

GENERAL DISCUSSION OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

About the Company

NLV Financial Corporation (“NLVF”) through its subsidiaries (collectively, the “Company”, “we”, “our”) offers life insurance policies, annuity contracts, and investment products and services.

The Company’s leading life insurance product lines include indexed universal life, whole life, term life, and universal life. The Company offers a wide array of options and riders in connection with these policies to provide such benefits as waiver of premium, accidental death benefits, paid up additions, supplemental term insurance, lifetime income and accelerated benefits.

The Company’s leading annuity product lines are indexed annuities and fixed interest rate annuities. The Company offers a guaranteed lifetime income rider on its index annuity products, which allows the contract holder the option to elect a guaranteed annual income that is fixed and will continue for the remaining life of the contract holder, even if the annuity’s account value reaches zero. The Company also offers variable annuities, but does not offer, and has never offered, guaranteed minimum withdrawal, accumulation or income benefits on its variable annuities. A return of premium guaranteed minimum death benefit is the only guarantee the Company currently offers on its variable annuity products.

For indexed life and annuity products, indexed interest, if any, is credited based on the change in an equity index over a specified period, subject to a cap rate, a participation rate and a floor of zero percent. Indexed products also offer the contract holder the option of selecting a guaranteed fixed interest rate instead of indexed interest.

Prior to October 27, 2017, the Company also distributed and provided investment advisory and administrative services to the Sentinel Group Funds, Inc. 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.

Distribution

The Company provides a broad range of life insurance and annuity products to a national client base, primarily through an extensive network of independent agents and a career agency distribution channel. The Company focuses on serving Middle America in its target market of customers with household income of between \$75,000 and \$150,000, offering products with benefits that help Middle America customers meet needs during their lifetime, including lifetime income in retirement and accelerated death benefits if the insured becomes terminally, chronically or critically ill. In its individual annuity business, the Company focuses on the 403(b) K-12 educator markets. The Company also provides financial solutions in the form of estate, business succession and retirement planning, and deferred compensation and other key executive benefit planning to small business owners, professionals, and other middle to upper income individuals. The Company markets and distributes its products throughout the United States through two principal channels: Career and Affiliated Independent:

- **Career:** The Career channel consists of producing and general agents who specialize in selling products to the middle and emerging affluent markets, professionals, business owners and other individuals for financial and business planning purposes.
- **Affiliated Independent:** The Affiliated Independent channel consists of agents who primarily offer life insurance, annuity, and mutual fund products to the middle and emerging affluent markets, for purposes of providing for the financial consequences of specific life events, such as death, retirement, and chronic or long-term illness. While the agents have access to all products, certain agents sell life

insurance and annuity products with an emphasis on the 403(b) qualified tax deferred retirement savings market for individuals employed by public schools.

Organization

In 1999, National Life Insurance Company (“NLIC”) reorganized from a mutual to a stock insurance company as part of a reorganization into a mutual insurance holding company structure in order, among other things, to compete more effectively, have a more flexible and cost-effective capital structure, and be part of an enterprise which is better positioned to make strategic acquisitions. Concurrent with the reorganization into a mutual insurance holding company structure, NLIC created a closed block for the benefit of holders of certain of NLIC’s individual participating life insurance and annuity policies (“the Closed Block”). The Closed Block is designed to give reasonable assurance to owners of policies in the Closed Block that assets will be available to provide for payment of policy benefits, including the continuation of dividends. National Life Holding Company, a Vermont mutual insurance holding company, owns 100% of the outstanding common stock of NLVF, an intermediate stock insurance holding company incorporated under the laws of the state of Delaware. NLVF directly owns 100% of the outstanding common stock of NLIC, Sentinel Asset Management, Inc. (“Sentinel Investments”), Equity Services, Inc. (“ESI”), Catamount Reinsurance Company (“Catamount”), and certain other subsidiaries, and indirectly owns 100% of the outstanding common stock of Life Insurance Company of the Southwest (“LSW”), and Longhorn Reinsurance Company (“Longhorn”) which are both wholly owned by NLIC. NLVF indirectly owns National Life Distribution, LLC (“NLD”), whose sole member is LSW.

Non-GAAP Measures

The discussion herein, unless otherwise noted, is prepared in conformity with accounting principles generally accepted in the United States of America (“U.S. GAAP”). In addition to net income, we use pre-tax operating income and core earnings, which are both pre-tax, non-GAAP financial measures, to evaluate our financial performance. Pre-tax operating income excludes income taxes and net realized capital gains (losses). It also excludes the portion of amortization of deferred policy acquisition costs (“DAC”) and deferred sales inducements, and policyholder dividend obligations that are related to net realized capital gains (losses).

Core earnings equal pre-tax operating income after excluding volatility caused by the periodic fair value measurement of certain liabilities for indexed life and annuity products, and the related impact to DAC and deferred sales inducements. Significant short-term income volatility may result from the measurement of these indexed product liabilities under GAAP, because they are sensitive to movements in equity market indexes and future interest rate assumptions. We exclude such volatility from core earnings.

On a non-GAAP core earnings basis, we also exclude from revenues any investment income (losses) from derivative instruments that hedge indexed product liabilities; instead, those hedging results are presented within interest credited to policyholder account liabilities. Core earnings is a useful measure for the Company to analyze our results and trends because it excludes such short-term volatility and is more consistent with the economics and long-term performance of our indexed products. We believe the combined presentation and discussion of pre-tax operating income, core earnings, and net income provides information that will enhance readers’ understanding of our underlying results, operating trends and profitability.

A reconciliation of total revenues on a GAAP basis to total revenues on a core earnings basis is presented below:

	For the Year Ended December 31,	
	2018	2017
	<i>(in thousands)</i>	
Total Revenues	\$ 1,905,399	\$ 2,274,898
Net realized capital losses	23,480	36,303
Net investment loss (income) from derivatives that hedge equity indexed products, which is included in interest credited to policyholder liabilities on a core earnings basis	166,185	(333,998)
Total revenues on a core earnings basis	<u>\$ 2,095,064</u>	<u>\$ 1,977,203</u>

A reconciliation of net income to non-GAAP pre-tax operating income and core earnings is presented below:

	For the Year Ended December 31,	
	2018	2017
	<i>(in thousands)</i>	
Net income	\$ 150,054	\$ 259,938
Net realized capital losses	23,480	36,303
Amortization of DAC and sales inducements, and policyholder dividend obligations, related to net realized capital losses	704	866
Income tax expense (benefit)	23,560	(50,182)
Pre-tax operating income	<u>197,798</u>	<u>246,925</u>
Non-core earnings (loss), primarily volatility resulting from the measurement of indexed product liabilities	26,929	(21,744)
Core earnings	<u>\$ 224,727</u>	<u>\$ 225,181</u>

ANNUAL FINANCIAL PERFORMANCE REVIEW

This annual financial performance review provides an overview of the Company's results of operations for the years ended December 31, 2018 and 2017, and, where applicable, factors that may affect the Company's future financial performance. This review should be read in conjunction with the Consolidated Financial Statements and Notes to Consolidated Financial Statements as of and for the years ended December 31, 2018 and 2017, which have been audited by PricewaterhouseCoopers LLP.

In 2018, the Company continued to deliver top line growth and stable bottom line results while maintaining its capital strength. Sales of life and annuity products in 2018 exceeded prior year by 15% in total. Life sales increased 28% over 2017, led by very strong growth in sales of indexed universal life, and reflected the highest levels in the Company's history. This sales growth was primarily driven by expanding our distribution footprint through an increase in the number of producing agents in our career and affiliated independent agencies, and customer demand for indexed products and living benefits. As discussed below, our 2018 financial performance was solid in this challenging period of growth in sales, declining investment yields and market volatility.

Net income decreased \$109.8 million to \$150.1 million in 2018, from \$259.9 million in 2017, due to one-time tax benefits in 2017 and volatility in non-core earnings. Total income tax expense in 2018 was \$23.6 million compared to a benefit of \$50.2 million in 2017. In 2017, the Company recorded a one-time federal income tax benefit of \$119.7 million, due to the remeasurement of net deferred tax liabilities to reflect the decrease in the federal corporate income tax rate from 35% to 21%.

Pre-tax operating income of \$197.8 million decreased by \$49.1 million from \$246.9 million in 2017, due to market volatility in non-core earnings, which reflect the short-term volatility related to the measurement of our

indexed product reserves. Non-core earnings decreased pre-tax operating income by \$26.9 million in 2018 and increased pre-tax operating income by \$21.7 million in 2017, primarily due to movement in equity market indexes, particularly the volatility in the fourth quarter of 2018.

Core earnings in 2018 of \$224.7 million were consistent with the prior year, decreasing just 0.2% from \$225.2 million in 2017. Core earnings in 2018 were impacted by growth in life policy charge revenues and strong investment performance, partially offset by higher operating expenses and interest expense on \$350 million of surplus notes issued in July 2018. In 2018, we added personnel and upgraded systems to improve service and customer experience, in addition to supporting the higher volume of business resulting from strong sales.

The net impact of actuarial assumption updates increased core earnings by \$12.6 million in 2018, compared to net adjustments that increased core earnings by \$13.0 million in 2017. Included in the 2017 adjustments was a \$14.1 million positive impact on core earnings from an adjustment to deferred acquisition costs related to refining the composition of assets that support our indexed universal life products. The adjustments in the 2018 period primarily reflected updated assumptions for life mortality. The adjustments in the 2017 period primarily reflected updated assumptions for life premium persistency and mortality, which were largely offset by refinements in modeling and spread assumptions for indexed annuity products.

Each of the components of core earnings and the factors that contribute to the changes for the years ended December 31, 2018, and 2017 are described in detail below.

	For the Year Ended December 31,	
	2018	2017
	<i>(in thousands)</i>	
Revenues:		
Insurance premiums	\$ 217,241	\$ 220,629
Policy and contract charges	648,395	564,064
Mutual fund commissions, fees and other income	82,453	112,433
Net investment income	1,146,975	1,080,077
Total revenues, on a core earnings basis	2,095,064	1,977,203
Benefits and expenses:		
Decrease in policy liabilities	(83,762)	(21,468)
Policy benefits	536,813	474,918
Policyholders' dividends and dividend obligations	40,191	58,196
Interest credited to policyholder account liabilities	634,371	545,400
Operating expenses	322,770	316,377
Interest expense	49,286	39,620
Policy acquisition expenses and amortization of present value of future profits, net	370,668	338,979
Total benefits and expenses, on a core earnings basis	1,870,337	1,752,022
Core earnings	\$ 224,727	\$ 225,181

Insurance Premiums

Insurance premiums include considerations on traditional whole, term life insurance and disability income contracts. Insurance premiums do not include deposits received for investment-type products such as fixed interest annuities, index annuities and universal life policies, which comprise the majority of our new sales. Annuity products earn a net spread between net investment income on assets that support the policies and expenses for interest credited to policyholders. Revenue from universal life products is primarily reflected in policy and contract charges.

Insurance premiums decreased slightly to \$217.2 million in 2018 from \$220.6 million in 2017, due to lower sales of whole life products and lower renewal premiums due to the expected run-off of the Closed Block.

Policy and Contract Charges

Policy and contract charges include fees charged on indexed universal life products, variable annuities, premium loads, cost of insurance charges, surrender charges and rider charges. Policy and contract charges increased \$84.3 million, or 15%, to \$648.4 million in 2018 from \$564.1 million in 2017. This significant increase was driven by growth in overall account value due primarily to continued strong sales of indexed universal life products.

Mutual Fund Commissions, Fees and Other Income

Mutual fund commissions in 2018 consist of dealer concessions earned by the Company's affiliated broker-dealer, Equity Services, Inc. Prior to the October 27, 2017 sale of assets under management related to the mutual fund business, mutual fund fees also included mutual fund administration and asset management fees earned by the Company's affiliated administrator and investment advisor, Sentinel Administrative Services, Inc. and Sentinel Asset Management, Inc., respectively. Revenues from mutual fund commissions decreased \$29.9 million, or 27%, to \$82.5 million in 2018 from \$112.4 million in 2017. This decrease was primarily due to the sale of the mutual fund business and was largely offset by a corresponding decrease in mutual fund commission expense, which is reported within policy acquisition expenses and amortization of present value of future profits, net. Other income includes revenues from reinsurance, corporate owned life insurance and miscellaneous fee income.

Net Investment Income

Net investment income represents interest income on our portfolio of bonds, mortgage loans, contract loans and short-term investments, as well as amortization of premium or accretion of discount on bonds, dividends from preferred and common stock, and partnership income. On a non-GAAP core earnings basis, we exclude from net investment income any income (losses) from derivative instruments that hedge indexed product liabilities; instead, those hedging results are presented within interest credited to policyholder account liabilities. Net investment income on a core earnings basis increased \$66.9 million, or 6%, to \$1.15 billion in 2018 from \$1.08 billion in 2017. The increase was primarily driven by higher partnership income in the current year and an increase in the bond and mortgage loan portfolios due to the overall growth of in-force business.

