NLV Financial Corporation and Subsidiaries

Financial Statements

As of and for the Years Ended
December 31, 2017 and 2016

NLV Financial Corporation and Subsidiaries
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December 31, 2017 and 2016

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Report of Independent Auditors

To the Board of Directors of NLV Financial Corporation:

We have audited the accompanying consolidated financial statements of NLV Financial Corporation and its subsidiaries, which comprise the consolidated balance sheets as of December 31, 2017 and 2016, and the related consolidated statements of comprehensive income, of changes in stockholder's equity and of cash flows for each of the three years in the period ended December 31, 2017.

Management's Responsibility for the Consolidated Financial Statements

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

Auditors' Responsibility

Our responsibility is to express an opinion on the consolidated 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 consolidated financial statements are free from material misstatement.

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of NLV Financial Corporation and its subsidiaries as of December 31, 2017 and 2016, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2017 in accordance with accounting principles generally accepted in the United States of America.

PricewaterhouseCoopers LLP

February 22, 2018

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NLV Financial Corporation and Subsidiaries
Consolidated Balance Sheets
As of December 31, 2017 and 2016

(in thousands)	**2017**	**2016**
Assets:		
Cash and investments:		
Available-for-sale debt securities	**$ 20,048,333**	$ 18,165,166
Available-for-sale equity securities	**35,839**	60,142
Trading equity securities	**19,812**	14,764
Mortgage loans	**3,350,570**	3,205,842
Policy loans	**877,927**	838,541
Real estate investments	**24,465**	31,354
Derivative assets	**993,249**	824,214
Other invested assets	**960,415**	853,171
Short term investments	**228,480**	202,424
Cash and restricted cash	**284,070**	244,500
Total cash and investments	**26,823,160**	24,440,118
Deferred policy acquisition costs	**1,539,129**	1,512,211
Accrued investment income	**217,982**	208,048
Premiums and fees receivable	**22,577**	19,449
Amounts recoverable from reinsurers	**122,889**	147,489
Present value of future profits of insurance acquired	**—**	6,642
Property and equipment, net	**153,110**	186,268
Corporate owned life insurance	**420,069**	273,706
Other assets	**94,611**	132,290
Separate account assets	**814,928**	733,099
Total assets	**$ 30,208,455**	$ 27,659,320
Liabilities:		
Policy liabilities:		
Policy benefit liabilities	**$ 4,408,663**	$ 4,408,994
Policyholder account liabilities	**19,485,437**	17,679,354
Policyholders' deposits	**97,900**	89,115
Policy claims payable	**68,645**	100,487
Policyholders' dividends and dividend obligations	**184,931**	145,147
Total policy liabilities	**24,245,576**	22,423,097
Amounts payable to reinsurers	**23,457**	25,891
Derivative liabilities	**566,986**	489,398
Other liabilities and accrued expenses	**682,703**	543,880
Pension and other post-retirement benefit obligations	**194,257**	202,152
Deferred income taxes	**181,517**	231,439
Federal income tax payable	**66,109**	18,201
Debt	**452,638**	453,610
Separate account liabilities	**814,928**	733,099
Total liabilities	**$ 27,228,171**	$ 25,120,767
Stockholder's equity:		
Class A common stock, 2,000 shares authorized, no shares issued and outstanding	**$ —**	$ —
Class B common stock, par value of $0.01, 1,001 shares authorized, 100 shares issued and outstanding	**—**	—
Preferred stock, 500 shares authorized, no shares issued and outstanding	**—**	—
Retained earnings	**2,591,881**	2,399,476
Accumulated other comprehensive income	**388,403**	139,077
Total stockholder's equity	**$ 2,980,284**	$ 2,538,553
Total liabilities and stockholder's equity	**$ 30,208,455**	$ 27,659,320

The accompanying notes are an integral part of these financial statements.

NLV Financial Corporation and Subsidiaries
Consolidated Statements of Comprehensive Income
For the Years Ended December 31, 2017, 2016 and 2015

(in thousands)	**2017**	**2016**	**2015**
Revenues:			
Insurance premiums	**$ 220,629**	$ 218,435	$ 227,547
Policy and contract charges	**564,064**	503,559	445,899
Mutual fund commissions and fee income	**85,453**	92,351	100,826
Net investment income	**1,415,211**	1,154,842	925,208
Net realized capital gains (losses)	**(37,439)**	(7,460)	(8,581)
Change in value of trading equity securities	**1,136**	425	(1,130)
Other income	**25,844**	26,678	16,661
Total revenues	**2,274,898**	1,988,830	1,706,430
Benefits and expenses:			
Decrease in policy liabilities	**(21,468)**	(72,264)	(1,720)
Policy benefits	**474,918**	533,071	440,896
Policyholders' dividends and dividend obligations	**57,144**	58,089	64,289
Interest credited to policyholder account liabilities	**819,837**	679,079	427,754
Operating expenses	**316,377**	302,128	274,790
Interest expense	**39,620**	39,305	40,149
Policy acquisition expenses and amortization of present value of future profits, net	**378,714**	232,354	309,024
Total benefits and expenses	**2,065,142**	1,771,762	1,555,182
Income before income taxes	**209,756**	217,068	151,248
Income tax expense (benefit)	**(50,182)**	61,000	41,944
Net income	**$ 259,938**	$ 156,068	$ 109,304
Other comprehensive income (loss), net of tax:			
Unrealized gains (losses) on available-for-sale investments	**263,789**	106,164	(258,047)
Cash flow hedge on debt issuance	**(80)**	34	34
Change in funded status of retirement plans	**(14,383)**	6,304	14,917
Total other comprehensive income (loss)	**249,326**	112,502	(243,096)
Comprehensive income (loss)	**$ 509,264**	$ 268,570	$ (133,792)

The accompanying notes are an integral part of these financial statements.

NLV Financial Corporation and Subsidiaries
Consolidated Statements of Changes in Stockholder's Equity
For the Years Ended December 31, 2017, 2016, and 2015

(in thousands)	Class A Common Stock	Class B Common Stock	Preferred Stock	Retained Earnings	Accumulated Other Comprehensive Income	Total
December 31, 2014	$ —	$ —	$ —	$ 2,134,104	$ 269,671	$ 2,403,775
Net income	—	—	—	109,304	—	109,304
Other comprehensive income (loss)	—	—	—	—	(243,096)	(243,096)
Total comprehensive income (loss)						(133,792)
December 31, 2015	—	—	—	2,243,408	26,575	2,269,983
Net income	—	—	—	156,068	—	156,068
Other comprehensive income (loss)	—	—	—	—	112,502	112,502
Total comprehensive income (loss)						268,570
December 31, 2016	—	—	—	**2,399,476**	**139,077**	**2,538,553**
Net income	—	—	—	**259,938**	**—**	**259,938**
Other comprehensive income (loss)	—	—	—	**—**	**181,793**	**181,793**
Effect of change in tax rate on accumulated other comprehensive income	—	—	—	**(67,533)**	**67,533**	**—**
Total comprehensive income (loss)						**441,731**
December 31, 2017	**$ —**	**$ —**	**$ —**	**$ 2,591,881**	**$ 388,403**	**$ 2,980,284**

The accompanying notes are an integral part of these financial statements.

NLV Financial Corporation and Subsidiaries
Consolidated Statements of Cash Flows
For the Years Ended December 31, 2017, 2016, and 2015

(in thousands)	**2017**	**2016**	**2015**
Cash flows from operating activities:			
Net income	**$ 259,938**	$ 156,068	$ 109,304
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for deferred income taxes	**(145,808)**	20,320	29,663
Interest credited to policyholder account liabilities	**819,837**	679,079	427,754
Amortization of deferred policy acquisition costs	**265,002**	129,733	202,049
Policy and contract charges	**(564,064)**	(503,559)	(445,899)
Net realized capital losses	**37,439**	7,460	8,581
Change in fair value of derivatives	**(335,329)**	(122,093)	79,606
Change in corporate owned life insurance policies	**(6,363)**	(5,591)	(7,156)
Amortization of present value of future profits of insurance acquired	**6,642**	3,108	3,485
Depreciation	**28,478**	28,242	24,694
Other	**(22,529)**	(10,625)	(9,040)
Changes in assets and liabilities:			
Accrued investment income	**(9,935)**	(9,023)	(14,148)
Deferred policy acquisition costs	**(417,730)**	(371,790)	(318,636)
Policy liabilities	**80,165**	85,138	67,769
Other assets and liabilities	**64,795**	(37,326)	6,973
Net cash provided by operating activities	**60,538**	49,141	164,999
Cash flows from investing activities:			
Proceeds from sales, maturities and repayments of investments	**3,255,054**	3,403,072	3,272,590
Cost of investments acquired	**(4,582,323)**	(4,990,900)	(4,613,227)
Property and equipment additions	**(38,414)**	(41,980)	(40,036)
Cost of corporate owned life insurance acquired	**(140,000)**	—	(15,934)
Change in policy loans	**(39,386)**	(15,084)	(14,858)
Change in short term investments	**(26,056)**	41,619	26,277
Change in short term broker collateral	**113,506**	55,650	(145,130)
Other	**(12,256)**	(9,468)	(33,898)
Net cash used by investing activities	**(1,469,875)**	(1,557,091)	(1,564,216)
Cash flows from financing activities:			
Policyholders' deposits	**2,333,006**	2,105,604	1,823,046
Policyholders' withdrawals	**(1,153,580)**	(1,103,703)	(1,017,670)
Advances from Federal Home Loan Banks	**325,579**	606,936	610,770
Repayments to Federal Home Loan Banks	**(79,510)**	—	(100,000)
Debt retirement	**(1,995)**	—	(15,079)
Change in other deposits	**25,407**	2,445	(19,134)
Net cash provided by financing activities	**1,448,907**	1,611,282	1,281,933
Net increase (decrease) in cash	**39,570**	103,332	(117,284)
Cash and restricted cash:			
Beginning of year	**244,500**	141,168	258,452
End of year	**$ 284,070**	$ 244,500	$ 141,168
Supplemental disclosure of cash flow information:			
Interest paid	**$ 39,320**	$ 38,898	$ 40,421
Income taxes paid (received)	**$ 23,789**	$ 3,554	(18,645)

The accompanying notes are an integral part of these financial statements.

NOTE 1 – NATURE OF OPERATIONS AND STRUCTURE

NLV Financial Corporation (“NLVF”) and its subsidiaries and affiliates (collectively, the “Company”) offer a broad range of financial products and services, including life insurance, annuities, mutual funds, and investment advisory and administrative services. The flagship company of the organization, National Life Insurance Company (“National Life”), was chartered in 1848. The Company employs approximately 1,050 people, primarily concentrated in Montpelier, Vermont and Addison, Texas. Life Insurance Company of the Southwest (“LSW”), a Texas domiciled stock life insurer, is a wholly owned subsidiary of National Life. National Life, together with LSW, makes up NLVF’s insurance operations.

On January 1, 1999, pursuant to a mutual holding company reorganization, National Life converted from a mutual to a stock life insurance company. Concurrent with the conversion to a stock life insurance company, National Life created a closed block of insurance and annuity policies (the “Closed Block”). Prior to the conversion, policyowners held policy contractual and membership rights from National Life. The reference to “policyowner,” “policyholder” or “policy” throughout this document includes both life insurance and annuity contract owners. The contractual rights, as defined in the various insurance and annuity policies, remained with National Life after the conversion. This reorganization was approved by policyowners of National Life and was completed with the approval of the Commissioner of the Vermont Department of Financial Regulation. Membership interests held by policyowners of National Life at December 31, 1998, were converted to membership interests in NLHC, a mutual insurance holding Company created for this purpose. Under the provisions of the reorganization of National Life from a mutual to a stock life insurance company, National Life issued 2.5 million common stock $1 par shares to its parent, NLVF, as a transfer from retained earnings.

All of National Life’s outstanding shares are currently held by its parent, NLVF, which is a wholly-owned subsidiary of National Life Holding Company (“NLHC”), the mutual holding company. Policyholders of National Life hold membership interests in NLHC. NLHC and its subsidiaries are collectively known as the National Life Group. NLHC has ownership of all of NLVF’s common stock class B shares outstanding. NLVF has assets and operations primarily related to the issuance of debt and as the sponsor of certain employee related benefit plans. Under the terms of the reorganization, NLHC must always hold a majority of the voting shares of NLVF.

On March 6, 2015, National Life Distribution, LLC (“NLD”) was formed as a subsidiary of LSW. NLD serves as a master agency for National Life Group’s field force operations. The life companies incur commission expenses based on applicable product commission schedules agreed to with NLD.

On August 5, 2015, Catamount Reinsurance Company (“Catamount”) was formed as a subsidiary of National Life. Catamount is a special purpose financial insurance company domiciled in the state of Vermont. Catamount entered into a coinsurance with funds withheld agreement with National Life to reinsure the majority of in force Closed Block policies for statutory reporting. In 2016, the Catamount legal entity was transferred as a dividend to NLVF.

On August 17, 2016, Longhorn Reinsurance Company (“Longhorn”) was formed as a subsidiary of National Life. Longhorn is a special purpose financial insurance company domiciled in the state of Vermont. Longhorn entered into a coinsurance with funds withheld agreement with LSW to reinsure certain indexed universal life (“IUL”) insurance policies issued by LSW from January 1, 2011 through December 31, 2015. Effective October 1, 2017, Longhorn reinsured additional IUL policies issued by LSW from January 1, 2016 through December 31, 2016.

NOTE 1 – NATURE OF OPERATIONS AND STRUCTURE (continued)

The Company's insurance operations principally develop and distribute individual life insurance and annuity products. The Company markets this diverse product portfolio to small business owners, professionals, and other middle to upper income individuals. The Company provides financial solutions in the form of estate, business succession and retirement planning, and deferred compensation and other key executive benefit planning. Insurance and annuity products are primarily distributed through a number of general agencies and branch offices in major metropolitan areas and a system of marketing general agents and independent marketing organizations throughout the United States of America. The Company has in excess of 844,000 policyholders and, through its subsidiaries, is licensed to do insurance business in all 50 states and the District of Columbia. National Life is licensed to do business in all 50 states and the District of Columbia. LSW is licensed in 49 states and the District of Columbia. Catamount and Longhorn are licensed to do business in Vermont only. About 39% of the Company's total collected premiums and deposits are from residents of the states of California and Texas.

Prior to October 27, 2017, the Company also distributed and provided investment advisory and administrative services to the Sentinel Group Funds, Inc. ("Sentinel Funds") through Sentinel Asset Management, Inc. ("SAMI") and its subsidiaries. On October 27, 2017, the Company executed the sale of certain assets under management, related to the investment advisory and investment management services provided to the mutual fund business, to Touchstone Investments, a subsidiary of Western & Southern Financial Group. The results of operations of this mutual fund business were included in the Company's statements of comprehensive income, change in shareholder's equity and cash flows through the date of the sale. A pre-tax gain on the sale of $9.4 million was recorded in realized capital gains (losses), which included the disposal of $49.5 million of goodwill and intangibles associated with the mutual fund business. The final amount of gain recognized will include adjustments in future periods that are contingent upon the level of the assets under management at specified future dates.

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation and Principles of Consolidation

The Company's consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America ("U.S. GAAP").

The consolidated financial statements of the Company include the accounts of NLVF and its direct and indirect subsidiaries. Intercompany transactions and balances have been eliminated in consolidation.

Certain reclassifications have been made to conform prior periods to the current year's presentation.

Use of Estimates

The preparation of U.S. GAAP financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Use of Estimates (continued)

The most significant estimates include those used in determining estimated gross profits used in the valuation and amortization of assets and liabilities associated with variable annuity and universal life-type insurance contracts; policy liabilities; valuation of investments; derivative instruments; and embedded derivatives; determination of hedging effectiveness on interest rate swaps; evaluation of other-than-temporary impairments; valuations related to benefit plans, income taxes and litigation and regulatory contingencies. Certain of these estimates are particularly sensitive to market conditions, and deterioration and/or volatility in the debt or equity markets could have a material impact on the Company's consolidated financial position, results of operations or cash flows.

Subsequent Events

The Company has evaluated events subsequent to December 31, 2017 and through the consolidated financial statement issuance date of February 22, 2018. The Company has not evaluated subsequent events after the issuance date for presentation in these consolidated financial statements.

Cash and Restricted Cash

Included in cash are cash equivalents which consist of commercial paper with maturities of three months or less.

At December 31, 2017 and 2016, the Company had restricted cash of $241.4 million and $135.4 million, respectively, related to broker collateral on the Company's derivative investments.

Short Term Investments

Short term investments include money market accounts that are carried at amortized cost which approximates fair value. These short term investments include liquid debt instruments purchased with original maturities of one year or less.

Investments

The Company's investment portfolio consists primarily of available-for-sale ("AFS") debt and equity securities. These securities are reported at fair value. Changes in the fair values of AFS debt and equity securities are reflected in other comprehensive income ("OCI") after adjustments for related deferred policy acquisition costs, policyholder dividend obligations, loss reserve recognition, reserves, and deferred income taxes. When determining fair value, the Company utilizes observable market inputs and considers available data from a third party pricing service, independent brokers and pricing matrices. Publicly available prices are used whenever possible. In the event that publicly available pricing is not available, the securities are submitted to independent brokers for pricing, or they are valued using a pricing matrix, which maximizes the use of observable inputs that include, but are not limited to, reported trades, benchmark yields, issuer spreads, bids, offers and/or cash flows. The Company periodically performs an analysis on prices received from third parties to ensure that the price represents fair value. This process includes quantitative and qualitative analysis and is performed by the Company's investment professionals.

