
SCOTTISH RE GROUP LIMITED

CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2012

Table of Contents

Report of Independent Auditors.....	2
Consolidated Balance Sheets – December 31, 2012 and 2011	3
Consolidated Statements of Operations – Years Ended December 31, 2012, 2011, and 2010.....	4
Consolidated Statements of Shareholders’ Equity (Deficit) – Years Ended December 31, 2012, 2011, and 2010.....	5
Consolidated Statements of Cash Flows – Years Ended December 31, 2012, 2011, and 2010.....	6
Notes to Consolidated Financial Statements.....	7

Report of Independent Auditors

The Board of Directors and Shareholders of Scottish Re Group Limited

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Scottish Re Group Limited and subsidiaries, which comprise the consolidated balance sheets as of December 31, 2012 and 2011, and the related consolidated statements of operations, shareholders' equity (deficit), and cash flows for each of the three years in the period ended December 31, 2012, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in conformity with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free of material misstatement, whether due to fraud or error.

Auditor's Responsibility

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.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

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, 2012 and 2011, and the consolidated results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

/s/ Ernst & Young LLP

Charlotte, North Carolina
March 27, 2013

SCOTTISH RE GROUP LIMITED
CONSOLIDATED BALANCE SHEETS
(Expressed in Thousands of United States Dollars, except share data)

	December 31, 2012	December 31, 2011
Assets		
Fixed-maturity investments held as trading securities, at fair value	\$ 1,733,224	\$ 1,967,689
Preferred stock held as trading securities, at fair value	2,387	58,529
Cash and cash equivalents	368,809	282,028
Other investments	19,067	14,877
Funds withheld at interest	482,985	549,333
Total investments ¹	2,606,472	2,872,456
Accrued interest receivable ²	12,979	16,757
Reinsurance balances and risk fees receivable	129,159	120,976
Deferred acquisition costs	162,181	173,254
Amount recoverable from reinsurers	705,703	749,034
Present value of in-force business	24,001	27,027
Other assets	7,911	8,771
Total assets	\$ 3,648,406	\$ 3,968,275
Liabilities		
Reserves for future policy benefits	\$ 1,329,120	\$ 1,354,140
Interest-sensitive contract liabilities	1,104,413	1,301,511
Collateral finance facilities ³	450,000	450,000
Accounts payable and other liabilities	51,917	64,426
Embedded derivative liabilities, at fair value	26,290	33,758
Reinsurance balances payable	72,611	93,244
Deferred tax liability	43,129	45,223
Long-term debt, at par value	129,500	129,500
Total liabilities	\$ 3,206,980	\$ 3,471,802
Mezzanine Equity		
Convertible cumulative participating preferred shares, par value \$0.01; 1,000,000 shares issued and outstanding with \$600.0 million initial stated value (liquidation preference: 2012 - \$770.7 million; 2011 - \$802.8 million)	555,857	555,857
Shareholders' Deficit		
Ordinary shares, par value \$0.01: 68,383,370 shares issued and outstanding	684	684
Non-cumulative perpetual preferred shares, par value \$0.01: Shares issued and outstanding: 2012 – 3,246,776; 2011 – 4,806,083	81,169	120,152
Additional paid-in capital	1,218,190	1,218,190
Retained deficit	(1,414,474)	(1,407,269)
Total Scottish Re Group Limited shareholders' deficit	(114,431)	(68,243)
Noncontrolling interest	-	8,859
Total shareholders' deficit	(114,431)	(59,384)
Total liabilities, mezzanine equity, and shareholders' deficit	\$ 3,648,406	\$ 3,968,275
 ¹ Includes total investments of consolidated variable interest entity ("VIE")	 \$ 296,476	 \$ 282,429
² Includes accrued interest receivable of consolidated VIE	488	455
³ Reflects collateral finance facilities of consolidated VIE	450,000	450,000

See Accompanying Notes to Consolidated Financial Statements

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

	Year Ended		
	December 31, 2012	December 31, 2011	December 31, 2010
Revenues			
Premiums earned, net.....	\$ 325,374	\$ 302,920	\$ 421,134
Investment income, net.....	109,410	136,223	170,454
Net realized and unrealized gains (losses).....	139,012	(4,413)	242,246
Change in value of long-term debt, at fair value.....	-	-	(15,246)
Gain on extinguishment of debt.....	-	260,000	-
Change in value of embedded derivative assets and liabilities.....	7,468	(1,213)	3,187
Fees and other income.....	3,807	4,381	5,453
Total revenues.....	<u>585,071</u>	<u>697,898</u>	<u>827,228</u>
Benefits and expenses			
Claims, policy benefits, and changes in policyholder reserves, net.....	373,762	314,754	394,618
Interest credited to interest-sensitive contract liabilities.....	37,790	46,911	52,346
Amortization of deferred acquisition costs and other insurance expenses, net.....	49,037	462,242	88,660
Operating expenses.....	32,208	44,388	54,581
Collateral finance facilities expense.....	10,465	25,303	33,061
Interest expense.....	6,996	6,041	5,360
Total benefits and expenses.....	<u>510,258</u>	<u>899,639</u>	<u>628,626</u>
Income (loss) before income taxes	74,813	(201,741)	198,602
Income tax benefit.....	7,102	2,617	37,941
Net income (loss)	81,915	(199,124)	236,543
Dividends declared on non-cumulative perpetual preferred shares.....	(1,218)	-	-
Dividends declared on convertible cumulative participating preferred shares.....	(75,555)	-	-
Gain on redemption of non-cumulative perpetual preferred shares.....	14,039	-	3,878
Net (income) loss attributable to noncontrolling interest.....	281	141	(1,332)
Net income (loss) attributable to Scottish Re Group Limited	<u>\$ 19,462</u>	<u>\$ (198,983)</u>	<u>\$ 239,089</u>

See Accompanying Notes to Consolidated Financial Statements

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

	Year Ended		
	December 31, 2012	December 31, 2011	December 31, 2010
Share capital:			
Ordinary shares:			
Beginning of period	\$ 684	\$ 684	\$ 684
Merger activity, net	-	-	-
End of period	684	684	684
Non-cumulative perpetual preferred shares:			
Beginning of period	120,152	120,152	125,000
Non-cumulative perpetual preferred shares redeemed	(38,983)	-	(4,848)
End of period	81,169	120,152	120,152
Additional paid-in capital:			
Beginning of period	1,218,190	1,217,894	1,217,535
Option expense	-	296	359
End of period	1,218,190	1,218,190	1,217,894
Retained deficit:			
Beginning of period	(1,407,269)	(1,208,286)	(1,447,375)
Extinguishment of noncontrolling interest	7,778	-	-
Dividends declared on ordinary shares	(34,445)	-	-
Net income (loss) attributable to Scottish Re Group Limited	19,462	(198,983)	239,089
End of period	(1,414,474)	(1,407,269)	(1,208,286)
Total Scottish Re Group Limited shareholders' (deficit) equity	\$ (114,431)	\$ (68,243)	\$ 130,444
Noncontrolling interest:			
Beginning of period	8,859	9,000	7,668
Net income (loss)	(281)	(141)	1,332
Acquisition of noncontrolling interest	(800)	-	-
Extinguishment of noncontrolling interest	(7,778)	-	-
End of period	-	8,859	9,000
Total shareholders' (deficit) equity	\$ (114,431)	\$ (59,384)	\$ 139,444

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, 2012	December 31, 2011	December 31, 2010
Operating activities			
Net income (loss)	\$ 81,915	\$ (199,124)	\$ 236,543
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Net realized and unrealized (gains) losses.....	(139,012)	4,413	(242,246)
Change in value of long-term debt, at fair value	-	-	15,246
Change in value of embedded derivative assets and liabilities	(7,468)	1,213	(3,187)
Amortization and unlocking of deferred acquisition costs	11,073	12,090	31,141
Amortization of present value of in-force business	3,026	4,914	6,375
Amortization of deferred finance facility costs	868	10,696	5,081
Depreciation of fixed assets	163	217	415
Option expense.....	-	296	359
Adjustments attributed to the Orkney I Unwind Transaction:			
Gain on extinguishment of Orkney Notes	-	(260,000)	-
Release of deferred acquisition costs	-	83,204	-
Net increase in receivables and amounts recoverable from reinsurers	-	(252,388)	-
Changes in assets and liabilities:			
Funds withheld at interest	66,348	35,284	23,883
Accrued interest receivable	3,778	5,529	2,136
Reinsurance balances receivable	(8,183)	10,339	26,812
Deferred acquisition costs	-	804	(3,671)
Other assets	1,291	7,139	60,651
Reserves for future policy benefits, net of amounts recoverable from reinsurers	18,311	(55,231)	(47,745)
Interest-sensitive contract liabilities	(23,139)	(5,760)	(2,092)
Accounts payable and other liabilities, including deferred tax liabilities	(14,603)	10,633	(14,403)
Reinsurance balances payable	(20,633)	1,611	(17,935)
Net cash provided by (used in) operating activities.....	<u>(26,265)</u>	<u>(584,121)</u>	<u>77,363</u>
Investing activities			
Purchase of fixed-maturity investments	(282,202)	(305,334)	(849,344)
Proceeds from sales and maturities of fixed-maturity investments	651,981	1,442,124	886,205
Purchases of preferred stock.....	(179)	-	(1,865)
Proceeds from sales and maturities of preferred stock.....	57,273	8,239	15,823
Purchase of and proceeds from other investments, net	(3,006)	1,581	1,353
Proceeds from sales of fixed assets, net.....	-	153	-
Net cash provided by investing activities	<u>423,867</u>	<u>1,146,763</u>	<u>52,172</u>
Financing activities			
Redemption of collateral finance facilities	-	(590,000)	-
Withdrawals from interest-sensitive contract liabilities	(174,659)	(108,336)	(100,868)
Redemption on non-cumulative perpetual preferred shares	(24,944)	-	(970)
Deemed capitalization of Merger Sub by Investors prior to Merger.....	-	17,647	-
Payment of Merger consideration by Investors on behalf of Merger Sub.....	-	(17,647)	-
Payment of dividends on non-cumulative perpetual preferred shares.....	(1,218)	-	-
Payment of dividends on convertible cumulative participating preferred shares.....	(75,555)	-	-
Payment of dividends on ordinary shares	(34,445)	-	-
Net cash (used in) financing activities	<u>(310,821)</u>	<u>(698,336)</u>	<u>(101,838)</u>
Net change in cash and cash equivalents.....	86,781	(135,694)	27,697
Cash and cash equivalents, beginning of period.....	282,028	417,722	390,025
Cash and cash equivalents, end of period.....	<u>\$ 368,809</u>	<u>\$ 282,028</u>	<u>\$ 417,722</u>
Interest paid	<u>\$ 24,082</u>	<u>\$ -</u>	<u>\$ 4,349</u>
Taxes paid (refunded)	<u>\$ 29</u>	<u>\$ (48)</u>	<u>\$ (12,864)</u>

See Accompanying Notes to Consolidated Financial Statements

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

1. Organization and Business

Organization

Scottish Re Group Limited (“SRGL” and, together with SRGL’s consolidated subsidiaries and VIE(s), as applicable, the “Company”, “we”, “our”, and “us”) is a holding company incorporated under the laws of the Cayman Islands, and our principal executive office is located in Bermuda. Through our operating subsidiaries, we are principally engaged in the reinsurance of life insurance, annuities, and annuity-type products. As of December 31, 2012, we had principal operating companies, holding companies, financing companies, and a collateral finance facility in Bermuda, the Cayman Islands, Ireland, Luxembourg, and the United States, as follows:

Bermuda

Scottish Re Life (Bermuda) Limited (“SRLB”)

Cayman Islands

SRGL

Scottish Annuity & Life Insurance Company (Cayman) Ltd. (“SALIC”)

Ireland

Scottish Re (Dublin) Limited (“SRD”)

Orkney Re II plc (“Orkney Re II”)

Luxembourg

Scottish Financial (Luxembourg) S.á.r.l. (“SFL”)

Scottish Holdings (Luxembourg) S.á.r.l. (“SHL”)

United States (U.S.)

Scottish Holdings, Inc. (“SHI”)

Scottish Re (U.S.), Inc. (“SRUS”)

Scottish Re Life Corporation (“SRLC”)

On August 24, 2011, the Merger (as defined in Note 11, “Mezzanine Equity – Convertible Cumulative Participating Preferred Shares - *Merger Agreement*”) was completed. The Merger has been treated for purposes of these consolidated financial statements as a business combination.

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.

While pursuing our run-off strategy, the Company has purchased from time-to-time and, if opportunities arise, may in the future continue to purchase, in privately-negotiated transactions, open market purchases, or by means of general solicitations, tender offers, or otherwise, our outstanding 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 and recent transactions, please refer to Note 10, “Debt Obligations and Other Funding Arrangements”, and to Note 12, “Shareholders’ Deficit”. Further, the Company may continue to evaluate strategic alternatives to increase shareholder value, including consideration of transactions for the sale or disposition of our businesses or assets, which transactions, individually or in the aggregate, may be material. Please refer to Note 9, “Collateral Finance Facilities and Securitization Structures - *Orkney I Unwind Transaction*”, for information regarding the Orkney I Unwind Transaction (as defined therein) that

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

1. Organization and Business (continued)

we consummated on May 27, 2011.

Regulatory Considerations

We had been operating since 2009 under certain regulatory constraints with respect to SRUS. In connection with the receipt by SRUS, our primary U.S. reinsurance subsidiary, in late 2008 of approval for a permitted statutory accounting practice (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 for SRUS, which subsequently was amended and replaced with an Extended and Amended Order of Supervision, dated April 3, 2009 (the "Amended Order").

By its terms, the Amended Order was to remain in place until such time as SRUS could make certain enumerated showings to the Department related to its financial strength and results of operations. By an order dated June 23, 2011, the Department determined that its supervision of SRUS no longer was required and formally released SRUS from the Amended Order, effective immediately. Concurrent with the release of the Amended Order, SRUS ceased utilizing the Permitted Practice.