The table below provides a breakdown of the components of net investment income, excluding income on options that economically hedge our indexed products:

	For the Year Ended December 31,	
	2018	2017
	<i>(in thousands)</i>	
Net investment income		
Debt securities interest	\$ 895,800	\$ 867,329
Equity securities dividends	5,849	5,292
Mortgage loan interest	155,535	142,478
Policy loan interest	43,109	41,846
Real estate income	8,564	7,009
Derivative losses	(51)	(5,703)
Partnership income	66,997	46,563
Other investment income	6,044	1,363
Gross investment income	<u>1,181,847</u>	<u>1,106,177</u>
Less: Investment expenses	<u>(34,872)</u>	<u>(26,100)</u>
Net investment income on a core earnings basis	<u>\$ 1,146,975</u>	<u>\$ 1,080,077</u>

Policy Liabilities

Policy liabilities reflect the impact of changes in the product liability reserves for whole and term life insurance, disability income insurance and the additional reserves held on certain annuities. The change in policy reserves was a net decrease of \$83.8 million in 2018 compared to a \$21.5 million net decrease in 2017. The year over year decrease was primarily related to reserves released by the surrender of certain large whole life policies within the Closed Block in the current year.

Policy Benefits

Policy benefits include death benefits for life insurance policies, policy surrenders for whole life policies and disability income benefits. In addition, policy benefits include a small amount of miscellaneous benefits such as payments on life-contingent immediate annuities and premium waiver benefits due to disability. Policy benefits increased \$61.9 million to \$536.8 million in 2018 from \$474.9 million in 2017. The increase was primarily driven by higher mortality for indexed universal life and Closed Block policies, as well as the surrender of certain large whole life policies. In 2017, a premium persistency assumption update adjustment increased policy benefit expense by \$9 million.

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 ("PDO") primarily arising from the Closed Block. Dividends are based on a scale that is designed to reflect the relative contribution of each group of policies to the Company's overall operating results. The dividend scales are approved annually by the Company's Board of Directors. For the non-GAAP measure of core earnings, policyholders' dividends and dividend obligations exclude amounts related to current period net realized capital gains (losses). Policyholders' dividends and dividend obligations included in core earnings decreased \$18.0 million to \$40.2 million in 2018 from \$58.2 million in 2017. This decrease was related to lower earnings in the Closed Block compared to prior year.

Interest Credited to Policyholder Account Liabilities

Interest credited to policyholder account liabilities represents amounts credited to universal life insurance, fixed deferred annuities and indexed products, as well as the change in reserves related to guaranteed lifetime income riders ("GLIR") and the amortization of sales inducements. For the non-GAAP presentation of core earnings, interest credited also includes income on options that economically hedge our indexed products. Core interest credited increased \$89.0 million to \$634.4 million in 2018 from \$545.4 million in 2017.

This increase was primary attributable to growth in account value within our indexed product lines, as well as actuarial assumption updates. The actuarial assumption adjustments in 2018 included a decrease in core interest credited expense of \$3.7 million. The actuarial assumption adjustments in 2017 decreased core interest credited expense by \$14.4 million, which included an update of spread assumptions and a refinement of sales inducement amortization. As a result, the year over year change in the impact of actuarial assumption updates was a \$10.7 million increase in interest credited expense.

Operating Expenses

Operating expenses consist primarily of administrative, maintenance and operational expenses related to servicing the Company's business. Operating expenses increased \$6.4 million to \$322.8 million in 2018 from \$316.4 million in 2017. The increase was primarily related to growth-related expenses including additional personnel to support a higher level of customer service, higher premium taxes, increased software maintenance costs, and higher legal expenses, partially offset by a decrease in operating expenses related to the October 2017 sale of the mutual fund business.

Interest Expense

Interest expense consists of interest paid on the Company's surplus notes and senior notes. Interest expense totaled \$49.3 million in 2018 and \$39.6 million in 2017. The increase in interest expense compared to the prior year was due to the issuance in July 2018 of \$350 million of surplus notes of NLIC that mature in 2068. These surplus notes will accrue interest at a fixed rate of 5.25% until July 18, 2048, and thereafter at a floating rate. Interest is payable semi-annually, subject to approval of the Vermont Insurance Commissioner. The surplus notes are redeemable by NLIC on or after July 19, 2048.

NLIC also completed in July 2018 an exchange transaction in which it issued an additional \$22.1 million of the 5.25% 2068 surplus notes in exchange for a portion of its outstanding 10.5% surplus notes, originally issued in 2009, with a principal balance of \$12.8 million. The discount at the time of the exchange, \$9.3 million, will be charged to interest expense over the non-callable period of the 5.25% surplus notes.

In 2018 and 2017, the Company also repurchased \$7.1 million and \$1.2 million, respectively, of NLIC's outstanding 10.5% surplus notes. Losses of \$3.9 million and \$0.8 million were recorded on the repurchases and included in net realized capital losses in 2018 and 2017, respectively.

Policy Acquisition Expenses and Amortization of Present Value of Future Profits ("PVFP"), Net

Policy acquisition expenses include commissions and other costs related to the acquisition of new or renewal life and annuity business, as well as amortization of previously deferred acquisition costs ("DAC"). Commissions and other costs that are directly related to the successful acquisition of new or renewal insurance contracts are eligible to be deferred under U.S. GAAP. DAC for participating life insurance, universal life insurance, and annuities is amortized and recognized in income in relation to future estimated gross profits. DAC for non-participating term and whole life insurance and participating limited-payment and single-payment life insurance is amortized and recognized in relation to premium income. Policy acquisition expenses are reported net of amounts deferred in the current year and include the amortization of DAC.

For the non-GAAP presentation of core earnings, policy acquisition expenses exclude amortization of DAC related to net realized capital gains (losses) on assets that support policy reserves, and amortization of DAC related to non-core earnings.

Policy acquisition expenses for the life and annuity businesses included in core earnings increased \$46.9 million, or 17%, to \$323.8 million in 2018 from \$276.9 million in 2017 (excluding amortization of mutual fund commissions and PVFP, discussed below). The increase was primarily due to higher amortization expense primarily driven by higher gross profits on an increased volume of indexed universal life and annuity products.

At least annually, the Company reviews its actuarial assumptions for reserves and DAC, including assumptions for premium persistency, investment income, gross profits, mortality, and lapse and surrender rates, and any resulting adjustments to the DAC asset are reflected in current year core earnings. In 2018, such adjustments to DAC amortization expense increased core earnings by \$7.5 million, due to assumption updates related primarily to mortality rates. In 2017, actuarial assumption adjustments to DAC decreased core earnings by \$6.3 million, mainly due to spread assumptions on indexed annuities and mortality assumptions for universal life products. In addition, 2017 core earnings also included a positive \$14.1 million adjustment to DAC amortization related to a refinement in the asset mix used to support our indexed universal life reserves.

Policy acquisition expenses reported in core earnings also includes mutual fund commissions. Mutual fund commissions decreased \$8.6 million to \$46.9 million in 2018 from \$55.5 in 2017. The decrease was due to the sale of the mutual fund business (see "Mutual Fund Commissions" above).

Prior to December 31, 2017, the Company held PVFP attributable to two blocks of insurance purchased prior to 2000. Amortization of PVFP was \$6.6 million for the year ended December 31, 2017, which included \$3.8 million of accelerated amortization to write the remaining asset balance down to zero in 2017, as the underlying blocks of business were no longer projecting future profits.

Net Realized Capital Gains (Losses)

The Company recorded net realized capital losses of \$23.5 million in 2018 and \$36.3 million in 2017. Net realized capital losses in 2017 included \$40.7 million of impairments in capitalized software costs, and a \$9.3 million gain on the sale of assets related to the mutual fund business (see “About the Company,” above). The non-GAAP measure of pre-tax operating income excludes net realized capital gains (losses) and is also adjusted to exclude amortization of DAC and sales inducements, and policyholder dividend obligations, related to net realized capital gains (losses) (see “Non-GAAP Measures,” above). Details of net realized capital gains (losses) by asset category are provided in the table below:

	For the Year Ended December 31,	
	2018	2017
	<i>(in thousands)</i>	
Net realized capital gains (losses) on:		
Debt securities	\$ (6,187)	\$ 6,773
Equity securities	(3,599)	2,000
Mortgage loans	(627)	(1,074)
Partnerships	(9,531)	(8,613)
Other invested assets	319	(900)
Real estate	(405)	(2,371)
Embedded derivative	(98)	—
Sale of mutual fund business	538	9,346
Debt retirement	(3,890)	(775)
Impairment of capitalized software	—	(40,689)
Net realized capital losses	<u>(23,480)</u>	<u>(36,303)</u>

Federal Income Taxes

Federal income tax expense for 2018 was \$23.6 million, which represented an effective tax rate of 13.6%, compared to income tax benefit of \$50.2 million in 2017 with an effective tax rate of -23.9%. The low effective tax rate in 2018 was due in part to the benefit of contributions to the Company's qualified home office employee pension plan, which was fully funded as of December 31, 2018. The Company's significant net tax benefit and negative effective tax rate in 2017 were primarily due to a one-time tax benefit of \$119.7 million resulting from the Company's re-measurement of net deferred tax liabilities to reflect the decrease in the federal corporate income tax rate from 35% to 21% under the Tax Cuts and Jobs Act enacted on December 22, 2017 (see “Critical Accounting Estimates – Federal Income Taxes” below). Income tax expense in 2018 and benefit in 2017 included income tax benefits of \$3.4 million in 2018 and \$9.9 million in 2017 related to net realized capital gains and losses.

Non-Core Earnings

Non-core earnings primarily include short-term income volatility that results from the measurement under GAAP of certain indexed product liabilities, and the related impact to DAC and deferred sales inducements, which are sensitive to movement in equity market indexes and future interest rate assumptions. Non-core earnings reduced pre-tax operating earnings by \$26.9 million in 2018 and contributed \$21.7 million of positive non-core earnings to pre-tax operating earnings in 2017. The negative non-core earnings in 2018 were primarily due to volatile equity markets in the fourth quarter of 2018, which temporarily increased our accounting reserves for indexed products, and more than offset positive non-core earnings from the first half of 2018. The positive non-core earnings in 2017 were due primarily to appreciation in equity market indexes in 2017. Interest crediting on the majority of our indexed products is tied to the S&P 500 Index, which declined 6% in 2018 (14% in the fourth quarter of 2018), compared to an increase in the index of 19% in 2017.

SUMMARY OF FINANCIAL POSITION

Balance Sheet Information

The Company's investment objective is to keep its promises to policyholders by earning competitive net investment income within prudent and strategic asset allocation, asset liability management, and risk management frameworks. This includes portfolio and issuer diversification and careful consideration of various scenarios including interest rate, credit, and liquidity risks through market cycles. The Company's investment portfolio consists primarily of available-for-sale debt and equity securities, agency residential mortgage-backed securities, directly underwritten commercial real estate mortgages, and contract loans.

As of December 31, 2018, total assets under management (excluding unrealized gains and losses) were \$30.5 billion, of which \$24.2 billion was attributable to life insurance policy and annuity contract values with more than 856,000 customers. The Company's investments in available-for-sale debt and equity securities grew \$1.2 billion to just over \$20 billion as of December 31, 2018 compared to 2017, after excluding the change in net unrealized gains and losses (which declined in 2018 due to modest increases in market interest rates). The growth in our portfolio was driven primarily by strong life sales throughout 2018. The remainder of the portfolio consists primarily of commercial mortgage loans, other invested assets, cash, trading debt and equity securities, policy loans, and other short-term investments. The fair value of derivative assets, which are primarily options used to hedge our indexed product liabilities, declined \$762.0 million during 2018, primarily due to equity market volatility in the fourth quarter of 2018.

Total liabilities as of December 31, 2018 were \$27.8 billion, compared to \$27.2 billion for the same period in 2017. The year to date increase of \$547.7 million was primarily due to an increase in policyholder account liabilities, which was consistent with our strong sales growth in 2018. This growth was partially offset by a decrease in the market value of derivative liabilities, primarily due to equity market volatility in the fourth quarter of 2018.

Additionally, total debt increased by \$338.2 million as of December 31, 2018 to \$790.9 million, compared to \$452.6 million at December 31, 2017, due to the issuance of \$350 million of new 5.25% surplus notes and other surplus note activity in 2018 (see "Interest Expense" above).

