Floating Rate Capital Securities and Trust Preferred Securities*

In order to further preserve liquidity, we began deferring interest payments as of March 4, 2009 on our floating rate capital securities and trust preferred securities issued and sold through certain statutory trusts established by us. These deferrals are permitted by the terms of the indentures governing the securities and have been made at the discretion of our Board to preserve liquidity. As of December 31, 2009, we have accrued and deferred payment of \$6.0 million of interest on such securities. SHI and SALIC are restricted in their ability to make dividend payments in any period where interest payment obligations on these securities are not current.

For further discussion on the accrued and deferred payment on our floating rate capital securities and trust preferred securities subsequent to December 31, 2009, see Note 25, "Subsequent Events".

##### *Credit Facilities*

On November 30, 2006, SALIC and SRL entered into a one year, \$5 million letter of credit facility with a single bank on a fully secured basis. This facility was amended on October 31, 2007, to a term of two years and to a limit of \$15 million. On October 31, 2009, this facility was automatically renewed and remains in place until cancelled by either us or the bank. Outstanding letters of credit for SALIC at December 31, 2009 and 2008 were \$75,000.

#### 12. Mezzanine Equity

On May 7, 2007, we completed the equity investment transaction by MassMutual Capital Partners LLC ("MassMutual Capital"), a member of the MassMutual Financial Group, and SRGL Acquisition, LDC, an affiliate of Cerberus Capital Management, L.P. ("Cerberus"), announced by us on November 27, 2006 (the "2007 New Capital

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 12. Mezzanine Equity (continued)

Transaction”). Pursuant to the 2007 New Capital Transaction, MassMutual Capital and Cerberus invested an aggregate \$600 million in us in exchange for 1,000,000 in the aggregate newly issued Convertible Cumulative Participating Preferred Shares. The gross proceeds were \$600 million less \$44.1 million in closing costs, which resulted in aggregate net proceeds of \$555.9 million. Each Convertible Cumulative Participating Preferred Share has a par value of \$0.01 per share with a liquidation preference of \$600 per share, as adjusted for dividends or distributions as described further below.

As of December 31, 2009, MassMutual Capital and Cerberus hold in the aggregate approximately 68.7% of our equity voting power, along with the right to designate two-thirds of the members of our Board.

The Convertible Cumulative Participating Preferred Shares are convertible at the option of the holder, at any time, into an aggregate of 150,000,000 ordinary shares of SRGL. On the ninth anniversary of issue, the Convertible Cumulative Participating Preferred Shares automatically will convert into an aggregate of 150,000,000 ordinary shares if not previously converted. We are not required at any time to redeem the Convertible Cumulative Participating Preferred Shares for cash, except in the event of a liquidation or a change-in-control event.

We have accounted for the Convertible Cumulative Participating Preferred Shares in accordance with FASB ASC Subtopic 470-20, Debt – Debt with Conversion and Other Options (“FASB 470-20”), which incorporates EITF D-98: “Classification and Measurement of Redeemable Securities”. Dividends on the Convertible Cumulative Participating Preferred Shares are cumulative and accrete daily on a non-compounding basis at a rate of 7.25% per annum on the stated value of \$600 million. Dividends only will be paid in a liquidation preference scenario upon our liquidation or change-in-control prior to the ninth anniversary. There have been no dividends accrued in the period as this scenario is not deemed probable at this time. As of December 31, 2009, the amount of dividends not accrued pursuant to the terms of the Convertible Cumulative Participating Preferred Shares is \$116.2 million in the aggregate, or \$116 per share.

To the extent that the Convertible Cumulative Participating Preferred Shares participate on an as-converted basis in dividends paid on ordinary shares, a corresponding reduction will be made to the liquidation preference for the Convertible Cumulative Participating Preferred Shares. The Convertible Cumulative Participating Preferred Shares have a liquidation preference equal to their stated value, as adjusted for (x) the accretion of dividends and (y) any cash payment or payment in property of dividends or distributions. The holders of Convertible Cumulative Participating Preferred Shares may, among other things, require us to redeem the Convertible Cumulative Participating Preferred Shares upon a change-in-control.

Upon a change-in-control, the redemption price is an amount equal to the greater of (i) the stated value of the outstanding Convertible Cumulative Participating Preferred Shares, plus an amount equal to the sum of all accrued dividends through the earlier of (A) the date of payment of the consideration payable upon a change-in-control, or (B) the fifth anniversary of the issue date of the Convertible Cumulative Participating Preferred Shares, or (ii) the amount that the holder of the Convertible Cumulative Participating Preferred Shares would have been entitled to receive with respect to such change-in-control if it had exercised its right to convert all or such portion of its Convertible Cumulative Participating Preferred Shares for ordinary shares immediately prior to the date of such change-in-control.

The liquidation preference of the Convertible Cumulative Participating Preferred Shares is not applicable once the Convertible Cumulative Participating Preferred Shares have been converted into ordinary shares, as described above.

The Convertible Cumulative Participating Preferred Shares rank, with respect to payment of dividends and distribution of assets upon voluntary or involuntary liquidation, dissolution or winding-up (a “Liquidation Event”): (a) senior to our ordinary shares and to each other class or series of our shares established by the Board, the terms of which do not expressly provide that such class or series ranks senior to or *pari passu* with the Convertible

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 12. Mezzanine Equity (continued)

Cumulative Participating Preferred Shares as to payment of dividends and distribution of assets upon a Liquidation Event; (b) pari passu with each class or series of our shares, the terms of which expressly provide that such class or series ranks pari passu with the Convertible Cumulative Participating Preferred Shares as to payment of dividends and distribution of assets upon a Liquidation Event; and (c) junior to each other class or series of our securities outstanding as of the date of the completion of the 2007 New Capital Transaction that ranks senior to our ordinary shares, and to each class or series of our shares, the terms of which expressly provide that such class or series ranks senior to the Convertible Cumulative Participating Preferred Shares as to payment of dividends and distribution of assets upon a Liquidation Event and all classes of our preferred shares outstanding as of the completion of the 2007 New Capital Transaction.

The Convertible Cumulative Participating Preferred Shares conversion price (\$4.00 per ordinary share) was lower than the trading value of \$4.66 of our ordinary shares on the date of issue. This discount has been accounted for as an embedded beneficial conversion feature in accordance with FASB ASC 470-20 which incorporates EITF 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios", and EITF 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments". Accordingly, the Company recognized a \$120.8 million embedded beneficial conversion feature, which reduced the Convertible Cumulative Participating Preferred Share issue amount shown in Mezzanine Equity and increased the amount of additional paid in capital. Under the accounting guidance above, we had the choice to accrete the full intrinsic value of the embedded beneficial conversion feature out of retained earnings over the nine year term of the shares or immediately due to the ability of the holders to convert at their option at any time. Given the ability of the holders to convert at any time, we elected to accrete the full intrinsic value of the embedded beneficial conversion feature on the date of issue. As we did not have any retained earnings on the date of issue, the \$120.8 million beneficial conversion feature was accreted out of additional paid in capital into Mezzanine Equity.

Pursuant to our Securities Purchase Agreement, dated November 26, 2006 (the "Agreement"), with MassMutual Capital and Cerberus relating to the 2007 New Capital Transaction, certain representations and warranties were provided relating to our statutory accounting records. As discussed in Note 21 "Commitments and Contingencies", certain statutory accounting errors were discovered in 2006 which have resulted in an indemnification claim against us, by MassMutual and Cerberus. Resolution of this claim could result in an adjustment to the conversion price on these securities.

#### 13. Shareholders' Deficit

##### *NYSE Delisting and Securities and Exchange Commission Deregistration*

Our ordinary shares (new symbol SKRRF – PINKS) and perpetual preferred shares (new symbol SKRUF – PINKS) were delisted from the New York Stock Exchange as of April 7, 2008, and, therefore, we have no further reporting obligations under Section 12(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). We also had fewer than 300 holders of record of our securities as of January 1, 2008 and, as a result, our reporting obligations under Sections 13 and 15(d) of the Exchange Act, were suspended. On May 13, 2008, we filed a Form 15 indicating the suspension of our reporting obligations. As a result of the foregoing, notwithstanding the occurrence of material developments (either positive or negative), we are not required to make future public filings. Similarly, we no longer are required to issue press releases as we have in the past.

##### *Ordinary Shares*

We are authorized to issue 590,000,000 ordinary shares of par value \$0.01 each.

No stock options were exercised during the years ended December 31, 2009 and 2008. During the year ended December 31, 2007, we issued 475 ordinary shares to employees upon the exercise of stock options. As more fully

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**13. Shareholders' Deficit (continued)**

described in Note 15 "Employee Benefit Plans", we issued 388,313 ordinary shares to the holders of restricted stock awards on May 14, 2007. At December 31, 2009, there were 68,383,370 outstanding ordinary shares.

The following table summarizes the activity in our ordinary shares and non-cumulative Perpetual Preferred Shares during the years ended December 31, 2009, 2008 and 2007:

	<b>Year Ended December 31, 2009</b>	<b>Year Ended December 31, 2008</b>	<b>Year Ended December 31, 2007</b>
<b>Ordinary shares</b>			
Beginning of year .....	68,383,370	68,383,370	60,554,104
Issuance to holders of HyCUs on conversion of purchase contracts .....	-	-	7,440,478
Issuance to holders of restricted stock awards .....	-	-	388,313
Ordinary shares issued .....	-	-	-
Issuance to employees on exercise of options and awards .....	-	-	475
End of year .....	<u>68,383,370</u>	<u>68,383,370</u>	<u>68,383,370</u>
<b>Non-cumulative Perpetual Preferred Shares</b>			
Beginning of year .....	5,000,000	5,000,000	5,000,000
Non-cumulative Perpetual Preferred Shares issued .....	-	-	-
End of year .....	<u>5,000,000</u>	<u>5,000,000</u>	<u>5,000,000</u>

***Perpetual Preferred Shares***

We are authorized to issue 50,000,000 preferred shares of par value \$0.01 each.

