
SCOTTISH RE GROUP LIMITED

CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2014

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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, 2014 and 2013, and the related consolidated statements of comprehensive income, shareholders' deficit, and cash flows for the years then ended, 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 as of December 31, 2014 and 2013, 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 26, 2015

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

	<u>December 31,</u> <u>2014</u>	<u>December 31,</u> <u>2013</u>
Assets		
Fixed-maturity investments held as trading securities, at fair value	\$ 1,699,960	\$ 1,789,343
Fixed-maturity investments held as available-for-sale securities, at fair value (amortized cost: 2014 – \$7,714; 2013 - \$nil)	7,690	-
Preferred stock held as trading securities, at fair value	1,267	1,138
Cash and cash equivalents	227,871	247,409
Affiliated investments	40,176	18,472
Other investments	2,957	3,223
Funds withheld at interest	425,575	459,777
Total investments ¹	<u>2,405,496</u>	<u>2,519,362</u>
Accrued interest receivable ²	10,878	12,587
Amounts recoverable from reinsurers	704,400	695,163
Reinsurance balances receivable	127,621	128,319
Deferred acquisition costs	132,717	153,229
Present value of in-force business	21,048	22,215
Other assets	5,302	6,597
Total assets	<u>\$ 3,407,462</u>	<u>\$ 3,537,472</u>
Liabilities		
Reserves for future policy benefits	\$ 1,316,256	\$ 1,332,960
Interest-sensitive contract liabilities	942,990	1,026,307
Collateral finance facility ³	450,000	450,000
Reinsurance balances payable	60,426	65,796
Accounts payable and other liabilities ⁴	75,804	65,944
Deferred tax liabilities	31,542	37,532
Embedded derivative liabilities, at fair value	13,407	18,230
Long-term debt, at par value	86,500	116,500
Total liabilities	<u>\$ 2,976,925</u>	<u>\$ 3,113,269</u>
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: 2014 - \$857.7 million; 2013 - \$814.2 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: 3,246,776 shares issued and outstanding	81,169	81,169
Additional paid-in capital	1,218,190	1,218,190
Accumulated other comprehensive income (loss), net of tax	(24)	-
Retained deficit	(1,425,339)	(1,431,697)
Total shareholders' deficit	<u>(125,320)</u>	<u>(131,654)</u>
Total liabilities, mezzanine equity, and shareholders' deficit	<u>\$ 3,407,462</u>	<u>\$ 3,537,472</u>
¹ Includes total investments of consolidated variable interest entity ("VIE")	\$ 287,070	\$ 258,318
² Includes accrued interest receivable of consolidated VIE	1,274	1,088
³ Reflects collateral finance facility of consolidated VIE	450,000	450,000
⁴ Reflects accounts payable and other liabilities of consolidated VIE	54,883	45,759

See Accompanying Notes to Consolidated Financial Statements

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

	Year Ended	
	December 31, 2014	December 31, 2013
Revenues		
Premiums earned, net	\$ 352,504	\$ 339,171
Investment income, net	79,187	89,783
Net realized and unrealized gains.....	47,620	28,130
Gain on extinguishment of debt	12,692	6,240
Change in value of embedded derivative assets and liabilities	4,824	8,060
Fees and other income.....	2,307	2,412
Total revenues	<u>499,134</u>	<u>473,796</u>
Benefits and expenses		
Claims, policy benefits, and changes in policyholder reserves, net.....	378,339	383,640
Interest credited to interest-sensitive contract liabilities	26,384	29,280
Other insurance expenses, including amortization of deferred acquisition costs, net	61,384	48,925
Operating expenses	19,638	19,429
Collateral finance facility expense	9,992	9,943
Interest expense.....	4,681	4,873
Total benefits and expenses.....	<u>500,418</u>	<u>496,090</u>
Loss before income taxes	(1,284)	(22,294)
Income tax benefit.....	7,642	5,071
Net income (loss)	6,358	(17,223)
Other comprehensive income (loss), net of tax:		
Unrealized losses on available-for-sale investments, net of tax	(24)	-
Total other comprehensive income (loss), net of tax	<u>(24)</u>	<u>-</u>
Total comprehensive income (loss)	<u>\$ 6,334</u>	<u>\$ (17,223)</u>

See Accompanying Notes to Consolidated Financial Statements

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

	Year Ended	
	December 31, 2014	December 31, 2013
Share capital:		
Ordinary shares:		
Beginning and end of year	\$ 684	\$ 684
Non-cumulative perpetual preferred shares:		
Beginning and end of year	81,169	81,169
Additional paid-in capital:		
Beginning and end of year	1,218,190	1,218,190
Accumulated other comprehensive income (loss):		
Beginning of year.....	-	-
Other comprehensive income (loss), net of taxes	(24)	-
End of year.....	(24)	-
Retained deficit:		
Beginning of year.....	(1,431,697)	(1,414,474)
Net income (loss).....	6,358	(17,223)
End of year.....	(1,425,339)	(1,431,697)
Total shareholders' deficit	<u>\$ (125,320)</u>	<u>\$ (131,654)</u>

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, 2014	December 31, 2013
Operating activities		
Net income (loss)	\$ 6,358	\$ (17,223)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Net realized and unrealized gains	(47,620)	(28,130)
Gain on extinguishment of long-term debt	(12,692)	(6,240)
Change in value of embedded derivative assets and liabilities	(4,824)	(8,060)
Amortization of discount on fixed-maturity investments – available-for-sale	4	-
Amortization of deferred acquisition costs	20,512	8,952
Amortization of present value of in-force business	1,167	1,786
Amortization of deferred finance facility costs	868	868
Depreciation of fixed assets	126	142
Changes in assets and liabilities:		
Funds withheld at interest	34,202	23,208
Accrued interest receivable	1,709	392
Reinsurance balances receivable	698	840
Other assets	247	447
Reserves for future policy benefits, net of amounts recoverable from reinsurers ...	(25,941)	14,380
Interest-sensitive contract liabilities	(23,620)	(23,957)
Accounts payable and other liabilities, including deferred tax liabilities	6,512	8,430
Reinsurance balances payable	(5,370)	(6,815)
Net cash used in operating activities	<u>(47,664)</u>	<u>(30,980)</u>
Investing activities		
Purchases of fixed-maturity investments – trading	(202,823)	(338,717)
Purchases of fixed-maturity investments – available-for-sale	(7,719)	-
Proceeds from sales and maturities of fixed-maturity investments – trading	330,981	309,163
Proceeds from sales and maturities of fixed-maturity investments – available-for-sale	2	-
Proceeds from sales of preferred stock	-	1,060
Purchases of and proceeds from affiliated investments, net	(12,983)	327
Purchases of and proceeds from other investments, net	266	88
Net cash provided by (used in) investing activities	<u>107,724</u>	<u>(28,079)</u>
Financing activities		
Withdrawals from interest-sensitive contract liabilities	(59,648)	(55,581)
Acquisition of long-term debt	(19,950)	(6,760)
Net cash used in financing activities	<u>(79,598)</u>	<u>(62,341)</u>
Net change in cash and cash equivalents	(19,538)	(121,400)
Cash and cash equivalents, beginning of year	247,409	368,809
Cash and cash equivalents, end of year	<u>\$ 227,871</u>	<u>\$ 247,409</u>
Interest paid	\$ -	\$ -
Income taxes paid	<u>\$ 302</u>	<u>\$ 202</u>

See Accompanying Notes to Consolidated Financial Statements

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

1. Organization, Business Strategy, and Lines of Business

Organization

Scottish Re Group Limited (“SRGL” and, together with SRGL’s consolidated subsidiaries and, as a result of the application of FASB ASC 810-10 (as defined in Note 2, “Summary of Significant Accounting Policies – *Basis of Presentation*” herein) its consolidated VIE*, as applicable, the “Company”, “we”, “our”, and “us”) is a holding company incorporated under the laws of the Cayman Islands, and with its principal executive office located in Bermuda. Through its operating subsidiaries, the Company is principally engaged in the reinsurance of life insurance, annuities, and annuity-type products. All of the equity voting power of SRGL, along with the right to designate a controlling number of members of the SRGL Board of Directors (the “Board”), is controlled directly or indirectly by MassMutual Capital Partners LLC, a member of the MassMutual Financial Group (“MassMutual Capital”) and SRGL Acquisition, LDC, an affiliate of Cerberus Capital Management L.P. (“Cerberus” and, together with MassMutual Capital, the “Investors”). As of December 31, 2014, SRGL’s consolidated subsidiaries (consisting of operating companies, holding companies and financing companies) and its consolidated VIE (a collateral finance facility), by jurisdiction, were as follows:

Bermuda

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

Cayman Islands

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) (“SHL”) **

United States of America (“U.S.” or “United States”)

Scottish Holdings, Inc. (“SHI”)

Scottish Re (U.S.), Inc. (“SRUS”)

* *Orkney Re II is the consolidated VIE. References in the consolidated financial statements and accompanying notes to any discretionary acts of management or of any of the consolidated entities do not, unless explicitly stated otherwise, refer to any such acts by Orkney Re II.*

** *SHL deregistered with the Luxembourg Trade Registrar as of December 18, 2014, and is in the process of liquidation.*

Business Strategy

In 2008, our insurance operating companies ceased writing new business and notified existing clients that new reinsurance risks no longer would be accepted under existing reinsurance treaties, thereby placing the reinsurance business into run-off (the “Closed Block”). We continue to run-off the Closed Block, whereby we receive premiums, pay claims, and perform key activities under the related reinsurance treaties.

