



manages risks associated with interest rates, credit spreads, equity markets, real estate and currency exchange rates. The Company's continuing focus is to manage risks and returns and to position our portfolio to take advantage of market opportunities while attempting to mitigate adverse effects.

The Company continues to focus on shifting the portfolio mix to have less reliance on investments whose returns come primarily from interest payments to investments in which the Company has ownership interests and a greater proportion of return is derived from idiosyncratic operating or market performance including limited partnerships, equities and real estate. Reductions in contractholder funds were primarily funded through scheduled maturities.

The Company has a comprehensive portfolio monitoring process to identify and evaluate each security whose carrying value may be other than temporarily impaired. The portfolio monitoring process includes a quarterly review of all securities to identify instances where the fair value of a security compared to its amortized cost (for bonds) or cost (for stocks) is below established thresholds. The process also includes monitoring of other impairment indicators such as ratings, rating downgrades and payment defaults.

The composition of the investment portfolio at December 31 was:

| (in millions)                              | <u>2014</u>      | <u>2013</u>      |
|--------------------------------------------|------------------|------------------|
| Bonds                                      | \$ 25,814        | \$ 37,197        |
| Preferred stocks                           | 48               | 27               |
| Common stocks                              | 945              | 649              |
| Mortgage loans on real estate              | 3,564            | 5,405            |
| Property held for the production of income | 27               | 28               |
| Cash and cash equivalents                  | 827              | 610              |
| Short-term investments                     | 71               | 66               |
| Contract loans                             | 638              | 832              |
| Other invested assets                      | 3,160            | 2,892            |
| Other                                      | <u>86</u>        | <u>246</u>       |
| Total                                      | <u>\$ 35,180</u> | <u>\$ 47,952</u> |

Total invested assets decreased \$12.77 billion, or 27%, at December 31, 2014 and was primarily due to the transfer of investments for the reinsurance commutation associated with the sale of LBL. Explanation for the most significant items follow.

#### **Bonds**

The bond portfolio consists of corporate bonds including privately placed securities, tax-exempt and taxable municipal bonds, asset-backed securities ("ABS"), mortgage-backed securities ("MBS"), U.S. government bonds, and foreign government bonds.

At December 31, 2014, 88% of the consolidated bond portfolio was rated investment grade, which is defined as a security having a National Association of Insurance Commissioners ("NAIC") Securities Valuation Office designation of 1 or 2; an A.M. Best rating of aaa, aa, a, or bbb; a Moodys rating of Aaa, Aa, A, or Baa, a Standard & Poors and, Fitch, Dominion, Kroll, Realpoint or Egan Jones rating of AAA, AA, A or BBB; or a comparable internal rating if an externally provided rating is not available. The investment grade percentage for each individual bond category ranged from 80% to 100%. The most significant decreases in the bond portfolio mix from the prior year occurred in the publicly traded corporate bonds and the privately placed securities portfolio which decreased \$5.81 billion and \$2.23 billion, respectively. There was no significant change in the bond portfolio quality distribution from the prior year.

Bonds with an NAIC designation of 1 through 5, including loan-backed and other structured securities, are reported at amortized cost using the effective yield method. Bonds with an NAIC designation of 6 are reported at the lower of amortized cost or fair value, with the difference reflected in unassigned surplus as unrealized capital loss.

Corporate bonds totaled \$17.98 billion and \$26.02 billion at December 31, 2014 and 2013, respectively. As of December 31, 2014, the portfolio also contained \$5.20 billion of privately placed corporate securities compared with \$7.43 billion at December 31, 2013. Privately placed securities primarily consist of corporate issued senior debt securities that are directly negotiated with the borrower or are in unregistered form. Privately placed corporate obligations contain structured security features such as financial covenant and call protections that provide investors greater protection against credit deterioration, reinvestment risk or fluctuations in interest rates than those typically found in publicly registered debt securities. At December

31, 2014, 80% of the privately placed securities were rated investment grade.