On June 28, 2005, we priced our offering of 5,000,000 non-cumulative Perpetual Preferred Shares (the "Perpetual Preferred Shares") and entered into a purchase agreement relating to the shares pursuant to which the underwriters of the offering agreed to purchase the shares. Gross proceeds were \$125 million and related expenses were \$4.6 million. Settlement of the net proceeds occurred on July 6, 2005.

Dividends on the Perpetual Preferred Shares are payable on a non-cumulative basis at a rate per annum of 7.25% until the dividend payment date in July 2010. Thereafter, the dividend rate may be at a fixed rate determined through remarketing of the Perpetual Preferred Shares for specific periods of varying length not less than six months or may be at a floating rate reset quarterly based on a predefined set of interest rate benchmarks. During any dividend period, unless the full dividends for the current dividend period on all outstanding Perpetual Preferred Shares have been declared or paid, no dividend shall be paid or declared on our ordinary shares and no ordinary shares or other junior shares shall be purchased, redeemed or otherwise acquired for consideration. Declaration of dividends on the Perpetual Preferred Shares is prohibited if we fail to meet specified capital adequacy, net income or shareholders' equity levels.

The Perpetual Preferred Shares do not have a maturity date and we are not required to redeem the shares. The Perpetual Preferred Shares are not redeemable prior to July 2010. Subsequent to July 2010, the Perpetual Preferred Shares will be redeemable at our option, in whole or in part, at a redemption price equal to \$25.00 per share, plus any declared and unpaid dividends at the redemption date, without accumulation of any undeclared dividends. The Perpetual Preferred Shares are unsecured and subordinated to all indebtedness that does not by its terms rank *pari passu* or junior to the Perpetual Preferred Shares. The holders of the Perpetual Preferred Shares have no voting

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 13. Shareholders' Deficit (continued)

rights except with respect to certain fundamental changes in the terms of the Perpetual Preferred Shares and in the case of certain dividend non-payments.

The Perpetual Preferred Shares ratings were withdrawn by Standard & Poor's, Moody's, Fitch Ratings and A.M. Best Company in 2009 following our notification to each of the rating agencies that we would no longer be compensating the agencies for their maintenance of such ratings. See Note 20, "Rating Agencies".

#### *Warrants*

In connection with our initial capitalization, we issued Class A Warrants to related parties to purchase an aggregate of 1,550,000 ordinary shares. The aggregate consideration of \$0.1 million paid for these Class A Warrants is reflected as additional paid-in capital. In connection with our initial public offering, we issued an aggregate of 1,300,000 Class A Warrants. All Class A Warrants are exercisable at \$15.00 per ordinary share, in equal amounts over a three-year period commencing November 1999 and expiring in November 2008.

During the year ended December 31, 2003, we issued 200,000 ordinary shares upon the exercise of Class A Warrants. As at December 31, 2008, all Class A warrants had expired (2007 – 2,650,000 Class A warrants were outstanding).

#### *Dividends on Ordinary Shares*

The holders of the ordinary shares are entitled to receive dividends and are allowed one vote per share subject to certain restrictions in our Memorandum and Articles of Association.

On July 28, 2006, our Board suspended the dividend on the ordinary shares. All future payments of dividends are at the discretion of our Board and will depend on our income, capital requirements, insurance regulatory conditions, operating conditions and such other factors as the Board may deem relevant. Notwithstanding the foregoing, so long as any dividends remain outstanding from any prior dividend period on our Perpetual Preferred Shares, as discussed below, we generally are precluded from paying or declaring any dividend on the ordinary shares.

#### *Dividends on Perpetual Preferred Shares*

On April 14, 2008, we announced that, given our current financial condition, our Board in its discretion had decided not to declare a dividend on our Perpetual Preferred Shares for the April 15, 2008 dividend payment date. In addition, we announced that pursuant to the Certificate of Designations for our Perpetual Preferred Shares we may be precluded from declaring and paying dividends on the October 15, 2008 dividend payment date in the event we did not meet certain financial tests under the terms of the Perpetual Preferred Shares required for us to pay such dividends, which tests we subsequently did not meet for such dividend payment date. On July 3, 2008, the Board determined that in light of our financial condition and in accordance with the terms of the then outstanding forbearance agreements with the relevant counterparties to the HSBC II and Clearwater Re collateral finance facilities, we would suspend the cash dividend for the July 15, 2008 payment date. In addition, as previously indicated we were precluded from declaring and paying dividends on the October 15, 2008 dividend payment date as we did not meet the relevant financial tests under the terms of the Perpetual Preferred Shares. In accordance with the relevant financial tests under the terms of the Perpetual Preferred Shares, we were precluded from declaring and paying dividends on the January 15, 2009, April 15, 2009, July 15, 2009 and October 15, 2009 dividend payment dates and did not declare and pay a dividend on such dates. Nonpayment of dividends on July 15, 2009 marked the sixth dividend period for which dividends had not been declared and paid. Pursuant to the terms of the Certificate of Designations related to the Perpetual Preferred Shares, the holders of the Perpetual Preferred Shares are entitled to elect two directors to our Board in the event dividends on the Perpetual Preferred Shares have not been declared and paid for six or more dividend periods. For further discussion on the non-declaration of Perpetual Preferred Shares

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**13. Shareholders' Deficit (continued)**

dividends, see Note 25 "Subsequent Events".

In accordance with the Certificate of Designations, future dividends on the Perpetual Preferred Shares generally may be funded only to the extent they are payable out of our distributable profits, and/or the proceeds of a new issue of shares, and/or out of the Share Premium Account. At December 31, 2009, we had a shareholders' deficit of \$104.2 million and therefore lacked, and expect to continue to lack in the near to midterm, sufficient distributable profits to permit the funding of a dividend.

**14. Reinsurance**

*Premiums Earned*

Premiums earned are analyzed as follows for the year ended:

(U.S. dollars in thousands)	<u>December 31, 2009</u>	<u>December 31, 2008</u>	<u>December 31, 2007</u>
Premiums assumed .....	\$ 763,190	\$ 2,049,510	\$ 2,131,584
Premiums ceded.....	(311,390)	(398,404)	(358,196)
Premiums earned .....	<u>\$ 451,800</u>	<u>\$ 1,651,106</u>	<u>\$ 1,773,388</u>

Reinsurance agreements may provide for recapture rights on the part of the ceding company. Recapture rights permit the ceding company to reassume all or a portion of the risk formerly ceded to the reinsurer after an agreed-upon period of time or in some cases due to changes in the financial condition or ratings of the reinsurer. Recapture of business previously ceded does not affect premiums ceded prior to the recapture of such business, but would reduce premiums, claims and commissions in subsequent periods.

*Claims and Other Policy Benefits*

Claims and other policy benefits are net of reinsurance recoveries of \$290.2 million, \$374.8 million and \$241.4 million during the years ended December 31, 2009, 2008 and 2007, respectively.

At December 31, 2009 and 2008, there were no reinsurance ceded receivables associated with a single reinsurer with a carrying value in excess of 1% of total assets.

*Sale of a Block of Life Reinsurance North America Business*

We engaged in 2008 in a process to sell our entire Life Reinsurance North America Segment. In October 2008, the process led to exclusive negotiations with a prospective buyer; however, a satisfactory transaction for the sale of the entire Life Reinsurance North America Segment could not be reached, primarily as a result of the historic disruption in the financial markets. Thereafter, in an effort to find ways to address our capital, liquidity and collateral needs and the concerns of regulators, we pursued the sale of a specific block of individual life reinsurance

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 14. Reinsurance (continued)

in our North American business. These efforts culminated in the announcement on February 20, 2009 that we had closed the transactions contemplated by the Master Asset Purchase Agreement (the "Purchase Agreement"), by and among the Company, SHI, SRUS, SRLB and SRD (collectively, the "Sellers") with Hannover Re to sell a block of individual life reinsurance business acquired in 2004 from the ING Companies, which block consisted primarily of term life reinsurance universal life with secondary guarantees, and yearly renewable term business (the "Acquired Business").

Pursuant to the Purchase Agreement, Hannover Re purchased the Acquired Business, which was acquired in 2004 by us from the ING Companies. The Acquired Business consists primarily of term life reinsurance, universal life with secondary guarantees, and yearly renewable term business. When we originally purchased the Acquired Business in 2004, the ING Companies reinsured their individual life reinsurance business to us on a 100% indemnity reinsurance basis. A large portion of such business included guaranteed level premium term life insurance that was subject to the Regulation XXX reserve requirements and universal life policies with secondary guarantees subject to the "Regulation AXXX" reserve requirements. Under our 2004 agreement with the ING Companies, the ING Companies were obligated to maintain collateral for the Regulation XXX and AXXX reserve requirements of the Acquired Business for the duration of such requirements, and financial incentives were provided to encourage us to replace this financing with alternative third party financing. The Acquired Business does not include business ceded by SRUS to Ballantyne Re as the reinsurance transaction with this special purpose reinsurance vehicle was novated and assigned from SRUS to SLD effective October 1, 2008. However, the Acquired Business does include the business recaptured from Ballantyne Re in connection with a series of recaptures during 2008 in which SRUS recaptured business from Ballantyne Re, which business then was recaptured by SLD which in turn ceded the recaptured business to SLDI who ceded it to SRLB (the foregoing recaptures, collectively, the "Ballantyne Recaptures"), as well as the business recaptured in connection with the unwind of our HSBC II collateral finance facility (together with the Ballantyne Recaptures, the "ING Financings"). In connection with each of the ING Financings, SLD ceded the applicable recaptured business to SLDI, which ceded the recaptured business to SRLB. SLDI agreed to provide, or cause the provision of, one or more LOCs in order to provide SLD with statutory financial statement credit for the excess reserves associated with the recaptured business in respect of the ING Financings. As partial consideration for each of the ING Financings, the Company agreed to bear the costs of the LOCs by paying SLD a facility fee based on the face amount of such LOCs outstanding. The cost of these LOCs was consistent with the pricing schedules from our 2004 acquisition agreement with ING Companies, as such schedule was amended on May 7, 2007. Upon closing the transactions contemplated by the Purchase Agreement, Hannover Re assumed the business related to the ING Financings as part of the Acquired Business, as well as the obligation to pay the existing and any future increases in the related LOC fees.