Business

We have written reinsurance business that is wholly or partially retained in one or more of our reinsurance subsidiaries and have classified the reinsurance as Traditional Solutions or as Financial Solutions, as detailed below.

Traditional Solutions: Mortality risk on life insurance policies written by primary insurers (which business is often referred to as traditional life reinsurance). The products reinsured in our Traditional Solutions business include yearly renewable term life, term life with multi-year guarantees, ordinary life, universal life, and variable life. We wrote our Traditional Solutions business predominantly on an automatic basis, meaning that we automatically reinsured all policies written by a ceding company that met the underwriting criteria specified in the treaty with the ceding company.

Financial Solutions: Contracts under which we assumed the investment and persistency risks of existing, as well as then newly-written, blocks of business. The products reinsured in our Financial Solutions business include deferred and variable annuities, annuity-type products, cash value life insurance, and, to a lesser extent, disability products that are in a pay-out phase.

We generally wrote reinsurance for our Traditional Solutions and Financial Solutions products 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 investment experience. Under such agreements, we agree to indemnify the primary insurer for all or a portion of the risks associated with the underlying insurance policy or annuity contract in exchange for a proportionate share of the premiums thereon. Coinsurance differs from modified coinsurance with respect to the ownership of the assets supporting the reserves related to the liabilities reinsured. Under our coinsurance arrangements, ownership of the assets is transferred to us, whereas, in modified coinsurance arrangements, the ceding company retains ownership of the assets, but we share in the investment income and risks associated with the assets.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

1. Organization and Business (continued)

The following table summarizes the net premiums earned by product category for the years ended December 31, 2012, 2011 and 2010.

(U.S. dollars in millions)	Traditional Solutions	Financial Solutions	Total
Year Ended December 31, 2012	\$ 323.3	\$ 2.1	\$ 325.4
Year Ended December 31, 2011	\$ 298.5	\$ 4.4	\$ 302.9
Year Ended December 31, 2010	\$ 415.9	\$ 5.2	\$ 421.1

For further details on our revenue recognition policies associated with the amounts shown in the table above, please refer to Note 2, “Summary of Significant Accounting Policies - *Revenue Recognition*”.

2. Summary of Significant Accounting Policies

Basis of Presentation

Accounting Principles - Our consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles (“U.S. GAAP”).

Consolidation - The consolidated financial statements include the assets, liabilities, and results of operations of SRGL, its subsidiaries, and VIE(s) 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 in consolidation. We consolidated Merger Sub, as defined in Note 11, “Mezzanine Equity – Convertible Cumulative Participating Preferred Shares - *Merger Agreement*”, during the period in which the Merger was completed, as explained in Note 11. We currently consolidate one VIE, Orkney Re II, a special purpose vehicle incorporated under the laws of Ireland in connection with the Orkney Re II collateral finance facility and securitization structure. We consummated the Orkney I Unwind Transaction (as defined in Note 9, “Collateral Finance Facilities and Securitization Structures - *Orkney I Unwind Transaction*”) on May 27, 2011, and, as a result, we no longer consolidate Orkney Holdings, LLC (“OHL”) and Orkney Re, Inc. (“Orkney Re” and, together with OHL, “Orkney I”). All of the assets remaining after the completion of the Orkney I Unwind Transaction were transferred to SRUS, and OHL and Orkney Re were dissolved prior to December 31, 2011. For further discussion of Orkney I, the Orkney I Unwind Transaction, and Orkney Re II, please refer to Note 9, “Collateral Finance Facilities and Securitization Structures”. Effective October 8, 2009, we consolidated the Stingray Pass-Through Trust and the Stingray Investor Trust (together, “Stingray”). Following the acquisition of the entire \$325.0 million in aggregate stated amount of the Pass-Through Certificates (as defined in Note 10, “Debt Obligations and Other Funding Arrangements - *Stingray Investor Trust and Stingray Pass-Through Trust*”) on September 2, 2010, we cancelled the Pass-Through Certificates and no longer consolidate Stingray. For further discussion of Stingray, please refer to Note 10, “Debt Obligations and Other Funding Arrangements - *Stingray Investor Trust and Stingray Pass-Through Trust*”.

Noncontrolling Interest - The noncontrolling interest represented the 5% of SRLC that was not owned by the Company prior to December 21, 2012, when the Company acquired the remaining 5% of SRLC from the previous owner and extinguished the noncontrolling interest.

Estimates and Assumptions - 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

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

2. Summary of Significant Accounting Policies (continued)

assumptions used by management.

Our most significant assumptions are for:

- investment valuations;
- accounting for derivative instruments;
- assessment of risk transfer for structured insurance and reinsurance contracts;
- estimates of premiums;
- valuation of the 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; and
- income taxes, deferred taxes, and the determination of associated valuation allowances.

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

Reclassifications - Certain prior period amounts in our consolidated financial statements and accompanying notes have been reclassified to conform to the current presentation.

Assessment of Risk Transfer

For both assumed and ceded 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 expenses. 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 to determine if the contract provides indemnification against loss or liability relating to insurance risk, in accordance with applicable accounting standards. We 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 risk transfer requirements on a contract are not met, a contract is accounted for using the deposit method.

Revenue Recognition

Net earned premiums are recorded net of amounts retroceded and are matched with their respective benefits and expenses so as to result in the recognition of profits over the life of the contracts. The following is a summary of our revenue recognition policies:

- (i) Reinsurance premiums from traditional life policies and annuity policies with life contingencies generally are recognized as premiums when due from policyholders and are reported net of amounts retroceded.
- (ii) Reinsurance assumed for interest-sensitive and investment type products is accounted for under the deposit method and does not generate premiums. For this business, we recognize as fees and other income the investment income on the assets that we receive from ceding companies, net of policy charges for the cost of insurance, policy administration, and

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

2. Summary of Significant Accounting Policies (continued)

surrenders that have been assessed against policy account balances during the period. Fee income is recorded on an accrual basis.

- (iii) Net investment income includes interest and dividend income and is net of investment management and custody fees.

Investments

Our securities are classified as “trading”, and we carry our investments at fair value, as described in Note 5, “Fair Value Measurements”. As a result, unrealized gains and losses on investments are included in earnings. Realized gains and losses arising from the sale of investments are determined on a specific identification method and investment transactions are recorded on the trade date. Interest income is recorded on the accrual basis, based on the securities’ stated coupon rates, as a component of net investment income. Cash flows for investment transactions are classified as Investing Activities in the accompanying Consolidated Statements of Cash Flows, even though our investments are classified as trading securities, because the investment transactions are not part of our primary Operating Activities.

Cash and cash equivalents include cash and short-term investments with an original maturity, when purchased, of three months or less. Cash and cash equivalents are recorded at amortized cost, which approximates fair value.

Other investments as of December 31, 2011 represented policy loans, which are carried at the outstanding loan balances, which is deemed to approximate fair value, and, as of December 31, 2012, also included investments accounted for under the equity method, for which the resulting carrying value is deemed to approximate fair value. Because the inputs for the values are unobservable, both policy loans and the investments accounted for under the equity method are classified as Level 3 fair value measurements, as that term is explained in Note 5, “Fair Value Measurements”.

Funds withheld at interest are funds held by ceding companies under modified coinsurance agreements whereby the assets supporting the statutory reserves of the ceding companies are retained by the ceding companies; however, the assets are managed for our account, and we receive the interest income earned on the funds. The funds withheld at interest are equal to the net statutory reserve fund balances retained by the ceding company, and the amounts in the funding accounts are adjusted quarterly to equal the ceding companies’ net statutory reserve balances. In the event of an insolvency of a ceding company, we would make a claim on the assets supporting the contract liabilities. Interest accrues on these assets at rates defined by the treaty terms. The underlying agreements are considered to include embedded derivative liabilities, as further discussed in this Note under “Derivatives”. We included the change in funds withheld at interest as well as the change in the fair value of embedded derivative liabilities in Operating Activities in the accompanying Consolidated Statements of Cash Flows. In addition to our modified coinsurance agreements, we have entered into various reinsurance treaties that, although considered funds withheld, do not transfer significant insurance risk and are accounted for using the deposit method.

Deferred Acquisition Costs

Prior to January 1, 2012, the costs of acquiring new business, which varied with and primarily were related to the production of new business, were deferred to the extent that such costs were deemed recoverable from future gross profits. Such deferred acquisition costs (“DAC”) included commissions and allowances as well as certain costs of policy issuance and underwriting.

Effective January 1, 2012, we adopted the provisions of FASB issued Accounting Standards Update (“ASU”) No. 2010-26, Financial Services - Insurance (Topic 944) – Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts (“ASU No. 2010-26”), which indicated that only those costs which result directly from and are essential to the successful acquisition of new or renewal insurance contracts may be capitalized.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

2. Summary of Significant Accounting Policies (continued)

Because we no longer acquire or assume new business, while pursuing a run-off strategy of our remaining business, we ceased capitalizing DAC effective January 1, 2012. The provisions of ASU No. 2010-26 did not affect DAC previously capitalized, and we will continue to amortize DAC as described below.

DAC primarily is related to long-duration traditional life insurance contracts that we reinsured and is being amortized in proportion to the ratio of individual period premium revenues to total anticipated premium revenues over the lives of the policies. Such anticipated premium revenues are estimated using the same assumptions used for computing reserves for future policy benefits.

The remaining DAC that is related to interest-sensitive life and investment-type policies that we reinsured is being 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. Every quarter, we update the estimated gross profits with the actual gross profits for each block of business, and, annually, we review the future estimated gross profit for each block of business to determine the recoverability of DAC balances based on future expectations. When newly-estimated gross profits change from previously-estimated gross profits, which could result from changes in the future estimates for mortality, persistency, maintenance expense, and interest, the cumulative DAC amortization is recalculated and adjusted by a cumulative charge or credit to current operations.

Any significant modifications or exchanges of contracts that are considered to constitute a substantial contract change are accounted for as an extinguishment of the replaced contract, resulting in a release of any unamortized DAC. Additionally, any unearned revenue or deferred sales inducements associated with the replaced contract would also be released. In instances when business is terminated due to recapture or novation, the related DAC is fully recovered against current operations. We perform periodic tests to determine that the DAC remains recoverable, and, if financial performance were to significantly deteriorate to the point where a premium deficiency existed, the DAC amortization would be re-estimated and adjusted by a charge to current operations.

Amounts Recoverable from Reinsurers

In the ordinary course of business, our reinsurance subsidiaries cede reinsured liabilities to other reinsurance companies, which transactions are referred to as retrocessions. These agreements minimize our net loss potential arising from large risks. In the normal course of business, we seek to limit our exposure to losses on any single insured life. Our initial retention limit was set at \$0.5 million per life, but, for certain blocks of business, our retention limit can be up to \$3.0 million per life. Ceded reinsurance contracts, however, 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 accounting for those policies, except that the cost of reinsurance related to 100% retrocessions executed with the intent to exit a block of business is recognized immediately.

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 any 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 ultimately will be unable to recover due to reinsurer insolvency, a contractual dispute, or any other reason. As of December 31, 2012, we had no reserve for uncollectible reinsurance; as of December 31, 2011, we had a reserve for uncollectible reinsurance of \$3.0 million.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

2. Summary of Significant Accounting Policies (continued)

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 annual revenues) to total anticipated gross profits (or total anticipated revenues) expected over the life of the business, discounted at the assumed net credit rate (4.9% for 2012, 2011, and 2010). The carrying value of the present value of in-force business is reviewed at least annually for indicators of impairment in value.

Other Assets

Other assets consisted of the following:

(U.S. dollars in thousands)	December 31, 2012	December 31, 2011
Unamortized collateral finance facility and debt issuance costs	\$ 5,247	\$ 6,065
Prepaid expenses	2,170	1,922
Fixed assets	379	542
Current income tax receivable	-	236
Other	115	6
Total	\$ 7,911	\$ 8,771

During 2012, 2011, and 2010, we amortized collateral finance facility and debt issuance costs of \$0.9 million, \$1.1 million, and \$2.3 million, respectively. In 2011, we wrote off unamortized debt issuance costs of \$9.6 million related to the repurchase and subsequent cancellation of the Orkney Notes, which was part of the Orkney I Unwind Transaction. Both the Orkney Notes and the Orkney I Unwind Transaction are defined and explained in further detail in Note 9, "Collateral Finance Facilities and Securitization Structures - *Orkney I Unwind Transaction*".

Reserves for Future Policy Benefits

FASB ASC Topic 944, Financial Services – Insurance ("FASB ASC 944"), applies to the traditional life policies with continuing premiums that we have reinsured. 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 were made, they generally will not be changed over the life of the policies. We periodically review actual historical experience and future projections compared to the original assumptions used to establish reserves for future policy benefits, and we determine whether actual experience and future projections indicate 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 DAC and the present value of in-force business. Significant changes in experience or assumptions may require us to provide for expected losses by establishing additional net reserves.

During 2012, SRUS performed a review and update of the models utilized in its insurance liability valuation system. The changes to the SRUS models included the creation of new models and the greater utilization of seriatim in-force data for certain portions of the SRUS business. These changes constituted improvements in the SRUS models based on new inputs and enhancements to improve the insurance liability valuation process, and did not modify any of the actuarial assumptions. Accordingly, these changes have been accounted for as changes in accounting estimates. The foregoing model changes reduced SRUS's net GAAP liability, which represents the reserves for future policy benefits less the DAC for SRUS's business, and resulted in a \$12.6 million positive pre-tax effect for the year ended December 31, 2012 in the accompanying Consolidated Statements of Operations.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

2. Summary of Significant Accounting Policies (continued)

During 2011, SRLC performed a review and update of the models utilized in its insurance liability valuation system. The changes to the SRLC models included the updating of in-force populations, the modification of certain existing models, and the creation of new models for certain portions of SRLC's business. These changes constituted improvements in the SRLC models based on new information or inputs, and enhancements to improve the insurance liability valuation process, and did not modify any of the actuarial assumptions. Accordingly, these changes have been accounted for as changes in accounting estimates. The foregoing model changes reduced SRLC's net GAAP liability, which represents the reserves for future policy benefits less the present value of in-force business for SRLC's business, and resulted in a \$19.1 million positive pre-tax effect for the year ended December 31, 2011 in the accompanying Consolidated Statements of Operations.