Municipal bonds, including tax-exempt and taxable securities, totaled \$3.08 billion at December 31, 2014 compared to \$3.63 billion at December 31, 2013. The municipal bond portfolio includes general obligations of state and local issuers and revenue bonds (including pre-refunded bonds, which are bonds for which an irrevocable trust has been established to fund the remaining payments of principal and interest). At December 31, 2014, 99% of the municipal bonds were rated investment grade. The municipal bond portfolio at December 31, 2014 consisted of 418 issues from 203 issuers. The largest exposure to a single issuer was 4% of the municipal bond portfolio.

The bond portfolio also contained \$2.09 billion and \$3.55 billion of ABS at December 31, 2014 and 2013, respectively. The ABS portfolio includes collateralized debt obligations and consumer and other ABS. Credit risk is managed by monitoring the performance of the underlying collateral. Many of the securities in the ABS portfolio have credit enhancement with features such as overcollateralization, subordinated structures, reserve funds, guarantees and/or insurance. At December 31, 2014, 91% of the ABS securities were rated investment grade.

At December 31, 2014 and 2013, \$1.10 billion and \$2.09 billion, respectively, of the bond portfolio were invested in MBS, which consisted of residential MBS ("RMBS") and commercial MBS ("CMBS"). The RMBS portfolio is subject to interest risk, but unlike other fixed income securities, is additionally subject to significant prepayment risk from the underlying residential mortgage loans. The CMBS portfolio is subject to credit risk and has a sequential paydown structure. At December 31, 2014, 93% of the MBS portfolio were rated investment grade.

The fair value of all bonds was \$28.09 billion and \$38.70 billion at December 31, 2014 and 2013, respectively. Unrealized net capital gains on the bond portfolio, which are calculated as the difference between statement value and fair value, were \$2.28 billion and \$1.50 billion as of December 31, 2014 and 2013, respectively.

#### **Mortgage loans on real estate**

Mortgage loans on real estate decreased \$1.84 billion to \$3.56 billion at December 31, 2014. Mortgage loans are secured by first mortgages on developed commercial real estate. Geographical and property type diversification are key considerations used to manage exposure. Mortgage loans are evaluated for impairment on a specific loan basis through a quarterly credit monitoring process and review of key credit quality indicators. Mortgage loans are considered impaired when it is probable the Company will not collect the contractual principal and interest. The Company recorded \$3 million and \$16 million of realized capital losses related to other-than-temporary impairments on mortgage loans for the year ended December 31, 2014 and 2013, respectively. For the years ended December 31, 2014 and 2013, the Company did not report valuation allowances on mortgage loans.

#### **Other invested assets**

Other invested assets increased \$268 million to \$3.16 billion at December 31, 2014 mostly attributed to limited partnerships. The limited partnership portfolio consists of investments in private equity/debt funds, real estate funds, and other funds and is diversified across a number of characteristics including fund managers, vintage years, strategies, geography (including international), and company/property types.

#### **Common stocks**

Common stocks increased \$296 million to \$945 million at December 31, 2014 mostly due to the current investment strategy of re-positioning the investment portfolio to increase the proportion of ownership assets.

#### **From Separate Accounts**

Separate Accounts balances decreased \$2.38 billion, or 33%, to \$4.92 billion at December 31, 2014 mainly due to a decline in market performance.

The assets of the Separate Accounts are carried at fair value. Separate Accounts liabilities represent the contractholders' claims to the related assets and are carried at the fair value of the assets. In the event the asset values of certain contractholder accounts are projected to be below the value guaranteed by the Company, a liability is established through a charge to earnings. Reserves for guarantees provided by the Company are included in Exhibit 5 of the Company's General Account annual statement.

