



Annuity & Life Re

2005

ANNUAL REPORT

TO

SHAREHOLDERS

ANNUITY AND LIFE RE (HOLDINGS), LTD. AND SUBSIDIARIES

INDEX TO 2005 ANNUAL REPORT TO SHAREHOLDERS

	<u>PAGE</u>
Annual Report to Share Holders	
General	1
The Reinsurance Business	1
Risks Reinsured	2
Business Written.....	2
Significant Events.....	3
Investments.....	6
Regulation	7
Properties.....	9
Legal Proceedings	9
Dividends.....	10
Forward – Looking Statements	10
Financial Statements for the Years ended December 31, 2005 and 2004	

2005 Annual Report to Shareholders

General

Annuity and Life Re (Holdings), Ltd. (“Holdings”) was incorporated on December 2, 1997 under the laws of Bermuda. The Company has historically provided annuity and life reinsurance to select insurers and reinsurers through our wholly-owned subsidiaries: Annuity and Life Reassurance, Ltd., which is licensed under the insurance laws of Bermuda as a long term insurer; and Annuity and Life Re America, Inc., an insurance holding company based in the United States, and its subsidiary, Annuity and Life Reassurance America, Inc., a life insurance company authorized to conduct business in over 40 states of the United States and the District of Columbia. We acquired Annuity and Life Reassurance America on June 1, 2000. For more detailed information about the Company and its subsidiaries, please see our Audited GAAP Financial Statements for the year ended December 31, 2005. References in this Annual Report to “the Company”, “We”, “Us”, “our Company” or similar terms refer to Holdings and its direct and indirect subsidiaries.

As a result of significant operating losses, the Company became unable to meet its monetary obligations under certain reinsurance treaties in 2002. Since that time, the Company has negotiated termination, recapture, and novation or coinsurance agreements for all reinsurance treaties with the applicable counterparties or independent third parties, including transaction which provided for the novation or coinsurance of the Company’s remaining life and annuity reinsurance agreements to Wilton Re effective as of June 30, 2005. Please see “Significant Events – Wilton Re Transaction” and Note 3 of the accompanying audited financial statements for a more detailed description of the transaction. As of December 31, 2005, there are no reinsurance agreements in force that will generate operating revenue for the Company. The Company’s only source of revenue in the future is investment income

Due to the absence of ongoing insurance operations, the Company has significantly reduced its operations, including reduced the number of its employees, reducing the size of the Board of Directors, and moving to smaller office space. Because the Company continues to have residual commitments and contingencies as described in Notes 3 and 12 of our Audited GAAP Financial Statements, it does not expect to immediately wind-down or liquidate. The Company intends to continue to explore strategic alternatives to attempt to maximize its economic value for shareholders, including a merger of Holdings into another entity, the sale of one or both of its operating subsidiaries or other comparable transactions. In addition, the Company may consider cash distributions to shareholders, stock buybacks or similar transactions, to the extent its financial condition allows it to do so and it is not constrained by insurance regulatory or other laws or by its obligations under the Master Agreement with Wilton Re.

The Reinsurance Business

The business of reinsurance generally consists of reinsurers, such as our company, entering into contractual arrangements (known as treaties) with primary insurers (known as ceding companies) whereby the reinsurer agrees to indemnify the ceding company for all or a portion of the risks associated with an underlying insurance policy in exchange for a reinsurance premium payable to the reinsurer. Reinsurers also may enter into retrocessional reinsurance arrangements with other reinsurers, which operate in a manner similar to the underlying reinsurance arrangement described above. Under retrocessional reinsurance arrangements, the reinsurer cedes a portion of the risk associated with an underlying reinsurance contract to other reinsurers (known as retrocessionaires).

Risks Reinsured

We had historically written reinsurance predominantly on a direct basis with primary life insurance companies and other reinsurers, but are currently not pursuing any new reinsurance agreements. The treaties we wrote were generally for traditional life reinsurance and annuity reinsurance, which exposed us to the following categories of risks: (i) mortality, (ii) investment, (iii) persistency (or lapse) and (iv) expense.

As a result of the consummation of the Wilton Re transaction, under which we novated or coinsured our remaining life and annuity reinsurance agreements to Wilton Re, we are no longer subject to mortality related to those reinsurance agreements or persistency risk or expense risk . We remain subject to claims associated with a small number of treaties that were recaptured to the extent that the claims have not yet been reported but had occurred prior to the effective date of the recapture.

We continue to be subject to investment risk with respect to our own investments. Our investments, which primarily consist of investment grade fixed income securities, are subject to interest rate and credit risk. Significant changes in interest rates expose us to the risk of earning less income during periods when interest rates are falling, or realizing losses if we are forced to sell securities during periods when interest rates are rising. We are also subject to prepayment risk on certain securities in our investment portfolio, including mortgage-backed securities and collateralized mortgage obligations, which generally prepay faster during periods of falling interest rates as the underlying mortgage loans are repaid and refinanced by borrowers in order to take advantage of lower interest rates. During periods when interest rates have risen or are rising, the rate of prepayments on these types of securities will decelerate, effectively extending maturities and increasing the potential for losses.

Although we have historically had the ability to use interest rate swaps and other financial instruments as tools to mitigate the effects of asset/liability mismatches or the effect of interest rate changes on our balance sheet, we have not, in general hedged our investment risk.

Business Written

The following table sets forth selected information for the indicated periods concerning our insurance operations:

Policy Revenues, Insurance In Force and Annuity Reinsurance Deposits

	Year Ended December 31,	
	2005	2004
Policy Revenues		
Life Reinsurance		
First Year.....	\$ -	\$ -
Renewal.....	8,312,598	46,995,273
Annuity Reinsurance.....	-	1,302,433
Total.....	<u>\$ 8,312,598</u>	<u>\$ 48,297,706</u>
Insurance in force at end of year (in thousands).....	<u>\$ -</u>	<u>\$ 2,344,200</u>
Annuity Reinsurance Deposits	<u>\$ -</u>	<u>\$ 57,754,009</u>

Significant Events

Wilton Re Transaction

On August 10, 2005, the Company entered into a Master Agreement (the “Master Agreement”) with Prudential Select Life Insurance Company of America (which has subsequently been renamed Wilton Reassurance Company) and Wilton Reinsurance Bermuda Limited (collectively, the “Wilton Subsidiaries”), each a direct or indirect wholly owned operating subsidiary of Wilton Re Holdings, Ltd. The Master Agreement provided for the novation to or 100% coinsurance (the “Coinsurance Agreements”) by the Wilton Subsidiaries of all of the Company’s life and annuity reinsurance treaties identified in the Master Agreement (the “Treaties”), effective as of June 30, 2005 (the “Effective Date”).

The transactions contemplated by the Master Agreement closed on January 17, 2006. Accordingly, the Company transferred the following assets and liabilities to the Wilton Subsidiaries at closing: cash and investments of \$32.9 million, funds withheld at interest of \$58.7 million, future policy benefits liabilities of \$38.3, and interest sensitive contracts liabilities of \$53.3 million. The Company recorded the transactions as of the Effective Date. As of December 31, 2005, the Company recorded a liability of \$32.9 million representing the cash and investments transferred to the Wilton Subsidiaries at closing. As a result of the execution of the Master Agreement, the Company recorded a \$15.2 million loss from operations for the year ended December 31, 2005.

As of the Effective Date, the Company had 28 Treaties in force, all of which were included in the Master Agreement. At the closing twenty (20) Treaties were novated as of the Effective Date. Because the consents of the counterparties to the remaining eight Treaties were not obtained prior to the closing, the Company executed Coinsurance Agreements covering those Treaties with the Wilton Subsidiaries pursuant to the terms of the Master Agreement. As such, approximately \$1.1 billion of the Company’s life insurance in force has been 100% reinsured to the Wilton Subsidiaries as of the effective date. As of March 31, 2006, six (6) Treaties amounting to approximately \$365 million of life insurance in force, remain subject to the Coinsurance Agreements

The Company continues to be bound, as reinsurers, by the original terms of the Treaties with the primary insurer for the eight Treaties subject to the Coinsurance Agreements. The appropriate Wilton Subsidiary is, in turn, obligated to reimburse the Company for any payments made under a coinsured Treaty. In addition, the Coinsurance Agreements provide that, beginning on March 15, 2006, the Wilton Subsidiaries will provide all administrative and management services necessary to administer and manage the Treaties covered by the Coinsurance Agreements, as well as any associated ancillary agreements or retrocession agreements.

For a discussion of the proforma effects of the Wilton Re transaction, please see Note 3 to the Company’s Audited GAAP Financial Statements.

Repurchase of Common Shares

On September 14, 2005, the Company entered into a Purchase Agreement (the “Purchase Agreement”) with Overseas Partners, Ltd. (“Overseas Partners”). The Purchase Agreement provided for the purchase by the Company from Overseas Partners of 1,773,050 common shares of the Company (the “Shares”) and Class B warrants to purchase an additional 133,396 common shares of the Company (the “Warrants”) for a total cash purchase price of \$1,453,901. The Company completed the acquisition of the Shares and Warrants pursuant to the terms of the Purchase Agreement on September 14, 2005. The Shares represented approximately 6.74% of the Company’s outstanding common shares, and the Warrants had an exercise price of \$14.06 per share. Following the acquisition, the Shares and the Warrants were cancelled by the Company. As a consequence of the repurchase of the Shares and Warrants, Overseas Partners no longer has the right to nominate one person for election to the Company’s Board of Directors.

Separation of Chief Executive Officer

On September 23, 2005, the Company entered into a Separation of Employment Agreement and General Release (the "Separation Agreement") with John F. Burke, the Company's President and Chief Executive Officer. Pursuant to the Separation Agreement, the Amended and Restated Employment Agreement, dated July 28, 2003, by and among Mr. Burke, Holdings and Annuity and Life Reassurance (the "Employment Agreement") was terminated, and Mr. Burke resigned from all positions he held as a director or officer of the Company and its subsidiaries.

Pursuant to the Employment and Separation Agreements, the Company made a one-time payment to Mr. Burke of \$740,000 in cash on October 3, 2005. In addition, as a result of the closing of the Master Agreement as described above, the Company paid Mr. Burke a one-time cash payment of \$1,160,000 on January 23, 2006. Both payments were included in operating expenses in 2005. Effective with the execution of the Separation Agreement, all of Mr. Burke's restricted common shares became immediately vested which had no impact on the Company's results of operations and his stock options became immediately exercisable which resulted in a compensation expense of \$132,222.

The Separation Agreement also provides that Mr. Burke will cooperate fully with the Company and its counsel with respect to any matter (including any litigation, arbitration, investigation, or governmental proceeding) relating to matters with which Mr. Burke was involved during the term of his employment with the Company. Mr. Burke is entitled to receive a fee of \$2,500 for each day he provides services pursuant to this provision. The Separation Agreement also contains a mutual release by the Company and Mr. Burke of any and all claims relating to Mr. Burke's service as a director of the Company, his employment relationship with the Company, the Employment Agreement or Mr. Burke's separation from the Company.

Transamerica Transaction

On December 31, 2004, the Company entered into a binding letter of intent with Transamerica Occidental Life Insurance Company ("Transamerica") that provided for the novation of its life reinsurance agreements with Scottish Re Limited ("Scottish Re") and Fidelity and Guaranty Life Insurance Company ("F&G") to Transamerica as of December 31, 2004. The letter of intent also provided that, upon consummation of the novation of the life reinsurance agreements, Transamerica would terminate its annuity reinsurance agreement with the Company and recapture all business ceded under the agreement effective as of December 1, 2004.

Pursuant to the letter of intent with Transamerica, on January 31, 2005, the Company executed definitive documents (the "Novation Agreement") and novated its life reinsurance agreements with Scottish Re and F&G to Transamerica as of December 31, 2004. In consideration of the life reinsurance agreement novations, the Company paid Transamerica \$18.5 million. Also, on January 31, 2005, the Company executed an amendment to its annuity reinsurance agreement with Transamerica which terminated the agreement and resulted in Transamerica recapturing all business ceded under the agreement effective as of December 1, 2004. In consideration of the annuity recapture, the Company paid a \$14.0 million premium to terminate and recapture the agreement and approximately \$7.1 million for monthly settlement amounts owed under the annuity reinsurance agreement through November 30, 2004.

Settlement of Shareholder Lawsuit

On and since December 4, 2002, certain of the Company's shareholders, seeking to act as class representatives, filed lawsuits against the Company and certain of its present and former officers and directors in the United States District Court for the District of Connecticut seeking unspecified monetary damages. On July 20, 2004, the Company announced that it had reached an agreement in principle with the plaintiffs, subject to full documentation by the parties to the settlement, notice to the class, court approval and other steps required to consummate a class action settlement, to settle the lawsuit. The Company's share of the settlement was \$5.0 million in cash, of which it paid \$2.5 million into escrow in August 2004, and the remaining \$2.5 million on January 10, 2005. Following a Settlement Fairness Hearing, the District

Court entered an order and final judgment approving the settlement in January 2005. The Company recorded its \$5.0 million portion of the settlement as an operating expense in the second quarter of 2004.

Engagement of Financial Advisor

Pursuant to an engagement letter dated January 19, 2004, as amended (the “Engagement Letter”), the Company engaged UBS Securities LLC (“UBS”) to serve as its financial advisor and capital markets advisor in connection with identifying strategic alternatives available to the Company. On February 10, 2006, the Company paid \$1,400,000 to UBS for their involvement in closing the sale transaction to the Wilton Subsidiaries. A total amount of \$1,750,000 was recorded in operating expenses in the consolidated statement of operations for the year ended December 31, 2005.

Settlement of Litigation

On November 29, 2005, the Company paid \$425,000 to Imagine Group Holdings Limited (“Imagine”) to settle a civil proceeding in Bermuda. Imagine had demanded damages of \$640,000 related to a failed capital raising transaction in 2002. The expense incurred is included in operating expenses for the year ended December 31, 2005.

On October 25, 2005, the Company paid \$200,000 to Rodney Cordle, a former employee, to settle a civil proceeding in Bermuda. Mr. Cordle had alleged the Company failed to pay certain expenses in accordance with his employment agreement. The expense incurred is included in operating expenses for the year ended December 31, 2005.