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Recognition and Presentation of Other-Than-Temporary Impairments

The evaluation of securities for impairment is a quantitative and qualitative process, which is subject to risks and uncertainties and is intended to determine whether declines in fair value of investments should be recognized in current period earnings and whether the securities are other-than-temporarily impaired (“OTTI”). The risks and uncertainties include changes in general economic conditions, the issuer’s financial condition and/or future prospects, the effects of changes in interest rates or credit spreads and the expected recovery period. The Company has a security monitoring process overseen by investment and accounting professionals to identify securities, using certain quantitative and qualitative characteristics, that could potentially be impaired. These identified securities are subjected to an enhanced analysis to determine if the impairments are other-than-temporary.

A debt security is deemed to be other-than-temporarily impaired if it meets the following conditions: (1) the Company intends to sell, or it is more likely than not the Company will be required to sell, the security before a recovery in value, or (2) the Company does not expect to recover the entire amortized cost basis of the security. If the Company intends to sell, or it is more likely than not that the Company will be required to sell, the security before a recovery in fair value, a charge is recorded in net realized capital losses equal to the difference between the fair value and amortized cost basis of the security. For those other-than-temporarily impaired debt securities which do not meet the first condition and for which the Company does not expect to recover the entire amortized cost basis, the difference between the security’s amortized cost basis and the fair value is separated into the portion representing a credit impairment, which is recorded in net realized capital losses, and the remaining impairment, which is recorded in OCI. Generally, the Company determines a security’s credit impairment as the difference between its amortized cost basis and its best estimate of expected future cash flows discounted at the security’s effective yield prior to impairment. The remaining non-credit impairment, which is recorded in OCI, is the difference between the security’s fair value and the Company’s best estimate of expected future cash flows discounted at the security’s effective yield prior to the impairment. The remaining non-credit impairment typically represents current market liquidity, risk premiums, and interest rate fluctuations. The previous amortized cost basis less the impairment recognized in net realized capital losses becomes the security’s new cost basis.

Debt securities that are in an unrealized loss position are reviewed quarterly to determine if the decline in fair value would be considered other-than-temporary based on certain quantitative and qualitative factors. The primary factors considered in evaluating whether a decline in value is other-than-temporary include: (a) the length of time and extent to which the fair value has been less than cost or amortized cost and the expected recovery period of the security, (b) the financial condition, credit rating, and future prospects of the issuer, (c) whether the debtor is current on contractually obligated interest and principal payments, (d) the intent and ability of the Company not to sell the investment prior to anticipated recovery, and (e) the payment structure of the security.

For mortgage-backed or other collateralized structured debt securities, the Company considers factors including, but not limited to, commercial and residential property value declines that vary by property type and location, and average cumulative collateral loss rates that vary by vintage year. These assumptions require the use of significant management judgment and include the probability of issuer default and estimates regarding timing and amount of expected recoveries, which may include estimating the underlying collateral value. In addition, projections of expected future debt security cash flows may change based upon the new information regarding the performance of the issuer and/or underlying collateral such as changes in the projections of the underlying property value estimates.

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Recognition and Presentation of Other-Than-Temporary Impairments (continued)

The Company's best estimate of future cash flows involves assumptions including, but not limited to, various performance indicators, such as historical and projected default and recovery rates, credit ratings, current delinquency rates, loan-to-value ratios and the possibility of obligor re-financing. Estimating the underlying future cash flows is a quantitative and qualitative process, which incorporates information received from third-party sources along with certain internal assumptions and judgments regarding the future performance of the underlying collateral. Where possible, this data is benchmarked against third party sources.

For those equity securities where the decline in the fair value is deemed to be other-than-temporary, a charge is recorded in net realized capital losses equal to the difference between the fair value and cost basis of the security. The primary factors considered in evaluating whether an other-than-temporary impairment exists for an equity security include, but are not limited to: (a) the length of time and extent to which the fair value has been less than the cost of the security, (b) changes in the financial condition, credit rating and near-term prospects of the issuer, (c) whether there has been a reduction or elimination of dividends, (d) the intent and ability of the Company to hold the investment until an anticipated recovery, and (e) losses from the security that were recorded subsequent to the reporting period.

Trading Equity Securities

Trading equity securities are reported at fair value. Realized and unrealized gains (losses) on trading equity securities are included in change in fair value of trading equity securities within the Consolidated Statements of Comprehensive Income.

Mortgage Loans

Mortgage loans on commercial real estate are carried at amortized cost less a valuation allowance for probable losses on unidentified loans. The evaluation and assessment of the adequacy of the provision for losses and the need for mortgage impairments is based on known and inherent risks in the portfolio, adverse situations that may affect the borrowers' ability to repay, the value of the underlying collateral, composition of the loan portfolio, current economic conditions, loss experience and other relevant factors. These assumptions require the use of significant management judgment and include the probability and timing of borrower default and loss frequency and severity estimates. Changes in the valuation allowance are recognized through net realized capital gains (losses).

For mortgage loans that are deemed impaired, an impairment loss is recognized through net realized capital gains (losses) as the difference between the carrying amount and the Company's share of either (a) the present value of the expected future cash flows discounted at the loan's original effective interest rate, (b) the loan's observable market price or (c) the fair value of the collateral. Interest income on an impaired loan is accrued to the extent it is deemed collectable and the loan continues to perform under its original or restructured terms. Interest income on defaulted loans is recognized when received.

Policy Loans

Policy loans are reported at their unpaid balance and are fully collateralized by related cash surrender values.

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Real Estate

Real estate acquired in satisfaction of debt is classified either as held for investment or available for sale, and transferred to real estate at the lower of cost or fair value. Real estate investments held for investment purposes are reported at depreciated cost and real estate investments classified as held for sale are reported at the lower of cost or fair value, less the costs to sell, and are not depreciated. In evaluating real estate impairments, the Company considers, among other things, the fair value of the real estate compared to its carrying value.

Limited Partnerships

Investments in limited partnerships are included in other invested assets. Partnerships over which the Company does not have significant influence are carried at fair value. The Company obtains the fair value of these investments generally from net asset value ("NAV") information provided by the general partner or manager of the limited partnership, the financial statements of which generally are audited annually. Other-than-temporary impairments are recorded in net realized investment gains (losses) if the present value of future earnings is projected to be less than the carrying value of the investment. Changes in the fair value of these limited partnerships are included in change in unrealized gains and losses on available-for-sale investments, net of related deferred income taxes, within other comprehensive income. Limited partnerships over which the Company has significant influence are accounted for using the equity method. Under the equity method, the Company's pro-rata share of the partnerships' profits and losses are recognized in the Company's net investment income, and dividends received from the partnerships are recognized as return of capital up until the point that the initial investment has been fully recovered.

Investments in limited partnerships over which the Company does not have significant influence are reviewed quarterly to determine if a decline in fair value is other-than-temporary in nature. The selection of partnership investments to review for other-than-temporary declines is qualitative and quantitative in nature and based on many factors, including the severity and duration of the decline as well as qualitative information about the underlying investments. If a decline in fair value of a limited partnership is determined to be other-than-temporary, the value of the investment is reduced to its fair value, which becomes its new cost basis, through net realized capital losses. To determine fair value, the Company reviews, among other things, the underlying assets of the fund or partnership to determine the expected realizable value, which requires significant management judgment.

Other Invested Assets

The Company receives U.S. Treasuries as broker collateral on the Company's derivative investments. These assets are considered restricted and are included in other invested assets. The Company held $175.4 million and $174.8 million in Treasury securities as broker collateral as of December 31, 2017 and 2016, respectively. The Company also receives cash as broker collateral. For additional information, see Cash and Restricted Cash herein.

Derivatives

Derivatives include long options, short options, swaptions, interest rate swaps, and futures contracts. All derivatives are carried at fair value. Changes in the fair value of derivatives not designated as hedges are reflected in net investment income.

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Derivatives (continued)

The Company designates certain interest rate swaps as fair value hedges when they have met the requirements to be deemed fair value hedges. The interest rate swaps that are designated as fair value hedges are used to convert fixed rate assets to floating rate. The Company recognizes unrealized and realized gains and losses on the swaps and on the related hedged items within net investment income. For additional information, see Note 5.

Affordable Housing Tax Credits

The Company's investments in affordable housing projects are included in other invested assets and are amortized using the proportional amortization method within income tax expense. The associated tax credits are also included as a component of income tax expense. For additional information, see Note 8.

Realized Gains and Losses

Realized capital gains (losses) are recognized using the specific identification method and are reported on a net basis. Net realized capital gains (losses) include adjustments for related deferred policy acquisition costs, sales inducement assets, reserves, policyholder dividend obligations, and income taxes.

Accumulated Other Comprehensive Income ("AOCI")

The balance of and changes in each component of AOCI attributable to the Company for the years ended December 31 are as follows (in thousands):

	Unrealized gains (losses) on available-for-sale investments	Cash flow hedge on debt issuances	Change in funded status of retirement plans	Total
Balance, December 31, 2015	$ 125,249	$ (594)	$ (98,080)	$ 26,575
Other comprehensive income before reclassifications	102,824	34	(308)	102,550
Amounts reclassified from AOCI	3,340	—	6,612	9,952
Balance, December 31, 2016	$ 231,413	$ (560)	$ (91,776)	$ 139,077
Other comprehensive income before reclassifications	**263,018**	**(80)**	**(22,470)**	**240,468**
Amounts reclassified from AOCI	**771**	**—**	**8,087**	**8,858**
Balance, December 31, 2017	**$ 495,202**	**$ (640)**	**$ (106,159)**	**$ 388,403**

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Accumulated Other Comprehensive Income (continued)

Reclassifications out of AOCI during the year ended December 31, 2017 were as follows (in thousands):

AOCI component	**Amounts reclassified out of AOCI (1)**	**Affected line item in the Consolidated Statements of Comprehensive Income**
Unrealized gains (losses) on available-for-sale investments	**$ 10,739**	Sale of investments - in net realized capital gains/(losses)
	(11,715)	Impairment expense - in net realized capital gains/(losses)
	$ (976)	Total before tax
	205	Income tax expense
	(771)	Net of tax
Change in funded status of retirement plans (2)	**$ (10,236)**	Amortization of actuarial gain/(loss) - in operating expenses
	2,149	Income tax expense
	(8,087)	Net of tax
Total reclassifications for the period	**$ (8,858)**	Net of tax

(1) Positive amounts indicate gains/benefits reclassified out of AOCI. Negative amounts indicate losses/costs reclassified out of AOCI.
(2) These AOCI components are included in the computation of net periodic pension cost (see Note 9 for additional details).

Reclassifications out of AOCI during the year ended December 31, 2016 were as follows (in thousands):

AOCI component	Amounts reclassified out of AOCI (1)	Affected line item in the Consolidated Statements of Comprehensive Income
Unrealized gains (losses) on available-for-sale investments	$ 17,156	Sale of investments - in net realized capital gains/(losses)
	(22,295)	Impairment expense - in net realized capital gains/(losses)
	$ (5,139)	Total before tax
	1,799	Income tax expense
	(3,340)	Net of tax
Change in funded status of retirement plans (2)	$ (10,172)	Amortization of actuarial gain/(loss) - in operating expenses
	3,560	Income tax expense
	(6,612)	Net of tax
Total reclassifications for the period	$ (9,952)	Net of tax

(1) Positive amounts indicate gains/benefits reclassified out of AOCI. Negative amounts indicate losses/costs reclassified out of AOCI.
(2) These AOCI components are included in the computation of net periodic pension cost (see Note 9 for additional details).

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Federal Home Loan Banks

National Life is a member of the Federal Home Loan Bank of Boston (“FHLB Boston”) which provides National Life with access to a secured asset-based borrowing capacity of $1.5 billion, in total, as of December 31, 2017. National Life had a letter of credit of $110.0 million as of December 31, 2017 and 2016, and pledged collateral of $281.0 million and $243.8 million as of December 31, 2017 and 2016, respectively. Outstanding advances under this program were $102.1 million as of December 31, 2017 and 2016. The membership requires an investment in the common stock of FHLB Boston. National Life had an investment in the common stock of FHLB Boston of $9.4 million and $9.6 million as of December 31, 2017 and 2016, respectively. The common stock is redeemable by FHLB Boston. It is considered restricted and is reported in other invested assets at par value.

LSW is a member of the Federal Home Loan Bank of Dallas (“FHLB Dallas”) which provides LSW with access to a secured asset-based borrowing capacity of $4.1 billion as of December 31, 2017. LSW had pledged collateral of $1.53 billion and $1.23 billion as of December 31, 2017 and 2016, respectively. Outstanding advances under this program were $1.4 billion and $1.2 billion as of December 31, 2017 and 2016, respectively. The membership requires an investment in the common stock of FHLB Dallas. LSW had an investment in the common stock of FHLB Dallas of $59.5 million and $48.2 million as of December 31, 2017 and 2016, respectively. The common stock is redeemable by FHLB Dallas. It is considered restricted and is reported in other invested assets at par value.

All of the outstanding advances are in the form of funding agreements and included in policyholder account liabilities. The proceeds from these advances have been invested in a pool of fixed and floating rate income assets. Total interest expense of $1.1 million, $0.6 million, and $1.7 million was paid to FHLB Boston in 2017, 2016, and 2015, respectively. Total interest expense of $13.3 million, $5.0 million, and $0.8 million was paid to FHLB Dallas in 2017, 2016 and 2015, respectively.

No advances were repaid to FHLB Boston in 2017 and 2016. LSW repaid advances to FHLB Dallas of $79.5 million in 2017 and made no repayments in 2016.

Policy Acquisition Expenses

Commissions and other costs that are related directly to the successful acquisition of new or renewal insurance contracts are eligible to be deferred. Deferred policy acquisition costs (“DAC”) for participating life insurance, universal life insurance, and annuities are amortized in relation to estimated gross profits. Amortization is adjusted retrospectively for actual experience and when estimates of future gross profits are revised. Deferred policy acquisition costs for these products are adjusted for related unrealized gains (losses) on available-for-sale debt and equity securities (after deducting any related policyholder dividend obligations) through OCI, net of related deferred income taxes. DAC for non-participating term and whole life insurance and participating limited-payment and single-payment life insurance is amortized in relation to premium income using assumptions consistent with those used in computing policy benefit liabilities.

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Policy Acquisition Expenses (continued)

At least annually, the Company reviews long-term assumptions underlying the projections of estimated gross profits and its calculation of the recoverability of DAC balances. These assumptions include changes in projected investment rates, interest crediting rates, policyholder dividend rates, mortality, expenses, contract lapses, withdrawals, surrenders and amortization period. The adjustments to DAC to reflect the update of the actuarial assumptions in 2017 and 2016 resulted in a net increase to policy acquisition expenses of $6.4 million and a net decrease of $84.9 million, respectively. The update of actuarial assumptions also resulted in, to a lesser extent, adjustments to sales inducement assets and liabilities and policy liabilities.

The Company offers various sales incentives including bonus interest credited on its annuity products at the point of sale, as well as higher interest crediting rates in the first policy year. The Company capitalizes and amortizes these sales inducements to the extent they are explicitly identified in the contract at inception, incremental to amounts credited on similar contracts without bonus interest, and higher than the contract's expected ongoing crediting rates for periods after the bonus period. Sales inducement assets are reported within DAC and are amortized based on the underlying gross profits of the products, with amortization adjusted periodically to reflect actual experience, as well as updates to assumptions for future estimated gross profits.

For internal replacements of insurance contracts, the Company determines whether the new contract has substantially changed from the original contract based on certain criteria such as whether the change requires additional underwriting, pricing that was not contemplated in the original contract or significant benefit changes. If the Company determines that the contract has substantially changed, the deferred acquisition costs related to the original contract are written off through a charge to policy acquisition expenses.

Goodwill and Other Intangible Assets

Goodwill and other intangible assets with indefinite useful lives are reviewed for impairment on an annual basis, or more frequently if circumstances indicate that a possible impairment has occurred. The assessment for impairment begins with a qualitative determination of factors that could indicate that an impairment is more likely than not to exist. If it is deemed that an impairment is more likely than not to exist, then a quantitative assessment is completed. The quantitative impairment testing is performed using the fair value approach, which requires the use of estimates and judgment at the reporting unit or intangible asset level. The determination of a reporting unit's fair value is based on management's best estimate, which generally considers market-based earnings and revenue multiples of the unit's peer companies as well as a discounted cash flow analysis. If the carrying value of a reporting unit or intangible asset exceeds its fair value, an impairment is recognized as a charge against income equal to the excess of the carrying value of goodwill or intangible asset over its fair value. For further information on goodwill and other intangible assets, see Note 10.

