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NAIC Company Code 19232
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# Allstate Insurance Group
# Combined Management Discussion and Analysis
# For the Year Ended December 31, 2018

## OVERVIEW

The Allstate Insurance Group (referred to as the "Group") consists of Allstate County Mutual Insurance Company, Allstate Fire and Casualty Insurance Company ("AFCIC"), Allstate Indemnity Company ("AI"), Allstate Insurance Company ("AIC"), Allstate Northbrook Indemnity Company, Allstate North American Insurance Company, Allstate Property and Casualty Insurance Company ("APC"), Allstate Texas Lloyd's, Allstate Vehicle and Property Insurance Company, Encompass Home and Auto Insurance Company ("EHAIC"), Encompass Indemnity Company ("EI"), Encompass Independent Insurance Company ("EIIC"), Encompass Insurance Company ("EIC"), Encompass Insurance Company of America ("EICA"), Encompass Insurance Company of Massachusetts, Encompass Property and Casualty Company ("EPC"), Esurance Insurance Company and Esurance Property and Casualty Insurance Company. Since these insurers are part of a consolidated group that utilize 100% intercompany reinsurance agreements, regulatory approval was obtained to prepare a combined Management Discussion and Analysis ("MD&A"). Accordingly, the combined results of the aforementioned companies have been analyzed in this MD&A.

In addition to the combined affiliated property-liability insurers listed above, the Group has several uncombined subsidiaries, the largest of which is the Allstate Life Insurance Company ("Allstate Life"), which offers traditional interest-sensitive and variable life insurance products through Allstate exclusive agencies and exclusive financial specialists. There are also several uncombined property and casualty insurers, the two largest being Allstate New Jersey Insurance Company ("ANJ") and Castle Key Insurance Company ("CKIC"). ANJ writes auto and homeowners exclusively in New Jersey, while CKIC writes only homeowners in Florida. North Light Specialty Insurance Company ("NLSIC") writes excess and surplus lines through surplus lines brokers, with the concentration on homeowners. Separate MD&As were filed for Allstate Life and certain of its subsidiaries, ANJ, CKIC and NLSIC. Allstate Insurance Company of Canada is an affiliated foreign insurer, which has three subsidiary insurance companies and has regulatory filings with the Office of the Superintendent of Financial Institutions.

AIC is an Illinois domiciled insurer licensed to write property and casualty business in 49 states, the District of Columbia, Puerto Rico and Canada and offers a broad range of personal and commercial insurance products. Allstate Insurance Holdings, LLC ("Allstate Holdings"), a Delaware Corporation, owns all of AIC's outstanding shares of common stock and is wholly-owned by The Allstate Corporation.

## BUSINESS

The Group's property-liability operations consist of two reportable segments: Allstate Protection and Discontinued Lines and Coverages. Allstate Protection includes the Allstate®, Encompass® and Esurance® brands and offers private passenger auto, homeowners, other personal lines and commercial insurance through agencies and direct, including contact centers and the internet. Discontinued Lines and Coverages relates to property and casualty insurance policies written during the 1960's through the mid-1980's. These segments are consistent with the groupings of financial information that management uses to evaluate performance and to determine the allocation of resources.

The Group's products are marketed under the Allstate, Esurance and Encompass brand names. The Allstate brand serves customers who prefer local personalized advice and service and are brand-sensitive. The Esurance brand serves self-directed, brand-sensitive consumers online and through call centers, while the Encompass brand serves brand-neutral customers who prefer personal service and support from an independent agent.

The Allstate brand utilizes targeted marketing which includes messaging that communicates the value of the Group's "Good Hands®", the importance of having proper coverage, product options, and the ease of doing business with Allstate and Allstate exclusive agencies.

The Allstate brand differentiates itself by offering comprehensive product options and features through agencies that provide local advice and service. The Your Choice Auto® product offers qualified customers choice from a variety of options such as Accident Forgiveness, Deductible Rewards®, Safe Driving Bonus® and New Car Replacement. The Allstate House and Home® product featured options include Claim RateGuard®, Claim-Free Bonus, deductible rewards and flexibility in options and coverages, including graduated roof coverage and pricing based on roof type and age for damage related to wind and hail events. In addition, the Group offers a Claim Satisfaction Guarantee® that promises a return of premium to standard auto insurance customers dissatisfied with their claims experience. Bundling Benefits provides auto customers with a qualifying property policy an auto renewal guarantee and a deductible waiver (when the same event, with the same covered cause of loss, damages both auto and property). Bundling Benefits was offered in 15 states as of December 31, 2018. The Auto Replacement Protection replaces a qualifying customer's vehicle involved in a total loss accident with a vehicle of the same or similar make and model that is one year newer. The Drivewise® program is a telematics-based insurance program, available in 49 states and the District of Columbia as of December 31, 2018, that uses a mobile application or an in-car device to capture driving behaviors and encourage safe driving. The Drivewise program provides customers with information and tools, incentives and driving challenges. For example, in most states, Allstate Rewards® provides reward points for safe driving. Milewise®, Allstate's usage based insurance product, available in 6 states as of December 31, 2018, gives customers flexibility to customize their insurance and pay based on the number of miles they drive.