In connection with the Purchase Agreement, the ING Companies and certain of the Sellers entered into recapture agreements (and, in specific instances, novations to Hannover Re of certain existing reinsurance agreements) with respect to the Acquired Business, and the ING Companies and Hannover Re subsequently entered into new reinsurance agreements with respect to the Acquired Business immediately thereafter. These recapture and reinsurance transactions and the novations had an effective date of January 1, 2009. SRUS and SRLB remain responsible for liabilities and obligations to SLD and SLDI under their reinsurance agreements with these parties to the extent attributable to periods prior to January 1, 2009.

The Purchase Agreement also related to the purchase and sale of certain assets used by the Sellers in connection with their administration of the Acquired Business (the "Transferred Assets") and the transfer of certain employees from the Sellers to Hannover Re in connection therewith. Pursuant to the Purchase Agreement, the remaining lease on SRUS' Denver office location was assigned to Hannover Re as was a portion of SRUS' Charlotte office location. In addition, Hannover Re entered into an administrative services agreement with SRUS pursuant to which Hannover Re administers the accepted and ceded mortality business retained by SRUS and its affiliates. Similarly, Hannover Re entered into an administrative services agreement with the ING Companies pursuant to which Hannover Re administers the Acquired Business and provides certain other administrative services to the ING Companies.

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**14. Reinsurance (continued)**

In accordance with the Purchase Agreement, payments were made as follows: (i) the Sellers made recapture payments to the ING Companies in an aggregate amount equal to \$1,325 million (adjusted for interim period earnings from January 1, 2009 to the date of closing), (ii) the ING Companies made corresponding initial premium payments to Hannover Re, and (iii) Hannover Re made a payment to the Sellers in respect of the Transferred Assets in an amount equal to \$18 million.

Following the transfer of assets with respect to the recapture payments noted above, we were released of all associated policyholder liabilities on the sale of the Acquired Business as of the effective date of January 1, 2009. The release of such liabilities resulted in a pre-tax gain of \$703.6 million, after transaction expenses and related costs. This gain was also subject to certain contingencies, which have all been satisfied as at December 31, 2009. Of the \$703.6 million gain, \$642.4 million, \$59.8 million, \$1.0 million, and \$0.4 million were recognized in the first, second, third and fourth quarters of 2009, respectively. This total gain is summarized as follows:

<b>(U.S. dollars in millions)</b>	<b><u>Balance Sheet</u></b>	<b><u>Statement of Operations</u></b>
Transfer of investments .....	\$ (1,468.7)	
Release of reserve for future policy benefits .....	1,902.9	
Decrease in accounts payable and other liabilities.....	1.7	
Decrease in reinsurance balances and risk fees receivable .....	(6.3)	
Decrease in reinsurance balances payable .....	4.7	
Increase in other assets .....	18.7	
<b>Decrease in claims and other policy benefits .....</b>	<b>\$ 453.0</b>	<b>\$ 453.0</b>
Decrease in accounts payable and other liabilities.....	275.5	
<b>Change in value of embedded derivatives.....</b>	<b>\$ 275.5</b>	<b>275.5</b>
Release in deferred acquisition costs .....	(24.9)	
<b>Acquisition costs and other insurance expenses, net.....</b>	<b>\$ (24.9)</b>	<b>(24.9)</b>
<b>Total pre-tax gain as at December 31, 2009.....</b>		<b>\$ 703.6</b>

In connection with the Purchase Agreement, the Company, Hannover Re and the ING Companies agreed to use commercially reasonable efforts to transfer to Hannover Re certain retrocession agreements under which we and/or the ING Companies ceded to third parties certain risks related to the Acquired Business. If a certain amount of such third party retrocessionaires did not consent to such transfers prior to April 30, 2009, we were required under the Purchase Agreement to deposit into escrow with Hannover Re by May 14, 2009, a pro-rata amount related to such retrocession agreements for which consent had not been obtained as of that date. Pursuant to the Purchase Agreement, in the event none of the retrocessionaires consented to transfer their agreements, the maximum potential escrow funding amount was \$136.3 million. In the event one or more retrocessionaire consents had not been obtained by December 31, 2009, the related escrow funds would be released to Hannover Re. As of the escrow funding requirement date of May 14, 2009, the balance was \$1.9 million. As of December 31, 2009, the required escrow balance was reduced to \$0 million and all of the funds have been released back to us.

This transaction resulted in a \$49.8 million income tax expense due to an increase in our valuation allowance. The increased valuation allowance was because the remaining deferred tax liabilities did not support the full recoverability of our deferred tax assets. See Note 19, "Quarterly Financial Data".

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 15. Employee Benefit Plans

##### 401(k) Plan

We sponsor a 401(k) plan in the United States in which employee contributions on a pre-tax basis are supplemented by matching contributions. These contributions are invested, at the election of the employee, in one or more investment portfolios. Expenses for the 401(k) plan amounted to \$0.5 million, \$1.5 million and \$2.8 million, in the years ended December 31, 2009, 2008 and 2007, respectively.

##### Stock Based Incentive Compensation Plans

###### *2007 Stock Option Plan*

On July 18, 2007, our shareholders approved and adopted the Scottish Re Group Limited 2007 Stock Option Plan ("2007 Plan"). The 2007 Plan provides for the granting of stock options to our eligible employees, directors and consultants. The total number of our shares reserved and available for issuance under the 2007 Plan is 18,000,000. The exercise price of stock options granted under the 2007 Plan is the fair market value of our ordinary shares on the date of grant and such options expire ten years after the date of grant, or such shorter period as determined by the Compensation Committee of our Board of Directors (unless earlier exercised or terminated pursuant to the terms of the 2007 Plan).

Options issued under the 2007 Plan vest as follows:

- 50% of an option grant to an employee or consultant vests based on the recipient's continued employment with us ("Time-Based Options"). 20% of the Time-Based Options vest on the grant date and an additional 20% vest in four equal installments on each of the first, second, third and fourth anniversary of the grant date, based on continued employment. The Time-Based Options are exercisable upon vesting.
- 50% of an option grant to an employee or consultant vests based on the achievement of certain performance targets as established by the Board with respect to each relevant fiscal year ("Performance-Based Options"). 10% of the Performance-Based Options vest following the close of each of the five fiscal years following the grant date, subject to our attainment of the performance targets established by the Board with respect to the relevant fiscal year. In addition, 10% of the Performance-Based Options vest following the close of each of the five fiscal years following the grant date, subject to the recipient's respective division's or segment's attainment of the performance targets established by the Board with respect to the relevant fiscal year. Although the Performance-Based Options may vest, they do not become exercisable until the end of the fifth fiscal year following May 7, 2007; provided, however, that if we achieved an "A-" rating or better from Standard & Poor's or AM Best within eighteen (18) months following the closing of the 2007 New Capital Transaction, all Performance-Based Options with regard to fiscal years 2007 and 2008 would fully vest and become exercisable. We did not satisfy this ratings goal within the 18 month period.
- 100% of options granted to directors vest on the grant date and are exercisable.

Upon a change of control (as defined in the 2007 Plan), to the extent not previously cancelled or forfeited, all Time-Based Options and Performance-Based Options become 100% vested and exercisable.

As of December 31, 2009, we had 4,706,592 options outstanding of which 4,274,592 options are exercisable. As of December 31, 2008, we had 6,260,417 options outstanding of which 4,356,250 options were exercisable.

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**15. Employee Benefit Plans (continued)**

***Valuation of Options in 2007 Plan***

Stock options are accounted for in accordance with FASB ASC 718. The fair value of each option award is estimated on the date of grant using the Black-Scholes option-pricing model, which uses the assumptions noted in the following table.

- *Expected dividend yield* – We suspended dividends on ordinary shares on July 28, 2006. Consequently, we have assumed 0% for the expected dividend yield.
- *Expected volatility* – The expected volatility is a measure of the amount by which a price has fluctuated and is expected to fluctuate during a period of time. The expected volatility of our stock is based on historical volatility.
- *Expected term* - The expected term represents the anticipated amount of time between the grant date of the option and the exercise date or cancellation date based on historical data.
- *Risk free interest rate* - The risk-free interest rate at the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

Non-cash compensation expense incurred for stock options for the years ended December 31, 2009, 2008 and 2007 was \$0.7 million, \$2 million and \$11.1 million, respectively. Non-cash compensation expense incurred for restricted stock options for the years ended December 31, 2009, 2008 and 2007 was \$0 million, \$0 million and \$6.3 million, respectively. We recognize compensation costs for stock options based on the vesting schedule described above. A portion of the Time Based Options vest immediately and the remainder are earned evenly over the requisite service period. The Performance Based Options are earned evenly over the period from the grant date to vesting date. There was no tax benefit during the year ended December 31, 2009.

As of December 31, 2009 and 2008, there was \$1.1 million and \$3.7 million, respectively of total unrecognized compensation costs related to stock options. These costs are expected to be recognized over a period of up to five years or immediately upon a change in control. Upon a change in control, all stock options will immediately vest.

