

**The Variable Annuity Life  
Insurance Company**  
Audited GAAP Financial Statements  
At December 31, 2017 and 2016 and for each of  
the three years ended December 31, 2017

# THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

## TABLE OF CONTENTS

	Page
<b>CONSOLIDATED FINANCIAL STATEMENTS</b>	
Report of Independent Auditors	2
Consolidated Balance Sheets at December 31, 2017 and 2016	3
Consolidated Statements of Income for each of the years ended December 31, 2017, 2016 and 2015	4
Consolidated Statements of Comprehensive Income (Loss) for each of the years ended December 31, 2017, 2016 and 2015	5
Consolidated Statements of Equity for each of the years ended December 31, 2017, 2016 and 2015	6
Consolidated Statements of Cash Flows for each of the years ended December 31, 2017, 2016 and 2015	7
<b>NOTES TO CONSOLIDATED FINANCIAL STATEMENTS</b>	
1. Basis of Presentation	8
2. Summary of Significant Accounting Policies	9
3. Fair Value Measurements	14
4. Investments	31
5. Lending Activities	41
6. Reinsurance	43
7. Derivatives and Hedge Accounting	43
8. Deferred Policy Acquisition Costs and Deferred Sales Inducements	46
9. Variable Interest Entities	48
10. Insurance Liabilities	50
11. Variable Annuity Contracts	51
12. Debt	53
13. Commitments and Contingencies	54
14. Equity	55
15. Statutory Financial Data and Restrictions	57
16. Benefit Plans	57
17. Income Taxes	58
18. Related Party Transactions	62
19. Subsequent Events	63



## Report of Independent Auditors

To the Board of Directors of  
The Variable Annuity Life Insurance Company

We have audited the accompanying consolidated financial statements of The Variable Annuity Life Insurance Company and its subsidiaries (the "Company"), an indirect, wholly owned subsidiary of American International Group, Inc., which comprise the consolidated balance sheets as of December 31, 2017 and 2016, and the related consolidated statements of income, comprehensive income (loss), equity and cash flows for each of the three years in the period ended December 31, 2017.

### ***Management's Responsibility for the Consolidated Financial Statements***

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

### ***Auditors' Responsibility***

Our responsibility is to express an opinion on the consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

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

### ***Opinion***

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

*PricewaterhouseCoopers LLP*

April 26, 2018

# THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

## CONSOLIDATED BALANCE SHEETS

<i>(in millions, except for share data)</i>	December 31,	
	2017	2016
<b>Assets:</b>		
Investments:		
Fixed maturity securities:		
Bonds available for sale, at fair value (amortized cost: 2017 – \$34,313; 2016 – \$33,657)	\$ 35,638	\$ 34,591
Other bond securities, at fair value	1,680	1,778
Equity securities:		
Common and preferred stock, available for sale, at fair value (cost: 2017 – \$5; 2016 – \$4)	5	5
Mortgage and other loans receivable, net of allowance	6,850	6,083
Other invested assets (portion measured at fair value: 2017 – \$387; 2016 – \$528)	1,160	1,233
Short-term investments (portion measured at fair value: 2017 – \$758; 2016 – \$767)	761	818
Total investments	46,094	44,508
Cash	143	106
Accrued investment income	461	458
Amounts due from related parties	103	114
Premiums and other receivables - net of allowance	86	81
Deferred policy acquisition costs	888	955
Deferred income taxes	-	17
Other assets (including restricted cash of \$67 in 2017 and \$3 in 2016)	547	454
Separate account assets, at fair value	36,419	32,469
<b>Total assets</b>	<b>\$ 84,741</b>	<b>\$ 79,162</b>
<b>Liabilities:</b>		
Future policy benefits for life and accident and health insurance contracts	\$ 817	\$ 785
Policyholder contract deposits (portion measured at fair value: 2017 – \$439; 2016 – \$209)	40,433	39,593
Other policyholder funds	1	4
Current income tax payable	7	10
Deferred income taxes	9	-
Notes payable - to affiliates (portion measured at fair value: 2017 – \$241; 2016 – \$183)	241	183
Notes payable - to third parties	140	50
Amounts due to related parties	110	148
Securities lending payable	247	245
Other liabilities	602	590
Separate account liabilities	36,419	32,469
<b>Total liabilities</b>	<b>79,026</b>	<b>74,077</b>
Commitments and contingencies (see Note 13)		
<b>The Variable Annuity Life Insurance Company (VALIC) shareholder's equity:</b>		
Common stock, \$1 par value; 5,000,000 shares authorized, 3,575,000 shares issued and outstanding	4	4
Additional paid-in capital	4,081	4,103
Retained earnings	415	106
Accumulated other comprehensive income	1,208	872
<b>Total VALIC shareholder's equity</b>	<b>5,708</b>	<b>5,085</b>
<b>Noncontrolling interests</b>	<b>7</b>	<b>-</b>
<b>Total equity</b>	<b>5,715</b>	<b>5,085</b>
<b>Total liabilities and equity</b>	<b>\$ 84,741</b>	<b>\$ 79,162</b>

See accompanying Notes to Consolidated Financial Statements.

**THE VARIABLE ANNUITY LIFE INSURANCE COMPANY**  
**CONSOLIDATED STATEMENTS OF INCOME**

<i>(in millions)</i>	Years Ended December 31,		
	2017	2016	2015
<b>Revenues:</b>			
Premiums	\$ 27	\$ 27	\$ 21
Policy fees	427	383	401
Net investment income	2,167	2,045	2,077
Net realized capital gains (losses):			
Total other-than-temporary impairments on available for sale securities	(13)	(68)	(48)
Portion of other-than-temporary impairments on available for sale fixed maturity securities recognized in other comprehensive loss	(22)	(5)	(6)
Net other-than-temporary impairments on available for sale securities recognized in net income	(35)	(73)	(54)
Other realized capital (losses) gains	(22)	(54)	128
Total net realized capital (losses) gains	(57)	(127)	74
Other income	328	340	417
<b>Total revenues</b>	<b>2,892</b>	<b>2,668</b>	<b>2,990</b>
<b>Benefits and expenses:</b>			
Policyholder benefits	104	58	60
Interest credited to policyholder account balances	1,115	1,134	1,117
Amortization of deferred policy acquisition costs	90	135	20
General operating and other expenses	658	680	687
<b>Total benefits and expenses</b>	<b>1,967</b>	<b>2,007</b>	<b>1,884</b>
<b>Income before income tax expense</b>	<b>925</b>	<b>661</b>	<b>1,106</b>
<b>Income tax expense (benefit):</b>			
Current	203	201	243
Deferred	8	(57)	87
<b>Income tax expense</b>	<b>211</b>	<b>144</b>	<b>330</b>
<b>Net income</b>	<b>714</b>	<b>517</b>	<b>776</b>
<b>Less:</b>			
<b>Net income attributable to noncontrolling interests</b>	<b>-</b>	<b>-</b>	<b>1</b>
<b>Net income attributable to VALIC</b>	<b>\$ 714</b>	<b>\$ 517</b>	<b>\$ 775</b>

See accompanying Notes to Consolidated Financial Statements.

**THE VARIABLE ANNUITY LIFE INSURANCE COMPANY**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**

<i>(in millions)</i>	Years Ended December 31,		
	2017	2016	2015
<b>Net income</b>	\$ 714	\$ 517	\$ 776
<b>Other comprehensive income (loss), net of tax</b>			
Change in unrealized appreciation (depreciation) of fixed maturity investments on which other-than-temporary credit impairments were recognized	47	(29)	(49)
Change in unrealized appreciation (depreciation) of all other investments	284	(24)	(938)
Adjustments to deferred policy acquisition costs and deferred sales inducements	(54)	34	82
Change in unrealized insurance loss recognition	-	(17)	54
Change in foreign currency translation adjustments	-	-	(1)
<b>Other comprehensive income (loss)</b>	<b>277</b>	<b>(36)</b>	<b>(852)</b>
<b>Comprehensive income (loss)</b>	<b>991</b>	<b>481</b>	<b>(76)</b>
<b>Comprehensive income attributable to noncontrolling interests</b>	-	-	1
<b>Comprehensive income (loss) attributable to VALIC</b>	<b>\$ 991</b>	<b>\$ 481</b>	<b>(77)</b>

See accompanying Notes to Consolidated Financial Statements.

**THE VARIABLE ANNUITY LIFE INSURANCE COMPANY**  
**CONSOLIDATED STATEMENTS OF EQUITY**

<i>(in millions)</i>	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total VALIC Share- holder's Equity	Non- controlling Interests	Total Equity
Balance, January 1, 2015	\$ 4	\$ 5,305	\$ -	\$ 1,760	\$ 7,069	\$ 13	\$ 7,082
Net income attributable to VALIC or other							
noncontrolling interests	-	-	775	-	775	1	776
Dividends	-	-	(775)	-	(775)	-	(775)
Other comprehensive loss	-	-	-	(852)	(852)	-	(852)
Capital contributions from Parent	-	15	-	-	15	-	15
Return of capital	-	(805)	-	-	(805)	-	(805)
Balance, December 31, 2015	\$ 4	\$ 4,515	\$ -	\$ 908	\$ 5,427	\$ 14	\$ 5,441
Net income attributable to VALIC or other							
noncontrolling interests	-	-	517	-	517	-	517
Dividends	-	-	(411)	-	(411)	-	(411)
Other comprehensive loss	-	-	-	(36)	(36)	-	(36)
Capital contributions from Parent	-	1	-	-	1	-	1
Return of capital	-	(413)	-	-	(413)	-	(413)
Net decrease due to deconsolidation	-	-	-	-	-	(14)	(14)
Balance, December 31, 2016	\$ 4	\$ 4,103	\$ 106	\$ 872	\$ 5,085	\$ -	\$ 5,085
Net income attributable to VALIC or other							
noncontrolling interests	-	-	714	-	714	-	714
Dividends	-	-	(346)	-	(346)	-	(346)
Other comprehensive income	-	-	-	277	277	-	277
Return of capital	-	(22)	-	-	(22)	-	(22)
Consolidation of subsidiaries	-	-	-	-	-	7	7
Reclassification of certain tax effects from AOCI	-	-	(59)	59	-	-	-
Balance, December 31, 2017	\$ 4	\$ 4,081	\$ 415	\$ 1,208	\$ 5,708	\$ 7	\$ 5,715

See accompanying Notes to Consolidated Financial Statements.

# THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

## CONSOLIDATED STATEMENTS OF CASH FLOWS

<i>(in millions)</i>	Years Ended December 31,		
	2017	2016	2015
<b>Cash flows from operating activities:</b>			
Net income	\$ 714	\$ 517	\$ 776
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>			
Interest credited to policyholder account balances	1,115	1,134	1,117
Amortization of deferred policy acquisition costs	90	135	20
Fees charged for policyholder contract deposits	(374)	(333)	(349)
Net realized capital losses (gains)	57	127	(74)
Unrealized losses (gains) in earnings, net	(64)	10	25
Equity in income of partnerships and other invested assets	(23)	(34)	(32)
Accretion of net premium/discount on investments	(202)	(207)	(189)
Capitalized interest	(16)	(8)	(10)
Provision for deferred income taxes	8	(57)	87
<b>Changes in operating assets and liabilities:</b>			
Accrued investment income	(3)	6	18
Amounts due to related parties	(25)	(36)	(54)
Deferred policy acquisition costs	(80)	(80)	(78)
Current income tax receivable/payable	(3)	88	18
Future policy benefits	13	8	(11)
Other, net	10	30	101
Total adjustments	503	783	589
<b>Net cash provided by operating activities</b>	<b>1,217</b>	<b>1,300</b>	<b>1,365</b>
<b>Cash flows from investing activities:</b>			
Proceeds from (payments for)			
Sales or distribution of:			
Available for sale investments	2,464	3,447	2,405
Other investments, excluding short-term investments	409	1,220	716
Redemption and maturities of fixed maturity securities available for sale	3,998	3,464	3,239
Principal payments received on sales and maturities of mortgage and other loans receivable	1,187	1,078	930
Redemption and maturities of other investments, excluding short-term investments	257	86	84
Purchases of:			
Available for sale investments	(6,886)	(8,638)	(5,107)
Mortgage and other loans receivable	(2,036)	(1,613)	(1,488)
Other investments, excluding short-term investments	(194)	(699)	(649)
Net change in restricted cash	(64)	10	191
Net change in short-term investments	57	(215)	(160)
Other, net	(162)	16	2
<b>Net cash provided by (used in) investing activities</b>	<b>(970)</b>	<b>(1,844)</b>	<b>163</b>
<b>Cash flows from financing activities:</b>			
Policyholder contract deposits	2,933	3,293	2,635
Policyholder contract withdrawals	(3,423)	(3,178)	(3,570)
Net exchanges from separate accounts	555	852	484
Change in repurchase agreements	1	1	-
Repayment of notes payable	-	-	(68)
Issuance of notes payable	90	-	-
Change in securities lending payable	2	76	169
Dividends and return of capital paid	(368)	(476)	(1,206)
<b>Net cash provided by (used in) financing activities</b>	<b>(210)</b>	<b>568</b>	<b>(1,556)</b>
Net increase (decrease) in cash	37	24	(28)
Cash at beginning of year	106	82	110
<b>Cash at end of year</b>	<b>\$ 143</b>	<b>\$ 106</b>	<b>\$ 82</b>
<b>Supplementary Disclosure of Consolidated Cash Flow Information</b>			
<b>Cash paid during the period for:</b>			
Interest	\$ 21	\$ 9	\$ 2
Taxes	198	103	214
<b>Non-cash investing/financing activities:</b>			
Sales inducements credited to policyholder contract deposits	9	11	9
Non-cash dividends and return of capital and dividend payable	-	349	473
Settlement of non-cash dividend payable	-	-	702
Non-cash contributions from Parent	-	1	15

See accompanying Notes to Consolidated Financial Statements.



# THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### 1. BASIS OF PRESENTATION

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The Variable Annuity Life Insurance Company, including its wholly owned subsidiaries, is a wholly owned subsidiary of AGC Life Insurance Company (AGC Life or the Parent), an indirect, wholly owned subsidiary of American International Group, Inc. (AIG Parent). Unless the context indicates otherwise, the terms "VALIC," "the Company," "we," "us" or "our" mean The Variable Annuity Life Insurance Company and its consolidated subsidiaries, and the term "AIG Parent" means American International Group, Inc. and not any of its consolidated subsidiaries.

We are a Texas-domiciled life insurance company and a leading provider of defined contribution retirement savings plans sponsored by education, not-for-profit and government organizations. Our primary products include fixed and variable annuities, mutual funds and plan administrative and compliance services. We utilize career financial advisors and independent financial advisors to provide retirement plan participants with enrollment support and comprehensive financial planning services. No annual deposits for any individual advisor in 2017 or 2016 represented more than 10 percent of total annuity deposits.

Our operations are influenced by many factors, including general economic conditions, financial condition of AIG Parent, monetary and fiscal policies of the United States federal government and policies of state and other regulatory authorities. The level of sales of our insurance and financial products is influenced by many factors, including general market rates of interest, the strength, weakness and volatility of equity markets and terms and conditions of competing products. We are exposed to the risks normally associated with a portfolio of fixed income securities, which include interest rate, option, liquidity and credit risks. We control our exposure to these risks by, among other things, closely monitoring and managing the duration and cash flows of our assets and liabilities, monitoring and limiting prepayments and extension risk in our portfolio, maintaining a large percentage of our portfolio in highly liquid securities, engaging in a disciplined process of underwriting, and reviewing and monitoring credit risk. We are also exposed to market risk, policyholder behavior risk and mortality/longevity risk. Market volatility and other equity market conditions may affect our exposure to risks related to guaranteed death benefits and guaranteed living benefits on variable annuity products, and may reduce fee income on variable product assets held in separate accounts. Such guaranteed benefits are sensitive to equity and interest rate market conditions.

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP). All significant intercompany accounts and transactions have been eliminated.

The consolidated financial statements include the accounts of the Company, our controlled subsidiaries (generally through a greater than 50 percent ownership of voting rights and voting interests), and variable interest entities (VIEs) of which we are the primary beneficiary. Equity investments in entities that we do not consolidate, including corporate entities in which we have significant influence, and partnership and partnership-like entities in which we have more than minor influence over the operating and financial policies, are accounted for under the equity method unless we have elected the fair value option.

# THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### Use of Estimates

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The preparation of financial statements in accordance with GAAP requires the application of accounting policies that often involve a significant degree of judgment. Accounting policies that we believe are most dependent on the application of estimates and assumptions are considered our critical accounting estimates and are related to the determination of:

- income tax assets and liabilities, including recoverability of our net deferred tax asset and the predictability of future tax operating profitability of the character necessary to realize the net deferred tax asset and provisional estimates associated with the enactment of the Tax Cuts and Jobs Act of 2017 (Tax Act);
- reinsurance assets;
- valuation of future policy benefit liabilities and timing and extent of loss recognition;
- valuation of liabilities for guaranteed benefit features of variable annuity products;
- estimated gross profits (EGP) to value deferred policy acquisition costs (DAC) for investment-oriented products;
- impairment charges, including other-than-temporary impairments on available for sale securities and impairment on other invested assets;
- liability for legal contingencies; and
- fair value measurements of certain financial assets and liabilities.

These accounting estimates require the use of assumptions about matters, some of which are highly uncertain at the time of estimation. To the extent actual experience differs from the assumptions used, our consolidated financial condition, results of operations and cash flows could be materially affected.

### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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The following table identifies our significant accounting policies presented in other Notes to these Consolidated Financial Statements, with a reference to the Note where a detailed description can be found:

Note 3.	Fair Value Measurements <ul style="list-style-type: none"><li>• Short-term investments</li></ul>
Note 4.	Investments <ul style="list-style-type: none"><li>• Fixed maturity and equity securities</li><li>• Other invested assets</li><li>• Net investment income</li><li>• Net realized capital gains (losses)</li><li>• Other-than-temporary impairments</li></ul>
Note 5.	Lending Activities <ul style="list-style-type: none"><li>• Mortgage and other loans receivable – net of allowance</li></ul>
Note 6.	Reinsurance <ul style="list-style-type: none"><li>• Reinsurance assets, net of allowance</li></ul>
Note 7.	Derivatives and Hedge Accounting <ul style="list-style-type: none"><li>• Derivative assets and liabilities, at fair value</li></ul>
Note 8.	Deferred Policy Acquisition Costs and Deferred Sales Inducements <ul style="list-style-type: none"><li>• Deferred policy acquisition costs</li><li>• Amortization of deferred policy acquisition costs</li><li>• Deferred sales inducements</li></ul>
Note 9.	Variable Interest Entities
Note 10.	Insurance Liabilities <ul style="list-style-type: none"><li>• Future policy benefits</li></ul>

## THE VARIABLE ANNUITY LIFE INSURANCE COMPANY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	<ul style="list-style-type: none"><li>• Policyholder contract deposits</li><li>• Other policyholder funds</li></ul>
Note 11.	Variable Life and Annuity Contracts
Note 12.	Debt <ul style="list-style-type: none"><li>• Long-term debt</li></ul>
Note 13.	Commitments and Contingencies <ul style="list-style-type: none"><li>• Legal contingencies</li></ul>
Note 17.	Income Taxes

### Other significant accounting policies

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**Premiums** for life contingent annuities are recognized as revenues when due. Estimates for premiums due but not yet collected are accrued. For limited-payment contracts, net premiums are recorded as revenue. The difference between the gross premium received and the net premium is deferred and recognized in premiums in the Consolidated Statements of Income.

**Policy fees** represent fees recognized from investment-type products consisting of policy charges for cost of insurance or mortality and expense charges, policy administration charges, surrender charges and amortization of unearned revenue reserves. Policy fees are recognized as revenues in the period in which they are assessed against policyholders, unless the fees are designed to compensate us for services to be provided in the future. Fees deferred as unearned revenue are amortized in relation to the incidence of EGP to be realized over the estimated lives of the contracts, similar to DAC.

**Other income** primarily includes brokerage commissions, advisory fee income and income from legal settlements.

**Cash** represents cash on hand and non-interest bearing demand deposits.

**Short-term investments** consist of interest-bearing cash equivalents, time deposits, securities purchased under agreements to resell, and investments, such as commercial paper, with original maturities within one year from the date of purchase.

**Premiums and other receivables – net of allowance** include premium balances receivable, amounts due from agents and brokers and policyholders, and other receivables.

**Other assets** consist of prepaid expenses, deposits, other deferred charges, real estate, other fixed assets, capitalized software costs, deferred sales inducements, restricted cash and freestanding derivative assets.

**Separate accounts** represent funds for which investment income and investment gains and losses accrue directly to the contract holders who bear the investment risk. Each account has specific investment objectives and the assets are carried at fair value. The assets of each account are legally segregated and are not subject to claims that arise from any of our other businesses. The liabilities for these accounts are equal to the account assets. For a more detailed discussion of separate accounts, see Note 11.

**Other liabilities** include other funds on deposit, other payables, securities sold under agreements to repurchase and freestanding derivative liabilities.

### Accounting Standards Adopted During 2017

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#### Derivative Contract Novations

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In March 2016, the Financial Accounting Standards Board (FASB) issued an accounting standard that clarifies that a change in the counterparty (novation) to a derivative instrument that has been designated as a hedging instrument does not, in and of itself, require de-designation of that hedging relationship provided that all other hedge accounting criteria continue to be met.

## **THE VARIABLE ANNUITY LIFE INSURANCE COMPANY**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

We adopted the standard on its required effective date of January 1, 2017. The adoption of the standard did not have a material effect on our consolidated financial condition, results of operations or cash flows.

#### **Contingent Put and Call Options in Debt Instruments**

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In March 2016, the FASB issued an accounting standard that 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 standard requires an evaluation of embedded call (put) options solely on a four-step decision sequence that requires an entity to consider whether (1) the amount paid upon settlement is adjusted based on changes in an index, (2) the amount paid upon settlement is indexed to an underlying other than interest rates or credit risk, (3) the debt involves a substantial premium or discount and (4) the put or call option is contingently exercisable.

We adopted the standard on its required effective date of January 1, 2017. The adoption of this standard did not have a material effect on our consolidated financial condition, results of operations or cash flows.

#### **Simplifying the Transition to the Equity Method of Accounting**

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In March 2016, the FASB issued an accounting standard that eliminates the requirement that when an investment qualifies for use of the equity method as a result of an increase in the level of ownership interest or degree of influence, an investor must adjust the investment, results of operations, and retained earnings retroactively on a step-by-step basis as if the equity method had been in effect during all previous periods during which the investment had been held.

We adopted the standard on its required effective date of January 1, 2017. The adoption of the standard did not have a material effect on our consolidated financial condition, results of operations or cash flows.

#### **Interest Held through Related Parties that are under Common Control**

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In October 2016, the FASB issued an accounting standard that amends the consolidation analysis for a reporting entity that is the single decision maker of a VIE. The new guidance will require the decision maker's evaluation of its interests held through related parties that are under common control on a proportionate basis (rather than in their entirety) when determining whether it is the primary beneficiary of that VIE. The amendment does not change the characteristics of a primary beneficiary.

We adopted the standard on its required effective date of January 1, 2017. The adoption of the standard did not have a material effect on our consolidated financial condition, results of operations or cash flows.

#### **Clarifying the Definition of a Business**

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In January 2017, the FASB issued an accounting standard that changes the definition of a business to assist entities in evaluating when a set of transferred assets and activities is a business. The new standard will require an entity to evaluate if substantially all of the fair value of the gross assets acquired (or disposed of) is concentrated in a single identifiable asset or a group of similar assets; if so, the set of transferred assets and activities is not a business. At a minimum, a set must include an input and a substantive process that together significantly contribute to the ability to create output.

We adopted the standard on October 1, 2017. The impact of the standard is primarily related to our investments in real estate. As a result of the adoption, we anticipate that future acquisitions of certain real estate investments will no longer meet the definition of a business and will be treated as asset acquisitions. As a result, no goodwill would be recognized from these investments and certain costs can be capitalized as part of the asset acquisitions. The adoption of this standard did not have a material effect on our consolidated financial condition, results of operations and cash flows.

#### **Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income (AOCI)**

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In February 2018, the FASB issued an accounting standard that allows the optional reclassification of stranded tax effects within accumulated other comprehensive income to retained earnings that arise due to the enactment of the Tax

## **THE VARIABLE ANNUITY LIFE INSURANCE COMPANY**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Act. We have elected to early adopt the accounting standard in our financial statements for the year ended December 31, 2017. Accordingly, we have recorded a reclassification adjustment of \$59 million related to the effect of the change in the U.S. federal corporate income tax rate on the gross deferred tax amounts at the date of enactment of the Tax Act. Consistent with Staff Accounting Bulletin No. 118, Income Tax Accounting Implications of the Tax Cuts and Jobs Act (SAB 118), released by the Securities and Exchange Commission, these are provisional adjustments and may be revised as relevant guidance is released.

We use the security-by-security approach when releasing stranded income tax effects from AOCI for available for sale securities.

#### **Future Application of Accounting Standards**

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##### **Revenue Recognition**

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In May 2014, the FASB issued an accounting standard that supersedes most existing revenue recognition guidance. The standard excludes from its scope the accounting for insurance contracts, leases, financial instruments, and certain other agreements that are governed under other GAAP guidance, but could affect the revenue recognition for certain of our other activities.

We will adopt this standard on its effective date of January 1, 2018 using the modified retrospective approach. Our analysis of revenues indicates that substantially all of our revenues are from sources excluded from the scope of the standard. For those revenue sources within the scope of the standard, there are no material changes in the timing or measurement of revenues based upon the guidance. As substantially all of our revenue sources are excluded from the scope of the standard, the adoption of the standard will not have a material effect on our reported consolidated financial condition, results of operations, cash flows or required disclosures.

##### **Recognition and Measurement of Financial Assets and Financial Liabilities**

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In January 2016, the FASB issued an accounting standard that will require equity investments that do not follow the equity method of accounting or are not subject to consolidation to be measured at fair value with changes in fair value recognized in earnings, while financial liabilities for which fair value option accounting has been elected, changes in fair value due to instrument-specific credit risk will be presented separately in other comprehensive income. The standard allows the election to record equity investments without readily determinable fair values at cost, less impairment, adjusted for subsequent observable price changes with changes in the carrying value of the equity investments recorded in earnings. The standard also updates certain fair value disclosure requirements for financial instruments carried at amortized cost.