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

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

1. Organization, Business Strategy, and Lines of Business (continued)

discussion on our outstanding securities and any recent transactions, please refer to Note 9, "Debt Obligations and Other Funding Arrangements", and Note 11, "Shareholders' Deficit".

Lines of 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. All such business currently is part of the Closed Block.

Traditional Solutions: Mortality risk on life insurance policies written by primary insurers (which business is often referred to as traditional life insurance). 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 fixed annuities 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.

2. Summary of Significant Accounting Policies

Basis of Presentation

Accounting Principles - The 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 and its subsidiaries, as well as that of the VIE (i.e., Orkney Re II, an Irish special purpose reinsurance vehicle) 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.

Estimates and Assumptions - The preparation of consolidated financial statements in accordance with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ materially from those estimates and assumptions used by management, and such estimates and assumptions could change in the future as more information becomes known, which could impact the amounts reported and disclosed herein.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

2. Summary of Significant Accounting Policies (continued)

The assumptions impact:

- investment valuations;
- accounting for embedded 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.

Where applicable, management periodically reviews and revises 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 the consolidated financial statements and accompanying notes have been reclassified to conform to the current presentation. These reclassifications primarily impact amounts under the following captions reported in the Consolidated Statements of Comprehensive Income:

- Investment income, net;
- Net realized and unrealized gains;
- Fees and other income;
- Other insurance expenses including amortization of deferred acquisition costs, net; and
- Operating expenses.

The following table illustrates the reclassifications completed for the year ended December 31, 2013:

(U.S. dollars in thousands)	Year Ended December 31, 2013		
	Original Amount	Reclassified Amount	Year End Change – Increase (Decrease) Net Income
Consolidated Statements of Comprehensive Income Line Item			
Revenues			
Investment income, net	\$ 90,332	\$ 89,783	\$ (549)
Net realized and unrealized gains	25,087	28,130	3,043
Fees and other income	6,135	2,412	(3,723)
Benefits and expenses			
Other insurance expenses including amortization of deferred acquisition costs, net.....	43,781	48,925	(5,144)
Operating expenses	25,802	19,429	6,373

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 loss for the assuming entity. To assess risk transfer for certain contracts, we generally develop expected discounted cash flow analyses at contract inception to

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

2. Summary of Significant Accounting Policies (continued)

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

The following is a summary of our revenue recognition policies:

- (i) 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;
- (ii) 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;
- (iii) 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 surrenders that have been assessed against policy account balances during the period. Fee income is recorded on an accrual basis; and
- (iv) Net investment income includes interest and dividend income and is net of investment management, investment accounting, and custody fees.

Investments

Most of our securities are classified as trading, and we carry these investments at fair value, as described in Note 5, "Fair Value Measurements". As a result, unrealized gains and losses on investments classified as trading securities are included in earnings on the Consolidated Statements of Comprehensive Income. Realized gains and losses arising from the sale of investments classified as trading securities 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 most of our investments are classified as trading securities, because these investment transactions are not part of our primary operating activities.

Investments – In accordance with FASB ASC 320 Investments – Debt and Equity Securities, we are required to review the appropriateness of our investment classification at least annually. During 2014, we reevaluated the appropriateness of the accounting classification of our fixed-maturity investments and preferred stocks, which have been classified as trading since January 1, 2008. As a result of this evaluation, the Company has determined that as new fixed-maturity investments and preferred stocks are acquired, they will be classified as available-for-sale, such that over time the entire investment portfolio will be classified under available-for-sale. This process of migrating to available-for-sale as fixed-maturity investments and preferred stocks are acquired or replaced could take several years given the duration of some of our existing investments. Effective August 2014, the Company classified securities in defined portfolios as available-for-sale. Effective January 1, 2015, the Company will classify all securities purchased as available-for-sale. The unrealized appreciation (depreciation) on our investments classified as available-for-sale represents the difference between fair value and amortized cost and is recorded directly to equity with no impact earnings. The change in unrealized appreciation (depreciation) is included in accumulated other comprehensive income (loss) in shareholders' deficit after deductions for adjustments for any associated

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

2. Summary of Significant Accounting Policies (continued)

deferred acquisition costs and deferred income taxes, where applicable. For further discussion on our available-for-sale investments, please refer to Note 4, "Investments – Available-for-Sale".

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.

Affiliated investments represent investments accounted for under the equity method, for which the resulting carrying value is deemed to approximate fair value. Please refer to Note 16, "Related Party Transactions – Investment in Cerberus Affiliated Fund", for more information on our investments accounted for under the equity method.

Other investments represent policy loans, which are carried at the outstanding loan balances, and which are deemed to approximate fair value.

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 related to the liabilities reinsured to us are retained by the ceding companies; however, the assets are managed for our account, and we receive the benefit of the interest income earned thereon. 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. Interest accrues on these assets at rates defined by the treaty terms. In the event of an insolvency of a ceding company, we would make a claim on the assets at the ceding company supporting the contract liabilities. The underlying agreements are considered to include embedded derivative assets and liabilities, as further discussed in this Note under "Embedded Derivatives". We include the change in funds withheld at interest as well as the change in value of embedded derivative assets and 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.

Amounts Recoverable from Reinsurers

In the ordinary course of business, our reinsurance operating 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 lines of business, our retention limit has increased to up to \$3.0 million per life on certain issue years. The Company could look to increase the retention limit per life even higher on further issue years in the future. Ceded reinsurance contracts, however, do not relieve us of our obligation to the direct writing companies from which we assumed the liabilities. 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 line 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, 2014 and 2013, we had no reserve for uncollectible reinsurance.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

2. Summary of Significant Accounting Policies (continued)

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. Because we no longer acquired or assumed new business and instead were continuing to run-off the Closed Block, we ceased capitalizing DAC effective January 1, 2012. This policy may change in the future if and to the extent we acquire or begin to write new business. The provisions of ASU No. 2010-26 did not affect DAC previously capitalized, and we will continue to amortize DAC as described below.

The DAC previously capitalized that is related to long-duration traditional life insurance contracts that we reinsured 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 previously capitalized that is related to interest-sensitive life and investment-type policies that we reinsured is being 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 line of business, and, annually, we review the future estimated gross profits for each line 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 replacements 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; if financial performance were to deteriorate to the point where a premium deficiency existed, the DAC amortization would be re-estimated and adjusted by a charge to current operations.

Present Value of In-force Business

The present value of in-force business (“PVIF”) 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 locked-in assumed net credit rate of 4.9%. The carrying value of PVIF is reviewed at least annually for indicators of impairment in value.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

2. Summary of Significant Accounting Policies (continued)

Other Assets

Other assets consisted primarily of unamortized collateral finance facility and debt issuance costs (2014: \$3.5 million; 2013: \$4.4 million) and prepaid expenses (2014: \$1.7 million; 2013: \$1.9 million).

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 would 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 PVIF. Significant changes in experience or assumptions may require us to provide for expected losses by establishing additional net reserves.

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.

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

Assumptions and estimates used in establishing the reserve for future policy benefits were based on experience and industry studies and actuarial judgement at the time of issue. Because of the long-term nature of the reinsurance contracts, actual experience can vary from the original assumptions emphasizing the importance of the annual review of the reserve sufficiency.

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.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

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, 2014	December 31, 2013
Collateral finance facility accrued interest.....	\$ 30,673	\$ 26,022
Deferred financial guarantor fees.....	24,208	19,737
Accounts payable.....	10,330	11,241
Deferred interest on long-term debt, at par value.....	7,163	5,218
Uncertain income tax liabilities.....	3,202	3,403
Current income taxes payable.....	228	323
Total.....	\$ 75,804	\$ 65,944

Income Taxes

Income taxes are recorded in accordance with FASB ASC Topic 740, Income Taxes (“FASB ASC 740”). For all years presented, the asset and liability method is used 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 primarily are 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 some portion, or all, of the benefits related to the deferred tax assets will not be realized.