Employment Agreements

On October 19, 2005, the Company entered into letter agreements with William H. Mawdsley and John W. Lockwood setting forth the terms of their continued employment by the Company. Pursuant to the letter agreement with Mr. Mawdsley, he is entitled to an annual salary of \$250,000 and an additional \$10,000 per month as a housing and travel allowance. Effective with the execution of the letter agreement, Mr. Mawdsley was named the Company’s Chief Executive Officer and he was appointed to fill a vacancy on the Company’s Board of Directors. Mr. Mawdsley had previously been a Vice President of the Company and the Chief Actuary of its Bermuda based operating subsidiary. Pursuant to the letter agreement with Mr. Lockwood, he is entitled to an annual salary of \$200,000 and an additional \$7,500 per month as a housing and travel allowance. Mr. Lockwood will continue to serve as the Company’s Chief Financial Officer and President of the Company’s United States based subsidiaries.

The Company agreed to continue to provide Messrs. Mawdsley and Lockwood with the same benefits they are currently receiving, and they will be eligible for bonus compensation at the discretion of the Company’s Board of Directors. Mr. Mawdsley and Mr. Lockwood may be terminated at any time for any reason, but if such termination is without “cause” (as defined in the letter agreements), Mr. Mawdsley would be entitled to receive a severance payment of \$620,000 plus reasonable relocation expenses from Bermuda to the United States, and Mr. Lockwood would be entitled to receive a severance payment of \$490,000. Both men would also receive the foregoing severance payments if they resign because of a reduction in their base salary or housing allowance to which they did not agree or if they resign for any other reason within the period commencing 90 days and ending 180 days following the effective time of (i) the acquisition of all of the outstanding equity securities of Holdings or (ii) the merger of Holdings with another entity, other than one of Holding’s direct or indirect wholly owned subsidiaries.

Restructuring of the Board of Directors

On October 12, 2005, Messrs. Lee M. Gammill, Jr., Frederick S. Hammer and Jon W. Yoskin, II, who were members of the Company’s Board of Directors serving terms that expired at the Company’s annual general meeting (the “AGM”) of shareholders, informed the Company that they would not stand for re-election as directors. Accordingly, each of these Board members ceased to be a director of the Company following the AGM on December 1, 2005. Also on October 12, 2005, Messrs. Robert M. Lichten and

Robert P. Johnson, whose terms as directors would otherwise expire in 2006 and 2007, respectively, informed the Company that they would resign as directors of the Company effective as of the date of the AGM. The current members of the Board of Directors are Martin A. Berkowitz (Chairman), Albert R. Dowden, Jeffrey D. Watkins, Michael P. Esposito and William H. Mawdsley.

Termination of Registration of Securities

On February 2, 2006, the Company announced that it was filing a Form 15 with the Securities and Exchange Commission ("SEC"). The effect of this filing was to terminate the Company's reporting obligations under the Securities Exchange Act of 1934 and to terminate the registration of its common stock. Under the SEC's rules, a company with fewer than 300 record holders may voluntarily terminate the registration of its securities by filing a Form 15 with the SEC. The Company currently has fewer than 300 record holders. The Company's reporting obligations were terminated immediately upon the filing of the Form 15. The Company also anticipates, but cannot guarantee, that its shares will continue to trade on the over-the-counter market and be quoted in the Pink Sheets' quotation system under the trading symbol ANNRF.PK.

Investments

Our investments are governed by investment guidelines established and approved by our Board of Directors. Our investment objectives are to achieve above average risk-adjusted total returns, maintain a high quality portfolio, maximize current income, maintain an adequate level of liquidity in our portfolio and match the cash flows of our investments to our operating expenses and remaining insurance liabilities. Our investment guidelines require our overall fixed income portfolio to maintain a minimum weighted average credit quality of "A" and limit investment in fixed income securities that are non-rated or below investment grade at the time of purchase to an aggregate of \$3,000,000. A fixed income security rated "A" by Standard & Poor's is considered to be somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than higher rated issuers; however, the issuer's capacity to meet its financial commitment on the security is still considered to be strong. We currently do not invest in any fixed income securities in emerging markets.

Prudential Investment Corporation served as our advisor for our general investment portfolio until October 2005. Our investment portfolio is currently managed by management and the Board of the Directors.

At December 31, 2005, our invested assets, including cash and cash equivalents, had an aggregate fair value of \$84,543,905, including gross unrealized losses of \$837,723. Our fixed-income portfolio was comprised of fixed income securities with a weighted average credit quality rating of "AA" and a weighted average duration of 2.9 years. The effective yield rate earned on our total invested assets was approximately 4.13%. The yield on our fixed income portfolio was 4.94%.

The effective yield rate equals net investment income divided by the average of our total adjusted invested assets at the end of each calendar quarter in the year ended December 31, 2005. The effective yield rate for 2005 on our total invested assets is significantly lower than the yield on our fixed-income portfolio because approximately 22% of the total portfolio was in cash and cash equivalents for the majority of the year. At December 31, 2005, we continued to hold a large portion of our general account assets in short duration investments because of the low interest rate environment and flat yield curve.

Our results of operations and our financial condition are significantly affected by the performance of our investments and by changes in interest rates. During a period of declining interest rates, if our investments are prematurely sold, called, prepaid or redeemed, we may be unable to reinvest the proceeds in securities of equivalent risk with comparable rates of return. During a period of rising interest rates, the fair value of our invested assets could decline. In addition, rising interest rates could also cause disintermediation, which in turn could cause us to sell investments at prices and times when the fair values

of such investments are less than their amortized cost. Until the effective date of the Wilton Re Transaction, our results of operations were also significantly affected by the performance of assets held and managed by our ceding companies or others under modified coinsurance and coinsurance funds withheld arrangements.

Regulation

Bermuda

As a holding company, Holdings is not subject to Bermuda insurance regulations. Annuity and Life Reassurance, our Bermuda operating subsidiary, is licensed as a long-term insurer under the Bermuda Insurance Act of 1978, as amended, and related regulations (collectively, the “Insurance Act”). The Insurance Act, which regulates the insurance business of Annuity and Life Reassurance, provides that no person shall carry on an insurance business in Bermuda unless registered as an insurer under the Insurance Act by the Bermuda Monetary Authority (the “Authority”). The registration of an applicant as an insurer is subject to its complying with the terms of its registration and such other conditions as the Authority may impose at any time.

The Insurance Act imposes on Bermuda insurance company’s solvency and liquidity standards and auditing and reporting requirements and grants to the Authority powers to supervise, investigate and intervene in the affairs of insurance companies. Further deterioration of our financial condition will likely expose our operations in Bermuda to an increased level of regulatory scrutiny and could possibly lead to the Authority petitioning for the winding up of our company.

We have been designated as non-resident for exchange control purposes by the Authority whose permission for the issue and transfer of our common shares has been obtained, as discussed below. This designation allows us to engage in transactions, or to pay dividends to non-residents of Bermuda who are holders of our common shares, in currencies other than the Bermuda Dollar.

We have the consent from the Authority under the Exchange Control Act 1972 and regulations thereunder allowing for the transfer of our common shares between persons regarded as non-resident in Bermuda for exchange control purposes and our issuance of common shares to such persons, provided that the shares remain listed on an appointed stock exchange or are trading on the OTC Bulletin Board or in the Pink Sheets.

In addition, issues and transfers of the common shares to any person regarded as resident in Bermuda for exchange control purposes require specific prior approval under the Exchange Control Act 1972. The common shares of Annuity and Life Reassurance cannot be transferred without the consent of the Authority.

As “exempted companies,” Holdings and Annuity and Life Reassurance are exempt from Bermuda laws restricting the percentage of share capital that may be held by non-Bermudians, but as exempted companies they may not participate in certain business transactions, including (i) the acquisition or holding of land in Bermuda (except that required for our business and held by way of lease or tenancy for terms of not more than 21 years) without the express authorization of the Bermuda legislature, (ii) the taking of mortgages on land in Bermuda to secure an amount in excess of \$50,000 without the consent of the Bermuda Minister of Finance, (iii) the acquisition of any bonds or debentures secured by any land in Bermuda, other than certain types of Bermuda government securities, or (iv) the carrying on of business of any kind in Bermuda, including insuring domestic risks, except in furtherance of their business carried on outside Bermuda, and, in the case of Annuity and Life Reassurance, reinsuring any long-term business risks undertaken by any company incorporated in Bermuda and permitted to engage in the insurance and reinsurance business, or under a license granted by the Bermuda Minister of Finance.

Annuity and Life Reassurance is prohibited from declaring or paying any dividends during any financial year of it is in breach of its minimum solvency margin or minimum liquidity ratio or if the declaration or payment of such dividends would cause it to fail to meet such margin or ratio. Additionally, under the Bermuda Companies Act 1981 (the “Companies Act”), neither Holdings nor Annuity and Life Reassurance may declare or pay a dividend, or make a distribution from contributed surplus, if there are

reasonable grounds for believing that it is, or would after the payment be, unable to pay its liabilities as they become due, or the realizable value of its assets would be less than the aggregate of its liabilities and its unused share capital and share premium accounts.

United States

General. Our Bermuda operating subsidiary, Annuity and Life Reassurance, is not licensed or admitted as an insurer in any state of the United States and is not directly subject to regulation in any state of the United States. The insurance laws of each state in the United States regulate the sale of insurance and reinsurance within their jurisdiction by reinsurers, such as Annuity and Life Reassurance, which are not licensed or admitted to do business within such jurisdiction. Annuity and Life Reassurance conducts its business through its Bermuda office. Annuity and Life Reassurance does not maintain an office, and its personnel do not solicit, advertise, settle claims or conduct other activities that may constitute the transaction of the business of insurance, in any jurisdiction in which it is not licensed or otherwise authorized to engage in such activities.

Our United States operating subsidiary, Annuity and Life Reassurance America is licensed and authorized to conduct life insurance business in over 40 states of the United States and the District of Columbia. The insurance laws and regulations, as well as the supervisory authority that may be exercised by the various insurance departments in the United States, vary by jurisdiction, but generally grant broad powers to supervisory agencies or regulators to examine and supervise insurance companies and insurance holding companies with respect to the conduct of their insurance business. These laws and regulations generally require insurance companies to meet certain solvency standards, asset tests, standards of business conduct, guarantee fund assessments and to file certain reports with regulatory authorities, including information concerning their capital structure, ownership and financial condition. The insurance laws of Connecticut have the most significant impact on Annuity and Life Reassurance America because that is its state of domicile.

Annuity and Life Re America (our wholly-owned U.S. holding company) is domiciled in Delaware and regulated as a Delaware corporation. The Delaware insurance holding company system laws and regulations generally do not apply to Annuity and Life Re America because it is not an insurer and because Annuity and Life Reassurance America is not required to file registration statements with the Delaware Insurance Commissioner under applicable provisions of such laws and regulations. The books and records of Annuity and Life Re America may be subject to inspection by the Connecticut insurance regulators because Annuity and Life Re America is an affiliate of Annuity and Life Reassurance America, which is subject to Connecticut's laws governing insurance company systems.

The Connecticut insurance laws (applicable to Annuity and Life Reassurance America) require that transactions between or among Annuity and Life Reassurance America and any of its affiliates, including the payment of ordinary dividends to shareholders, shall be subject to the following requirements: (i) the terms shall be fair and reasonable; (ii) charges or fees for services performed shall be reasonable; (iii) expenses incurred and payment received shall be allocated to Annuity and Life Reassurance America in conformity with customary insurance accounting practices consistently applied; (iv) the books, accounts and records of each party shall be so maintained as to clearly and accurately disclose the precise nature and details of the transactions, including such accounting information as is necessary to support the reasonableness of the charges or fees to the respective parties; and (v) Annuity and Life Reassurance America's surplus with respect to policyholders shall be reasonable in relation to its outstanding liabilities and adequate to meet its financial needs. In addition, certain transactions, such as the payment of dividends, between or among Annuity and Life Reassurance America may not be entered into until notice of such transactions has been provided to the Connecticut Insurance Commissioner, and the Commissioner either approves the transaction or a thirty-day waiting period has passed during which the Commissioner has not disapproved the transaction.

Current Connecticut law permits the payment of ordinary shareholder dividends or distributions, the fair market value of which, together with that of other dividends or distributions made during the preceding twelve months, does not exceed the greater of (i) 10% of Annuity and Life Reassurance America's

statutory surplus as regards policyholders as of the immediately preceding December 31, or (ii) statutory net gain from operations for the immediately preceding calendar year, excluding pro rata distributions of any class of Annuity and Life Reassurance America's own securities. Any proposed dividend in excess of this amount is considered an "extraordinary dividend" and may not be paid until it has been approved, or a thirty-day waiting period has passed during which the Connecticut Insurance Commissioner has not disapproved the dividend. In addition, except as otherwise provided by law, no dividend or other distribution exceeding an amount equal to Annuity and Life Reassurance America's "earned surplus" may be paid without the prior approval of the Connecticut Insurance Commissioner.

If the Connecticut Insurance Commissioner determines that Annuity and Life Reassurance America paid or is about to pay a dividend, or committed or is about to commit another act, in violation of the Connecticut insurance laws referenced above, the Commissioner may, among other things, apply for an order enjoining Annuity and Life Reassurance America from violating or continuing such violation of the insurance laws. The Connecticut Insurance Commissioner has the authority to apply for an order authorizing him to rehabilitate an insurer if the Connecticut Insurance Commissioner determines that such insurer is in such condition that the further transaction of business would be hazardous, financially, to its policyholders, creditors or the public. If the Connecticut Insurance Commissioner finds, among other things, that further attempts to rehabilitate the insurer are futile, he may request a petition for an order of liquidation from a Connecticut court.

Under Connecticut insurance regulations, the Connecticut Insurance Commissioner is required to perform regular financial examinations of insurance companies under its jurisdiction at least every three to five years. In August 2005, the Commissioner completed an examination of Annuity and Life Reassurance America that covered the three year period ending December 31, 2004.