Property and Equipment

Property and equipment is reported at depreciated cost. Assets are depreciated over their useful life using the straight-line method of depreciation. The table below outlines the useful life for each asset class:

Asset Class	Years
Software	5
Equipment	5
Furniture	7
Renovations/semi-permanent fixtures	20
Home office/other buildings	40

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Property and Equipment (continued)

The tables below reflect the cost and accumulated depreciation for each major asset class as of December 31, 2017 and 2016 (in millions):

	December 31, 2017		
	Cost	**Accumulated Depreciation**	**Carrying Value**
Software	**$ 222.2**	**$ (128.9)**	**$ 93.3**
Equipment	**38.6**	**(29.0)**	**9.6**
Furniture	**23.5**	**(13.8)**	**9.7**
Renovations	**13.1**	**(3.2)**	**9.9**
Home office	**92.8**	**(62.2)**	**30.6**
	$ 390.2	**$ (237.1)**	**$ 153.1**

	December 31, 2016		
	Cost	Accumulated Depreciation	Carrying Value
Software	$ 250.7	$ (124.6)	$ 126.1
Equipment	36.2	(26.7)	9.5
Furniture	34.7	(24.6)	10.1
Renovations	12.5	(2.5)	10.0
Home office	90.1	(59.6)	30.5
	$ 424.2	$ (238.0)	$ 186.2

Depreciation expense recognized in operating expenses was $31.0 million, $29.8 million, and $24.3 million for the years ended December 31, 2017, 2016, and 2015, respectively. In 2017, the Company recognized impairments on certain software investments totaling $40.7 million. The most significant of these were related to the development of a policy administration system, which the Company decided in 2017 to abandon because it was not expected to provide substantive additional service potential commensurate with its cost. The system is no longer used for new business, and remaining in-force policies will be transferred to an existing policy administrative platform in 2018. The remaining impairments recognized in 2017 were related to projects where there had been a significant change in the extent or manner in which the software was expected to be used. The impairment loss was included in net realized capital gains (losses). No impairments were recognized in 2016 or 2015.

Corporate Owned Life Insurance

The Company holds life insurance contracts on certain members of management and other key individuals. During 2017, the Company expanded its Corporate Owned Life Insurance (“COLI”) program with a new carrier by purchasing additional COLI of $140.0 million. The Company’s investment in COLI is reported at the cash surrender value of these COLI contracts, which totaled $420.1 million and $273.7 million at December 31, 2017 and 2016, respectively.

COLI income includes the net change in cash surrender value and any benefits received or accrued. COLI income was $8.9 million, $10.4 million, and $9.4 million in 2017, 2016, and 2015, respectively, and is included in other income.

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Receivable from Agents

The Company accrues receivables for any amounts due from agents. These amounts due can take various forms including commissions recoverable from policy lapses or surrenders. As of December 31, 2017 and 2016, the Company had a receivable from agents of $51.6 million and $38.3 million, respectively, which is included in other assets on the Consolidated Balance Sheets. These numbers are reported net of an accrued valuation allowance if it is deemed that amounts may not be collectible. The allowance on the receivable was $6.0 million and $6.5 million as of December 31, 2017 and 2016, respectively.

Separate Accounts

Variable products are reported within the separate accounts when investment risk is borne by the policyholder, investment income and investment gains and losses accrue directly to the policyholder, and the separate account meets additional accounting criteria to qualify for separate account treatment. The assets supporting the variable portion of variable annuity and variable universal life contracts that qualify for separate account treatment are carried at fair value and reported as separate account assets, with an equivalent summary total reported as separate account liabilities. Liabilities for minimum guaranteed benefits related to separate account policies are included in policy liabilities. Separate account results related to policyholders' interests are excluded from the Company's consolidated results of operations.

The assets of the Company's separately funded pension plans are held in the Company's separate accounts at fair value.

Policy Liabilities

Policy benefit liabilities for participating life insurance are developed using the net level premium method, with interest and mortality assumptions used in calculating policy cash surrender values. Participating life insurance terminal dividend reserves are accrued in relation to gross profits, and are included in policy benefit liabilities. The average investment yield used in estimating gross profits for participating contracts was 4.63% and 4.76% as of December 31, 2017 and 2016, respectively.

Policy benefit liabilities for non-participating life insurance, disability income insurance, and certain annuities are developed using the net level premium method with assumptions for interest, mortality, morbidity, and voluntary terminations. In addition, disability income policy benefit liabilities include provisions for future claim administration expenses.

Policyholder account liabilities for non-indexed universal life insurance and investment-type annuities represent amounts that inure to the benefit of the policyholders before surrender charges. Policyholder account liabilities for indexed life insurance and annuity liabilities consist of a combination of underlying account value and embedded derivatives, which are carried at fair value with the change in fair value recorded through interest credited to policyholder account liabilities. The underlying account value is primarily based on the initial deposit plus any interest credited. The embedded derivative component is based on the fair value of expected participation through interest crediting in future increases in the S&P 500, Russell 2000 or MSCI Emerging Markets indexes.

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Policy Liabilities (continued)

The fair value of the embedded derivative component includes assumptions about future interest rates and interest rate structures, future costs for options used to hedge the contract obligations, projected withdrawal and surrender activity, the level and limits on contract participation in any future increases in the S&P 500, Russell 2000 or MSCI Emerging Markets indexes, and an explicit risk margin for variance of policyholder behavior along with the associated impact the Company's own credit rating would have in the view of a market participant.

The guaranteed minimum interest rates for the Company's fixed interest rate annuities range from 0.25% to 4.5%. The guaranteed minimum interest rates for the Company's fixed interest rate universal life insurance policies range from 1.0% to 5.0%. These guaranteed minimum rates are before deduction for any policy administration fees or mortality charges.

As part of the Company's annual actuarial assumption update certain assumptions were revised including premium persistency, investment income, mortality, pricing, and lapse and surrender rates in various blocks of business, which resulted in a $4.1 million increase and $66.6 million decrease in policy liabilities as of December 31, 2017 and 2016, respectively.

The Company tests reserves for any premium deficiency using best estimate assumptions. If a deficiency is found to exist, an additional reserve is typically recorded. In 2015, due to changes in the mortality tables, the Company increased the reserve to $15.1 million as of December 31, 2015. There were no increases to the premium deficiency reserve in 2017 or 2016. The Company also tests reserves for adequacy assuming that all unrealized gains (losses) on investments are realized, and posts shadow reserves for any deficiency. As of December 31, 2017 and 2016, the shadow loss reserve was $8.3 million and $(6.9) million, respectively.

The Company also held a shadow reserve related to its Guaranteed Lifetime Income Rider in policyholder account liabilities of $78.3 million and $40.0 million, as of December 31, 2017 and 2016. The change in this shadow reserve is recorded in unrealized gains (losses) on available-for-sale investments within other comprehensive income. The net impact to accumulated other comprehensive income after shadow DAC and tax offsets was $32.9 million and $16.9 million as of December 31, 2017 and 2016, respectively. The liability for such guaranteed benefits included in policyholder account liabilities excluding the shadow reserve was $511.6 million and $367.9 million as of December 31, 2017 and 2016, respectively.

Reserves are established, as appropriate, for separate account product guarantees. These reserves, which are not significant, are primarily related to guaranteed minimum death benefits on variable annuities equal to the amount of premiums paid less prior withdrawals (regardless of investment performance). In addition, a policyholder less than seventy-six years of age may elect, at issue, to purchase an enhanced death benefit rider, which pays a benefit on death equal to the sum of the highest prior anniversary value and the net of premiums received and funds withdrawn since that date. Coverage from this rider ceases at age eighty. Guaranteed death benefits are reduced dollar-for-dollar for partial withdrawals, which increases the risk profile of this benefit. Partial withdrawals from policies issued after November 1, 2003 will use the pro-rata method. Separate account product guarantee reserves are calculated as a percentage of collected mortality and expense risk and rider charges, with the current period change in reserves reported in policy benefits.

The Company offers persistency bonuses on certain products, whereby policyholders can receive additional interest credits by maintaining their policy in force for predetermined durations. These additional interest credits are accrued ratably over the bonus period and adjusted for actual persistency.

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Policy Liabilities (continued)

The components of the sales inducement liability ("SIL") are shown below (in thousands), and are included in policy liabilities:

	SIL	
	2017	2016
Beginning of year	**$ 66,782**	$ 44,897
Increase (decrease) due to interest, amortization and assumption updates	**14,735**	25,359
Payments	**(4,827)**	(3,474)
End of year	**$ 76,690**	$ 66,782

Reinsurance

Amounts recoverable from and payable to reinsurers are estimated in a manner consistent with the related liabilities associated with the reinsured policies. Reinsurance premiums and benefits paid or provided are accounted for on bases consistent with those used in accounting for the original policies issued and the terms of the reinsurance contracts.

Policyholders' Deposits

Policyholders' deposits primarily consist of death benefits held in interest-bearing accounts for life insurance contract beneficiaries.

Policyholders' Dividends and Dividend Obligations

Policyholders' dividends consist of the pro-rata amount of dividends earned that will be paid or credited at the next policy anniversary and policyholder dividend obligations arising from the Closed Block. Dividends are based on a scale that seeks to reflect the relative contribution of each group of policies to LSW's and National Life's overall operating results. The dividend scale is approved annually by the Board of Directors for the respective company.

Recognition of Insurance Revenues and Related Expenses

Premiums from traditional life insurance products, including term and whole life, and from certain annuities are recognized as revenue when due from the policyholder. Benefits and expenses are matched with income by providing for policy benefit liabilities and the deferral and amortization of policy acquisition costs so as to recognize profits over the life of the policies.

Premiums and surrenders from universal life insurance and investment-type annuities are reported as increases and decreases, respectively, in policyholder account liabilities. Revenues for these policies consist of mortality charges, policy administration fees, and surrender charges deducted from policyholder account liabilities. Policy benefits charged to expense include benefit claims in excess of related policyholder account liabilities.

Premiums from disability income policies are recognized as revenue over the period to which the premiums relate. Benefits and expenses are matched with income by providing for policy benefit liabilities and the deferral and amortization of policy acquisition costs so as to recognize profits over the life of the policies.

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Federal Income Taxes

The Company files a consolidated tax return. Current federal income taxes are charged or credited to operations based upon amounts estimated to be payable or recoverable as a result of taxable operations for the current year. Deferred income tax assets and liabilities are recognized based on temporary differences between financial statement carrying amounts and income tax bases of assets and liabilities using enacted income tax rates and laws.

Effective December 22, 2017, the U.S. enacted the Tax Cuts and Jobs Act (“Tax Reform”) into law. Under U.S. GAAP, the effects of changes in tax rates and laws are recognized in the period in which the new legislation is enacted. As a result, the Company recorded a one-time decrease in Federal income tax expense of $119.7 million, due to a re-measurement of net deferred tax liabilities resulting from the decrease in the Federal corporate income tax rate from 35% to 21%. The Company elected to adopt Accounting Standards Update (“ASU”) 2018-05 *Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income* (“ASU 2018-05”) in 2017. As permitted under ASU 2018-05, the portion of this decrease in tax expense attributable to the reduction in deferred tax liabilities related to unrealized gains (losses) was reflected in the Statement of Changes in Shareholder’s Equity as a reclassification of $67.5 million from retained earnings to accumulated other comprehensive income.

NOTE 3 – NEW ACCOUNTING PRONOUNCEMENTS

Adopted

Going Concern
In August 2014, the Financial Accounting Standards Board (“FASB”) issued ASU 2014-15, *Presentation of Financial Statements—Going Concern (Subtopic 205-40).* This update was issued to provide guidance about management’s responsibility to evaluate whether there is substantial doubt about an entity’s ability to continue as a going concern and to provide related footnote disclosures. If substantial doubt exists, certain disclosures are required. The pronouncement was effective for fiscal years ending after December 15, 2016. The adoption of this standard did not have a material effect on the Company’s consolidated financial condition, results of operations or cash flows.

Investments
In May 2015, the FASB issued ASU 2015-07, *Fair Value Measurement (Topic 820): Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or its Equivalent).* The guidance removes the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the practical expedient of net asset value per share. It also changes the requirement for disclosure of all investments eligible to be measured using the practical expedient, and now requires disclosure only for those investments which have been so measured. For public entities, the pronouncement was effective for fiscal years beginning after December 15, 2015, and for non-public entities, it was effective for fiscal years beginning after December 15, 2016. The guidance was applied retrospectively. The Company has updated its fair value disclosures to conform to the new guidance.

NOTE 3 – NEW ACCOUNTING PRONOUNCEMENTS (continued)

Adopted (continued)

Equity Method

In March 2016, the FASB issued ASU 2016-07, *Investments—Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting*. The guidance eliminates the requirement for retroactive adjustment upon qualifying for the equity method. For all entities, the pronouncement was effective for fiscal years beginning after December 15, 2016. No additional disclosures were required at transition. The adoption of this standard did not have a material effect on the Company's consolidated financial condition, results of operations or cash flows.

Reclassification of Certain Tax Effects from AOCI

In February 2018, the FASB issued ASU 2018-05. This guidance allows a reclassification from AOCI to retained earnings for stranded tax effects resulting from the newly enacted federal corporate income tax rates. For both public and non-public entities, the pronouncement is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted. The Company has elected to early adopt and implement this guidance in 2017 (see Note 2 which describes the impact of this guidance on the Company's financial statements).

Not Yet Adopted

Revenue Recognition

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606).* The objective of the amendments in this ASU is to clarify the principles for recognizing revenue and to develop a common revenue standard for U.S. GAAP and International Financial Reporting Standards (IFRS) to improve comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets and provide more useful information to users of financial statements through improved disclosure requirements. Insurance contracts are specifically excluded from the guidance, but it is applicable to the Company's non-insurance revenues. In August 2015, the FASB issued ASU 2015-14 which deferred the effective date of ASU 2014-09 for public entities to fiscal years beginning after December 15, 2017, and for non-public entities to fiscal years beginning after December 15, 2018. The adoption of this standard is not expected to have a material effect on the Company's consolidated financial condition, results of operations or cash flows.

Financial Assets and Liabilities

In January 2016, the FASB issued ASU 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*. The guidance requires several changes to equity investment reporting. For public entities, the pronouncement is effective for fiscal years beginning after December 15, 2017, and for non-public entities, it is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted for non-public entities starting with fiscal years beginning after December 15, 2017. The Company is currently assessing the impact the implementation of this guidance will have on its consolidated financial statements.

NOTE 3 – NEW ACCOUNTING PRONOUNCEMENTS (continued)

Not Yet Adopted (continued)

Leases

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)* which requires lease assets and lease liabilities to be recognized on the balance sheet, and key information about leasing arrangements to be disclosed. For public entities, the pronouncement is effective for fiscal years beginning after December 15, 2018, and for non-public entities, it is effective for fiscal years beginning after December 15, 2019. Early application is permitted. The adoption of this standard is not expected to have a material effect on the Company's consolidated financial condition, results of operations or cash flows.

Derivatives and Hedging - Novation

In March 2016, the FASB issued ASU 2016-05, *Derivatives and Hedging (Topic 815): Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships*. The guidance clarifies that a change in the counterparty to a derivative designated as a hedging instrument does not require de-designation of that hedging relationship, provided that all other hedge accounting criteria continue to be met. For public entities, the pronouncement is effective for fiscal years beginning after December 15, 2016, and for non-public entities, it is effective for fiscal years beginning after December 15, 2017. The adoption of this standard is not expected to have a material effect on the Company's consolidated financial condition, results of operations or cash flows.

Derivatives and Hedging – Debt Call Options

In March 2016, the FASB issued ASU 2016-06, *Derivatives and Hedging (Topic 815): Contingent Put and Call Options in Debt Instruments*. The guidance clarifies the requirements for assessing whether contingent call (put) options that can accelerate the payment of principal on debt instruments are clearly and closely related to their debt hosts. The guidance now requires only the four-step decision sequence, rather than including other analysis of indexing. For public entities, the pronouncement is effective for years beginning after December 15, 2016, and for non-public entities, the pronouncement is effective for fiscal years beginning after December 15, 2017. The Company is currently assessing the impact the implementation of this guidance will have on its consolidated financial statements.

Credit Losses

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. The guidance requires financial assets not reported at fair value to be presented at the amount expected to be collected, rather than only reporting losses probable of occurring. For public entities, the pronouncement is effective for fiscal years beginning after December 15, 2019, and for non-public entities, the pronouncement is effective for fiscal years beginning after December 15, 2020. Early application is permitted for fiscal years beginning after December 15, 2018. This guidance will be applied through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective. A prospective transition approach is required for debt securities for which an other-than-temporary impairment had been recognized before the effective date. The Company is currently assessing the impact the implementation of this guidance will have on its consolidated financial statements.

NOTE 3 – NEW ACCOUNTING PRONOUNCEMENTS (continued)

Not Yet Adopted (continued)

Cash Flow Statement

In August 2016, the FASB issued ASU 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments*. The guidance addresses eight specific cash flow issues such as debt prepayment and distributions received from equity method investees. For public entities, the pronouncement is effective for fiscal years beginning after December 15, 2017, and for non-public entities, the pronouncement is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted. An entity that elects early adoption must adopt all of the amendments in the same period. The amendments should be applied using a retrospective transition method to each period presented. If this is impracticable, then the amendments should be applied prospectively as of the earliest date practicable. The Company is currently assessing the impact the implementation of this guidance will have on its consolidated financial statements.

Financial Instruments

In January 2016, the FASB issued ASU 2016-01 *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities.* This guidance requires most equity investments to be recorded at fair value through net income. For public entities, the pronouncement is effective for fiscal years beginning after December 15, 2017. For non-public entities, the pronouncement is effective for fiscal years beginning after December 15, 2018. Early adoption is generally not permitted, with certain exceptions. The Company is currently assessing the impact the implementation of this guidance will have on its consolidated financial statements.