For the reserve for uncertain tax positions, which is recorded in the Consolidated Balance Sheets under the caption, “Accounts payable and other liabilities”, 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 relevant taxing authorities.

Embedded Derivatives

Our embedded derivative assets and 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, indicates that these transactions contain embedded derivatives. All embedded 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. The embedded derivatives are 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 assets and liabilities is reported in the Consolidated Statements of Comprehensive Income under the caption, “Change in value of embedded derivative assets and liabilities”.

3. Recent Accounting Pronouncements

In February 2013, the FASB issued ASU No. 2013-02, Comprehensive Income (Topic 220) - Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income (“ASU No. 2013-02”). The objective of ASU No. 2013-02 was to develop reporting and disclosure requirements about changes in accumulated other comprehensive income (“AOCI”) balances and reclassifications out of AOCI. For nonpublic companies, ASU No. 2013-02 was effective prospectively for fiscal years beginning after December 15, 2013 and interim and annual periods thereafter.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

3. Recent Accounting Pronouncements (continued)

Early adoption was permitted. Following our acquisition of investments in a defined portfolio of fixed-maturity investments classified as available-for-sale, effective August 2014, as discussed in Note 2, "Basis of Presentation", we were required to disclose unrealized gains and losses on available-for-sale investments under other comprehensive income, and so, as a result, we have adopted the provisions of ASU No. 2013-02 for the year ended December 31, 2014. The adoption did not have a material effect on the Company's consolidated financial position and results of operations.

The Company has evaluated newly-issued FASB accounting pronouncements and revisions made to existing FASB accounting pronouncements during 2014. The Company has determined that none of the newly-issued FASB accounting pronouncements and revisions made to existing FASB accounting pronouncements during 2014 and effective for 2015 will have a material effect on the Company's consolidated financial position and results of operations.

4. Investments

Trading Investments

The estimated fair values of our fixed-maturity investments and preferred stock held as trading securities as of December 31, 2014 and 2013, were as follows:

(U.S. dollars in thousands)	December 31, 2014	December 31, 2013*
U.S. Treasury securities and U.S. government agency obligations	\$ 28,934	\$ 32,828
Corporate securities	620,292	753,082
Municipal bonds	32,513	37,461
Residential mortgage-backed securities	487,118	515,724
Commercial mortgage-backed securities	196,299	198,498
Asset-backed securities	334,804	251,750
Total fixed-maturity investments held as trading securities .	1,699,960	1,789,343
Preferred stock	1,267	1,138
Total	\$ 1,701,227	\$ 1,790,481

* The December 31, 2013 comparative fair value figures in the above table have been updated based on management's review of more current information to reflect the allocation of the fair value amounts for corporate securities and asset-backed securities. This also impacted the beginning balance figures as of January 1, 2014.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

4. Investments (continued)

The contractual maturities of the fixed-maturity investments held as trading securities as of December 31, 2014 and 2013, were as follows (actual maturities may differ as a result of calls and prepayments):

(U.S. dollars in thousands)	Estimated Fair Value	Estimated Fair Value
	December 31, 2014	December 31, 2013*
Due in one year or less.....	\$ 108,402	\$ 84,470
Due after one year through five years.....	351,040	429,739
Due after five years through ten years.....	168,508	219,483
Due after ten years.....	53,789	89,679
	681,739	823,371
Residential mortgage-backed securities.....	487,118	515,724
Commercial mortgage-backed securities.....	196,299	198,498
Asset-backed securities.....	334,804	251,750
Total.....	<u>\$ 1,699,960</u>	<u>\$ 1,789,343</u>

* The December 31, 2013 comparative fair value figures in the above table have been updated based on management's review of more current information to reflect the allocation of the fair value amounts for corporate securities and asset-backed securities. This also impacted the beginning balance figures as of January 1, 2014.

Available-for-Sale Investments

As disclosed above in Note 2, "Basis of Presentation", in August 2014, we classified a defined portfolio of fixed-maturity investments as available-for-sale. As of December 31, 2014, we had acquired approximately \$7.7 million in two defined portfolios of fixed-maturity investments classified as available-for-sale in our consolidated financial statements.

The following table presents the amortized cost and estimated fair value of fixed maturity securities classified as available-for-sale as of December 31, 2014.

(U.S. dollars in thousands)	December 31, 2014				
	Cost or Amortized Cost	Gross Unrealized			Estimated Fair Value
Gains		Temporary Losses	Other Than Temporary Losses		
U.S. Treasury securities and U.S. government agency obligations.....	\$ -	\$ -	\$ -	\$ -	\$ -
Corporate securities.....	1,055	1	(11)	-	1,045
Municipal bonds.....	-	-	-	-	-
Residential mortgage-backed securities.....	-	-	-	-	-
Commercial mortgage-backed securities.....	2,952	11	(11)	-	2,952
Asset-backed securities.....	3,707	-	(14)	-	3,693
Total securities.....	<u>\$ 7,714</u>	<u>\$ 12</u>	<u>\$ (36)</u>	<u>\$ -</u>	<u>\$ 7,690</u>

We did not have any investments classified as available-for-sale as of December 31, 2013.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

4. Investments (continued)

The following tables show the Company's available-for-sale classified investments' estimated fair value and gross unrealized losses, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, as of December 31, 2014.

(U.S. dollars in thousands)	December 31, 2014					
	Less than 12 months		12 months or more		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
U.S. Treasury securities and U.S. government agency obligations...	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Corporate securities.....	835	(11)	-	-	835	(11)
Municipal bonds.....	-	-	-	-	-	-
Residential mortgage-backed securities.....	-	-	-	-	-	-
Commercial mortgage-backed securities.....	2,380	(11)	-	-	2,380	(11)
Asset-backed securities	3,693	(14)	-	-	3,693	(14)
Total available-for-sale fixed maturities.....	<u>\$ 6,908</u>	<u>\$ (36)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 6,908</u>	<u>\$ (36)</u>
Equity securities						
Preferred stock	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Total equity securities	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

We did not have any investments classified as available-for-sale as of December 31, 2013.

A total of 20 securities classified as available-for-sale had unrealized losses at December 31, 2014. The Company's unrealized losses on its fixed maturity investments were the result of interest rate increases. Since the decline in estimated fair value is attributable to changes in interest rates and not credit quality, and the Company has the intent and ability to hold these maturities through a recovery of unrealized losses, even if until maturity of the individual securities, the Company does not consider these investments other than temporarily impaired.

The contractual maturities of the fixed-maturity investments classified as available-for-sale securities as of December 31, 2014, were as follows (actual maturities may differ as a result of calls and prepayments):

(U.S. dollars in thousands)	Cost or Amortized Cost	Estimated Fair Value
	December 31, 2014	December 31, 2014
Due in one year or less.....	\$ -	\$ -
Due after one year through five years.....	115	115
Due after five years through ten years	940	930
Due after ten years	-	-
	<u>1,055</u>	<u>1,045</u>
Residential mortgage-backed securities.....	-	-
Commercial mortgage-backed securities	2,952	2,952
Asset-backed securities	3,707	3,693
Total.....	<u>\$ 7,714</u>	<u>\$ 7,690</u>

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

4. Investments (continued)

We did not have any investments classified as available-for-sale as of December 31, 2013.

Assets on Deposit

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. As a result of the various regulatory limitations on how these assets may be invested and their unavailability for general corporate purposes, these assets are considered “restricted”. We also have established trust funds* in connection with certain transactions for the benefit of the transaction counterparties, which amounts also include assets attributable to the VIE that we consolidate, Orkney Re II. As a result of the restrictions imposed on the foregoing assets in accordance with the respective reinsurance treaties and other agreements to which they relate, these assets (including the assets within the collateral finance facility that are held for the contractual obligations of that structure) are not available for general corporate purposes and also are considered “restricted”. (Please also refer to Note 8, “Collateral Finance Facility and Securitization Structure” for additional information.)

The estimated fair value of the components of the restricted assets* as of December 31, 2014 and 2013, were as follows:

(U.S. dollars in thousands)	December 31, 2014	December 31, 2013
Deposits with U.S. regulatory authorities.....	\$ 4,545	\$ 4,511
Trust funds	1,220,840	1,240,495
Total	<u>\$ 1,225,385</u>	<u>\$ 1,245,006</u>

*“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 hold in segregated portfolios under coinsurance arrangements. 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.