In addition to the regulatory requirements imposed by the jurisdictions in which a reinsurer is licensed, a reinsurer's business operations are affected by regulatory requirements in other jurisdictions governing "credit for reinsurance" which are imposed on its ceding companies. In general, a ceding company which obtains reinsurance from a reinsurer that is licensed, accredited or approved by the insurance regulator of the ceding company's domiciliary jurisdiction is permitted to reflect in its statutory financial statements a credit in an aggregate amount equal to the liability for policy reserves, claims and other amounts ceded to such reinsurer. Many jurisdictions permit ceding companies to take credit on their statutory financial statements for reinsurance obtained from unlicensed or non-admitted reinsurers only if adequate security is posted. Because our operating subsidiary Annuity and Life Reassurance is not licensed, accredited or approved in any jurisdiction except Bermuda, its reinsurance contracts typically required it to post a letter of credit or other security.

Properties

We conduct our operations from leased office space located at International Centre Suit 304, 26 Bermudiana Road, Hamilton, HM 11, Bermuda. Annuity and Life Re America conducts its operations from leased space located at 124 Palisado Avenue, Windsor, Connecticut, USA. We believe our space is adequate to meet our current and future needs.

Legal Proceedings

On and since December 4, 2002, certain of our shareholders, seeking to act as class representatives, filed lawsuits against us and certain of our present and former officers and directors in the United States District Court for the District of Connecticut seeking unspecified monetary damages. The plaintiffs claim that the defendants violated certain provisions of the United States securities laws by making various alleged material misstatements and omissions in public filings and press releases. The plaintiffs filed a single consolidated amended complaint in July 2003, adding as defendants XL Capital Ltd and two additional directors. On October 1, 2003, we answered the amended and consolidated complaint and denied liability on the claims the plaintiffs had asserted. In January 2004, the court ordered that a related action that the plaintiffs filed against the KPMG LLP (United States) and KPMG in Bermuda be consolidated with the action against us. In February 2004, the court denied certain individual defendants' motions to dismiss the action. In March 2004, the court denied motions to dismiss filed by certain other individual

defendants and XL Capital Ltd. Also in March 2004, KPMG LLP (United States) and KPMG in Bermuda filed motions to dismiss the action. The court has not yet ruled on KPMG LLP's (United States) and KPMG in Bermuda's respective motions to dismiss.

As described above under "Significant Events – Transamerica Transaction", the Company and Transamerica entered into a Novation Agreement to novate the Company's reinsurance contracts with F&G and Scottish Re to Transamerica effective December 31, 2004. In accordance with the terms of the Novation Agreement, the Company and Transamerica have been in discussions regarding possible adjustments to the policy benefit reserves transferred to Transamerica as part of the F&G novation. On March 30, 2005, the Company received a demand letter from Transamerica stating that \$7,000,000 was owed to Transamerica as an adjustment to the F&G policy benefit reserves. On June 14, 2005, the Company received an additional letter from Transamerica revising its original demand to \$6,000,000. The Company and Transamerica were unable to resolve the issues through negotiations and the matter is now in arbitration. Transamerica is seeking to rescind the Novation Agreement or recover damages and interest. The Company believes Transamerica's position is without merit and is working with counsel in presenting its position to the arbitration panel. As of March 31, 2006, the arbitration panel is being selected. It is not known when the arbitration process will conclude or what impact the outcome will have on the financial position of the Company.

There are no other material arbitration or other legal proceedings currently in process in which we are involved.

Dividends

Both Holdings and its Bermuda operating subsidiary, Annuity and Life Reassurance, are required to comply with the provisions of the Bermuda Companies Act that regulate the payment of dividends and the making of distributions from contributed surplus. Neither Holdings nor Annuity and Life Reassurance may declare or pay a dividend, or make a distribution out of contributed surplus, if there are reasonable grounds for believing that: (i) the relevant company is, or would be after the payment be, unable to pay its liabilities as they become due; or (ii) the realizable value of the relevant company's assets would thereby be less than the aggregate of its liabilities and its issued share capital and share premium accounts. Since December 31, 2002, we have not declared a dividend to shareholders and we do not expect to declare or pay dividends to shareholders in the near future. The declaration and payment of future dividends to holders of our common shares will be at the discretion of our Board of Directors and will depend upon our results of operations and financial condition, capital requirements of our subsidiaries, the ability of our operating subsidiaries to pay dividends to us, regulatory considerations and other factors the Board of Directors deems relevant.

For a discussion of other factors affecting our ability to pay dividends, see "Regulation" above and Note 17 to our Audited GAAP Financial Statements for the year ended December 31, 2005. Currently, there is no Bermuda withholding tax on dividends paid by us to shareholders.

Forward-Looking Statements

This annual report, together with other statements and information we may provide, contains "forward-looking statements". These statements may include, but are not limited to, projections of revenues, income or loss, capital expenditures, plans for future operations and financing needs or plans, as well as assumptions relating to the foregoing. The words "expect," "project," "estimate," "predict," "anticipate," "believe," and similar expressions are intended to identify forward-looking statements, although not all forward-looking statements include these expressions. Forward-looking statements are inherently subject to risks and uncertainties, some of which cannot be predicted or quantified. Future events and actual results, performance and achievements could differ materially from those set forth in, contemplated by or underlying the forward-looking statements. We assume no obligation to update any forward-looking statement to reflect actual results or changes in or additions to the factors affecting such forward-looking statements.

Factors that could materially and adversely affect our operations and financial condition and/or cause our actual results of operations or financial condition to differ from those expressed or implied in our forward-looking statements include, but are not necessarily limited to, the following:

- While we believe we have sufficient operating liquidity to sustain our operations through at least the next twelve months, we continue to explore strategic alternatives to attempt to maximize shareholder value. These alternatives include, but are not limited to, a merger, sale, joint venture, or other comparable transaction. We do not know the terms upon which these transactions might be available, if at all.

Our continued operations are dependent on our ability to manage investment risks. Unexpected volatility or illiquidity in the markets in which we directly or indirectly hold positions could adversely affect our business. Our investments include a limited amount of investments in below investment grade fixed income securities. While any investment carries some risk, the risks associated with lower-rated securities generally are greater than the risks associated with investment grade securities.

A portion of our cash and investments is held by our U.S. operating subsidiary and is unavailable to fund our operations or those of our Bermuda operating subsidiary. A portion of these assets are available to fund our U.S. operating subsidiary's operations.

- Under Bermuda law, a single creditor could make a statutory demand upon us for satisfaction of obligations owed to that creditor. If the statutory demand is held to be valid, and we are unable to satisfy our obligations to that creditor, the creditor may institute proceedings seeking the liquidation of our business.
- We ceased to write new reinsurance agreements. We do not anticipate resuming writing new reinsurance agreements in the foreseeable future. As a result, our cash flow and results of operations in the near future will be based solely upon the performance of the returns generated from our invested assets.
- In preparing our financial statements, we used estimates and assumptions based upon the best information available and management's best judgment at the time our financial statements are prepared. While we believe these estimates to be reasonable, we cannot assure you that they will be accurate. If these estimates prove to be inaccurate, they could have a significant adverse impact on our financial condition and results of operations.
- Significant changes in interest rates expose us to the risk of reduced investment income when interest rates are falling and to greater realized losses from the sale of securities when interest rates are rising.
- The loss of any member of our management team, particularly William H. Mawdsley, our Chief Executive Officer, or John W. Lockwood, our Chief Financial Officer, could adversely affect our business.
- When we purchase reinsurance from another reinsurance company, known as a retrocessionaire, to cover certain risks that we have ourselves reinsured, we are subject to the risk that the retrocessionaire will be unable to pay amounts due to us because of its own financial troubles. The failure of a retrocessionaire to pay amounts due to us will not absolve us of our responsibility to pay our customers for risks that we have insured. Failure of our retrocessionaires to pay us could have a material adverse effect on our business, results of operations and financial condition. In particular, when we purchased our United States operating subsidiary, Annuity and Life Reassurance America, Inc., 100% of the risks related to the directly written life and annuity policies existing at the date of our purchase transaction were ceded to Reassure America Life Insurance Company, a subsidiary of the seller, Swiss Re Life and Health, America. As the direct issuer of those policies, Annuity and Life Reassurance America remains liable to policyholders in the event the reinsurer is unable to pay its obligations to us under the reinsurance agreement. Reserves ceded under this reinsurance agreement amounted to approximately \$82.2 million and \$88.2 million at December 31, 2004 and December 31, 2003, respectively. Reassure America Life Insurance Company's financial strength is rated A+ (Superior) by A.M. Best as of December 31, 2005.

- We are subject to the laws and regulations of the jurisdictions in which we conduct business. These laws and regulations cover many aspects of our business, including licensure, premium rates, marketing practices and capital adequacy. Recently, the insurance and reinsurance regulatory framework has become subject to increased scrutiny in many jurisdictions and regulators have started to reexamine existing laws and regulations. Changes in these laws and regulations could have an adverse affect on our operations. Further deterioration in our financial condition could expose our operations in the United States and Bermuda to increased levels of regulatory scrutiny and possibly to the winding up of our operations.
- As a holding company, we have no significant operations or assets other than our ownership of the capital stock of our subsidiaries. Dividends and other permitted payments from our subsidiaries are our sole source of funds to pay expenses and dividends, and any limitations imposed on our subsidiaries to make such payments to us may cause us to have insufficient funds to operate our business and satisfy our obligations.
- Holdings and Annuity and Life Reassurance, are Bermuda corporations that we believe are not subject to United States income tax because neither engages in business in the United States. However, because there is no definitive guidance as to what constitutes being engaged in trade or business in the United States, there can be no assurance that in the future the Internal Revenue Service may not contend that we are engaged in trade or business in the United States. The Internal Revenue Service is currently conducting an audit of our United States subsidiaries and has requested certain information and documents from us and our Bermuda operating subsidiary. While our United States subsidiaries have complied with the IRS' requests for information, both we and our Bermuda operating subsidiary declined to supply the IRS with certain information in response to its initial requests for information on May 7, 2002 and July 1, 2002. We did provide the IRS with certain publicly available information regarding us and our Bermuda operating subsidiary in addition to minutes of the Board of Directors meetings and committee meetings held from 1999 through to 2001. We have not received any additional requests for information since July 1, 2002. If we were considered to be engaged in business in the United States, we could be subject to United States tax at regular corporate rates on our taxable income that is effectively connected with their United States business plus an additional 30% "branch profits" tax on such income remaining after the regular tax. Such taxes would have a material adverse effect on our results of operations and financial condition.

ANNUITY AND LIFE RE (HOLDINGS), LTD.
AND SUBSIDIARIES

FINANCIAL STATEMENTS

For the Years Ended December 31, 2005 and 2004

ANNUITY AND LIFE RE (HOLDINGS), LTD. AND SUBSIDIARIES

CONTENTS

	<u>Page</u>
INDEPENDENT AUDITORS' REPORT	1
FINANCIAL STATEMENTS	
Consolidated Balance Sheets	2
Consolidated Statements of Operations	3
Consolidated Statements of Comprehensive Loss	4
Consolidated Statements of Changes in Stockholders' Equity	5
Consolidated Statements of Cash Flows	6-7
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS	8-36

Marcum & Kliegman LLP

Certified Public Accountants & Consultants

A Limited Liability Partnership Consisting of Professional Corporations

INDEPENDENT AUDITORS' REPORT

To the Board of Directors of
Annuity and Life Re (Holding) Ltd.

We have audited the accompanying consolidated balance sheets of Annuity and Life Re (Holdings) Ltd. (the "Company") as of December 31, 2005 and 2004, and the related consolidated statements of operations, comprehensive loss, changes in stockholders' equity and cash flows for the years then ended. 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 also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Annuity and Life Re (Holdings) Ltd. as of December 31, 2005 and 2004, and the consolidated results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As more fully described in Note 2 to the consolidated financial statements, the Company has ceased all insurance operations effective on December 31, 2005. Although the Company is continuing to operate due to ongoing commitments, including regulatory requirements, the Company's Board of Directors may determine that it is in the Company's best interest to liquidate, which circumstances may arise in the near future that would cause the Company to adopt the liquidation basis of accounting.

Marcum & Kliegman LLP

March 15, 2006

1

ANNUITY AND LIFE RE (HOLDINGS), LTD. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

December 31, 2005 and 2004

<u>ASSETS</u>		
	<u>2005</u>	<u>2004</u>
Cash and cash equivalents	\$ 19,277,490	\$ 56,394,484
Fixed income investments at fair value (amortized cost of \$66,104,138 and \$80,767,893 at December 31, 2005 and 2004, respectively)	65,266,415	82,034,410
Funds withheld at interest	--	56,415,386
Accrued investment income	1,145,614	1,155,762
Receivable for reinsurance ceded	76,341,602	82,433,270
Other reinsurance receivables	104,135	4,306,931
Deferred policy acquisition costs	--	6,084,488
Other assets	<u>256,693</u>	<u>580,625</u>
TOTAL ASSETS	<u>\$162,391,949</u>	<u>\$289,405,356</u>
<u>LIABILITIES</u>		
Reserves for future policy benefits	\$ 77,476,039	\$113,675,250
Amounts due reinsurer	32,929,104	--
Interest sensitive contracts liability	--	57,754,009
Other reinsurance liabilities	1,742,753	45,371,890
Accounts payable and accrued expenses	<u>5,069,912</u>	<u>6,186,995</u>
TOTAL LIABILITIES	<u>117,217,808</u>	<u>222,988,144</u>
<u>STOCKHOLDERS' EQUITY</u>		
Preferred shares (par value \$1.00; 50,000,000 shares authorized; no shares issued or outstanding)	--	--
Common shares (par value \$1.00; 100,000,000 shares authorized; 24,793,811 and 26,338,528 shares issued and outstanding at December 31, 2005 and 2004, respectively)	24,793,811	26,338,528
Additional paid-in capital	334,123,757	333,810,766
Stock warrants	1,350,000	1,350,000
Unamortized stock-based compensation	(22,800)	(490,415)
Accumulated other comprehensive (loss) income	(837,723)	1,016,260
Accumulated deficit	<u>(314,232,904)</u>	<u>(295,607,927)</u>
TOTAL STOCKHOLDERS' EQUITY	<u>45,174,141</u>	<u>66,417,212</u>
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	<u>\$ 162,391,949</u>	<u>\$ 289,405,356</u>

See accompanying notes to the consolidated financial statements.