Compensation – Retirement Plans

In March 2017, the FASB issued ASU 2017-07, *Compensation – Retirement Plans (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost.* The guidance requires that an employer disaggregate the service cost component from the other components of net benefit cost. For public entities, the pronouncement is effective for fiscal years beginning after December 15, 2017, and for non-public entities, the pronouncement is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted. The amendments should be applied retrospectively for the presentation of the service cost component and the other components of net periodic pension cost and net periodic postretirement cost in the income statement, and prospectively, on and after the effective date, for the capitalization of the service cost component of net periodic pension cost and net periodic postretirement benefit in assets. The Company is currently assessing the impact the implementation of this guidance will have on its consolidated financial statements.

Receivables

In March 2017, the FASB issued ASU 2017-08 *Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities.* This guidance shortens the amortization period for certain callable debt securities held at a premium. For public entities, the pronouncement is effective for fiscal years beginning after December 15, 2018. For non-public entities, the pronouncement is effective for fiscal years beginning after December 15, 2020. Early adoption is permitted. The amendments should be applied on a modified retrospective basis. The Company is currently assessing the impact the implementation of this guidance will have on its consolidated financial statements.

NOTE 3 – NEW ACCOUNTING PRONOUNCEMENTS (continued)

<u>Not Yet Adopted (continued)</u>

Business Combinations
In January 2017, the FASB issued ASU 2017-01 *Business Combinations (Topic 805): Clarifying the Definition of a Business.* This guidance provides the requirements needed to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. For public entities, the pronouncement is effective for fiscal years beginning after December 15, 2017. For non-public entities, the pronouncement is effective for fiscal years beginning after December 15, 2018. The amendments should be applied prospectively on or after the effective date. The Company is currently assessing the impact the implementation of this guidance will have on its consolidated financial statements.

Derivatives and Hedging
In August 2017, the FASB issued ASU 2017-12 *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities.* This guidance simplifies the application of the hedge accounting guidance and permits entities to better align the entity's risk management activities and financial reporting for hedging relationships. For public entities, the pronouncement is effective for fiscal years beginning after December 15, 2018. For non-public entities, the pronouncement is effective for fiscal years beginning after December 15, 2019. Early application is permitted. The Company is currently assessing the timing for adoption of this standard. The adoption of this standard is not expected to have a material effect on the Company's consolidated financial condition, results of operations or cash flows.

NOTE 4 – FAIR VALUE MEASUREMENTS OF ASSETS AND LIABILITIES

The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (the exit price).

Fair value measurement requires consideration of three broad valuation techniques: (i) the market approach, (ii) the income approach, and (iii) the cost approach. Entities are required to determine the most appropriate valuation technique to use, given what is being measured and the availability of sufficient inputs. The guidance prioritizes the inputs to fair valuation techniques and allows for the use of unobservable inputs to the extent that observable inputs are not available.

The Company has categorized its assets and liabilities into a three-level hierarchy, based on the priority of the inputs to the respective valuation technique. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). The Company categorizes financial assets and liabilities recorded at fair value on the balance sheet as follows:

- **Level 1** - Unadjusted quoted prices accessible in active markets for identical assets or liabilities at the measurement date. The types of assets and liabilities utilizing Level 1 inputs include equity securities listed in active markets, U.S. Treasury securities, and certain short term investments.

NOTE 4 – FAIR VALUE MEASUREMENTS OF ASSETS AND LIABILITIES (continued)

- **Level 2** - Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly through corroboration with observable market data (market-corroborated inputs). The types of assets and liabilities utilizing Level 2 inputs generally include U.S. agency and government securities, mortgage-backed securities ("MBSs") and asset-backed securities ("ABSs"), corporate debt, private placement investments, preferred stocks, and derivatives, including options and interest rate swaps, and short term investments. Generally, the Company classifies debt securities in Level 2 as market activity is not deemed to be substantial enough to warrant classification as an active market. Separate account assets classified within this level are generally similar to those classified within this level for the general accounts.

- **Level 3** - Prices or valuation techniques that require inputs that are both unobservable and significant to the overall fair value measurement. Inputs reflect management's best estimate about the assumptions market participants would use at the measurement date in pricing the asset or liability. Consideration is given to the risk inherent in both the method of valuation and the valuation inputs. Generally, the types of assets and liabilities utilizing Level 3 valuations are embedded derivative liabilities.

In many situations, inputs used to measure the fair value of an asset or liability position may fall into different levels of the fair value hierarchy. In these situations, the Company will determine the level in which the fair value falls based upon the lowest level input that is significant to the determination of the fair value. In most cases, both observable (e.g., changes in interest rates) and unobservable (e.g., changes in risk assumptions) inputs are used in the determination of fair values that the Company has classified within Level 3. Consequently, these values and the related gains and losses are based upon both observable and unobservable inputs. If inputs to pricing models that were previously unobservable become observable, then an asset or liability can be transferred from Level 3 to Level 2.

Determination of fair values

The Company determines the fair values of certain financial assets and financial liabilities based on quoted market prices where available and where prices represent fair value. The Company also determines fair value based on future cash flows discounted at the appropriate current market rate. Fair values reflect adjustments for counterparty credit quality, the Company's default spreads, liquidity, and, where appropriate, risk margins on unobservable parameters. In the event that the Company believes that quoted prices are not representative of the true market value, due to distressed sales or inactive markets, the Company may make adjustments to quoted prices to estimate fair value.

NOTE 4 – FAIR VALUE MEASUREMENTS OF ASSETS AND LIABILITIES (continued)

Valuation Techniques

Available-for-sale debt securities and short term investments - The fair value of AFS securities and short term investments in an active and orderly market (e.g. not distressed or forced liquidation) is determined by management after considering one of four primary sources of information: unadjusted quoted prices accessible in active markets for identical assets or liabilities at the measurement date, third-party pricing services, independent broker quotations, or pricing matrices. Security pricing is applied using a "waterfall" approach whereby publicly available prices are first sought from third-party pricing services; the remaining unpriced securities are submitted to independent brokers for prices; or lastly, securities are priced using an internal pricing matrix. Typical inputs used by these three pricing methods include, but are not limited to, reported trades, benchmark yields, issuer spreads, bids, offers, and/or cash flows, and prepayments speeds. Based on the typical trading volumes and the lack of quoted market prices for fixed maturities, third-party pricing services will normally derive the security prices from recent reported trades for identical or similar securities, making adjustments through the reporting date based upon available market observable information as outlined above. If there are no recent reported trades, the third-party pricing services and brokers may use matrix or model processes to develop a security price where future cash flow expectations are developed based upon collateral performance and are then discounted at a market rate.

Prices from third-party pricing services are often unavailable for securities that are rarely traded or are traded only in privately negotiated transactions. As a result, certain securities are priced via independent broker quotations which utilize inputs that may be difficult to corroborate with observable market based data. Additionally, the majority of these independent broker quotations are non-binding. A pricing matrix is used to price securities for which the Company is unable to obtain either a price from a third-party pricing service or an independent broker quotation, by discounting the expected future cash flows from the security by a developed market discount rate utilizing current credit spreads on comparable securities.

The Company has analyzed the third-party pricing services' valuation methodologies and related inputs, and has also evaluated the various types of securities in its investment portfolio to determine an appropriate fair value hierarchy level based upon trading activity and the observability of market inputs. Money markets included in short term investments are classified into Level 1 of the fair value hierarchy. Most prices provided by a third-party pricing service are classified into Level 2 because the inputs used in pricing the securities are market observable. Due to a general lack of transparency in the process that brokers use to develop prices, valuations that are based on brokers' prices are classified as Level 3. Some valuations may be classified as Level 2 if the price can be corroborated.

Information specific to the valuation of certain classes of AFS securities is as follows:

U.S. government obligations - The fair values of U.S. government obligations, which include U.S. Treasuries, are based on observable broker bids from active market makers and inter-dealer brokers, as well as yield curves from dealers for same or comparable issues. U.S. Treasury securities are actively traded and categorized in Level 1 of the fair value hierarchy.

Government agencies - Government agencies, authorities and subdivisions securities include U.S. agencies and municipal bonds. The fair values of municipal bonds are using market quotations from recently executed transactions, spread pricing models, as well as interest rates. Government agency securities are valued based on market observable yield curves, interest rates, and spreads. Municipal bonds and government agency securities are generally categorized as Level 2.

NOTE 4 – FAIR VALUE MEASUREMENTS OF ASSETS AND LIABILITIES (continued)

Valuation Techniques (continued)

Corporates - Corporate bonds as well as ABS are valued using cash flow models based on appropriate observable inputs such as market quotes, yield curves, interest rates, and spreads and are generally categorized as Level 2.

Private placements - Fair values of private placement securities are determined using industry accepted models based on observable spreads. These securities are generally categorized in Level 2 of the fair value hierarchy. However, in instances where significant inputs are unobservable, they are categorized as Level 3.

Mortgage backed securities - The fair value of the MBS are valued using cash flow models based on appropriate observable inputs such as market quotes, yield curves, interest rates, and spreads and are generally categorized as Level 2.

Included in the pricing of ABS, commercial mortgage-backed securities ("CMBS"), and residential mortgage-backed securities ("RMBS") are estimates of the rate of future prepayments of principal over the remaining life of the securities. Such estimates are derived based on the characteristics of the underlying structure and prepayment speeds previously experienced at the interest rate levels projected for the underlying collateral. Actual prepayment experience may vary from these estimates. RMBS consist primarily of FNMA and GNMA mortgage-backed securities.

AFS equity securities - The fair value of equity securities is based on unadjusted quoted market prices from a third party pricing service as well as primary and secondary broker quotes. These securities are generally categorized in Level 1 for common stocks and Level 2 for preferred stocks. AFS equity securities that are valued using NAV as a practical expedient are not categorized in the fair value hierarchy.

Trading equity securities - Fair values of exchange traded equity securities are based on unadjusted quoted market prices from pricing services as well as primary and secondary brokers/dealers. Trading equity securities that are valued using NAV as a practical expedient are not categorized in the fair value hierarchy. All other trading equities are categorized into Level 1 of the fair value hierarchy.

Derivatives - Derivative instruments held by the Company include options, swaptions, interest rate swaps and futures contracts. Fair value of these over the counter ("OTC") derivative products is calculated using models such as the Black-Scholes option-pricing model, which uses pricing inputs observed from actively quoted markets, and is widely accepted by the financial services industry. The majority of the Company's OTC derivative products use this and other pricing models, and are categorized as Level 2. Fair values of futures are based on quoted prices which are observable and readily and regularly available in an active market. Therefore, futures are categorized as Level 1.

Other invested assets - Investments in limited partnerships are included in other invested assets. Limited partnerships do not have a readily determinable fair value, and as such, the Company values them at its pro-rata share of the limited partnership's NAV, or its equivalent. Investments in limited partnerships are not categorized in the fair value hierarchy. Also included in other invested assets are U.S. Treasuries held as restricted collateral, which are categorized as Level 1.

NOTE 4 – FAIR VALUE MEASUREMENTS OF ASSETS AND LIABILITIES (continued)

Valuation Techniques (continued)

Separate account assets - Separate account assets include assets supporting our variable products which are carried at fair value. Also included are the assets of the Company's separately funded pension plans, which are primarily comprised of bonds and common stocks. See Note 9 for additional information on the fair value hierarchy and valuation techniques for these pension plan assets. Separate account assets that are valued using NAV as a practical expedient are not categorized in the fair value hierarchy.

Policyholder account liabilities - The fair value of the embedded derivatives contained in equity-indexed annuity and life contracts are included in policyholder account liabilities. These derivatives are measured based on actuarial and capital market assumptions related to projected cash flows over the expected lives of the contracts. Option pricing models are used to estimate fair value, taking into account assumptions for future equity indexed credited rates in light of market conditions and policyholder behavior assumptions. The fair value incorporates an explicit risk margin for variance of policyholder behavior and the impact the Company's own credit rating would have in the view of a market participant. Given the significant unobservable inputs used to value embedded derivatives, they are included in Level 3.

Presented below is the fair value of all assets and liabilities subject to fair value determination as of December 31, 2017 (in thousands):

Assets	Level 1	Level 2	Level 3	Total
AFS debt and equity securities:				
U.S. government obligations	$ 265,764	$ —	$ —	$ 265,764
Government agencies, authorities and subdivisions	—	1,409,571	—	1,409,571
Corporates	—	13,397,155	—	13,397,155
Private placements	—	1,672,042	—	1,672,042
Mortgage-backed securities	—	3,303,801	—	3,303,801
Total AFS debt securities	265,764	19,782,569	—	20,048,333
Preferred stock	—	22,491	—	22,491
Common stock [2]	705	—	—	705
Total AFS equity securities	705	22,491	—	23,196
Total AFS debt and equity securities	266,469	19,805,060	—	20,071,529
Derivative assets	1,771	991,478	—	993,249
Other invested assets [2]	183,934	—	—	183,934
Separate account assets [2]	1,643	184,696	—	186,339
Total assets subject to fair value disclosure [2]	$ 453,817	$ 20,981,234	$ —	$ 21,435,051

Liabilities	Level1	Level2	Level3	Total
Policyholder account liabilities [1]	$ —	$ —	$ 2,057,471	$ 2,057,471
Derivative liabilities	—	566,986	—	566,986
Total liabilities subject to fair value disclosure	$ —	$ 566,986	$ 2,057,471	$ 2,624,457

1. The most sensitive assumption in determining policy liabilities for indexed annuities is the rate used to discount the excess projected contract values. This discount rate reflects the Company's nonperformance risk. If the discount rates used to discount the excess projected contract values at December 31, 2017 were to change by approximately 100 basis points, the fair value of the embedded derivative would change significantly with an offset to deferred policy acquisition costs.

2. In accordance with Topic 820, certain investments that are measured at fair value using NAV (or its equivalent) as a practical expedient have not been classified in the fair value hierarchy. As of December 31, 2017, the fair value of these investments in AFS common stock, trading equity securities, other invested assets, short term investments and separate account assets were $12,643, $19,812, $514,198, $228,480 and $628,589, respectively.

NOTE 4 – FAIR VALUE MEASUREMENTS OF ASSETS AND LIABILITIES (continued)

Valuation Techniques (continued)

The table below summarizes the reconciliation of the beginning and ending balances and related changes for the year ended December 31, 2017 for fair value measurements for which significant unobservable inputs were used in determining each instrument's fair value (in thousands):

	Beginning Balance	Net Investment Gains/Loss In Earnings (realized and unrealized) [1]	Unrealized in OCI[2]	Purchases	Issuances	Sales	Settlements	Transfer In to Level 3	Transfer Out of Level 3	Ending Balance	Net Investment Gains/Losses In Earnings for Assets and Liabilities Still Held at the Ending Date
Assets											
Common stock	$ 3	$ —	$ —	$ —	$ —	$ (3)	$ —	$ —	$ —	$ —	$ —
Total invested assets	$ 3	$ —	$ —	$ —	$ —	$ (3)	$ —	$ —	$ —	$ —	$ —
Liabilities											
Policyholder account liabilities	$ 1,848,132	$ 193,394	$ —	$ —	$ —	$ —	$ 15,945	$ —	$ —	$ 2,057,471	$ —
Total liabilities	$ 1,848,132	$ 193,394	$ —	$ —	$ —	$ —	$ 15,945	$ —	$ —	$ 2,057,471	$ —

1. Includes (losses) gains on sales of financial instruments, changes in fair value of certain instruments, and other-than-temporary impairments.
2. Includes changes in fair value of certain instruments.

During 2017, there were no significant transfers between levels.

Presented below are investments that are measured using NAV as a practical expedient as of December 31, 2017 and 2016 (in thousands):

Assets	Fair Value as of December 31, 2017	Fair Value as of December 31, 2016	Unfunded Commitments as of December 31, 2017	Redemption Frequency (If Currently Eligible)	Redemption Notice Period
	(in thousands)				
AFS common stock	$ 12,643	$ 37,520	$ —	Not applicable	Not applicable
Trading equity securities	19,812	14,764	—	Not applicable	Not applicable
Other invested assets	514,198	359,239	469,607	Not applicable	Not applicable
Short term investments	228,480	179,930	—	Not applicable	Not applicable
Separate account assets	628,589	656,524	10,013	Not applicable or Quarterly	Not applicable or 70 days
Total	$ 1,403,722	$ 1,247,977	$ 479,620		

NOTE 4 – FAIR VALUE MEASUREMENTS OF ASSETS AND LIABILITIES (continued)

Valuation Techniques (continued)

Presented below is the fair value of all assets and liabilities subject to fair value determination as of December 31, 2016 (in thousands):

Assets	Level 1	Level 2	Level 3	Total
AFS debt and equity securities:				
U.S. government obligations	$ 254,055	$ —	$ —	$ 254,055
Government agencies, authorities and subdivisions	—	1,121,943	—	1,121,943
Corporates	—	11,450,922	—	11,450,922
Private placements	—	1,609,333	—	1,609,333
Mortgage-backed securities	—	3,728,913	—	3,728,913
Total AFS debt securities	254,055	17,911,111	—	18,165,166
Preferred stock	—	22,345	—	22,345
Common stock [(2)]	274	—	3	277
Total AFS equity securities	274	22,345	3	22,622
Total AFS debt and equity securities	254,329	17,933,456	3	18,187,788
Derivative assets	2,052	822,162	—	824,214
Other invested assets [(2)]	181,704	—	—	181,704
Short term investments [(2)]	—	22,494	—	22,494
Separate account assets [(2)]	1,205	75,370	—	76,575
Total assets subject to fair value disclosure [(2)]	$ 439,290	$ 18,853,482	$ 3	$ 19,292,775

Liabilities	Level 1	Level 2	Level 3	Total
Policyholder account liabilities [(1)]	$ —	$ —	$ 1,848,132	$ 1,848,132
Derivative liabilities	—	489,398	—	489,398
Total liabilities subject to fair value disclosure	$ —	$ 489,398	$ 1,848,132	$ 2,337,530

1. The most sensitive assumption in determining policy liabilities for indexed annuities is the rate used to discount the excess projected contract values. This discount rate reflects the Company's nonperformance risk. If the discount rates used to discount the excess projected contract values at December 31, 2016 were to change by approximately 100 basis points, the fair value of the embedded derivative would change significantly with an offset to deferred policy acquisition costs.