Net Investment Income

Net investment income for the trading securities and the available-for-sale securities for the years ended December 31, 2014 and 2013, was derived from the following sources:

(U.S. dollars in thousands)	Year Ended December 31, 2014	Year Ended December 31, 2013
Fixed-maturity investments, held as trading	\$ 68,401	\$ 75,610
Fixed-maturity investments, held as available- for sale.....	39	-
Preferred stock	55	69
Funds withheld at interest	14,579	17,313
Other investments	228	963
Investment expenses	(4,115)	(4,172)
Net investment income	<u>\$ 79,187</u>	<u>\$ 89,783</u>

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

4. Investments (continued)

Realized and Unrealized Gains

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, 2014 and 2013, were as follows:

(U.S. dollars in thousands)	Year Ended December 31, 2014	Year Ended December 31, 2013
Realized and unrealized gains (losses)		
Fixed-maturity investments		
Gross realized gains.....	\$ 5,372	\$ 9,137
Gross realized losses	(5,204)	(9,585)
Net unrealized gains	38,612	27,013
	<u>38,780</u>	<u>26,565</u>
Preferred stock		
Gross realized gains.....	-	26
Gross realized losses	-	(11)
Net unrealized gains (losses)	129	(204)
	<u>129</u>	<u>(189)</u>
Other		
Cerberus Affiliated Fund* - unrealized gains.....	8,721	3,043
Realized gains (losses) on modified coinsurance treaties	49	(1,433)
Other.....	(59)	144
	<u>8,711</u>	<u>1,754</u>
Net realized and unrealized gains	<u>\$ 47,620</u>	<u>\$ 28,130</u>

* Defined in the Note 16, "Related Party Transactions – Investment in Cerberus Affiliated Fund".

The portion of net unrealized gains and losses that related to trading securities still held at the reporting date as of December 31, 2014 and 2013, was \$38.7 million and \$26.8 million, respectively.

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.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

5. Fair Value Measurements (continued)

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. We had no securities classified as Level 1 under FASB ASC 820 as of December 31, 2014 and 2013.

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.

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, such as certain of the Company's corporate securities and mortgage and asset-backed securities. 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 estimated 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 values of the embedded derivative liabilities were determined based on the embedded derivatives contained in the modified coinsurance agreements. The embedded derivatives are similar to 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

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

5. Fair Value Measurements (continued)

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 were classified as Level 3.

Fair Value Measurements on a Recurring Basis

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

(U.S. dollars in thousands)	December 31, 2014			
	Level 1	Level 2	Level 3	Total
Investments – trading				
U.S. Treasury securities and U.S. government agency obligations	\$ -	\$ 28,934	\$ -	\$ 28,934
Corporate securities	-	595,638	24,654	620,292
Municipal bonds	-	26,675	5,838	32,513
Residential mortgage-backed securities	-	217,543	269,575	487,118
Commercial mortgage-backed securities	-	196,025	274	196,299
Asset-backed securities	-	295,953	38,851	334,804
Fixed-maturity investments, held as trading	-	1,360,768	339,192	1,699,960
Investments – available-for-sale				
U.S. Treasury securities and U.S. government agency obligations	\$ -	\$ -	\$ -	\$ -
Corporate securities	-	1,045	-	1,045
Municipal bonds	-	-	-	-
Residential mortgage-backed securities	-	-	-	-
Commercial mortgage-backed securities	-	2,952	-	2,952
Asset-backed securities	-	3,693	-	3,693
Fixed-maturity investments, held as available-for-sale	-	7,690	-	7,690
Preferred stock	-	1,267	-	1,267
Total assets at fair value	\$ -	\$ 1,369,725	\$ 339,192	\$ 1,708,917
Embedded derivative liabilities	-	-	(13,407)	(13,407)
Total liabilities at fair value	\$ -	\$ -	\$ (13,407)	\$ (13,407)

We did not have any investments classified as available-for-sale as of December 31, 2013.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

5. Fair Value Measurements (continued)

(U.S. dollars in thousands)	December 31, 2013*			
	Level 1	Level 2	Level 3	Total
Investments – trading				
U.S. Treasury securities and U.S. government agency obligations	\$ -	\$ 32,828	\$ -	\$ 32,828
Corporate securities	-	710,180	42,902	753,082
Municipal bonds	-	37,461	-	37,461
Residential mortgage-backed securities	-	260,638	255,086	515,724
Commercial mortgage-backed securities	-	194,436	4,062	198,498
Asset-backed securities	-	112,071	139,679	251,750
Fixed-maturity investments	-	1,347,614	441,729	1,789,343
Preferred stock	-	1,138	-	1,138
Total assets at fair value	<u>\$ -</u>	<u>\$ 1,348,752</u>	<u>\$ 441,729</u>	<u>\$ 1,790,481</u>
Embedded derivative liabilities	-	-	(18,230)	(18,230)
Total liabilities at fair value	<u>\$ -</u>	<u>\$ -</u>	<u>\$ (18,230)</u>	<u>\$ (18,230)</u>

* The December 31, 2013 comparative fair value figures in the above table have been updated based on management's review of more current information to reflect the allocation of the fair value amounts for corporate securities and asset-backed securities. This also impacted the beginning balance figures as of January 1, 2014.

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, 2014

(U.S. dollars in thousands)	Corporate securities	Municipal bonds	Residential mortgage-backed securities	Commercial mortgage-backed securities	Asset-backed securities	Total assets at fair value	Total liabilities at fair value
Beginning balance as of January 1, 2014	\$ 42,902	\$ -	\$ 255,086	\$ 4,062	\$ 139,679	\$ 441,729	\$ (18,230)
Total realized and unrealized gains (losses) included on trading securities in net income	161	716	33,977	(6)	1,822	36,670	4,823
Total unrealized gains (losses) included on available-for-sale securities in comprehensive net income (loss)	-	-	-	-	-	-	-
Purchases	-	-	-	-	14,447	14,447	-
Settlements	(18,409)	(80)	(19,082)	(665)	(9,325)	(47,561)	-
Transfers in and/or out of Level 3, net	-	5,202	(406)	(3,117)	(107,772)	(106,093)	-
Ending balance as of December 31, 2014	<u>\$ 24,654</u>	<u>\$ 5,838</u>	<u>\$ 269,575</u>	<u>\$ 274</u>	<u>\$ 38,851</u>	<u>\$ 339,192</u>	<u>\$ (13,407)</u>

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

5. Fair Value Measurements (continued)

Fair Value Measurements Using Significant Unobservable Inputs (Level 3) for the year ended December 31, 2013*

(U.S. dollars in thousands)	Corporate securities	Municipal bonds	Residential mortgage-backed securities	Commercial mortgage-backed securities	Asset-backed securities	Total assets at fair value	Total liabilities at fair value
Beginning balance as of January 1, 2013	\$ 73,801	\$ 5,355	\$ 215,000	\$ 4,065	\$ 101,454	\$ 399,675	\$ (26,290)
Total realized and unrealized gains (losses) included in net income	(1,883)	-	64,696	(132)	(536)	62,145	8,060
Purchases.....	-	-	-	5,265	48,445	53,710	-
Settlements	(28,862)	-	(25,833)	(3,391)	(4,109)	(62,195)	-
Transfers in and/or out of Level 3, net.....	(154)	(5,355)	1,223	(1,745)	(5,575)	(11,606)	-
Ending balance as of December 31, 2013	<u>\$ 42,902</u>	<u>\$ -</u>	<u>\$ 255,086</u>	<u>\$ 4,062</u>	<u>\$ 139,679</u>	<u>\$ 441,729</u>	<u>\$ (18,230)</u>

* The December 31, 2013 comparative fair value figures in the above table have been updated based on management's review of more current information to reflect the allocation of the fair value amounts for corporate securities and asset-backed securities. This also impacted the beginning balance figures as of January 1, 2014.

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 that related to Level 3 trading and available-for-sale securities still held at the reporting date for the year ended December 31, 2014 was \$35.9 million, and for Level 3 trading securities still held at the reporting date for the year ended December 31, 2013 was \$60.6 million.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

5. Fair Value Measurements (continued)

The following tables summarizes the fair values, the valuation techniques, and the significant unobservable inputs of the Level 3 fair value measurements as of December 31, 2014 and 2013, respectively, for which we have been able to obtain quantitative information about the significant unobservable inputs used in those fair value measurements:

December 31, 2014				
Assets (U.S. dollars in thousands)	Fair Value	Valuation Technique	Significant Unobservable Inputs	Input Ranges
Corporate securities	\$ 17,423	Discounted Cash Flow	Liquidity/duration adjustment*	0.5% - 2.8%
Asset-backed securities.....	\$ 23,786	Discounted Cash Flow	Liquidity/duration adjustment*	1.1% - 1.7%

December 31, 2013				
Assets (U.S. dollars in thousands)	Fair Value	Valuation Technique	Significant Unobservable Inputs	Input Ranges
Corporate securities	\$ 37,017	Discounted Cash Flow	Liquidity/duration adjustment*	0.4% - 4.7%
Asset-backed securities.....	\$ 23,183	Discounted Cash Flow	Liquidity/duration adjustment*	1.7% - 1.8%

* 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 tables 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.