**16. Income Taxes**

For the years ended December 31, 2009, 2008 and 2007, we have income tax expense (benefit) from continuing operations, by jurisdiction, as follows:

<b>(U.S. dollars in thousands)</b>	<b>Year Ended December 31, 2009</b>	<b>Year Ended December 31, 2008</b>	<b>Year Ended December 31, 2007</b>
Current tax (benefit) expense:			
U.S. ....	\$ (8,088)	\$ -	\$ 5,441
Ireland.....	-	-	(4,079)
Other non-U.S. ....	-	43	5,967
Total current tax (benefit) expense .....	<u>(8,088)</u>	<u>43</u>	<u>7,329</u>

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**16. Income Taxes (continued)**

Deferred tax expense (benefit):			
U.S. ....	49,838	(9,957)	(168,621)
Ireland.....	(861)	(2,566)	3,936
Other non-U.S. ....	8,642	5,644	97
Total deferred tax expense (benefit) .....	<u>57,619</u>	<u>(6,879)</u>	<u>(164,588)</u>
Total worldwide tax expense (benefit) .....	<u>\$ 49,531</u>	<u>\$ (6,836)</u>	<u>\$ (157,259)</u>

The weighted average expected tax provision has been calculated using the pre-tax accounting income (loss) in each jurisdiction multiplied by that jurisdiction's applicable statutory tax rate. Reconciliation of the difference between the provision for income taxes and the expected tax provision at the weighted average tax rate for the years December 31, 2009, 2008 and 2007 is provided below:

<b>(U.S. dollars in thousands)</b>	<b>Year Ended December 31, 2009</b>	<b>Year Ended December 31, 2008</b>	<b>Year Ended December 31, 2007</b>
Pre-tax income (loss) .....	\$ 2,355,574	\$ (2,676,007)	\$ (1,026,017)
Expected tax provision at weighted average rate .....	196,629	(609,994)	(210,857)
Change in valuation allowance .....	(147,580)	617,973	65,677
Intercompany note cancellation .....	-	(6,154)	(48,846)
Other and state taxes .....	482	(8,661)	36,767
Total tax expense (benefit) .....	<u>\$ 49,531</u>	<u>\$ (6,836)</u>	<u>\$ (157,259)</u>

We are not subject to income taxation other than as stated above. There can be no assurance that there will not be changes in applicable laws, regulations or treaties, which might require us to change the way we operate or become subject to taxes. At December 31, 2009 and 2008, we had tax operating loss carry forwards in our U.S. and Irish entities, as presented in the table below.

<b>(U.S. dollars in thousands)</b>	<b>U.S. Life &amp; Non-Life Groups</b>	<b>Irish Operating Company</b>	<b>Irish Special Purpose Vehicles</b>	<b>Total</b>
Operating loss carry forwards available at December 31, 2008.....	\$ 357,089	\$ 433,475	\$ 1,812,709	\$ 2,603,273
Operating losses from 2008 attributable to Ballantyne Re .....	-	-	(1,496,139)	(1,496,139)
Operating losses accrued during 2009 .....	236,699	90,486	7,238	334,423
Operating loss carry forwards available at December 31, 2009.....	<u>\$ 593,788</u>	<u>\$ 523,961</u>	<u>\$ 323,808</u>	<u>\$ 1,441,557</u>
Deferred tax asset for operating losses, before valuation allowance, at December 31, 2009.....	<u>\$ 203,121</u>	<u>\$ 65,495</u>	<u>\$ 80,952</u>	<u>\$ 349,568</u>

The operating loss carry forwards in our U.S. entities will expire, if not utilized, in years 2021 through 2029. The operating loss carry forwards in our Irish entities benefit from an unlimited carry forward period. These net operating loss carry forwards resulted primarily from current operations of SRUS, SRLC, SHI, SRD, Orkney Re and Orkney Re II.

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**16. Income Taxes (continued)**

At December 31, 2008, we had an alternative minimum tax credit carry forward of approximately \$8.6 million. As a result of new tax legislation in the US, the Company is able to recover the alternative minimum tax related to this credit. Therefore, the alternative minimum tax credit carry forward is currently an income tax recoverable. There are no foreign tax credit carry forwards. In addition, at December 31, 2009, the Company recorded an additional \$4.0 million withholding tax liability.

During 2009, the Company did not incur or record any applicable deferred tax expense attributable to the undistributed earnings of its subsidiaries. As such, at December 31, 2009, we provided deferred taxes, if any, related to all the undistributed earnings of its subsidiaries. Our U.S. subsidiaries are subject to federal, state and local corporate income taxes and other taxes applicable to U.S. corporations. Upon distribution of current or accumulated earnings and profits in the form of dividends or otherwise from our U.S. subsidiaries to us, we would be subject to U.S. withholding taxes at a 30% rate. Significant components of our deferred tax assets and liabilities as of December 31, 2009 and 2008, all of which arise outside of our home country, were as follows:

<b>(U.S. dollars in thousands)</b>	<b>December 31, 2009</b>	<b>December 31, 2008</b>
<b>Deferred tax asset</b>		
Net operating losses (net of FASB ASC 740-10 and section 382) .....	\$ 349,568	\$ 629,854
Reserves for future policy benefits .....	217	48,456
Unrealized depreciation on investments/Other than temporary impairments ...	152,320	227,667
Intangible assets.....	4,272	5,205
Alternative minimum tax credit.....	-	8,580
Capital loss carryforwards .....	2,111	10,543
Collateral finance facilities costs .....	5,623	5,565
Surplus note accrual.....	10,594	7,759
Embedded derivatives.....	7,623	3,489
Other .....	6,840	11,485
Total deferred tax asset.....	<u>539,168</u>	<u>958,603</u>
<b>Deferred tax liability</b>		
Deferred acquisition costs.....	(43,302)	(47,062)
Reserves for future policy benefits .....	(140,459)	-
Present value of in-force .....	(13,027)	(13,636)
Other .....	(1,746)	(2,652)
Total deferred tax liability .....	<u>(198,534)</u>	<u>(63,350)</u>
Net deferred tax asset before valuation allowance.....	340,634	895,253
Valuation allowance .....	(386,855)	(892,413)
Net deferred tax (liability) asset .....	<u>\$ (46,221)</u>	<u>\$ 2,840</u>

Certain errors in the 2008 net deferred tax asset inventory balance were corrected, which resulted in an increase to deferred tax asset of \$62.0 million, a decrease to deferred tax liability of \$14.1 million, and an increase to the valuation allowance of \$76.1 million. The error corrections had no impact to the Company's net loss and shareholders' deficit as of December 31, 2008, because the increase in net deferred tax asset was offset by a corresponding increase to the valuation allowance.

At December 31, 2008, we had a valuation allowance of \$892.4 million established against our deferred tax assets, after the above mentioned errors were recorded. This amount represents an increase of \$76.1 million over the valuation allowance reported in the financial statements as at December 31, 2008, as a result of corrections to the deferred inventory discussed above. We currently provide a valuation allowance against deferred tax assets when it is more likely than not that some portion, or all, of our deferred tax assets will not be realized. Our valuation allowance decreased by approximately \$505.6 million during the year ended December 31, 2009, to \$386.9 million.

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**16. Income Taxes (continued)**

The reasons for the decrease are \$366.0 million in respect of the de-consolidation of Ballantyne Re, \$129.5 million as a result of the release of reserves due to the sale of the Acquired Business to Hannover Re and \$10.1 million as a result of other changes in net deferred tax assets. The de-consolidation of Ballantyne Re did not impact income tax expense because of a corresponding reduction in the net operating losses deferred tax assets. There also were losses generated in the U.S. and Irish entities for which no current period benefit is being recognized.

We have maintained a full valuation allowance against any remaining deferred tax asset in the U.S. and Ireland, given our inability to rely on future taxable income tax projections and the scheduling of our current deferred tax liabilities.

***Section 382 Event***

The investments made by MassMutual Capital and Cerberus on May 7, 2007 qualified as a change in ownership under Section 382 of the Internal Revenue Code. Section 382 operates to limit the future deduction of net operating losses that were in existence as of the change in ownership. As a result of this limitation, we wrote off \$142.6 million in 2007 of net operating losses that we will be unable to utilize prior to expiration with respect to our U.S. entities. Because we had previously established a valuation allowance against these net operating losses, there was not a significant tax expense associated with Section 382 limitations.

***FASB ASC Subtopic 740-10, Income Taxes – Overall (formerly FIN 48)***

On January 1, 2007, we adopted FASB ASC Subtopic 740-10, Income Taxes – Overall (“FASB ASC 740-10”), which incorporates what was formerly FIN 48. As a result of the implementation of FASB ASC 740-10, we recorded a net decrease to our beginning retained earnings of \$18.0 million reflecting the establishment of a FASB ASC 740-10 liability of \$75.3 million (excluding previously recognized liabilities of \$6.5 million and including interest and penalties of \$8.9 million) offset by a \$57.3 million reduction of our existing valuation allowance. At December 31, 2008, we had total unrecognized tax benefits (excluding interest and penalties) of \$167.9 million, the recognition of which would result in a \$16.9 million benefit to the effective tax rate. The statute of limitations expired for the 2005 U.S. federal income tax year, which resulted in a reduction of our unrecognized tax benefits in the amount of \$37.4 million. At December 31, 2009, we had total unrecognized tax benefits (excluding interest and penalties) of \$132.2 million, the recognition of which would result in a \$20.6 million benefit at the effective tax rate. The decrease in the total unrecognized tax benefits in 2009 was due to the removal of the Ballantyne Re FASB ASC 740-10 reserve and statute of limitations expiration on some positions. The decrease in the total unrecognized tax benefits in 2008 was due to the statute of limitations expiration on some positions.

The following is a roll-forward of our FASB ASC 740-10 unrecognized tax benefits from January 1, 2008 to December 31, 2009:

<b>(U.S. dollars in thousands)</b>	<b>December 31, 2009</b>	<b>December 31, 2008</b>
Total unrecognized tax benefits at beginning of year .....	\$ 167,864	\$ 187,142
Gross amount of decreases for prior year’s tax position .....	(22,000)	(1,882)
Gross amount of increases for current year’s tax position .....	1,737	4,549
Reductions due to lapse of statutes of limitation.....	(15,354)	(21,945)
Total unrecognized tax benefits at end of year.....	<u>132,247</u>	<u>167,864</u>
Unrecognized tax benefits that, if recognized, would favorably impact the effective tax rate.....	<u>\$ 20,639</u>	<u>\$ 16,920</u>

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**16. Income Taxes (continued)**

Interest and penalties (not included in the “unrecognized tax benefits” above) are a component of the position for income taxes.