We will adopt this standard on its effective date of January 1, 2018 using the modified retrospective approach. Based on our review substantially all of our assets and liabilities are not within the scope of the standard. The adoption of this standard will not have material effect on our reported consolidated financial condition, results of operations, cash flows or require disclosures.

##### **Leases**

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In February 2016, the FASB issued an accounting standard that will require lessees with lease terms of more than 12 months to recognize a right of use asset and a corresponding lease liability on their balance sheets. For income statement purposes, the FASB retained a dual model, requiring leases to be classified as either operating leases or finance leases.

We plan to adopt the standard on its effective date of January 1, 2019 using a modified retrospective approach upon adoption. We are currently quantifying the expected recognition on our balance sheet for a right to use asset and a lease liability as required by the standard. We do not expect the impact of the standard to have a material effect on our reported consolidated financial condition, results of operations, cash flows or required disclosures.

## **THE VARIABLE ANNUITY LIFE INSURANCE COMPANY**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

#### **Financial Instruments – Credit Losses**

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In June 2016, the FASB issued an accounting standard that will change how entities account for credit losses for most financial assets. The standard will replace the existing incurred loss impairment model with a new “current expected credit loss model” that generally will result in earlier recognition of credit losses. The standard will apply to financial assets subject to credit losses, including loans measured at amortized cost, reinsurance receivables and certain off-balance sheet credit exposures. Additionally, the impairment for available for sale debt securities, including purchased credit deteriorated securities, are subject to the new guidance and will be measured in a similar manner, except that losses will be recognized as allowances rather than reductions in the amortized cost of the securities. The standard will also require additional information to be disclosed in the footnotes.

The standard is effective on January 1, 2020, with early adoption permitted on January 1, 2019. We are continuing to develop our implementation plan to adopt the standard and are assessing the impact of the standard on our reported consolidated financial condition, results of operations, cash flows and required disclosures. While we expect an increase in our allowances for credit losses for the financial instruments within scope of the standard, given the objective of the new standard, the amount of any change will be dependent on our portfolios’ composition and quality at the adoption date as well as economic conditions and forecasts at that time.

#### **Classification of Certain Cash Receipts and Cash Payments**

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In August 2016, the FASB issued an accounting standard that addresses diversity in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments provide clarity on the treatment of eight specifically defined types of cash inflows and outflows.

We will adopt this standard retrospectively on its effective date of January 1, 2018. The standard addresses presentation in the Statement of Cash Flows only and will have no effect on our reported consolidated financial condition, results of operations or required disclosures.

#### **Intra-Entity Transfers of Assets Other than Inventory**

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In October 2016, the FASB issued an accounting standard that will require an entity to recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs, rather than when the asset is sold to a third party.

We will adopt the standard on its effective date of January 1, 2018 using a modified retrospective approach. The adoption of this standard will not have a material impact on our reported consolidated financial condition, results of operations, cash flows or required disclosures.

#### **Restricted Cash**

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In November 2016, the FASB issued an accounting standard that provides guidance on the presentation of restricted cash in the Statement of Cash Flows. Entities will be required to explain the changes during a reporting period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents in the statement of cash flows.

We will adopt the standard retrospectively on its effective date of January 1, 2018. The standard addresses presentation of restricted cash in the Statement of Cash Flows only and will have no effect on our reported consolidated financial condition, results of operations or required disclosures.

#### **Gains and Losses from the Derecognition of Nonfinancial Assets**

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In February 2017, the FASB issued an accounting standard that clarifies the scope of the derecognition guidance for the sale, transfer and derecognition of nonfinancial assets to noncustomers that aligns with the new revenue recognition principles. The standard also adds new accounting for partial sales of nonfinancial assets (including in substance real estate) that requires an entity to derecognize a nonfinancial asset when it 1) ceases to have a controlling financial



## THE VARIABLE ANNUITY LIFE INSURANCE COMPANY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

interest in the legal entity that holds the asset based on the consolidation model and 2) transfers control of the asset based on the revenue recognition model.

We will adopt this standard on its effective date of January 1, 2018 under the modified retrospective approach. Based on our evaluation, we do not expect the standard to have a material impact on our reported consolidated financial condition, results of operations, cash flows or required disclosures.

### Improving the Presentation of Net Periodic Pension and Postretirement Benefit Cost

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In March 2017, the FASB issued an accounting standard that requires entities to report the service cost component of net periodic pension and postretirement benefit costs in the same line item as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net periodic benefit costs are required to be separately presented in the income statement. The amendments also allow only the service cost component to be eligible for capitalization when applicable.

We will adopt this standard on its effective date of January 1, 2018. The standard primarily addresses the presentation of the service cost component of net periodic benefit costs in the income statement. AIG Parent's U.S. pension plans are frozen and no longer accrue benefits, which are reflected as service costs. Therefore, the standard will have no material effect on our reported consolidated financial condition, results of operations, cash flows or required disclosures.

### Derivatives and Hedging

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In August 2017, the FASB issued an accounting standard that improves and expands hedge accounting for both financial and commodity risks. The provisions of the amendment are intended to better align the accounting with an entity's risk management activities, enhance the transparency on how the economic results are presented in the financial statements and the footnote, and simplify the application of hedge accounting treatment.

The standard is effective on January 1, 2019, with early adoption permitted. We are evaluating the timing of adoption and are assessing the impact of the standard on our reported consolidated financial condition, results of operations, cash flows and required disclosures.

## 3. FAIR VALUE MEASUREMENTS

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### Fair Value Measurements on a Recurring Basis

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We carry certain of our financial instruments at fair value. We define the fair value of a financial instrument as the amount that would be received from the sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. We are responsible for the determination of the value of the investments carried at fair value and the supporting methodologies and assumptions.

The degree of judgment used in measuring the fair value of financial instruments generally inversely correlates with the level of observable valuation inputs. We maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Financial instruments with quoted prices in active markets generally have more pricing observability and less judgment is used in measuring fair value. Conversely, financial instruments for which no quoted prices are available have less observability and are measured at fair value using valuation models or other pricing techniques that require more judgment. Pricing observability is affected by a number of factors, including the type of financial instrument, whether the financial instrument is new to the market and not yet established, the characteristics specific to the transaction, liquidity and general market conditions.

### Fair Value Hierarchy

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Assets and liabilities recorded at fair value in the Consolidated Balance Sheets are measured and classified in accordance with a fair value hierarchy consisting of three "levels" based on the observability of valuation inputs:

## THE VARIABLE ANNUITY LIFE INSURANCE COMPANY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

- **Level 1:** Fair value measurements based on quoted prices (unadjusted) in active markets that we have the ability to access for identical assets or liabilities. Market price data generally is obtained from exchange or dealer markets. We do not adjust the quoted price for such instruments.
- **Level 2:** Fair value measurements based on inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals.
- **Level 3:** Fair value measurements based on valuation techniques that use significant inputs that are unobservable. Both observable and unobservable inputs may be used to determine the fair values of positions classified in Level 3. The circumstances for using these measurements include those in which there is little, if any, market activity for the asset or liability. Therefore, we must make certain assumptions about the inputs a hypothetical market participant would use to value that asset or liability. In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety.

The following is a description of the valuation methodologies used for instruments carried at fair value. These methodologies are applied to assets and liabilities across the levels discussed above, and it is the observability of the inputs used that determines the appropriate level in the fair value hierarchy for the respective asset or liability.

### Valuation Methodologies of Financial Instruments Measured at Fair Value

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#### Incorporation of Credit Risk in Fair Value Measurements

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- **Our Own Credit Risk.** Fair value measurements for certain derivative liabilities incorporate our own credit risk by determining the explicit cost for each counterparty to protect against its net credit exposure to us at the balance sheet date by reference to observable AIG credit default swap (CDS) or cash bond spreads. We calculate the effect of credit spread changes using discounted cash flow techniques that incorporate current market interest rates. A derivative counterparty's net credit exposure to us is determined based on master netting agreements, when applicable, which take into consideration all derivative positions with us, as well as collateral we post with the counterparty at the balance sheet date. For a description of how we incorporate our own credit risk in the valuation of embedded derivatives related to certain annuity and life insurance products, see Embedded Derivatives within Policyholder Contract Deposits, below.
- **Counterparty Credit Risk.** Fair value measurements for freestanding derivatives incorporate counterparty credit by determining the explicit cost for us to protect against our net credit exposure to each counterparty at the balance sheet date by reference to observable counterparty CDS spreads, when available. When not available, other directly or indirectly observable credit spreads will be used to derive the best estimates of the counterparty spreads. Our net credit exposure to a counterparty is determined based on master netting agreements, which take into consideration all derivative positions with the counterparty, as well as collateral posted by the counterparty at the balance sheet date.

Fair values for fixed maturity securities based on observable market prices for identical or similar instruments implicitly incorporate counterparty credit risk. Fair values for fixed maturity securities based on internal models incorporate counterparty credit risk by using discount rates that take into consideration cash issuance spreads for similar instruments or other observable information.

For fair values measured based on internal models, the cost of credit protection is determined under a discounted present value approach considering the market levels for single name CDS spreads for each specific counterparty, the mid-market value of the net exposure (reflecting the amount of protection required) and the weighted average life of the net exposure. CDS spreads are provided to us by an independent third party. We utilize an interest rate based on the benchmark London Interbank Offered Rate (LIBOR) curve to derive our discount rates.



## THE VARIABLE ANNUITY LIFE INSURANCE COMPANY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

While this approach does not explicitly consider all potential future behavior of the derivative transactions or potential future changes in valuation inputs, we believe this approach provides a reasonable estimate of the fair value of the assets and liabilities, including consideration of the impact of non-performance risk.

### Fixed Maturity Securities

---

Whenever available, we obtain quoted prices in active markets for identical assets at the balance sheet date to measure fixed maturity securities at fair value. Market price data is generally obtained from dealer markets.

We employ independent third-party valuation service providers to gather, analyze, and interpret market information to derive fair value estimates for individual investments, based upon market-accepted methodologies and assumptions. The methodologies used by these independent third-party valuation service providers are reviewed and understood by management, through periodic discussion with and information provided by the independent third-party valuation service providers. In addition, as discussed further below, control processes are applied to the fair values received from independent third-party valuation service providers to ensure the accuracy of these values.

Valuation service providers typically obtain data about market transactions and other key valuation model inputs from multiple sources and, through the use of market-accepted valuation methodologies, which may utilize matrix pricing, financial models, accompanying model inputs and various assumptions, provide a single fair value measurement for individual securities. The inputs used by the valuation service providers include, but are not limited to, market prices from completed transactions for identical securities and transactions for comparable securities, benchmark yields, interest rate yield curves, credit spreads, prepayment rates, default rates, recovery assumptions, currency rates, quoted prices for similar securities and other market-observable information, as applicable. If fair value is determined using financial models, these models generally take into account, among other things, market observable information as of the measurement date as well as the specific attributes of the security being valued, including its term, interest rate, credit rating, industry sector, and when applicable, collateral quality and other security or issuer-specific information. When market transactions or other market observable data is limited, the extent to which judgment is applied in determining fair value is greatly increased.

We have control processes designed to ensure that the fair values received from independent third-party valuation service providers are accurately recorded, that their data inputs and valuation techniques are appropriate and consistently applied and that the assumptions used appear reasonable and consistent with the objective of determining fair value. We assess the reasonableness of individual security values received from independent third-party valuation service providers through various analytical techniques, and have procedures to escalate related questions internally and to the independent third-party valuation service providers for resolution. To assess the degree of pricing consensus among various valuation service providers for specific asset types, we conduct comparisons of prices received from available sources. We use these comparisons to establish a hierarchy for the fair values received from independent third-party valuation service providers to be used for particular security classes. We also validate prices for selected securities through reviews by members of management who have relevant expertise and who are independent of those charged with executing investing transactions.

When our independent third-party valuation service providers are unable to obtain sufficient market observable information upon which to estimate the fair value for a particular security, fair value is determined either by requesting brokers who are knowledgeable about these securities to provide a price quote, which is generally non-binding, or by employing market accepted valuation models. Broker prices may be based on an income approach, which converts expected future cash flows to a single present value amount, with specific consideration of inputs relevant to particular security types. For structured securities, such inputs may include ratings, collateral types, geographic concentrations, underlying loan vintages, loan delinquencies and defaults, loss severity assumptions, prepayments, and weighted average coupons and maturities. When the volume or level of market activity for a security is limited, certain inputs used to determine fair value may not be observable in the market. Broker prices may also be based on a market approach that considers recent transactions involving identical or similar securities. Fair values provided by brokers are subject to similar control processes to those noted above for fair values from independent third-party valuation service providers, including management reviews. For those corporate debt instruments (for example, private placements) that are not traded in active markets or that are subject to transfer restrictions, valuations reflect illiquidity and non-transferability, based on available market evidence. When observable price quotations are not available, fair value is determined based on discounted cash flow models using discount rates based on credit spreads, yields or price levels of

## THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

comparable securities, adjusted for illiquidity and structure. Fair values determined internally are also subject to management review to ensure that valuation models and related inputs are reasonable.

