



**MML BAY STATE LIFE INSURANCE COMPANY**

**STATUTORY FINANCIAL STATEMENTS**

As of December 31, 2007 and 2006 and  
for the years ended December 31, 2007, 2006 and 2005

# MML BAY STATE LIFE INSURANCE COMPANY

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**KPMG LLP**  
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## **Independent Auditors' Report**

The Board of Directors and Shareholder of  
MML Bay State Life Insurance Company:

We have audited the accompanying statutory statements of financial position of MML Bay State Life Insurance Company (the "Company") as of December 31, 2007 and 2006, and the related statutory statements of income, changes in shareholder's equity, and cash flows for each of the years in the three-year period ended December 31, 2007. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

As described more fully in Note 2 to the financial statements, the Company prepared these financial statements using accounting practices prescribed or permitted by the State of Connecticut Insurance Department ("statutory accounting practices"), which practices differ from U.S. generally accepted accounting principles. The effects on the financial statements of the variances between the statutory accounting practices and U.S. generally accepted accounting principles, although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the variances between the statutory accounting practices and U.S. generally accepted accounting principles discussed in the preceding paragraph, the Company's financial statements do not present fairly, in conformity with U.S. generally accepted accounting principles, the financial position of the Company as of December 31, 2007 and 2006, or the results of its operations or its cash flows for each of the years in the three-year period ended December 31, 2007. In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2007 and 2006, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2007, on the basis of accounting described in Note 2.

**KPMG LLP**

February 22, 2008

MML BAY STATE LIFE INSURANCE COMPANY  
 STATUTORY STATEMENTS OF FINANCIAL POSITION

	December 31,	
	2007	2006
	(In Millions)	
Assets:		
Bonds	\$ 175	\$ 186
Mortgage loans	10	8
Policy loans	90	80
Derivatives and other invested assets	(1)	-
Cash, cash equivalents and short-term investments	(6)	5
Total invested assets	268	279
Investment income due and accrued	3	3
Insurance amounts receivable	6	5
Federal income taxes	14	2
Deferred income taxes	7	11
Total assets excluding separate accounts	298	300
Separate account assets	4,339	4,250
Total assets	\$ 4,637	\$ 4,550

See notes to statutory financial statements.

MML BAY STATE LIFE INSURANCE COMPANY

STATUTORY STATEMENTS OF FINANCIAL POSITION, continued

	December 31,	
	<u>2007</u>	<u>2006</u>
	(\$ In Millions Except For Par Value)	
Liabilities:		
Policyholders' reserves	\$ 99	\$ 88
Liabilities for deposit-type contracts	1	2
Contract claims and other benefits	21	14
General expenses due or accrued	4	5
Transfers due from separate accounts	(25)	(36)
Payable to affiliate	3	3
Asset valuation reserve	2	4
Other liabilities	<u>10</u>	<u>8</u>
Total liabilities excluding separate accounts	115	88
Separate account liabilities	<u>4,339</u>	<u>4,250</u>
Total liabilities	<u>4,454</u>	<u>4,338</u>
Shareholder's equity:		
Common stock, \$200 par value		
25,000 shares authorized		
12,501 shares issued and outstanding	2	2
Paid-in and contributed surplus	147	147
Surplus	<u>34</u>	<u>63</u>
Total shareholder's equity	<u>183</u>	<u>212</u>
Total liabilities and shareholder's equity	<u>\$ 4,637</u>	<u>\$ 4,550</u>

See notes to statutory financial statements.

MML BAY STATE LIFE INSURANCE COMPANY

STATUTORY STATEMENTS OF INCOME

	Years Ended December 31,		
	<u>2007</u>	<u>2006</u>	<u>2005</u>
	(In Millions)		
Revenue:			
Premium income	\$ 51	\$ 66	\$ 76
Net investment income	16	16	14
Fees and other income	<u>77</u>	<u>73</u>	<u>77</u>
Total revenue	<u>144</u>	<u>155</u>	<u>167</u>
Benefits and expenses:			
Policyholders' benefits	127	131	132
Change in policyholders' reserves	(33)	(36)	(23)
General insurance expenses	10	14	12
Commissions	5	5	6
State taxes, licenses and fees	<u>2</u>	<u>2</u>	<u>2</u>
Total benefits and expenses	<u>111</u>	<u>116</u>	<u>129</u>
Net gain from operations before federal income taxes	33	39	38
Federal income tax expense (benefit)	<u>19</u>	<u>2</u>	<u>(6)</u>
Net gain from operations	14	37	44
Net realized capital losses, after tax and transfers to interest maintenance reserve	<u>(3)</u>	<u>-</u>	<u>-</u>
Net income	<u>\$ 11</u>	<u>\$ 37</u>	<u>\$ 44</u>

See notes to statutory financial statements.

MML BAY STATE LIFE INSURANCE COMPANY

STATUTORY STATEMENTS OF CHANGES IN SHAREHOLDER'S EQUITY

	Years Ended December 31,		
	<u>2007</u>	<u>2006</u>	<u>2005</u>
	(In Millions)		
Shareholder's equity, beginning of year	\$ 212	\$ 218	\$ 222
Increase (decrease) due to:			
Net income	11	37	44
Dividend paid	(37)	(44)	(47)
Change in net deferred income taxes	7	(9)	(9)
Change in nonadmitted assets	(11)	9	8
Change in asset valuation reserve	2	(1)	-
Other	<u>(1)</u>	<u>2</u>	<u>-</u>
Net decrease	<u>(29)</u>	<u>(6)</u>	<u>(4)</u>
Shareholder's equity, end of year	<u>\$ 183</u>	<u>\$ 212</u>	<u>\$ 218</u>

See notes to statutory financial statements.

MML BAY STATE LIFE INSURANCE COMPANY

STATUTORY STATEMENTS OF CASH FLOWS

	Years Ended December 31,		
	<u>2007</u>	<u>2006</u>	<u>2005</u>
	(In Millions)		
Cash from operations:			
Premium and other income collected	\$ 136	\$ 139	\$ 152
Net investment income	17	16	15
Benefit payments	(127)	(130)	(125)
Net transfers from separate accounts	55	48	30
Commissions and other expenses	(18)	(20)	(22)
Federal income taxes paid	<u>(30)</u>	<u>(6)</u>	<u>(2)</u>
Net cash from operations	<u>33</u>	<u>47</u>	<u>48</u>
Cash from investments:			
Proceeds from investments sold, matured, or repaid:			
Bonds	53	31	44
Mortgage loans	<u>1</u>	<u>1</u>	<u>1</u>
Total investment proceeds	<u>54</u>	<u>32</u>	<u>45</u>
Cost of investments acquired:			
Bonds	(45)	(40)	(33)
Mortgage loans	<u>(3)</u>	<u>(6)</u>	<u>-</u>
Total investments acquired	<u>(48)</u>	<u>(46)</u>	<u>(33)</u>
Net increase in policy loans	<u>(10)</u>	<u>(9)</u>	<u>(6)</u>
Net cash from investments	<u>(4)</u>	<u>(23)</u>	<u>6</u>
Cash from financing and other sources:			
Net withdrawals on deposit-type contracts	(2)	(1)	-
Dividends paid to stockholders	(37)	(44)	(47)
Other cash (applied) provided	<u>(1)</u>	<u>1</u>	<u>1</u>
Net cash applied from financing and other sources	<u>(40)</u>	<u>(44)</u>	<u>(46)</u>
Net change in cash, cash equivalents and short-term investments	(11)	(20)	8
Cash, cash equivalents and short-term investments, beginning of year	<u>5</u>	<u>25</u>	<u>17</u>
Cash, cash equivalents and short-term investments, end of year	<u>\$ (6)</u>	<u>\$ 5</u>	<u>\$ 25</u>

See notes to statutory financial statements.

## NOTES TO STATUTORY FINANCIAL STATEMENTS

### 1. *Nature of operations*

MassMutual Financial Group (“MMFG”) is comprised of Massachusetts Mutual Life Insurance Company (“MassMutual”) and its subsidiaries. These statutory financial statements include the accounts of MML Bay State Life Insurance Company (the “Company”), a wholly-owned stock life insurance subsidiary of C.M. Life Insurance Company (“C.M. Life”) and an indirect subsidiary of MassMutual. The Company provides life insurance and annuities to individuals and group life insurance to institutions. MMFG is a global, diversified financial services organization providing life insurance, disability income insurance, long-term care insurance, annuities, retirement and savings products, investment management, mutual funds and trust services to individual and institutional customers.