<b>(U.S. dollars in thousands)</b>	<b>December 31, 2009</b>	<b>December 31, 2008</b>	<b>December 31, 2007</b>
Total interest & penalties in the Consolidated Balance Sheets at beginning of year .....	\$ 16,640	\$ 13,281	\$ 9,238
Total interest and penalties in the Consolidated Statements of Income (Loss) .....	2,802	3,359	4,043
Total interest & penalties in the Consolidated Balance Sheets at end of year.....	<u>\$ 19,442</u>	<u>\$ 16,640</u>	<u>\$ 13,281</u>

It is reasonably possible that significant changes in the gross balance of unrecognized tax benefits may occur in the next 12 months due to tax years closing because the statutes of limitations have expired. The unrecognized tax benefits are expected to decrease by \$16.0 million in 2010 as a result of additional statutes of limitations expiring, and, an additional tax liability amount of up to approximately \$35.9 million as a result of an unaffiliated third party U.S. tax court ruling in 2010. For further discussion on this, see Note 25, “Subsequent Events”.

We file our tax returns as prescribed by the tax laws of the jurisdictions in which we operate. As of December 31, 2009, we remained subject to examination in the following major tax jurisdictions for the years indicated below:

<u>Major Tax Jurisdictions</u>	<u>Open Years</u>
U.S.	
Life Group .....	2006 through 2009
Non-Life Group .....	2006 through 2009
Ireland .....	2005 through 2009

**17. Earnings per Ordinary Share**

Basic earnings per share is computed based on the weighted average number of ordinary shares outstanding and assumes an allocation of net income to Convertible Cumulative Participating Preferred Shares for the period or portion of the period that this security is outstanding. Losses are not allocated to Convertible Cumulative Participating Preferred Shares. Under the provisions of FASB ASC Topic 260, Earnings per Share (“FASB ASC 260”), formerly SFAS No. 128, basic earnings per share are computed by dividing the net loss attributable to ordinary shareholders by the weighted average number of shares of our ordinary shares outstanding for the period. Diluted earnings per share is calculated based on the weighted average number of ordinary shares outstanding plus the diluted effect of potential ordinary shares in accordance with the if-converted method. In accordance with FASB ASC 260, the exercise of options and warrants or conversion of convertible securities is not assumed unless it would reduce earnings per share or increase loss per share.

The following table sets forth the computation of basic and diluted earnings per ordinary share under the two-class method and the if-converted method, respectively, as required under FASB ASC 260 which incorporates EITF No. 03-06, “Participating Securities and the Two-Class Method under FASB Statement No. 128”.

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**17. Earnings per Ordinary Share (continued)**

(U.S. dollars in thousands, except share data)	<u>December 31, 2009</u>	<u>December 31, 2008</u>	<u>December 31, 2007</u>
<b>Basic income (loss) from continuing operations attributable to ordinary shareholders</b>			
<b>Numerator:</b>			
Income (loss) from continuing operations.....	\$ 2,305,341	\$ (2,667,316)	\$ (869,419)
Amounts allocable to convertible cumulative participating preferred shares .....	(33,226)	-	-
Numerator for basic income (loss) from continuing operations per ordinary share .....	<u>\$ 2,272,115</u>	<u>\$ (2,667,316)</u>	<u>\$ (869,419)</u>
<b>Denominator:</b>			
Denominator for basic income (loss) per ordinary share - weighted average number of ordinary shares .....	68,383,370	68,383,370	67,303,066
Basic income (loss) from continuing operations attributable to ordinary shareholders .....	<u>\$ 33.23</u>	<u>\$ (39.00)</u>	<u>\$ (12.92)</u>
 <b>Diluted income (loss) attributable to ordinary shareholders</b>			
<b>Numerator:</b>			
Numerator for diluted income (loss) from continuing operations attributable to ordinary shareholders.....	<u>\$ 2,305,341</u>	<u>\$ (2,667,316)</u>	<u>\$ (869,419)</u>
<b>Denominator:</b>			
Denominator for basic income (loss) per ordinary share - weighted average number of ordinary shares .....	68,383,370	68,383,370	67,303,066
Effect of dilutive securities* .....	150,000,000	-	-
Denominator for diluted income (loss) per ordinary share .....	<u>218,383,370</u>	<u>68,383,370</u>	<u>67,303,066</u>
Diluted income (loss) from continuing operations attributable to ordinary shareholders .....	<u>\$ 10.56</u>	<u>\$ (39.00)</u>	<u>\$ (12.92)</u>

Key:

\* In accordance with FASB ASC 260, exercise of options and warrants or conversion of convertible securities is not assumed if the result would be anti-dilutive, such as when a loss from continuing operations is reported. As a result, if there is a loss from continuing operations, such as during year ended December 31, 2008 and 2007, diluted EPS is computed in the same manner as basic EPS. Due to the anti-dilutive effect on EPS, our stock options (which are convertible into 4,706,592 ordinary shares) potentially could dilute EPS in the future.

**18. Business Products**

With the sale of the Wealth Management business and Life Reinsurance International Segment in 2008, together with the sale of the Acquired Business in our Life Reinsurance North America segment in the first quarter

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**18. Business Products (continued)**

of 2009, operating decisions and performance assessment of the Company is now performed without reference to any separate segments. Accordingly, we do not present information about distinct operating segments for the periods after January 1, 2009.

Revenues from transactions with a single external customer did not amount to 10% or more of our revenues.

The following table summarizes the net premiums earned for Life Reinsurance North America by product offering for the years ended December 31, 2009, 2008 and 2007.

<b>(U.S. dollars in millions)</b>	<b>Traditional</b>	<b>Financial Solutions</b>	<b>Total</b>
Year Ended December 31, 2009 .....	\$ 445.0	\$ 6.8	\$ 451.8
Year Ended December 31, 2008.....	\$ 1,626.0	\$ 25.1	\$ 1,651.1
Year Ended December 31, 2007 .....	\$ 1,737.2	\$ 36.2	\$ 1,773.4

**19. Quarterly Financial Data (Unaudited)**

Quarterly financial data for the year ended December 31, 2009 is as follows:

	<b>Quarter Ended</b>			<b>March 31,</b>
	<b>December 31,</b>	<b>September 30,</b>	<b>June 30,</b>	<b>2009</b>
	<b>2009</b>	<b>2009</b>	<b>2009</b>	<b>(Restated)</b>
<b>(U.S. dollars in thousands, except share data)</b>				
Total revenue .....	\$ 436,555	\$ 352,875	\$ 317,815	\$ 1,518,609
Income from continuing operations before income taxes and noncontrolling interest .....	\$ 261,025	\$ 203,850	\$ 178,434	\$ 1,712,265
Income tax benefit (expense) .....	\$ 3,470	\$ (1,050)	\$ (1,009)	\$ (50,942)
Net income attributable to ordinary shareholders .....	\$ 264,994	\$ 201,890	\$ 176,874	\$ 1,661,583
Basic income per ordinary share .....	\$ 3.82	\$ 2.91	\$ 2.55	\$ 23.95
Diluted income per ordinary share.....	\$ 1.22	\$ 0.92	\$ 0.81	\$ 7.61

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**19. Quarterly Financial Data (Unaudited) (continued)**

During the fourth quarter of 2009, we identified an error in the tax accounting following the sale of the Acquired Business to Hannover Re of \$49.8 million, representing deferred tax liabilities that reverse following the expiration of net operating losses in applicable jurisdictions. This represents an error understating income tax expense as of March 31, 2009. We have therefore restated the income statement and earnings per share amounts in the first quarter to reflect the increase in income tax expense of \$49.8 million.

Quarterly financial data for the year ended December 31, 2008 is as follows:

	<b>Quarter Ended</b>			
	<b>December 31, 2008</b>	<b>September 30, 2008</b>	<b>June 30, 2008</b>	<b>March 31, 2008</b>
<b>(U.S. dollars in thousands, except share data)</b>				
Total revenue .....	\$ (67,309)	\$ (33,150)	\$ 214,226	\$ (169,053)
Loss from continuing operations before income taxes and noncontrolling interest .....	\$ (794,181)	\$ (738,688)	\$ (415,081)	\$ (728,057)
Income (loss) on discontinued operations, net of related taxes .....	\$ -	\$ 8,776	\$ (52,177)	\$ 400
Net loss attributable to ordinary shareholders .....	\$ (795,179)	\$ (713,878)	\$ (465,970)	\$ (735,290)
Basic and diluted loss per ordinary share .....	\$ (11.63)	\$ (10.44)	\$ (6.81)	\$ (10.75)

Computations of results per share for each quarter are made independently of results per share for the year. Due to rounding and transactions affecting the weighted average number of shares outstanding in each quarter, the sum of the quarterly results per share does not equal results per share for the year.

**20. Rating Agencies**

As discussed elsewhere herein, our financial strength ratings and the financial strength ratings of our subsidiaries were lowered on several occasions since 2007, with a resulting material negative impact on our ability to achieve our previous goal of attaining an “A-” or better rating by the middle of 2009. Ratings at such levels also previously triggered the vesting of contractual recapture rights in respect of certain of our reinsurance business and resulted in the increase to a maximum “stepped up” rate of certain guarantor fees in respect of the securitization structures used to finance the Regulation XXX statutory reserve requirements associated with business ceded by SRUS to each of Orkney Re and Orkney Re II. In light of the foregoing and our pursuit of a run-off strategy for our remaining business, among other factors, we determined that we no longer would utilize capital for the payment of ratings fees to maintain the financial strength and other ratings for us and our operating subsidiaries at such levels. Accordingly, we notified each of the rating agencies in 2009 that we no longer will be compensating the agencies for their maintenance of such ratings.

Following this communication, on June 4, 2009, Standard & Poor’s Corporation (“S&P”), affirmed and then subsequently withdrew the “CC” counterparty credit rating of SRGL, the “C” rating of SRGL’s Perpetual Preferred Shares, and the “CCC-” counterparty credit and financial strength ratings of SALIC. At the same time, S&P affirmed and then withdrew the “R” counterparty credit and financial strength ratings of SRUS, the “CCC” counterparty credit and financial strength ratings of Scottish Re Life Corporation and the “CCC-” senior secured rating of the Pass-Through Certificates.