The methodology above is relevant for all fixed maturity securities including residential mortgage backed securities (RMBS), commercial mortgage backed securities (CMBS), collateralized debt obligations (CDO), other asset-backed securities (ABS) and fixed maturity securities issued by government sponsored entities and corporate entities.

#### Equity Securities Traded in Active Markets

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Whenever available, we obtain quoted prices in active markets for identical assets at the balance sheet date to measure equity securities at fair value. Market price data is generally obtained from exchange or dealer markets.

#### Mortgage and Other Loans Receivable

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We estimate the fair value of mortgage and other loans receivable that are measured at fair value by using dealer quotations, discounted cash flow analyses and/or internal valuation models. The determination of fair value considers inputs such as interest rate, maturity, the borrower's creditworthiness, collateral, subordination, guarantees, past-due status, yield curves, credit curves, prepayment rates, market pricing for comparable loans and other relevant factors.

#### Other Invested Assets

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We initially estimate the fair value of investments in certain hedge funds, private equity funds and other investment partnerships by reference to the transaction price. Subsequently, we generally obtain the fair value of these investments from net asset value information provided by the general partner or manager of the investments, the financial statements of which are generally audited annually. We consider observable market data and perform certain control procedures to validate the appropriateness of using the net asset value as a fair value measurement. The fair values of other investments carried at fair value, such as direct private equity holdings, are initially determined based on transaction price and are subsequently estimated based on available evidence such as market transactions in similar instruments, other financing transactions of the issuer and other available financial information for the issuer, with adjustments made to reflect illiquidity as appropriate.

#### Short-term Investments

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For short-term investments that are measured at amortized cost, the carrying amounts of these assets approximate fair values because of the relatively short period of time between origination and expected realization, and their limited exposure to credit risk. Securities purchased under agreements to resell (reverse repurchase agreements) are generally treated as collateralized receivables. We report certain receivables arising from securities purchased under agreements to resell as Short-term investments in the Consolidated Balance Sheets. When these receivables are measured at fair value, we use market-observable interest rates to determine fair value.

#### Separate Account Assets

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Separate account assets are composed primarily of registered and unregistered open-end mutual funds that generally trade daily and are measured at fair value in the manner discussed above for equity securities traded in active markets.

#### Freestanding Derivatives

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Derivative assets and liabilities can be exchange-traded or traded over-the-counter (OTC). We generally value exchange-traded derivatives such as futures and options using quoted prices in active markets for identical derivatives at the balance sheet date.

OTC derivatives are valued using market transactions and other market evidence whenever possible, including market-based inputs to models, model calibration to market clearing transactions, broker or dealer quotations or alternative pricing sources with reasonable levels of price transparency. When models are used, the selection of a particular model to value an OTC derivative depends on the contractual terms of, and specific risks inherent in the instrument, as well as

## THE VARIABLE ANNUITY LIFE INSURANCE COMPANY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

the availability of pricing information in the market. We generally use similar models to value similar instruments. Valuation models require a variety of inputs, including contractual terms, market prices and rates, yield curves, credit curves, measures of volatility, prepayment rates and correlations of such inputs. For OTC derivatives that trade in liquid markets, such as generic forwards, swaps and options, model inputs can generally be corroborated by observable market data by correlation or other means, and model selection does not involve significant management judgment.

For certain OTC derivatives that trade in less liquid markets, where we generally do not have corroborating market evidence to support significant model inputs and cannot verify the model to market transactions the transaction price may provide the best estimate of fair value. Accordingly, when a pricing model is used to value such an instrument, the model is adjusted so the model value at inception equals the transaction price. We will update valuation inputs in these models only when corroborated by evidence such as similar market transactions, independent third-party valuation service providers and/or broker or dealer quotations, or other empirical market data. When appropriate, valuations are adjusted for various factors such as liquidity, bid/offer spreads and credit considerations. Such adjustments are generally based on available market evidence. In the absence of such evidence, management's best estimate is used.

### Embedded Derivatives within Policyholder Contract Deposits

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Certain variable annuity and equity-indexed annuity and life contracts contain embedded derivatives that we bifurcate from the host contracts and account for separately at fair value, with changes in fair value recognized in earnings. These embedded derivatives are classified within Policyholder contract deposits. We have concluded these contracts contain either (i) a written option that guarantees a minimum accumulation value at maturity, (ii) a written option that guarantees annual withdrawals regardless of underlying market performance for a specific period or for life, or (iii) equity-indexed written options that meet the criteria of derivatives and must be bifurcated.

The fair value of embedded derivatives contained in certain variable annuity and equity-indexed annuity and life contracts is measured based on actuarial and capital market assumptions related to projected cash flows over the expected lives of the contracts. These discounted cash flow projections primarily include benefits and related fees assessed, when applicable. In some instances, the projected cash flows from fees may exceed projected cash flows related to benefit payments and therefore, at a point in time, the carrying value of the embedded derivative may be in a net asset position. The projected cash flows incorporate best estimate assumptions for policyholder behavior (including mortality, lapses, withdrawals and benefit utilization), along with an explicit risk margin to reflect a market participant's estimates of projected cash flows and policyholder behavior. Estimates of future policyholder behavior are subjective and based primarily on our historical experience.

Because of the dynamic and complex nature of the projected cash flows with respect to embedded derivatives in our variable annuity contracts, risk neutral valuations are used, which are calibrated to observable interest rate and equity option prices. Estimating the underlying cash flows for these products involves judgments regarding expected market rates of return, market volatility, credit spreads, correlations of certain market variables, fund performance, discount rates and policyholder behavior. The portion of fees attributable to the fair value of expected benefit payments are included within the fair value measurement of these embedded derivatives, and related fees are classified in net realized capital gains (losses) as earned, consistent with other changes in the fair value of these embedded policy derivatives. Any portion of the fees not attributed to the embedded derivatives are excluded from the fair value measurement and classified in policy fees as earned.

With respect to embedded derivatives in our equity-indexed annuity and life contracts, option pricing models are used to estimate fair value, taking into account assumptions for future equity index growth rates, volatility of the equity index, future interest rates, and our ability to adjust the participation rate and the cap on equity-indexed credited rates in light of market conditions and policyholder behavior assumptions.

Projected cash flows are discounted using the interest rate swap curve (swap curve), which is commonly viewed as being consistent with the credit spreads for highly-rated financial institutions (S&P AA-rated or above). A swap curve shows the fixed-rate leg of a non-complex swap against the floating rate (for example, LIBOR) leg of a related tenor. We also incorporate our own risk of non-performance in the valuation of the embedded derivatives associated with variable annuity and equity-indexed annuity and life contracts. The non-performance risk adjustment reflects a market participant's view of our claims-paying ability by incorporating an additional spread to the swap curve used to discount projected benefit cash flows in the valuation of these embedded derivatives. The non-performance risk adjustment is

## THE VARIABLE ANNUITY LIFE INSURANCE COMPANY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

calculated by constructing forward rates based on a weighted average of observable corporate credit indices to approximate our claims-paying ability rating.

### Notes Payable

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Certain VIEs that we consolidate have each elected the fair value option for certain tranches of their structured securities, which are included in notes payable – to affiliates. The fair value of the structured securities is determined using a mark-to-model approach, discounting cash flows produced by an internally validated model. Cash flows are discounted based on current market spreads for U.S. collateralized loan obligations (CLOs), adjusted for structural specific attributes. The market spreads are adjusted to include a spread premium to compensate for the complexity and perceived illiquidity of the structured securities. The spread premiums were derived on the respective issuance dates of the structured securities, with reference to the issuance spread on tranches of structured securities issued by the same entities that were purchased by independent, non-affiliated third parties.

### Other Liabilities

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Other liabilities measured at fair value include certain securities sold under agreements to repurchase and certain securities sold but not yet purchased. Liabilities arising from securities sold under agreements to repurchase are generally treated as collateralized borrowings. We estimate the fair value of liabilities arising under these agreements by using market-observable interest rates. This methodology considers such factors as the coupon rate, yield curves and other relevant factors. Fair values for securities sold but not yet purchased are based on current market prices.

# THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### Assets and Liabilities Measured at Fair Value on a Recurring Basis

The following table presents information about assets and liabilities measured at fair value on a recurring basis, and indicates the level of the fair value measurement based on the observability of the inputs used:

December 31, 2017 (in millions)	Level 1	Level 2	Level 3	Counterparty Netting <sup>(a)</sup>	Cash Collateral	Total
<b>Assets:</b>						
Bonds available for sale:						
U.S. government and government sponsored entities	\$ -	\$ 358	\$ -	\$ -	\$ -	358
Obligations of states, municipalities and political subdivisions	-	1,418	83	-	-	1,501
Non-U.S. governments	-	1,119	-	-	-	1,119
Corporate debt	-	20,069	224	-	-	20,293
RMBS	-	3,395	2,132	-	-	5,527
CMBS	-	4,028	269	-	-	4,297
CDO/ABS	-	619	1,924	-	-	2,543
Total bonds available for sale	-	31,006	4,632	-	-	35,638
Other bond securities:						
Non-U.S. governments	-	7	-	-	-	7
Corporate debt	-	239	-	-	-	239
RMBS	-	184	478	-	-	662
CMBS	-	95	37	-	-	132
CDO/ABS	-	5	635	-	-	640
Total other bond securities	-	530	1,150	-	-	1,680
Equity securities available for sale:						
Common stock	1	-	-	-	-	1
Preferred stock	4	-	-	-	-	4
Total equity securities available for sale	5	-	-	-	-	5
Other invested assets <sup>(b)</sup>	-	-	16	-	-	16
Short-term investments	326	432	-	-	-	758
Derivative assets:						
Interest rate contracts	-	66	-	-	-	66
Foreign exchange contracts	-	28	-	-	-	28
Equity contracts	5	298	-	-	-	303
Counterparty netting and cash collateral	-	-	-	(158)	(235)	(393)
Total derivative assets	5	392	-	(158)	(235)	4
Separate account assets	36,260	159	-	-	-	36,419
Total	\$ 36,596	\$ 32,519	\$ 5,798	\$ (158)	\$ (235)	\$ 74,520
<b>Liabilities:</b>						
Policyholder contract deposits	\$ -	\$ -	\$ 439	\$ -	\$ -	439
Notes payable - to affiliates	-	-	241	-	-	241
Derivative liabilities:						
Interest rate contracts	-	31	-	-	-	31
Foreign exchange contracts	-	60	-	-	-	60
Equity contracts	-	67	-	-	-	67
Counterparty netting and cash collateral	-	-	-	(158)	-	(158)
Total derivative liabilities	-	158	-	(158)	-	-
Total	\$ -	\$ 158	\$ 680	\$ (158)	\$ -	680

# THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2016 (in millions)	Level 1	Level 2	Level 3	Counterparty Netting <sup>(a)</sup>	Cash Collateral	Total
<b>Assets:</b>						
Bonds available for sale:						
U.S. government and government sponsored entities	\$ -	\$ 345	\$ -	\$ -	\$ -	345
Obligations of states, municipalities and political subdivisions	-	881	42	-	-	923
Non-U.S. governments	-	988	-	-	-	988
Corporate debt	-	19,638	180	-	-	19,818
RMBS	-	3,204	2,133	-	-	5,337
CMBS	-	4,137	314	-	-	4,451
CDO/ABS	-	970	1,759	-	-	2,729
<b>Total bonds available for sale</b>	-	<b>30,163</b>	<b>4,428</b>	-	-	<b>34,591</b>
Other bond securities:						
Non-U.S. governments	-	7	-	-	-	7
Corporate debt	-	224	-	-	-	224
RMBS	-	175	507	-	-	682
CMBS	-	119	35	-	-	154
CDO/ABS	-	5	706	-	-	711
<b>Total other bond securities</b>	-	<b>530</b>	<b>1,248</b>	-	-	<b>1,778</b>
Equity securities available for sale:						
Common stock	1	-	-	-	-	1
Preferred stock	4	-	-	-	-	4
<b>Total equity securities available for sale</b>	<b>5</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>5</b>
Other invested assets <sup>(b)</sup>	-	-	12	-	-	12
Short-term investments	385	382	-	-	-	767
Derivative assets:						
Interest rate contracts	-	122	-	-	-	122
Foreign exchange contracts	-	96	-	-	-	96
Equity contracts	15	13	-	-	-	28
Counterparty netting and cash collateral	-	-	-	(7)	(191)	(198)
<b>Total derivative assets</b>	<b>15</b>	<b>231</b>	<b>-</b>	<b>(7)</b>	<b>(191)</b>	<b>48</b>
Separate account assets	32,298	171	-	-	-	32,469
<b>Total</b>	<b>\$ 32,703</b>	<b>\$ 31,477</b>	<b>\$ 5,688</b>	<b>\$ (7)</b>	<b>\$ (191)</b>	<b>\$ 69,670</b>
<b>Liabilities:</b>						
Policyholder contract deposits	\$ -	\$ -	\$ 209	\$ -	\$ -	209
Notes payable - to affiliates	-	-	183	-	-	183
Derivative liabilities:						
Foreign exchange contracts	-	7	-	-	-	7
Counterparty netting and cash collateral	-	-	-	(7)	-	(7)
<b>Total derivative liabilities</b>	<b>-</b>	<b>7</b>	<b>-</b>	<b>(7)</b>	<b>-</b>	<b>-</b>
<b>Total</b>	<b>\$ -</b>	<b>\$ 7</b>	<b>\$ 392</b>	<b>\$ (7)</b>	<b>\$ -</b>	<b>\$ 392</b>

(a) Represents netting of derivative exposures covered by qualifying master netting agreements.