ANNUITY AND LIFE RE (HOLDINGS), LTD.
AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

For the Years Ended December 31, 2005 and 2004

	2005	2004
<u>REVENUES</u>		
Net premiums	\$ 8,312,598	\$ 48,297,706
Investment income, net of related expenses	4,068,816	21,697,563
Net realized investment gains	431,459	439,536
Net change in fair value of embedded derivatives	5,609,061	2,181,070
Surrender fees and other revenues	<u>61,313</u>	<u>4,475,691</u>
TOTAL REVENUES	<u>18,483,247</u>	<u>77,091,566</u>
<u>BENEFITS AND EXPENSES</u>		
Claims and policy benefits	16,725,225	14,101,129
Interest (charged) credited to interest sensitive products	(421,089)	5,399,460
Policy acquisition costs and other insurance expenses	8,285,903	110,922,948
Operating expenses	<u>12,518,185</u>	<u>14,628,524</u>
TOTAL BENEFITS AND EXPENSES	<u>37,108,224</u>	<u>145,052,061</u>
Loss before cumulative effect of a change in accounting principle	(18,624,977)	(67,960,495)
Cumulative effect of a change in accounting principle	<u> --</u>	<u> (365,960)</u>
NET LOSS	<u>\$(18,624,977)</u>	<u>\$(68,326,455)</u>
Loss per common share before cumulative effect of a change in accounting principle per common share		
Basic and diluted	\$ (0.73)	\$ (2.63)
Cumulative effect of a change in accounting principle per common share		
Basic and diluted	<u> --</u>	<u> (0.01)</u>
Net loss per common share		
Basic and diluted	<u>\$ (0.73)</u>	<u>\$ (2.64)</u>
WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING	<u>25,377,486</u>	<u>25,856,995</u>

See accompanying notes to the consolidated financial statements.

ANNUITY AND LIFE RE (HOLDINGS), LTD.
AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

For the Years Ended December 31, 2005 and 2004

	<u>2005</u>	<u>2004</u>
<u>NET LOSS FOR THE PERIOD</u>	\$(18,624,977)	\$(68,326,455)
<u>OTHER COMPREHENSIVE LOSS</u>		
Unrealized holding loss on fixed income investments arising during the period	(1,422,524)	(385,053)
Less reclassification adjustment for net realized investment gains in net loss	<u>431,459</u>	<u>439,536</u>
TOTAL COMPREHENSIVE LOSS	<u>\$(20,478,960)</u>	<u>\$(69,151,044)</u>

See accompanying notes to the consolidated financial statements.

ANNUITY AND LIFE RE (HOLDINGS), LTD.
AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN
STOCKHOLDERS' EQUITY

December 31, 2005 and 2004

	2005	2004
<u>Preferred shares par value \$1.00</u>		
Balance at beginning and end of period	\$ --	\$ --
<u>Common shares par value \$1.00</u>		
Balance at beginning of period	26,338,528	26,454,195
Issuance of shares	250,000	-
Cancellation of shares	<u>(1,794,717)</u>	<u>(115,667)</u>
Balance at end of period	<u>24,793,811</u>	<u>26,338,528</u>
<u>Additional paid-in capital</u>		
Balance at beginning of period	333,810,766	334,418,029
Issuance of shares and stock options	6,900	15,000
Cancellation of shares and stock options	<u>306,091</u>	<u>(622,263)</u>
Balance at end of period	<u>334,123,757</u>	<u>333,810,766</u>
<u>Stock warrants</u>		
Balance at beginning of period	1,350,000	1,250,000
Issuance of warrants	<u>--</u>	<u>100,000</u>
Balance at end of period	<u>1,350,000</u>	<u>1,350,000</u>
<u>Unamortized stock-based compensation</u>		
Balance at beginning of period	(490,415)	(1,509,022)
Cancellation of stock-based compensation	34,725	737,930
Issuance of stock-based compensation	(6,900)	(15,000)
Amortization of stock-based compensation	<u>439,790</u>	<u>295,677</u>
Balance at end of period	<u>(22,800)</u>	<u>(490,415)</u>
<u>Accumulated other comprehensive (loss) income</u>		
Balance at beginning of period	1,016,260	1,840,849
Net unrealized losses on fixed income investments	<u>(1,853,983)</u>	<u>(824,589)</u>
Balance at end of period	<u>(837,723)</u>	<u>1,016,260</u>
<u>Accumulated Deficit</u>		
Balance at beginning of period	(295,607,927)	(227,281,472)
Net loss	(18,624,977)	(68,326,455)
Stockholder dividends	<u>--</u>	<u>--</u>
Balance at end of period	<u>(314,232,904)</u>	<u>(295,607,927)</u>
TOTAL STOCKHOLDERS' EQUITY	<u>\$ 45,174,141</u>	<u>\$ 66,417,212</u>

See accompanying notes to the consolidated financial statements.

ANNUITY AND LIFE RE (HOLDINGS), LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Years Ended December 31, 2005 and 2004

	2005	2004
<u>CASH FLOWS FROM OPERATING ACTIVITIES</u>		
Net loss	\$(18,624,977)	\$(68,326,455)
Adjustments to reconcile net loss to cash used in operating activities:		
Net realized investment gains	(431,459)	(439,536)
Net change in fair value of embedded derivatives	(5,609,061)	(2,181,070)
Cumulative effect of change in accounting principle	--	365,960
Amortization of stock based compensation	439,790	295,677
Stock warrants expense	--	100,000
Changes in:		
Accrued investment income	10,148	335,408
Other reinsurance receivables	10,294,464	6,320,716
Deferred policy acquisition costs	6,084,488	99,012,150
Other assets	323,932	101,425
Reserves for future policy benefits	(36,199,211)	(49,649,044)
Amounts due reinsurer	32,929,104	--
Interest sensitive contracts, net of funds withheld	4,270,438	(37,771,764)
Other reinsurance liabilities	(43,629,136)	(6,357,538)
Accounts payable and accrued expenses	<u>(1,117,084)</u>	<u>(872,737)</u>
NET CASH USED IN OPERATING ACTIVITIES	<u>(51,258,564)</u>	<u>(59,066,808)</u>
 <u>CASH FLOWS FROM INVESTING ACTIVITIES</u>		
Proceeds from sales and maturities of fixed income investments	54,466,018	54,941,179
Purchases of fixed income investments	<u>(39,120,547)</u>	<u>(19,548,197)</u>
NET CASH PROVIDED BY INVESTING ACTIVITIES	<u>15,345,471</u>	<u>35,392,982</u>
 <u>CASH FLOWS FROM FINANCING ACTIVITIES</u>		
Purchase and cancellation of Company Stock	(1,453,901)	--
Net proceeds from exercise of Company Stock options	<u>250,000</u>	<u> --</u>
NET CASH USED IN FINANCING ACTIVITIES	<u>(1,203,901)</u>	<u> --</u>
DECREASE IN CASH AND CASH EQUIVALENTS	(37,116,994)	(23,673,826)
<u>CASH AND CASH EQUIVALENTS-Beginning</u>	<u>56,394,484</u>	<u>80,068,310</u>
<u>CASH AND CASH EQUIVALENTS-End</u>	<u>\$ 19,277,490</u>	<u>\$ 56,394,484</u>

See accompanying notes to the consolidated financial statements.

ANNUITY AND LIFE RE (HOLDINGS), LTD.
AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS, Continued

For the Years Ended December 31, 2005 and 2004

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION

	2005	2004
Non-Cash Disclosures:		
Amounts recorded from the cumulative effect of a change in accounting principle		
Deferred policy acquisition costs	\$ --	\$(36,154,010)
Reserves for future policy benefits	--	(1,878,760)
Interest sensitive contracts, net of funds withheld	--	<u>38,398,730</u>
 CUMULATIVE EFFECT OF A CHANGE IN ACCOUNTING PRINCIPLE	 \$ --	 \$ <u>365,960</u>

See accompanying notes to the consolidated financial statements.

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - Organization and Description of Business

Annuity and Life Re (Holdings), Ltd. (“Holdings”) was incorporated on December 2, 1997 under the laws of Bermuda. Prior to July 1, 2005, Holdings provided annuity and life reinsurance to insurers and reinsurers through its wholly-owned subsidiaries: Annuity and Life Reassurance, Ltd., which is licensed under the laws of Bermuda as a long term insurer, Annuity and Life Re America, Inc., an insurance holding company based in the United States of America, and Annuity and Life Reassurance America, Inc., a life insurance company domiciled in the United States of America. Holdings, Annuity and Life Reassurance, Ltd., Annuity and Life Re America, Inc. and Annuity and Life Reassurance America, Inc., collectively referred to herein as the “Company.”

NOTE 2 - Basis of Presentation and Management’s Plans

The accompanying consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. As a result of significant operating losses, the Company became unable to meet its monetary obligations under certain reinsurance treaties in 2002. Since that time, the Company has negotiated termination, recapture, and novation or coinsurance agreements for all reinsurance treaties with the applicable counterparties or independent third parties. As of December 31, 2005, there are no reinsurance agreements in force that will generate operating revenue for the Company. The Company’s only source of revenue in the future is investment income.

Due to the absence of ongoing insurance operations, the Company has significantly reduced its operations including terminating certain employees, reducing the size of the Board of Directors, and moving to smaller office space. Because the Company continues to have residual commitments and contingencies as described Notes 3 and 12, it does not expect to immediately wind-down or dissolve the Company or its subsidiaries. The Company intends to continue to explore strategic alternatives to attempt to maximize its economic value for stockholders, including a merger of Holdings into another entity, the sale of one or both of its operating subsidiaries or other comparable transactions. In addition, the Company may consider cash distributions to stockholders, stock buybacks or similar transactions, to the extent its financial condition allows it to do so and it is not constrained by insurance regulatory or other laws or by its obligations under the Master Agreement.

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3 - Significant Events

Wilton Re Transaction

On August 10, 2005, the Company entered into a Master Agreement (the “Master Agreement”) with Prudential Select Life Insurance Company of America (which has subsequently been renamed Wilton Reassurance Company) and Wilton Reinsurance Bermuda Limited (collectively, the “Wilton Subsidiaries”), each a direct or indirect wholly owned operating subsidiary of Wilton Re Holdings, Ltd. The Master Agreement provided for the novation to or 100% coinsurance (the “Coinsurance Agreements”) by the Wilton Subsidiaries of all of the Company’s life and annuity reinsurance treaties identified in the Master Agreement (the “Treaties”), effective as of June 30, 2005 (the “Effective Date”).

The Master Agreement was finalized on January 17, 2006 (the “Closing Date”). Accordingly, the Company transferred the following assets and liabilities to the Wilton Subsidiaries at closing: cash and investments of \$32.9 million, funds withheld at interest of \$58.7 million, future policy benefits liabilities of \$38.3, and interest sensitive contracts liabilities of \$53.3. Because the economic rights and obligations of the Treaties were effectively transferred to the Wilton Subsidiaries as a result of the novations and Coinsurance Agreements, the Company eliminated the operating impact as of the Effective Date. As of December 31, 2005, the Company has a liability of \$32.9 million representing the cash and investments transferred to the Wilton Subsidiaries at closing. As a result of the execution of the Master Agreement, the Company recorded a \$15.2 million loss from operations for the year ended December 31, 2005.

As of the Effective Date, the Company had 28 reinsurance treaties in force, all of which were included in the Master Agreement. Twenty (20) Treaties were novated as of the Effective Date. Because the consent of the counterparties to the remaining eight reinsurance treaties were not obtained prior to the closing, the Company executed Coinsurance Agreements with the Wilton Subsidiaries pursuant to the terms of the Master Agreement. As such, approximately \$1.1 billion of the Company’s life insurance in force has been 100% reinsured to the Wilton Subsidiaries as of the Effective Date.

The Company continues to be bound, as reinsurers, by the original terms of the Treaties with the primary insurer for the eight Treaties subject to the Coinsurance Agreement. The appropriate Wilton Subsidiary is, in turn, obligated to reimburse the Company for any payments made under a coinsured treaty. In addition, the Coinsurance Agreements provide that, beginning on the Transition Date (as defined below), the Wilton Subsidiaries will provide all administrative and management services necessary to administer and manage the Treaties covered by the Coinsurance Agreements, as well as any associated ancillary agreements or retrocession agreements.

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3 - Significant Events, continued

Wilton Re Transaction, continued

Pursuant to the terms of the Master Agreement and a supplemental letter agreement entered into between the Company and the Wilton Subsidiaries, between the Closing Date and March 15, 2006 (the "Transition Date"), the Company will continue to administer the Treaties in a manner consistent with current practices. The Wilton Subsidiaries will pay the Company a fee of \$30,000 per month for these administrative services and will reimburse the Company to the extent that the cost of any approved third party engaged to provide such services exceeds the \$30,000 fee.

The following unaudited pro forma condensed consolidated statements of operations for the years ended December 31, 2005 and 2004 adjusts the reported statement of operations by assuming that (1) the Wilton transaction occurred on January 1, 2004, (2) all of the Company's novation, recapture and termination transactions that had effective dates in 2004 occurred on January 1, 2004 (which removes from reported net loss the actual performance for each agreement through its novation, recapture or termination date), and (3) there was no gain or loss from the transactions with the Wilton Subsidiaries. No attempt has been made to estimate the impact of the aforementioned adjustments on cash flow for the periods presented, on net investment income earned on assets transferred to third parties in connection with the novated and coinsured life reinsurance agreements or on operating expenses. The pro forma information presented below is not necessarily indicative of the financial results that would have been attained had the transactions occurred on the dates referenced above and should not be viewed as indicative of operations in future periods.

	2005	2004
	(Unaudited)	
Investment income	\$ 4,570,583	\$ 7,848,236
Operating expenses	<u>7,879,177</u>	<u>15,766,622</u>
Net Loss	<u>\$(3,308,594)</u>	<u>\$(7,918,386)</u>
Net loss per common share:		
Basic and diluted	<u>\$ (0.13)</u>	<u>\$ (0.31)</u>

Repurchase of Common Shares

On September 14, 2005, the Company entered into a Purchase Agreement (the "Purchase Agreement") with Overseas Partners, Ltd. ("Overseas Partners"). The Purchase Agreement provided for the purchase by the Company from Overseas Partners of 1,773,050 common shares of the Company (the "Shares") and Class B warrants to purchase an additional 133,396 common shares of the Company (the "Warrants") for a total cash purchase price of \$1,453,901. The Company completed the acquisition of the Shares and Warrants pursuant to the terms of the Purchase Agreement on September 14, 2005. The Shares represented approximately 6.74% of the Company's outstanding common shares, and the Warrants had

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3 - Significant Events, continued

Repurchase of Common Shares

an exercise price of \$14.06 per share. Following the acquisition, the Shares and the Warrants were cancelled by the Company. As a consequence of the repurchase of the Shares and Warrants, Overseas Partners no longer has the right to nominate one person for election to the Company's Board of Directors.