When an Allstate product is not available, the Group may offer non-proprietary products to consumers through arrangements made with other companies, agencies, and brokers.

Other personal lines sold under the Allstate brand include renters, condominium, landlord, boat, umbrella, manufactured home and stand-alone scheduled personal property.

The Group's strategy for the Esurance brand is to make insurance surprisingly painless by innovating to make it simple, transparent, and affordable. We plan to grow profitably by delivering an excellent customer experience at an exceptional value through an engaged and high-performing workforce. To provide an enhanced customer experience we offer a seamless online and mobile experience with fast quoting for ease and convenience, provide hassle-free purchases and claims processing through intuitive tools and advanced technology, offer a broad suite of protection products and solutions to our customers and offer innovative product options and features.

The Group's strategy for the Encompass brand is to expand the independent agency footprint, broaden geographic and product diversification, enhance pricing and underwriting sophistication and provide a superior customer and agent experience. Over the past several years, Encompass has been executing on a profit improvement plan emphasizing pricing, governance and operational improvements at both the state and countrywide levels. These actions have improved underlying profitability but led to a reduction of policies in force compared to prior years for both auto and homeowners.

The Group's pricing and underwriting strategies and decisions are designed to generate sustainable profitable growth. The Group's proprietary database of underwriting and loss experience enables sophisticated pricing algorithms and methodologies to more accurately price risks while also seeking to attract and retain customers in multiple risk segments. A combination of underwriting information, pricing and discounts are also used to achieve a more competitive position and growth. The Group's pricing strategy involves local marketplace pricing and underwriting decisions based on risk evaluation factors and an evaluation of competitors to the extent permissible by applicable law.

Pricing of property products is intended to establish risk-adjusted returns that are acceptable over a long-term period. The Group pursues rate increases to keep pace with loss trends, including losses from catastrophic events and those that are weather-related (such as wind, hail, lightning and freeze not meeting the criteria to be declared a catastrophe) The Group also takes into consideration potential customer disruption, the impact on its ability to market our products, regulatory limitations, competitive position and profitability. In any reporting period, loss experience from catastrophic events and weather-related losses may contribute to negative or positive underwriting performance relative to the expectations we incorporated into product pricing.

## CATASTROPHE MANAGEMENT

Catastrophe losses are an inherent risk of the property and casualty insurance industry that have contributed, and will continue to contribute, to potentially material year-to-year fluctuations in the Group's results of operations and financial position. The Group defines a “catastrophe” as an event that produces pre-tax losses before reinsurance in excess of $1 million and involves multiple first party policyholders, or a winter weather event that produces a number of claims in excess of a preset, per-event threshold of average claims in a specific area, occurring within a certain amount of time following the event. Catastrophes are caused by various natural events including high winds, winter storms and freezes, tornadoes, hailstorms, wildfires, tropical storms, hurricanes, earthquakes and volcanoes. The Group is also exposed to man-made catastrophic events, such as certain types of terrorism or industrial accidents. The nature and level of catastrophes in any period cannot be reliably predicted.

The Group considers the greatest areas of potential catastrophe losses due to hurricanes generally to be major metropolitan centers in counties along the eastern and gulf coasts of the United States. Usually, the average premium on a property policy near these coasts is greater than in other areas. However, average premiums are often not considered commensurate with the inherent risk of loss. In addition, in various states the Group is subject to assessments from assigned risk plans, reinsurance facilities and joint underwriting associations providing insurance for wind related property losses.

Over time the Group has limited its aggregate insurance exposure to catastrophe losses in certain regions of the country that are subject to high levels of natural catastrophes, limited by our participation in various state facilities. However, the impact of these actions may be diminished by the growth in insured values, and the effect of state insurance laws and regulations. In addition, in various states the Group is required to participate in assigned risk plans, reinsurance facilities and joint underwriting associations that provide insurance coverage to individuals or entities that otherwise are unable to purchase such coverage from private insurers. Because of the Group’s participation in these and other state facilities such as wind pools, it may be exposed to losses that surpass the capitalization of these facilities and to assessments from these facilities.