(b) Excludes investments that are measured at fair value using the NAV per share (or its equivalent), which totaled \$371 million and \$516 million as of December 31, 2017 and 2016, respectively.

### Transfers of Level 1 and Level 2 Assets and Liabilities

Our policy is to record transfers of assets and liabilities between Level 1 and Level 2 at their fair values as of the end of each reporting period, consistent with the date of the determination of fair value. Assets are transferred out of Level 1 when they are no longer transacted with sufficient frequency and volume in an active market. Conversely, assets are transferred from Level 2 to Level 1 when transaction volume and frequency are indicative of an active market. We had no significant transfers from Level 1 to Level 2 as well as transfers from Level 2 to Level 1 during 2017 and 2016.

# THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### Changes in Level 3 Recurring Fair Value Measurements

The following tables present changes during the years ended December 31, 2017 and 2016 in Level 3 assets and liabilities measured at fair value on a recurring basis, and the realized and unrealized gains (losses) related to the Level 3 assets and liabilities in the Consolidated Balance Sheets at December 31, 2017 and 2016:

<i>(in millions)</i>	Fair Value Beginning of Year	Net Realized and Unrealized Gains (Losses) Included in Income	Other Comprehensive Income (Loss)	Purchases, Sales, Issuances and Settlements, Net	Gross Transfers In	Gross Transfers Out	Fair Value End of Year	Changes in Unrealized Gains (Losses) Included in Income on Instruments Held at End of Year
<b>December 31, 2017</b>								
<b>Assets:</b>								
Bonds available for sale:								
Obligations of states, municipalities and political subdivisions	\$ 42	\$ -	\$ 6	\$ 35	\$ -	\$ -	\$ 83	\$ -
Corporate debt	180	(6)	3	(31)	186	(108)	224	-
RMBS	2,133	126	122	(252)	3	-	2,132	-
CMBS	314	13	(17)	(31)	11	(21)	269	-
CDO/ABS	1,759	9	38	118	-	-	1,924	-
<b>Total bonds available for sale</b>	<b>4,428</b>	<b>142</b>	<b>152</b>	<b>(161)</b>	<b>200</b>	<b>(129)</b>	<b>4,632</b>	<b>-</b>
Other bond securities:								
Obligations of states, municipalities								
RMBS	507	67	-	(96)	-	-	478	54
CMBS	35	2	-	-	-	-	37	1
CDO/ABS	706	30	-	(101)	-	-	635	29
<b>Total other bond securities</b>	<b>1,248</b>	<b>99</b>	<b>-</b>	<b>(197)</b>	<b>-</b>	<b>-</b>	<b>1,150</b>	<b>84</b>
Other invested assets	12	-	-	4	-	-	16	-
<b>Total</b>	<b>\$ 5,688</b>	<b>\$ 241</b>	<b>\$ 152</b>	<b>\$ (354)</b>	<b>\$ 200</b>	<b>\$ (129)</b>	<b>\$ 5,798</b>	<b>\$ 84</b>
<b>Liabilities:</b>								
Policyholder contract deposits	\$ (209)	\$ (66)	\$ -	\$ (164)	\$ -	\$ -	\$ (439)	\$ 34
Notes payable - to affiliates	(183)	(58)	-	-	-	-	(241)	-
<b>Total</b>	<b>\$ (392)</b>	<b>\$ (124)</b>	<b>\$ -</b>	<b>\$ (164)</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ (680)</b>	<b>\$ 34</b>
<b>December 31, 2016</b>								
<b>Assets:</b>								
Bonds available for sale:								
Obligations of states, municipalities and political subdivisions	\$ 48	\$ -	\$ 1	\$ -	\$ -	\$ (7)	\$ 42	\$ -
Corporate debt	218	(5)	(14)	(14)	192	(197)	180	-
RMBS	1,918	87	9	87	36	(4)	2,133	-
CMBS	537	39	(50)	(83)	2	(131)	314	-
CDO/ABS	1,568	8	(29)	223	-	(11)	1,759	-
<b>Total bonds available for sale</b>	<b>4,289</b>	<b>129</b>	<b>(83)</b>	<b>213</b>	<b>230</b>	<b>(350)</b>	<b>4,428</b>	<b>-</b>
Other bond securities:								
RMBS	105	12	-	390	-	-	507	7
CMBS	15	-	-	31	-	(11)	35	-
CDO/ABS	715	23	-	(32)	-	-	706	17
<b>Total other bond securities</b>	<b>835</b>	<b>35</b>	<b>-</b>	<b>389</b>	<b>-</b>	<b>(11)</b>	<b>1,248</b>	<b>24</b>
Other invested assets	14	-	(2)	-	-	-	12	-
<b>Total</b>	<b>\$ 5,138</b>	<b>\$ 164</b>	<b>\$ (85)</b>	<b>\$ 602</b>	<b>\$ 230</b>	<b>\$ (361)</b>	<b>\$ 5,688</b>	<b>\$ 24</b>
<b>Liabilities:</b>								
Policyholder contract deposits	\$ (197)	\$ 9	\$ -	\$ (21)	\$ -	\$ -	\$ (209)	\$ (16)
Notes payable - to affiliates	(143)	(40)	-	-	-	-	(183)	-
<b>Total</b>	<b>\$ (340)</b>	<b>\$ (31)</b>	<b>\$ -</b>	<b>\$ (21)</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ (392)</b>	<b>\$ (16)</b>

Net realized and unrealized gains and losses included in income related to Level 3 assets and liabilities shown above were reported in the Consolidated Statements of Income as follows:

<i>(in millions)</i>	Net Investment Income	Net Realized Capital Gains (Losses)	Total
<b>December 31, 2017</b>			
Bonds available for sale	\$ 153	\$ (11)	\$ 142
Other bond securities	97	2	99
Policyholder contract deposits	-	(66)	(66)
Notes payable - to affiliates	(58)	-	(58)
<b>December 31, 2016</b>			
Bonds available for sale	\$ 145	\$ (16)	\$ 129
Other bond securities	33	2	35
Policyholder contract deposits	-	9	9
Notes payable - to affiliates	(40)	-	(40)



# THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table presents the gross components of purchases, sales, issues and settlements, net, shown above:

<i>(in millions)</i>	Purchases	Sales	Settlements	Purchases, Sales, Issuances and Settlements, Net*
<b>December 31, 2017</b>				
Assets:				
Bonds available for sale:				
Obligations of states, municipalities and political subdivisions	\$ 35	\$ -	\$ -	35
Corporate debt	7	-	(38)	(31)
RMBS	222	-	(474)	(252)
CMBS	56	(34)	(53)	(31)
CDO/ABS	491	(60)	(313)	118
Total bonds available for sale	811	(94)	(878)	(161)
Other bond securities:				
RMBS	34	(48)	(82)	(96)
CDO/ABS	-	-	(101)	(101)
Total other bond securities	34	(48)	(183)	(197)
Other invested assets	4	-	-	4
Total assets	\$ 849	\$ (142)	\$ (1,061)	\$ (354)
Liabilities:				
Policyholder contract deposits	\$ -	\$ (33)	\$ (131)	\$ (164)
Total liabilities	\$ -	\$ (33)	\$ (131)	\$ (164)

<i>(in millions)</i>	Purchases	Sales	Settlements	Purchases, Sales, Issuances and Settlements, Net
<b>December 31, 2016</b>				
Assets:				
Corporate debt	\$ 10	\$ -	\$ (24)	(14)
RMBS	495	-	(408)	87
CMBS	26	(31)	(78)	(83)
CDO/ABS	417	(38)	(156)	223
Total bonds available for sale	948	(69)	(666)	213
Other bond securities:				
RMBS	424	(7)	(27)	390
CMBS	33	-	(2)	31
CDO/ABS	13	-	(45)	(32)
Total other bond securities	470	(7)	(74)	389
Total assets	\$ 1,418	\$ (76)	\$ (740)	\$ 602
Liabilities:				
Policyholder contract deposits	\$ -	\$ (59)	\$ 38	\$ (21)
Total liabilities	\$ -	\$ (59)	\$ 38	\$ (21)

\* There were no issuances in 2017 and 2016.

Both observable and unobservable inputs may be used to determine the fair values of positions classified in Level 3 in the tables above. As a result, the unrealized gains (losses) on instruments held at December 31, 2017 and 2016 may include changes in fair value that were attributable to both observable (e.g., changes in market interest rates) and unobservable inputs (e.g., changes in unobservable long-dated volatilities).

### Transfers of Level 3 Assets and Liabilities

We record transfers of assets and liabilities into or out of Level 3 at their fair values as of the end of each reporting period, consistent with the date of the determination of fair value. The net realized and unrealized gains (losses) included in income (loss) or other comprehensive income (loss) and as shown in the table above excludes \$17.5 million of net losses related to assets transferred into Level 3 in 2017 and includes \$8.8 million of net losses related to assets transferred out of Level 3 in 2017. The net realized and unrealized gains (losses) included in income (loss) or other comprehensive income (loss) and as shown in the table above excludes \$43 million of net losses related to assets transferred into Level 3 in 2016 and includes \$44 million of net losses related to assets transferred out of Level 3 in 2016.



# THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### Transfers of Level 3 Assets

During the years ended December 31, 2017 and 2016, transfers into Level 3 assets primarily included certain investments in private placement corporate debt, RMBS, CMBS, and CDO/ABS. Transfers of private placement corporate debt and certain ABS into Level 3 assets were primarily the result of limited market pricing information that required us to determine fair value for these securities based on inputs that are adjusted to better reflect our own assumptions regarding the characteristics of a specific security or associated market liquidity. The transfers of investments in RMBS, CMBS and CDO and certain ABS into Level 3 assets were due to decreases in market transparency and liquidity for individual security types.

During the years ended December 31, 2017 and 2016, transfers out of Level 3 assets primarily included private placement and other corporate debt, CMBS, CDO/ABS, RMBS and certain investments in municipal securities. Transfers of certain investments in municipal securities, corporate debt, RMBS, CMBS and CDO/ABS out of Level 3 assets were based on consideration of market liquidity as well as related transparency of pricing and associated observable inputs for these investments. Transfers of certain investments in private placement corporate debt and certain ABS out of Level 3 assets were primarily the result of using observable pricing information that reflects the fair value of those securities without the need for adjustment based on our own assumptions regarding the characteristics of a specific security or the current liquidity in the market.

### Transfers of Level 3 Liabilities

There were no significant transfers of derivative or other liabilities into or out of Level 3 for the years ended December 31, 2017 and 2016.

### Quantitative Information about Level 3 Fair Value Measurements

The table below presents information about the significant unobservable inputs used for recurring fair value measurements for certain Level 3 instruments, and includes only those instruments for which information about the inputs is reasonably available to us, such as data from independent third-party valuation service providers and from internal valuation models. Because input information from third-parties with respect to certain Level 3 instruments (primarily CDO/ABS) may not be reasonably available to us, balances shown below may not equal total amounts reported for such Level 3 assets and liabilities:

<i>(in millions)</i>	Fair Value at December 31, 2017	Valuation Technique	Unobservable Input <sup>(b)</sup>	Range (Weighted Average)
<b>Assets:</b>				
Obligations of states, municipalities and political subdivisions	\$ 83	Discounted cash flow	Yield	3.50% - 4.19% (3.85%)
Corporate debt	209	Discounted cash flow	Yield	4.66% - 13.64% (9.15%)
RMBS <sup>(a)</sup>	2,435	Discounted cash flow	Constant prepayment rate	3.86% - 12.57% (8.21%)
			Loss severity	45.08% - 75.64% (60.36%)
			Constant default rate	3.60% - 8.61% (6.11%)
			Yield	2.86% - 5.40% (4.13%)
CMBS	133	Discounted cash flow	Yield	2.88% - 7.89% (5.39%)
CDO/ABS <sup>(a)</sup>	998	Discounted cash flow	Yield	3.38% - 4.74% (4.06%)
<b>Liabilities:</b>				
Embedded derivatives within Policyholder contract deposits: GMWB	\$ 186	Discounted cash flow	Equity volatility	06.45% - 51.25%
			Base lapse rate	00.35% - 14.00%
			Dynamic lapse rate	30.00% - 170.00%
			Mortality multiplier <sup>(c)</sup>	40.00% - 153.00%
			Utilization rate	90.00% - 100.00%
			Equity / interest-rate correlation	20.00% - 40.00%
Index annuities	253	Discounted cash flow	Lapse rate	00.50% - 40.00%
			Mortality multiplier <sup>(c)</sup>	42.00% - 162.00%
			Option budget	01.00%-04.00%

# THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

<i>(in millions)</i>	Fair Value at December 31, 2016	Valuation Technique	Unobservable Input <sup>(b)</sup>	Range (Weighted Average )
<b>Assets:</b>				
Obligations of states, municipalities and political subdivisions	\$ 42	Discounted cash flow	Yield	4.09% - 4.41% (4.25%)
Corporate debt	33	Discounted cash flow	Yield	3.64% - 9.35% (6.50%)
RMBS <sup>(a)</sup>	2,495	Discounted cash flow	Constant prepayment rate	1.21% - 9.52% (5.37%)
			Loss severity	48.91% - 79.57% (64.24%)
			Constant default rate	3.12% - 9.89% (6.51%)
			Yield	2.85% - 6.35% (4.60%)
CMBS	10	Discounted cash flow	Yield	2.02% - 2.04% (2.03%)
CDO/ABS <sup>(a)</sup>	602	Discounted cash flow	Yield	4.46% - 6.22% (5.34%)
<b>Liabilities:</b>				
Embedded derivatives within Policyholder contract deposits:				
GMWB	\$ 165	Discounted cash flow	Equity volatility	13.00% - 50.00%
			Base lapse rate	0.50% - 20.00%
			Dynamic lapse rate	30.00% - 170.00%
			Mortality multiplier <sup>(d)</sup>	42.00% - 161.00%
			Utilization rate	100.00%
			Equity / interest rate correlation	20.00% - 40.00%
Index annuities	44	Discounted cash flow	Lapse rate	1.00% - 66.00%
			Mortality multiplier <sup>(d)</sup>	50.00% - 75.00%
			Option budget	1.00% - 3.00%

(a) Information received from third-party valuation service providers. The ranges of the unobservable inputs for constant prepayment rate, loss severity and constant default rate relate to each of the individual underlying mortgage loans that comprise the entire portfolio of securities in the RMBS and CDO securitization vehicles and not necessarily to the securitization vehicle bonds (tranches) purchased by us. The ranges of these inputs do not directly correlate to changes in the fair values of the tranches purchased by us, because there are other factors relevant to the fair values of specific tranches owned by us including, but not limited to, purchase price, position in the waterfall, senior versus subordinated position and attachment points.

(b) Represents discount rates, estimates and assumptions that we believe would be used by market participants when valuing these assets and liabilities.

(c) Mortality inputs are shown as multipliers of the 2012 Individual Annuity Mortality Basic table.

The ranges of reported inputs for Obligations of states, municipalities and political subdivisions, Corporate debt, RMBS, CDO/ABS, and CMBS valued using a discounted cash flow technique consist of one standard deviation in either direction from the value-weighted average. The preceding table does not give effect to our risk management practices that might offset risks inherent in these Level 3 assets and liabilities.

### Sensitivity to Changes in Unobservable Inputs

We consider unobservable inputs to be those for which market data is not available and that are developed using the best information available to us about the assumptions that market participants would use when pricing the asset or liability. Relevant inputs vary depending on the nature of the instrument being measured at fair value. The following paragraphs provide a general description of sensitivities of significant unobservable inputs along with interrelationships between and among the significant unobservable inputs and their impact on the fair value measurements. The effect of a change in a particular assumption in the sensitivity analysis below is considered independently of changes in any other assumptions. In practice, simultaneous changes in assumptions may not always have a linear effect on the inputs discussed below. Interrelationships may also exist between observable and unobservable inputs. Such relationships have not been included in the discussion below. For each of the individual relationships described below, the inverse relationship would also generally apply.

# THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### *Obligations of States, Municipalities and Political Subdivisions*

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The significant unobservable input used in the fair value measurement of certain investments in obligations of states, municipalities and political subdivisions is yield. In general, increases in the yield would decrease the fair value of investments in obligations of states, municipalities and political subdivisions.

### *Corporate Debt*

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Corporate debt securities included in Level 3 are primarily private placement issuances that are not traded in active markets or that are subject to transfer restrictions. Fair value measurements consider illiquidity and non-transferability. When observable price quotations are not available, fair value is determined based on discounted cash flow models using discount rates based on credit spreads, yields or price levels of publicly-traded debt of the issuer or other comparable securities, considering illiquidity and structure. The significant unobservable input used in the fair value measurement of corporate debt is the yield. The yield is affected by the market movements in credit spreads and U.S. Treasury yields. In addition, the migration in credit quality of a given security generally has a corresponding effect on the fair value measurement of the security. For example, a downward migration of credit quality would increase spreads. Holding U.S. Treasury rates constant, an increase in corporate credit spreads would decrease the fair value of corporate debt.

### *RMBS and CDO/ABS*

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The significant unobservable inputs used in fair value measurements of RMBS and certain CDO/ABS valued by third-party valuation service providers are constant prepayment rates (CPR), loss severity, constant default rates (CDR) and yield. A change in the assumptions used for the probability of default will generally be accompanied by a corresponding change in the assumption used for the loss severity and an inverse change in the assumption used for prepayment rates. In general, increases in CPR, loss severity, CDR and yield, in isolation, would result in a decrease in the fair value measurement. Changes in fair value based on variations in assumptions generally cannot be extrapolated because the relationship between the directional change of each input is not usually linear.

### *CMBS*

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The significant unobservable input used in fair value measurements for CMBS is the yield. Prepayment assumptions for each mortgage pool are factored into the yield. CMBS generally feature a lower degree of prepayment risk than RMBS because commercial mortgages generally contain a penalty for prepayment. In general, increases in the yield would decrease the fair value of CMBS.

### *Embedded derivatives within Policyholder contract deposits*

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Embedded derivatives reported within policyholder contract deposits include guaranteed minimum withdrawal benefits (GMWB) within variable annuity products and interest crediting rates based on market indices within index annuities. For any given contract, assumptions for unobservable inputs vary throughout the period over which cash flows are projected for purposes of valuing the embedded derivative. The following unobservable inputs are used for valuing embedded derivatives measured at fair value:

- Long-term equity volatilities represent equity volatility beyond the period for which observable equity volatilities are available. Increases in assumed volatility will generally increase the fair value of both the projected cash flows from rider fees as well as the projected cash flows related to benefit payments. Therefore, the net change in the fair value of the liability may be either a decrease or an increase, depending on the relative changes in projected rider fees and projected benefit payments.
- Equity / interest rate correlation estimates the relationship between changes in equity returns and interest rates in the economic scenario generator used to value our GMWB embedded derivatives. In general, a higher positive correlation assumes that equity markets and interest rates move in a more correlated fashion, which generally increases the fair value of the liability.

## THE VARIABLE ANNUITY LIFE INSURANCE COMPANY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

- Base lapse rate assumptions are determined by company experience and are adjusted at the contract level using a dynamic lapse function, which reduces the base lapse rate when the contract is in-the-money (when the contract holder's guaranteed value, as estimated by the Company, is worth more than their underlying account value). Lapse rates are also generally assumed to be lower in periods when a surrender charge applies. Increases in assumed lapse rates will generally decrease the fair value of the liability, as fewer policyholders would persist to collect guaranteed withdrawal amounts.
- Mortality rate assumptions, which vary by age and gender, are based on company experience and include a mortality improvement assumption. Increases in assumed mortality rates will decrease the fair value of the liability, while lower mortality rate assumptions will generally increase the fair value of the liability, because guaranteed payments will be made for a longer period of time.
- Utilization assumptions estimate the timing when policyholders with a GMWB will elect to utilize their benefit and begin taking withdrawals. The assumptions may vary by the type of guarantee, tax-qualified status, the contract's withdrawal history and the age of the policyholder. Utilization assumptions are based on company experience, which includes partial withdrawal behavior. Increases in assumed utilization rates will generally increase the fair value of the liability.
- Option budget estimates the expected long-term cost of options used to hedge exposures associated with equity price changes. The level of option budgets determines future costs of the options, which impacts the growth in account value and the valuation of embedded derivatives.

# THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### Investments in Certain Entities Carried at Fair Value Using Net Asset Value per Share

The following table includes information related to our investments in certain other invested assets, including private equity funds, hedge funds and other alternative investments that calculate net asset value per share (or its equivalent). For these investments, which are measured at fair value on a recurring basis, we use the net asset value per share to measure fair value.

(in millions)	Investment Category Includes	December 31, 2017		December 31, 2016	
		Fair Value Using Net Asset Value Per Share (or its equivalent)	Unfunded Commitments	Fair Value Using Net Asset Value Per Share (or its equivalent)	Unfunded Commitments
<b>Investment Category</b>					
<i>Private equity funds:</i>					
Leveraged buyout	Debt and/or equity investments made as part of a transaction in which assets of mature companies are acquired from the current shareholders, typically with the use of financial leverage	\$ 90	\$ 50	\$ 112	\$ 57
Real Estate / Infrastructure	Investments in real estate properties and infrastructure positions, including power plants and other energy generating facilities	3	4	12	4
Venture capital	Early-stage, high-potential, growth companies expected to generate a return through an eventual realization event, such as an initial public offering or sale of the company	15	9	8	16
Distressed	Securities of companies that are in default, under bankruptcy protection, or troubled	2	1	2	1
Total private equity funds		110	64	134	78
<i>Hedge funds:</i>					
Event-driven	Securities of companies undergoing material structural changes, including mergers, acquisitions and other reorganizations	95	-	162	-
Long-short	Securities that the manager believes are undervalued, with corresponding short positions to hedge market risk	151	-	154	-
Distressed	Securities of companies that are in default, under bankruptcy protection or troubled	14	-	65	-
Other	Includes investments held in funds that are less liquid, as well as other strategies which allow for broader allocation between public and private investments	1	-	1	-
Total hedge funds		261	-	382	-
Total		\$ 371	\$ 64	\$ 516	\$ 78

Private equity fund investments included above are not redeemable, because distributions from the funds will be received when underlying investments of the funds are liquidated. Private equity funds are generally expected to have 10-year lives at their inception, but these lives may be extended at the fund manager's discretion, typically in one or two-year increments.

The hedge fund investments included above, which are carried at fair value, are generally redeemable monthly, quarterly, semi-annually and annually, as shown below, with redemption notices ranging from one day to 180 days. Certain hedge fund investments have partial contractual redemption restrictions. These partial redemption restrictions are generally related to one or more investments held in the hedge funds that the fund manager deemed to be illiquid. The majority of these contractual restrictions, which may have been put in place at the fund's inception or thereafter, have pre-defined end dates. The majority of these restrictions are generally expected to be lifted by the end of 2019.

## THE VARIABLE ANNUITY LIFE INSURANCE COMPANY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table presents information regarding the expected remaining lives of our investments in private equity funds, assuming average original expected lives of 10 years for the funds, and information regarding redemptions and contractual restrictions related to our hedge fund investments:

December 31,	2017
<i>Percentage of private equity fund investments with remaining lives of:</i>	
Three years or less	77%
Between four and six years	1
Between seven and 10 years	22
Total	100%
<i>Percentage of hedge fund investments redeemable:</i>	
Monthly	33%
Quarterly	32
Semi-annually	25
Annually	10
Total	100%
Percentage of hedge fund investments' fair value subject to contractual partial restrictions	15%

### Fair Value Option

Under the fair value option, we may elect to measure at fair value financial assets and financial liabilities that are not otherwise required to be carried at fair value. Subsequent changes in fair value for designated items are reported in earnings. We elect the fair value option for certain hybrid securities given the complexity of bifurcating the economic components associated with the embedded derivatives. Refer to Note 7 for additional information related to embedded derivatives.

Additionally, we elect the fair value option for certain alternative investments when such investments are eligible for this election. We believe this measurement basis is consistent with the applicable accounting guidance used by the respective investment company funds themselves. Refer to Note 4 for additional information on securities and other invested assets for which we have elected the fair value option.

Certain VIEs, which are securitization vehicles that we consolidate, have elected the fair value option for a tranche of their structured securities, which are included in notes payable – to affiliates. Refer to Note 9 for additional information on these VIEs.

The following table presents the difference between fair values and the aggregate contractual principal amounts of notes payable for which the fair value option was elected:

<i>(in millions)</i>	December 31, 2017			December 31, 2016		
	Fair Value	Outstanding Principal Amount	Difference	Fair Value	Outstanding Principal Amount	Difference
<b>Liabilities:</b>						
Notes payable – to affiliates	\$ 241	\$ 365	\$ (124)	\$ 183	\$ 365	\$ (182)

The following table presents the gains or losses recorded related to the eligible instruments for which we elected the fair value option:

<i>(in millions)</i>	Gain (Loss)		
	2017	2016	2015
<b>Years Ended December 31,</b>			
<b>Assets:</b>			
Bond and equity securities	\$ 179	\$ 92	\$ 33
Alternative investments <sup>(a)</sup>	13	(1)	(29)
<b>Liabilities:</b>			
Notes payable – to affiliates	(130)	(40)	6
Total gain	\$ 62	\$ 51	\$ 10

(a) Includes certain hedge funds, private equity funds and other investment partnerships.

## THE VARIABLE ANNUITY LIFE INSURANCE COMPANY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Interest income, dividend income and net unrealized gains (losses) on assets measured under the fair value option are recognized and included in net investment income in the Consolidated Statements of Income. Interest on liabilities measured under the fair value option is recognized in other income in the Consolidated Statements of Income. See Note 4 herein for additional information about our policies for recognition, measurement, and disclosure of interest, dividend and other income.