Fair Value Measurements on a Non-Recurring Basis

As discussed in the Note herein, the fair values of financial assets and liabilities were estimated in accordance with the framework established under FASB ASC 820. The methodology and assumptions for determining the fair value of financial instruments on a non-recurring basis presented, in addition to those disclosed in Note 2, "Summary of Significant Accounting Policies - Investments" were as follows:

(i) As discussed in Note 2, "Summary of Significant Accounting Policies – Investments", cash and cash equivalents include cash and short-term investments with an original maturity, when purchased, of three months or less. The carrying value amount for cash and cash equivalents is a reasonable estimate of fair value, due to the short-term maturity of these investments. These assets in cash and cash equivalents were classified as Level 1 fair value measurements;

(ii) As disclosed in Note 2, "Summary of Significant Accounting Policies – Investments", affiliated investments represent investments accounted for under the equity method, for which the resulting carrying value was deemed to approximate fair value. Because the inputs for the values were unobservable, the investments accounted for under the equity method were classified as Level 3 fair value measurements. Please refer to Note 16,

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

5. Fair Value Measurements (continued)

“Related Party Transactions – *Investment in Cerberus Affiliated Fund*”, for more information on our investments accounted for under the equity method;

(iii) As disclosed in Note 2, “Summary of Significant Accounting Policies – *Investments*”, other investments represent policy loans, which were carried at the outstanding loan balances and deemed to approximate fair value. Because the inputs for the values were unobservable, policy loans were classified as Level 3 fair value measurements;

(iv) As disclosed in Note 2, “Summary of Significant Accounting Policies – *Investments*”, the funds withheld at interest were 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 were 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 were 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;

(v) The carrying value of the accrued interest receivable for accrued dividends and interest was a reasonable approximation of fair value, due to the short-term maturity of assets. The accrued interest receivable was classified as Level 2;

(vi) 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;

(vii) The fair values for the collateral finance facility were determined with reference to underlying business models and observable market inputs and were classified as Level 3; and

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

(U.S. dollars in thousands)	December 31, 2014				
	Carrying Balance	Level 1	Level 2		Level 3
			Estimated Fair Value		
Assets					
Cash and cash equivalents.....	\$ 227,871	\$ 227,871	\$ -	\$ -	
Affiliated investments	40,176	-	-	40,176	
Other investments.....	2,957	-	-	2,957	
Funds withheld at interest.....	425,575	-	-	425,575	
Accrued interest receivable	10,878	-	10,878	-	
Liabilities					
Interest-sensitive contract liabilities	\$ 942,990	\$ -	\$ -	\$ 942,209	
Collateral finance facility	450,000	-	-	189,506	
Embedded derivative liabilities, at fair value	13,407	-	-	13,407	
Long-term debt, at par value	86,500	-	56,157	-	

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

5. Fair Value Measurements (continued)

(U.S. dollars in thousands)	Carrying Balance	December 31, 2013		
		Level 1	Level 2	Level 3
		Estimated Fair Value		
Assets				
Cash and cash equivalents.....	\$ 247,409	\$ 247,409	\$ -	\$ -
Affiliated investments	18,472	-	-	18,472
Other investments.....	3,223	-	-	3,223
Funds withheld at interest.....	459,777	-	-	459,777
Accrued interest receivable	12,587	-	12,587	-
Liabilities				
Interest-sensitive contract liabilities	\$ 1,026,307	\$ -	\$ -	\$ 1,025,308
Collateral finance facility	450,000	-	-	171,629
Embedded derivative liabilities, at fair value	18,230	-	-	18,230
Long-term debt, at par value	116,500	-	81,383	-

6. DAC

The components of DAC activity for the years ended December 31, 2014 and 2013, were as follows:

(U.S. dollars in thousands)	Year Ended December 31, 2014	Year Ended December 31, 2013
Balance at beginning of year	\$ 153,229	\$ 162,181
DAC amortization expense.....	(3,923)	(11,971)
DAC unlocking.....	(16,589)	3,019
Balance at end of year	\$ 132,717	\$ 153,229

7. PVIF Business

The components of the activity associated with PVIF for the years ended December 31, 2014 and 2013, were as follows:

(U.S. dollars in thousands)	Year Ended December 31, 2014	Year Ended December 31, 2013
Balance at beginning of year	\$ 22,215	\$ 24,001
Interest accrued.....	1,088	1,176
Amortization expense.....	(2,255)	(2,962)
Balance at end of year	\$ 21,048	\$ 22,215

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

7. PVIF Business (continued)

The gross amount of PVIF, the accumulated interest accrued, and the accumulated amortization as of December 31, 2014 and 2013, were as follows:

(U.S. dollars in thousands)	December 31, 2014	December 31, 2013
Gross amount of original PVIF	\$ 56,272	\$ 56,272
Accumulated interest accrued.....	20,794	19,706
Accumulated amortization.....	(56,018)	(53,763)
Net amount of PVIF	\$ 21,048	\$ 22,215

Future estimated amortization of PVIF, net of estimated interest, is as follows:

(U.S. dollars in thousands)	
<u>Year Ending December 31,</u>	
2015.....	\$ 1,582
2016.....	1,315
2017.....	985
2018.....	1,045
2019.....	(70)
Thereafter	16,191
	\$ 21,048

8. Collateral Finance Facility and Securitization Structure

Orkney Re II

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"). The Orkney Re II Notes are listed on the Irish Stock Exchange and proceeds from this private offering were used to fund the Valuation of Life Insurance Policies Regulation reserve requirements for a defined block of level premium term life insurance policies issued by third party ceding companies between January 1, 2004 and December 31, 2004, and reinsured by SRUS to Orkney Re II.

In addition to the private offering, Orkney Re II also issued to SALIC \$5.0 million of the Series B Notes and \$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. Proceeds from the Orkney Re II Notes, Series C Notes, Series D Convertible Notes, and Preference Shares were deposited into a series of accounts that collateralize the Orkney Re II Notes and the reserve obligations of SRUS.

In accordance with FASB ASC 810-10, Orkney Re II is considered to be a VIE, as we are considered to hold the primary beneficial interest. We cede to Orkney Re II all of the business assumed by Orkney Re II and would absorb a majority of the expected losses related to the insurance liabilities. As a result, Orkney Re II is consolidated in our consolidated financial statements.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

8. Collateral Finance Facility and Securitization Structure (continued)

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:

	December 31, 2014	December 31, 2013
(U.S. dollars in thousands)		
Assets		
Funds withheld at interest	\$ 376,948	\$ 366,561
Cash and cash equivalents	12,024	1,961
Embedded derivative assets	55,234	46,339
All other assets	33,956	41,873
Total assets	\$ 478,162	\$ 456,734
Liabilities		
Reserves for future policy benefits	\$ 135,021	\$ 137,491
Collateral finance facility.....	450,000	450,000
All other liabilities	55,813	46,833
Total liabilities.....	\$ 640,834	\$ 634,324

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 deduction of the assets needed to satisfy future policy benefits, based on current projections (“economic reserves”). The following table provides a reconciliation of the aforementioned adjustments:

	December 31, 2014	December 31, 2013
(U.S. dollars in thousands)		
Funds withheld at interest	\$ 376,948	\$ 366,561
Cash and cash equivalents	12,024	1,961
Embedded derivative assets	55,234	46,339
Total investments	\$ 444,206	\$ 414,861
Less: Economic reserves	(157,136)	(156,543)
Total investments in consolidated VIE.....	\$ 287,070	\$ 258,318

The reinsurance liabilities of Orkney Re II have been eliminated from the Consolidated Balance Sheets.

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 and Series A-2 Notes on all scheduled quarterly interest payment dates since May 11, 2009. As of December 31, 2014, Assured Guaranty (UK) Ltd. (“Assured”) has made guarantee payments in the cumulative amount of \$17.9 million on the Series A-1 Notes which are the subject of a financial guaranty policy issued by Assured in connection with the Orkney Re II transaction. Unlike the Series A-1 Notes, the Series A-2 Notes were not guaranteed under the Orkney Re II transaction and the amount of cumulative interest on the Series A-2 Notes was \$2.7 million as of December 31, 2014. This amount of cumulative interest on the Series A-1 Notes and the Series A-2 Notes 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

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

8. Collateral Finance Facility and Securitization Structure (continued)

plus 0.425%. As of December 31, 2014, the interest rate on the Series A-1 Notes was 0.66% (compared to 0.66% as of December 31, 2013). Interest on the Series A-2 Notes, which are not guaranteed as part of the Orkney Re II transaction, is payable quarterly at a rate equivalent to three-month LIBOR plus 0.730%. As of December 31, 2014, the interest rate on the Series A-2 Notes was 0.96% (compared to 0.97% as of December 31, 2013). For further discussion on Orkney Re II and scheduled interest payments on the Series A-1 Notes and the Series A-2 Notes, please refer to Note 17, "Subsequent Events - *Orkney Re II*".