2. In accordance with Topic 820, certain investments that are measured at fair value using NAV (or its equivalent) as a practical expedient have not been classified in the fair value hierarchy. As of December 31, 2016, the fair value of these investments in AFS common stock, trading equity securities, other invested assets, short term investments and separate account assets were $37,520, $14,764, $359,239, $179,930, and $656,524, respectively.

NOTE 4 – FAIR VALUE MEASUREMENTS OF ASSETS AND LIABILITIES (continued)

Valuation Techniques (continued)

The table below summarizes the reconciliation of the beginning and ending balances and related changes for the year ended December 31, 2016 for fair value measurements for which significant unobservable inputs were used in determining each instrument's fair value (in thousands):

	Beginning Balance	Net Investment Gains/Loss In Earnings (realized and unrealized) [1]	Unrealized in OCI[2]	Purchases	Issuances	Sales	Settlements	Transfer In to Level 3	Transfer Out of Level 3	Ending Balance	Net Investment Gains/Losses In Earnings for Assets and Liabilities Still Held at the Ending Date
Assets											
Common stock	$ 5	$ —	$ —	$ —	$ —	$ (2)	$ —	$ —	$ —	$ 3	$ —
Total invested assets	$ 5	$ —	$ —	$ —	$ —	$ (2)	$ —	$ —	$ —	$ 3	$ —
Liabilities											
Policyholder account liabilities	$ 1,760,404	$ 66,590	$ —	$ —	$ —	$ —	$ 21,138	$ —	$ —	$ 1,848,132	$ —
Total liabilities	$ 1,760,404	$ 66,590	$ —	$ —	$ —	$ —	$ 21,138	$ —	$ —	$ 1,848,132	$ —

1. Includes (losses) gains on sales of financial instruments, changes in fair value of certain instruments, and other-than-temporary impairments.
2. Includes changes in fair value of certain instruments.

During 2016, there were no significant transfers between levels.

Fair Value of Financial Instruments

The carrying values and fair values of financial instruments not carried at fair value as of December 31, 2017 and 2016 were as follows (in thousands):

	2017		2016	
	Carrying Value	**Fair Value**	Carrying Value	Fair Value
Mortgage loans	**3,350,570**	**3,408,805**	3,205,842	3,268,944
Policy loans	**877,927**	**978,787**	838,541	937,421
Investment product liabilities	**13,979,002**	**13,186,282**	13,105,779	11,966,605
Debt	**452,638**	**633,454**	453,610	594,025
FHLB capital stock	**68,910**	**68,910**	57,758	57,758
FHLB advances	**1,513,775**	**1,513,775**	1,272,100	1,272,100

Mortgage loan fair values are determined using the average of discounted cash flows for the portfolio using current market rates and average durations.

For variable rate policy loans, the unpaid balance approximates fair value. Fixed rate policy loan fair values are determined based on discounted cash flows using the current variable policy loan rate (including appropriate provisions for mortality and repayments).

Investment product liabilities, which are reported in policyholder account liabilities, include flexible premium annuities, single premium deferred annuities, and supplementary contracts not involving life contingencies. Investment product fair values are determined using the average of discounted cash flows under different scenarios of future interest rates of A-rated corporate bonds and related changes in premium persistency and surrenders.

Debt fair values are determined using discounted cash flows derived from current interest rates adjusted for the Company's credit rating.

NOTE 4 – FAIR VALUE MEASUREMENTS OF ASSETS AND LIABILITIES (continued)

Fair Value of Financial Instruments (continued)

For FHLB capital stock, par value approximates fair value.

For FHLB advances, that are in the form of funding agreements and reported in policyholder account liabilities, fair values are determined using the same methodology as other investment product liabilities.

NOTE 5 – INVESTMENTS

Available-for-Sale Debt and Equity Securities

The amortized cost and the fair values of AFS debt securities and the cost and fair values for AFS equity securities at December 31, 2017 and December 31, 2016 were as follows (in thousands):

At December 31, 2017	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
AFS debt and equity securities:				
U.S. government obligations	$ 245,375	$ 20,513	$ 124	$ 265,764
Government agencies, authorities and subdivisions	1,328,517	86,489	5,435	1,409,571
Corporates:				
Asset-backed securities	833,980	9,162	374	842,768
Communications	994,971	78,548	5,906	1,067,613
Consumer & retail	3,704,518	233,157	13,452	3,924,223
Financial institutions	2,580,029	221,472	2,697	2,798,804
Industrial and chemicals	1,821,257	141,971	3,731	1,959,497
REITS	570,732	17,825	2,896	585,661
Transportation	399,358	28,669	180	427,847
Utilities	1,678,648	118,263	6,170	1,790,741
Total corporates	12,583,493	849,067	35,406	13,397,154
Private placements	1,630,484	52,061	10,503	1,672,042
Mortgage-backed securities	3,206,239	116,669	19,106	3,303,802
Total AFS debt securities	18,994,108	1,124,799	70,574	20,048,333
Preferred stocks	22,700	83	291	22,492
Common stocks	13,125	729	507	13,347
Total AFS equity securities	35,825	812	798	35,839
Total AFS debt and equity securities	$ 19,029,933	$ 1,125,611	$ 71,372	$ 20,084,172

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2017

NOTE 5 – INVESTMENTS (continued)

Available-for-Sale Debt and Equity Securities (continued)

At December 31, 2016	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
AFS debt and equity securities:				
U.S. government obligations	$ 243,077	$ 11,035	$ 57	$ 254,055
Government agencies, authorities and subdivisions	1,120,003	27,532	25,592	1,121,943
Corporates:				
Asset-backed securities	490,535	6,342	1,800	495,077
Communications	935,154	54,809	6,703	983,260
Consumer & retail	3,054,026	121,701	37,870	3,137,857
Financial institutions	2,203,081	146,772	14,745	2,335,108
Industrial and chemicals	1,698,572	93,140	23,389	1,768,323
REITS	604,701	11,287	6,435	609,553
Transportation	335,425	19,831	2,976	352,280
Utilities	1,697,658	92,187	20,381	1,769,464
Total corporates	11,019,152	546,069	114,299	11,450,922
Private placements	1,583,622	49,422	23,711	1,609,333
Mortgage-backed securities	3,611,098	151,544	33,729	3,728,913
Total AFS debt securities	17,576,952	785,602	197,388	18,165,166
Preferred stocks	22,700	108	463	22,345
Common stocks	38,258	430	891	37,797
Total AFS equity securities	60,958	538	1,354	60,142
Total AFS debt and equity securities	$ 17,637,910	$ 786,140	$ 198,742	$ 18,225,308

NOTE 5 – INVESTMENTS (continued)

Available-for-Sale Debt and Equity Securities (continued)

Unrealized gains (losses) on available-for-sale debt and equity securities included as a component of accumulated other comprehensive income as of December 31 and changes therein included in other comprehensive income for the years ended December 31 were as follows (in thousands):

	2017	2016	2015
Balance, beginning of year	**$ 231,413**	$ 125,249	$ 383,296
Net unrealized gains (losses) on AFS securities	**469,723**	187,184	(734,177)
Net unrealized gains on separate accounts	**1,643**	816	30
Net unrealized gains (losses) on other invested assets	**18,187**	2,859	(8,926)
Deferred policy acquisition costs	**(125,810)**	(25,077)	227,484
Loss reserve	**(15,250)**	17,726	6,373
Reserves	**(38,273)**	(21,816)	22,736
Deferred income taxes, excluding ASU 2018-05	**(94,780)**	(57,165)	139,094
Effect of ASU 2018-05	**87,757**	—	—
Policyholder dividend obligation	**(39,408)**	1,637	89,339
Increase in net unrealized (losses) gains	**263,789**	106,164	(258,047)
Balance, end of year	**$ 495,202**	$ 231,413	$ 125,249

	2017	2016
Balance, end of year includes:		
Net unrealized gains on AFS securities	**$ 1,061,864**	$ 592,141
Net unrealized gains on separate accounts	**8,547**	6,904
Net unrealized gains on other invested assets	**37,323**	19,135
Deferred policy acquisition costs	**(243,507)**	(117,697)
Loss reserve	**(8,321)**	6,929
Reserves	**(78,274)**	(40,002)
Deferred income taxes	**(131,630)**	(124,607)
Policyholder dividend obligation	**(150,800)**	(111,390)
Total	**$ 495,202**	$ 231,413

Net other comprehensive income related to unrealized gains (losses) on AFS securities for 2017, 2016, and 2015, respectively, were presented net of reclassifications to net income for net realized capital gains (losses) during the period of $(5.6) million, $(67.2) million, and $22.0 million, and net of tax and deferred acquisition cost offsets of $(3.4) million, $(40.8) million, and $13.9 million, respectively.

NOTE 5 – INVESTMENTS (continued)

Available-for-Sale Debt and Equity Securities (continued)

The amortized cost and fair values of debt securities by contractual maturity at December 31, 2017, are shown below (in thousands). Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized cost	Fair Value
Due in one year or less	**$ 459,470**	**$ 467,004**
Due after one yr through 5 yrs	**3,081,271**	**3,213,278**
Due after 5 yrs through 10 yrs	**4,520,536**	**4,680,783**
Due after ten years	**7,726,592**	**8,383,466**
Mortgage-backed securities	**3,206,239**	**3,303,802**
Total	**$ 18,994,108**	**$ 20,048,333**

The Company determines the cost of investments sold based on average cost. The proceeds and gross realized gains (losses) on debt and equity securities are shown below (in millions):

	2017	2016	2015
Proceeds on debt and equity securities	**$ 390.6**	$ 1,200.0	$ 840.3
Gross realized gains on debt securities	**8.1**	23.1	36.4
Gross realized losses on debt securities	**(3.4)**	(15.3)	(0.4)
Gross realized gains on equity securities	**1.0**	2.8	0.02
Gross realized losses on equity securities	**(0.2)**	(0.2)	(0.2)

The Company recognized the following realized losses resulting from other-than-temporary declines in fair value for the years ended December 31, (in millions):

	2017	2016	2015
Debt securities	**$ 3.6**	$ 21.7	$ 33.9
Limited partnerships	**8.1**	0.6	1.4
Total	**$ 11.7**	$ 22.3	$ 35.3

See Note 2 for additional information on the factors considered in determining whether declines in the fair value of investments are other-than-temporary.

NOTE 5 – INVESTMENTS (continued)

Available-for-Sale Debt and Equity Securities (continued)

Gross unrealized losses and investment fair values, aggregated by investment category, industry sector, and length of time that individual securities have been in a continuous unrealized loss position as of December 31, 2017 were as follows (in thousands):

	Less than 12 months		12 months or more		Total	
2017	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**
Description of securities						
U.S. government obligations	$ 22,444	$ 68	$ 2,620	$ 56	$ 25,064	$ 124
Government agencies, authorities and subdivisions	74,316	888	116,802	4,547	191,118	5,435
Corporates:						
Asset-backed securities	55,989	358	16,236	16	72,225	374
Communications	32,698	2,181	29,301	3,725	61,999	5,906
Consumer & retail	122,965	2,924	200,798	10,528	323,763	13,452
Financial institutions	39,890	115	113,515	2,581	153,405	2,697
Industrial and chemicals	54,873	750	97,823	2,982	152,696	3,731
REITS	44,202	963	60,000	1,933	104,202	2,896
Transportation	17,267	100	14,644	80	31,911	180
Utilities	65,013	613	89,862	5,557	154,875	6,170
Total corporates	432,897	8,004	622,179	27,402	1,055,076	35,406
Private placements	201,064	2,053	202,124	8,450	403,188	10,503
Mortgage-backed securities	369,595	3,158	476,567	15,948	846,162	19,106
Subtotal debt securities	1,100,316	14,171	1,420,292	56,403	2,520,608	70,574
Preferred stock	—	—	9,709	291	9,709	291
Common stock	8,446	507	—	—	8,446	507
Total securities	$ 1,108,762	$ 14,678	$ 1,430,001	$ 56,694	$ 2,538,763	$ 71,372

NLV Financial Corporation and Subsidiaries
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NOTE 5 – INVESTMENTS (continued)

Available-for-Sale Debt and Equity Securities (continued)

Gross unrealized losses and investment fair values, aggregated by investment category, industry sector, and length of time that individual securities have been in a continuous unrealized loss position as of December 31, 2016 were as follows (in thousands):

	Less than 12 months		12 months or more		Total	
2016	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Description of securities						
U.S. government obligations	$ 12,141	$ 57	$ —	$ —	$ 12,141	$ 57
Government agencies, authorities and subdivisions	526,510	25,592	—	—	526,510	25,592
Corporates:						
Asset-backed securities	72,856	554	19,702	1,246	92,558	1,800
Communications	150,478	4,184	13,480	2,519	163,958	6,703
Consumer & retail	993,326	37,112	21,465	758	1,014,791	37,870
Financial institutions	484,226	12,206	32,658	2,539	516,884	14,745
Industrial and chemicals	391,045	13,143	126,388	10,246	517,433	23,389
REITS	235,907	5,477	13,953	958	249,860	6,435
Transportation	94,484	2,976	—	—	94,484	2,976
Utilities	268,401	6,046	180,417	14,335	448,818	20,381
Total corporates	2,690,723	81,698	408,063	32,601	3,098,786	114,299
Private placements	423,130	14,363	88,076	9,348	511,206	23,711
Mortgage-backed securities	846,354	24,104	97,499	9,625	943,853	33,729
Subtotal debt securities	4,498,858	145,814	593,638	51,574	5,092,496	197,388
Preferred stock	9,538	463	—	—	9,538	463
Common stock	1,435	31	31,565	860	33,000	891
Total securities	$ 4,509,831	$ 146,308	$ 625,203	$ 52,434	$ 5,135,034	$ 198,742

Based upon the Company’s analysis of market factors affecting the fair value of debt securities, as well as facts and circumstances surrounding the individual securities, the Company’s assessment around the probability of all contractual cash flows, and the Company’s ability and intent to hold the individual securities to maturity or recovery, the Company believes that the unrealized losses on these securities at December 31, 2017 and 2016 were temporary.

The Company does not intend to sell these securities nor are there any requirements to sell these securities. The Company will continue to monitor these holdings for any underlying deterioration in future quarters that would indicate that an individual security will not recover and will record OTTI as appropriate.

Trading Equity Securities

These securities represent investments by the Company in the Touchstone Funds. The cost of trading securities held at December 31, 2017 and 2016 was $19.1 million and $14.8 million, respectively.

The total return on these equity investments is intended to offset the net appreciation or depreciation in value of certain defined contribution deferred compensation liabilities. The net change in deferred compensation liabilities is included in operating expenses.

NOTE 5 – INVESTMENTS (continued)

Mortgage Loans and Real Estate

The distributions of mortgage loans and real estate at December 31 were as follows (in thousands):

	2017	2016
Geographic Region		
New England	**6.8 %**	6.1 %
Middle Atlantic	**4.5**	4.0
East North Central	**13.4**	14.9
West North Central	**12.8**	12.5
South Atlantic	**23.8**	22.0
East South Central	**4.8**	5.4
West South Central	**8.1**	9.7
Mountain	**11.4**	10.6
Pacific	**14.4**	14.8
Total	**100.0 %**	100.0 %
Property Type		
Apartment	**23.3 %**	19.1 %
Retail	**27.5**	27.1
Office Building	**30.0**	33.6
Industrial	**12.3**	12.7
Other Commercial	**6.9**	7.5
Total	**100.0 %**	100.0 %
Mortgage loans	**3,350,570**	3,205,842
Real estate investments	**24,465**	31,354
Total mortgage loans and real estate	**$ 3,375,035**	$ 3,237,196

The Company applies a consistent and disciplined approach to evaluating and monitoring credit risk, and monitors credit quality on an ongoing basis. Quality ratings are based on internal evaluations of each loan's specific characteristics, considering a number of key inputs. The two most significant contributors to the credit quality are debt service coverage and loan-to-value ratios. The debt service coverage ratio measures the amount of property cash flow available to meet annual interest and principal payments on debt. The loan-to-value ratio ("LTV"), commonly expressed as a percentage, compares the amount of the loan to the fair value of the underlying property collateralizing the loan.