Property catastrophe exposure management includes purchasing reinsurance to provide coverage for known exposure to hurricanes, earthquakes, wildfires, fires following earthquakes and other catastrophes. The Group is also working to promote measures to prevent and mitigate losses and make homes and communities more resilient, including enactment of stronger building codes and effective enforcement of those codes, adoption of sensible land use policies, and development of effective and affordable methods of improving the resilience of existing structures.

The Group continues to take actions to maintain an appropriate level of exposure to catastrophic events while continuing to meet the needs of the Group’s customer’s, including the following:

- Continuing to limit or not offer new homeowners, manufactured home and landlord package policy business in certain coastal geographies.
- Increased capacity in the brokerage platform for customers not offered an Allstate policy.
- In 2016, we began to write a limited number of homeowners policies in select areas of California. The Group will continue to renew current policyholders and allow replacement policies for existing customers who buy a new home, or change their residence to rental property.
- In certain states, the Group has been ceding wind exposure related to insured property located in wind pool eligible areas.
- Tropical cyclone deductibles are generally higher than all peril deductibles and are in place for a large portion of coastal insured properties.
- Auto physical damage coverage generally includes coverage for flood-related loss. We have additional catastrophe exposure, beyond the property lines, for auto customers who have purchased physical damage coverage. The Group manages this additional exposure through inclusion of auto losses in our nationwide reinsurance program, including Florida personal lines automobile business, as of June 1, 2016.
- Offer a homeowners policy available in 42 states and the District of Columbia, Allstate House and Home®, that provides options of coverage for roof damage including graduated coverage and pricing based on roof type and age.

The Group continues to seek appropriate returns for its risks. This may require further actions, similar to those already taken, in geographies where the Group is not getting appropriate returns. However, the Group may maintain or opportunistically increase its presence in areas where adequate risk adjusted returns can be achieved.

## DODD-FRANK: COVERED AGREEMENT

The Secretary of the Treasury (operating through FIO) and the Office of the U.S. Trade Representative ("USTR") are jointly authorized, pursuant to the Dodd-Frank, to negotiate Covered Agreements. A Covered Agreement is a bilateral or multilateral agreement that "relates to the recognition of prudential measures with respect to the business of insurance or reinsurance that achieves a level of protection for insurance or reinsurance consumers that is substantially equivalent to the level of protection achieved under State insurance or reinsurance regulation."

On September 22, 2017, the U.S. and European Union ("EU") signed a Covered Agreement. In addition to signing the Covered Agreement, Treasury and the USTR jointly issued a policy statement clarifying how the U.S. views implementation of certain provisions of the Covered Agreement. The policy statement affirms the U.S. system of insurance regulation, including the role of state insurance regulators as the primary supervisors of the business of insurance and addresses several other key provisions of the Covered Agreement for which constituents sought clarity, including prospective application to reinsurance agreements and an affirmation that the Covered Agreement does not require development of a group capital standard or group capital requirement in the U.S.

The U.S. has five years from the date of signing to amend its credit for reinsurance laws and regulations to conform with the requirements of the Covered Agreement or face federal preemption determinations by the FIO. To address the requirements of the Covered Agreement, the National Association of Insurance Commissioners ("NAIC") has formally adopted plans to revise the existing credit for reinsurance model law and model regulation to conform with the requirements of the Covered Agreement with the expectation that states will adopt and implement the modified model law and regulation. In addition, the NAIC plans to adopt reinsurance collateral requirements for reinsurers domiciled in NAIC qualified jurisdictions, other than those in the EU, consistent with those in the Covered Agreement provided the qualified jurisdictions also comply with the group capital mutual recognition and information sharing provisions of the Covered Agreement.

On December 18, 2018, the U.S. and the United Kingdom ("UK") signed a separate Covered Agreement consistent with the U.S.-EU Covered Agreement to coordinate regulation of the insurance industry doing business in the U.S. and UK in the event the UK leaves the EU in March 2019. Consistent with steps taken when the U.S. signed the U.S.-EU Covered Agreement in 2017, Treasury and the USTR also issued a policy statement regarding implementation of the U.S.-UK Covered Agreement affirming the role that state insurance regulators play as the primary supervisors of the insurance industry. The signing begins a review period in the UK that lasts for 21 legislative days. The Covered Agreement has also been submitted to Congress on December 11, 2018 for a period of 90 calendar days after which the U.S.-UK Covered Agreement may become effective without further congressional approval.