### 2. *Summary of significant accounting policies and practices*

#### a. *Basis of presentation*

The statutory financial statements have been prepared in conformity with the statutory accounting practices of the National Association of Insurance Commissioners (“NAIC”) and the accounting practices prescribed or permitted by the State of Connecticut Insurance Department (“Department”).

Statutory accounting practices are different in some respects from financial statements prepared in accordance with United States of America (“U.S.”) generally accepted accounting principles (“GAAP”). The more significant differences between statutory accounting principles and GAAP are as follows: (a) certain acquisition costs, such as commissions and other variable costs, that are directly related to acquiring new business, are charged to current operations as incurred, whereas GAAP generally capitalizes these expenses and amortizes them based on profit emergence over the expected life of the policies or over the premium payment period; (b) statutory policy reserves are based upon the Commissioners’ Reserve Valuation Method or net level premium method and prescribed statutory mortality and interest assumptions, whereas GAAP reserves would generally be based upon the net level premium method or the estimated gross margin, method with estimates of future mortality and interest assumptions; (c) bonds are generally carried at amortized cost, whereas GAAP generally reports bonds at fair value; (d) deferred income taxes, which provide for book versus tax temporary differences, are subject to limitation and are charged to surplus, whereas GAAP would generally include the change in deferred taxes in net income; (e) payments received for universal and variable life insurance products and variable annuities are reported as premium income and changes in reserves, whereas GAAP would treat these payments as deposits to policyholders’ account balances; (f) assets are reported at “admitted asset” value and “nonadmitted assets” are excluded through a charge against surplus, whereas GAAP records these assets net of any valuation allowance; (g) reinsurance reserve credits are reported as a reduction of policyholders’ reserves and liabilities for deposit-type contracts, whereas GAAP would report these balances as an asset; (h) an asset valuation reserve (“AVR”) is reported as a contingency reserve to stabilize surplus against fluctuations in the carrying value of stocks, real estate investments, partnerships, limited liability companies (“LLCs”), and certain credit related derivative instruments as well as

## NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

credit-related declines in the value of bonds and mortgage loans, whereas GAAP does not record this reserve; (i) after-tax realized capital gains and losses which result from changes in the overall level of interest rates for all types of fixed-income investments are deferred into the interest maintenance reserve (“IMR”) and amortized into revenue, whereas GAAP reports these gains and losses as revenue; (j) changes in the fair value of derivative financial instruments are recorded as changes in surplus, whereas GAAP generally reports these changes as revenue unless deemed an effective hedge; (k) comprehensive income is not presented, whereas GAAP presents changes in unrealized capital gains and losses as other comprehensive income; and (l) certain universal life contracts which do not pass through all investment gains to contract holders are maintained in the separate accounts, whereas GAAP reports these contracts in the general assets and liabilities of the Company.

The preparation of financial statements requires management to make estimates and assumptions that impact the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities as of the date of the statutory financial statements, and the reported amounts of revenues and expenses during the reporting periods. The most significant estimates include those used in determining the carrying values of investments, the liabilities for future policyholders’ reserves and deposit-type contracts, and the amount of investment valuation reserves on mortgage loans, other-than-temporary impairments and the liability for taxes. Future events including, but not limited to, changes in the levels of mortality, interest rates, persistency and asset valuations and defaults, could cause actual results to differ from the estimates used in the statutory financial statements. Although some variability is inherent in these estimates, management believes the amounts presented are appropriate.

### *b. Corrections of errors and reclassifications*

During 2007, the Company recorded a net pretax decrease to other, a component of changes in shareholder’s equity, of less than \$1 million attributable to corrections of prior year errors. This decrease was due to a correction in an executive benefits life incurred but not reported calculation.

During 2006, the Company recorded a net pretax increase to other, a component of changes in shareholder’s equity, of less than \$1 million attributable to corrections of prior year errors. This increase was primarily due to a correction in life reserves.

During 2005, the Company recorded a net pretax decrease to other, a component of changes in shareholder’s equity, of less than \$1 million attributable to corrections of prior year errors. This decrease was primarily due to a correction in investment management fees.

Certain 2006 balances have been reclassified to conform to the current year presentation.

## NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

### *c. Bonds*

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

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

For fixed income securities that do not have a fixed schedule of payments, such as asset-backed, mortgage-backed and structured securities, the effect on amortization or accretion is revalued quarterly based on the current estimated cash flows, using either the prospective or retrospective adjustment methodologies, consistently applied by type of security. Certain high quality fixed income securities follow the retrospective method of accounting. Under the retrospective method, the recalculated effective yield equates the present value of the actual and anticipated cash flows, including new prepayment assumptions, to the original cost of the investment. Prepayment assumptions are based on borrower constraints and economic incentives such as the original term, age and coupon of the loan as affected by the interest rate environment. The current carrying value is then increased or decreased to the amount that would have resulted had the revised yield been applied since inception, and investment income is correspondingly decreased or increased. The Company has elected to use the book value as of January 1, 1994 as the cost for applying the retrospective adjustment method to securities purchased prior to that date. All other fixed securities, such as floating rate bonds and interest only securities, follow the prospective method of accounting. Under the prospective method, the recalculated future effective yield equates the carrying value of the investment to the present value of the anticipated future cash flows.

Portfolios of asset-backed securities, including residential mortgage-backed securities, are evaluated on a periodic basis using scenarios customized by collateral type, performing sensitivity analysis on defaults as loan to values change, and on defaults as prepayments change using default curves under various scenarios. We combine scenario analysis with a monthly surveillance process in which we compare actual delinquencies and defaults to expectations established at the time securities are acquired and expectations considering current market conditions, and perform a statistical review of troubled loan exposures to credit support on a transaction-by-transaction basis.

Management utilized a combination of external vendor prices, broker quotations and internal models for purposes of deriving fair value. Internal inputs used in the determination of fair value included estimates of prepayment speeds, default rates, discount rates, collateral values and cash flow priority, among others. Fair values resulting from internal models are those expected to be paid by a willing market participant.

## NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

The carrying values of bonds, mortgage-backed and asset-backed securities are written down to fair value when a decline in value is considered to be other-than-temporary. The Company considers the following factors in the evaluation of whether a non-interest related decline in value is other-than-temporary: (a) the financial condition and near-term prospects of the issuer; (b) the likelihood that the Company will be able to collect all amounts due according to the contractual terms of a debt security in effect at the date of acquisition; (c) the Company's ability and intent to hold the investment for a period of time sufficient to allow for an anticipated recovery in value; and (d) the period and degree to which the market value has been below cost. The Company considers the following factors in the evaluation of whether an interest related decline in value is other-than-temporary: (a) the Company's near-term intent to sell; (b) the Company's contractual and regulatory obligations; and (c) the Company's ability to hold the investment until anticipated recovery of the cost of the investment. The Company conducts a quarterly management review of all bonds including those in default, not-in-good standing, or valued below 80% of cost. The Company also considers other qualitative and quantitative factors in determining the existence of other-than-temporary impairments including, but not limited to, unrealized loss trend analysis and significant short-term changes in value. If the impairment is other-than-temporary, a direct write-down is recognized in realized capital losses and a new cost basis is established.

### *d. Mortgage loans*

Mortgage loans are valued at the unpaid principal balance of the loan, net of unamortized premium and discount, non-refundable commitment fees and mortgage interest points, and valuation allowances. The mortgage loan portfolio is comprised of residential mortgage loan pools, which are pools of homogeneous residential mortgage loans substantially backed by Federal Housing Administration and Veterans Administration guarantees.

The fair value of mortgage loans is estimated by discounting expected future cash flows using current interest rates for similar loans with similar credit risk. For non-performing loans, the fair value is the estimated collateral value of the underlying real estate.

When, based upon current information and events, it is probable that the Company will be unable to collect all amounts of principal and interest due according to the contractual terms of the mortgage loan agreement, a valuation allowance is established for the excess of the carrying value of the mortgage loan over its fair value. Collectibility and estimated recoveries are assessed on a loan-by-loan basis considering all events and conditions relevant to the loan. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revisions as more information becomes available, as changes occur in the market or as negotiations with the borrowing entity evolve. Changes to the valuation allowance are recorded as unrealized capital losses in surplus.

When an event occurs resulting in an impairment that is other-than-temporary, a direct write-down is recognized in realized capital losses and a new cost basis is established. An impairment is deemed other-than-temporary when foreclosure proceedings or other procedures leading to the acquisition of the collateral are initiated, the acquisition of the

## NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

collateral is probable, and a reasonable estimate of the collateral value has been determined.