On certain lines of business, reserves for future policy benefits include an estimate of amounts payable for claims incurred but not reported ("IBNR"). Those IBNR 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 as a percentage of current in-force.

Because of the many assumptions and estimates used in establishing reserves for future policy benefits and the long-term nature of the reinsurance contracts, the reserving process, while based on actuarial science, is inherently uncertain.

Interest-sensitive Contract Liabilities

FASB ASC 944 also applies to investment contracts, limited premium contracts, and universal life-type contracts. The liabilities for interest-sensitive contract liabilities are equal to the accumulated account values of the policies or contracts as of the valuation date. 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.

Should the liabilities for future policy benefits plus the present value of expected future gross premiums be insufficient to provide for the expected future benefits and expenses, any unamortized DAC will be written off, and, thereafter, if required, a premium deficiency reserve will be established by a current period charge to earnings.

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"). The changes in the fair value of the Interest Rate Swap (as defined in Note 10, "Debt Obligations and Other Funding Arrangements - *Stingray Investor Trust and Stingray Pass-Through Trust*") were included in net realized and unrealized gains (losses) in the Consolidated Statements of Operations until it was settled in 2010.

Our embedded derivative liabilities are associated with funds withheld at interest, which arise on modified coinsurance agreements. FASB ASC Section 815-15-55, Derivatives and Hedging – Embedded Derivatives – Implementation Guidelines and Illustrations ("FASB ASC 815-15-55"), indicates that these transactions contain embedded derivatives. The embedded derivative is similar to a fixed-rate total return swap on the assets held by the ceding companies. The change in the fair value of embedded derivative liabilities is reported in the Consolidated Statements of Operations under the caption "Change in value of embedded derivative assets and liabilities".

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

2. Summary of Significant Accounting Policies (continued)

Accounts Payable and Other Liabilities

Accounts payable and other liabilities consisted of the following:

(U.S. dollars in thousands)	December 31, 2012	December 31, 2011
Accounts payable	\$ 10,794	\$ 10,744
Deferred financial guarantor fees	15,377	11,104
Uncertain income tax liabilities.....	3,876	9,054
Deferred interest on long-term debt	346	17,431
Collateral finance facility accrued interest.....	21,306	15,934
Current income taxes payable	218	159
Total	\$ 51,917	\$ 64,426

Income Taxes

Income taxes are recorded in accordance with FASB ASC Topic 740, Income Taxes (“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 reflect the net tax effect, using enacted tax rates, of the temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the corresponding amounts used for income tax purposes. Such temporary differences are primarily due to the tax basis of reserves, DAC, unrealized investment losses, capital loss carry-forwards, 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.

For the reserve for uncertain tax positions, we prescribe a recognition threshold and measurement attribution for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. For benefits to be recognized, we have concluded that a tax position is more likely than not to be sustained upon examination by taxing authorities.

3. Recent Accounting Pronouncements

In May 2011, the FASB issued ASU No. 2011-04, Fair Value Measurement (Topic 820) – Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs (“ASU No. 2011-04”). The objective of ASU No. 2011-04 was to develop common requirements for measuring fair value and for disclosing information about fair value measurements in accordance with U.S. GAAP and International Financial Reporting Standards (“IFRS”). The changes set forth by ASU No. 2011-04 prohibited the application of block discounts for all fair value measurement, regardless of hierarchy level, and specified that the “valuation premise” and “highest and best use” concepts (as defined therein) were not relevant to financial instruments. New disclosures required within ASU No. 2011-04 focused on Level 3 measurements, which disclosures include quantitative information about significant unobservable inputs used for all Level 3 measurements, a qualitative discussion about the sensitivity of recurring Level 3 measurements to changes in the unobservable inputs disclosed, and the interrelationship between inputs and a description of the valuation processes. Also required to be disclosed were any transfers between Level 1 and Level 2 within the fair value hierarchy, and the hierarchy classification for any items whose fair value was not recorded on the balance sheet but was disclosed in the notes. ASU No. 2011-04 was to be applied prospectively, effective during interim and annual periods beginning after December 15, 2011 for public companies; however, for non-public entities, the effective date was for annual periods beginning after December 15, 2011, and for interim and annual periods thereafter. We adopted the provisions of ASU No. 2011-04 during 2012; however, the adoption had no effect on the Company’s consolidated financial position and results of

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

3. Recent Accounting Pronouncements (continued)

operations.

4. Investments

The estimated fair values of our fixed-maturity investments and preferred stock held as trading securities at December 31, 2012 and 2011 were as follows:

(U.S. dollars in thousands)	December 31, 2012	December 31, 2011
U.S. Treasury securities and U.S. government agency obligations	\$ 36,330	\$ 33,904
Corporate securities.....	751,797	946,694
Municipal bonds.....	41,714	51,915
Mortgage and asset-backed securities	903,383	935,176
Fixed-maturity investments.....	1,733,224	1,967,689
Preferred stock	2,387	58,529
Total	<u>\$ 1,735,611</u>	<u>\$ 2,026,218</u>

The contractual maturities of the fixed-maturity investments and preferred stock held as trading securities at December 31, 2012 and 2011 were as follows (actual maturities may differ as a result of calls and prepayments):

(U.S. dollars in thousands)	Estimated Fair Value December 31, 2012	Estimated Fair Value December 31, 2011
Due in one year or less	\$ 121,390	\$ 176,075
Due after one year through five years.....	403,789	529,659
Due after five years through ten years	220,866	272,512
Due after ten years.....	86,183	112,796
	<u>832,228</u>	<u>1,091,042</u>
Mortgage and asset-backed securities.....	903,383	935,176
Total.....	<u>\$ 1,735,611</u>	<u>\$ 2,026,218</u>

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

4. Investments (continued)

The components of realized and unrealized gains (losses) and of the change in net unrealized appreciation (depreciation) on investments and other balances for the years ended December 31, 2012, 2011, and 2010 were as follows:

(U.S. dollars in thousands)	Year Ended December 31, 2012	Year Ended December 31, 2011	Year Ended December 31, 2010
Realized and unrealized gains (losses)			
Fixed-maturity investments			
Gross realized gains.....	\$ 67,667	\$ 24,114	\$ 72,157
Gross realized losses.....	(12,450)	(23,106)	(39,523)
Net unrealized gains (losses)	80,139	(8,356)	184,899
	<u>135,356</u>	<u>(7,348)</u>	<u>217,533</u>
Preferred stock			
Gross realized gains.....	705	759	3,129
Gross realized losses.....	(6)	(10)	(2,540)
Net unrealized gains (losses)	253	(1,883)	3,868
	<u>952</u>	<u>(1,134)</u>	<u>4,457</u>
Other			
Change in value of Interest Rate Swap	-	-	13,329
Interest Rate Swap interest income.....	-	-	6,906
Other	2,704	4,069	21
	<u>2,704</u>	<u>4,069</u>	<u>20,256</u>
Net realized and unrealized gains (losses)	<u>\$ 139,012</u>	<u>\$ (4,413)</u>	<u>\$ 242,246</u>

The portion of net unrealized gains and losses that related to trading securities still held at the reporting date was \$80.4 million of net unrealized gains as of December 31, 2012 and \$10.2 million of net unrealized losses as of December 31, 2011.

Net investment income for the years ended December 31, 2012, 2011, and 2010 was derived from the following sources:

(U.S. dollars in thousands)	Year Ended December 31, 2012	Year Ended December 31, 2011	Year Ended December 31, 2010
Fixed-maturity investments	\$ 89,566	\$ 107,336	\$ 134,802
Preferred stock.....	431	3,519	4,284
Funds withheld at interest.....	21,741	27,431	32,132
Other investments	845	1,610	3,474
Investment expenses	(3,173)	(3,673)	(4,238)
Net investment income	<u>\$ 109,410</u>	<u>\$ 136,223</u>	<u>\$ 170,454</u>

We are required to maintain assets on deposit with various U.S. regulatory authorities, in accordance with the statutory regulations of the individual jurisdictions, to support our insurance and reinsurance operations. We also have established trust funds in connection with certain transactions for the benefit of the transaction counterparties, which amounts include controlled assets within collateral finance facilities that we may also consolidate. The assets within collateral finance facilities were held for the contractual obligations of those structures and were not available for general corporate purposes. (Please refer to Note 9, "Collateral Finance Facilities and Securitization Structures" for additional information.)

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

4. Investments (continued)

The estimated fair value of the components of the restricted assets at December 31, 2012 and 2011 were as follows:

(U.S. dollars in thousands)	December 31, 2012	December 31, 2011
Deposits with U.S. regulatory authorities.....	\$ 4,563	\$ 17,767
Trust funds	1,297,782	1,424,196
Total	\$ 1,302,345	\$ 1,441,963

“Trust funds” in the above table reflects the fair value of assets held by ceding companies under modified coinsurance arrangements and the fair value of assets we held in segregated portfolios under coinsurance arrangements. Such assets are considered restricted in accordance with the respective treaties. The assets that comprise the “Trust funds” are included in fixed-maturity investments held as trading securities, preferred stock held as trading securities, cash and cash equivalents, and funds withheld at interest in the Consolidated Balance Sheets.

5. Fair Value Measurements

FASB ASC 820 defines fair value, establishes a framework for measuring fair value based on an exit price definition, 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.

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 public equities and actively-traded mutual fund investments.

Level 2 includes those financial instruments that are traded in markets without quoted prices or are valued by independent pricing services or valued using models or other valuation methodologies. These models are primarily 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 securities; government or agency securities; and certain mortgage and asset-backed securities.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

5. Fair Value Measurements (continued)

Level 3 is comprised of financial instruments whose fair value is estimated based on non-binding broker prices or internally-developed models or methodologies that utilize significant inputs not based on or corroborated by readily-available market information. This category primarily consists of certain less liquid fixed-maturity securities where we cannot corroborate the significant valuation inputs with market observable data. Additionally, the Company's embedded derivative liabilities were classified as Level 3.

At each reporting period, we classify all assets and liabilities 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 requires judgment and considers factors specific to the asset or liability.

The fair values for the majority of our fixed-maturity investments were classified as Level 2. These fair values were obtained primarily from independent pricing services which utilize Level 2 inputs. The pricing services also 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 expected cash flows were discounted utilizing market interest rates obtained from third-party sources, based on the credit quality and duration of the instrument.

For securities that may not be reliably priced using internally-developed pricing models, broker quotes were obtained. These broker quotes represent an exit price, but the assumptions used to establish the fair value may not be observable, and, as a result, the fair values were classified as Level 3.

The fair value of the embedded derivative liabilities is determined based on the embedded derivatives contained in the modified coinsurance agreements. We have a group of fixed rate total return swaps, whose fair values are based on the fair values of the applicable assets less the fair values of the related liabilities. The fair values of the underlying assets generally are based upon observable and unobservable market data using valuation methods similar to those used for assets held directly by us. The fair values of the liabilities are determined by using market-observable swap rates applied to the estimated future cash flows of the underlying agreements, as derived from best estimate actuarial models. The significant assumptions used in the projected cash flows are lapse rates and mortality rates. The lapse rate represents the probability that a policyholder will surrender a policy during a year. The lapse rate is based on experience studies on the underlying agreements and the structure of the business. The base lapse rate has historically ranged from 4% to 15%, the selection of which could significantly affect the fair values of the liabilities. Some agreements may also experience a shock lapse. A shock lapse is generally associated with a time period during which no penalty for withdrawal is applicable. A shock lapse has historically ranged from 20% to 50%, the selection of which could significantly affect the fair values of the liabilities. The mortality rate is based on the "Annuity 2000 Mortality Table" developed by the Society of Actuaries. These assumptions require the use of judgment, which is why the resulting fair values of the embedded derivative liabilities are classified as Level 3.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

5. Fair Value Measurements (continued)

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

(U.S. dollars in millions)	December 31, 2012			
	Level 1	Level 2	Level 3	Total
Investments				
Government securities.....	\$ -	\$ 36.3	\$ -	\$ 36.3
Corporate securities.....	-	677.6	74.2	751.8
Municipal bonds.....	-	36.3	5.4	41.7
Mortgage and asset-backed securities	-	583.3	320.1	903.4
Fixed-maturity investments.....	-	1,333.5	399.7	1,733.2
Preferred stock	-	2.4	-	2.4
Total assets at fair value	<u>\$ -</u>	<u>\$ 1,335.9</u>	<u>\$ 399.7</u>	<u>\$ 1,735.6</u>
Embedded derivative liabilities	-	-	(26.3)	(26.3)
Total liabilities at fair value.....	<u>\$ -</u>	<u>\$ -</u>	<u>\$ (26.3)</u>	<u>\$ (26.3)</u>

(U.S. dollars in millions)	December 31, 2011			
	Level 1	Level 2	Level 3	Total
Investments				
Government securities.....	\$ -	\$ 33.9	\$ -	\$ 33.9
Corporate securities.....	-	862.2	84.5	946.7
Municipal bonds.....	-	46.4	5.5	51.9
Mortgage and asset-backed securities	-	599.4	335.8	935.2
Fixed-maturity investments.....	-	1,541.9	425.8	1,967.7
Preferred stock	-	8.5	50.0	58.5
Total assets at fair value	<u>\$ -</u>	<u>\$ 1,550.4</u>	<u>\$ 475.8</u>	<u>\$ 2,026.2</u>
Embedded derivative liabilities	-	-	(33.8)	(33.8)
Total liabilities at fair value.....	<u>\$ -</u>	<u>\$ -</u>	<u>\$ (33.8)</u>	<u>\$ (33.8)</u>