## DIVISION STATUTE

On November 27, 2018, the Illinois General Assembly passed legislation authorizing a statute that makes available a process by which a domestic insurance company may divide into two or more domestic insurance companies. The statute could be used to isolate an existing block of life, health or property-casualty business for sale to a third party or to manage risks associated with indemnification programs. The statute could also be used to divide continuing blocks of insurance business from insurance business that is no longer marketed, or otherwise has been discontinued, into separate companies with separate capital. Before a plan of division can be effected, it must be approved according to the organizational documents of the dividing insurer and submitted for approval by the Illinois Department of Insurance. The bill was effective January 1, 2019. The Illinois Department of Insurance will likely promulgate rules and the rule-making process will take several months once filed.

## FINANCIAL POSITION

**(in millions)**

| | 2018 | 2017 |
|---|---|---|
| Cash and invested assets | $ 43,559 | $ 43,047 |
| Investment income due and accrued | 265 | 233 |
| Premiums and considerations | 4,940 | 4,654 |
| Net deferred tax asset | 729 | 609 |
| Receivable from parent, subsidiaries and affiliates | 235 | 203 |
| Other assets | 233 | 257 |
| Total assets | $ 49,961 | $ 49,003 |
| | | |
| Loss and loss adjustment expenses | $ 17,618 | $ 17,102 |
| Commissions payable, contingent commissions and other similar charges | 198 | 191 |
| Other expenses | 1,332 | 1,304 |
| Current federal and foreign income taxes | 3 | 235 |
| Unearned premium | 10,650 | 10,117 |
| Advance premium | 290 | 271 |
| Payable to parent, subsidiaries and affiliates | 201 | 204 |
| Payable for securities lending | 920 | 583 |
| Accounts payable | 305 | 271 |
| Payable for securities | 245 | 155 |
| Other liabilties | 520 | 385 |
| Total liabilties | 32,282 | 30,818 |
| Capital and surplus | 17,679 | 18,185 |
| Total liabilties and capital and surplus | $ 49,961 | $ 49,003 |

### Cash and invested assets

The Group's investment strategy emphasizes protection of principal and consistent income generation, within a total return framework. This approach has produced competitive returns over the long term and is designed to ensure financial strength and stability for paying claims, while maximizing economic value and surplus growth. Products with lower liquidity needs, such as auto insurance, and capital create capacity to invest in less liquid higher yielding bond securities, performance-based investments such as limited partnerships, and equity securities. Products with higher liquidity needs, such as homeowners insurance, are invested primarily in high quality liquid bond securities.

The Group identifies a strategic asset allocation which considers the nature of the liabilities and the risk and return characteristics of the various asset classes in which it invests. This allocation is informed by our long-term and market expectations, as well as other considerations such as risk appetite, portfolio diversification, duration, desired liquidity and capital. Within appropriate ranges relative to strategic allocations, tactical allocations are made in consideration of prevailing and potential future market conditions. We manage risks that involve uncertainty related to interest rates, credit spreads, equity returns and currency exchange rates.

The Group utilizes two primary strategies to manage risks and returns and to position the portfolio to take advantage of market opportunities while attempting to mitigate adverse effects. As strategies and market conditions evolve, the asset allocation may change or assets may move between strategies.

*Market-based* strategies include investments primarily in public bonds and common stocks. *Market-based core* seeks to deliver predictable earnings aligned to business needs and returns consistent with the markets in which the Company invests. Private fixed income assets, such as commercial mortgages, bank loans and privately placed debt that provide liquidity premiums are also included in this category. As of December 31, 2018, 70% of the portfolio follows this strategy with 71% in bonds and commercial mortgage loans and 25% in common stocks.

*Market-based active* strategy seeks to outperform within the public markets through tactical positioning and by taking advantage of short-term opportunities. This category may generate results that meaningfully deviate from those achieved by market indices, both favorably and unfavorably. As of December 31, 2018, 19% of the portfolio follows this strategy with 89% in bonds and 5% in common stock.

*Performance-based* strategy seeks to deliver attractive risk-adjusted returns and supplement market risk with idiosyncratic risk. Returns are impacted by a variety of factors including general macroeconomic and public market conditions as public benchmarks are often used in the valuation of underlying investments. Variability in earnings will also result from the performance of the underlying assets or business and the timing of sales of those investments. Earnings from the sales of investments may be recorded as net investment income or realized capital gains and losses. The portfolio, which primarily includes private equity and real estate with a majority being limited partnerships, is diversified across a number of characteristics, including managers or partners, vintage years, strategies, geographies (including international) and industry sectors or property types. These investments are generally illiquid in nature, often require specialized expertise, typically involve a third party manager, and often enhance returns and income through transformation at the company or property level. A portion of these investments seek returns in markets or asset classes that are dislocated or special situations, primarily in private markets. As of December 31, 2018, 11% of the portfolio follows this strategy with 88% in other invested assets primarily invested in limited partnerships.