Separate Accounts held by the Company are for variable annuity contracts, variable life policies and indexed variable annuity contracts. The assets and liabilities of variable annuity contracts and variable life policies are

recorded as assets and liabilities of the Separate Accounts and are legally insulated from the General Account. The legal insulation of the Separate Accounts prevents such assets from being generally available to satisfy claims resulting from the General Account. Separate Accounts which contain variable annuity and variable life business are unit investment trusts and registered with the Securities and Exchange Commission ("SEC"). As of December 31, 2014 and 2013, all assets of the Separate Accounts that support the variable annuity and variable life business were legally insulated. The assets and liabilities of indexed variable annuity contracts are also recorded as assets and liabilities of the Separate Accounts, however, they are not legally insulated from the General Account. The indexed variable annuity product is non-unitized and is registered with the SEC.

Variable annuity and variable life business allow the contractholder to accumulate funds within a variety of portfolios, at rates which depend upon the return achieved from the types of investments chosen. The net investment experience of the Separate Accounts is credited directly to the contractholder and can be favorable or unfavorable. The assets of each portfolio are held separately from the other portfolios and each has distinct investment objectives and policies. Absent any contract provision wherein the Company provides a guarantee, the contractholders of the variable annuity and variable life products bear the investment risk that the Separate Account's funds may not meet their stated investment objectives.

Indexed variable annuity products provide the opportunity for the contractholder to invest for a specified length of 5, 7, or 10 years in one or more investment options linked to the S&P 500 and subject to a maximum and minimum investment performance which may be negative.

#### **Aggregate reserve for life contracts**

| (in millions)                            | <u>2014</u>      | <u>2013</u>      |
|------------------------------------------|------------------|------------------|
| Fixed annuities                          | \$ 7,000         | \$ 11,636        |
| Structured settlements                   | 7,075            | 7,097            |
| Interest sensitive life                  | 6,952            | 10,572           |
| Traditional life                         | 2,204            | 2,059            |
| Market value adjusted annuities ("MVAA") | 1,487            | 3,735            |
| Indexed annuities                        | 1,166            | 3,319            |
| Annuity buyouts                          | 855              | 909              |
| Payout annuities                         | 656              | 625              |
| Single premium immediate annuities       | 493              | 531              |
| Other                                    | <u>308</u>       | <u>364</u>       |
| Total                                    | <u>\$ 28,196</u> | <u>\$ 40,847</u> |

Aggregate reserves for life contracts decreased \$12.65 billion to \$28.20 billion as of December 31, 2014 and were primarily driven by reserves decreases for fixed annuities (\$4.64 billion), interest sensitive life (\$3.62 billion), MVAA (\$2.25 billion) and indexed annuities (\$2.15 billion). These decreases were primarily driven by the reinsurance commutation associated with the sale of LBL.

#### **Asset valuation reserve**

Asset valuation reserve ("AVR") increased \$173 million to \$796 million as of December 31, 2014. The increase was mostly attributed to bonds (\$77 million) within the default component, and common stocks (\$49 million) and other invested assets (\$45 million) within the equity component. The overall increase in AVR was primarily driven by the significant increase in the current year realized and unrealized capital gains in the investment portfolio.

#### **Payable for securities lending**

Payable for securities lending increased \$186 million to \$508 million as of December 31, 2014 due to increased securities lending activities in the current year.

#### **Capital and surplus**

Capital and surplus decreased \$164 million to \$2.81 billion as of December 31, 2014. The decrease was mainly due to a return of capital to the Company's parent of \$700 million that was approved by the Illinois Department of Insurance, a decrease in net deferred income tax assets (\$211 million), an increase in AVR (\$173 million), and an increase in net unrealized capital losses (\$90 million). The overall decrease was partially offset by current year net income (\$1.01 billion).