Interest income earned on impaired loans is accrued on the outstanding principal balance of the loan based on the loan's contractual coupon rate. Interest is not accrued for impaired loans more than 60 days past due, for loans delinquent more than 90 days, or when collection is improbable. The Company continually monitors mortgage loans where the accrual of interest has been discontinued, and will resume the accrual of interest on a mortgage loan when the facts and circumstances of the borrower and property indicate that the payments will continue to be received per the terms of the original mortgage loan agreement or modified mortgage loan agreement.

### *e. Policy loans*

Policy loans are carried at the outstanding loan balance less amounts unsecured by the cash surrender value of the policy. At issuance, policy loans are fully secured by the cash surrender value of the policy. Unsecured amounts can occur when subsequent charges are incurred on the underlying policy without the receipt of additional premium. There were no unsecured amounts as of December 31, 2007 and 2006. Policy loans earn interest calculated based upon either a fixed or a variable interest rate. Variable rate policy loans are adjusted at least annually and their fair value approximates the carrying value. For loans issued with a fixed interest rate, fair value is estimated by discounting expected future cash flows using current interest rates for similar loans with similar credit risk. Accrued investment income on policy loans more than 90 days past due is included in the unpaid balance of the policy loan.

### *f. Derivatives and other invested assets*

Derivatives and other invested assets consist of investments in derivative financial instruments and other miscellaneous investments.

The Company may use derivative financial instruments in the normal course of business to manage risks, primarily to reduce interest rate and duration imbalances determined in asset/liability analyses. The Company also may use a combination of derivatives and fixed income investments to create synthetic investment positions. These combined investments are created opportunistically when they are economically more attractive than the replicated instrument or when the replicated instrument is unavailable. Some of the synthetic assets are considered replicated asset transactions as defined under statutory accounting principles. The Company's derivative strategy employs a variety of derivative financial instruments, including interest rate swaps, currency swaps, equity and credit default swaps, options, interest rate caps and floors, forward contracts, and financial futures. Investment risk is assessed on a portfolio basis and individual derivative financial instruments are not designated in hedging relationships; therefore, as allowed by accounting rules, the Company specifically and intentionally made the decision not to apply hedge accounting.

Derivative financial instruments are carried at estimated fair value, which is based primarily upon quotations obtained from independent sources. Changes in the fair value

## NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

of these instruments are recorded as unrealized capital gains and losses in surplus. Gains and losses realized on the termination, closing or assignment of contracts are recorded as realized capital gains and losses. Amounts receivable and payable are accrued.

### *g. Cash, cash equivalents and short-term investments*

The Company considers all highly liquid investments purchased with maturities of three months or less to be cash and cash equivalents.

Short-term investments, which are carried at amortized cost, consist of all highly liquid investments purchased with maturities of greater than three months and less than or equal to 12 months. Investments in money market mutual funds are classified as short-term investments.

The carrying value for these instruments approximates the fair value reported in the Statutory Statements of Financial Position.

### *h. Investment income due and accrued*

Accrued investment income consists primarily of interest which is recognized on an accrual basis. Due and accrued income is not recorded on: (a) bonds in default; (b) impaired bonds and mortgage loans more than 60 days past due; (c) bonds and mortgage loans delinquent more than 90 days or where collection of interest is improbable; and (d) policy loan interest due and accrued in excess of the cash surrender value of the underlying contract.

### *i. Nonadmitted assets*

Assets designated as nonadmitted by the NAIC include the amount of the deferred tax asset that will not be realized by the end of the next calendar year, prepaid agent commissions and premium, and related party amounts outstanding greater than 90 days from the due date. Such amounts are excluded from the Statutory Statements of Financial Position.

### *j. Separate accounts*

Separate account assets and liabilities represent segregated funds administered and invested by the Company for the benefit of variable annuity and variable life and other insurance policyholders to meet specific investment objectives. Separate account assets consist principally of marketable securities reported at fair value and are not available to satisfy liabilities that arise from any other business of the Company. The Company receives administrative and investment advisory fees from these accounts.

Separate accounts reflect two categories of risk assumption: non-guaranteed separate accounts, for which the policyholder assumes the investment risk; and guaranteed non-indexed separate accounts for which the Company contractually guarantees either a minimum return or minimum account value to the policyholder. Premium income, benefits and expenses of the separate accounts are included in the Statutory Statements of

## NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

Income. Investment income and realized and unrealized capital gains and losses on the assets of separate accounts accrue to policyholders and, accordingly, are not recorded in the Statutory Statements of Income.

### *k. Policyholders' reserves*

Policyholders' reserves provide amounts adequate to discharge estimated future obligations in excess of estimated future premium on policies in force.

Reserves for life insurance contracts are developed using accepted actuarial methods computed principally on the net level premium and the Commissioners' Reserve Valuation Method bases using the 1958 and 1980 Commissioners' Standard Ordinary mortality tables with assumed interest rates.

Reserves for individual annuities are developed using accepted actuarial methods computed principally under the Commissioners' Annuity Reserve Valuation Method using applicable interest rates and mortality tables, primarily, 1994 Minimum Guaranteed Death Benefit and Annuity 2000.

Tabular interest, tabular less actual reserves released, and tabular cost for all life and annuity contracts are determined in accordance with NAIC annual statement instructions. Variable life and group life insurance products use a formula which applies a weighted-average credited rate to the mean account value.

The Company waives deduction of deferred fractional premium at death and returns any portion of the final premium beyond the date of death. Reserves are computed using continuous functions to reflect these practices.

The same reserve methods applied to standard policies are used for substandard reserve calculations that are based on a substandard mortality rate (a multiple of standard reserve tables).

Certain variable universal life products issued by the Company offer guaranteed minimum death benefits ("GMDBs"). GMDBs provide a death benefit if the contract holder dies and the contract value is less than a guaranteed amount specified in the contract. This amount is based on the premium paid less amounts withdrawn or contract value on a specified anniversary date. The liability for GMDBs is included in policyholders' reserves and the related change in this liability is included in change in policyholders' reserves.

Certain individual variable annuity products issued by the Company offer GMDBs. The liability for GMDBs is included in policyholders' reserves and the related change in this liability is included in change in policyholders' reserves. The Company's GMDB reserves are calculated in accordance with actuarial guidelines.

Annuity GMDBs provide a death benefit if the contract value is less than the guaranteed minimum amount. Some contracts provide that guarantee upon the contract owner's death while others provide it upon the annuitant's death. This amount may be based on a

## NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

return of premium (the premium paid less amounts withdrawn), a roll-up (an accumulation of premium at a specified interest rate adjusted for withdrawals), a reset (the contract value on a specified anniversary date adjusted for subsequent withdrawals, which is allowed to decrease when reset), or a ratchet (the contract value on a specified anniversary date adjusted for subsequent withdrawals, which is never allowed to decrease when reset). For an annuity contract, a decline in the stock market causing the contract value to fall below the specified amount will increase the net amount at risk, which is the GMDB in excess of the contract value.

All policyholders' reserves and accruals are based on the various estimates discussed previously and are presented net of reinsurance. Management believes that these liabilities and accruals will be sufficient, in conjunction with future revenues, to meet future anticipated obligations of policies and contracts in force.

### *l. Liabilities for deposit-type contracts*

Reserves for investment-type contracts such as supplementary contracts not involving life contingencies are based on account value or accepted actuarial methods using applicable interest rates. Fair value is estimated by discounting expected future cash flows using current market rates.

### *m. Transfers due from separate accounts*

Transfers due from separate accounts represent a net receivable from the Company's separate accounts.

### *n. Asset valuation reserve*

The Company maintains an asset valuation reserve ("AVR"). The AVR is a contingency reserve to stabilize surplus against fluctuations in the statement value of common stocks, real estate investments, partnerships and LLCs as well as credit-related declines in the value of bonds, mortgage loans, and certain derivatives. The AVR is reported in the Statutory Statements of Financial Position and the change in AVR is reported in the Statutory Statements of Changes in Surplus.

### *o. Other liabilities*

Other liabilities primarily include liabilities related to due and accrued expenses.