The following table provides a summary of the Company's consolidated balance sheet data:

	As of December 31,	
	2018	2017
	<i>(in thousands)</i>	
Assets:		
Cash and investments	\$ 26,395,180	\$ 26,823,160
Other general account assets	3,271,985	2,570,367
Separate account assets	769,763	814,928
Total assets	\$ 30,436,928	\$ 30,208,455
Liabilities and Stockholder's Equity:		
Total liabilities	27,775,918	27,228,171
Stockholder's Equity:		
Retained earnings	2,741,935	2,591,881
Accumulated other comprehensive (loss) income	(80,925)	388,403
Total stockholder's equity	2,661,010	2,980,284
Total liabilities and stockholder's equity	\$ 30,436,928	\$ 30,208,455

Cash Flow Information

The following table includes the Company's consolidated cash flows provided by or used in operating, investing, and financing activities:

	For the Year Ended December 31,	
	2018	2017
	<i>(in thousands)</i>	
Net cash (used) provided by operating activities	\$ (134,706)	\$ 60,538
Net cash used in investing activities	(1,922,286)	(1,469,875)
Net cash provided by financing activities	1,930,508	1,448,907
Net (decrease) increase in cash	<u>\$ (126,484)</u>	<u>\$ 39,570</u>

Net cash used by operations was \$134.7 million in 2018, compared to \$60.5 million of net cash provided by operations in the same period in the prior year. The decrease was primarily due to higher acquisition expenditures related to increased sales, higher benefit payments in the current year, and \$46.9 million of contributions to the Company's qualified pension plans.

Net cash used in investing activities increased to \$1.9 billion in 2018, compared to \$1.5 billion in the prior year. The increase in net investing activity is directly correlated to the increase in net cash provided by financing activities in the current year.

Net cash provided by financing activities was \$1.9 billion in 2018, compared to \$1.4 billion in 2017. The increase was due to the issuance of \$350 million of surplus notes, less \$5 million of associated costs, as well as a \$178 million increase in net policyholder deposits and withdrawals. Net issuances of FHLB funding agreements (advances net of repayments) were \$268 million in 2018, compared to net issuances of \$246 million in the prior year. Our Institutional Markets FHLB activity is managed opportunistically, so the volume of funding agreements issued depends on pricing and the availability of desirable assets to support these liabilities. New issuances of funding agreements in 2018 were primarily in the fourth quarter, because lower asset spreads throughout much of 2018 resulted in no issuances in the second and third quarters of 2018.

	As of December 31,		Change
	2018	2017	
	<i>(in millions)</i>		
Other Selected Data			
Life insurance in force (before reinsurance ceded)	<u>\$ 142,317</u>	<u>\$ 119,912</u>	<u>\$ 22,405</u>
Total assets under management (excluding unrealized gains and losses)	<u>\$ 30,474</u>	<u>\$ 29,398</u>	<u>\$ 1,076</u>
<u>Weighted New Annualized Premium (WNAP) Sales</u>			
Life	\$ 309	\$ 241	\$ 68
Annuity	247	241	6
Total Life and Annuity WNAP	<u>\$ 556</u>	<u>\$ 482</u>	<u>\$ 74</u>

The increase in Life WNAP reflected continued growth in sales of indexed universal life, primarily driven by expanding our distribution footprint through an increase in the number of producing agents in our career and independent agencies, and customer demand for indexed products and living benefits. The increase in Annuity WNAP reflected strong sales of single premium deferred annuities, partially offset by lower WNAP from flow (flexible premium) annuities. Flow annuity sales slowed in 2018, primarily due to challenges in accessing teachers in K-12 public schools due to heightened school security nationwide.

CRITICAL ACCOUNTING 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. The most significant areas of management's judgment include:

- actuarial assumptions affecting policyholder reserves and estimated gross profits;
- policy liabilities;
- valuation of derivatives;
- valuation of mortgages;
- pension and other postretirement employee benefits;
- evaluation of other-than-temporary impairments; and
- federal income taxes.

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 consolidated financial statements.

Actuarial Assumptions Affecting Policyholder Reserves and Estimated Gross Profits

Commissions and other costs that are directly related to the successful acquisition of new or renewal insurance contracts are eligible to be deferred. Deferred policy acquisition costs for participating life insurance, universal life insurance, and non-life contingent 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 also adjusted for related unrealized gains (losses) on available-for-sale debt and equity securities (after deducting any related policyholder dividend obligations) through Other Comprehensive Income, net of related deferred income taxes.

DAC for non-participating term and whole life insurance and participating single-payment and limited-payment life insurance is amortized in relation to premium income using assumptions consistent with those used in computing policy benefit liabilities.

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 scales, mortality, expenses, contract lapses, withdrawals, surrenders and amortization period.

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 4.50% and 4.63% as of December 31, 2018 and 2017, respectively.

Policy benefit liabilities for non-participating life insurance, disability income, 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 balances for indexed life insurance and annuity liabilities consist of a combination of underlying account value and embedded derivative values. The underlying account value is primarily based on the initial deposit plus any interest credited less applicable fees or policy charges. The embedded derivative values are measured at fair value based on actuarial and capital market assumptions related to projected cash flows over the expected lives of the contracts. Option pricing models are used, taking into account assumptions for future equity indexed crediting rates in light of market conditions and policyholder behavior assumptions. The fair value of the embedded derivatives 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.

Valuation of Derivatives

Derivative instruments held include options, swaptions, interest rate swaps, and futures contracts, all of which are carried at fair value. The fair value of derivatives is based on modeling using publicly available data. When that data is not available, the Company uses independent broker pricing quotes.

Valuation of Mortgages

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 borrower's 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 as well as loss frequency and severity estimates.

For mortgage loans that are deemed impaired, an impairment loss is recognized through realized capital 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. Mortgage loans of \$3.67 billion and \$3.35 billion reported on the Company's consolidated balance sheet were net of related valuation allowances of \$1.1 million and \$1.7 million as of December 31, 2018 and 2017, respectively, and net of \$3.3 million and \$3.3 million of impairments as of December 31, 2018 and 2017, respectively.

Pension and Other Postretirement Employee Benefits

The Company sponsors a qualified defined benefit pension plan covering substantially all employees. The plan is non-contributory, with benefits for NLIC employees hired prior to July 1, 2001, based on an employee's retirement age, years of service, and compensation near retirement. Benefits for NLIC 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 plan was fully funded as of December 31, 2018. 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 bonds held in a Company separate account and funds invested in a group variable annuity contract held in the general account of NLIC. None of the securities held in the Company's separate account were issued by the Company.

The Company also sponsors other pension plans, including a non-contributory defined benefit plan for Career general agents who met the eligibility requirements to enter the plan prior to January 1, 2005 and a non-

contributory 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 postretirement 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.

Evaluation 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 that identifies securities, using certain quantitative and qualitative characteristics, which could be potentially impaired. These identified securities are subjected to an enhanced analysis to determine if the impairments are other-than-temporary.

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 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 in 2017, due to the re-measurement of net deferred tax liabilities resulting from the decrease in the federal corporate income tax rate from 35% to 21%. Under U.S. GAAP, the Company was permitted to reflect the portion of this 2017 decrease in tax expense attributable to the reduction in deferred tax liabilities related to unrealized gains (losses) in the Consolidated Statement of Changes in Stockholder's Equity, as a reclassification of \$67.5 million from retained earnings to accumulated other comprehensive income.

STATUTORY INFORMATION

Statutory information reflects financial data prepared in conformity with the statutory accounting practices prescribed or permitted by the Vermont Department of Financial Regulation. In any particular year, the statutory net income and surplus of the Company's insurance subsidiaries may increase or decrease depending on a variety of factors, including changes in interest rates, equity market and credit market conditions, other macroeconomic conditions, the amount of capital needed to support business growth, the value of certain fixed-income and equity securities in their investment portfolios, and the value of certain hedging instruments.

The table below sets forth statutory income and statutory capital and surplus for the Company's insurance subsidiaries NLIC, LSW, Catamount and Longhorn. The statutory capital and surplus amounts as of December 31, 2018 and December 31, 2017 in the table below are based on actual statutory filings with the applicable U.S. regulatory authorities. For all of these companies, statutory capital and surplus as of December 31, 2018 was significantly in excess of the aggregate minimum required statutory capital and surplus, with minimum requirements defined as the level of risk-based capital that would trigger state regulatory action.

		Net Income (Loss)		Capital and Surplus
		<i>(in millions)</i>		
National Life Insurance Company ⁽¹⁾	2018	\$ (22.8)	\$	2,131.1
	2017	14.9		2,015.6
Life Insurance Company of the Southwest ⁽¹⁾	2018	(193.8)		1,241.1
	2017	61.2		1,207.6
Catamount Reinsurance Company	2018	13.4		60.3
	2017	9.2		53.8
Longhorn Reinsurance Company ⁽²⁾	2018	13.9		60.4
	2017	(3.2)		59.7

- (1) The net losses in 2018 for National Life Insurance Company and Life Insurance Company of the Southwest were primarily driven by:
- a. Higher commissions and premium taxes related to significant growth in sales and volume of business, and
 - b. The effect of equity market volatility, particularly in the fourth quarter of 2018, on the mark-to-market valuation of derivative instruments used to hedge indexed products.
- (2) Longhorn Reinsurance Company's net loss in 2017 was driven by a nonrecurring ceding commission payment of \$5 million to LSW, related to a 2017 reinsurance transaction in which LSW ceded to Longhorn certain indexed universal life insurance policies that had been issued by LSW from January 1, 2016 through December 31, 2016.

The following table summarizes the financial strength ratings of the Company's primary insurance subsidiaries, NLIC and LSW, from the major independent rating organizations as of December 31, 2018:

A.M. Best	Standard & Poor's	Moody's
A (Excellent)	A+ (Strong)	A2 (Good)

These ratings may be revised or revoked at any time at the sole discretion of the rating organization. These financial strength ratings are not ratings of the debt securities of NLVF or any of its subsidiaries, nor are they a recommendation to buy or hold any such debt securities.

PROSPECTIVE INFORMATION

Forward-looking statements contained in the following discussion are not guarantees of future performance and involve risks and uncertainties. Actual results may differ materially from those in the forward-looking statements as a result of various factors. The following uncertainties, among others, may have such an effect:

- Difficult conditions in the global capital markets and the economy;
- Significant market valuation fluctuations of the Company's investments, including any that are relatively illiquid;
- Differing interpretations in the methodologies, estimations and assumptions for the valuation of fixed maturity, equity and trading securities;
- Subjectivity in determining the amount of allowances and impairments taken on certain Company investments;
- Defaults on commercial mortgages held by the Company and volatilities in performance;
- Exposure to structured finance securities;
- Exposure to alternative investments;
- Exposure to mortgage-backed securities;
- Impairments of other institutions;
- Changes in interest rates and exposure to credit spreads;
- Effectiveness of the Company's hedging strategies and availability of hedging instruments;
- Impact of economic conditions on customers and vendors;
- Downgrades or potential downgrades in the Company's ratings;
- Changes in accounting rules;
- Adverse regulatory and legislative developments;
- Litigation and regulatory investigations;
- Changes in tax laws and the interpretation thereof;
- Inability to pay guaranteed policy benefits;
- Effectiveness of the Company's risk management policies and procedures;
- Lack of available, affordable or adequate reinsurance;
- Failure of counterparties to perform under reinsurance agreements, hedging instruments, or other contracts with the Company;
- Significant competition in the Company's businesses;

- Sensitivity of the amount of statutory capital the Company must hold to factors outside of its control;
- Adequacy of the Company's reserves for future policy benefits and claims;
- Deviations from assumptions regarding future mortality, morbidity, and interest rates used in calculating reserve amounts and pricing the Company's products;
- Ability to attract and retain independent agents, career agents, and key personnel;
- Ability to raise additional capital;
- Costs related to future pension obligations;
- Impact of international tension between the United States and other nations, terrorist attacks or ongoing military and other actions;
- Pandemics or other catastrophic events; and
- A computer system failure or security breach.

Consequently, such forward-looking statements should be regarded solely as our current plans, estimates, and beliefs. We do not intend, and do not undertake, any obligation to update any forward-looking statements to reflect future events or circumstances after the date of such statements.

Our goals over the next several years include continued responsible growth across all of our product lines, as well as improving the efficiency and effectiveness of the overall organization. The Company will continue to deliver new and innovative products and riders, and partner with distributors who share our mission, values, and purpose. We will also continue to invest in our technology infrastructure to improve services for all our key stakeholders.

We will continue to effectively manage our investment portfolio to maximize risk-adjusted returns and to maintain targeted duration matching of our product obligations and related investments.

Basis of Presentation and Principles of Consolidation

The accompanying consolidated financial statements of NLVF have been prepared in conformity with U.S. GAAP. These financial statements should be read in conjunction with and are qualified in their entirety by reference to the Company's consolidated financial statements as of and for the years ended December 31, 2018 and 2017, which have been audited by PricewaterhouseCoopers LLP, including the accompanying notes which are an integral part of the audited financial statements. The preparation of financial statements in conformity with U.S. GAAP requires the Company to make estimates and assumptions that affect the reported amounts and related disclosures. Actual results could differ, possibly materially, from those estimates.

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.