## RESULTS OF OPERATIONS

| (in millions)                                                                                                                 | <u>2014</u>     | <u>2013</u>   |
|-------------------------------------------------------------------------------------------------------------------------------|-----------------|---------------|
| Premiums and annuity considerations                                                                                           | \$ (9,605)      | \$ 2,652      |
| Net investment income including IMR amortization                                                                              | 1,938           | 2,513         |
| Commissions and expense allowances                                                                                            | 85              | 256           |
| Reserve adjustments on reinsurance ceded                                                                                      | (1,018)         | (1,099)       |
| Income from fees                                                                                                              | 42              | 59            |
| Other income                                                                                                                  | 2               | 3             |
| Total revenue                                                                                                                 | <u>(8,556)</u>  | <u>4,384</u>  |
| Provision for benefits                                                                                                        | (8,437)         | 4,177         |
| Commissions and general insurance expenses                                                                                    | 939             | 765           |
| Insurance taxes, licenses and fees, excluding federal income taxes                                                            | 35              | 65            |
| Net transfers to or (from) Separate Accounts                                                                                  | (1,101)         | (1,052)       |
| Transfer of IMR due to reinsurance agreement                                                                                  | (161)           | -             |
| Total expense                                                                                                                 | <u>(8,725)</u>  | <u>3,955</u>  |
| Net gain from operations before dividends to policyholders and before federal income taxes                                    | 169             | 429           |
| Federal and foreign income taxes incurred (excluding tax on capital gains)                                                    | <u>(153)</u>    | <u>(56)</u>   |
| Net gain from operations after dividends to policyholders and federal income taxes and before realized capital gains (losses) | 322             | 485           |
| Realized gains (losses), net of IMR and federal income taxes                                                                  | <u>684</u>      | <u>(38)</u>   |
| Net income                                                                                                                    | <u>\$ 1,006</u> | <u>\$ 447</u> |

### Net income

The Company reported net income of \$1.01 billion for 2014, representing an increase of \$559 million over the prior year, mostly attributed to realized gains net of IMR and federal income taxes of \$684 million. Net gain from operations after dividends to policyholders and federal income taxes and before realized capital gains (losses) decreased \$163 million to \$322 million primarily due to the decreases in premiums (\$12.26 billion) and net investment income (\$575 million), partially offset by the \$12.61 billion decrease in provision for benefits.

### Premiums and annuity considerations

Premiums and annuity considerations decreased \$12.26 billion, or 462%, mainly due to the reinsurance commutation associated with the sale of LBL (\$11.31 billion), the decreases in indexed annuities (\$603 million) and interest sensitive life (\$245 million).

### Net investment income including IMR amortization

Net investment income including IMR amortization decreased \$575 million, or 23%, primarily due to a decrease in average invested asset base caused by the sale of LBL.

### Provision for benefits

Provision for benefits decreased \$12.61 billion primarily due to a \$11.18 billion favorable change in aggregate reserves for life and accident and health contracts and a \$1.03 billion decrease in surrenders. The decrease in reserves was primarily due to the reinsurance commutation associated with the sale of LBL (\$11.28 billion). The decrease in surrenders was attributable to the sale of LBL (\$1.10 billion) as the prior year amount included a full year of LBL's activities for 2013.

### Realized gains net of IMR and federal income taxes

Realized gains net of IMR and federal income taxes was \$684 million for 2014, compared to losses of \$38 million for 2013. The increase in realized capital gains was primarily attributed to the \$618 million capital gains on the sale of LBL.

## CASH FLOW AND LIQUIDITY

The following table summarizes cash flow.

| (in millions)                                                   | 2014           | 2013            |
|-----------------------------------------------------------------|----------------|-----------------|
| Net cash from operations                                        | \$ (12,680)    | \$ (1,196)      |
| Net cash from investments                                       | 13,962         | 3,658           |
| Net cash from financing and miscellaneous sources               | <u>(1,060)</u> | <u>(2,986)</u>  |
| Net change in cash, cash equivalents and short-term investments | <u>\$ 222</u>  | <u>\$ (524)</u> |

The principal sources of cash flows from operations were investment income, net transfers from Separate Accounts and refund of federal income taxes. The principal uses were premiums, the payment of benefits and loss related expenses, commissions and operating expenses paid. The cash outflow of premiums were mostly related to the reinsurance commutation associated with the sale of LBL.