### *p. Reinsurance*

The Company enters into reinsurance agreements with MassMutual and other insurance companies in the normal course of business in order to limit its insurance risk. Such transfers do not relieve the Company of its primary liability and, as such, failure of reinsurers to honor their obligations could result in losses. The Company reduces this risk by evaluating the financial condition of reinsurers and monitoring for possible concentrations of credit risk. Premium income, benefits to policyholders, and policyholders' reserves are stated net of reinsurance. Premium, benefits and reserves

## NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

related to reinsured business are accounted for on bases consistent with those used in accounting for the original policies issued and the terms of the reinsurance contracts. The Company records a receivable for reinsured benefits paid and reduces policyholders' reserves for the portion of insurance liabilities that are reinsured. Commissions and expense allowances on reinsurance ceded and modified coinsurance reserve adjustments on reinsurance ceded are recorded as revenue. Reserve credits on modified coinsurance agreements are recorded in fees and other income.

### *q. Premium and related expense recognition*

Life insurance premium revenue is generally recognized annually on the anniversary date of the policy and excess premium for flexible products is recognized when received. Annuity premium is recognized as revenue when received. Commissions and other costs related to issuance of new policies and policy maintenance and settlement costs are charged to current operations when incurred. Surrender fee charges on certain life and annuity products are recorded as a reduction of benefits and expenses.

### *r. Realized and unrealized capital gains and losses*

Realized capital gains and losses, net of taxes, exclude gains and losses deferred into the interest maintenance reserve ("IMR") and gains and losses of the separate accounts. Realized capital gains and losses are recognized in net income and are determined using the specific identification method.

All after-tax realized capital gains and losses which result from changes in the overall level of interest rates for all types of fixed-income investments and interest-related derivative activities are deferred into the IMR and amortized into revenue. These interest-related gains and losses are amortized into net investment income using the grouped method over the remaining life of the investment sold or, in the case of derivative financial instruments, over the remaining life of the underlying asset.

Unrealized capital gains and losses are recorded as a change in surplus.

## *3. New accounting standards*

### *Adoption of new accounting standards*

In December 2007, the NAIC issued Statement of Statutory Accounting Principles ("SSAP") No. 97, "Investments in Subsidiary, Controlled and Affiliated Entities ("SCAs"), A Replacement of SSAP No. 88." SSAP No. 97 made clarifications and provided additional guidance to SSAP No. 88. The most significant clarification was related to the requirement that SCAs, including downstream noninsurance holding companies, receive an unqualified U.S. GAAP opinion or receive an unqualified opinion on financial statements prepared in accordance with a foreign GAAP that includes an audited footnote reconciliation of the foreign GAAP to U.S. GAAP to be admitted assets. A limited exception to this audit requirement was provided to downstream noninsurance holding companies, which would allow the downstream noninsurance holding company not to be audited when certain requirements are met. Provided that the entities owned by

## NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

an unaudited downstream noninsurance holding company receive U.S. GAAP audits, they are permitted to be an admitted asset. Assets of an unaudited downstream holding company would be nonadmitted. This statement is effective for fiscal year 2007. The adoption of this statement did not result in an impact to the Company's financial condition or results of operations.

In December 2006, the NAIC issued SSAP No. 96, "Settlement Requirements for Intercompany Transactions, An Amendment to SSAP No. 25 – Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties" with an effective date of January 1, 2007. This statement establishes a statutory aging threshold for admission of loans and advances to related parties outstanding as of the reporting date. In addition, this statement establishes an aging threshold for admission of receivables associated with transactions for services provided to related parties outstanding as of the reporting date. SSAP No. 96 requires that transactions between related parties be in writing and that written agreements provide for the timely settlement of amounts owed, with a specific due date. Amounts outstanding greater than 90 days from the due date are required to be nonadmitted. Adoption of this statement did not result in an impact to the Company's financial condition or results of operations.

In September 2006, the NAIC issued SSAP No. 95, "Exchanges of Nonmonetary Assets, A Replacement of SSAP No. 28 – Nonmonetary Transactions" with an effective date of January 1, 2007. SSAP No. 95 establishes statutory accounting principles for nonmonetary transactions. Specific statutory requirements for certain types of nonmonetary transactions are addressed in other statements. Accounting for nonmonetary transactions shall generally be based on the fair values of the assets or services involved. Adoption of this statement did not result in an impact to the Company's financial condition or results of operations.

NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

4. *Investments*

The Company maintains a diversified investment portfolio. Investment policies limit concentration in any asset class, geographic region, industry group, economic characteristic, investment quality, or individual investment.

a. *Bonds*

The carrying value and fair value of bonds were as follows:

	December 31, 2007			
	Carrying Value	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
(In Millions)				
U. S. government	\$ 5	\$ -	\$ -	\$ 5
Special revenue	6	-	-	6
Public utilities	16	-	-	16
Industrial and miscellaneous	<u>148</u>	<u>1</u>	<u>3</u>	<u>146</u>
Total	<u>\$ 175</u>	<u>\$ 1</u>	<u>\$ 3</u>	<u>\$ 173</u>

	December 31, 2006			
	Carrying Value	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
(In Millions)				
U. S. government	\$ 5	\$ -	\$ -	\$ 5
Special revenue	11	-	-	11
Public utilities	15	-	-	15
Industrial and miscellaneous	154	1	3	152
Parent, subsidiaries and affiliates	<u>1</u>	<u>-</u>	<u>-</u>	<u>1</u>
Total	<u>\$ 186</u>	<u>\$ 1</u>	<u>\$ 3</u>	<u>\$ 184</u>

## NOTES TO STATUTORY FINANCIAL STATEMENTS

The table below sets forth the Securities Valuation Office ratings for the bond portfolio along with what the Company believes were the equivalent rating agency designations:

<u>NAIC Class</u>	<u>Equivalent Rating Agency Designation</u>	December 31,			
		2007		2006	
		Carrying Value	% of Total	Carrying Value	% of Total
(\$ In Millions)					
1	Aaa/Aa/A	\$ 110	63%	\$ 123	66%
2	Baa	59	33	58	31
3	Ba	5	3	4	2
4	B	<u>1</u>	<u>1</u>	<u>1</u>	<u>1</u>
	Total	<u>\$ 175</u>	<u>100%</u>	<u>\$ 186</u>	<u>100%</u>

As a result of the continuing decline in the credit markets, certain bonds may have a credit quality which is lower than the December 31, 2007 NAIC class and equivalent rating agency designations in the above table.

The following table summarizes the carrying value and fair value of bonds as of December 31, 2007 by contractual maturity. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without prepayment penalties. Securities that are not due on a single maturity date are included as of the final maturity.

	Carrying Value	Fair Value
	(In Millions)	
Due in one year or less	\$ 11	\$ 11
Due after one year through five years	46	46
Due after five years through ten years	58	58
Due after ten years	<u>60</u>	<u>58</u>
Total	<u>\$ 175</u>	<u>\$ 173</u>

As of December 31, 2007, 2006 and 2005, the proceeds from sales on bonds were \$24 million, \$8 million and \$10 million, respectively. Gross realized capital gain and loss activity on sales and other-than-temporary impairments on bonds were a loss of \$3 million for the year ended December 31, 2007, and less than \$1 million for the years ended December 31, 2006 and 2005. Portions of realized capital gains and losses which were determined to be interest related were deferred into the IMR.

For the year ended December 31, 2007, of the \$3 million of other-than-temporary impairments, 51% were determined based on internally developed models.

NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

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

The following is an analysis of the fair values and gross unrealized losses aggregated by bond category and length of time that the securities were in a continuous unrealized loss position as of December 31, 2007 and 2006.

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

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

	December 31, 2006					
	Less than 12 months			12 months or longer		
	Fair Value	Unrealized Losses	Number of Issuers	Fair Value	Unrealized Losses	Number of Issuers
	(\$ In Millions)					
U. S. government	\$ -	\$ -	1	\$ 5	\$ -	2
Special revenue	2	-	3	8	-	11
Public utilities	1	-	4	11	-	28
Industrial and miscellaneous	26	-	52	78	3	137
Parent, subsidiaries and affiliates	-	-	-	1	-	1
Total	<u>\$ 29</u>	<u>\$ -</u>	<u>60</u>	<u>\$ 103</u>	<u>\$ 3</u>	<u>179</u>

## NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

For U.S. government and special revenue investments, the unrealized losses as of December 31, 2006 were primarily caused by increases in interest rates since original purchase. The unrealized loss for a period of 12 months or more for special revenue investments was less than \$1 million. These investments are of the highest credit quality rating and are backed by the U.S. government or government sponsored agencies. For U.S. governments, the unrealized loss position for a period of 12 months or more was less than \$1 million. The contractual terms of these investments are guaranteed by the full faith and credit of the U.S. government and cannot be settled for less than par at maturity.