Separation of Chief Executive Officer

On September 23, 2005, the Company entered into a Separation of Employment Agreement and General Release (the "Separation Agreement") with John F. Burke, the Company's President and Chief Executive Officer. Pursuant to the Separation Agreement, the Amended and Restated Employment Agreement, dated July 28, 2003, by and among Mr. Burke, Holdings and Annuity and Life Reassurance, Ltd. (the "Employment Agreement") was terminated, and Mr. Burke resigned from all positions he held as a director or officer of the Company and its subsidiaries.

Pursuant to the Separation Agreement, the Company made a one-time payment to Mr. Burke of \$740,000 in cash on October 3, 2005. In addition, as a result of the closing of the Master Agreement as described above, the Company accrued an additional \$1,160,000, which was paid to Mr. Burke on January 23, 2006. Both payments were included in operating expenses in 2005. Effective with the execution of the Separation Agreement, all of Mr. Burke's restricted common shares became immediately vested, which had no impact on the Company's results of operations, and his stock options became immediately exercisable, which resulted in a compensation expense of \$132,222.

The Separation Agreement also provides that Mr. Burke will cooperate fully with the Company and its counsel with respect to any matter (including any litigation, arbitration, investigation, or governmental proceeding) relating to matters with which Mr. Burke was involved during the term of his employment with the Company. Mr. Burke is entitled to receive a fee of \$2,500 for each day he provides services pursuant to this provision. The Separation Agreement also contains a mutual release by the Company and Mr. Burke of any and all claims relating to Mr. Burke's service as a director of the Company, his employment relationship with the Company, the Employment Agreement or Mr. Burke's separation from the Company.

Transamerica Transaction

On December 31, 2004, the Company entered into a binding letter of intent with Transamerica Occidental Life Insurance Company ("Transamerica") that provided for the novation of its life reinsurance agreements with Scottish Re Limited ("Scottish Re") and Fidelity and Guaranty Life Insurance Company ("F&G") to Transamerica as of December 31, 2004. The letter of intent also provided that, upon consummation of the novation of the life reinsurance agreements, Transamerica would terminate its annuity reinsurance agreement with the Company and recapture all business ceded under the agreement effective as of December 1, 2004.

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3 - Significant Events, continued

Transamerica Transaction, continued

Pursuant to the letter of intent with Transamerica, on January 31, 2005, the Company executed definitive documents (the "Novation Agreement") and novated its life reinsurance agreements with Scottish Re and F&G to Transamerica as of December 31, 2004. In consideration of the life reinsurance agreement novations, the Company paid Transamerica \$18.5 million. Also, on January 31, 2005, the Company executed an amendment to its annuity reinsurance agreement with Transamerica which terminated the agreement and resulted in Transamerica recapturing all business ceded under the agreement effective as of December 1, 2004. In consideration of the annuity recapture, the Company paid a \$14.0 million premium to terminate and recapture the agreement and approximately \$7.1 million for monthly settlement amounts owed under the annuity reinsurance agreement through November 30, 2004.

Settlement of Stockholder Lawsuit

Since December 4, 2002, certain of the Company's Stockholders, seeking to act as class representatives, filed lawsuits against the Company and certain of its present and former officers and directors in the United States District Court for the District of Connecticut seeking unspecified monetary damages. On July 20, 2004, the Company announced that it had reached an agreement in principle with the plaintiffs, subject to full documentation by the parties to the settlement, notice to the class, court approval and other steps required to consummate a class action settlement, to settle the lawsuit. The Company's share of the settlement was \$5.0 million in cash, of which it paid \$2.5 million into escrow in August 2004, and the remaining \$2.5 million on January 10, 2005. Following a Settlement Fairness Hearing, the District Court entered an order and final judgment approving the settlement in January 2005. The Company recorded its \$5.0 million portion of the settlement as an operating expense in the second quarter of 2004.

Engagement of Financial Advisor

Pursuant to an engagement letter dated January 19, 2004, as amended (the "Engagement Letter"), the Company engaged UBS Securities LLC ("UBS") to serve as its financial advisor and capital markets advisor in connection with identifying strategic alternatives available to the Company. The Engagement Letter provides that if, during the term of the Engagement Letter, the Company closes an equity investment, the Company is obligated to pay UBS a minimum transaction fee of \$1,000,000. If the Company closes a sale transaction during the term of the Engagement Letter, the Company is obligated to pay UBS a minimum transaction fee of either \$1,500,000 or \$2,000,000, depending on whether the other party to that transaction is one identified in the Engagement Letter. In any case, the transaction fee payable to UBS may increase as the transaction value increases. Any transaction fee payable to UBS under the Engagement Letter will be offset by certain fees paid by the Company to UBS prior to the closing of the equity investment or sale transaction. On January 22, 2006, the Company paid UBS a fee of \$1,450,000, in addition to the previously paid retainer of \$350,000, upon the consummation of the novation and coinsurance transaction with the Wilton Subsidiaries. The total amount of \$1,750,000 was recorded in operating expenses in the consolidated statement of operations for the year ended December 31, 2005.

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3 - Significant Events, continued

Settlement of Litigation

On November 29, 2005, the Company paid \$425,000 to Imagine Group Holdings Limited (“Imagine”) to settle a civil proceeding in Bermuda. Imagine had demanded damages of \$640,000 related to a failed capital raising transaction in 2002. The expense incurred is included in operating expenses for the year ended December 31, 2005.

On October 25, 2005, the Company paid \$200,000 to Rodney Cordle, a former employee, to settle a civil proceeding in Bermuda. Mr. Cordle had alleged the Company failed to pay certain expenses in accordance with his employment agreement. The expense incurred is included in operating expenses for the year ended December 31, 2005.

Employment Agreements

On October 19, 2005, the Company entered into letter agreements with William H. Mawdsley and John W. Lockwood setting forth the terms of their continued employment by the Company. Pursuant to the letter agreement with Mr. Mawdsley, he is entitled to an annual salary of \$250,000 and an additional \$10,000 per month as a housing and travel allowance. Effective with the execution of the letter agreement, Mr. Mawdsley was named the Company’s Chief Executive Officer and he was appointed to fill a vacancy on the Company’s Board of Directors. Mr. Mawdsley had previously been a Vice President of the Company and the Chief Actuary of its Bermuda based operating subsidiary. Pursuant to the letter agreement with Mr. Lockwood, he is entitled to an annual salary of \$200,000 and an additional \$7,500 per month as a housing and travel allowance. Mr. Lockwood will continue to serve as the Company’s Chief Financial Officer and President of the Company’s United States based subsidiaries.

The Company agreed to continue to provide Messrs. Mawdsley and Lockwood with the same benefits, consisting primarily of housing allowances they are currently receiving, and they will be eligible for bonus compensation at the discretion of the Company’s Board of Directors. Mr. Mawdsley and Mr. Lockwood may be terminated at any time for any reason, but if such termination is without “cause” (as defined in the letter agreements), Mr. Mawdsley would be entitled to receive a severance payment of \$620,000 plus reasonable relocation expenses from Bermuda to the United States, and Mr. Lockwood would be entitled to receive a severance payment of \$490,000. Both men would also receive the foregoing severance payments if they resign because of a reduction in their base salary or housing allowance to which they did not agree or if they resign for any other reason within the period commencing 90 days and ending 180 days following the effective time of (i) the acquisition of all of the outstanding equity securities of Holdings or (ii) the merger of Holdings with another entity, other than one of Holding’s direct or indirect wholly owned subsidiaries.

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3 - Significant Events, continued

Restructuring of the Board of Directors

On October 12, 2005, Messrs. Lee M. Gammill, Jr., Frederick S. Hammer and Jon W. Yoskin, II, who were members of the Company's Board of Directors serving terms that expired at the Company's annual general meeting (the "AGM") of stockholders, informed the Company that they would not stand for re-election as directors. Accordingly, each of these Board members ceased to be a director of the Company following the AGM on December 1, 2005. Also on October 12, 2005, Messrs. Robert M. Lichten and Robert P. Johnson, whose terms would otherwise expire in 2006 and 2007, respectively, informed the Company that they would resign as directors of the Company effective as of the date of the AGM. As of December 1, 2005, the members of the Board of Directors included Martin A. Berkowitz (Chairman), Albert R. Dowden, Jeffrey D. Watkins, Michael P. Esposito and William H. Mawdsley.

NOTE 4 - Summary of Significant Accounting Policies

Use of Estimates

The accompanying consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America which require management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements. Actual results could differ from those estimates.

Basis of consolidation

The consolidated financial statements include the accounts of Holdings and its subsidiaries, Annuity and Life Reassurance, Ltd., Annuity and Life Re America, Inc. and Annuity and Life Reassurance America, Inc. All significant inter-company accounts and transactions have been eliminated upon consolidation.

Revenues

Reinsurance premiums from traditional life and annuity policies with life contingencies, where premiums collected match the period over which benefits are provided, are recognized as revenue when due from policyholders. Traditional life policies include those contracts with fixed and guaranteed premiums and benefits, and consist principally of whole life and term insurance policies. Benefits and expenses are matched with revenue so as to result in the recognition of profits over the life of the contracts. This is achieved by means of the provision for liabilities for future policy benefits and deferral and subsequent amortization of policy acquisition costs.

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4 - Summary of Significant Accounting Policies, continued

Revenues, continued

For contracts with a single premium or a limited number of premium payments due over a significantly shorter period than the total period over which benefits are provided (“limited payment contracts”), reinsurance premiums are recorded as net premiums when due with any excess profit deferred and recognized in net premiums in a constant relationship to the insurance in force or, for annuities, in relation to the amount of expected future benefit payments.

Amounts collected on universal life and investment-type contracts are considered deposits and are reported in the balance sheet as interest sensitive contracts liability. Revenues from these investment-type contracts consist of income earned on the assets and amounts assessed during the period against policyholders’ account balances for mortality charges, policy administration charges and surrender charges. Deposit accounting procedures are applied to consideration received or paid relating to reinsurance contracts that do not qualify for reinsurance accounting, with any revenue or expense associated with such deposits reflected in net investment income and other insurance expenses, respectively.

Deferred policy acquisition costs

The costs of acquiring new business, principally allowances, which vary with and are primarily related to the production of new business, are deferred. Where a ceding company pays a bonus interest amount in the first year of a policy to induce a policyholder to acquire the product, and this bonus interest amount is distinct from and incremental to the expected ongoing interest crediting amount, the bonus interest is capitalized and amortized to policy acquisition costs in a manner similar to deferred acquisition costs. Deferred policy acquisition costs are subject to recoverability testing at the time of policy issuance and loss recognition testing at the end of each accounting period.

For traditional life and annuity policies with life contingencies, deferred policy acquisition costs are charged to expense using assumptions consistent with those used in computing policy reserves. Assumptions as to anticipated premiums are estimated at the date of the policy issuance, or the effective date of the most recent premium rate increase, and are consistently applied during the life of the contracts. Deviations from estimated experience are reflected in the results of operations in the period such deviations occur. For these contracts, the amortization periods are generally the estimated life of the policies.

For universal life and investment-type contracts, deferred policy acquisition costs are amortized over the expected average life of the contracts as a constant percentage of the present value of estimated gross profits arising principally from investment results, mortality and expense margins and surrender charges based on historical and anticipated future experience, which is updated at the end of each accounting period. In computing amortization, interest accrues to the unamortized balance of capitalized policy acquisition costs at the rate used to discount expected gross profit. The effect on the amortization of deferred policy acquisition costs of revisions to estimated gross profits are reflected in the results of operations in the period such estimated gross profits are revised.

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4 - Summary of Significant Accounting Policies, continued

Deferred policy acquisition costs, continued

The change in deferred policy acquisition costs for the year ended December 31, 2005, was due to the write down of the Company's remaining deferred acquisition costs for its life and annuity policy business due to transfer of such business to the Wilton Subsidiaries. At December 31, 2005, there are no deferred acquisition costs on the Company's consolidated balance sheet.

Reserves for future policy benefits and interest sensitive contracts liability

The development of reserves for policy benefits and for claims incurred but not reported ("IBNR") for the Company's products requires management to make estimates and assumptions regarding mortality, lapse, persistency, expenses and investment experience. Such estimates are primarily based on historical experience and information provided by ceding companies. Actual results could differ materially from those estimates. Management considers all of the Company's reinsurance contracts to be long duration contracts. Management monitors actual experience and, where circumstances warrant, will revise its assumptions and the related reserve estimates.

The Company's liability for contracts providing reinsurance for life insurance policies is recorded in the balance sheet as reserves for future policy benefits. The reserve is estimated using a net level premium method utilizing actuarial assumptions for mortality, persistency, interest and expenses established when the contract is underwritten. These assumptions are based on anticipated experience with a margin for adverse deviation. If the reserves for future policy benefits plus the present value of expected future gross premiums are insufficient to provide for expected future benefits and expenses, deferred policy acquisition costs are written down and, if required, a premium deficiency reserve is established, by a charge to claims and policy benefits. Benefit liabilities for traditional annuities that contain mortality risk are recorded at the present value of expected future benefit payments. Reserves are also established to cover death claims that may have been incurred and reported to the ceding company, but not yet reported to the Company due to timing delays. The average discount rate used to compute the Company's reserves for future policy benefits, net of any receivable for reinsurance ceded, was approximately 5.1% for 2004.