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

5. Fair Value Measurements (continued)

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

Fair Value Measurements Using Significant Unobservable Inputs (Level 3) for the year ended December 31, 2012

(U.S. dollars in millions)	Corporate securities	Municipal bonds	Mortgage and asset-backed securities	Preferred stock	Total assets at fair value	Total liabilities at fair value
Beginning balance at January 1, 2012.....	\$ 84.5	\$ 5.5	\$ 335.8	\$ 50.0	\$ 475.8	\$ (33.8)
Total realized and unrealized gains (losses) included in net income.....	1.2	-	99.0	-	100.2	7.5
Purchases	0.1	-	88.5	-	88.6	-
Settlements.....	(21.2)	(0.1)	(200.5)	(50.0)	(271.8)	-
Transfers in and/or out of Level 3, net	9.6	-	(2.7)	-	6.9	-
Ending balance at December 31, 2012...	<u>\$ 74.2</u>	<u>\$ 5.4</u>	<u>\$ 320.1</u>	<u>\$ -</u>	<u>\$ 399.7</u>	<u>\$ (26.3)</u>

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

5. Fair Value Measurements (continued)

Fair Value Measurements Using Significant Unobservable Inputs (Level 3) for the year ended December 31, 2011

(U.S. dollars in millions)	Corporate securities	Municipal bonds	Mortgage and asset-backed securities	Preferred stock	Total assets at fair value	Total liabilities at fair value
Beginning balance at January 1, 2011	\$ 128.5	\$ -	\$ 530.2	\$ 56.0	\$ 714.7	\$ (32.5)
Total realized and unrealized gains (losses) included in net loss	(2.3)	1.3	(19.2)	(1.0)	(21.2)	(1.3)
Purchases	19.6	-	7.6	-	27.2	-
Settlements.....	(46.6)	(0.2)	(136.6)	(5.0)	(188.4)	-
Transfers in and/or out of Level 3, net	(14.7)	4.4	(46.2)	-	(56.5)	-
Ending balance at December 31, 2011 ...	<u>\$ 84.5</u>	<u>\$ 5.5</u>	<u>\$ 335.8</u>	<u>\$ 50.0</u>	<u>\$ 475.8</u>	<u>\$ (33.8)</u>

Changes in classifications impacting Level 3 financial instruments were reported in the above tables as transfers in (out) of the Level 3 category at the end of each quarterly period in which the transfers occurred. The portion of net unrealized gains and losses that related to Level 3 trading securities still held at the reporting date was \$49.1 million of net unrealized gains for the year ended December 31, 2012 and \$29.7 million of net unrealized losses for the year ended December 31, 2011.

The following table summarizes the fair values (in millions), the valuation techniques, and the significant unobservable inputs of the Level 3 fair value measurements as of December 31, 2012 for which we have been able to obtain quantitative information about the significant unobservable inputs used in those fair value measurements:

Assets (U.S. dollars in millions)	Fair Value	Valuation Technique	Significant Unobservable Inputs	Input Ranges
Corporate securities	\$ 25.5	Discounted Cash Flow	Liquidity/duration adjustment*	0.7%-9.0%
Mortgage and asset-backed securities	\$ 74.0	Discounted Cash Flow	Liquidity/duration adjustment*	2.1%-3.5%

* The liquidity/duration adjustment input represents an estimated market participant composite interest spread that would be applied to the risk-free rate to discount the estimated projected cash flows for individual securities, and such liquidity/duration adjustment would reflect adjustments attributable to liquidity premiums, expected durations, credit structures, credit quality, etc., as applicable.

We have excluded from the table above Level 3 fair value measurements obtained from independent, third-party pricing sources, including prices obtained from brokers, for which we do not develop the significant inputs used to measure the fair values and information regarding the significant inputs is not readily available to us from the independent, third-party pricing sources or brokers.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

6. Fair Value of Financial Instruments

As discussed above, the fair values of financial assets and liabilities are estimated in accordance with the framework established under FASB ASC 820. The methodology for determining the fair value of financial instruments, in addition to those disclosed in Note 2, "Summary of Significant Accounting Policies - Investments" and Note 5, "Fair Value Measurements" are as follows:

(i) As noted above, the funds withheld at interest are equal to the net statutory reserve fund balances retained by the ceding company, and the securities in the funding accounts consist of fixed-maturity investments held by the ceding companies. The funding accounts are adjusted quarterly to equal the ceding companies' net statutory reserve balances. The methodologies and assumptions used to determine the fair values of the underlying securities generally were consistent with the fair value methodologies and assumptions we used to value our fixed-maturity investments carried at fair value, which included a combination of both Level 2 and Level 3 fair value measurements. As a result, the funds withheld at interest are classified as a combination of both Level 2 and Level 3 in the fair value hierarchy. Changes in the fair values of the fixed-maturity investments held by the ceding companies were a component in the calculation of the embedded derivative liabilities, at fair value.

(ii) Fair values for collateral finance facilities were determined with reference to underlying business models and observable market inputs, including considerations of negotiated repurchases, and were classified as Level 3.

(iii) The fair values of interest-sensitive contract liabilities, which liabilities exclude significant mortality risk and were accounted for under the deposit method, were based on the cash surrender values of the liabilities, which were deemed to approximate fair value. The interest-sensitive contract liabilities were classified as Level 3.

(iv) Fair values for long-term debt, at par were determined with reference to observable prices of similar securities, and were classified as Level 2.

(U.S. dollars in thousands)	December 31, 2012		December 31, 2011	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Assets				
Fixed-maturity investments	\$ 1,733,224	\$ 1,733,224	\$ 1,967,689	\$ 1,967,689
Preferred stock	2,387	2,387	58,529	58,529
Other investments	19,067	19,067	14,877	14,877
Funds withheld at interest	482,985	482,985	549,333	549,333
Liabilities				
Interest-sensitive contract liabilities	\$ 1,104,413	\$ 1,102,704	\$ 1,301,511	\$ 1,291,720
Collateral finance facilities	450,000	114,638	450,000	40,451
Embedded derivative liabilities	26,290	26,290	33,758	33,758
Long-term debt, at par value	129,500	69,370	129,500	72,071

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

7. Deferred Acquisition Costs

The components of DAC activity for the years ended December 31, 2012 and 2011 were as follows:

(U.S. dollars in thousands)	Year Ended December 31, 2012	Year Ended December 31, 2011
Balance at beginning of year	\$ 173,254	\$ 269,352
DAC amortization expense	(7,966)	(12,090)
DAC unlocking	2,193	-
Cumulative correction of error in DAC amortization	(5,300)	-
DAC recovered due to recaptures	-	(804)
Orkney I Unwind Transaction*	-	(83,204)
Balance at end of year	<u>\$ 162,181</u>	<u>\$ 173,254</u>

* Please refer to Note 9, "Collateral Finance Facilities and Securitization Structures - Orkney I Unwind Transaction" for information regarding the Orkney I Unwind Transaction.

The cumulative correction of an error in the calculation of DAC amortization during 2012, as shown in the above table, was associated with certain coinsurance treaties covering investment-type policies that we have reinsured. The effect of the error was not significant in any prior year.

8. Present Value of In-force Business

The components of the activity associated with the present value of in-force business for the years ended December 31, 2012 and 2011 were as follows:

(U.S. dollars in thousands)	Year Ended December 31, 2012	Year Ended December 31, 2011
Balance at beginning of year	\$ 27,027	\$ 31,941
Interest accrued	1,324	1,565
Amortization expense	(4,350)	(6,479)
Balance at end of year	<u>\$ 24,001</u>	<u>\$ 27,027</u>

The amortization of the present value of in-force business for the years ended December 31, 2012 and 2011 included \$1.4 million and \$3.7 million, respectively, attributable to ceding company recaptures that were executed during each year.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

8. Present Value of In-force Business (continued)

The gross amount of the present value of in-force business, the accumulated interest accrued, and the accumulated amortization at December 31, 2012 and 2011 were as follows:

(U.S. dollars in thousands)	December 31, 2012	December 31, 2011
Gross amount of original present value of in-force business	\$ 56,272	\$ 56,272
Accumulated interest accrued	18,530	17,206
Accumulated amortization	(50,801)	(46,451)
Net amount of present value of in-force business	\$ 24,001	\$ 27,027

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

(U.S. dollars in thousands)	
Year ending December 31,	
2013	\$ 1,187
2014	1,246
2015	1,346
2016	1,363
2017	1,283
Thereafter.....	17,576
	\$ 24,001

9. Collateral Finance Facilities and Securitization Structures

Orkney Re II

The following table reflects the significant balances included in the accompanying Consolidated Balance Sheets that were attributable to the Orkney Re II collateral finance facility and securitization structure providing collateral support to the Company:

(U.S. dollars in thousands)	December 31, 2012	December 31, 2011
Assets		
Funds withheld at interest	\$ 358,856	\$ 362,937
Cash and cash equivalents	2,253	1,211
All other assets	46,226	41,870
Total assets	\$ 407,335	\$ 406,018
Liabilities		
Reserves for future policy benefits	\$ 133,045	\$ 132,280
Collateral finance facilities.....	450,000	450,000
All other liabilities.....	37,762	28,145
Total liabilities.....	\$ 620,807	\$ 610,425

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

9. Collateral Finance Facilities and Securitization Structures (continued)

The assets listed in the foregoing table are subject to a variety of restrictions on their use, as set forth in and governed by the transaction documents for the Orkney Re II collateral finance facility and securitization structure. The total investments of the consolidated VIE disclosed in the accompanying Consolidated Balance Sheets include the following adjustments: (i) deduction of the assets needed to satisfy future policy benefits, based on current projections (“economic reserves”), and (ii) addition of the market value of consolidated assets held in a segregated account in excess of Orkney Re II’s funds withheld at interest. The reinsurance liabilities of Orkney Re II have been eliminated from the Consolidated Balance Sheets.

On December 21, 2005, 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, \$450.0 million of debt primarily to external investors. The debt consisted of \$382.5 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 \$25.0 million of Series B Floating Rate Notes (the “Series B Notes”), all due December 31, 2035 (collectively, the “Orkney Re II Notes”). In addition to \$5.0 million of the Series B Notes, Orkney Re II also issued to SALIC \$30.0 million of Series C Floating Rate Notes (“Series C Notes”) due December 21, 2036. The Series C Notes accrue interest only until the Orkney Re II Notes are fully repaid. SRGL owns \$0.5 million of Orkney Re II Series D Convertible Notes due December 21, 2036, and 76,190,000 Preference Shares of Orkney Re II of \$1.00 each in capital. The Orkney Re II Notes are listed on the Irish Stock Exchange. Proceeds from this private 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, and 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.

In accordance with FASB ASC 810-10, Orkney Re II is considered to be a VIE, and we are considered to hold the primary beneficial interest (as we cede to Orkney Re II all of the business assumed by Orkney Re II), following an 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 consolidated financial statements.

Orkney Re II Event of Default, Acceleration and Foreclosure

Orkney Re II has been unable to make scheduled interest payments on the Series A-1 Notes on all scheduled quarterly interest payment dates since May 11, 2009. As of December 31, 2012, Assured Guaranty (UK) Ltd. (“Assured”) has made guarantee payments in the cumulative amount of \$12.6 million on the Series A-1 Notes. This amount of cumulative interest has been accrued by us in Accounts Payable and Other Liabilities in the Consolidated Balance Sheets. Interest on the Series A-1 Notes on which Assured is making guarantee payments is payable quarterly at a rate equivalent to three-month LIBOR plus 0.425% for the Series A-1 Notes. As of December 31, 2012, the interest rate on the Series A-1 Notes was 0.74% (compared to 0.87% as of December 31, 2011). For further discussion on the Orkney Re II scheduled interest payments on the Series A-1 Notes, please refer to Note 18, “Subsequent Events - *Orkney Re II*”.

Orkney I

On February 11, 2005, OHL issued and sold, in a private offering, an aggregate of \$850.0 million Series A Floating Rate Insured Notes due February 11, 2035 (the “Orkney Notes”). OHL was organized for the limited purpose of issuing the Orkney Notes and holding the stock of Orkney Re. SRUS held all of the limited liability company interest in OHL, and had contributed capital to Orkney I in the amount of \$268.5 million. Initially, in accordance with FASB ASC 810-10, Orkney I was considered to be a VIE, and, following an analysis whereby it was determined that we would absorb a majority of the expected losses, we were considered to hold the primary beneficial interest (because all of the business assumed by Orkney Re had been ceded by us). As a result, Orkney I was consolidated in our consolidated financial statements through December 31, 2010. Following the Orkney I Unwind Transaction (see below), Orkney I was dissolved prior to December 31, 2011.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

9. Collateral Finance Facilities and Securitization Structures (continued)

Orkney I Unwind Transaction

On April 15, 2011, we entered into agreements to unwind the Orkney I transaction and to recapture from Orkney Re and immediately cede to Hannover Life Reassurance Company of America (“Hannover Life Re”) the defined block of level premium term life insurance policies issued by direct ceding companies between January 1, 2000 and December 31, 2003 (such defined block, the “Orkney Block”, and such transactions, as further discussed below, the “Orkney I Unwind Transaction”). The Orkney I Unwind Transaction was accomplished on May 27, 2011 in part pursuant to the Settlement and Release Agreement, dated as of April 15, 2011, by and among Orkney Re, OHL, SRUS, SRGL, the financial guarantor of the Orkney Notes, and the investment manager for the Orkney I transaction (the “Settlement Agreement”). Contemporaneous with the transactions contemplated by the Settlement Agreement, SRUS recaptured the Orkney Block from Orkney Re (the “Orkney Recapture”) and immediately ceded the Orkney Block to Hannover Life Re pursuant to a coinsurance reinsurance agreement, effective January 1, 2011 (the “New Reinsurance Agreement”). SRUS is obligated pursuant to the New Reinsurance Agreement to use commercially reasonable best efforts to work with Hannover Life Re and the direct writers of the Orkney Block to obtain full novations from SRUS to Hannover Life Re of the underlying reinsurance treaties such that SRUS no longer would be a party to such reinsurance treaties.