For industrial and miscellaneous, the majority of the unrealized losses as of December 31, 2006 were due to changes in interest rates and were spread across multiple industry sectors with no single sector experiencing a disproportionate amount of losses as compared to other sectors. For these investments, \$3 million was in an unrealized loss position for a period of 12 months or more.

Based on the Company's policies for the evaluation of impairments discussed in Note 2c, the Company did not consider these investments to be other-than-temporarily impaired as of December 31, 2007 and 2006.

The Company did not sell any securities with the NAIC's designation 3 or below during the years ended December 31, 2007, 2006 and 2005 that were reacquired within 30 days of the sale date.

The Company had assets in the amount of \$4 million as of December 31, 2007 and 2006, respectively, which were on deposit with government authorities or trustees as required by law.

### *Residential mortgage-backed securities*

The Company holds certain investments backed by pools of residential mortgages. These investments are included in bonds. The mortgages in these pools have varying risk characteristics and are commonly categorized as being of U.S. Government agency and non-agency prime, Alt-A and subprime borrower quality. The mortgage collateral classified as U.S. Government agency is considered of lowest relative risk while those classified as subprime are of the highest relative risk. Of the \$148 million of industrial and miscellaneous bonds, the Company had \$47 million of residential mortgage-backed securities ("RMBS") of which \$17 million was prime, \$16 million was Alt-A and \$14 million was subprime. The Alt-A category includes option adjustable rate mortgages and subprime investments include "scratch and dent" pools, high loan to value pools, and pools where the borrowers have very impaired credit but the average loan to value is low, typically 70% or below. In identifying Alt-A and subprime exposure, management utilized a combination of qualitative and quantitative factors, including FICO scores and loan to value ratios.

In 2007, market conditions for subprime and Alt-A investments deteriorated due to higher delinquencies, reduced home prices, and reduced refinancing opportunities. This market turbulence has spread to other credit markets. It is unclear how long it will take for a return to more normal market conditions. Over the second half of 2007 there were a

NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

large number of credit downgrades by rating agencies for residential mortgage-backed investments. Subsequent to year end there were additional credit downgrades for securities backed by residential mortgage pools which were held by the Company, however such downgrades did not significantly change the overall credit quality mix of the RMBS portfolio.

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

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

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

<u>Year</u>	<u>AAA</u>	<u>AA</u>	<u>A</u>	<u>BBB</u>	<u>BB and Below</u>	<u>Total</u>
2007	10.0%	3.3%	-%	-%	-%	13.3%
2006	16.7	3.3	-	-	-	20.0
2005 and prior	<u>53.4</u>	<u>13.3</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>66.7</u>
Total	<u>80.1%</u>	<u>19.9%</u>	<u>-%</u>	<u>-%</u>	<u>-%</u>	<u>100.0%</u>

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

*b. Mortgage loans*

Mortgage loans are comprised of residential mortgage loan pools with carrying values of \$10 million and \$8 million as of December 31, 2007 and 2006, respectively. Residential mortgage loan pools are pools of homogeneous residential mortgage loans

NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

As of December 31, 2007 and 2006, the lending rates, including fixed and variable, on the portfolio of mortgage loans were:

	<u>December 31, 2007</u>			<u>December 31, 2006</u>		
	<u>Low</u>	<u>High</u>	<u>Weighted</u>	<u>Low</u>	<u>High</u>	<u>Weighted</u>
			<u>Average</u>			<u>Average</u>
Residential mortgage loan pools	5.9%	7.4%	6.6%	5.9%	7.5%	6.8%

During the years ended December 31, 2007 and 2006, residential mortgage loan lending rates, including fixed and variable, on new issues were:

	<u>2007</u>		<u>2006</u>	
	<u>Low</u>	<u>High</u>	<u>Low</u>	<u>High</u>
Residential mortgage loan pools	6.3%	6.8%	5.9%	7.5%

There were no realized gains and losses or other-than-temporary impairments for the years ended December 31, 2007, 2006 and 2005.

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

There was no valuation allowance as of December 31, 2007 and 2006. The changes in the valuation allowance are recorded as unrealized capital losses in surplus.

There was no recorded investment in impaired loans for the years ended December 31, 2007, 2006 and 2005.

There was no interest income on impaired loans or mortgage loans with interest more than 180 days past due for the years ended December 31, 2007, 2006 and 2005.

Geographical concentration is considered prior to the purchase of mortgage loans and residential mortgage loan pools. There was no material negative impact to surplus based on the geographical concentrations for the years ended December 31, 2007, 2006 and 2005.

NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

c. *Net investment income*

Net investment income was derived from the following sources:

	Years Ended December 31,		
	2007	2006	2005
	(In Millions)		
Bonds	\$ 10	\$ 10	\$ 9
Policy loans	5	4	4
Cash, cash equivalents and short-term investments	<u>1</u>	<u>2</u>	<u>1</u>
Net investment income	<u>\$ 16</u>	<u>\$ 16</u>	<u>\$ 14</u>

Net investment income from mortgage loans, as well as investment expenses, were less than \$1 million for the years ended December 31, 2007, 2006 and 2005.

d. *Net realized capital gains and losses*

Net realized capital losses after tax and transfer to the IMR, primarily related to bonds, were \$3 million for the year ended December 31, 2007, and less than \$1 million for the years ended, December 31, 2006 and 2005.

5. *Derivative financial instruments*

The Company may use derivative financial instruments in the normal course of business to manage risks, primarily to reduce interest rate and duration imbalances determined in asset/liability analyses. The Company may also use a combination of derivatives and fixed income investments to create synthetic investment positions. These combined investments are created opportunistically when they are economically more attractive than the replicated instrument or when the replicated instruments are unavailable.

Credit default swaps involve a transfer of credit risk on fixed income instruments from one party to another in exchange for periodic premium payments. The buyer of the credit swap receives credit protection, whereas the seller of the swap guarantees the credit worthiness of the underlying security. This transfers the risk of default from the buyer of the swap to the seller. If a specified credit event occurs, as defined by the agreement, the seller is obligated to pay the counterparty the contractually agreed upon amount and receives in return the underlying security in an amount equal to the notional value of the credit default swap. A credit event is generally defined as default on contractually obligated interest or principal payments or bankruptcy.

The Company uses credit default swaps to either reduce exposure to particular issuers by buying protection or increase exposure to issuers by selling protection against specified credit events. The Company buys protection as an efficient means to reduce credit exposure to particular issuers or sectors in the Company's investment portfolio. The Company sells protection to enhance the return on its investment portfolio by providing comparable exposure to fixed income securities that might not be available in the primary market or to

## NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

enter into synthetic transactions by buying a high quality liquid bond to match against the credit default swap.

The Company is exposed to credit-related losses in the event of non-performance by counterparties to derivative financial instruments. In order to minimize credit risk, the Company and its derivative counterparties require collateral to be posted in the amount owed under each transaction, subject to threshold and minimum transfer amounts that are functions of the rating on the counterparty's long term, unsecured, unsubordinated debt. Additionally, in many instances, the Company enters into agreements with counterparties that allow for contracts in a positive position, where the Company is due amounts, to be offset by contracts in a negative position. This right of offset, combined with collateral obtained from counterparties, reduces the Company's exposure. As of December 31, 2007 and 2006, no collateral was pledged by the counterparties. Market value exposure at risk, in a net gain position, net of offsets and collateral, as of December 31, 2007 was less than \$1 million. There was no market value exposure as of December 31, 2006. Negative values in the carrying value of a particular derivative category can result due to a counterparty's right to offset positions in multiple derivative financial instruments. The Company regularly monitors counterparty credit ratings and exposures, derivative positions and valuations, and the value of collateral posted to ensure counterparties are credit-worthy and the concentration of exposure is minimized. The Company monitors this exposure as part of its management of the Company's overall credit exposures.

At December 31, 2007 and 2006, the Company had a credit default swap included in assets with a carrying value and notional amount of less than \$1 million. Derivative liabilities are recorded in other liabilities on the Statutory Statements of Financial Position.

Notional amounts do not represent amounts exchanged by the parties and thus are not a measure of the Company's exposure. The amounts exchanged are calculated on the basis of the notional amounts and the other terms of the instruments, which relate to interest rates, exchange rates, security prices or financial and other indices. At December 31, 2007, the remaining life of the notional amounts by contractual maturity was greater than one year but less than or equal to five years.