Amounts collected on universal life and investment-type contracts and benefit liabilities for traditional annuities (during the accumulation period) are reported in the balance sheet as interest sensitive contracts liability. Universal life and investment-type contracts are recorded at their accumulated policyholder values (without reduction for potential surrender or withdrawal charges). Revenues from these contracts consist of income earned on the assets and amounts assessed during the period against policyholders' account balances for mortality charges, policy administration charges and surrender charges. Items that are charged to expense represent interest credited to the policyholder account and other benefits in excess of related policyholders' account balances, including minimum interest guarantee payments.

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4 - Summary of Significant Accounting Policies, continued

Reserves for future policy benefits and interest sensitive contracts liability, continued

The Company historically reinsured certain minimum guarantees, including Guaranteed Minimum Death Benefits (“GMDB”) and Guaranteed Minimum Income Benefits (“GMIB”), associated with variable annuity contracts, although as of December 31, 2004, it no longer reinsured these types of contracts. The Company’s accounting policy was designed to establish reserves for expected benefit payments over the life of the underlying policies, based upon the original pricing assumptions. The Company’s reserving policy allows the Company to increase reserves if claim amounts or claims volume exceeded what was anticipated in pricing.

As a result of the transactions consummated under the Master Agreement with the Wilton Subsidiaries, the Company no longer has any interest sensitive contracts liability at December 31, 2005.

Investments

The Company classifies its investments in fixed income securities as available for sale and, accordingly, such securities are carried at fair value. The cost of fixed income securities is adjusted for amortization of premiums and discounts. The carrying value of fixed income securities is adjusted for declines in value that are considered other than temporary and any such adjustment is considered a realized loss.

Realized gains and losses on investments are recognized in the results of operations, using the specific identification method. Changes in fair values of securities classified as available for sale are reflected in accumulated other comprehensive (loss) income.

Translation of foreign currencies

The Company’s functional currency is the United States dollar. Premiums written and receivable in foreign currencies and liabilities for future benefits payable in foreign currencies are recorded at exchange rates prevailing at the time such assets and liabilities are first recorded. Exchange gains or losses resulting from the periodic revaluation and settlement of such assets and liabilities are recorded in the Company’s statement of operations. There were no transactions in foreign currencies for the year ended December 31, 2005.

Loss per common share

The Company calculates basic earnings per common share and earnings per common share assuming dilution. Basic earnings per common share is calculated by dividing net loss attributable to common stockholders by the weighted average number of common shares outstanding during the period. Restricted common stock issued to employees (see Note 10) is not included in calculating basic earnings per common share until it has vested.

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4 - Summary of Significant Accounting Policies, continued

Loss per common share, continued

Diluted earnings per common share is calculated by dividing the net income attributable to common stockholders by the weighted average number of common shares outstanding during the period, plus potential dilutive common shares. Options and warrants issued by the Company are considered potential dilutive common shares and are included in the calculation using the treasury stock method, unless their inclusion would be considered anti-dilutive.

Cash and cash equivalents

For the purposes of the statements of cash flows, the Company considers all time deposits and short-term investments with original maturities of 90 days or less as equivalent to cash.

Stock plans

In December 2002, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 148 - Accounting for Stock-Based Compensation - Transition and Disclosure, an amendment of SFAS No. 123. This statement provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. On January 1, 2003, the Company voluntarily adopted the fair value based method of accounting for stock-based employee compensation under the prospective method described in SFAS No. 148. Under this method, the Company applies fair value accounting to all grants of employee stock options subsequent to December 31, 2002. Previously, the Company had applied the intrinsic value method when accounting for its stock-based compensation and continues to apply the intrinsic value method to stock-based compensation issued prior to January 1, 2003, whereby all stock options granted were at market value with no corresponding charges to compensation expense. SFAS No. 148 also amends the disclosure requirements of SFAS No. 123 to require more prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The following table provides the required disclosure for grants made prior to the Company's adoption of the prospective method described in SFAS No. 148.

	<u>Year Ended December 31,</u>	
	<u>2005</u>	<u>2004</u>
Net loss - as reported	\$(18,624,977)	\$(68,326,455)
Stock based compensation expense recognized	439,790	295,678
Pro forma effect on net loss of applying fair value accounting to all stock based compensation grants	<u>(439,790)</u>	<u>(791,776)</u>
Net loss - pro forma	<u>\$(18,624,977)</u>	<u>\$(68,822,553)</u>
Net loss per common share - as reported:		
Basic and diluted	<u>\$ (0.73)</u>	<u>\$ (2.64)</u>
Net loss per common share - pro forma:		
Basic and diluted	<u>\$ (0.73)</u>	<u>\$ (2.66)</u>

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4 - Summary of Significant Accounting Policies, continued

Stock plans, continued

The Company also granted restricted shares to employees in 2003 and 2002 included in above table. The stock based compensation expense for these grants amounted to \$302,632 and \$215,795 in 2005 and 2004, respectively.

The fair value of the options is estimated on the date of grant using the Black-Scholes option-pricing model. The following table details the assumptions and fair values for options issued in the past five years:

<u>Year of Grant</u>	<u>Dividend Yield</u>	<u>Expected Volatility</u>	<u>Weighted Average Risk Free Rate</u>	<u>Weighted Average Fair Value</u>
2001	0.69%	37.07%	5.05%	\$15.19
2002	1.22%	62.19%	4.99%	\$10.62
2003	0.00%	241.10%	3.68%	\$ 1.03
2004	0.00%	50.00%	4.46%	\$ 0.30
2005	0.00%	15.50%	4.45%	\$ 0.46

Funds withheld at interest and embedded derivatives

Funds withheld at interest represents a receivable balance equivalent to the Company's proportionate share of its ceding companies' statutory reserves related to policies reinsured by the Company under reinsurance agreements written on a modified coinsurance or coinsurance funds withheld basis. The premiums received by a ceding company on the policies underlying these types of reinsurance agreements are used to purchase investment securities that are managed by that ceding company or investment managers appointed by it. Net investment income includes the Company's proportionate share of the investment income and realized capital gains and losses on the sale of investments purchased with those premiums, as well as distributions from the embedded derivatives contained in certain of these agreements.

A portion of the Company's funds withheld at interest receivable asset contained embedded derivatives, which required bifurcation and separate accounting under SFAS No. 133 — Accounting for Derivative Instruments and Hedging Activities, which the Company adopted as of January 1, 2001. The net fair value of these embedded derivatives was classified as part of the Company's funds withheld asset on its balance sheet. The change in the fair value of these embedded derivatives is recorded in the Company's statement of operations as Net change in fair value of embedded derivatives, which is a non-cash item. The Company, with the assistance of outside advisors, had developed a cash flow model to arrive at an estimate of the fair value of these embedded derivatives that uses various assumptions regarding future cash flows under the affected annuity reinsurance contracts. While the Company had made an estimate of the fair value of these embedded derivatives using a model that it believes is appropriate and based upon reasonable assumptions, the assumptions used were

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4 - Summary of Significant Accounting Policies, continued

Funds withheld at interest and embedded derivatives, continued

subjective and may have required adjustment in the future. As a result of the transactions consummated under the Master Agreement with the Wilton Subsidiaries, the Company no longer has a funds withheld at interest receivable asset nor embedded derivatives at December 31, 2005.

Accounting Pronouncements

Emerging Issues Task Force Issue No. 03-1

The Emerging Issues Task Force (“EITF”) of the FASB issued EITF Issue No. 03-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments” in late 2003. It contains two aspects that impact the Company. First, it provides details regarding disclosures about unrealized losses on available-for-sale debt and equity securities accounted for under SFAS No. 115, “Accounting for Certain Investments in Debt and Equity Securities.” These disclosures were effective in annual financial statements for fiscal years ended after December 15, 2003. Second, it provides additional guidance for evaluating whether an investment is other-than-temporarily impaired. This guidance was scheduled to be effective for reporting periods beginning after June 30, 2004. However, the FASB determined that a delay in the effective date of these provisions was necessary until it could issue additional guidance on the application of EITF Issue No. 03-1. At the June 29, 2005 meeting, the FASB decided not to provide additional guidance on the meaning of other-than-temporary impairment and decided that (1) transition would be applied prospectively and (2) the effective date would be reporting periods beginning after December 15, 2005. The Company has adopted the provisions of EITF Issue No. 03-1 and has determined that such adoption had no material impact on the Company’s results of operations or financial condition.

AICPA Statement of Position (SOP) 03-1

In July 2003, the Accounting Standards Executive Committee of the American Institute of Certified Public Accountant’s (“AICPA”) issued Statement of Position (“SOP”) 03-1, “Accounting and Reporting by Insurance Enterprises for Certain Non-Traditional Long-Duration Contracts and for Separate Accounts.” The SOP is effective for financial statements for fiscal years beginning after December 15, 2003 and provides guidance on accounting and reporting by insurance enterprises for certain nontraditional long-duration contracts and for separate accounts. The SOP changed the manner in which life insurance companies account for certain types of insurance and reinsurance contracts. On January 1, 2004, the Company adopted this new accounting standard. At that time, the Company had a combined GMDB/GMIB agreement with Connecticut General Life Insurance Company (“CIGNA”) and an annuity reinsurance agreement with Transamerica that were both affected by the adoption of the new SOP. The cumulative effect of the change in accounting principle was a net loss of \$365,960 for the three months ended March 31, 2004. The Company no longer has any reinsurance agreements that are affected by the SOP.

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4 - Summary of Significant Accounting Policies, continued

Share-Based Payments

On December 16, 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123R"). SFAS No. 123R replaces SFAS No. 123 "Accounting for Stock-Based Compensation" and supersedes APB opinion No. 25 "Accounting for Stock Issued to Employees." SFAS No. 123R requires all entities to recognize compensation expense in an amount equal to the fair value of share-based payments granted to employees and is effective as of the beginning of the first fiscal year that begins after December 15, 2005. Because the Company applies fair value accounting to all employee stock options granted or modified subsequent to December 31, 2002, the impact of this statement will be to record compensation expense utilizing fair value accounting for awards vesting on or after July 1, 2005 that were granted on or before December 31, 2002. The Company has no unvested options granted on or before December 31, 2002. The pro forma table in Note 4 illustrates the impact of SFAS No. 123 on the Company's consolidated statements of operations; SFAS No. 123R will have no material impact on the Company's financial position and results of operations.

The Company elected to adopt SFAS123R on January 1, 2005 and has recorded compensation expense of \$137,158 to reflect the fair value of options granted in 2005.

Presentation of prior year information

Prior year financial information is reclassified, when necessary, to be consistent with current year presentation.

NOTE 5 - Investments

The amortized cost and fair values of investments in fixed income securities classified as available for sale at December 31, 2005 and 2004 are as follows:

2005	Amortized Cost	Unrealized Gain	Unrealized Loss	Fair Value
U.S. Government Securities	\$45,529,396	\$ 69,819	\$(672,225)	\$44,926,990
Preferred Securities	9,298,832	38,466	(195,478)	9,141,820
U.S. Corporate Securities	9,090,659	9,890	(103,853)	8,996,696
Non U.S. Corporate Securities	1,416,789	3,826	(6,722)	1,413,893
Mortgage Securities	<u>768,462</u>	<u>18,554</u>	<u>--</u>	<u>787,016</u>
	<u>\$66,104,138</u>	<u>\$ 140,555</u>	<u>\$(978,278)</u>	<u>\$65,266,415</u>

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 5 - Investments, continued

2004	Amortized Cost	Unrealized Gain	Unrealized Loss	Fair Value
U.S. Government Securities	\$13,936,764	\$ 97,150	\$(137,871)	\$13,896,043
Non U.S. Government Securities	2,645,786	54,474	--	2,700,260
U.S. Corporate Securities	49,160,980	942,565	(92,340)	50,011,205
Non U.S. Corporate Securities	5,171,239	95,963	(32,511)	5,234,691
Mortgage Securities	<u>9,853,124</u>	<u>350,455</u>	<u>(11,368)</u>	<u>10,192,211</u>
	<u>\$80,767,893</u>	<u>\$1,540,607</u>	<u>\$(274,090)</u>	<u>\$82,034,410</u>

The following table sets forth certain information regarding the investment ratings of the Company's fixed income securities portfolio at December 31, 2005 and 2004.

Ratings (1)	2005		2004	
	Amortized Cost	%	Amortized Cost	%
AAA	\$47,623,363	72.0%	\$26,446,323	32.7%
AA	3,473,867	5.3%	13,959,513	17.3%
A	8,516,641	12.9%	25,057,816	31.0%
BAA	5,697,267	8.6%	13,332,326	16.5%
BA	--	--	949,683	1.2%
Non Rated	<u>793,000</u>	<u>1.2%</u>	<u>1,022,232</u>	<u>1.3%</u>
	<u>\$66,104,138</u>	<u>100.0%</u>	<u>\$80,767,893</u>	<u>100.0%</u>

(1) Ratings as assigned by Moody's.

On January 17, 2005, the Company transferred to Wilton Re certain fixed income securities in settlement of the Master Agreement. These securities had an amortized cost of \$32.4 million and a market value of approximately \$31.9 million at December 31, 2005.

At December 31, 2005 and 2004, letters of credit totaling approximately \$8,797,000 and \$35,100,000, respectively, issued in the ordinary course of the Company's business, had been issued by its bankers in favor of certain ceding insurance companies to provide security and meet regulatory requirements. At December 31, 2005 and 2004, cash and investments of approximately \$10,840,000 and \$41,300,000, respectively, were pledged as collateral for letters of credit. Subsequent to December 31, 2005, letters of credit amounting to approximately \$5,200,000 have been returned to the Company by ceding companies with reinsurance agreements that novated to Wilton Re. Letters of credit amounting to approximately \$3,500,000 remain outstanding as of March 15, 2006.

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 5 - Investments, continued

The Company's U.S. operating subsidiary has placed approximately \$7,500,000 of cash and investments on deposit with various states to meet regulatory requirements at December 31, 2005.

The maturity distribution of fixed income securities held as of December 31, 2005 and 2004 is shown below. Actual maturity dates may differ from contractual maturity dates because certain borrowers have the ability to prepay their obligations without penalty.