On the date of the closing of these transactions, SRUS effectuated the Orkney Recapture and received recapture consideration from Orkney Re of \$582.4 million, which recapture consideration was used to fund the ceding commission of \$564.8 million due from SRUS to Hannover Life Re under the New Reinsurance Agreement. All assets thereafter remaining in the accounts at Orkney Re were transferred to OHL. OHL purchased all of the outstanding Orkney Notes pursuant to privately-negotiated purchase agreements (the “Note Purchase Agreements”) for an aggregate amount of \$590.0 million, which represented a discount to the \$850.0 million aggregate principal amount of the Orkney Notes. Following the repurchase of the Orkney Notes, OHL immediately cancelled the Orkney Notes, and, thereafter, transferred its remaining assets to its parent, SRUS.

Approximately \$700.0 million of the aggregate principal amount of the Orkney Notes purchased by OHL were held by affiliates of Cerberus Capital Management, L.P. (“Cerberus”), one of our controlling shareholders. Under the terms of the Registration Rights and Shareholders Agreement, dated May 2007 among the Company, Cerberus, MassMutual Capital Partners LLC, a member of the MassMutual Financial Group (“MassMutual Capital”), and certain other (now former) shareholders of the Company (the “Shareholders Agreement”), the Company’s execution of the Note Purchase Agreement with affiliates of Cerberus required the prior approval of the independent directors of our Board of Directors (the “Board”). To this end, a special committee of our Board, comprised of disinterested directors, was appointed to consider, and determine whether the Company should engage in, the Orkney I Unwind Transaction. In its evaluation and approval of the Orkney I Unwind Transaction and related agreements, including the Note Purchase Agreement with Cerberus, the special committee engaged separate legal counsel and a separate financial advisor.

The closing of the Orkney I Unwind Transaction, which occurred on May 27, 2011, was subject to a number of closing conditions, including the receipt of required approvals from the Department, which were received on May 25, 2011.

SRGL recorded a consolidated net loss in 2011 of approximately \$153.3 million as a result of consummating the Orkney I Unwind Transaction. Due to the New Reinsurance Agreement with Hannover Life Re being effective January 1, 2011, the reinsurance activity associated with the Orkney Block for the period from January 1, 2011 through March 31, 2011 and the negotiated interest on the ceding commission that was paid to Hannover Life Re for the period from January 1, 2011 through May 27, 2011 were settled with Hannover Life Re following the consummation of the Orkney I Unwind Transaction. The Orkney I Unwind Transaction reduced our consolidated total assets and liabilities by approximately \$1,007.2 million and \$853.9 million, respectively. The following tables illustrate the impact of the Orkney I Unwind transaction on SRGL’s Consolidated Balance Sheets and Consolidated Statements of Operations for 2011:

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

9. Collateral Finance Facilities and Securitization Structures (continued)

**Impact of the Orkney I Unwind Transaction
Condensed Consolidated Balance Sheet**

(U.S. dollars in thousands)	December 31, 2011
Assets	
Total investments.....	\$ (1,175,334)
Deferred acquisition costs.....	(83,204)
Receivables and amounts recoverable from reinsurers	252,388
Other assets.....	(1,002)
Total assets	<u>\$ (1,007,152)</u>
Liabilities	
Collateral finance facilities	\$ (850,000)
Other liabilities	(3,860)
Total liabilities.....	<u>\$ (853,860)</u>
Shareholders' (Deficit)	(153,292)
Total liabilities, and shareholders' (deficit)	<u>\$ (1,007,152)</u>

**Impact of the Orkney I Unwind Transaction
Condensed Statement of Operations**

(U.S. dollars in thousands)	Year Ended December 31, 2011
Revenues	
Gain on extinguishment of debt.....	\$ 260,000
Total revenues.....	<u>\$ 260,000</u>
Benefits, expenses, and taxes	
Amortization of deferred acquisition costs and other insurance expenses, net	\$ 411,374
Collateral finance facilities expense	10,227
Operating expenses.....	280
Income tax benefit	(8,589)
Total benefits, expenses, and taxes.....	<u>\$ 413,292</u>
Net loss attributable to Scottish Re Group Limited	<u>\$ (153,292)</u>

The Orkney I Unwind Transaction was recorded in accordance with the Company's accounting policy to recognize, as a net loss in current period income, the full cost of reinsurance on 100% retrocessions executed with the intent to exit that block of business. The Company viewed the Orkney I Unwind Transaction as a sale of the Orkney Block and is contractually obligated to utilize commercially reasonable efforts to facilitate the novation of the underlying business from SRUS to Hannover Life Re.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

10. Debt Obligations and Other Funding Arrangements

Long-term debt, at par value (collectively, the “Capital and Trust Preferred Securities”, as individually defined below), consisted of:

(U.S. dollars in thousands)	December 31, 2012	December 31, 2011
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 December 2034*	50,000	50,000
Long-term debt, at par value.....	<u>\$ 129,500</u>	<u>\$ 129,500</u>

**Defined below.*

(U.S. dollars in thousands)	Capital Securities Due 2032*	Preferred Trust Securities Due 2033*	Trust Preferred Securities Due 2033*	Trust Preferred Securities Due 2034*	Trust Preferred Securities Due December 2034*
Issuer of long-term debt (as defined below)	Capital Trust*	Capital Trust II*	GPIC Trust*	Capital Trust III*	SFL Trust I*
Long-term debt outstanding.....	\$17,500	\$20,000	\$10,000	\$32,000	\$50,000
Maturity date	Dec. 4, 2032	Oct. 29, 2033	Sept. 30, 2033	June 17, 2034	Dec. 15, 2034
Redeemable (in whole or in part) after	Dec. 4, 2007	Oct. 29, 2008	Sept. 30, 2008	June 17, 2009	Dec. 15, 2009
Interest Payable	Quarterly	Quarterly	Quarterly	Quarterly	Quarterly
Interest rate: 3-month LIBOR +	4.00%	3.95%	3.90%	3.80%	3.50%
Interest rate at December 31, 2012.....	4.31%	4.26%	4.21%	4.11%	3.81%
Interest rate at December 31, 2011.....	4.58%	4.53%	4.48%	4.38%	4.08%
Maximum number of quarters for which interest may be deferred.....	20	20	20	20	20
Number of quarters for which interest was deferred as of December 31, 2012.....	0	0	0	0	0

**Defined below.*

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 Due 2032”). All of the common shares of the Capital Trust are owned by SHI, one of our wholly-owned subsidiaries. The sole assets of the Capital Trust consist of \$18.0 million principal amount of Floating Rate Debentures (the “Debentures”) issued by SHI, and have all the same features (maturity date, interest payable, interest rate, maximum number of quarters for which interest may be deferred, and the number of quarters

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

10. Debt Obligations and Other Funding Arrangements (continued)

for which interest was deferred as of December 31, 2012) as the Capital Securities Due 2032.

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 \$20.0 million Preferred Trust Securities (the “Preferred Trust Securities Due 2033”). All of the common shares of Capital Trust II are owned by SHI. 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, and have all the same features (maturity date, interest payable, interest rate, maximum number of quarters for which interest may be deferred, and the number of quarters for which interest was deferred as of December 31, 2012) as the Preferred Trust Securities Due 2033.

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 \$10.0 million Trust Preferred Securities (the “Trust Preferred Securities Due 2033”). All of the common shares of GPIC Trust are owned by SHI. The sole assets of GPIC Trust consist of \$10.3 million principal amount of Junior Subordinated Notes (the “Junior Subordinated Notes”) issued by SHI, and have all the same features (maturity date, interest payable, interest rate, maximum number of quarters for which interest may be deferred, and the number of quarters for which interest was deferred as of December 31, 2012) as the Trust Preferred Securities Due 2033.

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 \$32.0 million Trust Preferred Securities (the “Trust Preferred Securities Due 2034”). All of the common shares of Capital Trust III are owned by SHI. The sole assets of Capital Trust III consist of \$33.0 million principal amount of Floating Rate Debentures (the “2034 Floating Rate Debentures”) issued by SHI, and have all the same features (maturity date, interest payable, interest rate, maximum number of quarters for which interest may be deferred, and the number of quarters for which interest was deferred as of December 31, 2012) as the Trust Preferred Securities Due 2034.

For further discussion on the Trust Preferred Securities Due 2034 subsequent to December 31, 2012, please refer to Note 18, “Subsequent Events - *Capital and Trust Preferred Securities*”.

Trust Preferred Securities Due December 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 \$50.0 million Trust Preferred Securities (the “Trust Preferred Securities Due December 2034” and, together with the Trust Preferred Securities Due 2034, the Trust Preferred Securities Due 2033, the Preferred Trust Securities Due 2033 and the Capital Securities Due 2032, the “Capital and Trust Preferred Securities”). All of the common shares of SFL Trust I are owned by SFL. 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, and have all the same features (maturity date, interest payable, interest rate, maximum number of quarters for which interest may be deferred, and the number of quarters for which interest was deferred as of December 31, 2012) as the Trust Preferred Securities Due December 2034.

SALIC has guaranteed SHI’s and SFL’s obligations under the Debentures, the 2033 Floating Rate Debentures, the Junior Subordinated Notes, the 2034 Floating Rate Debentures, and the December 2034 Floating Rate Debentures and distributions and other payments due on the Capital and Trust Preferred Securities.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

10. Debt Obligations and Other Funding Arrangements (continued)

For all the securities listed above, any deferred payments would accrue interest quarterly on a compounded basis.

Deferral of Interest Payments on the Capital and Trust Preferred Securities

In order to preserve liquidity, we began deferring interest payments as of March 4, 2009 on the Capital and Trust Preferred Securities. These deferrals were permitted by the terms of the indentures governing the securities and were made at the discretion of our Board. SHI, SFL, and SALIC are restricted in their ability to make dividend payments in any period during which the interest payment obligations on these securities are not current. During the fourth quarter of 2012, we paid all of the outstanding cumulative interest due on our floating rate Capital and Trust Preferred Securities. The total net cumulative interest amount paid by the Company during the fourth quarter of 2012 was approximately \$24.1 million.

For further discussion on the accrued and deferred payment on our Capital and Trust Preferred Securities subsequent to December 31, 2012, please refer to Note 18, "Subsequent Events - *Deferral of Interest Payments on the Capital and Trust Preferred Securities*".

Stingray Investor Trust and Stingray Pass-Through Trust

On January 12, 2005, SALIC entered into a put agreement with the Stingray Investor Trust for an aggregate value of \$325.0 million, which put agreement relates to \$325.0 million aggregate stated amount of 5.902% Pass-Through Certificates (the "Pass-Through Certificates") 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, which was fully utilized by early 2008.

The Stingray structure included an interest rate swap (the "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. Movements in the fair value of the Interest Rate Swap were included in net realized and unrealized gains (losses) in our Consolidated Statements of Operations.

During 2009, we acquired Pass-Through Certificates, and, in the fourth quarter of 2009, we determined we were the primary beneficiary of Stingray and were required to consolidate Stingray in our consolidated financial statements.

During 2010, we acquired additional Pass-Through Certificates, and we obtained consent from the sellers to proposed amendments that provided for the termination of the Interest Rate Swap effective July 2, 2010. The termination of the Interest Rate Swap resulted in a swap termination payment to the Stingray Pass-Through Trust of \$39.2 million (the "Swap Termination Payment"), which amount subsequently was distributed on the July 12, 2010 payment date pro rata to all holders of record of Pass-Through Certificates as of June 30, 2010. As a result of its ownership as of June 30, 2010 of \$244.8 million in aggregate stated amount of Pass-Through Certificates, SALIC received \$29.5 million of the Swap Termination Payment on the July 12, 2010 distribution date.

Subsequent to June 30, 2010, we acquired \$80.2 million additional Pass-Through Certifications, and, on September 2, 2010, we cancelled the entire \$325.0 million in aggregate stated amount of the Pass-Through Certificates. In connection with the cancellation, the corresponding \$325.0 million of funding agreements were surrendered by the Stingray Investor Trust, and all unamortized debt issuance costs relating to Stingray, in the amount of \$2.8 million, were written off. These were included in collateral finance facilities expenses in our Consolidated Statements of Operations. In 2010, changes in fair value of the then outstanding Pass-Through Certificates were reflected in change in value of long term debt, at fair value, in our Consolidated Statement of Operations.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

11. Mezzanine Equity – Convertible Cumulative Participating Preferred Shares

On May 7, 2007, we completed the equity investment transaction by MassMutual Capital and SRGL Acquisition, LDC, an affiliate of Cerberus, announced by us on November 27, 2006 (the “2007 New Capital Transaction”). Pursuant to the 2007 New Capital Transaction, MassMutual Capital and Cerberus (together, the “Investors”) invested an aggregate \$600.0 million in the Company in exchange for 1,000,000, in the aggregate, newly-issued Convertible Cumulative Participating Preferred Shares (the “CCPP Shares”). The gross proceeds were \$600.0 million less \$44.1 million in closing costs, which resulted in aggregate net proceeds of \$555.9 million. Each CCPP Share has a par value of \$0.01 per share with an initial stated value and liquidation preference of \$600 per share, as adjusted for the accretion of dividends or the payment of dividends or distributions as described further below.

The CCPP Shares are convertible at the option of the holder, at any time, into an aggregate of 150,000,000 ordinary shares (“Ordinary Shares”) of SRGL. On the ninth anniversary of issue, the CCPP 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 CCPP Shares for cash, except in the event of a liquidation or upon the occurrence of a change-in-control event.

We have accounted for the CCPP Shares in accordance with FASB ASC Subtopic 470-20, Debt – Debt with Conversion and Other Options (“FASB ASC 470-20”). Dividends on the CCPP Shares are cumulative and accrete daily on a non-compounding basis at a rate of 7.25% per annum on the stated value of \$600.0 million, whether or not there are profits, surplus, or other funds available for the payment of dividends. Such dividend accretion is reflected solely by increasing the liquidation preference of the CCPP Shares. The liquidation preference of the CCPP shares is equal to their initial stated value, as adjusted for the accretion of dividends and any cash payment or payment in property of dividends or distributions. Redemption of the CCPP Shares is contingent upon a change in control. Since neither liquidation nor a change-in-control event is currently probable, the accreted dividends have not been accrued in our consolidated financial statements.