**Portfolio composition by investment strategy**

The Group continues to increase performance-based investments in the portfolio consistent with the ongoing strategy to have a greater proportion of return derived from idiosyncratic assets or operating performance. Income related to performance-based investments will result in variability of earnings.

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

The following table presents the investment portfolio by strategy as of December 31:

|  | 2018 |  |  |  | 2017 |
|---|---|---|---|---|---|
| **($ in millions)** | **Market-based core** | **Market-based active** | **Performance-based** | **Total** | **Total** |
| Bonds | $ 21,510 | $ 7,263 | $ 63 | $ 28,836 | $ 28,645 |
| Preferred stocks | 93 | 10 | 12 | 115 | 105 |
| Common stocks | 7,402 | 439 | 151 | 7,992 | 9,094 |
| Mortgage loans on real estate | 390 | - | - | 390 | 394 |
| Real estate | - | - | 347 | 347 | 334 |
| Cash and cash equivalents | 41 | - | - | 41 | (319) |
| Short-term investments | 466 | 277 | - | 743 | 406 |
| Derivatives | 103 | 8 | 2 | 113 | - |
| Other invested assets | 431 | 187 | 4,364 | 4,982 | 4,388 |
| Total cash and invested assets | $ 30,436 | $ 8,184 | $ 4,939 | $ 43,559 | $ 43,047 |
| Percent to total | 70% | 19% | 11% | 100% |  |

Total invested assets increased $506 million, or 1%, compared to prior year. Explanations for the more significant items follow.

**Bonds**

The Group's bond portfolio consists of publicly traded and privately placed corporate obligations, municipal bonds, U.S. government bonds, asset-backed securities ("ABS"), mortgage-backed securities ("MBS") and foreign government bonds.

As of December 31, 2018, 89.8% of the consolidated bond portfolio was rated investment grade quality, which is defined as having a National Association of Insurance Commissioners ("NAIC") designation of 1 or 2, a Moody's rating of Aaa, Aa, A or Baa, a rating of AAA, AA, A or BBB from S&P Global Ratings ("S&P") a comparable rating from another nationally recognized rating agency, or a comparable internal rating if an externally provided rating is not available. There was no significant change in the bond portfolio quality distribution from the prior year.

Bonds with an NAIC designation of 1 or 2, including loan-backed and structured securities and excluding Securities Valuation Office-identified investments, are reported at amortized cost using the effective yield method. Bonds with an NAIC designation of 3 through 6 are reported at the lower of amortized cost or fair value, with the difference reflected in unassigned surplus as unrealized capital loss.

Publicly traded corporate bonds totaled $13.59 billion as of December 31, 2018 compared to $14.53 billion as of December 31, 2017. As of December 31, 2018, the portfolio also contained $4.91 billion of privately placed corporate obligations, compared with $6.19 billion as of December 31, 2017. 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 may contain structural security features such as financial covenants 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. As of December 31, 2018, 91% of the publicly traded corporate obligations and 66% of the privately placed securities were rated investment grade.

Municipal bonds totaled $5.99 billion as of December 31, 2018 compared to $4.83 billion as of December 31, 2017. The municipal bond portfolio as of December 31, 2018 consisted of 3,763 issues and is made up of 882 issuers. The largest exposure to a single issuer was 2% of the municipal bond portfolio. Corporate entities were the ultimate obligors of less than 1% of the municipal bond portfolio. As of December 31, 2018, 99% of the Municipal bonds were rated investment grade.

U.S. government bonds totaled $3.38 billion as of December 31, 2018 compared to $1.78 billion as of December 31, 2017. As of December 31, 2018, 100% of the U.S. government bonds were rated investment grade.

ABS totaled $705 million as of December 31, 2018 compared to $1.04 billion as of December 31, 2017. 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.

MBS totaled $212 million as of December 31, 2018 compared to $262 million as of December 31, 2017. The MBS portfolio is subject to interest rate risk, but unlike other fixed income securities, is additionally subject to prepayment risk from the underlying mortgages.

Foreign government bonds totaled $55 million as of December 31, 2018 compared to $4 million as of December 31, 2017.

The fair value of all bonds was $28.72 billion and $28.84 billion as of December 31, 2018 and 2017, respectively. As of December 31, 2018, unrealized net capital gains and losses on the bond portfolio, which are calculated as the difference between statement value and fair value, were $117 million unrealized loss compared to $199 million unrealized gain as of December 31, 2017.