NLV Financial Corporation and Subsidiaries

Financial Statements

**As of and for the Years Ended
December 31, 2018 and 2017**

NLV Financial Corporation and Subsidiaries
Index
December 31, 2018 and 2017

	Page(s)
Report of Independent Auditors	<u>2</u>
Consolidated Financial Statements	
Consolidated Balance Sheets	<u>3</u>
Consolidated Statements of Comprehensive Income	<u>4</u>
Consolidated Statements of Changes in Stockholder's Equity	<u>5</u>
Consolidated Statements of Cash Flows	<u>6</u>
Note 1 – Nature of Operations and Structure	<u>7</u>
Note 2 – Summary of Significant Accounting Policies	<u>8</u>
Note 3 – New Accounting Pronouncements	<u>21</u>
Note 4 – Fair Value Measurements	<u>24</u>
Note 5 - Investments	<u>33</u>
Note 6 - Reinsurance	<u>45</u>
Note 7 – Deferred Policy Acquisition Costs	<u>47</u>
Note 8 – Federal Income Taxes	<u>48</u>
Note 9 – Benefit Plans	<u>49</u>
Note 10 – Goodwill and Other Intangibles	<u>56</u>
Note 11 - Debt	<u>57</u>
Note 12 – Commitments and Contingencies	<u>58</u>
Note 13 – National Life Closed Block	<u>60</u>
Note 14 – Statutory Information and Restrictions	<u>62</u>
Note 15 – Participating Life Insurance	<u>63</u>



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, 2018 and 2017, and the related consolidated statements of comprehensive income, of changes in stockholder's equity and of cash flows for the years then ended.

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, 2018 and 2017, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

A handwritten signature in black ink that reads "PricewaterhouseCoopers LLP". The signature is written in a cursive, flowing style.

February 20, 2019

NLV Financial Corporation and Subsidiaries
Consolidated Balance Sheets
As of December 31, 2018 and 2017

(in thousands)

	2018	2017
Assets:		
Cash and investments:		
Available-for-sale debt securities	\$ 20,122,717	\$ 20,048,333
Available-for-sale equity securities	30,978	35,839
Trading debt securities	19,082	—
Trading equity securities	24,382	19,812
Mortgage loans	3,674,383	3,350,570
Policy loans	921,516	877,927
Real estate investments	16,210	24,465
Derivative assets	231,174	993,249
Other invested assets	932,402	960,415
Short term investments	264,750	228,480
Cash and restricted cash	157,586	284,070
Total cash and investments	<u>26,395,180</u>	<u>26,823,160</u>
Deferred policy acquisition costs	2,093,111	1,539,129
Accrued investment income	232,368	217,982
Premiums and fees receivable	22,639	22,577
Amounts recoverable from reinsurers	132,164	122,889
Property and equipment, net	165,934	153,110
Corporate owned life insurance	493,679	420,069
Federal income tax recoverable	31,306	—
Other assets	100,784	94,611
Separate account assets	769,763	814,928
Total assets	<u>\$ 30,436,928</u>	<u>\$ 30,208,455</u>
Liabilities:		
Policy liabilities:		
Policy benefit liabilities	\$ 4,159,561	\$ 4,408,663
Policyholder account liabilities	21,115,895	19,485,437
Policyholders' deposits	90,082	97,900
Policy claims payable	95,698	68,645
Policyholders' dividends and dividend obligations	62,342	184,931
Total policy liabilities	<u>25,523,578</u>	<u>24,245,576</u>
Amounts payable to reinsurers	38,734	23,457
Derivative liabilities	102,391	566,986
Other liabilities and accrued expenses	309,911	682,703
Pension and other post-retirement benefit obligations	149,422	194,257
Deferred income taxes	91,253	181,517
Federal income tax payable	—	66,109
Debt	790,866	452,638
Separate account liabilities	769,763	814,928
Total liabilities	<u>\$ 27,775,918</u>	<u>\$ 27,228,171</u>
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	2,741,935	2,591,881
Accumulated other comprehensive income	(80,925)	388,403
Total stockholder's equity	<u>\$ 2,661,010</u>	<u>\$ 2,980,284</u>
Total liabilities and stockholder's equity	<u>\$ 30,436,928</u>	<u>\$ 30,208,455</u>

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, 2018 and 2017

(in thousands)

	2018	2017
Revenues:		
Insurance premiums	\$ 217,241	\$ 220,629
Policy and contract charges	648,395	564,064
Mutual fund commissions and fee income	51,571	85,453
Net investment income	980,790	1,415,211
Net realized capital losses	(23,480)	(36,303)
Other income	30,882	25,844
Total revenues	1,905,399	2,274,898
Benefits and expenses:		
Decrease in policy liabilities	(83,762)	(21,468)
Policy benefits	536,813	474,918
Policyholders' dividends and dividend obligations	40,224	57,144
Interest credited to policyholder account liabilities	504,945	819,837
Operating expenses	322,770	316,377
Interest expense	49,286	39,620
Policy acquisition expenses and amortization of present value of future profits, net	361,509	378,714
Total benefits and expenses	1,731,785	2,065,142
Income before income taxes	173,614	209,756
Income tax expense (benefit)	23,560	(50,182)
Net income	\$ 150,054	\$ 259,938
Other comprehensive (loss) income, net of tax:		
Unrealized (losses) gains on available-for-sale investments	(473,345)	263,789
Cash flow hedge on debt issuance	41	(80)
Change in funded status of retirement plans	3,976	(14,383)
Total other comprehensive (loss) income	(469,328)	249,326
Comprehensive (loss) income	\$ (319,274)	\$ 509,264

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, 2018 and 2017

	Class A Common Stock	Class B Common Stock	Preferred Stock	Retained Earnings	Accumulated Other Comprehensive Income	Total
<i>(in thousands)</i>						
December 31, 2016	—	—	—	2,399,476	139,077	2,538,553
Net income	—	—	—	259,938	—	259,938
Other comprehensive income	—	—	—	—	181,793	181,793
Effect of change in tax rate on accumulated other comprehensive income	—	—	—	(67,533)	67,533	—
Total comprehensive income						441,731
December 31, 2017	—	—	—	2,591,881	388,403	2,980,284
Net income	—	—	—	150,054	—	150,054
Other comprehensive loss	—	—	—	—	(469,328)	(469,328)
Total comprehensive loss						(319,274)
December 31, 2018	\$ —	\$ —	\$ —	\$ 2,741,935	\$ (80,925)	\$ 2,661,010

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, 2018 and 2017

(in thousands)

	2018	2017
Cash flows from operating activities:		
Net income	\$ 150,054	\$ 259,938
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for deferred income taxes	34,489	(145,808)
Interest credited to policyholder account liabilities	504,945	819,837
Amortization of deferred policy acquisition costs	250,042	265,002
Policy and contract charges	(648,395)	(564,064)
Net realized capital losses	23,480	37,439
Change in fair value of derivatives	166,865	(335,329)
Change in corporate owned life insurance policies	(13,610)	(6,363)
Amortization of present value of future profits of insurance acquired	—	6,642
Depreciation	29,115	28,478
Other	(6,243)	(22,529)
Changes in assets and liabilities:		
Accrued investment income	(14,385)	(9,935)
Deferred policy acquisition costs	(507,138)	(417,730)
Policy liabilities	35,390	80,165
Other assets and liabilities	(139,315)	64,795
Net cash (used) provided by operating activities	<u>(134,706)</u>	<u>60,538</u>
Cash flows from investing activities:		
Proceeds from sales, maturities and repayments of investments	3,057,579	3,255,054
Cost of investments acquired	(4,601,584)	(4,582,323)
Property and equipment additions	(49,662)	(38,414)
Cost of corporate owned life insurance acquired	(60,000)	(140,000)
Change in policy loans	(43,589)	(39,386)
Change in short term investments	(36,270)	(26,056)
Change in short term broker collateral	(192,689)	113,506
Other	3,929	(12,256)
Net cash used by investing activities	<u>(1,922,286)</u>	<u>(1,469,875)</u>
Cash flows from financing activities:		
Policyholders' deposits	2,684,083	2,333,006
Policyholders' withdrawals	(1,326,884)	(1,153,580)
Advances from Federal Home Loan Banks	440,598	325,579
Repayments to Federal Home Loan Banks	(172,165)	(79,510)
Proceeds from debt issuance	345,022	—
Debt retirement	(10,940)	(1,995)
Change in other deposits	(29,206)	25,407
Net cash provided by financing activities	<u>1,930,508</u>	<u>1,448,907</u>
Net (decrease) increase in cash	(126,484)	39,570
Cash and restricted cash:		
Beginning of year	284,070	244,500
End of year	<u>\$ 157,586</u>	<u>\$ 284,070</u>
Supplemental disclosure of cash flow information:		
Interest paid	<u>\$ 39,273</u>	<u>\$ 39,342</u>
Income taxes paid	<u>\$ 50,429</u>	<u>\$ 23,789</u>

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

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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 1,150 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 National Life Holding Company (“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 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 the Company’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.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

NOTE 1 – NATURE OF OPERATIONS AND STRUCTURE (continued)

The Company's principal product lines are traditional whole life, term life, fixed interest universal life, indexed universal life, variable universal life, variable annuities, fixed interest rate annuities and fixed indexed annuities. The Company provides this broad range of life insurance and annuity products to a national client base through an extensive network of independent agents and a career agency distribution channel. The Company focuses on serving Middle America in its target market of customers with household income of between \$75,000 and \$150,000, offering products with benefits that help Middle America customers meet needs during their lifetime, including lifetime income in retirement and accelerated death benefits if the insured becomes terminally, chronically or critically ill. In its individual annuity business, the Company focuses on the 403(b) and 457 K-12 educator markets. The Company also provides financial solutions in the form of estate, business succession and retirement planning, and deferred compensation and other key executive benefit planning to small business owners, professionals, and other middle to upper income individuals. The Company has in excess of 856,000 customers 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 38% 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) in 2017, which included the disposal of \$49.5 million of goodwill and intangibles associated with the mutual fund business. In 2018, a pre-tax gain of \$0.5 million was recognized as an adjustment to the net gain on sale, based on the level of assets under management. The final amount of gain recognized will include additional 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.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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, 2018 and through the consolidated financial statement issuance date of February 20, 2019. 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, 2018 and 2017, the Company had restricted cash of \$48.7 million and \$241.4 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.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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 Securities

Assets held in a segregated custody account in support of a modified coinsurance arrangement have been designated as trading debt securities. Trading debt securities are reported at fair value with changes in fair value recognized in net realized capital gains (losses). See Reinsurance Note 6 for additional information on the modified coinsurance arrangement.

Trading equity securities are reported at fair value. Realized and unrealized gains (losses) on trading equity securities are included in net realized capital gains (losses) 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.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Policy Loans

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

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 from mortgage loans 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 available 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.

Other Invested Assets

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.

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 also receives cash as broker collateral. For additional information, see Cash and Restricted Cash herein.

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.

The Company’s investments in solar tax credit entities are included in other invested assets and are accounted for using the equity method. The Company’s share of the entities’ profits and losses are recognized as a component of net investment income.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Variable Interest Entities

A variable interest entity (“VIE”) is a legal entity that does not have sufficient equity at risk to finance its activities without additional subordinated financial support, or is structured such that equity investors lack the ability to make significant decisions related to the entity’s operations through voting rights or do not substantively participate in the gains and losses of the entity. The primary beneficiary, which is the interest holder that has both the power to direct the activities that most significantly affect the VIE’s economic performance and the obligation to absorb losses or the right to receive benefits that could be significant to the VIE, is required to consolidate the VIE. The Company has variable interests in VIEs through a certain investment in notes and other invested assets. At December 31, 2018 and 2017, the Company had no interests in VIEs that met the criteria for consolidation. See Note 5 for additional information.

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.

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.

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, 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	<u>\$ 495,202</u>	<u>\$ (640)</u>	<u>\$ (106,159)</u>	<u>\$ 388,403</u>
Other comprehensive income before reclassifications	(485,618)	41	(5,239)	(490,816)
Amounts reclassified from AOCI	12,273	—	9,215	21,488
Balance, December 31, 2018	<u>\$ 21,857</u>	<u>\$ (599)</u>	<u>\$ (102,183)</u>	<u>\$ (80,925)</u>

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Accumulated Other Comprehensive Income (continued)

Reclassifications out of AOCI during the year ended December 31, 2018 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	\$ 2,033	Sale of investments - in net realized capital gains/(losses)
	<u>(17,569)</u>	
	\$ (15,536)	Impairment expense - in net realized capital gains/(losses)
	<u>3,263</u>	Total before tax
	<u>(12,273)</u>	Income tax expense
		Net of tax
Change in funded status of retirement plans (2)	\$ (11,664)	Amortization of actuarial gain/(loss) - in operating expenses
	<u>2,449</u>	Income tax expense
	<u>(9,215)</u>	Net of tax
Total reclassifications for the period	<u>\$ (21,488)</u>	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, 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)
	<u>(11,715)</u>	
	\$ (976)	Impairment expense - in net realized capital gains/(losses)
	<u>205</u>	Total before tax
	<u>(771)</u>	Income tax expense
		Net of tax
Change in funded status of retirement plans (2)	\$ (10,236)	Amortization of actuarial gain/(loss) - in operating expenses
	<u>2,149</u>	Income tax expense
	<u>(8,087)</u>	Net of tax
Total reclassifications for the period	<u>\$ (8,858)</u>	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).