	2005		2004	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Within one year	\$ 9,459,750	\$ 9,389,034	\$ 8,828,595	\$ 8,852,139
From one year to five years	40,301,501	39,647,862	29,657,989	25,295,585
From six to ten years	6,084,923	6,077,410	19,673,564	24,524,027
More than ten years	9,489,502	9,365,093	12,754,622	13,170,449
Mortgage securities	<u>768,462</u>	<u>787,016</u>	<u>9,853,123</u>	<u>10,192,210</u>
	<u>\$66,104,138</u>	<u>\$65,266,415</u>	<u>\$80,767,893</u>	<u>\$82,034,410</u>

Investment income, net of related expenses, earned during the years ended December 31, 2005 and 2004 was as follows:

	2005	2004
Interest income	\$ 4,620,859	\$ 6,790,108
Investment income earned on funds withheld under modified coinsurance agreements	675,143	16,362,237
Amortization of premiums paid on fixed income Investments	(1,042,797)	(1,141,637)
Investment expenses	<u>(184,389)</u>	<u>(313,145)</u>
	<u>\$4,068,816</u>	<u>\$21,697,563</u>

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 6 - Operating Lease Obligations

The following table shows the Company's contractual obligations under its operating leases over the periods indicated:

	<u>2006</u>	<u>2007</u>	<u>Thereafter</u>	<u>Total</u>
Operating Leases (1)	\$ 91,328	\$ 20,052	--	\$111,380

(1) The Company leases office space in Bermuda and the United States; these leases expire on March 15, 2006 and January 31, 2007, respectively. The Company's Bermuda operating subsidiary has negotiated a one year lease for office space to replace its existing premises which is effective as of March 16, 2006 at a rate of \$2,000 per month.

NOTE 7 - Stockholders' Equity

Preferred Stock

The Company is authorized to issue 50,000,000 preferred shares of par value \$1.00 each. Currently, there are no preferred shares issued or outstanding.

Common Stock

The Company is authorized to issue 100,000,000 common shares of par value \$1.00 each. The common stockholders have no pre-emptive, redemption, conversion or sinking fund rights. Subject to certain voting restrictions, which limit the voting power of United States persons to less than 10%, and non-United States persons to less than 17%, of the combined voting power of the issued voting shares of the Company, each holder is entitled to one vote per share.

In the event of a liquidation, dissolution or winding up of the Company, the holders of the common shares are able to share equally in the assets of the Company, if any remain after payment of all liabilities and the liquidation preference of any outstanding preferred shares. Certain restrictions exist with respect to the transfer of shares, should such a transfer cause the number of shares held by one United States person to be 10% or more, or a non-United States person to be 17% or more, of the Company's outstanding common shares.

Class A Warrants

In connection with the initial capitalization of the Company, the Company issued Class A Warrants that initially entitled the holders to purchase up to 3,059,990 common shares of the Company. The initial exercise price of the Class A Warrants was \$15.00, which was equal to the price of the Company's common shares in the initial public offering. As the result of the issuance of warrants to Hartford Life Insurance Co. and CIGNA, discussed below, the effect of anti-dilution adjustment provisions in the Class A Warrants has increased the number of shares issuable upon exercise of the Class A Warrants to 3,265,515 common shares and the exercise price of the Class A Warrants has been adjusted to \$14.06. The Class A Warrants are all currently exercisable and will expire on January 15, 2008. No Class A Warrants had been exercised at December 31, 2005.

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 7 - Stockholders' Equity, continued

Class B Warrants

In connection with the direct sales of equity securities to certain "Strategic Investors" in connection with the Company's initial public offering, the Company issued Class B Warrants that initially enabled the holders to purchase an aggregate of 397,500 common shares of the Company. The initial exercise price of the Class B Warrants was \$15.00 per share, which was equal to the price of the common shares in the initial public offering. As the result of our issuance of warrants to Hartford Life and CIGNA, discussed below, the effect of anti-dilution adjustment provisions in the Class B Warrants has increased the number of shares issuable upon exercise of the Class B Warrants to 424,198 common shares and the exercise price of the Class B Warrants has been adjusted to \$14.06.

On September 14, 2005, the Company purchased from Overseas Partners 133,396 Class B warrants. Following the acquisition, the Warrants were cancelled by the Company. The remaining 290,802 Class B Warrants are all currently exercisable and expire on April 15, 2008. No Class B Warrants had been exercised at December 31, 2005.

Stock Warrants

On June 30, 2003, the Company issued warrants to purchase an aggregate one million common shares of the Company at an exercise price of \$1.25 per share to Hartford Life, the ceding company under the Company's then largest guaranteed minimum death benefit reinsurance agreement. The warrants were issued in connection with the recapture of that agreement and expire on June 30, 2013, and are currently exercisable. At June 30, 2003, the fair value of these warrants, using a Black-Scholes pricing model, was estimated at \$1,250,000, which was included in a charge associated with the recapture that the Company recorded during 2003. The expense of issuing these warrants is presented as Stock warrants in the stockholders' equity section of the Company's consolidated balance sheet as at December 31, 2005.

In connection with the recapture of the Company's GMDB/GMIB reinsurance agreement with CIGNA on October 26, 2004, the Company issued CIGNA a warrant dated as of September 30, 2004 to acquire one million common shares of the Company at an exercise price of \$1.00 per share. The warrant expires on September 30, 2014 and is currently exercisable. At September 30, 2004, the fair value of this warrant, using a Black-Scholes pricing model, was estimated at \$100,000, which was included in a charge associated with the recapture that the Company recorded during the third quarter of 2004 as a component of claim and policy benefits expense. The expense of issuing this warrant is presented as stock warrants in the stockholders' equity section of the Company's consolidated balance sheet at December 31, 2005.

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8 - Loss Per Common Share

As of December 31, 2005 and 2004 the Company had 407,702 and 719,035 stock options outstanding, respectively. There were Class A and Class B warrants outstanding representing the right to acquire 3,556,317 shares and 3,689,713 shares as of December 31, 2005 and 2004, respectively.

The calculation of the diluted loss per common share does not include the incremental number of shares from the assumed exercise of options and warrants because their inclusion would be anti-dilutive.

NOTE 9 - Agreements with Related Parties

Michael P. Esposito, Jr., a director of the Company, currently serves as the non-executive Chairman of the Board of XL Capital Ltd (“XL Capital”). Robert M. Lichten, a director of the Company until his retirement on December 1, 2005, serves as a director of a United States-based subsidiary of XL Capital. XL Capital is a major stockholder of the Company.

NOTE 10 - Compensation Plans

Stock Option Plan

In 1998, the Board of Directors adopted a Stock Option Plan (the “Plan”) under which it may grant, subject to certain restrictions, Incentive Stock Options (“ISO’s”) and Non-Qualified Stock Options (“NQSO’s”). The aggregate number of common shares for which options may be granted under the Plan was initially limited to 1,552,500 common shares. In 1999, the Plan was amended such that options may be granted in any fiscal year equal to not more than 2% of the adjusted average of the outstanding common shares of the Company, as that number is determined by the Company to calculate diluted earnings per share. Only eligible employees of the Company are entitled to ISO’s, while NQSO’s may be granted to eligible employees, non-employee directors and consultants. The Board of Directors administers the Plan.

The term of the options granted under the Plan will not be more than ten years from the date of grant. Unless otherwise provided in the option agreement related to a specific grant, options granted under the Plan will be exercisable in three equal annual installments, commencing on the first anniversary of the grant date.

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 10 - Compensation Plans, continued

Stock Option Plan, continued

Each person who becomes an eligible non-employee director, as defined in the plan, is automatically granted an option to purchase 15,000 common shares on the date he or she becomes an eligible non-employee director. These options have an exercise price equal to the greater of par value per common share or the fair market value of the common shares on the date the options are granted and are exercisable in three equal annual installments commencing with the first anniversary of the grant date. In addition, prior to 2006 and subject to certain conditions, each non-employee director was automatically granted an option to purchase 5,000 common shares at each successive annual general meeting. These options had an exercise price equal to the greater of fair market value of the optioned common shares on the date the options were granted or par value and are immediately exercisable if granted after April 8, 1999.

	2005		2004	
	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Outstanding at beginning of year	719,035	\$10.38	955,869	\$13.03
Granted	15,000	1.00	50,000	1.00
Exercised	(250,000)	1.00	--	--
Forfeitures	<u>(76,333)</u>	<u>(19.58)</u>	<u>(286,834)</u>	<u>(17.92)</u>
Outstanding at end of year	<u>407,702</u>	<u>\$14.08</u>	<u>719,035</u>	<u>\$10.38</u>

At December 31, 2005, options to acquire 387,702 common shares were exercisable. The weighted average remaining contractual life of these exercisable options was approximately 5 years.

The following table summarizes information about the Company's stock options for options outstanding and exercisable as of December 31, 2005:

Range of Exercise Prices	Options Outstanding			Options Exercisable		
	Number of options	Average Remaining Contractual Life	Average Exercise Price	Number of options	Average Exercise Price	
\$ 1.00	122,500	\$8.26	\$ 1.10	102,500	\$ 1.09	
15.00	197,202	4.01	15.91	197,202	15.91	
20.13	25,500	3.76	21.41	25,500	21.41	
27.75	15,000	4.32	27.79	15,000	27.79	
<u>28.50</u>	<u>47,500</u>	<u>5.69</u>	<u>31.71</u>	<u>47,500</u>	<u>31.71</u>	
<u>\$ 1.00</u>	<u>407,702</u>	<u>\$5.48</u>	<u>\$14.08</u>	<u>387,702</u>	<u>\$14.75</u>	

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 10 - Compensation Plans, continued

Stock Option Plan, continued

On January 1, 2003, the Company voluntarily adopted the fair value based method of accounting for stock-based employee compensation under the prospective method described in SFAS No. 148. Under this method, the Company applies fair value accounting to all grants of employee stock options subsequent to December 31, 2002. Based on the vesting of the options granted, and offset partially by cancellations of options, the Company recorded stock-based compensation expense of approximately \$137,000 and \$80,000 in 2005 and 2004, respectively. Unamortized stock-based compensation expense at December 31, 2005 amounted to \$22,800 and will be amortized over the remaining vesting period and is reflected as unamortized stock-based compensation. The fair value of stock options awarded to employees and new directors will be amortized into income over the three-year vesting period. The fair value of stock options awarded to all other directors will be expensed immediately as their options are exercisable on the day of grant and vest upon their award.

Restricted Stock Plan

In 2002, the Board of Directors adopted a Restricted Stock Plan (the "Restricted Stock Plan") under which it may grant common shares to key employees. The aggregate number of common shares that may be granted under the Restricted Stock Plan is 1,200,000, and the Compensation Committee of the Board of Directors administers the Restricted Stock Plan. Since the Restricted Stock Plan inception, the Company has issued 976,000 shares of restricted stock. As a result of certain employees terminating their employment with the Company, 115,667 shares of restricted stock were cancelled in 2004 and 21,667 shares of restricted stock were cancelled in 2005. Also, 60,833 shares of restricted stock vested in 2004 prior to certain employees terminating their employment with the Company. Effective with the execution of the Separation Agreement with John F. Burke, the Company's former CEO, there were 66,667 restricted common shares that became immediately vested on September 23, 2005 which would have otherwise vested in 2006.

As of December 31, 2005, there remain no outstanding restricted common shares. The Company believes that the transactions executed by the Master Agreement fell within the scope of the definition of "Change of Control" under the equity incentive plan pursuant to which these restricted shares were granted. As a consequence, 78,334 unvested restricted common shares that would have otherwise vested on June 25, 2006, vested immediately upon the consummation of the transactions under the Master Agreement. The fair value as determined at the date of grant of the restricted stock awards that were outstanding on December 31, 2005 was zero and is reflected in the Company's balance sheet as common shares and additional paid-in-capital. The fair value of the outstanding restricted stock was being amortized on a straight-line basis over the three-year vesting period. Based on the vesting of the restricted stock, and offset partially by cancellations of restricted stock, approximately \$303,000 and \$216,000 was recorded as an expense during the years ended December 31, 2005 and 2004, respectively. The unamortized balance of outstanding restricted stock is reflected in the balance sheet as a component of unamortized stock based compensation and was zero at December 31, 2005 and approximately \$334,000 at December 31, 2004.

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 11 - Retrocession Agreements

As a result of the transaction with the Wilton Subsidiaries described in Note 3, the Company novated or co-insured 100% of its remaining assumed reinsurance in force risks. With respect to the co-insured treaties, the Company has a retrocession agreement that generally enables it to limit the amount of life reinsurance it retained to \$1,000,000 per single life. The contract was automatic and effective for risks assumed and in force from January 1, 1997. At December 31, 2005 and 2004, the Company had ceded approximately \$200 million and \$342 million of in force insurance coverage, respectively, to other reinsurers. Total amounts of \$104,000 and \$102,000 were recoverable from reinsurers at December 31, 2005 and 2004, respectively, and were recorded in other reinsurance receivables on the Company's balance sheets. The amount of in force co-insured to the Wilton Subsidiaries at December 31, 2005 was \$387.9 million. The Company recorded a reserve credit of \$1,331,000 on this business.

Prior to its acquisition by Annuity and Life Re America, Inc. on June 1, 2000, the in force insurance business of Capitol Bankers Life Insurance Company was 100% reinsured with its former owner, Reassure America Life Insurance Company ("Reassure"), a subsidiary of Swiss Reinsurance Company, who continues to administer the business reinsured. The amounts related to the reinsured business are included on the Company's consolidated balance sheet in assets as receivable for reinsurance ceded and with an offsetting liability equal to the same amount. At December 31, 2005 and 2004, these amounts were \$76.1 million and \$82.2 million, respectively. Capital Bankers Life Insurance Company was renamed Annuity and Life Reassurance America, Inc. in December 2000.

Retrocession agreements do not relieve the Company from its obligations to its ceding companies and failure of the Company's reinsurers to honor their obligations could result in losses to the Company. The Company evaluates the financial condition of its reinsurers and monitors any concentrations of credit risk that may develop to minimize its exposure. The parties to the retrocession agreements described above have a current credit rating at December 31, 2005 and 2004 of A- or better, as assigned by A.M. Best.

NOTE 12 - Contingencies

The Company is subject to contingencies for amounts that may be due under previously terminated or recaptured reinsurance agreements relating to deaths that occurred prior to such terminations or recaptures. The Company is also liable for obligations that have been 100% reinsured with third parties in the event the reinsurer is unable or unwilling to pay its obligations.