**Equity securities**

Equity securities include $7.99 billion of common and $115 million of non-redeemable preferred stocks, and investments in affiliates as of December 31, 2018 compared to $9.09 billion of common and $105 million of non-redeemable preferred stocks, and investments in affiliates as of December 31, 2017. The net decrease was due to the decreased investments in equity markets.

**Short-term investments**

The $337 million increase in short-term investments was due primarily to the increase in the Allstate Short Term Pool.

**Other invested assets**

The $594 million increase in other invested assets was driven by the funding of new investments primarily limited partnerships. Limited partnership interests include interests in private equity funds, real estate funds and other funds.

**Off-balance sheet financial instruments**

The contractual amounts of off-balance-sheet financial instruments as of December 31 were as follows:

| **(in millions)** | **2018** | **2017** |
|---|---|---|
| Commitments to invest in limited partnership interests | $ 1,832 | $ 1,776 |
| Other loan commitments | $ 43 | $ 10 |
| Private placement commitments | $ 40 | $ 59 |
| Commitments to invest in real estate | $ 9 | $ - |

Commitments to invest in limited partnership interests represent agreements to acquire new or additional participation in certain limited partnership investments. The Company enters into these agreements in the normal course of business.

Other loan commitments are agreements to lend to a borrower provided there is no violation of any condition established in the contract. The Company enters into these agreements to commit to future loan fundings at predetermined interest rates. Commitments have either fixed or varying expiration dates or other termination clauses.

Private placement commitments represent commitments to purchase private placement debt and private equity securities at a future date. The Company enters into these agreements in the normal course of business.

Commitments to invest in real estate represent an agreement to provide additional capital for the development of real estate property. The Company enters into these agreements in the normal course of business.

The contractual amounts represent the amount at risk if the contract was fully drawn upon, the counterparty defaults and the value of any underlying security becomes worthless.

The Company does not require collateral or other security to support off-balance-sheet financial instruments with credit risk.

**Non-Investment Grade Investments**

The Company's investment policy allows it to purchase and hold below investment grade securities. The Company believes with quality research and underwriting, these securities complement its broader investment strategy and provide the appropriate level of return for the increased risk.

**Reserves for losses and loss adjustment expenses**

Incurred losses and loss adjustment expenses represent the sum of paid losses, loss adjustment expenses and reserve changes in the calendar year. This expense included net losses from catastrophes of $2.67 billion and $3.16 billion in 2018 and 2017, respectively. Activity in the reserve for losses and loss adjustment expenses is summarized as follows:

| **(in millions)** | **2018** | **2017** |
|---|---|---|
| Balance at January 1 | $ 17,102 | $ 16,426 |
| Incurred related to | | |
| Current year | 20,958 | 20,488 |
| Prior years | (229) | (343) |
| Total incurred | 20,729 | 20,145 |
| Paid related to: | | |
| Current year | 13,454 | 13,172 |
| Prior years | 6,759 | 6,297 |
| Total paid | 20,213 | 19,469 |
| Balance as of December 31 | $ 17,618 | $ 17,102 |

Incurred losses and loss adjustment expenses attributable to insured events of prior years were $(229) million and $(343) million as a result of the reestimation of unpaid losses and loss adjustment expenses for the years ended December 31, 2018 and 2017, respectively. These changes were generally the result of ongoing analyses of recent loss development trends. Initial estimates were revised as additional information regarding claims became known.

## Unsecured reinsurance recoverables

The Group has unsecured reinsurance recoverables that exceeded 3% of policyholder surplus as of December 31 as follows:

**($ in millions)**

| Reinsurer | NAIC Group Code | FEIN | 2018 | 2017 |
|---|---|---|---|---|
| Michigan Catastrophic Claim Association ("MCCA") | 0000 | AA-9991159 | $ 5,399 | $ 5,261 |