In the event that dividends or distributions are made to ordinary shareholders, the holders of the CCPP Shares will receive a dividend or distribution equal to the dividend or distribution that such holders would have been entitled to receive had the right been exercised to convert all of the CCPP Shares to Ordinary Shares immediately prior to the date of such dividend distribution (i.e., on an as-converted basis).

On December 12, 2012, our Board resolved to declare and pay dividends on our Ordinary Shares (as discussed in more detail in Note 12, “Shareholders’ Deficit – *Ordinary Shares*”). As a result, the holders of the CCPP Shares were also entitled to receive dividends on an as-converted basis, and our Board also resolved to declare and pay dividends on the CCPP Shares, in accordance with the Certificate of Designations related to the CCPP Shares. The aggregate amount of the dividend declared was \$110.0 million, with \$75.6 million allocated to the holders on the CCPP Shares, and such dividends were paid on December 20, 2012. The payment of the dividend, which represented a portion of the accreted cumulative participating dividends on the CCPP Shares, resulted in a corresponding reduction to the liquidation preference of the CCPP Shares. As of December 31, 2012, the amount of dividends accreted pursuant to the terms of the CCPP Shares, subsequent to the payment of the December 20, 2012 dividend, was \$170.7 million in the aggregate, or \$170.70 per share.

The holders of CCPP Shares may, among other things, require us to redeem all or a portion of the CCPP Shares upon a change-in-control event. Upon a change-in-control event, the redemption price of the CCPP Shares is an amount equal to the greater of (i) the stated value of the outstanding CCPP Shares, plus an amount equal to the sum of all accreted dividends through the fifth anniversary of the issue date of the CCPP Shares, or (ii) the amount that the holder of the CCPP Shares would have been entitled to receive with respect to such change-in-control event if it had exercised its right to convert all or such portion of its CCPP Shares for Ordinary Shares immediately prior to the date of such change-in-control event. The liquidation preference of the CCPP Shares (including any adjustments thereto) is not applicable once the CCPP Shares have been converted into Ordinary Shares, as described above.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

11. Mezzanine Equity - Convertible Cumulative Participating Preferred Shares (continued)

The CCPP 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 CCPP 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 CCPP 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 CCPP 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.

In connection with the closing of the Merger (as defined below in this Note under "*Merger Agreement*"), the Investors were required to release their indemnification claim against SRGL arising from alleged breaches of representations and warranties made by SRGL in the Securities Purchase Agreement, dated November 26, 2006. The Investors waived in connection with the Merger Agreement any claim to indemnification in respect of this matter.

Merger Agreement

On April 15, 2011, we entered into an agreement and plan of merger (the "*Merger Agreement*") with affiliates of the Investors, pursuant to which an affiliate of the Investors ("*Merger Sub*") was merged into SRGL and SRGL continued as the surviving entity. Under the Merger Agreement, all Ordinary Shares were converted into the right to receive \$0.30 per share, which represented a premium of \$0.14 (or 87.5%) over the average trading price of the Ordinary Shares for the three months preceding April 15, 2011 (collectively, the "*Merger*"), provided that any Ordinary Shares held by shareholders that properly exercised dissenter rights (the "*Dissenting Shareholders*") under the Companies Law (2010 Revised) of the Cayman Islands (the "*Companies Law*") would be valued in accordance with the procedures set forth under the Companies Law. The Merger consideration to all such Ordinary Shares held by non-Dissenting Shareholders was funded solely by the Investors, on behalf of Merger Sub. Following the effectiveness of the Merger, all of the outstanding Ordinary Shares of SRGL are owned by affiliates of the Investors. The CCPP Shares and the Perpetual Preferred Shares were unaffected by the Merger. Under the terms of the Shareholders Agreement, any agreement for the Company to merge with the Investors or an affiliate of the Investors required the prior approval of a majority of disinterested directors of our Board. To this end, a special committee of the Board, comprised of disinterested directors, was appointed to consider, and determine whether to recommend to the full Board that the Company should engage in, the Merger Agreement. In its evaluation and approval of the Merger and related agreements, the special committee engaged separate legal counsel and a separate financial advisor.

The Merger Agreement permitted SRGL to solicit, receive, evaluate, and enter into negotiations with respect to alternative proposals for a 45 day "go-shop" period beginning April 15, 2011. The special committee, with the assistance of its independent advisors, solicited during this period alternative proposals for the acquisition of the Ordinary Shares. The Merger Agreement also provided the Investors with a customary right to match a superior proposal. This process did not result in a superior proposal.

Completion of the Merger was subject to, among other conditions, approval by a majority of the Ordinary Shares held by parties unaffiliated with the Investors or the Company attending and voting at the shareholders meeting (whether in person or by proxy). SRGL prepared and delivered to shareholders on May 11, 2011, in connection with the extraordinary general meeting of shareholders held on June 8, 2011, an Information Statement (which Information Statement subsequently was posted to the Company's website) containing detailed information regarding the Merger. The Merger was approved at such meeting by the Company's shareholders, including by a majority of the Ordinary Shares held by parties not affiliated with the Investors or the Company (attending and

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

11. Mezzanine Equity - Convertible Cumulative Participating Preferred Shares (continued)

voting at the shareholders meeting whether in person or by proxy).

The Merger Agreement imposed certain conditions to the obligations of the respective parties to close the Merger. Among these conditions was the receipt of required governmental consents and approvals, all of which were received. Additionally, it was a condition to the obligation of the Investors and Merger Sub to effect the Merger that ordinary shareholders holding no more than 10% of the issued and outstanding Ordinary Shares (excluding, generally, any Ordinary Shares owned by the Investors, the Company, or their respective affiliates (“Owned Shares”)) have exercised dissenters’ rights under the Companies Law. In connection with the procedures set forth in the Information Statement and Section 238 of the Companies Law, the Company received notices to exercise such dissenter’s rights from the Dissenting Shareholders holding in excess of 10% of the outstanding Ordinary Shares (excluding Owned Shares). The Investors and Merger Sub subsequently waived this condition, and, on August 24, 2011, the Merger was completed. Upon the closing and effectiveness of the Merger on August 24, 2011, all existing Ordinary Shares of the Company were cancelled and all shareholders (other than Dissenting Shareholders and the holders of any Owned Shares) were eligible to receive Merger consideration of \$0.30 per ordinary share. With the completion of the Merger, all outstanding voting shares of the Company are now owned by the Investors. The deemed capitalization of Merger Sub by the Investors prior to the Merger and the subsequent payment of the Merger consideration by the Investors on behalf of the Merger Sub, effective on August 24, 2011, totaled approximately \$17.7 million, and had no net impact on the Company’s consolidated financial statements. Following the closing and effectiveness of the Merger, the Company continued to have certain obligations under Section 238 of the Companies Law which could have included participating in court proceedings in the Cayman Islands to determine the fair value of the Dissenting Shareholders’ Ordinary Shares. In connection with the requirements of Section 238 of the Companies Law, the Company engaged in negotiations with each of the Dissenting Shareholders in respect of the consideration to be paid for their Ordinary Shares and reached resolution with each such Dissenting Shareholder. Other than with respect to the reimbursement of a minimal amount of costs and expenses that were paid by the Company, all amounts paid to the Dissenting Shareholders in respect of their Ordinary Shares were funded by the Investors.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

12. Shareholders' Deficit

Ordinary Shares

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

The following table summarizes the activity in our Ordinary Shares during the years ended December 31, 2012, 2011, and 2010:

	<u>Year Ended December 31, 2012</u>	<u>Year Ended December 31, 2011</u>	<u>Year Ended December 31, 2010</u>
Ordinary Shares			
Beginning of year	68,383,370	68,383,370	68,383,370
Ordinary Shares cancelled in connection with the Merger*	-	(68,383,370)	-
Ordinary Shares into which shares of Merger Sub were converted in connection with the Merger*	-	68,383,370	-
End of year	<u>68,383,370</u>	<u>68,383,370</u>	<u>68,383,370</u>

* Please refer to Note 11, "Mezzanine Equity - Convertible Cumulative Participating Preferred Shares - Merger Agreement", for information regarding the Merger.

Perpetual Preferred Shares

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

In 2005, we issued 5,000,000 non-cumulative Perpetual Preferred Shares (the "Perpetual Preferred Shares"). Gross proceeds were \$125 million, and related expenses were \$4.6 million.

Dividends on the Perpetual Preferred Shares were payable on a non-cumulative basis at a rate per annum of 7.25% until the dividend payment date of July 15, 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. The quarterly floating rates from September 30, 2010 through December 31, 2012 ranged between 6.07% and 8.04%. 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 may be paid or declared on the Ordinary Shares and no Ordinary Shares or other junior shares may be purchased, redeemed, or otherwise acquired for consideration. Please refer below to "Dividends on Perpetual Preferred Shares" in this Note for additional information.

The following table summarizes the activity in our Perpetual Preferred Shares during the years ended December 31, 2012, 2011, and 2010:

	<u>Year Ended December 31, 2012</u>	<u>Year Ended December 31, 2011</u>	<u>Year Ended December 31, 2010</u>
Perpetual Preferred Shares			
Beginning of year	4,806,083	4,806,083	5,000,000
Perpetual Preferred Shares redeemed	(1,559,307)	-	(193,917)
End of year.....	<u>3,246,776</u>	<u>4,806,083</u>	<u>4,806,083</u>

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

12. Shareholders' Deficit (continued)

On February 10, 2012, SRGL agreed to acquire, in a privately-negotiated transaction, approximately \$18.8 million in aggregate liquidation preference of its Perpetual Preferred Shares, with a liquidation preference of \$25.00 per share, at a purchase price of \$16.00 per share (the "Privately-Negotiated Transaction"). The Privately-Negotiated Transaction settled on February 13, 2012, and the related Perpetual Preferred Shares subsequently were redeemed by SRGL. Subsequent to the execution of the Privately-Negotiated Transaction, SRGL launched on February 10, 2012 a cash tender offer to purchase any and all of its then-outstanding Perpetual Preferred Shares (other than those acquired pursuant to the Privately-Negotiated Transaction) at the same per share price as the Privately-Negotiated Transaction (i.e., \$16.00 per share). The tender offer was made to all holders of such Perpetual Preferred Shares upon the terms and subject to the conditions set forth in the related Offer to Purchase, dated February 10, 2012 (the "Offer to Purchase"), and the related Letter of Transmittal, dated February 10, 2012 (together with the Offer to Purchase, the "Perpetual Preferred Share Offer").

In connection with the expiration of the Perpetual Preferred Share Offer on March 9, 2012, holders of Perpetual Preferred Shares with an aggregate liquidation preference of approximately \$20.1 million tendered their Perpetual Preferred Shares and SRGL accepted for purchase all such tendered Perpetual Preferred Shares. Payment in respect of the tendered Perpetual Preferred Shares was made on March 13, 2012, and all such shares subsequently were redeemed by SRGL.

Following the completion of the Perpetual Preferred Share Offer, SRGL acquired during the remainder of 2012, in separate negotiated transactions, approximately \$110.0 thousand in aggregate liquidation preference of its Perpetual Preferred Shares, at an average purchase price of \$14.93 per share.

As a result of the foregoing transactions, a gain on the redemption of Perpetual Preferred Shares of approximately \$14.0 million was recorded as a component of net income attributable to SRGL for the year ended December 31, 2012.

Dividends on Ordinary Shares

The Investors, as 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 December 12, 2012, our Board resolved to declare and pay dividends on the Ordinary Shares. The amount of the dividend declared on the Ordinary Shares amounted to \$34.4 million, and such dividends were paid on December 20, 2012.

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, if dividends on the Perpetual Preferred Shares have not been declared and paid (or declared and a sum sufficient for the payment thereof set aside) for a dividend period, we generally are precluded from paying or declaring any dividend on the Ordinary Shares.

Dividends on Perpetual Preferred Shares

In accordance with the relevant financial tests under the terms of the Perpetual Preferred Shares, our Board was precluded from declaring and paying dividends on each of the 2009 and 2010 dividend payment dates and, as a result, did not declare and pay a dividend on such dates. Although permitted under the terms of the Perpetual Preferred Shares to declare and pay a dividend in connection with the 2011 dividend payment dates and on the January 15, 2012, April 15, 2012, and July 15, 2012 dividend payment dates, our Board resolved not to declare and pay a dividend on such dates. Pursuant to the terms of, and subject to the procedures set forth in, 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

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

12. Shareholders' Deficit (continued)

paid for six or more dividend periods, consecutive or not (a "Nonpayment"). Nonpayment of dividends on July 15, 2009 marked the sixth dividend period for which dividends had not been declared and paid. This right to elect two directors to our Board has not been exercised as of December 31, 2012. If and when dividends for at least four dividend periods, whether or not consecutive, following a Nonpayment have been paid in full, then the right of the holders of the Perpetual Preferred Shares to elect directors to the Company's Board shall cease.

On September 24, 2012, our Board resolved to declare and pay a dividend on the Perpetual Preferred Shares, in accordance with the Certificate of Designations related to the Perpetual Preferred Shares. The amount of the dividend declared was \$1.2 million. The dividend on the Perpetual Preferred Shares was paid on the October 15, 2012 dividend payment date. There can be no assurances that we will make subsequent dividend payments on the Perpetual Preferred Shares, either at our Board's discretion or as a result of the application of the financial tests contained in the terms of the Perpetual Preferred Shares. For further discussion on the non-declaration of the Perpetual Preferred Shares dividends, please refer to Note 18, "Subsequent Events – *Non-declaration of Dividend on Perpetual Preferred Shares*".