The Company has continuing obligations under employment agreements with certain of its employees, including obligations to make severance payments under certain circumstances. The amount of funds that may be available for distribution from its subsidiaries to the Company and its stockholders will also likely be limited by continuing regulatory requirements and policyholder obligations that will remain following the Closing Date (Note 3) and normal working capital requirements.

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 12 - Contingencies, continued

The Master Agreement includes mutual indemnification provisions covering, among other things, all costs and expenses arising or resulting from any breach of any representation or warranty, any breach of any covenant and certain excluded liabilities. The Company's liability if a breach of the Master Agreement occurs is the costs and expenses greater than \$25,000 up to a maximum of \$2,000,000. In accordance with the Master Agreement, the Company's two operating subsidiaries are required to maintain statutory capital and surplus of at least \$2,000,000 for 18 months following the Closing Date, and the Company has agreed not to take any action that would reduce the statutory capital and surplus of these subsidiaries below such levels.

As described in Note 3, the Company and Transamerica entered into a Novation Agreement to novate the Company's reinsurance contracts with F&G and Scottish Re to Transamerica effective December 31, 2004. In accordance with the terms of the Novation Agreement, the Company and Transamerica have been in discussions regarding possible adjustments to the policy benefit reserves transferred to Transamerica as part of the F&G novation. On March 30, 2005, the Company received a demand letter from Transamerica stating that \$7,000,000 was owed to Transamerica as an adjustment to the F&G policy benefit reserves. On June 14, 2005, the Company received an additional letter from Transamerica revising its original demand to \$6,000,000. The Company and Transamerica were unable to resolve the issues through negotiations and the matter is now in arbitration. Transamerica is seeking to rescind the Novation Agreement or recover damages and interest. The Company believes Transamerica's position is without merit and is working with counsel in presenting its position to the arbitration panel. It is not known when the arbitration process will conclude or what impact the outcome will have on the financial position of the Company.

The United States Internal Revenue Service ("IRS") has conducted an audit of the Company's United States operating subsidiaries. These subsidiaries currently have a significant tax based net operating loss carry forward. In addition, the IRS has requested certain information and documents related to the Company's Bermuda operations. While the Company's United States operating subsidiaries have complied with the IRS' requests for information, both the Company and its Bermuda operating subsidiary have declined to supply the IRS with certain information in response to its initial requests for information on May 7, 2002 and July 1, 2002. The Company did provide the IRS with certain publicly available information in addition to minutes of the Board of Directors meetings and committee meetings held from 1999 through to 2001. The Company has not received any additional requests for information since July 1, 2002. If the IRS were to determine that the Company or its Bermuda operating subsidiary were engaged in business in the United States, those entities could be subject to United States tax at regular corporate rates on their taxable income that is attributable to a permanent establishment, if any, in the United States plus an additional 30% "branch profits" tax on such income remaining after the regular tax. Such taxes would have a material effect on the Company's results of operations and financial condition.

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 13 - Vulnerability Due to Concentrations

As discussed in Note 11, 100% of Annuity and Life Reassurance America's life and annuity policies that were in force prior to the Company's acquisition of Capitol Bankers Life Insurance Company were reinsured with Reassure. Following the acquisition, the policies continue to be 100% reinsured with Reassure; however, Annuity and Life Reassurance America remains the primary carrier. Reassure is required to indemnify Annuity and Life Reassurance America for any losses associated with these policies. However, Annuity and Life Reassurance America, Inc. is not discharged from its primary liability as the direct insurer of the risks reinsured should Reassure default on its obligations. Reserves ceded under its reinsurance agreement amounted to approximately \$76.1 million and \$82.2 million at December 31, 2005 and December 31, 2004, respectively, which are included in "reserves for future policy benefits". As of December 31, 2005, Reassure is rated A+ (g) (superior) by A.M. Best.

NOTE 14 - Fair Value of Financial Instruments

The following discussion outlines the methodologies and assumptions used to determine the estimated fair value of the Company's financial instruments. Considerable judgment is required to develop these fair values. Accordingly, the estimates shown are not necessarily indicative of the amounts that would be realized in a one-time, current market exchange of all of the Company's financial instruments.

Fixed Income Securities

Fair values for fixed income securities are based on quoted market prices, where available. For fixed income securities not actively traded, fair values are estimated using values obtained from independent pricing services.

Cash and Cash Equivalents

The carrying value of assets classified as cash and cash equivalents approximates fair value.

Embedded Derivatives

At December 31, 2005, the Company no longer has any modified coinsurance annuity reinsurance agreements and therefore no embedded derivative required bifurcation and no separate accounting under SFAS No. 133 — Accounting for Derivative Instruments and Hedging Activities was required. The valuation of an embedded derivative required cash flow modeling that used various assumptions regarding future cash flows under the agreement. The fair value of this embedded derivative was zero and approximately \$(5,609,000) at December 31, 2005 and 2004, respectively and was reported as a component of Funds withheld at interest.

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 14 - Fair Value of Financial Instruments, continued

Other Items

Fair value disclosures are not required for reinsurance balances recoverable, deferred policy acquisition costs, or liabilities arising from insurance and annuity contracts. As a result, the Company has not determined such disclosures. Fair values of other assets and liabilities approximate their carrying values due to their short-term nature.

NOTE 15 - Segments

The Company separately tracks financial results of its life and annuity operations in segments. Each segment is defined by a dominant risk characteristic inherent in all products in that segment. The life segment consists of all products where the dominant risk characteristic is mortality risk. The annuity segment comprises all products where the dominant risk characteristic is investment risk, including those products which provide minimum guarantees on variable annuity products. Certain of the Company's modified coinsurance and coinsurance funds withheld annuity reinsurance agreements have features that constitute embedded derivatives that require bifurcation and separate accounting under SFAS No. 133 — Accounting for Derivative Instruments and Hedging Activities; the change in the fair value of these embedded derivatives since that date are included in the annuity segment.

Both the life and annuity segments have specific assets, liabilities, stockholders' equity, revenue, benefits and expenses that apply only to them. The corporate segment contains all stockholders' equity not otherwise deployed to the life or annuity segment. In addition, the corporate segment includes all capital gains and losses from sales of securities in the Company's portfolio and investment income on undeployed invested assets. Operating expenses are generally allocated to the segments proportionately based upon the amount of stockholders' equity deployed to the segment. Costs associated with the Company's efforts to raise capital and pursue other strategic alternatives and the costs of settling the stockholder class action lawsuit have been completely allocated to the corporate segment. Due to the transfer of the Company's remaining life and annuity reinsurance treaties to the Wilton Subsidiaries in 2005, the Company will cease to track the financial results of its operations in segments in future periods.

2005	Life Reinsurance	Annuity Reinsurance	Corporate	Consolidated
Revenues	\$ 9,709,362	\$6,324,915	\$ 2,448,970	\$ 18,483,247
Expenses	<u>21,961,540</u>	<u>3,203,425</u>	<u>11,943,259</u>	<u>37,108,224</u>
Net (Loss) Income	<u>\$ (12,252,178)</u>	<u>\$3,121,490</u>	<u>\$ (9,494,289)</u>	<u>\$ (18,624,977)</u>
Total Assets	<u>\$112,147,896</u>	<u>\$ --</u>	<u>\$50,244,053</u>	<u>\$162,391,949</u>

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 15 – Segments, continued

2004	Life Reinsurance	Annuity Reinsurance	Corporate	Consolidated
Revenues	\$ 50,153,025	\$23,847,196	\$ 3,091,345	\$ 77,091,566
Expenses	<u>50,271,120</u>	<u>83,505,926</u>	<u>11,275,015</u>	<u>145,052,061</u>
Loss before cumulative effect of a change in accounting principle	(118,095)	(59,658,730)	(8,183,670)	(67,960,495)
Cumulative effect of a change in accounting principle	<u>--</u>	<u>(365,960)</u>	<u>--</u>	<u>(365,960)</u>
Net Loss	<u>\$ (118,095)</u>	<u>\$(60,024,690)</u>	<u>\$ (8,183,670)</u>	<u>\$(68,326,455)</u>
Total Assets	<u>\$163,747,140</u>	<u>\$ 59,554,009</u>	<u>\$66,104,207</u>	<u>\$289,405,356</u>
	Life Scottish Re and F&G Novations	Annuity Transamerica Recapture	Corporate	Consolidated
Deferred policy acquisition costs	\$(24,929,642)	\$ (63,083,919)	\$ --	\$ (88,013,561)
Funds held at interest	--	(522,778,128)	--	(522,778,128)
Reserves for future policy benefits	36,854,506	--	--	36,854,506
Interest sensitive contract liabilities	--	545,810,176	--	545,810,176
Other reinsurance liabilities	<u>(18,500,000)</u>	<u>(14,000,000)</u>	<u>--</u>	<u>(32,500,000)</u>
Net non-cash elements of the Transamerica recapture and novation transaction	<u>\$ (6,575,136)</u>	<u>\$ (54,051,871)</u>	<u>\$ --</u>	<u>\$ (60,627,007)</u>

NOTE 16 - Taxation

The effective tax rate provided for in the financial statements is computed at a rate of zero. A substantial portion of the Company's operations is based in Bermuda and as a result income is exempt from taxation.

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 16 - Taxation, continued

Under current Bermuda law, there is no income or capital gains tax payable by the Company or Annuity and Life Reassurance. The Company and Annuity and Life Reassurance have received from the Bermuda Minister of Finance, under The Exempted Undertakings Tax Protection Act 1966 of Bermuda, assurances to the effect that in the event of there being enacted by Bermuda any legislation imposing tax computed on profits or income, or computed on any capital asset, gain or appreciation, or any tax in the nature of estate duty or inheritance tax, then the imposition of any such tax shall not be applicable to them or to any of their respective operations or to their shares, debentures or other obligations until March 28, 2016. This is not to be construed so as to prevent the application of any tax or duty to such persons as are ordinarily resident in Bermuda or to prevent the application of any tax payable in accordance with the provisions of The Land Tax Act 1967 of Bermuda or otherwise payable in relation to any property leased to the Company or its Bermuda subsidiary.

Annuity and Life Re America and Annuity and Life Reassurance America, the Company's United States operating subsidiaries, are subject to all applicable Federal and State taxes of the United States. U.S. income taxes applicable to the Company's U.S. operations are not material to the consolidated financial statements and, therefore, no separate item appears in the consolidated statement of operations or the consolidated balance sheet.

No deferred tax asset or liability related to operations has been recognized. Stand alone net operating results for the Company's U.S. operations for the year ended 2005 and 2004 was a loss of \$10,610,000 and \$610,000, respectively. The tax basis net operating loss carry forward at December 31, 2005 was \$9,661,000, which begins expiring in 2015. The Company does not expect that its future taxable net income will be sufficient to offset its deferred tax asset within a reasonable time period. The Company's deferred tax asset is primarily the result of net operating loss carry forwards. Therefore, the Company has established valuation allowances of \$7,376,969 and \$3,672,000 at December 31, 2005 and 2004, respectively, against its deferred tax asset.

Subsequent to the Effective Date of Master Agreement described in Note 3, the Company has no reinsurance treaties in force that generate operating revenue. As a result, there may be tax consequences to stockholders that are US taxpayers. Those consequences include, but are not limited to, taxes, tax penalties, and certain elections required or imposed for an investment in a Passive Foreign Investment Company.

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 17 - Statutory Requirements and Dividend Restrictions

The Company and Annuity and Life Reassurance are required to comply with the provisions of the Companies Act that regulate the payment of dividends and the making of distributions from contributed surplus. Neither the Company nor Annuity and Life Reassurance may declare or pay a dividend, or make a distribution out of contributed surplus, if there are reasonable grounds for believing that: (i) the relevant company is, or would be after the payment, unable to pay its liabilities as they become due; or (ii) the realizable value of the relevant company's assets would thereby be less than the aggregate of its liabilities and its issued share capital and share premium accounts. As of and since December 31, 2002, the Company has not declared a dividend. The Company's ability to pay dividends depends on the ability of its operating subsidiaries to pay dividends to the Company, which may be subject to regulatory constraints that affect their ability to pay dividends to the Company.

As a long-term insurer, Annuity and Life Reassurance must maintain long-term business assets of a value of at least \$250,000 greater than its long-term business liabilities. Annuity and Life Reassurance is prohibited from declaring or paying dividends unless the value of its long-term business assets exceed the amount of its long-term business liabilities (as certified by an approved actuary), by the amount of the dividend and by at least \$250,000. Additionally, the amounts of any such dividend must not exceed the aggregate of that excess and other funds properly available for the payment of dividends, including funds arising out of its business aside from its long-term business. Any dividends paid out of contributed capital and in excess of 15% of the prior year's stockholders' equity must be approved by the Bermuda Monetary Authority.

Annuity and Life Reassurance America, Inc. is subject to statutory regulations of the state of Connecticut in the United States that restrict the payment of dividends. It may not pay dividends in any 12-month period in excess of the greater of the statutory net gain from operations for the immediately preceding calendar year excluding pro rata distributions of any class of Annuity and Life Reassurance America's securities or 10% of Annuity and Life Reassurance America's statutory surplus as regards policyholders as of the immediately preceding December 31 at the end of the preceding year, without regulatory approval. Connecticut regulations also require that dividends be paid from earned surplus unless prior regulatory approval is granted. At December 31, 2005, the statutory capital and surplus of Annuity and Life Reassurance America was \$11,547,180 (unaudited).

NOTE 18 - Subsequent Events

On February 2, 2006, the Company announced that it was filing a Form 15 with the Securities and Exchange Commission ("SEC"). The effect of this filing was to terminate the Company's reporting obligations under the Securities Exchange Act of 1934 and to terminate the registration of its common stock.

ANNUITY AND LIFE RE (HOLDINGS), LTD.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 18 - Subsequent Events, continued

Under the SEC's rules, a company with fewer than 300 record holders may voluntarily terminate the registration of its securities by filing a Form 15 with the SEC. The Company currently has fewer than 300 record holders. Under the Form 15, the Company's reporting obligations were terminated immediately upon the filing of the Form 15. The Company also anticipates, but cannot guarantee, that its shares will continue to trade on the over-the-counter market and be quoted in the Pink Sheets' quotation system under the trading symbol ANNRF.PK.