The MCCA is a statutory indemnification mechanism for member insurers' qualifying personal injury protection claims paid for the unlimited lifetime medical benefits above the applicable retention level for qualifying injuries from automobile, motorcycle and commercial vehicle accidents. Indemnification recoverables on paid and unpaid claims, including IBNR, as of December 31, 2018 and 2017 include $5.40 billion and $5.26 billion, respectively, from the MCCA for its indemnification obligation. As required for member companies by the MCCA, the Company reports covered paid and unpaid claims to the MCCA when estimates of loss for a reported claim are expected to exceed the retention level, the claims involve certain types of severe injuries, or there are litigation demands received suggesting the claim value exceeds certain thresholds. The retention level is adjusted upward every other MCCA fiscal year by the lesser of 6% or the increase in the Consumer Price Index. The retention level will be $580 thousand per claim for the fiscal two-years ending June 30, 2021 compared to $555 thousand per claim for the fiscal two-years ending June 30, 2019. The MCCA is obligated to fund the ultimate liability of member companies' qualifying claims and claim expenses. The MCCA does not underwrite the insurance coverage or hold any underwriting risk. The MCCA is funded by participating member companies (companies actively writing motor vehicle coverage in Michigan) through a per vehicle annual assessment that is currently $192 per vehicle insured. The MCCA is required to assess an amount each year sufficient to cover members' actuarially determined present value of expected payments on lifetime claims of all persons expected to be catastrophically injured in that year, its operating expenses, and adjustments for the amount of excesses or deficiencies in prior assessments. The assessment is incurred by the Company as policies are written and recovered as a component of premiums from our customers. The MCCA indemnifies members as qualifying claims are paid and billed by members to the MCCA. Unlimited lifetime covered losses result in significant levels of ultimate incurred claim reserves being recorded by member companies along with offsetting indemnification recoverables. Disputes with claimants over coverage on certain reported claims can result in additional losses, which may be recoverable from the MCCA, excluding litigation expenses. The MCCA prepares statutory-basis financial statements in conformity with accounting practices prescribed or permitted by the State of Michigan Department of Insurance and Financial Services ("MI DOI"). The MI DOI has granted the MCCA a statutory permitted practice that expires in 2019 to discount its liabilities for loss and loss adjustment expense. As of June 30, 2018, the date of its most recent annual financial report, the MCCA had cash and invested assets of $20.54 billion and an accumulated deficit of $2.92 billion. The permitted practice reduced the accumulated deficit by $47.24 billion.

The MCCA is financially structured to meet its future indemnification obligations as its cash and invested assets at June 30, 2018 were $20.54 billion or 90% of its discounted loss and loss adjustment expense reserves of $22.86 billion and it continues to be authorized to annually assess member companies for their incurred indemnifiable claims, the MCCA's annual operating expenses, and any amounts necessary to recoup prior year assessment differences. The MCCA's current fiscal year private passenger per vehicle assessment is $192 comprising $161 for current fiscal year claims and expenses and $31 for deficit recoupment. The MCCA has a statutory accounting permitted practice that has been granted by the Michigan Department of Insurance to discount its liabilities for loss and loss adjustment expense. As of June 30, 2018, the date of the most recent statutory financial reports, the permitted practice reduced the MCCA's accumulated deficit of $50.17 billion by $47.25 billion to $2.92 billion. Calculation of the pre-funding discount is dependent on actuarial estimates and investment funding decisions. As of December 31, 2017, our auto market share in Michigan was 8.2%.

**Capital and surplus**

The following table summarizes the Group's capital position as of December 31:

| (in millions) | 2018 | 2017 |
|---|---|---|
| Common capital stock | $ 51 | $ 22 |
| Gross paid in and contributed surplus | 4,051 | 4,082 |
| Unassigned funds (surplus) | 13,547 | 14,046 |
| Aggregate write-ins for special surplus funds | 30 | 35 |
| Total surplus as regards policyholders | $ 17,679 | $ 18,185 |

Total surplus as regards policyholders decreased $506 million or 3%, and was mainly comprised of the following items:

- $2.74 billion Net Income in 2018 compared to $2.88 billion in 2017
- $374 million change in net unrealized capital loss in 2018 compared to $1.03 billion unrealized capital gains in 2017
- $2.90 billion dividends paid to Allstate Insurance Holdings in 2018 compared to $1.61 billion in 2017

## RESULTS OF OPERATIONS

| (in millions) | 2018 | 2017 |
|---|---|---|
| Premiums earned | $ 30,386 | $ 29,038 |
| Losses incurred | 17,478 | 16,843 |
| Loss adjustment expenses incurred | 3,251 | 3,302 |
| Other underwriting expenses incurred | 8,066 | 7,542 |
| Total underwriting deductions | 28,795 | 27,687 |
| Net underwriting gain | 1,591 | 1,351 |
| Net investment income earned | 1,805 | 2,028 |
| Net realized capital gains (losses) | (278) | 110 |
| Net investment gain | 1,527 | 2,138 |
| Total other income | 133 | 122 |
| Net income, after dividends to policyholders but before all other federal and foreign income taxes | 3,251 | 3,611 |
| Federal and foreign income taxes incurred | 513 | 728 |
| Net income | $ 2,738 | $ 2,883 |

**Net underwriting gain**

The $240 million increase in underwriting gain was mostly due to increased premiums earned, lower catastrophe losses and improved auto claim frequency, partially offset by higher claim severity, agency and employee-related compensation costs and advertising costs and lower favorable non-catastrophe prior year reserves reestimates.