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 20. Rating Agencies (continued)

On June 12, 2009, A.M. Best Company Inc. (“A.M. Best”) affirmed and then withdrew the financial strength ratings and issuer credit ratings of SALIC, Scottish Re Life Corporation and Orkney Re. At the same time, A.M. Best affirmed and then withdrew our issuer credit rating and the rating of our Perpetual Preferred Shares, as well as our indicative ratings of senior unsecured debt, subordinated debt and preferred stock. SRUS’ financial strength rating of “E” (Under Regulatory Supervision) and issuer credit rating of “rs” was unchanged.

On June 22, 2009, Fitch Ratings (“Fitch”) downgraded the issuer default rating of SRGL to “CC” from “CCC” and then withdrew its rating of SRGL. At the same time, Fitch affirmed and then withdrew the insurer financial strength rating of SRUS. Fitch also has withdrawn the insurer financial strength rating of SALIC and the rating of the Pass-Through Certificates and the Perpetual Preferred Shares. As such, Fitch has withdrawn all of our ratings and no longer will provide analytical coverage in respect of us and our affiliates.

On August 18, 2009, Moody’s downgraded the insurance financial strength ratings of SALIC to “Ca” from “C” and SRUS to “Ba3” from “Ba1”, before withdrawing both ratings. At the same time, Moody’s downgraded to “Ca” from “C” and then withdrew the senior secured rating of the Pass-Through Certificates and our preferred stock rating.

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 21. Commitments and Contingencies

##### *Class Action and Shareholder Derivative Lawsuits*

On August 2, 2006, a putative class action lawsuit was filed against SRGL and certain of its current and former officers and directors in the U.S. District Court for the Southern District of New York on behalf of a putative class consisting of investors who purchased SRGL's publicly traded securities between December 16, 2005 and July 28, 2006. Between August 7, 2006 and October 3, 2006, seven additional related class action lawsuits were filed against SRGL, certain of its current and former officers and directors, and certain third parties.

On October 12, 2006, all of the class actions were consolidated. On December 4, 2006, a consolidated class action complaint was filed.

The consolidated complaint which was brought on behalf of a putative class consisting of investors who purchased SRGL's securities between February 17, 2005 and July 31, 2006, alleged violations of various sections of the Securities Exchange Act of 1934, as amended, including section 10(b), and various rules and sections of the Securities Act of 1933, as amended. The complaint sought an unspecified amount of damages, as well as other forms of relief. SRGL and its former officers and directors named in the complaint reached agreement in principle with the plaintiffs on August 1, 2008 to settle the lawsuit. On September 8, 2008, the court entered an order preliminarily approving the proposed settlement. In connection with the settlement, which formally was approved by the court on December 11, 2008, SRGL contributed \$31 million, of which \$5.8 million was paid by SRGL on October 7, 2008, and the remaining \$25.3 million was paid by SRGL's insurance carriers.

##### *Indemnification*

In connection with an examination of the statutory accounting books of certain of our operating insurance subsidiaries, and specifically, the purchase accounting entries made in connection with the 2004 acquisition of the ING business, we determined that certain intercompany receivables and intercompany claims were not reflected in the statutory financial statements of SRUS and SRD in accordance with applicable statutory accounting practices. Management determined that as a result of these errors the statutory surplus for SRD was overstated on a cumulative basis at year end 2004, 2005 and 2006, resulting in a restated statutory surplus at year end 2006 of approximately \$285 million after giving effect to these corrections.

In addition, management determined that the statutory surplus for SRUS was understated on a cumulative basis at year end 2005 and 2006, resulting in a restated statutory surplus at year end 2006 of approximately \$344 million after giving effect to these corrections.

The restated statutory surplus of each of SRUS and SRD met the applicable minimum statutory surplus requirements at December 31, 2006. None of these corrections impact our historical consolidated financial statements under U.S. GAAP.

Pursuant to the Agreement with MassMutual Capital and Cerberus, we made certain representations and warranties regarding the statutory financial statements of each of our insurance subsidiaries, including SRD and SRUS, for the years ended 2003, 2004 and 2005 and, with respect to SRUS but not SRD, the first three quarters of 2006, including that these statements were prepared in conformity with applicable statutory accounting practices and fairly present in accordance with such practices, in all material respects, the statutory financial condition of the relevant insurance subsidiary at the respective dates. In light of our discovery of the corrections described above, we have notified MassMutual Capital and Cerberus, as required by the terms of the Agreement, of the overstatement of statutory surplus in SRD at year end 2004 and the understatement of such statutory surplus at year end 2005 resulting in a cumulative overstatement for the two year period at year end 2005 of approximately \$70 million on an after-tax basis, and the understatement of statutory surplus in SRUS for the year ended 2005 of approximately \$14.5 million on an after-tax basis. On November 16, 2007, MassMutual Capital and Cerberus responded by notifying us of their concern that the corrections described above may constitute breaches of certain of the representations and

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**21. Commitments and Contingencies (continued)**

warranties made by us in the Agreement. Under the Agreement, in the event of a claim for losses resulting from a diminution in value, such losses would be determined by an independent investment banking firm of national reputation, agreed upon by us and MassMutual Capital and Cerberus, based on changes in the valuation of SRGL using the assumptions and models used by MassMutual Capital and Cerberus at the time of their decision to invest in us. Furthermore, should any claim for indemnification be made by MassMutual Capital and Cerberus, the Agreement provides that any decision regarding defending or settling such claim will be taken by a committee of independent directors of our Board of Directors. In their November 16, 2007 correspondence, MassMutual Capital and Cerberus requested that we convene a committee of independent directors. No action has since been taken by us or the Investors in respect of this claim. At this time, we do not know what the amount of any indemnifiable losses would be, if any, or what potential defenses or other limitations on indemnification may be available to us under those circumstances. The Agreement provides that any indemnification claim would be satisfied by adjusting the conversion amount at which the Convertible Cumulative Participating Preferred Shares issued to MassMutual Capital and Cerberus are convertible into our Ordinary Shares.

***Lease Commitments***

We lease office space in the countries in which we conduct business under operating leases that expire at various dates through 2016. Total rent expense with respect to these operating leases for the years ended December 31, 2009, 2008 and 2007 was approximately \$1.4 million, \$2.7 million and \$3.1 million, respectively.

Future minimum lease payments under the leases are expected to be:

<b>(U.S. dollars in thousands)</b>	<b>Gross Lease</b>	<b>Sublease</b>	<b>Net Lease</b>
<b>Year ending December 31,</b>	<b>Payments</b>	<b>Rentals</b>	<b>Payments</b>
2010 .....	\$ 1,859	\$ (250)	\$ 1,608
2011 .....	1,759	(433)	1,326
2012 .....	1,458	(568)	890
2013 .....	1,256	(585)	671
2014 .....	1,294	(603)	691
Thereafter .....	2,705	(1,260)	1,445
Total future lease commitments .....	<u>\$ 10,331</u>	<u>\$ (3,699)</u>	<u>\$ 6,631</u>

The operating lease for our former Denver office was sold as part of the sale of the Acquired Business to Hannover Re in 2009. As at December 31, 2009, we held operating leases for our Charlotte, Dublin and Bermuda offices.

In December 31, 2009, we entered into a new operating lease in Charlotte. The new lease agreement is for three years (through 2012) with the option to renew for a further four years (through 2016). Our lease in the previous Charlotte office remains in place and does not terminate until 2016. We have negotiated two subleases in respect of this property which reduce the associated leasehold commitment for this office. The first sublease is committed through March 2011, and includes extension options but has no renewal obligation. The second sublease commences in January 2010 and expires in 2016. The remainder of the lease commitment on the previous Charlotte office not covered by the subleases is still borne by us and is included in the figures above.

***Concentrations of Credit Risk***

The creditworthiness of a counter party is evaluated by us, taking into account credit ratings assigned by rating agencies. The credit approval process involves an assessment of factors including, among others, the counterparty,

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 21. Commitments and Contingencies (continued)

country and industry credit exposure limits. Collateral may be required, at our discretion, on certain transactions based on the creditworthiness of the counterparty.

The areas where significant concentrations of credit risk may exist include amounts recoverable from reinsurers and reinsurance balances receivable (collectively “reinsurance assets”), investments and cash and cash equivalent balances. A credit exposure exists with respect to reinsurance assets as they may become uncollectible. We manage our credit risk in our reinsurance relationships by transacting with reinsurers that we consider financially sound, and if necessary, we may hold collateral in the form of funds, trust accounts and/or irrevocable letters of credit. This collateral can be drawn on for amounts that remain unpaid beyond specified time periods on an individual reinsurer basis.

#### *Indemnification of Our Directors, Officers, Employees and Agents*

We indemnify our directors, officers, employees and agents against any action, suit or proceeding, whether civil, criminal, administrative or investigative by reason of the fact that they are our director officer, employee or agent, as provided in our articles of association. Since this indemnity generally is not subject to limitation with respect to duration or amount, we do not believe that it is possible to determine the maximum potential amount due under this indemnity in the future.

#### 22. Statutory Requirements and Dividend Restrictions

##### *Statutory Requirements for Non U.S. Subsidiaries*

Our insurance and reinsurance subsidiaries are subject to insurance laws and regulations in the jurisdictions in which they operate which include Bermuda, Cayman, the United States, and Ireland. Certain of these regulations include restrictions that limit the amount of dividends or other distributions, such as loans or cash advances, available to shareholders without prior approval of the insurance regulatory authorities. The difference between financial statements prepared for insurance regulatory authorities and statements prepared in accordance with U.S. GAAP vary by jurisdiction; however the primary difference is that financial statements prepared for some insurance regulatory authorities do not reflect DAC, limit the amount of deferred income tax net assets, limit or disallow certain intangible assets and, establishes reserves for invested assets and calculate benefit reserves by defined formulaic process.

Our Bermuda insurance companies are required to maintain a minimum capital of \$0.25 million. There are no statutory restrictions on the payment of dividends from retained earnings by any of the Bermuda subsidiaries as the minimum statutory capital and surplus requirements are satisfied by the share capital and additional paid-in capital of each of the Bermuda subsidiaries.

Under The Insurance Law of the Cayman Islands, SALIC must maintain a minimum net capital worth of \$0.24 million. There are no statutory restrictions on the payment of dividends from retained earnings by any of the Cayman subsidiaries as the minimum statutory capital and surplus requirements are satisfied by the share capital and additional paid-in capital of each of the Cayman subsidiaries.