9. 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, 2014	December 31, 2013
Capital Securities Due 2032*	\$ 17,500	\$ 17,500
Preferred Trust Securities Due 2033*	-	20,000
Trust Preferred Securities Due 2033*	-	10,000
Trust Preferred Securities Due 2034*	19,000	19,000
Trust Preferred Securities Due December 2034*	50,000	50,000
Long-term debt, at par value	<u>\$ 86,500</u>	<u>\$ 116,500</u>

*Defined below.

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December 31, 2014

9. Debt Obligations and Other Funding Arrangements (continued)

(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, at par value	Capital Trust*	Capital Trust II*	GPIC Trust*	Capital Trust III*	SFL Trust I*
Long-term debt outstanding.....	\$17,500	\$nil**	\$nil***	\$19,000****	\$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 as of December 31, 2014	4.26%	4.21%	4.16%	4.06%	3.76%
Interest rate as of December 31, 2013	4.25%	4.20%	4.15%	4.05%	3.75%
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, 2014	8	8	8	8	8

*Defined below.

**Not included in this amount is \$20.0 million of outstanding Preferred Trust Securities Due 2033 owned by SRGL, as further explained in this Note.

***Not included in this amount is \$10.0 million of outstanding Trust Preferred Securities Due 2033 owned by SRGL, as further explained in this Note.

****Not included in this amount is \$13.0 million of outstanding Trust Preferred Securities Due 2034 owned by SRGL, as further explained in this Note.

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 for which interest was deferred as of December 31, 2014) 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, 2014) as the Preferred Trust Securities Due 2033.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

9. Debt Obligations and Other Funding Arrangements (continued)

On December 3, 2014, SRGL agreed to acquire, in a privately-negotiated transaction, the entire \$20.0 million in aggregate liquidation amount of Preferred Trust Securities Due 2033, with a liquidation preference of \$1,000 per security, at a purchase price of \$665.00 per security. In accordance with FASB ASC 405, Extinguishment of Liabilities, the Company recorded a \$8.5 million gain on the extinguishment of debt (which included \$1.8 million in deferred and accrued interest that is now payable to SRGL following the acquisition) in the Consolidated Statements of Comprehensive Income in the fourth quarter of 2014.

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, 2014) as the Trust Preferred Securities Due 2033.

On December 3, 2014, SRGL agreed to acquire, in a privately-negotiated transaction, the entire \$10.0 million in aggregate liquidation amount of Trust Preferred Securities Due 2033, with a liquidation preference of \$1,000 per security, at a purchase price of \$665.00 per security. In accordance with FASB ASC 405, Extinguishment of Liabilities, the Company recorded a \$4.2 million gain on the extinguishment of debt (which included \$0.9 million in deferred and accrued interest that is now payable to SRGL following the acquisition) in the Consolidated Statements of Comprehensive in the fourth quarter of 2014.

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, 2014) as the Trust Preferred Securities Due 2034.

On January 31, 2013, SRGL agreed to acquire, in a privately-negotiated transaction, approximately \$13.0 million in aggregate liquidation amount of Trust Preferred Securities Due 2034, with a liquidation preference of \$1,000 per security, at a purchase price of \$520.00 per security. In accordance with FASB ASC 405, Extinguishment of Liabilities, the Company recorded a \$6.2 million gain on the extinguishment of debt in the Consolidated Statements of Comprehensive Income in the first quarter of 2013.

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, 2014) as the Trust Preferred Securities Due December 2034.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

9. Debt Obligations and Other Funding Arrangements (continued)

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.

For all the securities listed above, any deferred interest 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 January 29, 2013 on the Capital and Trust Preferred Securities as permitted by the terms of the indentures governing the securities. These deferrals were permitted by the terms of the indentures governing the securities and were made at the discretion of our Board of Directors (the "Board"). As of December 31, 2014, we have accrued and deferred net payments of \$7.2 million in interest on the Capital and Trust Preferred Securities. SHI, SFL, and SALIC generally are restricted in their ability to make certain dividend payments and payments in respect of obligations ranking junior or *pari passu* to the Capital and Trust Preferred Securities in any period where interest payment obligations on these securities are not current.

For further discussion on the accrued and deferred payment on our Capital and Trust Preferred Securities subsequent to December 31, 2014, please refer to Note 17, "Subsequent Events - *Deferral of Interest Payments on the Capital and Trust Preferred Securities*".

10. Mezzanine Equity – Convertible Cumulative Participating Preferred Shares

On May 7, 2007, we completed the equity investment transaction by the Investors, announced by us on November 27, 2006 (the "2007 New Capital Transaction"). Pursuant to the 2007 New Capital Transaction, 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 (the "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

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

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

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).

As of December 31, 2014, the amount of dividends accreted pursuant to the terms of the CCPP Shares, after giving effect a reduction in the liquidation preference of the CCPP Shares resulting from receipt by holders of the CCPP Shares on December 20, 2012 of \$75.6 million of accreted cumulative participating dividends on the CCPP Shares, was \$257.7 million in the aggregate, or \$257.70 per CCPP 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.

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 our 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.

11. Shareholders' Deficit

Ordinary Shares

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

As of December 31, 2014 and 2013, we have 68,383,370 Ordinary Shares issued and outstanding, all of which are owned by the Investors.

Perpetual Preferred Shares

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

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. Through December 31, 2014, we have repurchased and cancelled 1,753,224 Perpetual Preferred Shares, and as of December 31, 2014 and 2013, 3,246,776 Perpetual Preferred Shares remain issued and outstanding.

The dividend rate on the Perpetual Preferred Shares 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 for December

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

11. Shareholders' Deficit (continued)

31, 2014 and 2013, were 6.00% and 7.29%, respectively. 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 by SRGL. Please refer below to “*Dividends on Perpetual Preferred Shares*” in this Note for additional information.

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.

All future payments of dividends are at the discretion of our Board and will depend on such 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 declaring and paying any dividend on the Ordinary Shares.

Dividends on Perpetual Preferred Shares

In accordance with the relevant financial tests under the terms of our Perpetual Preferred Shares, our Board was precluded from declaring and paying a dividend in connection with each of the 2013 and 2014 dividend payment dates.

Pursuant to the terms of, and subject to the procedures set forth in, the Certificate of Designations related to our Perpetual Preferred Shares, the holders of our Perpetual Preferred Shares are entitled to elect two directors to our Board in the event dividends on our Perpetual Preferred Shares have not been declared and paid for six or more dividend periods, consecutive or not (a “Nonpayment”). Failure to declare and pay dividends on the July 15, 2009 dividend payment date marked the sixth dividend period for which dividends had not been declared and paid (i.e., a Nonpayment); however, the right of the holders of our Perpetual Preferred Shares to elect two directors to our Board has not been exercised as of December 31, 2014. If and when dividends for at least four dividend periods, whether or not consecutive, following a Nonpayment have been paid in full, this right will cease.

There can be no assurances when or whether, as a result of the application of the financial tests contained in the terms of our Perpetual Preferred Shares, our Board will be permitted to make subsequent dividend payments on our Perpetual Preferred Shares or, if permitted, when or whether our Board will choose in its discretion to make any such dividend payments on our Perpetual Preferred Shares.

For further discussion on the non-declaration of dividends on our Perpetual Preferred Shares, please refer to Note 17, “*Subsequent Events – Non-declaration of Dividends on Perpetual Preferred Shares*”.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

12. Reinsurance

Premiums Earned, Net

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

(U.S. dollars in thousands)	December 31, 2014	December 31, 2013
Premiums assumed.....	\$ 620,425	\$ 660,497
Premiums ceded	(267,921)	(321,326)
Premiums earned, net	<u>\$ 352,504</u>	<u>\$ 339,171</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)	December 31, 2014	December 31, 2013
Claims, policy benefits, and changes in policyholder reserves assumed.....	\$ 653,343	\$ 678,410
Claims, policy benefits, and changes in policyholder reserves ceded	(275,004)	(294,770)
Claims, policy benefits, and changes in policyholder reserves, net.....	<u>\$ 378,339</u>	<u>\$ 383,640</u>

13. Income Taxes

For the years ended December 31, 2014 and 2013, we had income tax expense (benefit) from operations, as follows:

(U.S. dollars in thousands)	Year Ended December 31, 2014	Year Ended December 31, 2013
Current tax expense:		
U.S.	\$ -	\$ -
Non-U.S.	159	295
Total current tax expense	<u>159</u>	<u>295</u>
Deferred tax (benefit) expense:		
U.S.	(5,989)	(5,597)
Non-U.S.	(1,812)	231
Total deferred tax benefit.....	<u>(7,801)</u>	<u>(5,366)</u>
Total tax benefit	<u>\$ (7,642)</u>	<u>\$ (5,071)</u>

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

13. Income Taxes (continued)

The deferred tax benefit for the years ended December 31, 2014 and 2013 for the U.S. entities in the preceding table were principally 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 years ended December 31, 2014 for the non-U.S. entities in the preceding table was principally caused by a release of reserves for uncertain tax positions due to the expiration of the statute of limitations related to these positions. The deferred tax expense for the year ended December 31, 2013, for the non-U.S. entities in the preceding table was principally caused by an increase of reserves related to uncertain tax positions. The deferred tax benefit also includes true-up adjustments that were made related to the validation of net operating losses as of December 31, 2013.