NOTE 5 – INVESTMENTS (continued)

Mortgage Loans and Real Estate (continued)

The following tables summarize the credit quality of the Company's current commercial mortgage loan portfolio based on loan-to-value and debt service coverage ratios:

Debt Service Coverage Ratios as of December 31, 2017 (amounts in millions)

LTV Range	≥ 2.0x	1.5x to <2.0x	1.25x to <1.5x	1.0x to <1.25x	<1.0x	Total Carrying Value
< 50%	**703.2**	**$ 175.3**	**$ 55.1**	**$ 19.0**	**$ 1.3**	**$ 953.9**
50% - 60%	**833.6**	**366.2**	**53.4**	**9.1**	**—**	**1,262.3**
60% - 70%	**329.6**	**363.5**	**142.1**	**6.3**	**0.9**	**842.4**
70% - 80%	**21.4**	**36.1**	**76.5**	**29.1**	**7.9**	**171.0**
80% - 90%	**13.2**	**—**	**7.1**	**50.6**	**—**	**70.9**
> 90%	**—**	**5.9**	**9.5**	**32.8**	**3.7**	**51.9**
Total	**$ 1,901.0**	**$ 947.0**	**$ 343.7**	**$ 146.9**	**$ 13.8**	**$ 3,352.4**

Debt Service Coverage Ratios as of December 31, 2016 (amounts in millions)

LTV Range	≥ 2.0x	1.5x to <2.0x	1.25x to <1.5x	1.0x to <1.25x	<1.0x	Total Carrying Value
< 50%	611.2	$ 144.8	$ 41.9	$ 18.8	$ 1.6	$ 818.3
50% - 60%	597.8	238.1	38.5	15.7	—	890.1
60% - 70%	290.3	524.0	142.6	12.9	6.0	975.8
70% - 80%	28.5	215.3	119.1	17.1	4.8	384.8
80% - 90%	—	5.9	29.0	27.9	2.6	65.4
> 90%	7.6	32.8	11.0	9.8	12.1	73.3
Total	$ 1,535.4	$ 1,160.9	$ 382.1	$ 102.2	$ 27.1	$ 3,207.7

The difference between the total carrying value reflected in the tables above and the carrying value reflected in the Consolidated Balance Sheets is due to the related valuation allowance which is a general valuation allowance not attributable to any one mortgage.

Mortgage loans and related valuation allowances at December 31 were as follows (in thousands):

	2017	**2016**
Commercial loans	**$ 3,355,689**	$ 3,211,066
Valuation allowance	**(1,713)**	(2,119)
Impaired loans	**(3,335)**	(3,335)
Market value adjustment on hedge	**(71)**	230
Total	**$ 3,350,570**	$ 3,205,842

NOTE 5 – INVESTMENTS (continued)

Mortgage Loans and Real Estate (continued)

The table below includes additional disclosures for impaired loans as of December 31, (in thousands):

	2017	2016	2015
Impaired loans:			
Average total investment	**$ 12,885**	$ 18,492	$ 20,876
Interest income recognized	**546**	538	1,132
Interest received	**531**	523	699
Unpaid principal balance	**12,946**	12,824	24,159

The Company recognized mortgage loan impairments of $1.5 million in 2017. The Company did not recognize any mortgage loan impairments in 2016. The Company recognized mortgage loan impairments of $0.7 million in 2015, through net realized capital losses.

The Company did not recognize any real estate impairments in 2017. The Company recognized real estate impairments of $1.0 million and $1.1 million in 2016 and 2015, respectively, through net realized capital losses.

Activity in the valuation allowance for mortgage loans for the years ended December 31 was as follows (in thousands):

	2017	2016	2015
Balance, beginning of year	**$ 2,119**	$ 1,568	$ 1,566
Changes to previously established valuation allowance	**(406)**	551	2
Balance, end of year	**$ 1,713**	$ 2,119	$ 1,568

Mortgage Loans Modified in a Troubled Debt Restructuring

For a small portion of the Company’s commercial mortgage loan portfolio classified as troubled debt restructuring, the Company grants concessions related to the borrowers’ financial difficulties. Generally, the types of concessions include: 1) reduction of the contractual interest rate, 2) extension of the maturity date at an interest rate lower than current market interest rates and/or 3) a reduction of accrued interest. The Company considers the amount, timing and extent of the concession granted in determining any impairment or changes in the specific valuation allowance recorded in connection with the troubled debt restructuring. Through the portfolio monitoring process, the Company may have recorded a specific valuation allowance prior to the quarter when the loan was modified in a troubled debt restructuring. Accordingly, the carrying value (after specific valuation allowance) before and after modification through a troubled debt restructuring may not change significantly.

At December 31, 2017 and 2016, no loans were modified during the period in a troubled debt restructuring. Payment default is determined in the same manner as delinquency status, which is when interest and principal payments are 90 days past due.

NOTE 5 – INVESTMENTS (continued)

Net Investment Income

The components of net investment income for the years ended December 31 were as follows (in thousands):

	2017	2016	2015
Debt securities interest	**$ 867,329**	$ 844,022	$ 821,146
Equity securities dividends	**5,292**	3,087	2,936
Mortgage loan interest	**142,478**	140,100	135,120
Policy loan interest	**41,846**	40,565	41,175
Real estate income	**7,009**	8,029	9,254
Derivative income	**329,431**	113,746	(86,402)
Partnership income	**46,563**	31,554	27,131
Other investment income	**1,363**	1,560	273
Gross investment income	**1,441,311**	1,182,663	950,633
Less: investment expenses	**(26,100)**	(27,821)	(25,425)
Net investment income	**$ 1,415,211**	$ 1,154,842	$ 925,208

Net Realized Capital Gains (Losses)

The following summarizes the components of net realized capital gains (losses), including other-than-temporary impairments, by asset category for the years ended December 31 (in thousands):

	2017	2016	2015
Debt securities	**$ 6,773**	$ (6,885)	$ 1,664
Equity securities	**864**	2,483	(179)
Mortgage loans	**(1,074)**	(2,751)	(2,802)
Partnerships	**(8,613)**	(736)	(1,725)
Other invested assets	**(900)**	95	(156)
Real estate	**(2,371)**	334	26
Sale of mutual fund business (see Note 2)	**9,346**	—	—
Debt retirement	**(775)**	—	(5,409)
Impairment of capitalized software	**(40,689)**	—	—
Total	**$ (37,439)**	$ (7,460)	$ (8,581)

NOTE 5 – INVESTMENTS (continued)

Derivatives

The Company enters into interest rate swaps to reduce market risks from changes in interest rates. These swaps are used to hedge changes in fair value of certain bond and mortgage investments. The Company has designated interest rate swaps as fair value hedges. The interest rate swaps are used to convert fixed rate assets to floating rate. The Company recognizes gains and losses on the swaps along with the related hedged items within net investment income on the Consolidated Statements of Comprehensive Income. Ineffectiveness recognized through net investment income in the years ended December 31, 2017 and 2016 was $(0.2) million and $0.5 million, respectively.

The Company credits interest on policyholder account liabilities for certain of its products based on S&P 500, Russell 2000, or MSCI Emerging Markets index performance subject to contractual participation rates and caps on returns. These participation rates and caps are set each policy year. The Company economically hedges this annual exposure, at the time the participation rates and caps are set, by entering into S&P 500, Russell 2000, and MSCI Emerging Markets over-the-counter (OTC) options and exchange traded futures contracts in an amount that approximates the obligation of the Company to credit interest at the policy anniversary, with adjustments for lapse assumptions. These derivative instruments do not qualify for hedge accounting and, therefore, changes in their fair value are included within net investment income. Call options purchased are included in derivatives assets at fair value. Call options written are included in derivatives liabilities and are carried at fair value. Since the derivatives purchased are based on the same indexes that the crediting rates are based upon, they substantially offset the market risk associated with the crediting rate in the policy year being hedged.

Under U.S. GAAP, indexed annuity and life contracts reported in policyholder account liabilities include embedded derivatives, which reflect the fair value of the contracts' expected participation in future increases in the S&P 500, Russell 2000, or MSCI Emerging Markets indexes. Changes in the fair value of such embedded derivatives are included in income through interest credited to policyholder liabilities. The embedded derivative liability was $2.06 billion and $1.85 billion at December 31, 2017 and 2016, respectively.

The Company purchases options only from highly rated counterparties. However, in the event a counterparty failed to perform, the Company's loss would be equal to the fair value of the net options held from that counterparty. The Company held collateral from counterparties as secured OTC call options to mitigate a portion of this risk in the amount of $416.8 million as of December 31, 2017. The Company utilizes a scale based on credit rating of the counterparty to determine the appropriate amount of counterparty risk. As of December 31, 2017, there was no derivative counterparty exposure that exceeded $13.3 million, net of collateral.

The Company entered the synthetic Guaranteed Investment Contracts ("GIC") market in 2015. The Company's synthetic GIC product is fee based and provides a book value guarantee as a fully benefit-responsive investment contract to benefit plan sponsors. The fund assets are owned by the plan sponsors and the fund manager manages the assets within investment guidelines agreed to by the Company. Through the crediting mechanism the Company passes through the investment experience of the fund. At December 31, 2017 and 2016, the Company had issued synthetic GIC contracts with a total notional amount of $718.3 million and $643.1 million, respectively. The fair value of associated plan assets was $721.0 million and $659.0 million, as of December 31, 2017 and 2016, respectively.

NOTE 5 – INVESTMENTS (continued)

Derivatives (continued)

The notional amounts and the fair value of derivatives at December 31, excluding embedded derivatives, were as follows (in thousands):

	2017		2016		Primary Underlying
	Notional	**Fair Value**	**Notional**	**Fair Value**	**Risk Exposure**
Options purchased	**$ 9,136,090**	**$ 983,531**	$ 8,446,420	$ 821,182	Equity market
Options written	**(8,299,830)**	**(565,355)**	(7,712,960)	(489,398)	Equity market
Swaptions purchased	**500,000**	**357**	500,000	1,256	Interest rates
Interest rate swaps	**597,425**	**5,960** [1]	597,425	(276)	Interest rates
Futures purchased	**58,244**	**1,770**	50,375	2,052	Equity market
Net fair market value		**$ 426,263**		$ 334,816	

1. Interest rates swaps are reflected net of cash margin collateral of $(0.2) million and $(3.5) million as of December 31, 2017 and 2016, respectively, in the Consolidated Balance Sheets.

NOTE 6 – REINSURANCE

The Company reinsures certain risks assumed in the normal course of business. For individual life products sold on or after August 16, 2004, the Company generally retains no more than $2 million of risk on any person (excluding accidental death benefits and dividend additions). For individual life products sold after 2001 but prior to August 16, 2004, the Company generally retains no more than $1 million of risk on any person (excluding accidental death benefits and dividend additions). On individual life business issued prior to 2002, the Company generally retains no more than $3 million of risk (excluding accidental death benefits and dividend additions). Reinsurance for life products is ceded under yearly renewable term, coinsurance, and modified coinsurance agreements with various reinsurers.

Disability income products are reinsured under coinsurance and modified coinsurance agreements primarily with Unum Provident Corporation (“UNUM”). Under the terms of the agreements, the Company has agreed to pay UNUM an interest rate of 9.5% on the reserves of original modified coinsurance block and 7.0% on the other modified coinsurance reserves held by the Company. All other rights and responsibilities outlined in the reinsurance agreements between the Company and UNUM remain in force.

Other income includes $6.3 million, $6.2 million, and $4.2 million in 2017, 2016, and 2015, respectively, related to the Company’s disability income reinsurance. Such income is primarily offset by expenses incurred by the Company related to this block of business. Reserve transfers and interest payments under modified coinsurance agreements are included in the Consolidated Statements of Comprehensive Income as a component of decrease in policy liabilities expense.

Effective December 31, 2017, the Company entered into an agreement to cede approximately $392.5 million of statutory reserves for certain term and universal life products, which are subject to statutory reserve requirements resulting from the NAIC Model Regulation “Valuation of Life Insurance Policies” (Regulation XXX) and NAIC Actuarial Guideline 38 (Guideline AXXX), to an unaffiliated reinsurer. Under GAAP, this reinsurance transaction is subject to deposit accounting with a reinsurance risk charge which will be recorded in interest expense.

NOTE 6 – REINSURANCE (continued)

The effects of reinsurance for the years ended December 31 were as follows (in thousands).

	2017	2016	2015
Insurance premiums:			
Direct	**$ 277,230**	$ 278,300	$ 284,452
Reinsurance assumed	**289**	832	1,047
Reinsurance ceded	**(56,890)**	(60,697)	(57,952)
Total insurance premiums	**$ 220,629**	$ 218,435	$ 227,547
Decrease in policy liabilities:			
Direct	**$ (65,377)**	$ (117,055)	$ (38,970)
Reinsurance assumed	**—**	—	—
Reinsurance ceded	**43,909**	44,791	37,250
Total decrease in policy liabilities	**$ (21,468)**	$ (72,264)	$ (1,720)
Policy benefits:			
Direct	**$ 559,097**	$ 655,615	$ 519,441
Reinsurance assumed	**811**	799	—
Reinsurance ceded	**(84,990)**	(123,343)	(78,545)
Total policy benefits	**$ 474,918**	$ 533,071	$ 440,896
Policyholders' dividends:			
Direct	**$ 57,516**	$ 58,511	$ 64,751
Reinsurance ceded	**(372)**	(422)	(462)
Total policyholders' dividends	**$ 57,144**	$ 58,089	$ 64,289

The Company remains liable in the event any reinsurer is unable to meet its assumed obligations. The Company regularly evaluates the financial condition of its reinsurers and concentrations of credit risk of reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. The Company's largest reserve credit as of December 31, 2017 and 2016 was with Swiss Reinsurance Company for $135.4 million and $103.3 million, respectively. Total life insurance in force subject to reinsurance as of December 31, 2017 and 2016 was approximately $119.9 billion and $104.9 billion, respectively.

The Company assumes a small amount of reinsurance from other companies. These reinsurance arrangements provide for greater diversification of business, allow management to control exposure to potential losses, and provide additional capacity for growth.

NOTE 7 – DEFERRED POLICY ACQUISITION COSTS AND PRESENT VALUE OF FUTURE PROFITS OF INSURANCE ACQUIRED

The table below reflects the changes in the deferred policy acquisition costs asset for the years ended December 31. In 2016, the amortization period for certain indexed annuity products was extended to 30 years to better align with industry standards.

(in thousands)	2017	2016	2015
Balance, beginning of year	**$ 1,512,211**	$ 1,295,231	$ 951,160
Acquisition costs deferred	**417,730**	371,790	318,636
Amortization	**(265,002)**	(129,733)	(202,049)
Adjustment through other comprehensive income	**(125,810)**	(25,077)	227,484
Balance, end of year	**$ 1,539,129**	$ 1,512,211	$ 1,295,231

Prior to December 31, 2017, the Company held present value of future profits of insurance acquired ("PVFP") attributable to two purchased blocks of insurance; the first attributed to an indirect purchase of a two-thirds ownership interest in LSW in February 1996; the second attributed to the indirect purchase of the remaining one-third ownership interest in July 1999. Amortization of PVFP was $6.6 million for the year ended December 31, 2017, which included $3.8 million of accelerated amortization. The remaining asset balance was written down to zero in 2017 as the underlying blocks of business were no longer projecting future profits. Amortization of PVFP was $3.1 million and $3.5 million for the years ended December 31, 2016 and 2015, respectively.

The components of the sales inducement asset ("SIA") are shown below (amounts in millions):

	SIA	
	2017	2016
Beginning of year	**$ 103.2**	$ 68.5
Deferral	**31.2**	42.4
Amortization and assumption changes, net	**(11.3)**	(7.7)
End of year	**$ 123.1**	$ 103.2

NOTE 8 – FEDERAL INCOME TAXES

The Company files income tax returns in the U.S. federal and certain state jurisdictions. The Company is no longer subject to U.S federal, state, and local income tax examinations by tax authorities for years prior to 2010. The Company's 2010 through 2013 consolidated federal income tax returns are under examination by the IRS.

The components of federal income taxes and a reconciliation of the expected and actual federal income taxes and income tax rates for the years ended December 31 were as follows (in thousands):

	2017		2016		2015	
	Amount	**Rate**	Amount	Rate	Amount	Rate
Current	**95,626**		$ 40,680		$ 12,281	
Deferred	**(145,808)**		20,320		29,663	
Total income tax (benefit) expense	**$ (50,182)**		$ 61,000		$ 41,944	
Expected income taxes	**73,414**	**35.0%**	$ 75,974	35.0 %	$ 52,937	35.0 %
Dividends received deduction	**(1,312)**	**(0.6)**	(1,799)	(0.8)	(2,156)	(1.4)
Affordable housing tax credits	**(27,942)**	**(13.3)**	(25,750)	(11.9)	(20,602)	(13.6)
Corporate owned life insurance	**(3,288)**	**(1.6)**	(3,858)	(1.8)	(3,503)	(2.3)
Enacted change in tax rate	**(119,721)**	**(57.1)**	—	—	—	—
Other, net	**13,113**	**6.3**	3,757	1.8	3,901	2.5
Total without amortization	**$ (65,736)**		$ 48,324		$ 30,577	
Effective rate without amortization		**-31.3%**		22.3 %		20.2 %
Affordable housing tax credit amortization	**15,554**	**7.4**	12,676	5.8	11,367	7.5
Total income tax (benefit) expense	**$ (50,182)**		$ 61,000		$ 41,944	
Effective federal income tax rate		**-23.9%**		28.1 %		27.7 %

The Company paid $13.5 million, $2.4 million, and $0.0 million in federal income taxes during 2017, 2016, and 2015, respectively.