SRD is required by the Irish Financial Services Regulatory Authority (“IFRSRA”) to maintain a minimum level of paid up share capital. IFRSA has put certain restrictions in place on the ability of SRD to make dividend payments from profits available for distribution within the meaning of the Companies (Amendment) Act, 1983. On July 15, 2006, Statutory Instrument 380 of 2006 transposed into Irish law European Union Council Directive 2005/68/EC. The Directive establishes a regulatory regime for reinsurance organizations and defines minimum requirements for certain liabilities, assets backing these liabilities and surplus. As at December 31, 2009, SRD had solvency margin of 232%.

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**22. Statutory Requirements and Dividend Restrictions (continued)**

SALIC is a party to a net worth maintenance agreement with SRD, pursuant to which SALIC effectively guarantees SRD's regulatory solvency. In the fourth quarter of 2008, IFSRA notified the Company that corrective action needed to be taken with respect to SRD's solvency calculations primarily as a result of market value degradation in respect of the assets SRD held to support business ceded to it from SRUS and other of its affiliates. In response, the Company effectuated a transfer of a majority of its business in SRD to SALIC, effective October 1, 2008, SALIC, in return received modified coinsurance assets with respect to certain of the ING Business originally ceded to SRD and the residual interests in reserve credit trust assets with respect to business originally ceded from SRUS to SRD. Absent the October 1, 2008 transfer, SALIC's obligations under the net worth maintenance agreement would have been triggered and the Company likely would have needed to seek bankruptcy protection. A significant portion of the business transferred from SRD to SALIC was included in the Acquired Business sold to Hannover Re. In connection with the closing of the transactions contemplated by the Purchase Agreement with Hannover Re, the remaining business at SRD was recaptured from SRD or transferred to SALIC. Effective October 1, 2009, SRD entered into a reinsurance agreement with SRUS pursuant to which SRD has reinsured from SRUS the liabilities related to a certain block of reinsurance business previously ceded by SRUS to SRD prior to the October 1, 2008 transfer.

*Statutory Requirements for U.S. Subsidiaries*

Our United States subsidiaries file financial statements prepared in accordance with statutory accounting practices prescribed or permitted by the Department. Except as otherwise noted in the statutory financial statements of SRUS, the Department adheres to National Association of Insurance Commissioners (the "NAIC") risk-based capital ("RBC") requirements for Delaware domiciled life and health insurance companies. As of December 31, 2009 and 2008, SRUS, SRLC and Orkney Re exceeded all minimum RBC requirements on a Delaware basis. The maximum amount of dividends that can be paid by SRUS, SRLC and Orkney Re (Delaware domiciled insurance companies) without prior approval of the State Insurance Commissioner (the "Commissioner") is subject to restrictions relating to statutory surplus and operating earnings. The maximum dividend payment that may be made without prior approval is limited to the greater of the net gain from operations for the preceding year or 10% of statutory surplus as of December 31 of the preceding year not exceeding earned surplus. The applicable statutory provisions only permit an insurer to pay a shareholder dividend from unassigned surplus. SRUS, SRLC and Orkney Re cannot pay dividends in 2010 without prior approval of the Commissioner.

The following table presents, for each of our U.S. reinsurance subsidiaries, the statutory capital and surplus as of December 31, 2009 and 2008, and the statutory net earned income (loss) for the years ended December 31, 2009, 2008 and 2007. The amounts shown in the table are those reflected in each company's most recent statutory financial statement filings with insurance regulators. The 2008 comparables have been updated to reflect the re-filing of our statutory financial statements in May 2009.

<b>(U.S. dollars in thousands)</b>	<b>Statutory Capital &amp; Surplus</b>		<b>Statutory Net Earned Income (Loss)</b>		
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>
Scottish Re (U.S.), Inc. ....	\$ 233,684	\$ 167,348	\$ 123,149	\$ (125,301)	\$ (380,864)
Scottish Re Life Corporation .....	\$ 72,808	\$ 57,577	\$ (4,102)	\$ (19,405)	\$ 7,396
Orkney Re, Inc.....	\$ 912,852	\$ 727,890	\$ 14,116	\$ (185,630)	\$ (55,286)

During 2009, our U.S. reinsurance subsidiaries adopted Statement of Statutory Accounting Principles No. 43 – Revised ("SSAP 43R"). SSAP 43R permitted insurance companies to revise their methodology for recording impairments of structured securities. As a result of adopting SSAP 43R, we recorded an increase to surplus for cumulative effect changes of adoption of accounting principal of \$57.7 million, \$158.6 million and \$11.4 million for SRUS, SRLC and Orkney Re respectively.

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 22. Statutory Requirements and Dividend Restrictions (continued)

The company action level risk based capital percentage at December 31, 2009 as filed with regulators on March 19, 2010 for SRUS, SRLC and Orkney Re was 320%, 257% and 2,094%, respectively. The 2009 U.S. statutory filings are subject to audit and consequently may be subject to further negative or positive adjustments.

All other regulated insurance entities are in excess of their minimum regulatory capital requirements as of December 31, 2009.

#### *SRUS*

The statutory financial statements of SRUS are presented on the basis of accounting practices prescribed or permitted by the Department.

The Department recognizes only statutory accounting practices prescribed or permitted by the State for determining and reporting the financial condition and results of operations of an insurance company and for determining its solvency under Delaware Insurance Law. The AP&P Manual has been adopted as a component of prescribed or permitted practices by the State

The Company historically has obtained credit for reinsurance on its statutory financial statements for reinsurance ceded to each of Orkney Re, and certain of its non-U.S. affiliated reinsurers (each a "Subject Reinsurer" and, collectively, the "Subject Reinsurers") to the extent of the fair market value of eligible securities held in the qualifying reserve credit trust account established by each respective Subject Reinsurer, for the exclusive benefit of the Company pursuant to and in accordance with Delaware Insurance Regulation §1003 (Credit for Reinsurance) (each such eligible security meeting the requirements of subsection 9.1.2 thereof an "Eligible Security", and each such trust account, a "Trust Account").

In connection with the filing of its statutory financial statement for the period ending September 30, 2008, the Company requested and received approval for Permitted Practice from the Department. In connection with the receipt by SRUS of the Permitted Practice in late 2008, SRUS consented to the issuance of the Order of Supervision. Specifically, the Company has received permission to take as a reduction from liability the reinsurance ceded by the Company to each Subject Reinsurer in an amount up to but not greater than the specific obligations under the reinsurance agreements with such Subject Reinsurer that the respective Trust Account was established to secure, provided that:

1. The original book value of all Eligible Securities on deposit in the applicable Trust Account (such book value to be determined at the time such securities were deposited to such Trust Account) is, when combined with any cash on deposit therein, not less than the specific obligations related to such Trust Account; and
2. The current fair market value of cash and Eligible Securities held in the applicable Trust Account is not less than the specific obligations related to such Trust Account calculated using the Commissioners Standard Ordinary mortality basis (2001 CSO) for new issues (promulgated under Delaware Insurance Regulation §1213 and effective for use in the State as of January 1, 2004); and
3. The appointed actuary opines that sufficient experience exists to demonstrate that such 2001 CSO mortality basis provides reasonable margin relative to experience.

In the event any one or more of the foregoing conditions (each a "Condition") is not met, the reduction from liability for reinsurance ceded by the Company to the applicable Subject Reinsurer will be reduced by an amount equal to the absolute value of the shortfall resulting from application of the specific Condition failing to be met (or if more than one Condition is not met, application of the specific Condition that results in the greatest shortfall).

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**22. Statutory Requirements and Dividend Restrictions (continued)**

On February 17, 2009, citing, among other things, then current economic conditions and the uncertainty of the conditions that lay ahead, the Commissioner issued an emergency order amending Delaware Insurance Regulation §1215 relating to Recognition of Preferred Mortality Tables for use in Determining Minimum Reserve Liabilities (the “Preferred Mortality Table Emergency Regulation”) and an emergency order amending Delaware Insurance Regulation §1212 relating to Valuation of Life Insurance Policies (the “X-Factor Emergency Regulation”, and together with the Preferred Mortality Table Regulation, the “Emergency Regulations”). Generally, the Preferred Mortality Table Emergency Regulation allows, upon receipt of the Commissioner’s approval, use of the 2001 CSO Preferred Class Structure Mortality Table as the minimum valuation standard for policies issued after January 1, 2004. In connection with the Preferred Mortality Table Emergency Regulation, the Company sought and, on February 26, 2009, obtained the Department’s approval for use of the 2001 CSO Preferred Class Structure Mortality Table in accordance with such Emergency Regulation. The X-Factor Emergency Regulation relaxes existing constraints related to the X-factor assumptions used in the calculation of statutory reserves.

The Emergency Regulations by their terms became effective for valuations on and after December 31, 2008. The Emergency Regulations were adopted into law pursuant to the Delaware Administrative Procedures Act on September 1, 2009. Similar regulations were adopted by the NAIC during the 2009 Fall National Meeting and as such, the Emergency Regulations no longer are considered a prescribed practice.

A reconciliation of net income (loss) and capital and surplus per the Permitted Practice and Prescribed Practice (Emergency Regulation) and NAIC prescribed reserving as of December 31, 2009 and December 31, 2008 follows

	<b>December 31, 2009</b>	
<b>(U.S. dollars in thousands)</b>	<b>Statutory Net Earned Income (Loss)</b>	<b>Statutory Capital &amp; Surplus</b>
Financial statements - Delaware basis .....	\$ 123,149	\$ 233,684
Permitted increase in reserve credit .....	-	(152,568)
Financial statements – NAIC basis .....	<u>\$ 123,149</u>	<u>\$ 81,116</u>
	<b>December 31, 2008</b>	
<b>(U.S. dollars in thousands)</b>	<b>Statutory Net Earned Income (Loss)</b>	<b>Statutory Capital &amp; Surplus</b>
Financial statements - Delaware basis .....	\$ (125,301)	\$ 167,348
Permitted increase in reserve credit .....	-	(197,206)
Permitted mortality table .....	-	(43,206)
Prescribed increase in reserve credit .....	-	(146,662)
Financial statements – NAIC basis .....	<u>\$ (125,301)</u>	<u>\$ (219,726)</u>

*SRLC*

SRLC did not utilize any permitted or prescribed practices during and as of the years ended December 31, 2009 and 2008.