The expected tax expense (benefit) at jurisdictional tax rates 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, 2014 and 2013 is provided below:

(U.S. dollars in thousands)	Year Ended December 31, 2014	Year Ended December 31, 2013
Loss before taxes	\$ (1,284)	\$ (22,294)
Expected tax (benefit) expense at jurisdictional tax rates.....	(5,259)	(18,049)
Change in valuation allowance.....	(730)	12,551
Other and state taxes.....	(1,653)	427
Income tax benefit	<u>\$ (7,642)</u>	<u>\$ (5,071)</u>

Any net incomes from the operations of our Cayman Island entities are not subject to income tax. The operations of our U.S., Bermuda, and Irish entities did not generate a current tax expense, other than potential interest and penalties on accrued tax liabilities for unrecognized tax benefits, due to operating performance and the availability of tax losses from prior tax years. The utilization of tax losses results in a reduction in deferred tax assets and a corresponding reduction in the valuation allowance established against those deferred tax assets.

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. As of December 31, 2014 and 2013, 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 as of December 31, 2013	\$ 824,120	\$ 544,623	\$ 320,488	\$ 1,689,231
Operating loss incurred (utilized) during 2014	28,369	(16,950)	(10,050)	1,369
Operating loss carryforwards available as of December 31, 2014	<u>\$ 852,489</u>	<u>\$ 527,673</u>	<u>\$ 310,438</u>	<u>\$ 1,690,600</u>
Deferred tax asset for operating losses, before valuation allowance, as of December 31, 2014.....	<u>\$ 291,255</u>	<u>\$ 65,959</u>	<u>\$ 77,609</u>	<u>\$ 434,823</u>

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

13. Income Taxes (continued)

The operating loss carryforwards in our U.S. entities will expire, if not utilized, in years 2019 through 2034, while the operating loss carryforwards in our Irish entities benefit from an unlimited carryforward period. The net operating loss carryforward generated in the current and prior years resulted principally from the operations of SRUS, SHI, SRD, and Orkney Re II.

Significant components of our deferred tax assets and liabilities as of December 31, 2014 and 2013 were as follows:

(U.S. dollars in thousands)	December 31, 2014	December 31, 2013
Deferred tax assets		
Net operating losses (net of FASB ASC 740-10 and Section 382*).....	\$ 434,823	\$ 429,784
Capital loss carryforwards	41,096	50,991
Embedded derivative liabilities	19,082	16,197
Other	3,062	3,017
Total deferred tax assets	<u>498,063</u>	<u>499,989</u>
Deferred tax liabilities		
Deferred acquisition costs.....	(18,819)	(21,338)
Reserves for future policy benefits	(46,968)	(48,552)
Unrealized appreciation on investments	(9,048)	(16,521)
Present value of in-force business	(7,156)	(7,553)
Deferred market discount	(32,794)	(16,917)
Other	-	(4,522)
Total deferred tax liabilities.....	<u>(114,785)</u>	<u>(115,403)</u>
Net deferred tax assets before valuation allowance.....	383,278	384,586
Valuation allowance	(414,820)	(422,118)
Net deferred tax liabilities	<u>\$ (31,542)</u>	<u>\$ (37,532)</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 decreased by approximately \$7.3 million during the year ended December 31, 2014, to \$414.8 million.

Section 382 Event

The 2007 New Capital Transaction (as discussed in Note 10, “Mezzanine Equity – Convertible Cumulative Participating Preferred Shares”) qualified as a change in ownership under Section 382 of the Internal Revenue Code. Section 382 operates to limit the future deduction of net operating losses that were in existence as of the change in ownership. Because we had previously established a valuation allowance against these net operating losses, there was not a significant tax expense associated with Section 382 limitations.

FASB ASC Subtopic 740-10, Income Taxes – Overall

In 2014, the statute of limitations expired for the 2010 U.S. income tax year, which resulted in a reduction of our unrecognized tax benefits in the amount of \$0.9 million. In 2013, there was no change in the balance for unrecognized tax benefits aside from the accrual of potential interest and penalties for existing unrecognized tax benefits.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

13. Income Taxes (continued)

As of December 31, 2014 and 2013, we had total unrecognized tax benefits (excluding interest and penalties) of \$2.2 million and \$3.1 million, respectively, the recognition of which would result in a \$0.7 million and \$1.5 million tax benefit, at the effective tax rate.

The following is a roll-forward of our FASB ASC 740-10 unrecognized tax benefits for the years ended December 31, 2014 and 2013:

(U.S. dollars in thousands)	Year Ended December 31, 2014	Year Ended December 31, 2013
Total unrecognized tax benefits at beginning of year	\$ 3,061	\$ 3,061
Reductions due to lapse of statutes of limitation.....	(828)	-
Total unrecognized tax benefits at end of year.....	2,233	3,061
Tax benefit of unrecognized tax benefits if recognized at the effective tax rate.....	\$ 690	\$ 1,517

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

(U.S. dollars in thousands)	December 31, 2014	December 31, 2013
Total interest & penalties in the Consolidated Balance Sheets at beginning of year	\$ 1,886	\$ 1,655
Total interest & penalties in the Consolidated Statements of Comprehensive Income	(986)	231
Total interest & penalties in the Consolidated Balance Sheets at end of year	\$ 900	\$ 1,886

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

We file separate tax returns as prescribed by the tax laws of the jurisdictions in which we operate. As of December 31, 2014, we remained subject to examination in the following major tax jurisdictions for the years indicated in the table below:

Major Tax Jurisdictions	Open Years
U.S.	
Life Group	2011 through 2014
Non-Life Group.....	2011 through 2014
Ireland	2010 through 2014

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 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

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

13. Income Taxes (continued)

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.

14. Commitments and Contingencies

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.

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 to SALIC, \$181.2 million in Preference Shares to SALIC, and \$500,000 in Class D Notes to SRGL.

As of December 31, 2014, we continue to have no remaining direct loss exposure related to Ballantyne Re since our interests in the Ballantyne Re Class D Notes and Preference Shares are valued at \$0. The Class C Notes were fully written-off in 2008 under the contractual terms of the Ballantyne Re indenture.

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.

Davis v. Scottish Re Group Limited, et al.

SRGL and SRUS (together, “Scottish Re”) learned that a lawsuit was filed on or about November 20, 2013, in New York state court against Scottish Re, SRGL’s shareholders and certain of their affiliates, and various former

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

14. Commitments and Contingencies (continued)

and current directors of Scottish Re (collectively, the “Defendant Parties”). The plaintiff, a holder of Perpetual Preferred Shares and a former holder of Ordinary Shares (please refer to Note 11, “Shareholders’ Deficit” for information regarding the Perpetual Preferred Shares and the Ordinary Shares), alleges, among other things, claims against the Defendant Parties for breach of contract, breach of fiduciary duty, tortious interference, and derivative claims centered largely around the following events:

- (i) the 2011 unwind of a formerly consolidated collateral finance facility and the associated acquisition by affiliates of Cerberus of debt related to the collateral finance facility;
- (ii) the completion in 2011 of a cash-out merger between SRGL and affiliates of the Investors;
- (iii) the cancellation by SRGL of Perpetual Preferred Shares acquired pursuant to cash tender offers made by SRGL in 2010 and 2012; and
- (iv) a purported distribution policy affecting the Perpetual Preferred Shares.

On February 21, 2014, Motions to Dismiss were filed with the court on behalf of the Defendant Parties pursuant to a briefing schedule previously agreed with the court and the plaintiff. Pursuant to that schedule, the plaintiff submitted on May 7, 2014 its opposition to the Motions to Dismiss. The Defendant Parties submitted replies in further support of their Motions to Dismiss on June 23, 2014. Oral arguments on the Motions to Dismiss were heard by the court on September 29, 2014.

Following oral arguments on the Motions to Dismiss on September 29, 2014, on October 7, 2014, the presiding judge issued a decision dismissing all claims against the Defendant Parties, with the exception of two breach of contract claims against SRGL. The judge directed that the plaintiff and SRGL engage in jurisdictional discovery limited to these two claims, which jurisdictional discovery has commenced. After jurisdictional discovery is complete, the judge will decide whether these claims should also be dismissed on jurisdictional grounds. The plaintiff filed on October 28, 2014 his opening appellate brief challenging the court’s October 7, 2014 decision.