13. Reinsurance

Premiums Earned, Net

The components of the net premiums earned were as follows for the years ended:

(U.S. dollars in thousands)	<u>December 31, 2012</u>	<u>December 31, 2011</u>	<u>December 31, 2010</u>
Premiums assumed	\$ 658,704	\$ 647,871	\$ 714,916
Premiums ceded.....	<u>(333,330)</u>	<u>(344,951)</u>	<u>(293,782)</u>
Premiums earned, net	<u>\$ 325,374</u>	<u>\$ 302,920</u>	<u>\$ 421,134</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. The recapture of business previously ceded to the Company does not affect premiums assumed prior to the recapture of such business, but would reduce premiums in subsequent periods.

Claims, Policy Benefits, and Changes in Policyholder Reserves, Net

The components of the claims, policy benefits, and changes in policyholder reserves, net were as follows for the years ended:

(U.S. dollars in thousands)	<u>December 31, 2012</u>	<u>December 31, 2011</u>	<u>December 31, 2010</u>
Claims, policy benefits, and changes in policyholder reserves assumed	\$ 735,935	\$ 656,628	\$ 617,723
Claims, policy benefits, and changes in policyholder reserves ceded.....	<u>(362,173)</u>	<u>(341,874)</u>	<u>(223,105)</u>
Claims, policy benefits, and changes in policyholder reserves, net	<u>\$ 373,762</u>	<u>\$ 314,754</u>	<u>\$ 394,618</u>

At December 31, 2012 and 2011, there were no reinsurance ceded receivables associated with a single reinsurer in excess of 1% of total assets.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

14. Income Taxes

For the years ended December 31, 2012, 2011, and 2010, we had income tax expense (benefit) from operations, as follows:

(U.S. dollars in thousands)	Year Ended December 31, 2012	Year Ended December 31, 2011	Year Ended December 31, 2010
Current tax expense (benefit):			
U.S.	\$ 50	\$ -	\$ -
Non-U.S.	67	178	(33,590)
Total current tax expense (benefit).....	<u>117</u>	<u>178</u>	<u>(33,590)</u>
Deferred tax expense (benefit):			
U.S.	(2,095)	1,035	(5,892)
Non-U.S.	(5,124)	(3,830)	1,541
Total deferred tax (benefit).....	<u>(7,219)</u>	<u>(2,795)</u>	<u>(4,351)</u>
Total tax (benefit).....	<u>\$ (7,102)</u>	<u>\$ (2,617)</u>	<u>\$ (37,941)</u>

The deferred tax benefit for the year ended December 31, 2012 for the U.S. entities in the preceding table was primarily caused by a reduction in the valuation allowance related to changes in the scheduling of deferred tax liabilities reversing over the next 15 years. The deferred tax benefit for the year ended December 31, 2012 for the non-U.S. entities in the preceding table was primarily caused by a release of reserves for uncertain tax positions due to the completion of the Internal Revenue Service (“IRS”) audit of certain prior tax years, as discussed further below.

The deferred tax expense for the year ended December 31, 2011 for the U.S. entities listed above was primarily caused by an increase of approximately \$10.8 million in our deferred tax liabilities associated with the SRLC model change (as explained in Note 2, “Summary of Significant Accounting Policies - *Reserves for Future Policy Benefits*”), offset by an approximately \$8.6 million deferred tax benefit associated with the Orkney I Unwind Transaction (as discussed in Note 9, “Collateral Finance Facilities and Securitization Structures - *Orkney I Unwind Transaction*”). The deferred tax benefit for the year ended December 31, 2011 for the non-U.S. entities listed above was primarily caused by the release of a potential withholding tax liability due to the formation of a new Luxembourg subsidiary, SHL, and the related transfer of an intercompany surplus note (issued by SRUS) from SALIC to SHL.

The current tax benefit for the year ended December 31, 2010 for the non-U.S. entities listed above was primarily caused by the release of a reserve for an uncertain tax position of \$35.9 million (as discussed below in this Note under “*FASB ASC Subtopic 740-10, Income Taxes – Overall (formerly FIN 48)*”). The deferred tax benefit for the year ended December 31, 2010 for the U.S. entities listed above was primarily caused by a reduction in the valuation allowance related to changes in the scheduling of deferred tax liabilities reversing over the next 15 years. The deferred tax expense for the year ended December 31, 2010 for the non-U.S. entities listed above was primarily caused by an increase of reserves for uncertain tax positions.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

14. Income Taxes (continued)

The weighted average expected tax expense (benefit) has been calculated using the pre-tax accounting income (loss) in each jurisdiction multiplied by that jurisdiction's applicable statutory tax rate. The reconciliation of the difference between the expected tax expense (benefit) at the weighted average tax rate and the total tax benefit for the years ended December 31, 2012, 2011, and 2010 is provided below:

(U.S. dollars in thousands)	Year Ended December 31, 2012	Year Ended December 31, 2011	Year Ended December 31, 2010
Pre-tax income (loss)	\$ 74,813	\$ (201,741)	\$ 198,602
Expected tax expense (benefit) at weighted average rate	7,773	(62,701)	53,516
Change in valuation allowance	(10,788)	60,832	(55,271)
Uncertain tax positions	(5,617)	(2,446)	(37,484)
Other and state taxes	1,530	1,698	1,298
Total tax (benefit)	<u>\$ (7,102)</u>	<u>\$ (2,617)</u>	<u>\$ (37,941)</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 tax laws, regulations, or treaties which might require us to change the way we operate or become subject to taxes. At December 31, 2012 and 2011, we had tax operating loss carryforwards in our U.S. and Irish entities, as presented in the table below.

(U.S. dollars in thousands)	U.S. Life & Non-Life Groups	SRD	Orkney Re II	Total
Operating loss carryforwards available at December 31, 2011	\$ 852,461	\$ 544,547	\$ 317,003	\$ 1,714,011
Provision to return	10,417	-	-	10,417
Impact of FIN48 adjustment	(136,158)	-	-	(136,158)
Operating loss incurred during 2012	53,964	484	1,763	56,211
Operating loss carryforwards available at December 31, 2012	<u>\$ 780,684</u>	<u>\$ 545,031</u>	<u>\$ 318,766</u>	<u>\$ 1,644,481</u>
Deferred tax asset for operating losses, before valuation allowance, at December 31, 2012	<u>\$ 267,450</u>	<u>\$ 68,129</u>	<u>\$ 79,691</u>	<u>\$ 415,270</u>

The operating loss carryforwards in our U.S. entities will expire, if not utilized, in years 2021 through 2032, while the operating loss carryforwards in our Irish entities benefit from an unlimited carryforward period. The net operating loss carryforward generated in the current year resulted primarily from the operations of SRUS, SRLC, SHI, SRD, and Orkney Re II. The net operating loss carryforward generated in the prior year resulted primarily from the operations of SRUS, SRLC, SHI, SRD, and Orkney Re II, and the Orkney I Unwind Transaction. Please refer to Note 9, "Collateral Finance Facilities and Securitization Structures – *Orkney I Unwind Transaction*" for information regarding the Orkney I Unwind Transaction.

Section 382 Event

The 2007 New Capital Transaction (as discussed in Note 11, "Mezzanine Equity – Convertible Cumulative Participating Preferred Shares") qualified as a change in ownership under Section 382 of the Internal Revenue

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

14. Income Taxes (continued)

Code. Section 382 operates to limit the future deduction of net operating losses that were in existence as of the change in ownership. 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.

Significant components of our deferred tax assets and liabilities as of December 31, 2012 and 2011 were as follows:

(U.S. dollars in thousands)	December 31, 2012	December 31, 2011
Deferred tax asset		
Net operating losses (net of FASB ASC 740-10 and section 382*)	\$ 415,270	\$ 438,604
Unrealized depreciation on investments	-	5,822
Intangible assets.....	1,476	2,408
Capital loss carryforwards	56,051	55,287
Surplus note accrual.....	-	709
Embedded derivative liabilities	12,359	9,668
Foreign affiliate accruals	326	6,230
Other	1,578	3,364
Total deferred tax asset.....	<u>487,060</u>	<u>522,092</u>
Deferred tax liability		
Deferred acquisition costs.....	(21,918)	(24,316)
Reserves for future policy benefits	(51,658)	(143,547)
Unrealized appreciation on investments	(20,290)	-
Present value of in-force business	(8,160)	(9,189)
Deferred market discount	(12,700)	(7,483)
Other.....	(2,762)	(2,226)
Total deferred tax liability	<u>(117,488)</u>	<u>(186,761)</u>
Net deferred tax asset before valuation allowance.....	<u>369,572</u>	<u>335,331</u>
Valuation allowance	(412,701)	(380,552)
Net deferred tax liability.....	<u>\$ (43,129)</u>	<u>\$ (45,221)</u>

* Described in this Note

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. 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 projections and the scheduling of our current deferred tax liabilities. Our valuation allowance increased by approximately \$32.1 million during the year ended December 31, 2012, to \$412.7 million.

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

In 2012, the conclusion of the IRS audit (as discussed below in this Note under “*IRS Examination*”) resulted in a reduction of unrecognized tax benefits in the amount of \$106.5 million, primarily related to the 2007 redomestication of Orkney Re. The conclusion of the IRS audit, which included the 2007 tax year, effectively settled this issue, closed the statute of limitations period, and allowed the reduction of unrecognized tax benefits, which resulted in a \$5.6 million tax benefit.

In 2011, the statute of limitations expired for the 2006 Irish income tax year, which resulted in a reduction of our unrecognized tax benefits in the amount of \$2.4 million. At December 31, 2012 and 2011, we had total unrecognized tax benefits (excluding interest and penalties) of \$3.1 million and \$109.5 million, respectively, the recognition of which would result in a \$1.5 million tax benefit and a \$4.2 million tax benefit, respectively, at the

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

14. Income Taxes (continued)

effective tax rate.

As a result of a 2010 U.S. tax court ruling that applied to an unaffiliated third party (Container Corporation v. Commissioner, 134 T.C. 5 (2010)), we reconsidered our position in respect of an uncertain tax position and evaluated the implications of the ruling in accordance with FASB ASC 740-10. As a result of the tax court ruling, we released a tax liability of \$35.9 million (inclusive of interest and penalties) during 2010.

The following is a roll-forward of our FASB ASC 740-10 unrecognized tax benefits for the years ended December 31, 2012 and 2011:

(U.S. dollars in thousands)	Year Ended December 31, 2012	Year Ended December 31, 2011
Total unrecognized tax benefits at beginning of year	\$ 109,509	\$ 111,266
Gross amount of increases for current tax positions	-	689
Reductions due to lapse of statutes of limitation.....	(106,448)	(2,446)
Total unrecognized tax benefits at end of year.....	<u>3,061</u>	<u>109,509</u>
Tax benefit of unrecognized tax benefits if recognized at the effective tax rate	<u>\$ 1,517</u>	<u>\$ 4,168</u>

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

(U.S. dollars in thousands)	December 31, 2012	December 31, 2011	December 31, 2010
Total interest & penalties in the Consolidated Balance Sheets at beginning of year.....	\$ 4,130	\$ 2,946	\$ 19,442
Total interest & penalties in the Consolidated Statements of Operations	(2,475)	1,184	(16,496)
Total interest & penalties in the Consolidated Balance Sheets at end of year.....	<u>\$ 1,655</u>	<u>\$ 4,130</u>	<u>\$ 2,946</u>

We do not expect any significant changes in the gross balance of unrecognized tax benefits to occur in the next twelve months.

We file our tax returns as prescribed by the tax laws of the jurisdictions in which we operate. As of December 31, 2012, we remained subject to examination in the following major tax jurisdictions for the years indicated in the table below:

<u>Major Tax Jurisdictions</u>	<u>Open Years</u>
U.S.	
Life Group	2010 through 2012
Non-Life Group	2009 through 2012
Ireland	2008 through 2012

Our U.S. subsidiaries are subject to U.S. 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

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

14. Income Taxes (continued)

dividends or otherwise from our U.S. subsidiaries to us, we would be subject to U.S. withholding taxes at a 30% rate.

Net operating losses are being carried forward from closed years and could be examined by the applicable tax authorities if utilized in an open tax year in the future. Additionally, to the extent that a net operating loss is carried back to an otherwise closed year, that earlier year could be subject to examination as long as the loss year remains open.

IRS Examination

On March 30, 2011, SRUS was notified that the IRS would perform an examination of the U.S. Life Group consolidated tax returns for 2004, 2007, 2008, and 2009 prompted by an income tax refund of approximately \$12.6 million that SRUS had received during 2010. The IRS issued a Revenue Agent's Report ("RAR"), which contained several Notices of Proposed Adjustments, and SRUS accepted the RAR on April 25, 2012, thereby accepting the proposed adjustments and completing the IRS examination. None of the IRS adjustments resulted in a cash tax liability to the IRS. On April 30, 2012, the IRS submitted SRUS's case (consisting of the RAR and the related IRS workpapers) to the Joint Committee on Taxation (the "Joint Committee") for the Joint Committee's review and approval. The submission of the IRS examination report to the Joint Committee for review and approval is a statutory requirement in cases involving refunds of tax in excess of \$2.0 million. On November 9, 2012, we were informed that the Joint Committee had completed its consideration of our case and had taken no exception to the conclusions reached by the IRS. This communication effectively closed the case; therefore, all of the IRS adjustments have been reflected in the accompanying consolidated financial statements, and tax years 2004, 2007, 2008, and 2009 are now closed.

The conclusion of the IRS audit and the resulting adjustments, primarily related to the disallowance of a bad debt deduction for partial worthlessness on certain securities, affected certain line items in the deferred tax assets and liabilities inventory table disclosed above; however, there was no resulting impact to the net deferred tax liability presented in the accompanying Consolidated Balance Sheets. Additional guidance from the IRS, as discussed below in this Note, was subsequently received, and the guidance changed the determination of bad debt deductions for partial worthlessness on certain securities.