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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. National Life has a letter of credit of \$100.0 million and \$110.0 million as of December 31, 2018 and 2017, respectively, and pledged collateral of \$370.9 million and \$281.0 million as of December 31, 2018 and 2017, respectively. Outstanding advances under this program were \$101.8 million and \$102.1 million as of December 31, 2018 and 2017, respectively. The membership requires an investment in the common stock of FHLB Boston. 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. LSW had pledged collateral of \$2.34 billion and \$1.53 billion as of December 31, 2018 and 2017, respectively. Outstanding advances under this program were \$1.7 billion and \$1.4 billion as of December 31, 2018 and 2017, respectively. The membership requires an investment in the common stock of FHLB Dallas. 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 \$2.1 million and \$1.1 million was paid to FHLB Boston in 2018 and 2017, respectively. Total interest expense of \$29.8 million and \$13.3 million was paid to FHLB Dallas in 2018 and 2017, respectively.

NLIC repaid advances to FHLB Boston of \$0.3 million in 2018. No advances were repaid to FHLB Boston in 2017. LSW repaid advances to FHLB Dallas of \$171.9 million and \$79.5 million in 2018 and 2017, respectively.

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.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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 2018 and 2017 resulted in a net decrease to policy acquisition expenses of \$5.6 million and a net increase of \$6.4 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

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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, 2018 and 2017 (in millions):

	December 31, 2018		
	Cost	Accumulated Depreciation	Carrying Value
Software	\$ 252.0	\$ (148.8)	\$ 103.2
Equipment	40.0	(32.5)	7.5
Furniture	25.8	(17.0)	8.8
Renovations	14.1	(4.0)	10.1
Home office	101.2	(64.9)	36.3
	<u>\$ 433.1</u>	<u>\$ (267.2)</u>	<u>\$ 165.9</u>

	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
	<u>\$ 390.2</u>	<u>\$ (237.1)</u>	<u>\$ 153.1</u>

Depreciation expense recognized in operating expenses was \$30.0 million and \$31.0 million for the years ended December 31, 2018 and 2017, 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 were 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. In 2018 no impairments were recognized. The impairment loss was included in net realized capital gains (losses).

Corporate Owned Life Insurance

The Company holds life insurance contracts on certain members of management and other key individuals. During 2018, the Company increased its investment in Corporate Owned Life Insurance (“COLI”) and purchased additional COLI of \$60.0 million. During 2017, the Company added a new carrier and purchased 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 \$493.7 million and \$420.1 million at December 31, 2018 and 2017, respectively.

COLI income includes the net change in cash surrender value and any benefits received or accrued. COLI income was \$13.6 million and \$8.9 million in 2018 and 2017, respectively, and is included in other income.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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, 2018 and 2017, the Company had receivables from agents of \$65.4 million and \$51.6 million, respectively, which are included in other assets on the Consolidated Balance Sheets. These receivables are reported net of an accrued valuation allowance if it is deemed that amounts may not be collectible. The allowance for receivables from agents was \$6.5 million and \$6.0 million as of December 31, 2018 and 2017, 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 4.50% and 4.63% as of December 31, 2018 and 2017, 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. The underlying account value is primarily based on deposits plus any interest credited, less amounts assessed for mortality, administrative and other policy fees. The embedded derivative component represents the fair value of the Company's future obligations related to interest crediting that is based on the performance of various indexes, as specified in the respective contracts. Such embedded derivatives are carried at fair value, with the change in fair value recorded through interest credited to policyholder account liabilities.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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 underlying indexes, and an explicit risk margin for policyholder behavior, as well as a margin to reflect the 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 for various blocks of business, including premium persistency, investment income, mortality, pricing, and lapse and surrender rates, which resulted in a \$3.8 million and \$4.1 million net decrease in policy liabilities as of December 31, 2018 and 2017, 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. There were no increases to the premium deficiency reserve in 2018 or 2017. 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, 2018, and 2017, the shadow loss reserve was \$4.3 million and \$8.3 million, respectively.

The Company also held a shadow reserve related to its Guaranteed Lifetime Income Rider in policy benefit liabilities of (\$23.4) million and \$78.3 million, as of December 31, 2018 and 2017. 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 (\$12.5) million and \$32.9 million as of December 31, 2018 and 2017, 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. 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.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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:

	<u>SIL</u>	
	<u>2018</u>	<u>2017</u>
Beginning of year	\$ 76,690	\$ 66,782
Increase (decrease) due to interest, amortization and assumption updates	15,702	14,735
Payments	(6,859)	(4,827)
End of year	<u>\$ 85,533</u>	<u>\$ 76,690</u>

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.

Under a modified coinsurance (“modco”) arrangement through which a quota share of new sales of certain indexed annuity products are ceded to an unaffiliated reinsurer, we retain the reserves and the assets supporting these reserves. The assets are held in a segregated custody account and have been designated as trading debt securities. Investment results from these assets, including gains and losses from sales, are passed directly to the reinsurer, and as a result we record a modco embedded derivative. The modco embedded derivative is recorded at fair value within amounts payable to reinsurers. Changes in the modco embedded derivative, which are equal to and offset by changes in the fair value of the assets, are reported in net realized capital gains (losses).

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.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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.

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 in 2017, 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”) 2018-02 *Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income* (“ASU 2018-02”) in 2017. As permitted under ASU 2018-02, 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 in 2017.

NOTE 3 – NEW ACCOUNTING PRONOUNCEMENTS

Adopted

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. The adoption of this standard in 2018 did not 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. The adoption of this standard in 2018 did not have a material effect on the Company’s consolidated financial condition, results of operations or cash flows.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

NOTE 3 – NEW ACCOUNTING PRONOUNCEMENTS (continued)

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 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 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*. The guidance requires several changes to equity investment reporting. 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.

In February 2018, the FASB issued ASU 2018-03 *Technical Corrections and Improvements to Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*. This guidance is intended to improve certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. For non-public entities, the pronouncement is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted if ASU 2016-01 has been adopted. The Company determined the impact of the implementation of this guidance will result in a \$58.0 million reclass from accumulated other comprehensive income to retained earnings.

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 non-public entities, it is effective for fiscal years beginning after December 15, 2019. Early application is permitted. 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 non-public entities, the pronouncement is effective for fiscal years beginning after December 15, 2021. 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.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

NOTE 3 – NEW ACCOUNTING PRONOUNCEMENTS (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 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.

In November 2016, the FASB issued ASU 2016-18, *Statement of Cash Flows (Topic 230)*. This guidance addresses the classification and presentation of changes in restricted cash on the statement of cash flows. 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. 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 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.

In August 2018, the FASB issued ASU 2018-14 *Compensation-Retirement Plans-Defined Benefit Plans-General (Subtopic 715-20): Disclosure Framework-Changes to the Disclosure Requirements for Defined Benefit Plans*. This guidance is intended to improve the effectiveness of defined benefit plan disclosures in the notes to the financial statements. For non-public entities, the pronouncement is effective for fiscal years beginning after December 15, 2021. 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.

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 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.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

NOTE 3 – NEW ACCOUNTING PRONOUNCEMENTS (continued)

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 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 adoption of this standard is not expected to have a material effect on the Company's financial statements.

Derivatives and Hedging – Targeted Improvements

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 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.

Long-Duration Contracts

In August 2018, the FASB issued ASU 2018-12 *Financial Services-Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts*. This guidance is intended to simplify and improve the recognition, measurement, presentation, and disclosure requirements for long-duration contracts issued by an insurance entity. For non-public entities, the pronouncement is effective for fiscal years beginning after December 15, 2021. Early application is permitted. The Company is currently assessing the timing for adoption of this standard. The adoption of this standard is expected to have a material effect on the Company's consolidated financial condition and results of operations.

Fair Value Measurement

In August 2018, the FASB issued ASU 2018-13 *Fair Value Measurement (Topic 820): Disclosure Framework-Changes to the Disclosure Requirements for Fair Value Measurement*. This guidance is intended to improve the effectiveness of fair value disclosures in the notes to the financial statements. For all 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

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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

(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.
- **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.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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 valued using NAV as a practical expedient and are not categorized in 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.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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 as 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 debt and equity securities - Fair values of exchange traded debt and 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 securities are categorized as Level 2 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.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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 and categorized as Level 1. Separate account assets also include 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 - Embedded derivatives contained in equity-indexed annuity and life contracts are included in policyholder account liabilities at fair value. The fair value of these derivatives is 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, using assumptions about market conditions and policyholder behavior. The fair value measurement incorporates an explicit risk margin for policyholder behavior and for the impact the Company's own credit or nonperformance risk 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.

Amounts payable to reinsurers – Modco embedded derivatives are carried at fair value and included in amounts payable to reinsurers. The fair value of modco embedded derivatives is measured at an amount equal to the unrealized gains (losses) of trading debt securities held in a segregated custody account in support of modified coinsurance arrangements. Accordingly, such modco embedded derivatives are categorized on a basis consistent with the related trading debt securities.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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

Financial Instruments Measured at Fair Value on a Recurring Basis

Presented below is the fair value of all assets and liabilities measured at fair value on a recurring basis as of December 31, 2018 (in thousands):

Assets	Level 1	Level 2	Level 3	Total
AFS debt and equity securities:				
U.S. government obligations	\$ 247,898	\$ —	\$ —	\$ 247,898
Government agencies, authorities and subdivisions	—	1,853,843	12,282	1,866,125
Corporates	—	13,082,124	267,880	13,350,004
Private placements	—	1,667,507	—	1,667,507
Mortgage-backed securities	—	2,991,183	—	2,991,183
Total AFS debt securities	247,898	19,594,657	280,162	20,122,717
Preferred stock	—	22,133	—	22,133
Common stock ⁽²⁾	7,147	—	—	7,147
Total AFS equity securities	7,147	22,133	—	29,280
Total AFS debt and equity securities	255,045	19,616,790	280,162	20,151,997
Trading debt securities	—	19,082	—	19,082
Derivative assets	7,133	224,041	—	231,174
Other invested assets ⁽²⁾	35,150	—	—	35,150
Separate account assets ⁽²⁾	1,708	301,729	—	303,437
Amounts recoverable from reinsurers	—	—	1,571	1,571
Total assets subject to fair value disclosure ⁽²⁾	<u>\$ 299,036</u>	<u>\$ 20,161,642</u>	<u>\$ 281,733</u>	<u>\$ 20,742,411</u>
Liabilities	Level1	Level2	Level3	Total
Policyholder account liabilities ⁽¹⁾	\$ —	\$ —	\$ 1,970,049	\$ 1,970,049
Amounts payable to reinsurers	—	98	—	98
Derivative liabilities	—	102,391	—	102,391
Total liabilities subject to fair value disclosure	<u>\$ —</u>	<u>\$ 102,489</u>	<u>\$ 1,970,049</u>	<u>\$ 2,072,538</u>

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, 2018 were to change by approximately 100 basis points, the fair value of the embedded derivative would change significantly, partially offset by a change 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. See Financial Instruments Measured Using NAV, below.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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

Financial Instruments Measured at Fair Value on a Recurring Basis (continued)

The table below summarizes the reconciliation of the beginning and ending balances and related changes for the year ended December 31, 2018 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											
Government agencies, authorities and subdivisions	\$ —	\$ 131	\$ 128	\$ —	\$ —	\$ (1,226)	\$ —	\$ 13,249	\$ —	\$ 12,282	\$ —
Corporates	—	(46)	(2,914)	249,641	—	(621)	—	21,820	—	267,880	—
Amounts recoverable from reinsurers	—	(1,119)	—	—	—	—	2,690	—	—	1,571	—
Total assets	\$ —	\$ (1,034)	\$ (2,786)	\$ 249,641	\$ —	\$ (1,847)	\$ 2,690	\$ 35,069	\$ —	\$ 281,733	\$ —
Liabilities											
Policyholder account liabilities	\$ 2,057,471	\$ (56,542)	\$ —	\$ —	\$ —	\$ —	\$ (30,880)	\$ —	\$ —	\$ 1,970,049	\$ —
Total liabilities	\$ 2,057,471	\$ (56,542)	\$ —	\$ —	\$ —	\$ —	\$ (30,880)	\$ —	\$ —	\$ 1,970,049	\$ —

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.

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	—	13,397,154	—	13,397,154
Private placements	—	1,672,042	—	1,672,042
Mortgage-backed securities	—	3,303,802	—	3,303,802
Total AFS debt securities	265,764	19,782,569	—	20,048,333
Preferred stock	—	22,492	—	22,492
Common stock ⁽²⁾	705	—	—	705
Total AFS equity securities	705	22,492	—	23,197
Total AFS debt and equity securities	266,469	19,805,061	—	20,071,530
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	\$ 20,981,235	\$ —	\$ 21,435,052
Liabilities				
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. See Financial Instruments Measured Using NAV, below.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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

Financial Instruments Measured at Fair Value on a Recurring Basis (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.