### 6. *Fair value of financial instruments*

The following fair value disclosures may not necessarily be indicative of amounts that could be realized in immediate settlement of the financial instrument. The use of different assumptions or valuation methodologies may have a material impact on the estimated fair value amounts.

NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

The following table summarizes the Company's financial instruments:

	December 31,			
	2007		2006	
	<u>Carrying Value</u>	<u>Fair Value</u>	<u>Carrying Value</u>	<u>Fair Value</u>
	(In Millions)			
Financial assets:				
Bonds	\$ 175	\$ 173	\$ 186	\$ 184
Mortgage loans	10	10	8	8
Policy loans	90	90	80	80
Derivatives and other invested assets	(1)	(1)	-	-
Cash, cash equivalents and short-term investments	(6)	(6)	5	5
Financial liabilities:				
Investment-type insurance contracts:				
Individual annuity investment contracts	\$ 2	\$ 2	\$ 2	\$ 2
Supplementary investment contracts	1	1	2	2

At December 31, 2007, the Company had no derivative liabilities and at December 31, 2006 the Company had derivative liabilities with a carrying value and fair value of less than \$1 million.

As of December 31, 2007 and 2006, 83.3% and 87.1%, respectively, of bond securities were priced by external vendors and broker quotations. Internal models were used to price 16.7% and 12.9% of bond securities as of December 31, 2007 and 2006, respectively.

7. *Related party transactions*

The Company has an agreement whereby MassMutual, for a fee, furnishes the Company, as required, operating facilities, human resources, computer software development and managerial services. Also, investment and administrative services are provided to the Company pursuant to a management services agreement with MassMutual. Fees incurred under the terms of these agreements were \$10 million, \$11 million and \$12 million in 2007, 2006 and 2005, respectively. While management believes that these fees are calculated on a reasonable basis, these fees may not necessarily be indicative of the costs that would have been incurred on a stand-alone basis. The net amounts due to MassMutual were \$3 million as of December 31, 2007 and 2006. These outstanding balances are billed quarterly and are due and payable within 30 days.

The Company participates in variable annuity exchange programs with MassMutual whereby certain Company variable annuity contract holders can make a non-taxable exchange of their contract for an enhanced MassMutual variable annuity contract. The Company recorded surrender benefits of \$3 million, \$1 million, and less than \$1 million in 2007, 2006, and 2005, respectively, related to this exchange program.

## NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

The Company cedes a portion of its life insurance business to MassMutual and other insurers in the normal course of business. The Company's initial retention limit per individual life insured is generally \$15 million; the portion of the risk exceeding the retention limit is reinsured with other insurers, including MassMutual.

The Company has a modified coinsurance quota-share reinsurance agreement with MassMutual whereby the Company cedes substantially all of the premium on new issues of certain life insurance policies. In return, MassMutual pays the Company a stipulated expense allowance, death and surrender benefits. The Company retains the assets and related reserves for payment of future benefits on the ceded policies. The modified coinsurance adjustment is the mechanism by which MassMutual funds the reserve on the reinsured portion of the risk. It is needed to adjust for the financial effect of the Company holding the reserves on the ceded coverage rather than MassMutual. No premium income was ceded to MassMutual in 2007, 2006 and 2005.

The Company also has a stop-loss agreement with MassMutual under which the Company cedes claims which, in aggregate, exceed 0.43% of the covered volume for any year, with maximum coverage of \$25 million above the aggregate limit. The aggregate limit was \$35 million in 2007 and \$33 million in 2006 and 2005, and it was not exceeded in any of the years.

The Company has a quota-share reinsurance agreement with MassMutual in which MassMutual assumes specific plans of insurance on a yearly renewable term basis.

The net amounts outstanding with MassMutual for the various reinsurance agreements were \$1 million due from MassMutual as of December 31, 2007 and 2006. These outstanding balances are due and payable with terms ranging from monthly to annually, depending on the agreement in effect.

NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

The following table summarizes the various reinsurance agreement transactions between the Company and MassMutual:

	Years Ended December 31,		
	<u>2007</u>	<u>2006</u>	<u>2005</u>
	(In Millions)		
Premium income ceded, related to:			
Stop-loss agreements	\$ -	\$ 1	\$ 1
Quota-share reinsurance agreements	8	8	8
Policyholder benefits ceded, related to:			
Modified coinsurance agreements	7	1	3
Quota-share reinsurance agreements	5	5	4
Expense allowances on reinsurance assumed, included in fees and other income, related to:			
Modified coinsurance agreements	2	2	2
Modified coinsurance adjustments ceded, included in fees and other income	17	14	14
Experience refunds received	7	5	4

8. *Reinsurance*

The Company cedes insurance to unaffiliated insurers in order to limit its insurance risk. The Company's initial retention limit per individual life insured is generally \$15 million. The Company reinsures a portion of its life business under either a first dollar quota share arrangement or an in excess of the retention limit arrangement. The amounts reinsured are on a yearly renewable term or coinsurance basis.

The Company and its officers and directors do not own any portion of a reinsurer nor were any policies issued by the Company reinsured with a company chartered in a country other than the U.S. and which is owned in excess of 10% or controlled directly or indirectly by an insured, a beneficiary, a creditor or any other person not primarily engaged in the insurance business. There are no reinsurance agreements in effect under which the reinsurer may unilaterally cancel any reinsurance for reasons other than for nonpayment of premium or other similar credits. The Company has no reinsurance agreements in effect such that the amount of losses paid or accrued through the statement date may result in a payment to the reinsurer of amounts which, in aggregate and allowing for offset of mutual credits from other reinsurance agreements with the same reinsurer, exceed the total direct premium collected under the reinsured policies.

If all reinsurance agreements were terminated by either party as of the date of this statement, the resulting reduction in surplus due to loss of reinsurance reserve credits net of unearned

NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

premium would be approximately \$21 million assuming no return of the assets backing these reserves from the reinsurer to the Company.

Reinsurance amounts included in the Statutory Financial Statements were as follows:

	December 31,	
	2007	2006
	(In Millions)	
Reserves ceded	\$ 29	\$ 31
Amounts recoverable from reinsurers	4	11

	Years Ended December 31,		
	2007	2006	2005
	(In Millions)		
Premium ceded	\$ 15	\$ 16	\$ 15
Reinsurance recoveries	19	18	15

As of December 31, 2007, one reinsurer accounted for 29% of the outstanding reinsurance recoverable and the next largest reinsurer had 23% of the balance. The Company believes that no exposure to a single reinsurer represents an inappropriate concentration of risk to the Company, nor is the Company's business substantially dependent upon any single reinsurer.

9. *Policyholders' liabilities*

a. *Policyholders' reserves*

The following table summarizes policyholders' reserves, net of reinsurance, and the range of interest rates by type of product:

	December 31,			
	2007		2006	
	Amount	Interest Rates	Amount	Interest Rates
	(\$ In Millions)			
Variable life	\$ 97	3.0% - 5.5%	\$ 86	3.0% - 5.5%
Individual annuities	2	5.0% - 7.3%	2	5.0% - 7.3%
Total	<u>\$ 99</u>		<u>\$ 88</u>	

b. *Liabilities for deposit-type contracts*

Supplementary contracts not involving life contingencies of \$1 million and \$2 million as of December 31, 2007 and 2006, respectively, were included in liabilities for deposit-type contracts. The interest rate on supplementary contracts was 3.0% as of December 31, 2007 and 2006.

## NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

### *c. Secondary guarantees*

The liabilities for guaranteed minimum death benefits (“GMDBs”) on annuity contracts were less than \$1 million as of December 31, 2007 and 2006. There were no liabilities for GMDBs on variable universal life contracts as of December 31, 2007 and 2006.

For annuity contracts with GMDBs classified as policyholders’ reserves and separate account liabilities, the account values were \$132 million and \$161 million as of December 31, 2007 and 2006, respectively. The net amount at risk was \$9 million and \$11 million as of December 31, 2007 and 2006, respectively. The net amount at risk is defined as the minimum guarantee less the account value calculated on a policy-by-policy basis, but not less than zero. The weighted average attained age was 67 years as of December 31, 2007 and 2006.

Account balances of annuity contracts with GMDB guarantees invested in separate accounts were \$131 million and \$159 million as of December 31, 2007 and 2006, respectively. In addition to the amount invested in separate account options, \$1 million and \$2 million of account balances of annuity contracts with GMDB guarantees were invested in general account options as of December 31, 2007 and 2006, respectively.