### FAIR VALUE MEASUREMENTS ON A NON-RECURRING BASIS

We measure the fair value of certain assets on a non-recurring basis, generally quarterly, annually, or when events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. These assets include cost and equity-method investments and mortgage and other loans. See Notes 4 and 5 herein for additional information about how we test various asset classes for impairment.

Impairments for other investments for the year ended December 31, 2017 primarily relate to commercial mortgage loans, the fair values of which are determined based on independent broker quotations or valuation models using unobservable inputs, as well as the estimated fair value of the underlying collateral or the present value of the expected future cash flows. Impairments for other investments for the year ended December 31, 2015 primarily related to hedge funds and private equity funds that were held for sale.

The following table presents assets measured at fair value on a non-recurring basis at the time of impairment and the related impairment charges recorded during the periods presented:

<i>(in millions)</i>	Assets at Fair Value				Impairment Charges		
	Non-Recurring Basis				December 31,		
	Level 1	Level 2	Level 3	Total	2017	2016	2015
<b>December 31, 2017</b>							
Other investments	\$ -	\$ -	\$ -	\$ -	\$ 10	\$ -	\$ 9
<b>December 31, 2016</b>							
Other investments	\$ -	\$ -	\$ -	\$ -			

### FAIR VALUE INFORMATION ABOUT FINANCIAL INSTRUMENTS NOT MEASURED AT FAIR VALUE

Information regarding the estimation of fair value for financial instruments not carried at fair value (excluding insurance contracts) is discussed below.

- **Mortgage and other loans receivable:** Fair values of loans on commercial real estate and other loans receivable were estimated for disclosure purposes using discounted cash flow calculations based on discount rates that we believe market participants would use in determining the price that they would pay for such assets. For certain loans, our current incremental lending rates for similar types of loans are used as the discount rates, because we believe this rate approximates the rates market participants would use. Fair values of residential mortgage loans are generally determined based on market prices, using market based adjustments for credit and servicing as appropriate. The fair values of policy loans are generally estimated based on unpaid principal amount as of each reporting date. No consideration is given to credit risk because policy loans are effectively collateralized by the cash surrender value of the policies.
- **Other invested assets:** that are not measured at fair value represent our investments in Federal Home Loan Bank common stock. These investments are carried at amortized cost, which approximates fair value.
- **Cash and short-term investments:** The carrying amounts of these assets approximate fair values because of the relatively short period of time between origination and expected realization, and their limited exposure to credit risk.
- **Policyholder contract deposits associated with investment-type contracts:** Fair values for policyholder contract deposits associated with investment-type contracts not accounted for at fair value are estimated using discounted cash flow calculations based on interest rates currently being offered for similar contracts with maturities consistent with those of the contracts being valued. When no similar contracts are being offered, the discount rate is the appropriate swap rate (if available) or current risk-free interest rate consistent with the currency in which the cash



## THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

flows are denominated. To determine fair value, other factors include current policyholder account values and related surrender charges and other assumptions include expectations about policyholder behavior and an appropriate risk margin.

- **Notes Payable:** Fair values of these obligations were estimated based on discounted cash flow calculations using a discount rate that is indicative of the current market for securities with similar risk characteristics.

The following table presents the carrying amounts and estimated fair values of our financial instruments not measured at fair value, and indicates the level in the fair value hierarchy of the estimated fair value measurement based on the observability of the inputs used:

(in millions)	Estimated Fair Value				Carrying Value
	Level 1	Level 2	Level 3	Total	
<b>December 31, 2017</b>					
Assets:					
Mortgage and other loans receivable	\$ -	\$ 28	\$ 6,992	\$ 7,020	\$ 6,850
Other invested assets	-	9	-	9	9
Short-term investments	-	3	-	3	3
Cash	143	-	-	143	143
Liabilities:					
Policyholder contract deposits*	-	-	46,118	46,118	40,190
Note payable - to third parties, net	-	-	139	139	140
<b>December 31, 2016</b>					
Assets:					
Mortgage and other loans receivable	\$ -	\$ 42	\$ 6,181	\$ 6,223	\$ 6,083
Other invested assets	-	9	-	9	9
Short-term investments	-	51	-	51	51
Cash	106	-	-	106	106
Liabilities:					
Policyholder contract deposits*	-	-	45,417	45,417	39,560
Note payable - to third parties, net	-	-	50	50	50

\* Excludes embedded policy derivatives which are carried at fair value on a recurring basis.

## 4. INVESTMENTS

### Fixed Maturity and Equity Securities

Bonds held to maturity are carried at amortized cost when we have the ability and positive intent to hold these securities until maturity. When we do not have the ability or positive intent to hold bonds until maturity, these securities are classified as available for sale or are measured at fair value at our election. None of our fixed maturity securities met the criteria for held to maturity classification at December 31, 2017 or 2016.

Fixed maturity and equity securities classified as available for sale are carried at fair value. Unrealized gains and losses from available for sale investments in fixed maturity and equity securities are reported as a separate component of accumulated other comprehensive income (AOCI), net of DAC, deferred sales inducements and deferred income taxes, in shareholder's equity. Realized and unrealized gains and losses from fixed maturity and equity securities measured at fair value at our election are reflected in net investment income. Investments in fixed maturity and equity securities are recorded on a trade-date basis.

Premiums and discounts arising from the purchase of bonds classified as available for sale are treated as yield adjustments over their estimated holding periods, until maturity, or call date, if applicable. For investments in certain RMBS, CMBS and CDO/ABS, (collectively, structured securities), recognized yields are updated based on current information regarding the timing and amount of expected undiscounted future cash flows. For high credit quality structured securities, effective yields are recalculated based on actual payments received and updated prepayment expectations, and the amortized cost is adjusted to the amount that would have existed had the new effective yield been applied since acquisition with a corresponding charge or credit to net investment income. For structured securities that are not high credit quality, effective yields are recalculated and adjusted prospectively based on changes in expected



## THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

undiscounted future cash flows. For purchased credit impaired (PCI) securities, at acquisition, the difference between the undiscounted expected future cash flows and the recorded investment in the securities represents the initial accretible yield, which is to be accreted into net investment income over the securities' remaining lives on an effective level-yield basis. Subsequently, effective yields recognized on PCI securities are recalculated and adjusted prospectively to reflect changes in the contractual benchmark interest rates on variable rate securities and any significant increases in undiscounted expected future cash flows arising due to reasons other than interest rate changes.

#### Other Securities Measured at Fair Value

Securities for which we have elected the fair value option are carried at fair value and reported in other bond securities or other common and preferred stocks in the Consolidated Balance Sheets. Changes in fair value of these assets are reported in net investment income. Interest income and dividend income on assets measured under the fair value option are recognized and included in net investment income. See Note 3 for additional information on financial assets designated under the fair value option.

#### Securities Available for Sale

The following table presents the amortized cost or cost and fair value of our available for sale securities:

<i>(in millions)</i>	Amortized Cost or Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Other-Than- Temporary Impairments in AOCI <sup>(a)</sup>
<b>December 31, 2017</b>					
Bonds available for sale:					
U.S. government and government sponsored entities	\$ 297	\$ 61	\$ -	\$ 358	-
Obligations of states, municipalities and political subdivisions	1,406	98	(3)	1,501	-
Non-U.S. governments	1,083	49	(13)	1,119	-
Corporate debt	19,627	830	(164)	20,293	2
Mortgage-backed, asset-backed and collateralized:					
RMBS	5,176	402	(51)	5,527	235
CMBS	4,234	104	(41)	4,297	12
CDO/ABS	2,490	61	(8)	2,543	11
Total mortgage-backed, asset-backed and collateralized	11,900	567	(100)	12,367	258
<b>Total bonds available for sale<sup>(b)</sup></b>	<b>34,313</b>	<b>1,605</b>	<b>(280)</b>	<b>35,638</b>	<b>260</b>
Equity securities available for sale:					
Common stock	1	-	-	1	-
Preferred stock	4	-	-	4	-
<b>Total equity securities available for sale</b>	<b>5</b>	<b>-</b>	<b>-</b>	<b>5</b>	<b>-</b>
<b>Total</b>	<b>\$ 34,318</b>	<b>\$ 1,605</b>	<b>\$(280)</b>	<b>\$ 35,643</b>	<b>260</b>
<b>December 31, 2016</b>					
Bonds available for sale:					
U.S. government and government sponsored entities	\$ 285	\$ 60	\$ -	\$ 345	-
Obligations of states, municipalities and political subdivisions	880	53	(10)	923	-
Non-U.S. governments	1,000	25	(37)	988	-
Corporate debt	19,287	823	(292)	19,818	(7)
Mortgage-backed, asset-backed and collateralized:					
RMBS	5,099	317	(79)	5,337	163
CMBS	4,382	128	(59)	4,451	21
CDO/ABS	2,724	38	(33)	2,729	11
Total mortgage-backed, asset-backed and collateralized	12,205	483	(171)	12,517	195
<b>Total bonds available for sale<sup>(b)</sup></b>	<b>33,657</b>	<b>1,444</b>	<b>(510)</b>	<b>34,591</b>	<b>188</b>
Equity securities available for sale:					
Common stock	1	-	-	1	-
Preferred stock	4	-	-	4	-
<b>Total equity securities available for sale</b>	<b>5</b>	<b>-</b>	<b>-</b>	<b>5</b>	<b>-</b>
<b>Total</b>	<b>\$ 33,662</b>	<b>\$ 1,444</b>	<b>\$(510)</b>	<b>\$ 34,596</b>	<b>188</b>

(a) Represents the amount of other-than-temporary impairments recognized in accumulated other comprehensive income. Amount includes unrealized gains and losses on impaired securities relating to changes in the value of such securities subsequent to the impairment measurement date.

# THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(b) At December 31, 2017 and 2016, bonds available for sale held by us that were below investment grade or not rated totaled \$4.5 billion and \$4.7 billion, respectively.

### Securities Available for Sale in a Loss Position

The following table summarizes the fair value and gross unrealized losses on our available for sale securities, aggregated by major investment category and length of time that individual securities have been in a continuous unrealized loss position:

<i>(in millions)</i>	Less than 12 Months		12 Months or More		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
<b>December 31, 2017</b>						
Bonds available for sale:						
U.S. government and government sponsored entities	\$ 18	\$ -	\$ -	\$ -	\$ 18	\$ -
Obligations of states, municipalities and political subdivisions	84	-	59	3	143	3
Non-U.S. governments	129	2	115	11	244	13
Corporate debt	2,526	86	1,757	78	4,283	164
RMBS	632	14	1,136	37	1,768	51
CMBS	1,209	15	641	26	1,850	41
CDO/ABS	223	1	141	7	364	8
<b>Total bonds available for sale</b>	<b>\$ 4,821</b>	<b>\$ 118</b>	<b>\$ 3,849</b>	<b>\$ 162</b>	<b>\$ 8,670</b>	<b>\$ 280</b>
<b>December 31, 2016</b>						
Bonds available for sale:						
U.S. government and government sponsored entities	\$ 16	\$ -	\$ -	\$ -	\$ 16	\$ -
Obligations of states, municipalities and political subdivisions	259	10	-	-	259	10
Non-U.S. governments	447	22	61	15	508	37
Corporate debt	4,588	163	902	129	5,490	292
RMBS	1,574	53	464	26	2,038	79
CMBS	1,674	54	64	5	1,738	59
CDO/ABS	1,059	20	337	13	1,396	33
<b>Total bonds available for sale</b>	<b>\$ 9,617</b>	<b>\$ 322</b>	<b>\$ 1,828</b>	<b>\$ 188</b>	<b>\$ 11,445</b>	<b>\$ 510</b>

At December 31, 2017, we held 1,185 individual fixed maturity securities that were in an unrealized loss position, of which 381 individual fixed maturity securities were in a continuous unrealized loss position for 12 months or more. We did not recognize the unrealized losses in earnings on these fixed maturity securities at December 31, 2017 because we neither intend to sell the securities nor do we believe that it is more likely than not that we will be required to sell these securities before recovery of their amortized cost basis. For fixed maturity securities with significant declines, we performed fundamental credit analyses on a security-by-security basis, which included consideration of credit enhancements, expected defaults on underlying collateral, review of relevant industry analyst reports and forecasts and other available market data.

### Contractual Maturities of Fixed Maturity Securities Available for Sale

The following table presents the amortized cost and fair value of fixed maturity securities available for sale by contractual maturity:

<i>(in millions)</i>	Total Fixed Maturity Securities Available for Sale		Fixed Maturity Securities in a Loss Position Available for Sale	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
<b>December 31, 2017</b>				
Due in one year or less	\$ 550	\$ 558	\$ 25	\$ 25
Due after one year through five years	7,425	7,780	568	549
Due after five years through ten years	7,929	8,102	2,503	2,396
Due after ten years	6,509	6,831	1,772	1,718
Mortgage-backed, asset-backed and collateralized	11,900	12,367	4,082	3,982
<b>Total</b>	<b>\$ 34,313</b>	<b>\$ 35,638</b>	<b>\$ 8,950</b>	<b>\$ 8,670</b>

Actual maturities may differ from contractual maturities because certain borrowers have the right to call or prepay certain obligations with or without call or prepayment penalties.