Scottish Re has certain obligations to indemnify those Defendant Parties that are current or former directors of Scottish Re for the reasonable cost of their defense of the Davis lawsuit.

We believe the plaintiff’s allegations to be without merit and are vigorously defending our interest in the action. Accordingly, it is not possible to estimate any loss in respect of the plaintiff’s claims.

For further discussion regarding the Davis litigation, please refer to Note 17, “Subsequent Events – *Davis v. Scottish Re Group Limited, et al.*”.

15. 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 United States. 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 differences are 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.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

15. Statutory Requirements and Dividend Restrictions (continued)

Statutory Requirements for Non-U.S. Subsidiaries

Our Bermuda insurance company, SRLB, is required by the Bermuda Monetary Authority to maintain a minimum capital requirement of \$500 thousand as of December 31, 2014, and, under The Insurance Law of the Cayman Islands, our Cayman licenced insurance company, SALIC, must maintain a minimum capital requirement of \$200 thousand as of December 31, 2014. 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. As of December 31, 2014 and 2013, SRD had a solvency margin of 231% and 202%, 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.

Statutory Requirements for U.S. Subsidiaries

Our Delaware-domiciled reinsurance subsidiary, SRUS, prepares its 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 the insurance laws of the State of Delaware. The Delaware Department of Insurance (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 did not utilize any prescribed or permitted accounting practices during the years ended December 31, 2014 and 2013.

Prior to completion of the SRUS/SRLC Merger (as defined herein), Scottish Re Life Corporation (“SRLC”) was another Delaware-domiciled reinsurance subsidiary. 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 would be merged with and into SRUS, with SRUS continuing as the surviving corporation (the “SRUS/SRLC Merger”). From and after the effective date of the SRUS/SRLC Merger (the “Effective Date”), SRUS, as the surviving corporation, would be responsible and liable for all of the liabilities and obligations of SRUS and SRLC existing as of the Effective Date, and all policies of insurance and contracts and agreements of reinsurance or retrocession assumed or issued by SRLC, or pursuant to which SRLC was a party would, as of the Effective Date, become policies of insurance and contracts and agreements of reinsurance or retrocession (as the case may be) of SRUS. Approval of the SRUS/SRLC Merger was received from the Insurance Commissioner of the State of Delaware (the “Delaware Commissioner”) on May 8, 2013 and from the Insurance Commissioner of the State of California on July 12, 2013. The Effective Date of the SRUS/SRLC Merger was July 30, 2013. The SRUS/SRLC Merger had no effect on the Company’s consolidated financial position and results of operations.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

15. Statutory Requirements and Dividend Restrictions (continued)

The following table presents the statutory capital and surplus of our U.S. reinsurance subsidiary, SRUS, as of December 31, 2014 and 2013, and the statutory net loss for the years ended December 31, 2014 and 2013, as reflected in SRUS's most recent statutory financial statement filings with the Department.

(U.S. dollars in thousands)	2014	2013
Statutory Capital and Surplus	<u>\$ 169,863</u>	<u>\$ 171,746</u>
Statutory Net Loss	<u>\$ (1,307)</u>	<u>\$ (24,224)</u>

As of December 31, 2014 and 2013, SRUS exceeded all minimum risk-based capital ("RBC") requirements for life and health insurance companies under the laws of the State of Delaware. The company action level RBC percentage for SRUS as of December 31, 2014 and December 31, 2013 was 372% and 351%, respectively, each as filed with the Department. SALIC is a party to a net worth maintenance agreement with SRUS, pursuant to which SALIC effectively guarantees SRUS's regulatory solvency.

The payment of dividends by SRUS to its shareholder, SHI, is limited and can only be made from earned profits, unless prior approval is received from the Delaware Commissioner. The maximum amount of dividends that may be paid by life insurance companies without prior approval of the Delaware Commissioner is also subject to restrictions relating to statutory surplus and net income. The maximum dividend payout that can be made by SRUS without prior approval of the Delaware 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 positive unassigned surplus. SRUS had an unassigned deficit as of December 31, 2014 and 2013. Accordingly, SRUS cannot pay a dividend in 2015 without the prior approval of the Delaware Commissioner. During the years ended December 31, 2014 and 2013, SRUS did not request or receive approval from the Delaware Commissioner to make, and did not make, any dividend payments to its shareholder.

16. Related Party Transactions

MassMutual Capital

For the years ended December 31, 2014 and 2013, we had premiums earned of \$20.0 million and \$18.0 million, respectively, associated with Massachusetts Mutual Life Insurance Company ("MassMutual Life"), the ultimate parent of MassMutual Capital, and with CM Life Insurance Company ("CM Life"), an affiliate of MassMutual Capital. As of December 31, 2014 and 2013, we had net receivables from MassMutual Life and CM Life, of \$5.1 million and \$4.4 million, respectively.

We also incurred \$2.0 million and \$2.2 million for investment management fees payable to Babson Capital Management LLC, an affiliate of MassMutual Capital, for the years ended December 31, 2014 and 2013, respectively.

Cerberus

For the years ended December 31, 2014 and 2013, we incurred \$0.2 million in both years, associated with advisors' fees payable to Cerberus, associated with the Company's review of certain business opportunities.

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

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

16. Related Party Transactions (continued)

indirectly, by Cerberus (the “Cerberus Affiliated Fund”). The Cerberus Affiliated Fund, which is included in Affiliated Investments on the accompanying Consolidated Balance Sheets, had costs and carrying values as of December 31, 2014 and 2013, as follows:

(U.S. dollars in thousands)	<u>Cost (Total Commitment)</u>	<u>Carrying Value</u>
December 31, 2014.....	\$ 26,428	\$ 40,176
December 31, 2013.....	\$ 13,445	\$ 18,472

For further discussion of investments in the Cerberus Affiliated Fund subsequent to December 31, 2014, please refer to Note 17, “Subsequent Events – *Investment in Cerberus Affiliated Fund*”.

17. Subsequent Events

The subsequent events disclosed in these notes to the consolidated financial statements have been evaluated by management up to and including the filing of the consolidated financial statements on March 26, 2015.

Non-declaration of Dividends on Perpetual Preferred Shares

In accordance with the relevant financial tests under the terms of the Perpetual Preferred Shares, the Board was precluded from declaring and paying, and therefore did not declare and pay, a dividend on the January 15, 2015 dividend payment date.

Investment in Cerberus Affiliated Fund

Subsequent to December 31, 2014, SALIC received one return of capital distribution, as well as one capital call request, associated with the Cerberus Affiliated Fund, resulting in a net received amount of \$0.9 million. As of March 26, 2015, SALIC had invested \$25.5 million of its \$30.0 million total commitment.

Deferral of Interest Payments on the Capital and Trust Preferred Securities

Subsequent to December 31, 2014, we have accrued and deferred net payments of an additional \$0.9 million of interest on our Capital and Trust Preferred Securities (as outlined in Note 9, “Debt Obligations and Other Funding Arrangements - *Deferral of Interest Payments on the Capital and Trust Preferred Securities*”) as permitted by terms of the indentures governing the Capital and Trust Preferred Securities. As of March 26, 2015, we had accrued and deferred net payments on a total of \$8.1 million of interest on the Capital and Trust Preferred Securities.

Orkney Re II

On the scheduled interest payment date of February 11, 2015, Orkney Re II was unable to make scheduled interest payments on the Series A-1 Notes and the Series A-2 Notes. As a result, and pursuant to the financial guaranty policy issued by Assured (as discussed in Note 8, “Collateral Finance Facility and Securitization Structure – *Orkney Re II*”), Assured made guarantee payments on the Series A-1 Notes in the amount of \$0.6 million. The unpaid interest amount for the Series A-2 Notes, which was not guaranteed under the Orkney Re II transaction, was \$0.1 million. We have accrued the interest on both the Series A-1 Notes and the Series A-2 Notes.

SCOTTISH RE GROUP LIMITED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2014

17. Subsequent Events (continued)

Davis v. Scottish Re Group Limited, et al.

Following the plaintiff's filing on October 28, 2014 of his opening appellate brief challenging the October 7, 2014 decision of the court, as previously discussed in Note 14, "Commitments and Contingencies – *Davis v. Scottish Re Group Limited, et al.*", on January 28, 2015, Scottish Re and the other Defendant Parties filed opposition briefs with the court. Thereafter, the plaintiff filed his reply brief with the court on February 13, 2015. Oral arguments on the appellate brief are expected to be heard by the court in 2015, although no date currently has been scheduled.