*Orkney Re*

Orkney Re is a Special Purpose Captive Insurance Company under the laws of the State of Delaware. Pursuant to its Certificate of Authority issued by the Department, Orkney Re establishes and maintains its reserves in accordance with U.S. GAAP rather than the statutory reserves prescribed by the NAIC Accounting Practices and Procedures Manual.

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**22. Statutory Requirements and Dividend Restrictions (continued)**

A reconciliation of net income and capital and surplus per the permitted practice established by the Certificate of Authority and NAIC prescribed reserving as of December 31, 2009 and 2008 follows:

	<b>December 31, 2009</b>	
<b>(U.S. dollars in thousands)</b>	<b>Statutory Net Earned Income (Loss)</b>	<b>Statutory Capital &amp; Surplus</b>
Financial statements - Delaware basis .....	\$ 14,116	\$ 912,852
Permitted valuation basis adjustment .....	(57,940)	(890,898)
Financial statements – NAIC basis .....	\$ (43,824)	\$ 21,954

	<b>December 31, 2008</b>	
<b>(U.S. dollars in thousands)</b>	<b>Statutory Net Earned Income (Loss)</b>	<b>Statutory Capital &amp; Surplus</b>
Financial statements - Delaware basis .....	\$ (185,630)	\$ 727,890
Permitted valuation basis adjustment .....	(81,903)	(832,957)
Financial statements – NAIC basis .....	\$ (267,533)	\$ (105,067)

**23. Related Party Transactions**

In connection with the 2007 New Capital Transaction on May 7, 2007, MassMutual Capital and Cerberus hold in the aggregate approximately 68.7% of our equity voting power at December 31, 2008, along with the right to designate two-thirds of the members of our Board of Directors.

We incurred \$38,238 and \$348,650 for legal fees and consulting fees associated with Cerberus for the years ended December 31, 2009 and 2008, respectively. Also in connection with the 2007 New Capital Transaction, we paid fees totaling \$2.6 million to Ableco Finance LLC, a related party of Cerberus, for an interim term loan facility put in place on March 9, 2007 and terminated on May 7, 2007.

For the year ended December 31, 2009 and 2008, we had premiums earned of \$15.1 million and \$118.1 million, respectively with MassMutual Capital. As of December 31, 2009 we had a net payable to MassMutual Capital of \$9.6 million (as compared to \$5.7 million in 2008).

We incurred \$15,000 and \$244,000 for Board of Director fees payable to Babson Capital Management LLC, a subsidiary of MassMutual Capital for the years ended December 31, 2009 and 2008, respectively.

We also incurred \$0.4 million and \$0.2 million for investment management fees payable to Babson Capital Management LLC for the years ended December 31, 2009 and 2008, respectively. The investment management fees incurred in 2008 related to assets held in Clearwater Re. The investment management fees incurred in 2009 related to the appointment, in the fourth quarter of 2009, of Babson Capital Management LLC as investment manager for all

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 23. Related Party Transactions (continued)

our invested assets, excluding investments held in securitization structures and certain company directed investments.

For as long as the Cypress Entities in the aggregate beneficially own at least 2.5% of our outstanding voting shares on a fully diluted basis, they will be entitled to designate at least one individual for election to the Board of Directors. The Cypress Entities owned collectively 4.3% of our outstanding voting shares on a fully diluted basis as at December 31, 2009 and 2008.

Included in Other Investments are \$3.7 million and \$4.7 million at December 31, 2009 and 2008 respectively, for Investment in Cypress Sharpridge Investments, Inc., which is an affiliate of the Cypress Entities. During the year ended December 31, 2009, 2008 and 2007, we received \$0.7 million, \$0.4 million and \$1 million in dividend income from our investment in Cypress Sharpridge.

We have been informed by Cerberus that an affiliate of Cerberus acquired from one or more unaffiliated third parties \$700 million in aggregate principal amount of the Orkney Notes in 2009. None of the Company, Orkney I, Orkney Re or any of our other subsidiaries were a party to this purchase. No terms of the Orkney Notes or any of the underlying transaction documents were changed as a result of this purchase.

#### 24. Discontinued Operations

##### *Disposal of Wealth Management Business*

On July 11, 2008, the sale of the Wealth Management business closed with respect to Scottish Annuity & Life Insurance Company (Bermuda) Ltd. and Scottish Annuity & Life International Insurance Company (Bermuda) Ltd., and on August 5, 2008, the transaction closed with respect to The Scottish Annuity Company (Cayman) Ltd. We generated proceeds of \$9.3 million and recognized a net loss of \$4.9 million on this sale.

##### *Disposal of Life Reinsurance International Segment*

On July 18, 2008, Pacific Life Insurance Company concluded the purchase of Scottish Re Holdings Limited and the U.K. portion of the Life Reinsurance International Segment for \$67.1 million after purchase price adjustments of \$4.1 million. The purchase of the Asia portion of the Life Reinsurance International Segment was completed on August 20, 2008, for an additional payment by Pacific Life Insurance Company of \$0.5 million. We recorded an aggregate loss of \$31 million on these transactions in fiscal year 2008. Pre-sale, the Life Reinsurance International Segment incurred a loss from operations of approximately \$7 million. Additionally, in March 2009, the Singapore branch was closed and \$6.1 million of capital was returned to SALIC.

**SCOTTISH RE GROUP LIMITED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2009**

**24. Discontinued Operations (continued)**

The following table presents the assets and liabilities held for sale for the Life Reinsurance International Segment and the Wealth Management business as of December 31, 2007:

<b>(U.S. dollars in thousands)</b>	<b>As of December 31, 2007</b>
Fixed maturity investments, trading at fair value .....	\$ 189,124
Cash and cash equivalents .....	68,598
Other investments .....	6
Funds withheld at interest .....	(68)
Total investments .....	257,660
Accrued interest receivable .....	3,219
Reinsurance balances and risk fees receivable .....	119,835
Deferred acquisition costs .....	39,634
Amount recoverable from reinsurers .....	29,519
Present value of in-force business .....	3,701
Other assets .....	10,471
Current income tax receivable .....	104
Deferred tax liability .....	2,045
Segregated assets .....	703,945
Total Assets held for sale .....	\$ 1,170,133
Reserves for future policy benefits .....	\$ 226,112
Accounts payable and other liabilities .....	14,585
Reinsurance balances payable .....	37,233
Segregated liabilities .....	703,945
Total Liabilities held for sale .....	\$ 981,875

The above activity affected the 2008 consolidated financial statements. There were no discontinued operations in 2009.

**25. Subsequent Events**

The subsequent events disclosed in these notes to the consolidated financial statements have been evaluated by Company management up to and including the filing of the financial statements on April 30, 2010.

***Deferral of Interest Payments on Floating Rate Capital Securities and Trust Preferred Securities***

Subsequent to December 31, 2009, we have accrued and deferred payment of an additional \$1.6 million of interest on our floating rate capital securities and trust preferred securities. As of April 30, 2010, we have accrued and deferred payment on a total of \$7.6 million of interest.

***Non-declaration of Perpetual Preferred Shares Dividends***

In accordance with the relevant financial tests under the terms of the Perpetual Preferred Shares, we were precluded from declaring and paying dividends on the January 15, 2010 and April 15, 2010 dividend payment dates. As discussed in Note 13, "Shareholders' Deficit", the holders of the Perpetual Preferred Shares continue to be entitled to elect two directors of SRGL's Board as a result of dividends on the Perpetual Preferred Shares having not been declared and paid for six or more dividend periods. This right has not been exercised to date.

## SCOTTISH RE GROUP LIMITED

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

#### 25. Subsequent Events (continued)

##### *Stingray*

Subsequent to December 31, 2009, we acquired in a privately negotiated transaction an additional \$18.1 million of aggregate stated amount of Pass-Through Certificates. As of April 30, 2010, \$80.2 million in aggregate stated amount of outstanding Pass-Through Certificates were held by third party Holders. This transaction will not result in an additional gain or loss on the consolidation of the funding arrangement.

##### *Orkney Re II*

On the scheduled interest payment date of February 11, 2010, Orkney Re II was unable to make scheduled interest payments on the Series A-1 Notes. As a result, Assured made guarantee payments on the Series A-1 Notes in the amount of \$0.7 million.

##### *Orkney Re*

As discussed in Note 10, "Collateral Finance Facilities and Securitization Structures-*Orkney Re, Inc. Notices of Default*", on September 21, 2009, MBIA served a notice of default under the restructuring agreement to Orkney Re, Orkney I and SRUS, alleging failure to provide MBIA with an actuarial review in accordance with the terms of the restructuring agreement. Such alleged failure, because not cured within five business days of such notice, would constitute an event of default under the Orkney Insurance Agreement if ultimately determined to be a default under the restructuring agreement. As of the date hereof, the parties are in the process of negotiating a settlement agreement related to such event of default.

On February 22, 2010, MBIA served Orkney Re, Orkney I and SRUS with notices of default under each of the Orkney I indenture and the Orkney Insurance Agreement, alleging failure by the parties to provide certain required financial statements and other documents required to be delivered under these transaction documents. SRUS subsequently caused such documents to be delivered within the applicable cure periods and, as of the date hereof, there is no event of default resulting from such notices of default.

##### *Income Taxes*

As a result of a recent U.S. tax court ruling relating to an unaffiliated third party (*Container Corporation v. Commissioner*, 134 T.C. 5 (2010)), we have reconsidered our position in respect of an uncertain tax position and evaluated the implications of the ruling in accordance with FASB ASC 740-10. We have concluded that we will release a tax liability of up to approximately \$35.9 million in the first quarter of 2010. The release will occur in the first quarter of 2010 because the *Container Corporation* ruling had not occurred at December 31, 2009.