A reconciliation of the beginning to ending amount of unrecognized tax benefits is as follows (in thousands):

	2017	**2016**
Balance, beginning of year	**$ 10,062**	$ 6,160
Additions/(reductions) based on tax positions related to current year	**(2,245)**	(2,576)
Additions/(reductions) based on tax positions related to prior years	**—**	6,478
Reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations	—	—
Settlements	**—**	—
Balance, end of year	**$ 7,817**	$ 10,062

Total unrecognized tax benefits were $11.1 million at December 31, 2017, including $3.2 million that would impact net income if recognized. It is reasonably possible that the amount of the Company's unrecognized tax benefits could change within the next twelve months due to the settlement of outstanding audit issues with the IRS. Accordingly, the Company believes it is reasonably possible that its existing unrecognized tax benefits may be reduced by an amount up to $8 million within the next twelve months.

NOTE 8 – FEDERAL INCOME TAXES (continued)

The Company recognizes interest and penalties accrued related to unrecognized tax benefits in tax expense. During the years ended December 31, 2017, 2016, and 2015, the Company recognized approximately $1.2 million in expense, $1.1 million in expense, and $0.2 million in expense, respectively, related to interest and penalties. The Company had approximately $3.3 million, $2.1 million and $1.0 million accrued for interest and penalties at December 31, 2017, 2016 and 2015 respectively.

Components of net deferred income tax assets at December 31 were as follows (in thousands):

	2017	2016
Deferred income tax assets:		
Policy liabilities	**270,481**	$ 375,829
Pension and other employee benefits	**43,510**	74,319
Loss carryforwards	**—**	3,284
Tax credits	**(16)**	16,933
Other	**16,128**	11,380
Total deferred income tax assets	**330,103**	481,745
Deferred income tax liabilities:		
Deferred policy acquisition costs	**246,479**	418,165
Debt/equity securities	**14,219**	40,268
Other invested assets	**3,180**	4,316
Net UCL AFS debt/equity securities	**228,721**	211,914
Present value of future profits	**—**	2,325
Property and equipment	**19,021**	36,196
Total deferred income tax liabilities	**511,620**	713,184
Total net deferred income tax assets (liabilities)	**$ (181,517)**	$ (231,439)

Management believes it is more likely than not that the Company will realize the benefit of deferred tax assets. Therefore, no valuation allowance was recorded as of December 31, 2017 or 2016.

At December 31, 2017, the Company has no federal operating loss carryforwards and no tax credit carryforwards.

NOTE 9 – BENEFIT PLANS

The Company sponsors a qualified defined benefit pension plan covering substantially all employees. The plan is non-contributory, with benefits for National Life employees hired prior to July 1, 2001, based on an employee's retirement age, years of service, and compensation near retirement. Benefits for National Life employees hired after June 30, 2001, and other Company employees, are based on the amount credited to the employee's account each year, which is a factor of the employee's age, service, and compensation, increased at a specified rate of interest. The Company also sponsors a frozen non-contributory qualified defined benefit plan that provided benefits to employees in the Career channel general agencies. The plan was amended effective January 1, 2004 to freeze plan benefits. No new participants were admitted to the plan after December 31, 2003, and there were no increases in benefits after December 31, 2003 for existing participants. These pension plans are separately funded. Plan assets are primarily mutual funds and bonds held in a Company separate account and funds invested in a group variable annuity contract held in the general account of National Life. None of the securities held in the Company's separate account were issued by the Company.

NOTE 9 – BENEFIT PLANS (continued)

The Company sponsors other pension plans, including a non-contributory defined benefit plan for National Life career general agents who met the eligibility requirements to enter the plan prior to January 1, 2005, and a noncontributory defined supplemental benefit plan for certain executives. These defined benefit pension plans are non-qualified and are not separately funded.

The Company sponsors defined benefit postemployment plans that provide medical benefits to employees, agency staff and agents. Medical coverage is contributory; with retiree contributions adjusted annually, and contain cost sharing features such as deductibles and copayments. The postemployment plans are not separately funded, and the Company, therefore, pays for plan benefits from operating cash flows. The costs of providing these benefits are recognized as they are earned by employees.

The Company also sponsors various defined contribution and deferred compensation plans.

Information with respect to the defined benefit plans as of and for the years ended December 31 was as follows (in thousands):

	Pension Benefits			Other Benefits		
	2017	2016	2015	**2017**	2016	2015
Change in benefit obligation:						
Benefit obligation, beginning of year	**$ 431,162**	$ 434,969	$ 457,918	**$ 25,511**	$ 23,867	$ 32,086
Service cost for benefits earned during the period	**8,498**	9,434	9,541	**375**	229	335
Interest cost on benefit obligation	**17,310**	17,856	17,008	**1,024**	967	1,196
Plan participants' contributions	**—**	—	—	**1,291**	1,141	1,067
Actuarial losses (gains)	**23,461**	641	(27,336)	**1,318**	2,192	(7,689)
Plan amendment	**129**	—	—	**—**	—	—
Benefits paid	**(23,206)**	(31,738)	(22,162)	**(2,810)**	(2,885)	(3,128)
Benefit obligation, end of year	**457,354**	431,162	434,969	**26,709**	25,511	23,867
Change in plan assets:						
Plan assets, beginning of year	**284,802**	262,475	266,332	**—**	—	—
Actual income on plan assets	**39,788**	20,858	(5,824)	**—**	—	—
Employer contributions	**25,286**	33,207	24,129	**1,519**	1,744	2,061
Plan participants' contributions	**—**	—	—	**1,291**	1,141	1,067
Benefits paid	**(23,206)**	(31,738)	(22,162)	**(2,810)**	(2,885)	(3,128)
Plan assets, end of year	**326,670**	284,802	262,475	—	—	—
Funded Status	**$ (130,684)**	$ (146,360)	$ (172,494)	**$ (26,709)**	$ (25,511)	$ (23,867)

NOTE 9 – BENEFIT PLANS (continued)

	Pension Benefits			Other Benefits		
	2017	2016	2015	**2017**	2016	2015
Amounts recognized in the Consolidated Balance Sheets as of December 31,:						
Pension and other post-retirement benefit obligations liability	**$ (523)**	$ 6,057	$ 17,198	**$ 23,536**	$ 24,620	$ 28,271
Accumulated other comprehensive income	**131,207**	140,303	155,296	**3,172**	891	(4,404)
Net amount recognized	**$ 130,684**	$ 146,360	$ 172,494	**$ 26,708**	$ 25,511	$ 23,867
Pension and other post-retirement benefit obligations liability	**$ (130,684)**	$ (146,360)	$ (172,494)	**$ (26,708)**	$ (25,511)	$ (23,867)
Amounts recognized in accumulated other comprehensive income consists of:						
Net actuarial loss	**$ 131,207**	$ 140,303	$ 155,296	**$ 3,172**	$ 1,906	$ (374)
Net prior service benefits	**—**	—	—	**—**	(1,015)	(4,030)
	$ 131,207	$ 140,303	$ 155,296	**$ 3,172**	$ 891	$ (4,404)

The total accumulated benefit obligation ("ABO"), the accumulated benefit obligation and fair value of plan assets for the Company's pension plans with accumulated benefit obligations in excess of plan assets, and the projected benefit obligation and fair value of plan assets for pension plans with projected benefit obligations in excess of plan assets as of the measurement date was as follows as of December 31, (in thousands):

	2017	2016	2015
Total Accumulated Benefit Obligation	**$ 428,934**	$ 386,376	$ 406,842
Plans with ABO in excess of plan assets:			
ABO	**428,934**	386,376	406,842
Fair value of plan assets (1)	**326,685**	284,857	262,489
Plans with PBO in excess of plan assets:			
PBO	**457,354**	431,162	434,969
Fair value of plan assets (1)	**326,685**	284,857	262,489

(1) The difference to total plan assets shown on the prior page is due to accrual for income and liabilities that are not carried at fair value.

NOTE 9 – BENEFIT PLANS (continued)

The components of net periodic benefit cost for the years ended December 31 were as follows (in thousands):

	Pension Benefits			Other Benefits		
	2017	2016	2015	**2017**	2016	2015
Service cost for benefits earned during the period	**$ 8,498**	$ 9,434	$ 9,541	**$ 375**	$ 229	$ 335
Interest cost on benefit obligation	**17,310**	17,856	17,008	**1,024**	967	1,196
Expected income on plan assets	**(18,404)**	(18,499)	(19,151)	**—**	—	—
Net amortization of actuarial losses (gains)	**11,290**	13,274	14,315	**52**	(89)	1,478
Amortization of prior service benefits and plan amendments	**12**	—	—	**(1,015)**	(3,014)	(3,014)
Net periodic benefit cost (included in operating expenses)	**$ 18,706**	$ 22,065	$ 21,713	**$ 436**	$ (1,907)	$ (5)

Other changes in plan assets and benefit obligations recognized in other comprehensive income (in thousands):

	Pension Benefits			Other Benefits		
	2017	2016	2015	**2017**	2016	2015
Net gain (loss)	**$ (2,077)**	$ 1,719	$ 2,482	**$ (1,318)**	$ (2,192)	$ 7,690
Prior service cost	**(129)**	—	—	**—**	—	—
Amortization of (gain) loss	**11,290**	13,274	14,315	**52**	(89)	1,477
Amortization of prior service cost (benefits)	**12**	—	—	**(1,015)**	(3,014)	(3,014)
Total recognized in other comprehensive income	**$ 9,096**	$ 14,993	$ 16,797	**$ (2,281)**	$ (5,295)	$ 6,153

Over the next year, the estimated amount of amortization from accumulated other comprehensive income into net periodic benefit cost related to net actuarial losses and prior service benefit is $10.3 million and $0.0 million, respectively.

The actuarial assumptions used in determining benefit obligations at the measurement dates were as follows:

	Pension Benefits			Other Benefits		
	2017	2016	2015	**2017**	2016	2015
Discount rate	**3.65%**	4.15%	4.20%	**3.65%**	4.15%	4.20%
Rate of increase in future compensation levels	**3.0% - 5.0%**	3.0% - 5.0%	3.0% - 5.0%			

The weighted-average assumptions used to determine net periodic benefit cost:

	Pension Benefits			Other Benefits		
	2017	2016	2015	**2017**	2016	2015
Discount rate	**4.15%**	4.20%	3.85%	**4.15%**	4.20%	3.85%
Rate of increase in future compensation levels	**3.0% - 5.0%**	3.0% - 5.0%	3.0% - 5.0%			
Expected long term return on plan assets	**6.50%**	7.00%	7.00%			

NOTE 9 – BENEFIT PLANS (continued)

Included in the pension and other post-retirement benefit obligations liability as reported on the Consolidated Balance Sheets are deferred compensation and employee disability liabilities of $36.9 million and $30.3 million as of December 31, 2017 and 2016, respectively.

Assumed health care cost trend rates ("HCCTR") at December 31, 2017:

Weighted average health care cost trend rate assumed for next year	7.16%
Rate to which the cost trend rate is assumed to decline	5%
Year that the rate reaches the ultimate trend rate	2025

Increasing the assumed HCCTR by one percentage point in each year would increase the accumulated post-retirement benefit obligation ("APBO") by about $0.9 million and would increase service and interest costs by approximately $0.1 million. Decreasing the assumed HCCTR by one percentage point in each year would reduce the APBO by approximately $0.8 million and would reduce service and interest costs by approximately $0.0 million.

The Company uses the straight-line method of amortization for prior service cost and unrecognized gains and losses.

In 2015, the Company changed the amortization period for two of its plans where all or almost all of the participants are inactive. For these plans, the change in amortization base went from average future service to average future life expectancy. The change in methodology resulted in a decrease in net periodic expense of $1.6 million in 2015.

The percentage distribution of the fair value of total plan assets held as of the measurement date is as follows:

Plan Asset Category	December 31, 2017	December 31, 2016
Fixed income	**65%**	41%
Equities	**29%**	53%
Group annuity contract and other	**6%**	6%
Total	**100%**	100%

The primary objective is to maximize long-term total return within the investment policy and guidelines. The Company's investment policy for the plan assets associated with the separately funded plans is to maintain a target allocation of approximately 15%-35% equities, 55%-75% fixed income, and 0–10% alternative investments when measured at fair value.

The Company's expected future long-term rate of return of 6.5% is based upon the combination of current asset mix of equities and fixed income, the Company's historical and projected experience, and on long-term projections by investment research organizations.

NOTE 9 – BENEFIT PLANS (continued)

The concentrations of credit risk associated with the plan assets are shown in the table below (in thousands):

		2017	2016
Equities – unaffiliated	Equity Funds	**$ 94,960**	**$ 150,253**
	Total equities - unaffiliated	**94,960**	**150,253**
Fixed income	Aerospace/Defense	**6,808**	**2,396**
	Banking	**25,324**	**2,398**
	Cable	**3,917**	**2,688**
	Chemicals	**2,449**	**2,240**
	Retailers	**22,135**	**6,968**
	Energy	**2,026**	**1,868**
	Food and Beverage	**9,670**	**6,484**
	Health Care	**4,208**	**953**
	Insurance - Health	**3,661**	**1,534**
	Insurance - Property and Casualty	**10,519**	**5,622**
	Insurance - Life	**3,816**	**2,111**
	Machine Construction	**6,009**	**3,065**
	Manufacturing	**4,352**	**4,199**
	Media	**4,832**	**2,449**
	Metals/Mining	**6,888**	**—**
	Pharmaceuticals	**11,895**	**7,205**
	Real Estate Investment Trusts	**1,046**	**1,861**
	Technology	**22,466**	**4,591**
	Transportation	**12,155**	**4,542**
	Utilities	**14,553**	**10,507**
	Wireless	**3,197**	**—**
	Wirelines	**1,046**	**1,017**
	Bond Funds	**28,399**	**41,751**
	Total fixed income	**211,371**	**116,449**
Partnerships		**17,227**	**15,465**
Cash		**959**	**544**
Group annuity		**444**	**1,475**
	Total Investments (1) (2)	**$ 324,961**	**$ 284,186**

(1) Includes investments totaling $28,399 in 2017 and $27,254 in 2016 advised by Touchstone Investments and SAMI, respectively.
(2) The difference to total plan assets of $326,670 for 2017 and $284,802 for 2016 shown in the changes in plan assets are accruals for income and liabilities.

The assets of the Company's separately funded pension plans are held in the Company's separate account.

The valuation techniques used for the plan assets are:

Common Stock – Common stocks consist of mutual funds that are traded daily and have a net asset value. These securities are not categorized in the fair value hierarchy.

Corporates – Corporate bonds are valued using cash flow models based on appropriate observable inputs such as market quotes, yield curves, interest rates, and spreads. Corporate bonds are categorized as Level 2 in the fair value hierarchy. Bond mutual funds that have a readily determinable NAV are not categorized in the fair value hierarchy.

NOTE 9 – BENEFIT PLANS (continued)

Partnerships - Investments in limited partnerships do not have a readily determinable fair value, and, as such, the Company values them at its pro-rata share of the limited partnership's NAV, or its equivalent. Investments in limited partnerships are not categorized in the fair value hierarchy.

Group annuity - This category consists of an investment in a National Life group variable annuity contract. The contract is carried at amortized cost, which approximates fair value. These assets are categorized in Level 2 of the hierarchy.

The valuation of plan assets as of December 31 is as follows (in thousands):

2017 Fair Value	**Level 1**	**Level 2**	**Level 3**	**Total**
Assets				
Corporates [1]	**—**	**184,696**	**—**	**184,696**
Cash	**959**	**—**	**—**	**959**
Group annuity	**—**	**444**	**—**	**444**
Total Assets	**$ 959**	**$ 185,140**	**$ —**	**$ 186,099**
Liabilities				
Total Liabilities	**—**	**—**	**—**	**—**
Total Plan Assets [1]	**$ 959**	**$ 185,140**	**$ —**	**$ 186,099**

2016 Fair Value	Level 1	Level 2	Level 3	Total
Assets				
Corporates [1]	—	75,369	—	75,369
Cash	544	—	—	544
Group annuity	—	1,475	—	1,475
Total Assets	$ 544	$ 76,844	$ —	$ 77,388
Liabilities				
Total Liabilities	—	—	—	—
Total Plan Assets [1]	$ 544	$ 76,844	$ —	$ 77,388

1. In accordance with Topic 820, certain investments that are measured at fair value using NAV (or its equivalent) as a practical expedient have not been classified in the fair value hierarchy. As of December 31, 2017, the fair value of these investments in common stock, corporates and partnerships were $94,960, $28,399 and $17,227, respectively. As of December 31, 2016, the fair value of these investments in common stock, corporates and partnerships were $150,253, $41,751 and 15,465, respectively.

NOTE 9 – BENEFIT PLANS (continued)

Projected benefit payments for defined benefit obligations, and for projected Medicare Part D reimbursements for each of the five years following December 31, 2017, and in aggregate for the five years thereafter is as follows (in thousands):

Year	Projected Pension Benefit Payments	Projected Other Benefit Payments	Projected Medicare Part D Reimbursements
2018	$ 25,259	$ 1,735	$ 82
2019	25,543	1,733	85
2020	30,677	1,739	87
2021	28,838	1,743	89
2022	27,897	1,762	91
2023-2027	144,652	8,661	453

The Company's general policy is to contribute the regulatory minimum required amount into its separately funded defined benefit pension plan. However, the Company may elect to make larger contributions subject to maximum contribution limitations. The Company's expected contribution for 2018 into its separately funded defined benefit pension plans is anticipated to be up to $15.9 million.