Financial Instruments Measured Using NAV

Presented below are investments that are measured using NAV as a practical expedient as of December 31, 2018 and 2017 (in thousands):

Assets	Fair Value as of December 31,		Unfunded	Redemption Frequency (If Currently Eligible)	Redemption Notice Period
	2018	2017	Commitments as of December 31, 2018		
	<i>(in thousands)</i>				
AFS equity securities	\$ 1,698	\$ 12,643	\$ —	Not applicable	Not applicable
Trading equity securities	24,382	19,812	—	Not applicable	Not applicable
Other invested assets	659,545	514,198	559,205	Not applicable	Not applicable
Short term investments	264,750	228,480	—	Not applicable	Not applicable
Separate account assets	466,326	628,589	17,232	Not applicable or Quarterly	Not applicable or 70 days
Total	\$ 1,416,701	\$ 1,403,722	\$ 576,437		

Fair Value of Financial Instruments not Carried at Fair Value

The carrying values and fair values of financial instruments not carried at fair value as of December 31, 2018 and 2017 were as follows (in thousands):

	2018		2017	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Mortgage loans	3,674,383	3,691,928	3,350,570	3,408,805
Policy loans	921,516	1,007,238	877,927	978,787
Investment product liabilities	14,612,491	15,218,653	13,979,002	13,186,282
Debt	790,866	993,276	452,638	633,454
FHLB capital stock	79,682	79,682	68,910	68,910
FHLB advances	1,782,208	1,782,208	1,513,775	1,513,775

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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

Fair Value of Financial Instruments not Carried at Fair Value (continued)

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.

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.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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, 2018 and December 31, 2017 were as follows (in thousands):

At December 31, 2018	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
AFS debt and equity securities:				
U.S. government obligations	\$ 236,473	\$ 11,583	\$ 158	\$ 247,898
Government agencies, authorities and subdivisions	1,843,645	51,708	29,228	1,866,125
Corporates:				
Asset-backed securities	1,605,742	6,955	18,935	1,593,762
Communications	964,589	26,511	35,140	955,960
Consumer & retail	3,872,828	57,226	174,743	3,755,311
Financial institutions	2,576,541	98,154	59,743	2,614,952
Industrial and chemicals	1,921,856	50,076	66,781	1,905,151
REITS	555,964	3,605	12,716	546,853
Transportation	437,765	10,294	12,965	435,094
Utilities	1,547,371	42,230	46,680	1,542,921
Total corporates	13,482,656	295,051	427,703	13,350,004
Private placements	1,691,088	20,749	44,330	1,667,507
Mortgage-backed securities	2,957,954	78,890	45,661	2,991,183
Total AFS debt securities	20,211,816	457,981	547,080	20,122,717
Preferred stocks	22,700	—	567	22,133
Common stocks	9,985	733	1,873	8,845
Total AFS equity securities	32,685	733	2,440	30,978
Total AFS debt and equity securities	<u>\$ 20,244,501</u>	<u>\$ 458,714</u>	<u>\$ 549,520</u>	<u>\$ 20,153,695</u>

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

NOTE 5 – INVESTMENTS (continued)

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

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	<u>\$ 19,029,933</u>	<u>\$ 1,125,611</u>	<u>\$ 71,372</u>	<u>\$ 20,084,172</u>

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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):

	<u>2018</u>	<u>2017</u>
Balance, beginning of year	\$ 495,202	\$ 231,413
Net unrealized gains (losses) on AFS securities	(1,137,106)	469,723
Net unrealized gains (losses) on separate accounts	(319)	1,643
Net unrealized gains on other invested assets	21,852	18,187
Deferred policy acquisition costs	296,886	(125,810)
Loss reserve	4,027	(15,250)
Reserves	101,654	(38,273)
Deferred income taxes, excluding ASU 2018-05	125,819	(94,780)
Effect of ASU 2018-05	—	87,757
Policyholder dividend obligation	113,842	(39,408)
(Decrease) increase in net unrealized gains (losses)	(473,345)	263,789
Balance, end of year	\$ 21,857	\$ 495,202

	<u>2018</u>	<u>2017</u>
Balance, end of year includes:		
Net unrealized (losses) gains on AFS securities	\$ (75,242)	\$ 1,061,864
Net unrealized gains on separate accounts	8,228	8,547
Net unrealized gains on other invested assets	59,175	37,323
Deferred policy acquisition costs	53,379	(243,507)
Loss reserve	(4,294)	(8,321)
Reserves	23,380	(78,274)
Deferred income taxes	(5,811)	(131,630)
Policyholder dividend obligation	(36,958)	(150,800)
Total	\$ 21,857	\$ 495,202

Net other comprehensive income related to unrealized gains (losses) on AFS securities for 2018 and 2017, respectively, were presented net of reclassifications to net income for net realized capital gains (losses) during the period of \$9.8 million and \$(5.6) million, and net of tax and deferred acquisition cost offsets totaling \$4.9 million and \$(3.4) million, respectively.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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, 2018, 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.

	<u>Amortized cost</u>	<u>Fair Value</u>
Due in one year or less	\$ 432,103	\$ 436,514
Due after one year through 5 years	3,171,570	3,187,944
Due after 5 years through 10 years	4,113,755	4,077,180
Due after ten years	9,536,437	9,429,899
Mortgage-backed securities	2,957,951	2,991,180
Total	<u>\$ 20,211,816</u>	<u>\$ 20,122,717</u>

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):

	<u>2018</u>	<u>2017</u>
Proceeds on debt and equity securities	\$ 351.0	\$ 390.6
Gross realized gains on debt securities	1.6	8.1
Gross realized losses on debt securities	(4.3)	(3.4)
Gross realized gains on equity securities	0.6	1.0
Gross realized losses on equity securities	(0.3)	(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):

	<u>2018</u>	<u>2017</u>
Debt securities	\$ 8.1	\$ 3.6
Limited partnerships	9.5	8.1
Total	<u>\$ 17.6</u>	<u>\$ 11.7</u>

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

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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, 2018 were as follows (in thousands):

2018 Description of securities	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized	Fair Value	Unrealized	Fair Value	Unrealized
		Losses		Losses		Losses
U.S. government obligations	\$ 52	\$ 1	\$ 7,984	\$ 157	\$ 8,036	\$ 158
Government agencies, authorities and subdivisions	459,955	19,472	133,043	9,756	592,998	29,228
Corporates:						
Asset-backed securities	1,027,307	18,828	7,200	107	1,034,507	18,935
Communications	468,733	24,930	49,873	10,210	518,606	35,140
Consumer & retail	2,146,725	142,062	275,083	32,681	2,421,808	174,743
Financial institutions	1,231,533	52,933	125,246	6,810	1,356,779	59,743
Industrial and chemicals	970,067	58,841	91,186	7,940	1,061,253	66,781
REITS	215,933	3,971	96,326	8,745	312,259	12,716
Transportation	245,955	12,130	15,567	835	261,522	12,965
Utilities	715,111	32,336	118,416	14,344	833,527	46,680
Total corporates	7,021,364	346,031	778,897	81,672	7,800,261	427,703
Private placements	680,497	23,603	353,136	20,727	1,033,633	44,330
Mortgage-backed securities	590,123	9,897	750,277	35,764	1,340,400	45,661
Subtotal debt securities	8,751,991	399,004	2,023,337	148,076	10,775,328	547,080
Preferred stock	12,597	113	9,545	454	22,142	567
Common stock	4,425	1,403	238	470	4,663	1,873
Total securities	\$ 8,769,013	\$ 400,520	\$ 2,033,120	\$ 149,000	\$ 10,802,133	\$ 549,520

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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):

2017 Description of securities	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
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

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, 2018 and 2017 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 Debt and Equity Securities

Trading debt securities consist of fixed maturity securities held in a segregated custody account, which support a modified coinsurance arrangement that became effective in 2018. The cost of trading debt securities held at December 31, 2018 was \$19.0 million.

The cost of trading equity securities held at December 31, 2018 and 2017 was \$27.7 million and \$19.1 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.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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):

	<u>2018</u>	<u>2017</u>
<u>Geographic Region</u>		
New England	5.9 %	6.8 %
Middle Atlantic	6.8	4.5
East North Central	10.8	13.4
West North Central	12.4	12.8
South Atlantic	21.5	23.8
East South Central	4.8	4.8
West South Central	8.2	8.1
Mountain	13.3	11.4
Pacific	16.3	14.4
Total	<u>100.0 %</u>	<u>100.0 %</u>
<u>Property Type</u>		
Apartment	22.7 %	23.3 %
Retail	25.2	27.5
Office Building	31.5	30.0
Industrial	14.3	12.3
Other Commercial	6.3	6.9
Total	<u>100.0 %</u>	<u>100.0 %</u>
Mortgage loans	3,674,383	3,350,570
Real estate investments	16,210	24,465
Total mortgage loans and real estate	<u>\$ 3,690,593</u>	<u>\$ 3,375,035</u>

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.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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:

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%	674.6	\$ 278.0	\$ 28.1	\$ 17.7	\$ —	\$ 998.4
50% - 60%	952.7	427.5	58.8	14.9	—	1,453.9
60% - 70%	280.3	365.7	103.8	15.0	—	764.8
70% - 80%	77.6	93.0	83.3	16.7	7.6	278.2
80% - 90%	40.2	20.0	49.5	2.3	0.8	112.8
> 90%	18.8	10.9	2.9	23.1	12.0	67.7
Total	\$ 2,044.2	\$ 1,195.1	\$ 326.4	\$ 89.7	\$ 20.4	\$ 3,675.8

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

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 and the market value adjustment on the hedge.

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

	2018	2017
Commercial loans	\$ 3,679,204	\$ 3,355,689
Valuation allowance	(1,100)	(1,713)
Impaired loans	(3,335)	(3,335)
Market value adjustment on hedge	(386)	(71)
Total	\$ 3,674,383	\$ 3,350,570

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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):

	2018	2017
Impaired loans:		
Average total investment	\$ 12,946	\$ 12,885
Interest income recognized	548	546
Interest received	533	531
Unpaid principal balance	12,946	12,946

The Company recognized mortgage loan impairments of \$1.0 million and \$1.5 million in 2018 and 2017, respectively.

The Company recognized real estate impairments of \$0.8 million in 2018. The Company did not recognize any real estate impairments in 2017.

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

	2018	2017
Balance, beginning of year	\$ 1,713	\$ 2,119
Changes to previously established valuation allowance	(613)	(406)
Balance, end of year	\$ 1,100	\$ 1,713

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, 2018 and 2017, 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.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

NOTE 5 – INVESTMENTS (continued)

Other Invested Assets

Other invested assets included the following as of December 31 (in thousands):

	<u>2018</u>	<u>2017</u>
Limited partnerships	\$ 651,316	\$ 514,198
Affordable housing tax credits	157,332	190,351
Non-cash broker collateral	35,150	175,387
FHLB common stock	79,682	68,910
Other	8,922	11,569
Other invested assets	<u>\$ 932,402</u>	<u>\$ 960,415</u>

Variable Interest Entities

The table below includes certain information regarding VIEs in which the Company held a variable interest as of December 31, 2018 (in thousands). The Company's investments in unconsolidated VIEs at December 31, 2017 were not material to the Company's financial position.

<u>Investment Type</u>	<u>Total VIE Assets (1)</u>	<u>Maximum Exposure to Loss (2)</u>
Investment in notes	\$ 17,116	\$ 17,116
Other invested assets	33,483	1,005

- (1) Represents assets of the VIEs which the Company does not have the right to make use of to satisfy its own obligations.
(2) Represents the Company's investments in these entities, plus any accrued receivables due from these entities.

Net Investment Income

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

	<u>2018</u>	<u>2017</u>
Debt securities interest	\$ 895,800	\$ 867,329
Equity securities dividends	5,849	5,292
Mortgage loan interest	155,535	142,478
Policy loan interest	43,109	41,846
Real estate income	8,564	7,009
Derivative (loss) income	(166,236)	329,431
Partnership income	66,997	46,563
Other investment income	6,044	1,363
Gross investment income	<u>1,015,662</u>	<u>1,441,311</u>
Less: investment expenses	<u>(34,872)</u>	<u>(26,100)</u>
Net investment income	<u>\$ 980,790</u>	<u>\$ 1,415,211</u>

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

NOTE 5 – INVESTMENTS (continued)

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):

	<u>2018</u>	<u>2017</u>
Debt securities	\$ (6,187)	\$ 6,773
Equity securities	(3,599)	2,000
Mortgage loans	(627)	(1,074)
Partnerships	(9,531)	(8,613)
Other invested assets	319	(900)
Real estate	(405)	(2,371)
Embedded derivative	(98)	—
Sale of mutual fund business (see Note 2)	538	9,346
Debt retirement	(3,890)	(775)
Impairment of capitalized software	—	(40,689)
Total	<u>\$ (23,480)</u>	<u>\$ (36,303)</u>

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, 2018 and 2017 was \$0.7 million and \$(0.2) million respectively.