Section 166 Deduction for Partial Worthlessness

On July 30, 2012, the IRS issued a directive (Large Business & International (LB&I) Control No. LB&I-4-0712-009, the "LB&I Directive") instructing LB&I examiners not to challenge an insurance company's partial worthlessness deduction under IRC Section 166(a)(2) for the amount of credit-related impairments recognized on eligible securities within the insurer's annual statement in accordance with Statements of Statutory Accounting Principles 43R - *Loan-backed and Structured Securities*. The partial worthless deductions(s) may be taken under the LB&I Directive no earlier than the 2009 tax year and no later than the 2012 tax year.

SRUS decided to implement the LB&I Directive by amending its 2009 – 2011 tax returns and will reflect the deductions for partial worthlessness in the appropriate tax years. The tax calculations reflected in these consolidated financial statements have incorporated the deductions that will be taken on the to-be filed amended tax returns. The deductions for partial worthlessness affected certain line items in the deferred tax assets and liabilities inventory table disclosed above; however, there was no resulting impact to the net deferred tax liability presented in the accompanying Consolidated Balance Sheets.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

15. Commitments and Contingencies

Lease Commitments

We lease office space in certain countries in which we conduct business under operating leases that expire at various dates through 2016. Total rent expense, net of sublease receipts, with respect to these operating leases for the years ended December 31, 2012, 2011, and 2010 was approximately \$0.4 million, \$0.7 million, and \$1.2 million, respectively. At December 31, 2012, we held operating leases for our offices in Charlotte, North Carolina, U.S.; Dublin, Ireland; and Hamilton, Bermuda.

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

(U.S. dollars in thousands)	Gross Lease	Sublease	Net Lease
Year ending December 31,	Payments	Rentals	Payments
2013	\$ 1,394.8	\$ (700.0)	\$ 694.8
2014	1,293.7	(602.8)	690.9
2015	1,332.5	(620.9)	711.6
2016	1,372.5	(639.5)	733.0
2017	-	-	-
Total future lease commitments	<u>\$ 5,393.5</u>	<u>\$ (2,563.2)</u>	<u>\$ 2,830.3</u>

Concentrations of Credit Risk

The creditworthiness of counterparties is evaluated by us, taking into account credit ratings assigned by rating agencies and other factors. The credit approval process involves an assessment of factors including, among others, counterparty, country, and industry credit exposure limits. Collateral may be required, at our discretion, on certain transactions, based on our evaluation of the creditworthiness of the counterparty.

The areas where significant concentrations of credit risk may exist include investments, amounts recoverable from reinsurers, and reinsurance balances receivable. We manage our credit risk in our investment portfolio by establishing and following investment guidelines complying with regulatory restrictions and limiting our exposure to individual issuers. 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 upon for amounts that remain unpaid beyond specified time periods on an individual reinsurer basis.

Revenue from treaties with one ceding company, in our Traditional Solutions business, accounted for approximately 14.3% of our total revenue. No other ceding company's treaties amounted to 10% or more of our total revenue.

Ballantyne Re plc

Ballantyne Re plc ("Ballantyne Re"), which was previously a consolidated VIE of the Company, is a special purpose reinsurance vehicle incorporated under the laws of Ireland. In May 2006, Ballantyne Re issued, in a private offering, \$1.74 billion of debt to third party investors, \$178.0 million of Class C Notes and \$181.2 million in preference shares to SALIC, and \$500,000 in Class D Notes to SRGL.

As of December 31, 2012, 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 in the accompanying Consolidated Balance Sheets. The Class C Notes were contractually written-off in 2008.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

15. Commitments and Contingencies (continued)

SRUS remains liable for the accuracy and performance, as applicable, of its representations, warranties, covenants, and other obligations that relate to periods before the assignment and novation to Security Life of Denver Insurance Company of the reinsurance agreement with Ballantyne Re. In addition, the Company and SRUS remain responsible for certain ongoing covenants and indemnities made for the benefit of Ballantyne Re and the financial guarantors of certain of the notes issued by Ballantyne Re.

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.

16. Statutory Requirements and Dividend Restrictions

Our insurance and reinsurance subsidiaries are subject to insurance laws and regulations in the jurisdictions in which they operate, which include Bermuda, the Cayman Islands, Ireland, and the U.S. Certain of these regulations include restrictions that limit the amount of dividends or other distributions, such as loans or cash advances, available to shareholders of the reinsurance subsidiaries 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 of the insurance regulatory authorities do not reflect DAC, limit the amount of deferred income tax net assets, limit or disallow certain assets, have different investment measurement methodologies, establish reserves for invested assets, and calculate benefit reserves by a defined, formulaic process, among other differences from U.S. GAAP.

Statutory Requirements for Non-U.S. Subsidiaries

Our Bermuda insurance company, SRLB, is required to maintain a minimum capital of \$375.0 thousand as of December 31, 2012, and, under The Insurance Law of the Cayman Islands, SALIC must maintain a minimum capital of \$240.0 thousand. There were no statutory restrictions on the payment of dividends from retained earnings by any of the Bermuda or Cayman subsidiaries as the minimum statutory capital and surplus requirements were satisfied by the share capital and additional paid-in capital of each of the subsidiaries.

SRD is required by the Central Bank of Ireland (the "Central Bank") to maintain a minimum level of paid up share capital. The Central Bank 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 ("SI 380") of 2006 transposed into Irish law the European Union Council Directive 2005/68/EC, which establishes a regulatory regime for reinsurance organizations and defines minimum requirements for certain liabilities, assets backing those liabilities, and surplus. At December 31, 2012 and 2011, SRD had a solvency margin of 178% and 195%, respectively. These percentages were based on the available capital versus a minimum capital amount, which is required to be held under Schedule 2 of SI 380.

SALIC is a party to a net worth maintenance agreement with SRD, pursuant to which SALIC effectively guarantees SRD's regulatory solvency.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

16. Statutory Requirements and Dividend Restrictions (continued)

Statutory Requirements for U.S. Subsidiaries

Our Delaware-domiciled reinsurance subsidiaries, SRUS and SRLC, prepare their statutory-basis financial statements on the basis of statutory accounting practices prescribed or permitted by the State of Delaware for determining and reporting the financial condition and results of operations of an insurance company and for determining solvency under Delaware Insurance Law. The Department has adopted Statutory Accounting Principles, which are included in the National Association of Insurance Commissioners' *Accounting Practices and Procedures Manual*, as a component of prescribed accounting practices. SRUS and SRLC did not utilize any permitted accounting practices during the years ended December 31, 2012 and 2011.

Prior to completion of the Orkney I Unwind Transaction, Orkney Re was another Delaware-domiciled reinsurance subsidiary. Please refer to Note 9, "Collateral Finance Facilities and Securitization Structures - *Orkney I Unwind Transaction*", for information regarding the dissolution of Orkney Re.

The following table presents, for each of our U.S. reinsurance subsidiaries, the statutory capital and surplus as of December 31, 2012 and 2011 and the statutory net income (loss) for the years ended December 31, 2012, 2011, and 2010, as reflected in each company's most recent statutory financial statement filings with the Department.

(U.S. dollars in thousands)	Statutory Capital & Surplus		Statutory Net Income (Loss)		
	2012	2011	2012	2011	2010
SRUS	\$ 193,488	\$ 328,626	\$ (28,534)	\$ (199,667)	\$ 49,397
SRLC	\$ 26,502	\$ 44,460	\$ (40,416)	\$ (22,334)	\$ (7,396)
Orkney Re*	\$ -	\$ -	\$ -	\$ -	\$ 22,194

* With the Department's approval, in connection with the Orkney I Unwind Transaction, Orkney Re did not make a statutory financial statement filing for the year ended December 31, 2011.

As of December 31, 2012 and 2011, SRUS and SRLC exceeded all minimum risk-based capital ("RBC") requirements for life and health insurance companies. The company action level RBC percentage at December 31, 2012 for SRUS and SRLC was 328% and 127%, respectively, as filed with the Department. The company action level RBC percentage at December 31, 2011 for SRUS and SRLC was 527% and 219%, respectively, as filed with the Department. SALIC is a party to net worth maintenance agreements with SRUS and SRLC, pursuant to which SALIC effectively guarantees SRUS's and SRLC's regulatory solvency.

The maximum dividend payout that can be made by SRUS and SRLC without prior approval of the Insurance Commissioner of the State of Delaware (the "Commissioner") is limited to the greater of the net gain from operations for the preceding year or 10% of statutory surplus as of the preceding year-end, not exceeding earned surplus. The applicable statutory provisions only permit an insurer to pay a shareholder dividend from unassigned surplus. Unassigned surplus for SRUS and SRLC at December 31, 2012 and 2011 was negative. Accordingly, SRUS and SRLC cannot pay dividends in 2013 without the prior approval of the Commissioner.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

17. Related Party Transactions

In connection with the 2007 New Capital Transaction and the completion of the Merger, the Investors hold all of our equity voting power along with the right to designate members of our Board. Please refer to Note 11, “Mezzanine Equity – Convertible Cumulative Participating Preferred Shares” for information regarding the 2007 New Capital Transaction and the Merger Agreement.

MassMutual Capital

For the years ended December 31, 2012, 2011, and 2010, we had premiums earned of \$17.8 million, \$16.1 million, and \$15.7 million, respectively, associated with Massachusetts Mutual Life Insurance Company, the ultimate parent of MassMutual Capital, and CM Life Insurance Company, an affiliate of MassMutual Capital. As of December 31, 2012 and 2011, we had net receivables from Massachusetts Mutual Life Insurance Company and CM Life Insurance Company, of \$4.0 million and \$3.7 million, respectively.

We also incurred \$2.3 million, \$2.4 million, and \$2.5 million for investment management fees payable to Babson Capital Management LLC, a subsidiary of MassMutual Capital, for the years ended December 31, 2012, 2011, and 2010, respectively.

Cypress Entities

For as long as Cypress Merchant B Partners II (Cayman) L.P., Cypress Merchant B II-A C.V., Cypress Side-By-Side (Cayman) 25 L.P. and 55th Street Partners II (Cayman) L.P. (collectively, the “Cypress Entities”) beneficially owned in the aggregate at least 2.5% of our outstanding voting shares on a fully-diluted basis, they were entitled to designate at least one individual for election to the Board. The Cypress Entities owned collectively 4.3% of our outstanding voting shares on a fully-diluted basis as of December 31, 2010, and had a representative on the Board. These shares were cancelled in exchange for Merger consideration as part of the Merger and the Cypress Entities’ director subsequently resigned from the Board.

During 2010, we sold our entire investment (\$3.7 million) in Cypress Sharpridge Investments, Inc., which is an affiliate of the Cypress Entities. During the year ended December 31, 2010, we received \$0.4 million in dividend income from our investment in Cypress Sharpridge Investments, Inc.

Cerberus

As disclosed in Note 9, “Collateral Finance Facilities and Securitization Structures - *Orkney I Unwind Transaction*”, Cerberus acquired from one or more unaffiliated third parties \$700.0 million in aggregate principal amount of the Orkney Notes in 2009. Orkney I paid interest of \$3.2 million and \$6.2 million on the Orkney Notes that were owned by Cerberus during 2011 and 2010, respectively. These Orkney Notes were repurchased by OHL, at a discount to the aggregate principal amount, as part of the Orkney I Unwind Transaction.

Investment in Cerberus Affiliated Fund

On March 26, 2012, SALIC executed subscription documents pursuant to which SALIC committed to make an investment of up to an aggregate \$30.0 million in an investment fund affiliated with and controlled, directly or indirectly, by Cerberus (the “Cerberus Affiliated Fund”). As of December 31, 2012, SALIC had invested \$13.8 million of its total commitment, which investment is included in Other Investments on the accompanying Consolidated Balance Sheets at a carrying value of \$15.8 million.

For further discussion on related party transactions, please refer to Note 18, “Subsequent Events – *Investment in Cerberus Affiliated Fund*”.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012

18. 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 consolidated financial statements on March 27, 2013.

Non-declaration of Dividends on Perpetual Preferred Shares

In accordance with the relevant financial tests under the terms of the Perpetual Preferred Shares, our Board was precluded from declaring and paying a dividend on the January 15, 2013 dividend payment date, and, as a result, did not declare and pay a dividend on such date.

Deferral of Interest Payments on the Capital and Trust Preferred Securities

Subsequent to December 31, 2012, we began deferring interest payments as of January 29, 2013 on our Capital and Trust Preferred Securities (as outlined in Note 10, "Debt Obligations and Other Funding Arrangements"). These deferrals are permitted by terms of the indentures governing the Capital and Trust Preferred Securities and have been made at the discretion of our Board. As of March 27, 2013, we had accrued and deferred payment on a total of \$1.2 million of interest on the Capital and Trust Preferred Securities.

Capital and Trust Preferred Securities

On January 31, 2013, SRGL agreed to acquire, in a private transaction, approximately \$13.0 million in aggregate liquidation amount of Trust Preferred Securities Due 2034, at a purchase price of \$520.00 per security.

Orkney Re II

On the scheduled interest payment date of February 11, 2013, 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.

Investment in Cerberus Affiliated Fund

Subsequent to December 31, 2012, SALIC invested, pursuant to capital calls, an additional \$5.3 million in the Cerberus Affiliated Fund and, as of March 27, 2013, had invested \$19.1 million of its \$30.0 million total commitment.

Plan of Merger of Subsidiaries

On January 14, 2013, SRUS and its wholly-owned subsidiary, SRLC, entered into an Agreement and Plan of Merger. Upon the terms and subject to the conditions therein, including receipt of all required approvals, and in accordance with the provisions of Section 253 of the Delaware General Corporation Law and Section 4930 of the Delaware Insurance Code, SRLC will be merged with and into SRUS, with SRUS continuing as the surviving corporation (the "SRUS/SRLC Merger"). The SRUS/SRLC Merger is expected to become effective prior to June 30, 2013; however, there can be no assurance that the conditions to effectiveness, including obtaining the required regulatory approvals, will be satisfied by such time, if at all. The SRUS/SRLC Merger will have no effect on the Company's consolidated financial position and results of operations.