The Company provides employees with a 401(k) plan. Under the Company's 401(k) pension plan for employees, eligible employees earning less than a specified amount receive a 75% match up to 6% of an employee's salary, subject to maximum contribution guidelines. Employees earning more than the specified amount receive a 50% match up to 6% of an employee's salary, subject to maximum contribution guidelines. Additional employee voluntary contributions may be made to the plans subject to contribution guidelines. Vesting and withdrawal privilege schedules are attached to the Company's matching contributions. Effective January 1, 2016, agency employees became a part of the employee 401(k) plan with the same matching contributions as home office employees.

The Company also provides a 401(k) plan for its regular full-time agents. The Company makes an annual contribution equal to 6.1% of an agent's compensation up to the Social Security Taxable Wage Base plus 7.5% of the agent's compensation in excess of the Social Security Taxable Wage Base. In addition, the agent may elect to defer a portion of the agent's compensation, up to the legal limit on elective deferrals, and have that amount contributed to the plan. Total annual contributions cannot exceed certain limits which vary based on total agent compensation.

For all of the Company's 401(k) plans, accumulated funds may be invested in a group annuity contract issued by National Life or in mutual funds. These plans are not separately funded. Costs associated with these plans are included in operating expenses. Liabilities for these plans are included in pension and other post-retirement benefit obligations.

NOTE 10 – GOODWILL AND OTHER INTANGIBLES

The Company had goodwill of $3.5 million and no intangible assets at December 31, 2017. The $3.5 million of goodwill is related to the acquisition of LSW. There were no impairments recorded in 2017 or 2016. In 2017, goodwill and intangible assets in the amount of $49.5 million were disposed of as a result of the sale of certain assets related to the mutual fund business (see Note 1), which was reflected in the net realized capital gain recorded on the sale.

NOTE 11 – DEBT

Debt consists of the following (in thousands):

	2017	2016
7.5% Senior Notes:	**$ 198,033**	$ 197,909
$200 million, maturing August 2033, interest payable semiannually on February 15 and August 15. The notes are unsecured and subordinated to any existing or future indebtedness of NLVF and its subsidiaries.		
6.5% Senior Notes:	**67,404**	67,368
Original issue of $75 million, maturing March 2035, interest payable semiannually on March 15 and September 15. The notes are unsecured and subordinated to any existing or future indebtedness of NLVF and its subsidiaries. In 2009, the Company's subsidiary, National Life repurchased $7.0 million of the senior notes. Interest paid to the subsidiary is eliminated in consolidation.		
10.5% Surplus Notes:	**187,201**	188,333
Original issue of $200 million, maturing September 15, 2039, interest payable semiannually on March 15 and September 15. The notes are unsecured and subordinated to any existing or future indebtedness of National Life.		
Total debt	**$ 452,638**	$ 453,610

Total debt is shown net of debt issuance costs, in accordance with ASU 2015-03, *Interest – Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs.*

Interest paid on the 7.5% senior notes was $15.0 million in 2017, 2016, and 2015. Interest paid on the 6.5% senior notes was $4.4 million in 2017, 2016 and 2015. Interest paid on the 10.5% surplus note was $19.9 million in 2017, $19.5 million in 2016 and $21.0 million in 2015.

In 2017, National Life repurchased $1.2 million of the outstanding 10.5% surplus notes. A loss of $0.8 million was recorded on the repurchase and included in net realized capital gains (losses). There were no repurchases in 2016.

National Life and LSW have secured asset-based borrowing capacity of $1.5 billion with FHLB Boston and $4.1 billion with FHLB Dallas, respectively. Outstanding advances as of December 31, 2017 are in the form of funding agreements and are included in policyholder account liabilities. For additional information on FHLB, see Note 2.

NOTE 12 – COMMITMENTS AND CONTINGENCIES

The Company is subject, in the ordinary course of business, to claims, litigation, arbitration proceedings, and governmental examinations. Although the Company is not aware of any actions, proceedings or allegations that reasonably should give rise to a material adverse impact to the Company's financial position or liquidity, the outcome of any particular matter cannot be foreseen with certainty. It is the opinion of management that the ultimate resolution of these matters will not materially impact the Company's financial condition.

The Company is also involved in class action or putative class action litigation. On September 24, 2010, three individuals (including two former policyholders and one now former policyholder) brought a putative class action against LSW concerning their purchases of indexed universal life insurance policies sold in California (SecurePlus Provider and SecurePlus Paragon), before the U.S. District Court for the Central District of California and captioned Walker, et al. v. Life Ins. Co. of the Southwest. Plaintiffs asserted claims under the California Unfair Competition Law and for fraudulent concealment, alleging that LSW and independent agents did not sufficiently and/or appropriately disclose, in illustrations and otherwise, certain features of the policies, including the amount and duration of certain charges and fees set forth in the policies themselves, the method by which policy values are calculated under the policies, and the potential tax treatment for policy loans under certain circumstances. A jury trial on the fraudulent concealment claims was held in April 2014 and resulted in a defense verdict. No liability was found and no damages awarded. In an Order dated April 14, 2015, U.S. District Court Judge James V. Selna found in favor of LSW as to all remaining claims. On May 29, 2015, plaintiffs filed a notice of appeal from the final judgment with the United States Court of Appeals for the Ninth Circuit. Plaintiffs filed their appellate brief in December 2015. LSW filed its answer brief on February 8, 2016. Plaintiffs filed their reply brief on May 23, 2016. Oral argument occurred on February 7, 2017. The US Court of Appeals for the Ninth Circuit issued its decision on March 3, 2017. The Ninth Circuit affirmed the defense verdict on all of the claims that went to trial finding that Plaintiff's had failed to prove the merits of any of their claims. The Ninth Circuit reversed the District Court's conclusion that Plaintiffs could not bring an unlawfulness claim under California's Unfair Competition Law for alleged violations of California's Illustration Statute, and remanded that claim back to the District Court for further proceedings (including an analysis of whether any class action could be maintained as to that claim). The appellants (Walker, et al) then filed a petition for rehearing with the Ninth Circuit. That petition for rehearing was denied. Following the remand to the United States District Court, the plaintiffs filed a Third Amended Complaint which included the previously dismissed claims alleging violations of the California Illustration Statute. LSW filed a motion for summary judgment and defendants a motion for partial summary judgment on these claims. The motions were heard on December 11, 2017 and the Court issued its opinion on December 22, 2017. The Court granted and denied LSW's motion in part and granted and denied Plaintiff's motion in part. Among other things, the ruling permits Plaintiffs to pursue certain limited claims under the California Unfair Competition Law that had previously been dismissed by the Court. LSW answered the Third Amended Complaint on January 22, 2018. The matter is currently scheduled for a Pre-Trial Conference before the Court on November 27, 2018 and Trial is currently scheduled to begin on January 15, 2019. LSW intends to continue to contest the matter vigorously.

NOTE 12 – COMMITMENTS AND CONTINGENCIES (continued)

The Company currently leases rights to the use of certain data processing hardware from NTT Data, Boston, Massachusetts (formerly known as Dell Systems Corporation). This agreement was extended through January 31, 2025. The following is a schedule of future minimum lease payments as of December 31, 2017 (in thousands).

Year	Contract Obligation
2018	5,500
2019	5,500
2020	5,500
2021	5,500
2022	5,500
Thereafter	11,458
Total minimum payments	$ 38,958

The Company also has a services contract with NTT Data. In total, the Company paid $15.4 million, $13.4 million, and $15.0 million for the years ended December 31, 2017, 2016, and 2015, respectively to NTT Data under this contract.

Additionally, the Company has a multi-year contract for information systems application and infrastructure services from NTT Data. The contract expires January 1, 2020. Total expense paid to NTT Data under this contract was $26.9 million, $29.6 million, and $25.0 million for the years ended December 31, 2017, 2016, and 2015, respectively. The expense paid includes a base amount and variable expenses related to project work performed during the year.

The Company has a multi-year contract with I-Pipeline which expires December 31, 2018. The contract provides new business support through electronic applications. The Company paid $2.3 million, $2.2 million, and $2.3 million under this contract, for the years ended December 31, 2017, 2016, and 2015, respectively.

The Company signed a multi-year contract with Cognizant which expires December 31, 2017. The contract provides application support, web development and Quality Assurance (“QA”) services. The Company paid $14.2 million, $11.4 million, and $10.2 million under this contract for the years ended December 31, 2017, 2016, and 2015, respectively.

The Company’s subsidiary, LSW, is a party to an amended lease agreement with Gaedeke Holdings IX, LLC for office facilities in Addison, Texas. The expiration date of this agreement is January 31, 2027. Rental expense incurred under this agreement was $1.2 million, $1.3 million, and $1.3 million in 2017, 2016, and 2015, respectively.

NOTE 12 – COMMITMENTS AND CONTINGENCIES (continued)

The following is a schedule of future minimum rental payments pursuant to the amended lease as described above (in thousands):

Year	Contract Obligation
2018	1,578
2019	1,730
2020	1,808
2021	1,846
2022	1,684
Thereafter	7,147
Total minimum payments	$ 15,793

The Company had unfunded mortgage loan, partnership, and private placement commitments of $89.0 million, $469.6 million, and $29.2 million respectively, at December 31, 2017. Partnership commitments may be called by the partnership during the commitment period (on average two to five years) to fund the purchase of new investments and partnership expenses. Once the commitment period expires, the Company is under no obligation to fund the remaining unfunded commitment but may elect to do so.

NOTE 13 – NATIONAL LIFE CLOSED BLOCK

National Life established and began operating the Closed Block on January 1, 1999. The Closed Block was established pursuant to regulatory requirements as part of the reorganization into a mutual holding company corporate structure. The Closed Block was established for the benefit of policyholders of participating policies in force at December 31, 1998, and includes traditional dividend paying life insurance policies, certain participating term insurance policies, dividend paying flex premium annuities, and other related liabilities. The Closed Block's primary purpose is to protect the policy dividend expectations related to these policies. The Closed Block is expected to remain in effect until all policies within the Closed Block are no longer in force. Assets assigned to the Closed Block at January 1, 1999, together with projected future premiums and investment returns, are reasonably expected to be sufficient to pay out all future Closed Block policy benefits, expenses, and taxes. Such benefits include dividends paid out under the current dividend scale, adjusted to reflect future changes in the underlying experience. The assets and liabilities allocated to the Closed Block are recorded in the Company's financial statements on the same basis as other similar assets and liabilities. National Life remains contingently liable for all contractual benefits and expenses of the Closed Block.

If actual cumulative Closed Block earnings are greater than expected cumulative earnings, only the expected earnings will be recognized in net income of the Company. Actual cumulative earnings in excess of expected earnings represent undistributed earnings attributable to Closed Block policyholders.

These excess earnings are recorded as a policyholder dividend obligation (included in policyholders' dividend liability) to be paid to Closed Block policyholders unless offset by future results that are less than expected. If actual cumulative performance is less favorable than expected, only actual earnings will be recognized in income. In 2017 and 2016, the Company recorded increases in policyholder dividend obligation of $11.1 million and $7.2 million respectively. Unrealized gains in the Closed Block generated a policyholder dividend obligation through accumulated other comprehensive income of $150.8 million, $111.4 million, and $113.0 million at December 31, 2017, 2016 and 2015, respectively. The total policyholder dividend obligation at December 31, 2017 and 2016 was $161.8 million and $118.6 million, respectively.

NOTE 13 – NATIONAL LIFE CLOSED BLOCK (continued)

Summarized financial information for the Closed Block effects included in the consolidated financial statements as of December 31, 2017 and 2016, and for the three years ended December 31, 2017, 2016 and 2015 is as follows (in thousands):

	2017	2016
Liabilities:		
Policy liabilities and accruals	**$ 3,187,740**	$ 3,255,190
Other liabilities	**172**	40
Total liabilities	**$ 3,187,912**	$ 3,255,230
Assets:		
Cash	**$ 929**	$ 2,798
Short term investments	**31,500**	4,495
Available-for-sale debt and equity securities	**2,331,516**	2,387,284
Mortgage loans	**171,552**	178,699
Policy loans	**379,547**	392,177
Accrued investment income	**31,196**	32,474
Premiums and fees receivable	**5,942**	6,257
Other assets	**10,146**	32,934
Total assets	**$ 2,962,328**	$ 3,037,118
Excess of reported liabilities over assets	**$ 225,584**	$ 218,112
Closed Block accumulated other comprehensive loss	**—**	—
Unrealized loss and liabilities	**$ 225,584**	$ 218,112

	2017	2016	2015
Revenues:			
Insurance premiums and other income	**$ 96,100**	$ 103,650	$ 116,480
Net investment income	**128,232**	139,319	147,947
Net realized investment gain (loss)	**(459)**	6,459	93
Total revenues	**$ 223,873**	$ 249,428	$ 264,520
Benefits and Expenses:			
Decrease in policy liabilities	**(84,481)**	(135,109)	(60,593)
Policy benefits	**235,331**	310,547	243,208
Policyholders' dividends and dividend obligations	**46,620**	47,124	53,619
Interest credited to policyholder account liabilities	**7,333**	7,575	7,659
Operating expenses	**4,433**	4,694	5,264
Commission expenses	**995**	1,049	1,177
Total benefits and expenses	**$ 210,231**	$ 235,880	$ 250,334
Pre-tax results of operations	**13,642**	13,548	14,186
Income taxes	**21,114**	4,742	4,966
Closed Block results of operations	**$ (7,472)**	$ 8,806	$ 9,220
Other comprehensive income:			
Unrealized loss	**—**	—	—
Total Closed Block comprehensive income (loss)	**$ (7,472)**	$ 8,806	$ 9,220
Excess of reported Closed Block liabilities over Closed Block assets:			
Beginning of year	**218,112**	226,918	236,138
Closed Block comprehensive income (loss)	**(7,472)**	8,806	9,220
End of year	**$ 225,584**	$ 218,112	$ 226,918

NOTE 13 – NATIONAL LIFE CLOSED BLOCK (continued)

Amortized cost of available for sale securities held by the Closed Block at December 31, 2017 and 2016 were $2.2 billion.

Participating insurance in force within the Closed Block at December 31, 2017 and 2016 was $5.8 billion and $6.2 billion, respectively.

Many expenses related to Closed Block policies and operations, including amortization of policy acquisition costs, are charged to operations outside the Closed Block; accordingly, the contribution from the Closed Block presented above does not represent the actual profitability of the Closed Block operations. Operating costs and expenses outside the Closed Block are therefore disproportionate to the actual business outside the Closed Block.

NOTE 14 – STATUTORY INFORMATION AND RESTRICTIONS

The Company's insurance operations, domiciled in the states of Vermont (National Life, Catamount Reinsurance Company, and Longhorn Reinsurance Company) and Texas (LSW), prepare statutory financial statements in accordance with statutory accounting principles ("SAP") prescribed or permitted by the insurance departments of the states of domicile. Prescribed statutory accounting principles include the Accounting Practices and Procedures Manual of the National Association of Insurance Commissioners ("NAIC") as well as state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state. Permitted statutory accounting practices include practices not prescribed by the domiciliary state, but allowed by the domiciliary state regulatory authority. National Life and LSW do not have any permitted practices. Catamount and Longhorn have permitted practices approved by the State of Vermont. Longhorn's use of permitted practices has no impact on National Life's surplus.

LSW paid no dividends to National Life in 2017, 2016 or 2015. In 2017, National Life paid a $20 million dividend to NLVF. National Life paid no dividends to NLVF in 2016 or 2015. For U.S. GAAP, the dividends were eliminated in consolidation. Dividends declared by National Life in excess of the greater of ten percent of statutory surplus or statutory net gain from operations require pre-approval by the Commissioner of the Vermont Department of Financial Regulation.

In 2017, there was a capital contribution of $100 million from National Life to LSW. In 2016, National Life's ownership of Catamount Reinsurance Company was transferred to its parent, NLV Financial Corporation. In 2015, there was a capital contribution of $18 million from NLVF to National Life. There was a subsequent capital contribution of $18 million from National Life to LSW.

The New York Department of Financial Services recognizes only statutory accounting practices for determining and reporting the financial condition and results of operations of an insurance company and for determining solvency under the New York Insurance Law. No consideration is given by the New York Department of Financial Services to financial statements prepared in accordance with U.S. GAAP in making such determinations.

National Life's statutory surplus was $2.02 billion (unaudited) and $1.93 billion at December 31, 2017 and 2016, respectively. Statutory net income was $14.9 million (unaudited), $(51.1) million, and $12.0 million in 2017, 2016, and 2015, respectively.

Pursuant to certain statutory requirements, as of December 31, 2017, National Life and LSW had securities on deposit with a statutory carrying value of $7.0 million and $3.4 million, respectively, in insurance department special deposit accounts.

NOTE 15 – PARTICIPATING LIFE INSURANCE

Participating life insurance in force was 21.3% and 25.0% of the face value of total insurance in force at December 31, 2017 and 2016, respectively. The premiums on participating life insurance policies were 16.2%, 13.8%, and 16.1% of total individual life insurance premiums in 2017, 2016, and 2015, respectively.