The Company credits interest on policyholder account liabilities for certain of its products based on the performance of certain indexes (which include but are not limited to the S&P 500, Russell 2000, or MSCI Emerging Markets), subject to contractual participation rates and caps on returns. These participation rates and caps are set each policy anniversary. The Company economically hedges the exposure for the next policy year, at the time the participation rates and caps are set, by entering into over-the-counter (OTC) options and exchange-traded futures contracts on the underlying indexes 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 Company's future obligations related to interest crediting that is based on the performance of certain indexes, as specified in the respective contracts. The embedded derivative liabilities were \$1.97 billion and \$2.06 billion at December 31, 2018 and 2017, respectively.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

NOTE 5 – INVESTMENTS (continued)

Derivatives (continued)

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 \$83.9 million and \$416.8 million as of December 31, 2018 and 2017, respectively. The Company utilizes a scale based on credit rating of the counterparty to determine the appropriate amount of counterparty risk. As of December 31, 2018, there was no derivative counterparty exposure that exceeded \$7.1 million, net of collateral.

The Company is not currently offering synthetic Guaranteed Investment Contract ("GIC") products. The Company's fee-based synthetic GIC product provided a book value guarantee as a fully benefit-responsive investment contract to benefit plan sponsors. The fund assets were owned by the plan sponsors and managed by a fund manager subject to investment guidelines agreed to by the Company. At December 31, 2018 the Company had no open synthetic GIC contracts. At December 31, 2017 the Company had issued synthetic GIC contracts with a total notional amount of \$718.3 million, and the fair value of associated plan assets was \$721.0 million as of December 31, 2017.

The Company has embedded derivatives related to reinsurance contracts that are accounted for on a modified coinsurance basis. An embedded derivative exists because the arrangement exposes the reinsurer to third party credit risk. The embedded derivative is included in amounts recoverable from/payable to reinsurers, with changes in the fair value of the embedded derivative reported in net realized capital gains (losses).

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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):

	2018		2017		Primary Underlying Risk Exposure
	Notional	Fair Value	Notional	Fair Value	
Options purchased	\$ 10,034,550	198,071	\$ 9,136,090	\$ 983,531	Equity market
Options written	(9,113,170)	(102,391)	(8,299,830)	(565,355)	Equity market
Swaptions purchased	200,000	676	500,000	357	Interest rates
Interest rate swaps	(1) 597,425	25,294	597,425	5,960	Interest rates
Futures purchased	82,195	7,133	58,244	1,770	Equity market
Net fair market value		<u>\$ 128,783</u>		<u>\$ 426,263</u>	

(1) Interest rates swaps are reflected net of cash margin collateral of \$9.9 million and \$(0.2) million as of December 31, 2018 and 2017, respectively, in the Consolidated Balance Sheets.

NOTE 6 – REINSURANCE

The Company reinsures certain risks assumed in the normal course of business. Effective in March 2018, for certain indexed universal life products, the Company may retain up to \$4 million of risk on an individual life. For other 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.

Other income includes \$5.1 million and \$6.3 million in 2018 and 2017, respectively, related to the Company's disability income reinsurance. Such income is largely 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 October 1, 2018, new issuances of certain of our indexed annuity products are subject to a quota share modified coinsurance arrangement with an unaffiliated reinsurer. The quota share ceded is currently 50% and may be adjusted for future sales. As the ceding company we retain the reserves, as well as the assets backing those reserves, and the reinsurer shares proportionally in all financial terms of the reinsured policies based on their respective percentage of the risk.

The Company has entered into reinsurance agreements to cede statutory reserves for certain term and universal life products, that 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

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

NOTE 6 – REINSURANCE (continued)

AXXX), to an unaffiliated reinsurer. Effective December 31, 2018, the Company entered into an agreement to cede approximately \$59.7 million of statutory reserves for certain term products. 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. Under GAAP, these reinsurance transactions are subject to deposit accounting with a reinsurance risk charge which will be recorded in interest expense.

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

	<u>2018</u>	<u>2017</u>
Insurance premiums:		
Direct	\$ 269,087	\$ 277,230
Reinsurance assumed	839	289
Reinsurance ceded	(52,685)	(56,890)
Total insurance premiums	<u>\$ 217,241</u>	<u>\$ 220,629</u>
Decrease in policy liabilities:		
Direct	\$ (143,848)	\$ (65,377)
Reinsurance assumed	—	—
Reinsurance ceded	60,086	43,909
Total decrease in policy liabilities	<u>\$ (83,762)</u>	<u>\$ (21,468)</u>
Policy benefits:		
Direct	\$ 624,326	\$ 559,097
Reinsurance assumed	—	811
Reinsurance ceded	(87,513)	(84,990)
Total policy benefits	<u>\$ 536,813</u>	<u>\$ 474,918</u>
Policyholders' dividends:		
Direct	\$ 40,427	\$ 57,516
Reinsurance ceded	(203)	(372)
Total policyholders' dividends	<u>\$ 40,224</u>	<u>\$ 57,144</u>

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, 2018 and 2017 was with Hannover Life Reinsurance Company of America for \$479.4 million and \$397.8 million, respectively. Total life insurance in force subject to reinsurance as of December 31, 2018 and 2017 was approximately \$142.3 billion and \$119.9 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.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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 thousands)	<u>2018</u>	<u>2017</u>
Balance, beginning of year	\$ 1,539,129	\$ 1,512,211
Acquisition costs deferred	507,138	417,730
Amortization	(250,042)	(265,002)
Adjustment through other comprehensive income	296,886	(125,810)
Balance, end of year	<u>\$ 2,093,111</u>	<u>\$ 1,539,129</u>

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.

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

	<u>SIA</u>	
	<u>2018</u>	<u>2017</u>
Beginning of year	\$ 123.1	\$ 103.2
Deferral	34.8	31.2
Amortization and assumption changes, net	(8.2)	(11.3)
End of year	<u>\$ 149.7</u>	<u>\$ 123.1</u>

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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):

	2018		2017	
	Amount	Rate	Amount	Rate
Current	\$ (7,980)		\$ 95,626	
Deferred	31,540		(145,808)	
Total income tax expense (benefit)	\$ 23,560		\$ (50,182)	
Expected income taxes	\$ 36,459	21.0%	\$ 73,414	35%
Dividends received deduction	(410)	(0.2)	(1,312)	(0.6)
Affordable housing tax credits	(28,421)	(16.4)	(27,942)	(13.3)
Corporate owned life insurance	(2,968)	(1.7)	(3,288)	(1.6)
Enacted change in tax rate	(6,169)	(3.6)	(119,721)	(57.1)
Other, net	577	0.3	13,113	6.3
Total without amortization	\$ (932)		\$ (65,736)	
Effective rate without amortization		-0.5%		-31.3%
Affordable housing tax credit amortization	\$ 24,492	14.1	\$ 15,554	7.4
Total income tax expense (benefit)	\$ 23,560		\$ (50,182)	
Effective federal income tax rate		13.6%		-23.9%

The Company paid \$47.7 million and \$13.5 million in federal income taxes during 2018 and 2017, respectively.

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

	2018	2017
Balance, beginning of year	\$ 7,817	\$ 10,062
Reductions based on tax positions related to current year	(1,348)	(2,245)
Balance, end of year	\$ 6,469	\$ 7,817

Total unrecognized tax benefits were \$10.5 million at December 31, 2018, including \$7.2 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 \$10.5 million within the next twelve months.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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, 2018 and 2017, the Company recognized approximately \$0.7 million in expense and \$1.2 million in expense, respectively, related to interest and penalties. The Company had approximately \$4.0 million and \$3.3 million accrued for interest and penalties at December 31, 2018 and 2017, respectively.

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

	2018	2017
Deferred income tax assets:		
Policy liabilities	\$ 222,525	\$ 270,481
Pension and other employee benefits	37,830	43,510
Loss carryforwards	26,605	—
Tax credits	9,312	(16)
Net UCL AFS debt/equity securities	6,370	—
Other	—	16,128
Total deferred income tax assets	302,642	330,103
Deferred income tax liabilities:		
Deferred policy acquisition costs	348,326	246,479
Debt/equity securities	11,760	14,219
Other invested assets	12,127	3,180
Net UCG AFS debt/equity securities	—	228,721
Property and equipment	20,378	19,021
Other	1,304	—
Total deferred income tax liabilities	393,895	511,620
Total net deferred income tax liabilities	\$ (91,253)	\$ (181,517)

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, 2018 or 2017.

At December 31, 2018, the Company has \$127 million federal operating loss carryforwards and \$9.3 million 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.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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 non-contributory 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	
	2018	2017	2018	2017
Change in benefit obligation:				
Benefit obligation, beginning of year	\$ 457,354	\$ 431,162	\$ 26,709	\$ 25,511
Service cost for benefits earned during the period	8,450	8,498	238	375
Interest cost on benefit obligation	16,416	17,310	921	1,024
Plan participants' contributions	—	—	1,166	1,291
Actuarial losses (gains)	(23,380)	23,461	(1,475)	1,318
Settlement/curtailment	(2,605)	—	—	—
Plan amendment	12	129	—	—
Benefits paid	(25,102)	(23,206)	(2,473)	(2,810)
Benefit obligation, end of year	431,145	457,354	25,086	26,709
Change in plan assets:				
Plan assets, beginning of year	326,670	284,802	—	—
Actual (losses) income on plan assets	(10,393)	39,788	—	—
Employer contributions	58,379	25,286	1,306	1,519
Settlement/curtailment	(2,605)	—	—	—
Plan participants' contributions	—	—	1,167	1,291
Benefits paid	(25,102)	(23,206)	(2,473)	(2,810)
Plan assets, end of year	346,949	326,670	—	—
Funded Status	\$ (84,196)	\$ (130,684)	\$ (25,086)	\$ (26,709)

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

NOTE 9 – BENEFIT PLANS (continued)

	Pension Benefits		Other Benefits	
	2018	2017	2018	2017
Amounts recognized in the Consolidated Balance Sheets as of December 31,:				
Pension and other post-retirement benefit obligations liability	\$ (43,598)	\$ (523)	\$ 23,533	\$ 23,536
Accumulated other comprehensive income	127,794	131,207	1,553	3,172
Net amount recognized	\$ 84,196	\$ 130,684	\$ 25,086	\$ 26,708
Pension and other post-retirement benefit obligations liability	\$ (84,196)	\$ (130,684)	\$ (25,086)	\$ (26,708)
Amounts recognized in accumulated other comprehensive income consists of:				
Net actuarial loss	\$ 127,680	\$ 131,207	\$ 1,553	\$ 3,172
Net prior service cost	114	—	—	—
	\$ 127,794	\$ 131,207	\$ 1,553	\$ 3,172

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):

	2018	2017
Total Accumulated Benefit Obligation	\$ 407,651	\$ 428,934
Plans with ABO in excess of plan assets:		
ABO	407,651	428,934
Fair value of plan assets (1)	346,971	326,685
Plans with PBO in excess of plan assets:		
PBO	431,145	457,354
Fair value of plan assets (1)	346,971	326,685

(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.

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

	Pension Benefits		Other Benefits	
	2018	2017	2018	2017
Service cost for benefits earned during the period	\$ 8,450	\$ 8,498	\$ 238	\$ 375
Interest cost on benefit obligation	16,416	17,310	921	1,024
Expected income on plan assets	(21,083)	(18,404)	—	—
Net amortization of actuarial losses (gains)	10,610	11,290	144	52
Settlement/curtailment	896	—	—	—
Amortization of prior service benefits and plan amendments	14	12	—	(1,015)
Net periodic benefit cost (included in operating expenses)	\$ 15,303	\$ 18,706	\$ 1,303	\$ 436

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

NOTE 9 – BENEFIT PLANS (continued)

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

	Pension Benefits		Other Benefits	
	2018	2017	2018	2017
Net gain (loss)	\$ (8,095)	\$ (2,077)	\$ 1,475	\$ (1,318)
Prior service cost	(12)	(129)	—	—
Amortization of loss	10,610	11,290	144	52
Amortization of prior service cost (benefits)	14	12	—	(1,015)
Recognition of settlement loss	896	—	—	—
Total recognized in other comprehensive income	\$ 3,413	\$ 9,096	\$ 1,619	\$ (2,281)

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 \$9.9 million and less than \$0.1 million, respectively.

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

	Pension Benefits		Other Benefits	
	2018	2017	2018	2017
Discount rate	4.25%	3.65%	4.25%	3.65%
Rate of increase in future compensation levels	3.0% - 5.0%	3.0% - 5.0%		

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

	Pension Benefits		Other Benefits	
	2018	2017	2018	2017
Discount rate	3.65%	4.15%	3.65%	4.15%
Rate of increase in future compensation levels	3.0% - 5.0%	3.0% - 5.0%		
Expected long term return on plan assets	6.50%	6.50%		

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 \$40.1 million and \$36.9 million as of December 31, 2018 and 2017, respectively.