The Company sells variable universal life type contracts, a portion of which offer secondary guarantees, such as a guarantee that the policy will not lapse, even if the account value is reduced to zero, as long as the policyholder makes scheduled premium payments. As of December 31, 2007 and 2006, there was no net liability for contracts with secondary guarantees on variable universal life type contracts including GMDB reserves.

The determination of GMDB reserves is based on actuarial guidelines. Reserve assumptions for GMDB benefits generally anticipate payout between ages 60 and 90.

### *10. Federal income taxes*

Total federal income taxes are based upon the Company’s best estimate of its current and deferred tax liabilities. Current tax expense is reported on the income statement as federal income tax expense if resulting from operations, and within net realized capital gains (losses) if resulting from capital transactions. Deferred income taxes, which provide for book versus tax temporary differences, are subject to limitations and are reported within surplus. Changes to deferred income taxes are reported on various lines within surplus. Limitations of deferred income taxes are recorded on the change in nonadmitted assets line, whereas, deferred taxes associated with net unrealized capital gains (losses) are shown within that caption on a net basis. Accordingly, the reporting of statutory to tax temporary differences, such as reserves and policy acquisition costs, and of statutory to tax permanent differences, such as tax credits, results in effective tax rates that differ from the federal statutory tax rate.

NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

The components of the net deferred tax asset recognized in the Company's assets, liabilities and surplus are as follows:

	December 31,	
	2007	2006
	(In Millions)	
Total deferred tax assets	\$ 26	\$ 21
Total deferred tax liabilities	<u>-</u>	<u>(2)</u>
Net deferred tax asset	26	19
Deferred tax assets nonadmitted	<u>(19)</u>	<u>(8)</u>
Net admitted deferred tax asset	<u>\$ 7</u>	<u>\$ 11</u>
(Increase) decrease in nonadmitted asset	<u>\$ (11)</u>	<u>\$ 9</u>

The provision for current tax expense on earnings is as follows:

	Years Ended December 31,		
	2007	2006	2005
	(In Millions)		
Federal income tax expense (benefit)	<u>\$ 19</u>	<u>\$ 2</u>	<u>\$ (6)</u>

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities are as follows:

	December 31,	
	2007	2006
	(In Millions)	
Deferred tax assets:		
Policy acquisition costs	\$ 18	\$ 13
Investment items	4	4
Reserve items	2	2
Other	<u>2</u>	<u>2</u>
Total deferred tax assets	26	21
Nonadmitted deferred tax assets	<u>(19)</u>	<u>(8)</u>
Admitted deferred tax assets	<u>7</u>	<u>13</u>
Deferred tax liabilities:		
Investment items	-	1
Deferred and uncollected premium	<u>-</u>	<u>1</u>
Total deferred tax liabilities	<u>-</u>	<u>2</u>
Net admitted deferred tax asset	<u>\$ 7</u>	<u>\$ 11</u>

NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

The change in net deferred income taxes, excluding amounts nonadmitted, is comprised of the following and is presented as a change to net unrealized capital gains (losses) and net deferred income taxes within the Statutory Statements of Changes in Surplus:

	Years Ended December 31,	
	2007	2006
	(In Millions)	
Change in deferred tax assets	\$ 5	\$ (8)
Change in deferred tax liabilities	<u>2</u>	<u>(1)</u>
Increase (decrease) in net deferred income tax	<u>\$ 7</u>	<u>\$ (9)</u>

As of December 31, 2007, the Company had no net operating or capital loss carryforwards to include in deferred income taxes.

The components of federal and foreign income tax on operating items is recorded on the Statutory Statements of Income and Statutory Statements of Changes in Surplus and is different from that which would be obtained by applying the statutory federal income tax rate to operating income before taxes. The significant items causing this difference are as follows:

	Years Ended December 31,					
	2007		2006		2005	
	Effective Amount	Tax Rate	Effective Amount	Tax Rate	Effective Amount	Tax Rate
	(\$ In Millions)					
Provision computed at statutory rate	\$ 10	35%	\$ 14	35%	\$ 13	35%
Investment items	<u>2</u>	<u>7</u>	<u>(3)</u>	<u>(7)</u>	<u>(10)</u>	<u>(27)</u>
Total statutory income tax expense	<u>\$ 12</u>	<u>42%</u>	<u>\$ 11</u>	<u>28%</u>	<u>\$ 3</u>	<u>8%</u>
Federal income tax expense (benefit)	\$ 19		\$ 2		\$ (6)	
Change in net deferred income taxes	<u>(7)</u>		<u>9</u>		<u>9</u>	
Total statutory income tax expense	<u>\$ 12</u>		<u>\$ 11</u>		<u>\$ 3</u>	

During the years ended December 31, 2007, 2006, and 2005, the Company paid federal income taxes in the amount of \$30 million, \$6 million and \$2 million, respectively. As of December 31, 2007, federal income taxes paid in the current and prior years that will be available for recovery in the event of future net losses were \$4 million in 2007, \$6 million in 2006 and \$5 million in 2005.

The Company is included in a consolidated U.S. federal income tax return with Massachusetts Mutual Life Insurance Company ("MassMutual"), a mutual life insurance

NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

company domiciled in the Commonwealth of Massachusetts, and MassMutual's eligible U.S. subsidiaries. The Company also files income tax returns in various states and foreign jurisdictions. The Company, MassMutual, and MassMutual's eligible subsidiaries and certain affiliates (the "Parties") have executed and are subject to a written tax allocation agreement (the "Agreement"). The Agreement sets forth the manner in which the total combined federal income tax is allocated among the Parties. The Agreement provides the Company with the enforceable right to recoup federal income taxes paid in prior years in the event of future net losses, which it may incur. Further, the Agreement provides the Company with the enforceable right to utilize its net losses carried forward as an offset to future net income subject to federal income taxes.

In June 2006, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. ("FIN") 48, "Accounting for Uncertainty in Income Taxes." The NAIC is still evaluating the applicability of FIN 48 to statutory financial reporting. Because statutory guidance has not been issued, the Company has not yet determined the statutory impact of adoption on its statutory financial statements. The Company continues to recognize tax benefits and related reserves in accordance with SSAP No. 5, "Liabilities, Contingencies and Impairments of Assets".

The following is a reconciliation of the beginning and ending liability for unrecognized tax benefits:

	(In Millions)
Balance, January 1, 2007	\$ 1
Gross increase related to positions taken in prior years	12
Gross increase related to positions taken in current year	-
Gross decrease related to settlements	(13)
Gross increase (decrease) related to lapse of statutes of limitations	<u>-</u>
Balance, December 31, 2007	<u>\$ -</u>

The Company recognized accrued interest and penalties related to the liability for unrecognized tax benefits as a component of the provision for income taxes.

The IRS recently completed its examination of the Company's income tax returns for the tax years 2001 through 2003. The IRS issued a Revenue Agent's Report proposing to assess the Company additional income taxes for the years 2001 through 2003. In 2007, the Company made additional payments of \$14 million with respect to tax years 2001 through 2003. Settlement has been reached with the IRS for tax years prior to 2001, although the Company has reserved the right to pursue refunds for certain pre-2001 contested issues. As of December 31, 2007 and 2006, the Company has no protective deposits recognized as admitted assets.

### 11. Shareholder's equity

The Board of Directors of MassMutual has authorized the contribution of funds to the Company sufficient to meet the capital requirements of each state in the U.S. in which the Company is licensed to do business. A majority of the statutory shareholder's equity is

## NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

subject to dividend restrictions. Dividend restrictions, imposed by various state regulations, limit the payment of dividends to the shareholder without prior approval from the Department. Under these regulations, \$18 million of shareholder's equity is available for distribution to the shareholder in 2008 without prior regulatory approval. In 2007, the Company paid \$37 million in dividends to its parent, C.M. Life.

### *12. Business risks, commitments and contingencies*

#### *a. Risks and uncertainties*

The Company operates in a business environment subject to various risks and uncertainties. Such risks and uncertainties include, but are not limited to, interest rate risk and credit risk. Interest rate risk is the potential for interest rates to change, which can cause fluctuations in the value of investments and amounts due to policyholders. To the extent that fluctuations in interest rates cause the duration of assets and liabilities to differ, the Company controls its exposure to this risk by, among other things, asset/liability management techniques that account for the cash flow characteristics of the assets and liabilities.

The Company's currency exchange risk is related to non-U.S. dollar denominated investments.

Asset based fees calculated as a percentage of the separate account assets are a source of revenue to the Company. Gains and losses in the equity markets may result in corresponding increases and decreases in the Company's separate account assets and related revenue.