The net cash from investments was primarily attributed to bonds. The maturity structure of the Company's bonds, which represent 73% of the Company's total investments, is managed to meet the anticipated cash flow requirements of the underlying liabilities. A portion of the diversified product portfolio, primarily fixed deferred annuities and universal life insurance policies, is subject to discretionary surrender and withdrawal by customers. The net cash from investments also included the \$596 million sale proceeds from the sale of LBL.

The most significant component of the negative cash flows from financing and miscellaneous sources was return of capital of \$700 million and net withdrawals on deposit-type contracts of \$400 million mainly due to scheduled distributions of maturing funding agreements.

Liquidity for life insurance companies is measured by the ability to pay contractual benefits and operating expenses, and fund investment commitments. Annuity reserves at December 31, 2014, excluding Separate Accounts, consisted of \$22.01 billion, or 69%, of total reserves in force. Of the total annuity reserves, \$15.25 billion, or 55%, are not subject to discretionary withdrawal. The Company maintains a strong liquidity position and is well positioned to meet its policyholders' obligations.

### **Financial strength ratings and outlook**

The Company's financial strength ratings were A+ (superior), A+ (good) and A1 (good) by A.M. Best, Standard & Poors and Moodys, respectively; all with a stable outlook.

### **Risk-based capital**

The NAIC has a uniform capital adequacy standard, referred to as the risk-based capital ("RBC"), that serves as one of the solvency monitoring regulatory tools to measure and assess the amount of capital that is appropriate for an insurance company to support its overall business operations in consideration of its size and risk profile. The standard utilizes a formula to calculate a company's minimum capital requirement ("company action level RBC") based on the insurance, business, asset, interest rate, health credit and market risk associated with its business. There is no regulatory action required if a company maintains an actual capital level greater than the company action level RBC. A RBC model law does, however, mandate four levels of regulatory action based on a company's degree of capital impairment. At December 31, 2014, each of the insurers comprising the Group had actual capital that was significantly above the company action level RBC.

### **IRIS ratios**

The NAIC has also developed a set of financial relationships or tests known as the Insurance Regulatory Information System ("IRIS") to assist state regulators in monitoring the financial condition of insurance companies that require special attention or action. IRIS ratios are not applicable to ALIC Re, a special purpose financial captive insurance company domiciled in South Carolina. The NAIC analyzes financial data provided by insurance companies using prescribed ratios, each with defined usual range. Additional regulatory scrutiny may occur if a company's ratio results fall outside the usual range for four or more of the twelve ratios. At December 31, 2014, 3 of the 5 applicable insurers comprising the Company had at least one ratio that was out of the usual range.

## OTHER

The Company's reinsurance ceded on life insurance inforce decreased \$97.84 billion to \$97.57 billion at December 31, 2014 compared to \$195.41 billion at December 31, 2013 primarily due to the sale of LBL. The Company enters

into reinsurance agreements with unaffiliated reinsurers to limit risk of mortality and morbidity losses, while retaining primary liability as a direct insurer for all risks ceded to reinsurers.

ALIC's insurance subsidiaries, excluding ALIC Re, are domiciled in Illinois and New York. The IL domiciled insurance subsidiaries have a 100% intercompany reinsurance agreement in place with ALIC.

As of December 31, 2014 and 2013, 23% and 36%, respectively, of the Company's face amount of life insurance inforce was reinsured. The Company also cedes substantially all of the risk associated with variable annuity contracts to non-affiliates.

The credit worthiness of external reinsurers is continuously monitored. As of December 31, 2014, 90% of ceded premiums under uncollateralized external reinsurance treaties were ceded to companies that currently have an A.M. Best financial strength rating of A- or better.