**Net investment gains**

Net investment gain decreased $611 million, mainly due to a net realized capital loss of $278 million in 2018 compared to a net realized capital gain of $110 million in 2017, primarily due losses from bonds and common stocks. Net investment income earned decreased $223 million compared to prior year due mostly to the $279 million decrease in dividends from subsidiaries, partially offset by $89 million in other investment income, which includes $116 million final distributions from limited partnerships. AIC received $250 million from ALIC in 2018 compared to $600 million in 2017.

**CASH FLOW AND LIQUIDITY**
The following table summarizes cash flow.

| (in millions) | 2018 | 2017 |
|---|---|---|
| Net cash from operations | $ 3,777 | $ 3,824 |
| Net cash from investments | (1,522) | (3,292) |
| Net cash from financing and miscellaneous sources | (1,558) | (1,604) |
| Net change in cash, cash equivalents and short-term investments | $ 697 | $ (1,072) |

The Group's operations typically generate substantial cash flows from operations as most premiums are received in advance of the time claim payments are made. Net cash from operations decreased in 2018 as a result of an increase in commissions, expenses paid and aggregate write-ins for deductions and benefit and loss related payments, partially offset by an increase in premiums collected net of reinsurance. Lower negative net cash from investments in 2018 compared to 2017 were driven by higher investment proceeds, partially offset by higher investments acquired. Lower negative net cash flows from financing in 2018 compared to 2017 were mainly due to the increase in securities lending.

**Dividend restriction**
The ability of AIC, AI, APC, AFCIC, EI, EIC, EICA, EIIC, EPC and EHAIC to pay dividends is generally dependent on business conditions, income, cash requirements, receipt of dividends and other relevant factors. More specifically, the Illinois Insurance Code ("Code") provides a two-step process. First, no dividend may be declared or paid except from earned (unassigned) surplus, as distinguished from contributed surplus, nor when the payment of a dividend reduces surplus below the minimum amount required by the Code. Secondly, a determination of the ordinary versus extraordinary dividends that can be paid is formula based and considers net income and capital and surplus, as well as the timing and amounts of dividends paid in the preceding twelve months as specified by the Code. Ordinary dividends to shareholders do not require prior approval of the IL DOI. Dividends are not cumulative. As of December 31, 2018, the maximum ordinary dividend that can be declared and paid in 2019 by AIC, AI, APC, AFCIC, EI, EIC, EICA, EIIC, EPC and EHAIC is limited to $2.73 billion, $0.9 million, $0.8 million, $1 million, $0.5 million, $0.4 million, $0.4 million, $0.2 million, $0.2 million and $0.8 million, respectively.

ESIC's ability to pay dividends in 2019 will be limited to $4 million by the state insurance laws of the State of Wisconsin. Wisconsin law provides that the Company may pay out dividends without the prior approval of the Wisconsin Commissioner of Insurance in an amount, when added to other shareholder distributions made in the last 12 months, not in the excess of the lesser of (a) 10% of the insurer's surplus as regards to policyholders as of the prior year December 31 or (b) the greater of (1) its net income (excluding realized capital gains) for that same year end, (2) the aggregate of the net income of the insurer for the 3 calendar years preceding the date of the dividend or distribution, minus realized capital gains for those calendar years and minus dividends paid or credited and distributions made within the first 2 of the preceding 3 calendar years.

EICMA's ability to pay dividends is dependent on business conditions, income, cash requirements and other relevant factors. Without prior approval of the MA DOI, ordinary dividends to shareholder are limited to $0.6 million. This amount is formula driven based on capital and surplus, as well as the timing and amount of dividends paid in the preceding twelve months as specified by Massachusetts insurance law. Dividends are not cumulative.

**Financial strength ratings and outlook**
The Company's most recent financial strength ratings and outlook were A+ (exceptional), Aa3 (excellent) and AA- (excellent) from A.M. Best, Moody's and S&P, 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, market, credit, underwriting and reserving 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.  As of December 31, 2018, the total adjusted capital of each insurer comprising the Group 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 to assist state regulators in monitoring the financial condition of insurance companies and identifying companies that require special attention or action.  The NAIC analyzes financial data provided by insurance companies using prescribed ratios, each with a 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 thirteen ratios.  As of December 31, 2018, no insurer comprising the Group had more than three ratio results outside the usual range.