#### *Risks related to credit markets*

Credit risk is the risk that issuers of investments owned by the Company may default or that other parties may not be able to pay amounts due to the Company. The Company attempts to manage its investments to limit credit risk by diversifying its portfolio among various security types and industry sectors. Management did not believe that significant concentrations of credit risk existed as of and for the year ended December 31, 2006.

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

## NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

quality of loan vintage, collateral type and investment structure are critical elements of determining fair values.

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

### *b. Guaranty funds*

The Company is subject to insurance guaranty fund laws in the states in which it does business. These laws assess insurance companies amounts to be used to pay benefits to policyholders and policy claimants of insolvent insurance companies. Many states allow these assessments to be credited against future premium taxes. The Company believes such assessments in excess of amounts accrued will not materially impact its financial position, results of operations, or liquidity.

### *c. Litigation*

The Company is involved in litigation arising in and out of the normal course of business, which seek both compensatory and punitive damages. While the Company is not aware of any actions or allegations that should reasonably give rise to a material adverse impact to the Company's financial position or liquidity, the outcome of litigation cannot be foreseen with certainty.

In 2005, the Company received final approval of a nationwide class action settlement involving alleged insurance sales practices claims. In 2006, all appeals to this settlement were resolved. The settlement class includes all policyholders, with certain limited exceptions, who have or had an ownership interest in permanent life policies issued between January 1, 1983 and December 31, 2003. Through December 31, 2007, the Company has paid \$5 million of the original \$10 million accrual. Additionally in 2007, the Company revised this estimate and reduced the liability by \$1 million.

It is the opinion of management that the ultimate resolution of these matters will not materially impact the Company's financial position or liquidity. However, the outcome of a particular proceeding may be material to the Company's operating results for a particular period depending upon, among other factors, the size of the loss or liability and the level of the Company's income for the period.

## NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

### *d. Regulatory inquiries*

The Company and MassMutual are subject to governmental and administrative proceedings and regulatory examinations and investigations in the ordinary course of its business. The Company has cooperated fully with these regulatory agencies with regard to their examinations and investigations and has responded to information requests and comments.

These examinations and investigations include industry-wide investigations of issues such as (a) late trading and market timing in connection with mutual funds and variable insurance contracts, (b) revenue sharing, and (c) compensation and bidding arrangements and possible anti-competitive activities between insurance producers and brokers and issuers of insurance products. In connection with examinations and investigations, the Company and MassMutual have been contacted by various regulatory agencies and state attorneys general including the Securities and Exchange Commission, Financial Industry Regulatory Authority, Commonwealth of Massachusetts Division of Insurance, the State of Connecticut Insurance Department, and the Attorneys General of Connecticut, Massachusetts and New York.

The Company believes that it is reasonable to expect that regulatory inquiries, examinations and investigations into the financial services industry will continue for the foreseeable future and may result in new industry-wide legislation, rules, and regulations that could significantly affect the financial services industry as a whole. It is the opinion of management that the ultimate resolution of these matters will not materially impact the Company's financial position or liquidity. The outcome of a particular matter may be material to the Company's operating results for a particular period depending upon, among other factors, the size of the matter and the level of the Company's income for the period.

### *e. Commitments*

In the normal course of business, the Company enters into commitments to purchase bank loans. These commitments, which totaled \$1 million as of December 31, 2007, have funding periods that extend between one and two years. The Company is not required to fund commitments once the commitment period expires.

NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

13. *Withdrawal characteristics*

a. *Annuity actuarial reserves and liabilities for deposit-type contracts*

The withdrawal characteristics of the Company's annuity actuarial reserves and deposit-type contracts as of December 31, 2007 are illustrated below:

	<u>Amount</u> (In Millions)	<u>% of Total</u>
Subject to discretionary withdrawal -		
With fair value adjustment	\$ 1	1%
At fair value	<u>131</u>	<u>98</u>
Subtotal	132	99
Subject to discretionary withdrawal -		
At book value without fair value adjustment	1	1
Not subject to discretionary withdrawal	<u>-</u>	<u>-</u>
Total	<u>\$ 133</u>	<u>100%</u>

The following is the reconciliation of total annuity actuarial reserves and liabilities for deposit-type contracts as of December 31, 2007:

	(In Millions)
Statutory Statements of Financial Position:	
Policyholders' reserves – individual annuities	\$ 2
Liabilities for deposit-type contracts	<u>1</u>
Subtotal	3
Separate Account Annual Statement:	
Annuities	<u>130</u>
Total	<u>\$ 133</u>

b. *Separate accounts*

The Company has separate accounts classified as the following: (1) non-indexed, which have reserve interest rates at no greater than 4% and/or fund a long-term interest guarantee in excess of a year that does not exceed 4%; and (2) non-guaranteed, which are variable accounts where the benefit is determined by the performance and/or market value of the investment held in the separate account with incidental risk, notional expense, and minimum death benefit guarantees.

NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

Information regarding the separate accounts of the Company as of and for the year ended December 31, 2007 is as follows:

	<u>Non- Indexed</u>	<u>Non- Guaranteed</u> (In Millions)	<u>Total</u>
Net premium, considerations or deposits	<u>\$ -</u>	<u>\$ 73</u>	<u>\$ 73</u>
Reserves:			
For accounts with assets at:			
Fair value	\$ -	\$ 3,443	\$ 3,443
Amortized cost	<u>858</u>	<u>-</u>	<u>858</u>
Total reserves	858	3,443	4,301
Other liabilities	<u>-</u>	<u>38</u>	<u>38</u>
Total	<u>\$ 858</u>	<u>\$ 3,481</u>	<u>\$ 4,339</u>
By withdrawal characteristics:			
Subject to withdrawal:			
At book value without fair value adjustment and current surrender charge of 5% or more	\$ -	\$ 220	\$ 220
At fair value, which may or may not have a surrender charge	858	2,656	3,514
At book value without fair value adjustment and with current surrender charge less than 5%	<u>-</u>	<u>567</u>	<u>567</u>
Subtotal	858	3,443	4,301
Other liabilities	<u>-</u>	<u>38</u>	<u>38</u>
Total	<u>\$ 858</u>	<u>\$ 3,481</u>	<u>\$ 4,339</u>

For the year ended December 31, 2007, net transfers from separate accounts included in the Statutory Statements of Income were \$44 million, which included transfers to separate accounts of \$73 million and transfers from separate accounts of \$117 million.

*14. Presentation of the Statutory Statements of Cash Flows*

As required by SSAP No. 69 "Statement of Cash Flows," the Company has included in the Statutory Statements of Cash Flows non-cash transactions primarily related to the exchange of bonds for bonds of \$1 million, \$1 million and \$4 million for the years ended December 31, 2007, 2006 and 2005, respectively.

NOTES TO STATUTORY FINANCIAL STATEMENTS, continued

15. *Subsidiaries and affiliated companies*

A summary of ownership and relationship of MassMutual and its subsidiaries and affiliated companies as of December 31, 2007 is illustrated below. Subsidiaries are wholly-owned, except as noted.

Subsidiaries of Massachusetts Mutual Life Insurance Company

C.M. Life Insurance Company  
MassMutual Holding LLC  
The MassMutual Trust Company  
MML Distributors, LLC – 99% (remaining 1% owned by MassMutual Holding LLC)  
MML Private Placement Investment Company I, LLC  
MML Mezzanine Investor, LLC  
MML Private Equity Fund Investor, LLC  
MMC Equipment Finance LLC

Subsidiaries of C.M. Life Insurance Company

MML Bay State Life Insurance Company  
CML Mezzanine Investor, LLC

Subsidiary of MMC Equipment Finance LLC

MassMutual Asset Finance LLC

Subsidiaries of MassMutual Holding LLC

HYP Management LLC  
MassMutual Assignment Company  
MassMutual Benefits Management, Inc.  
MassMutual Holding MSC, Inc.  
MassMutual International LLC  
MMHC Investment LLC  
MML Investors Services, Inc.  
MML Realty Management Corporation  
Cornerstone Real Estate Advisers LLC  
Babson Capital Management LLC  
Oppenheimer Acquisition Corporation – 97.7%  
MassMutual Baring Holding, LLC  
MML Financial, LLC  
MassMutual Capital Partners LLC

Affiliates of Massachusetts Mutual Life Insurance Company

MML Series Investment Fund  
MML Series Investment Fund II  
MassMutual Select Funds  
MassMutual Premier Funds

NOTES TO STATUTORY FINANCIAL STATEMENTS, continued