Assumed health care cost trend rates (“HCCTR”) at December 31, 2018:

Weighted average health care cost trend rate assumed for next year	6.68%
Rate to which the cost trend rate is assumed to decline	5%
Year that the rate reaches the ultimate trend rate	2026

Increasing the assumed HCCTR by one percentage point in each year would increase the accumulated post-retirement benefit obligation (“APBO”) by about \$0.1 million and would increase service and interest costs by less than \$0.1 million. Decreasing the assumed HCCTR by one percentage point in each year would reduce the APBO by approximately \$0.1 million and would reduce service and interest costs by less than \$0.1 million.

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

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

NOTE 9 – BENEFIT PLANS (continued)

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, 2018	December 31, 2017
Fixed income	94%	65%
Equities	0%	29%
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 90%-100% fixed income and 0–10% alternative investments when measured at fair value.

The Company's expected future long-term rate of return of 5.30% 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.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

NOTE 9 – BENEFIT PLANS (continued)

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

		2018	2017
Equities – unaffiliated	Equity Funds	\$ —	\$ 94,960
	Total equities - unaffiliated	—	94,960
Fixed income	Aerospace/Defense	9,284	6,808
	Airlines	688	—
	Automotive	3,109	—
	Banking	31,681	25,324
	Cable	5,431	3,917
	Chemicals	3,264	2,449
	Consumer products	7,930	—
	Energy	—	2,026
	Food and Beverage	12,052	9,670
	Government agency	29,021	—
	Health Care	9,189	4,208
	Housing	10,110	—
	Insurance - Health	3,294	3,661
	Insurance - Property and Casualty	15,518	10,519
	Insurance - Life	4,496	3,816
	Independent	2,480	—
	Integrated	3,977	—
	Local authorities	10,082	—
	Machine Construction	5,690	6,009
	Manufacturing	3,546	4,352
	Media	5,078	4,832
	Metals/Mining	8,555	6,888
	Midstream	3,001	—
	Pharmaceuticals	13,923	11,895
	Railroads	14,027	—
	Real Estate Investment Trusts	3,367	1,046
	Retailers	12,584	22,135
	Technology	19,192	22,466
	Transportation	9,596	12,155
	Utilities	31,143	14,553
	Wireless	2,889	3,197
	Wirelines	4,429	1,046
	Bond Funds	22,901	28,399
	Total fixed income	321,527	211,371
Partnerships		20,721	17,227
Cash		1,038	959
Group annuity		587	444
	Total Investments (1)	\$ 343,873	\$ 324,961

(1) The difference to total plan assets of \$346,949 in 2018 and \$326,670 for 2017 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.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

NOTE 9 – BENEFIT PLANS (continued)

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.

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):

2018 Fair Value	Level 1	Level 2	Level 3	Total
Assets				
Corporates ⁽¹⁾	\$ —	\$ 301,729	\$ —	\$ 301,729
Cash	1,038	—	—	1,038
Group annuity	—	587	—	587
Total Plan Assets ⁽¹⁾	\$ 1,038	\$ 302,316	\$ —	\$ 303,354
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 Plan Assets ⁽¹⁾	\$ 959	\$ 185,140	\$ —	\$ 186,099

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, 2018, the fair value of these investments in corporates and partnerships were \$22,901 and \$20,721, respectively. 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.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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, 2018, 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
2019	\$ 34,153	\$ 1,728	\$ 56
2020	31,947	1,747	60
2021	29,667	1,743	68
2022	28,276	1,777	73
2023	27,981	1,811	76
2024-2028	145,083	8,990	436

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 2019 into its separately funded defined benefit pension plans is anticipated to be up to \$0.5 million.

The Company provides employees with a 401(k) plan. Under the Company's 401(k) 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, 2018. The \$3.5 million of goodwill is related to the acquisition of LSW. There were no impairments recorded in 2018 or 2017. 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.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

NOTE 11 – DEBT

Debt consists of the following (in thousands):

	2018	2017
7.5% Senior Notes:	\$ 198,158	\$ 198,033
\$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:	67,439	67,404
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:	167,449	187,201
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.		
5.25% Surplus Notes:	357,820	—
\$350 million, maturing July 19, 2068, interest payable semiannually on January 19 and July 19. The notes are unsecured and subordinated to any existing or future indebtedness of National Life.		
Total debt	<u>\$ 790,866</u>	<u>\$ 452,638</u>

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*.

In July 2018, the Company issued surplus notes with a principal balance of \$350 million that mature in 2068. These surplus notes will accrue interest at a fixed rate of 5.25% until July 18, 2048, and thereafter at a floating rate equal to the Three-month USD LIBOR rate plus 3.314%. The surplus notes are redeemable by the Company on or after July 19, 2048. In July 2018, National Life also completed an exchange transaction, in which it issued an additional \$22.1 million of the 5.25% surplus notes in exchange for its 10.5% surplus notes, originally issued in 2009, with a principal balance of \$12.8 million. The discount at the time of the exchange, \$9.3 million, will be recognized in interest expense over the life of the 5.25% surplus notes.

In 2018 and 2017, National Life repurchased \$7.1 million and \$1.2 million, respectively, of the outstanding 10.5% surplus notes. Losses of \$3.9 million and \$0.8 million were recorded on the repurchases and included in net realized capital gains (losses) in 2018 and 2017, respectively.

Interest paid on the 7.5% senior notes was \$15.0 million in 2018 and in 2017. Interest paid on the 6.5% senior notes was \$4.9 million in 2018 and \$4.4 million in 2017. Interest paid on the 10.5% surplus note was \$19.8 million in 2018 and \$19.9 million in 2017. No interest was paid on the 5.25% surplus note in 2018.

National Life and LSW have secured asset-based borrowing capacity of \$1.4 billion with FHLB Boston and \$4.0 billion with FHLB Dallas, respectively. For additional information on FHLB, see Note 2.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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 the Company 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 the Company 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. The Company 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 Plaintiffs 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. The Company filed a motion for summary judgment and Plaintiffs filed a cross 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 the cross motions for summary judgment with respect to certain claims under the California Unfair Competition Law that had previously been dismissed by the Court. The Company answered the Third Amended Complaint on January 22, 2018. On June 15, 2018, the Court granted Plaintiffs leave to file a Fourth Amended Complaint which among other things added two additional named Plaintiffs. Plaintiffs filed their Fourth Amended Complaint on June 22, 2018 and LSW answered on June 29, 2018. On May 11, 2018, Plaintiffs filed a motion for class certification and LSW opposed on June 1, 2018. After a hearing on July 28, 2018, the Court granted class certification as to certain of the remanded claims on July 31, 2018. Both parties have sought permission to appeal the July 31, 2018 class certification ruling to the Ninth Circuit Court of Appeals. Those requests are pending. Trial is currently scheduled to begin in the matter on May 21, 2019. The Company intends to continue to contest the matter vigorously.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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, 2018 (in thousands).

Year	<u>Contract Obligation</u>
2019	5,500
2020	5,500
2021	5,500
2022	5,500
2023	5,500
Thereafter	5,958
Total minimum payments	<u>\$ 33,458</u>

The Company also has a services contract with NTT Data. In total, the Company paid \$10.3 million and \$15.4 million in 2018 and 2017, 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 25, 2025. Total expense paid to NTT Data under this contract was \$27.9 million and \$26.9 million in 2018 and 2017, 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, 2020. The contract provides new business support through electronic applications. The Company paid \$2.8 million and \$2.3 million under this contract in 2018 and 2017, respectively.

The Company signed a multi-year contract with Cognizant which expires January 30, 2020. The contract provides application support, web development and Quality Assurance (“QA”) services. The Company paid \$20.1 million and \$14.2 million under this contract in 2018 and 2017, respectively.

The Company signed a multi-year contract with Salesforce.com which expires December 31, 2020. The contract provides customer relationship management application licenses and support. The Company paid \$2.6 million and \$0.6 million under this contract in 2018 and 2017, 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 \$1.4 million and \$1.2 million in 2018 and 2017, respectively.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

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	<u>Contract Obligation</u>
2019	1,730
2020	1,808
2021	1,846
2022	1,684
2023	1,709
Thereafter	5,438
Total minimum payments	<u>\$ 14,215</u>

The Company had unfunded mortgage loan, partnership, and AFS debt security commitments of \$152.4 million, \$559.2 million, and \$301.1 million respectively, at December 31, 2018. 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 holders of certain of National Life's individual participating life insurance and annuity policies in force at December 31, 1998. The Closed Block is designed to give reasonable assurance to holders of policies in the Closed Block that assets will be available to provide for payment of policy benefits, including the continuation of dividends throughout the life of such policies based upon the 1998 dividend scale if the experience underlying such dividend scale (including portfolio interest rates) continues as it was in 1998, and for appropriate adjustment in such dividend scale if the experience changes. 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 2018 and 2017, the Company recorded increases in policyholder dividend obligation of \$5.2 million and \$11.1 million respectively. Unrealized gains in the Closed Block generated a policyholder dividend obligation through accumulated other comprehensive income of \$37.0 million and \$150.8 million at

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

NOTE 13 – NATIONAL LIFE CLOSED BLOCK (continued)

December 31, 2018 and 2017, respectively. The total policyholder dividend obligation at December 31, 2018 and 2017 was \$42.2 million and \$161.8 million, respectively.

Summarized financial information for the Closed Block effects included in the consolidated financial statements as of December 31, 2018 and 2017, and for the two years ended December 31, 2018 and 2017 is as follows (in thousands):

	<u>2018</u>	<u>2017</u>
Liabilities:		
Policy liabilities and accruals	\$ 2,966,311	\$ 3,187,740
Other liabilities	256	172
Total liabilities	<u>\$ 2,966,567</u>	<u>\$ 3,187,912</u>
Assets:		
Cash	\$ 2,343	\$ 929
Short term investments	—	31,500
Available-for-sale debt and equity securities	2,175,885	2,331,516
Mortgage loans	162,053	171,552
Policy loans	367,221	379,547
Accrued investment income	30,546	31,196
Premiums and fees receivable	5,742	5,942
Other assets	13,785	10,146
Total assets	<u>\$ 2,757,575</u>	<u>\$ 2,962,328</u>
Excess of reported liabilities over assets	\$ 208,992	\$ 225,584
Closed Block accumulated other comprehensive loss	—	—
Unrealized loss and liabilities	<u>\$ 208,992</u>	<u>\$ 225,584</u>

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

NOTE 13 – NATIONAL LIFE CLOSED BLOCK (continued)

	<u>2018</u>	<u>2017</u>
Revenues:		
Insurance premiums and other income	\$ 87,218	\$ 96,100
Net investment income	120,111	128,232
Net realized investment gain (loss)	72	(459)
Total revenues	<u>\$ 207,401</u>	<u>\$ 223,873</u>
Benefits and Expenses:		
Decrease in policy liabilities	(94,084)	(84,481)
Policy benefits	245,145	235,331
Policyholders' dividends and dividend obligations	31,083	46,620
Interest credited to policyholder account liabilities	6,565	7,333
Operating expenses	4,571	4,433
Commission expenses	929	995
Total benefits and expenses	<u>\$ 194,209</u>	<u>\$ 210,231</u>
Pre-tax results of operations	13,192	13,642
Income taxes	(3,400)	21,114
Closed Block results of operations	<u>\$ 16,592</u>	<u>\$ (7,472)</u>
Other comprehensive income:		
Unrealized loss	—	—
Total Closed Block comprehensive income (loss)	<u>\$ 16,592</u>	<u>\$ (7,472)</u>
Excess of reported Closed Block liabilities over Closed Block assets:		
Beginning of year	225,584	218,112
Closed Block comprehensive income (loss)	16,592	(7,472)
End of year	<u>\$ 208,992</u>	<u>\$ 225,584</u>

Amortized cost of available for sale securities held by the Closed Block at December 31, 2018 and 2017 were \$2.1 billion and \$2.2 billion, respectively.

Participating insurance in force within the Closed Block at December 31, 2018 and 2017 was \$5.5 billion and \$5.8 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.

NLV Financial Corporation and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2018

NOTE 14 – STATUTORY INFORMATION AND RESTRICTIONS (continued)

LSW paid no dividends to National Life in 2018 or 2017. National Life paid a \$35 million and \$20 million dividend to NLVF in 2018 and 2017, respectively. 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 2018 and 2017, there was a capital contribution of \$180 million and \$100 million, respectively, from National Life to LSW.

National Life's statutory surplus was \$2.13 billion (unaudited) and \$2.02 billion (unaudited) at December 31, 2018 and 2017, respectively. Statutory net income (loss) was a net loss of \$(22.8) million (unaudited) and net income of \$14.9 million (unaudited) in 2018 and 2017, respectively.

Pursuant to certain statutory requirements, as of December 31, 2018, National Life and LSW had securities on deposit with a statutory carrying value of \$7.1 million and \$3.5 million, respectively, in insurance department special deposit accounts.

NOTE 15 – PARTICIPATING LIFE INSURANCE

Participating life insurance in force was 17.9% and 21.3% of the face value of total insurance in force at December 31, 2018 and 2017, respectively. The premiums on participating life insurance policies were 12.6% and 16.2% of total individual life insurance premiums in 2018 and 2017, respectively.