## THE VARIABLE ANNUITY LIFE INSURANCE COMPANY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table presents the gross realized gains and gross realized losses from sales or maturities of our available for sale securities:

<i>(in millions)</i>	Years Ended December 31,					
	2017		2016		2015	
	Gross Realized Gains	Gross Realized Losses	Gross Realized Gains	Gross Realized Losses	Gross Realized Gains	Gross Realized Losses
Fixed maturity securities	\$ 71	\$ 25	\$ 133	\$ 130	\$ 53	\$ 50
Equity securities	-	-	-	-	1	-
<b>Total</b>	<b>\$ 71</b>	<b>\$ 25</b>	<b>\$ 133</b>	<b>\$ 130</b>	<b>\$ 54</b>	<b>\$ 50</b>

In 2017, 2016, and 2015, the aggregate fair value of available-for-sale securities sold was \$2.5 billion, \$3.5 billion and \$6.8 billion, respectively.

### Other Securities Measured at Fair Value

The following table presents the fair value of other securities measured at fair value based on our election of the fair value option:

<i>(in millions)</i>	December 31, 2017		December 31, 2016	
	Fair Value	Percent of Total	Fair Value	Percent of Total
Non-U.S. governments	\$ 7	- %	\$ 7	- %
Corporate debt	239	14	224	13
Mortgage-backed, asset-backed and collateralized:				
RMBS	662	40	682	38
CMBS	132	8	154	9
CDO/ABS	640	38	711	40
<b>Total other bond securities</b>	<b>\$ 1,680</b>	<b>100 %</b>	<b>\$ 1,778</b>	<b>100 %</b>

### Other Invested Assets

The following table summarizes the carrying amounts of other invested assets:

<i>(in millions)</i>	December 31,	
	2017	2016
Alternative investments <sup>(a)(b)</sup>	\$ 946	\$ 1,170
Investment real estate <sup>(c)</sup>	185	39
Federal Home Loan Bank (FHLB) common stock	9	9
All other investments	20	15
<b>Total</b>	<b>\$ 1,160</b>	<b>\$ 1,233</b>

(a) At December 31, 2017, includes hedge funds of \$351 million and private equity funds of \$595 million. At December 31, 2016, includes hedge funds of \$550 million and private equity funds of \$620 million.

(b) Approximately 47 percent of our hedge fund portfolio is available for redemption in 2018, an additional 53 percent will be available between 2019 and 2021.

(c) Net of accumulated depreciation of \$1 million and \$2 million at December 31, 2017 and 2016, respectively.

### Other Invested Assets Carried at Fair Value

Certain hedge funds, private equity funds and other investment partnerships for which we have elected the fair value option are reported at fair value with changes in fair value recognized in net investment income. Other investments in hedge funds, private equity funds and other investment partnerships in which AIG's insurance operations do not hold aggregate interests sufficient to exercise more than minor influence over the respective partnerships are reported at fair value with changes in fair value recognized as a component of accumulated other comprehensive income. These investments are subject to other-than-temporary impairment evaluations (see discussion below on evaluating equity investments for other-than-temporary impairment).

## THE VARIABLE ANNUITY LIFE INSURANCE COMPANY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The gross unrealized loss recorded in accumulated other comprehensive income on such investments was \$2 million at December 31, 2017, the majority of which pertains to investments in private equity funds and hedge funds that have been in continuous unrealized loss positions for less than 12 months. We did not have any gross unrealized loss recorded in 2016.

### Other Invested Assets – Equity Method Investments

We account for hedge funds, private equity funds and other investment partnerships using the equity method of accounting unless our interest is so minor that we may have virtually no influence over partnership operating and financial policies, or we have elected the fair value option. Under the equity method of accounting, our carrying amount generally is our share of the net asset value of the funds or the partnerships, and changes in our share of the net asset values are recorded in net investment income. In applying the equity method of accounting, we consistently use the most recently available financial information provided by the general partner or manager of each of these investments, which is one to three months prior to the end of our reporting period. The financial statements of these investees are generally audited annually.

### Summarized Financial Information of Equity Method Investees

The following is the aggregated summarized financial information of our equity method investees, including those for which the fair value option has been elected:

<i>(in millions)</i>	Years ended December 31,		
	2017	2016	2015
Operating results:			
Total revenues	\$ 883	\$ 94	\$ 2,067
Total expenses	(220)	(552)	(628)
Net income	\$ 663	\$ (458)	\$ 1,439

  

<i>(in millions)</i>	December 31,	
	2017	2016
Balance sheet:		
Total assets	\$ 8,530	\$ 23,601
Total liabilities	(665)	(2,551)

The following table presents the carrying amount and ownership percentage of equity method investments at December 31, 2017 and 2016:

<i>(in millions, except percentages)</i>	2017		2016	
	Carrying Value	Ownership Percentage	Carrying Value	Ownership Percentage
Equity method investments	\$ 671	Various	\$ 880	Various

Summarized financial information for these equity method investees may be presented on a lag, due to the unavailability of information for the investees at our respective balance sheet dates, and is included for the periods in which we held an equity method ownership interest.

### Other Investments

Also included in other invested assets are real estate held for investment or held for sale, based on management's intent. Real estate held for investment is carried at cost, less accumulated depreciation and subject to impairment review. Properties acquired through foreclosure and held for sale are carried at the lower of carrying amount or fair value less estimated costs to sell the property.

We are a member of the FHLB of Dallas and such membership requires members to own stock in the FHLB. Our FHLB stock is carried at amortized cost, which approximates fair value, and is included in other invested assets.

# THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### Net Investment Income

Net investment income represents income primarily from the following sources:

- Interest income and related expenses, including amortization of premiums and accretion of discounts with changes in the timing and the amount of expected principal and interest cash flows reflected in yield, as applicable.
- Dividend income from common and preferred stock.
- Realized and unrealized gains and losses from investments in other securities and investments for which we elected the fair value option.
- Earnings from alternative investments.
- Interest income on mortgage, policy and other loans.

The following table presents the components of net investment income:

<i>(in millions)</i>	Years Ended December 31,		
	2017	2016	2015
Available for sale fixed maturity securities, including short-term investments	\$ 1,672	\$ 1,664	\$ 1,722
Other fixed maturity securities	179	92	33
Interest on mortgage and other loans	313	312	302
Real estate	(2)	1	12
Alternative investments*	72	39	76
Other investments	3	3	2
Total investment income	2,237	2,111	2,147
Investment expenses	70	66	70
Net investment income	\$ 2,167	\$ 2,045	\$ 2,077

\* Includes income from hedge funds and private equity funds. Hedge funds for which we elected the fair value option are recorded as of the balance sheet date. Other hedge funds are generally reported on a one-month lag, while private equity funds are generally reported on a one-quarter lag.

### Net Realized Capital Gains and Losses

Net realized capital gains and losses are determined by specific identification. The net realized capital gains and losses are generated primarily from the following sources:

- Sales or full redemptions of available for sale fixed maturity securities, available for sale equity securities, real estate and other alternative investments.
- Reductions to the amortized cost basis of available for sale fixed maturity securities, available for sale equity securities and certain other invested assets for other-than-temporary impairments.
- Changes in fair value of derivatives except for those instruments that are designated as hedging instruments when the change in the fair value of the hedged item is not reported in net realized capital gains and losses.
- Exchange gains and losses resulting from foreign currency transactions.

# THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table presents the components of net realized capital gains (losses):

<i>(in millions)</i>	Years Ended December 31,		
	2017	2016	2015
Sales of fixed maturity securities	\$ 46	\$ 3	\$ 3
Sales of equity securities	-	-	1
Mortgage and other loans	3	2	(22)
Investment real estate	6	6	-
Alternative investments	15	43	6
Derivatives	(149)	(41)	192
Other	58	(65)	(44)
Other-than-temporary impairments	(36)	(75)	(62)
Net realized capital income (losses)	\$ (57)	\$ (127)	\$ 74

### Evaluating Investments for Other-Than-Temporary Impairments

#### Fixed Maturity Securities

If we intend to sell a fixed maturity security or it is more likely than not that we will be required to sell a fixed maturity security before recovery of its amortized cost basis and the fair value of the security is below amortized cost, an other-than-temporary impairment has occurred and the amortized cost is written down to current fair value, with a corresponding charge to realized capital losses. When assessing our intent to sell a fixed maturity security, or whether it is more likely than not that we will be required to sell a fixed maturity security before recovery of its amortized cost basis, management evaluates relevant facts and circumstances including, but not limited to, decisions to reposition our investment portfolio, sales of securities to meet cash flow needs and sales of securities to take advantage of favorable pricing.

For fixed maturity securities for which a credit impairment has occurred, the amortized cost is written down to the estimated recoverable value with a corresponding charge to realized capital losses. The estimated recoverable value is the present value of cash flows expected to be collected, as determined by management. The difference between fair value and amortized cost that is not related to a credit impairment is presented in unrealized appreciation (depreciation) of fixed maturity securities on which other-than-temporary credit impairments were recognized (a separate component of accumulated other comprehensive income).

When estimating future cash flows for structured fixed maturity securities (e.g., RMBS, CMBS, CDO, ABS) management considers historical performance of underlying assets and available market information as well as bond-specific structural considerations, such as credit enhancement and priority of payment structure of the security. In addition, the process of estimating future cash flows includes, but is not limited to, the following critical inputs, which vary by asset class:

- Current delinquency rates;
- Expected default rates and the timing of such defaults;
- Loss severity and the timing of any recovery; and
- Expected prepayment speeds.

For corporate, municipal and sovereign fixed maturity securities determined to be credit impaired, management considers the fair value as the recoverable value when available information does not indicate that another value is more relevant or reliable. When management identifies information that supports a recoverable value other than the fair value, the determination of a recoverable value considers scenarios specific to the issuer and the security, and may be based upon estimates of outcomes of corporate restructurings, political and macroeconomic factors, stability and financial strength of the issuer, the value of any secondary sources of repayment and the disposition of assets.

We consider severe price declines in our assessment of potential credit impairments. We may also modify our model inputs when we determine that price movements in certain sectors are indicative of factors not captured by the cash flow models.

## THE VARIABLE ANNUITY LIFE INSURANCE COMPANY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In periods subsequent to the recognition of an other-than-temporary impairment charge for available for sale fixed maturity securities that are not foreign exchange related, we prospectively accrete into earnings the difference between the new amortized cost and the expected undiscounted recoverable value over the remaining expected holding period of the security.

### Credit Impairments

The following table presents a rollforward of the cumulative credit losses in other-than-temporary impairments recognized in earnings for available for sale fixed maturity securities:

<i>(in millions)</i>	Years Ended December 31,		
	2017	2016	2015
Balance, beginning of year	\$ 446	\$ 532	\$ 716
Increases due to:			
Credit impairments on new securities subject to impairment losses	21	37	18
Additional credit impairments on previously impaired securities	8	28	14
Reductions due to:			
Credit impaired securities fully disposed for which there was no prior intent or requirement to sell	(37)	(52)	(106)
Credit impaired securities for which there is a current intent or anticipated requirement to sell	-	-	1
Accretion on securities previously impaired due to credit	(90)	(99)	(111)
Balance, end of year	\$ 348	\$ 446	\$ 532

\* Represents both accretion recognized due to changes in cash flows expected to be collected over the remaining expected term of the credit impaired securities and the accretion due to the passage of time.

### Equity Securities

We evaluate our available for sale equity securities for impairment by considering such securities as candidates for other-than-temporary impairment if they meet any of the following criteria:

- The security has traded at a significant (25 percent or more) discount to cost for an extended period of time (nine consecutive months or longer);
- A discrete credit event has occurred resulting in (i) the issuer defaulting on a material outstanding obligation; (ii) the issuer seeking protection from creditors under the bankruptcy laws or any similar laws intended for court-supervised reorganization of insolvent enterprises; or (iii) the issuer proposing a voluntary reorganization pursuant to which creditors are asked to exchange their claims for cash or securities having a fair value substantially lower than the par value of their claims; or
- We have concluded that we may not realize a full recovery on our investment, regardless of the occurrence of one of the foregoing events.

The determination that an equity security is other-than-temporarily impaired requires the judgment of management and consideration of the fundamental condition of the issuer, its near-term prospects and all the relevant facts and circumstances. In addition to the above criteria, all equity securities that have been in a continuous decline in value below cost over 12 months are impaired. We also consider circumstances of a rapid and severe market valuation decline (50 percent or more) discount to cost, in which we could not reasonably assert that the impairment period would be temporary (severity losses).

### Other Invested Assets

Our equity and cost method investments in private equity funds, hedge funds and other entities are evaluated for impairment similar to the evaluation of equity securities for impairments as discussed above. Such evaluation considers market conditions, events and volatility that may impact the recoverability of the underlying investments within these private equity funds and hedge funds and is based on the nature of the underlying investments and specific inherent risks. Such risks may evolve based on the nature of the underlying investments.

Investments in real estate are periodically evaluated for recoverability whenever changes in circumstances indicate the carrying amount of an asset may be impaired. When impairment indicators are present, we compare expected investment cash flows to carrying amount. When the expected cash flows are less than the carrying amount, the investments are written down to fair value with a corresponding charge to earnings.



## THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### Purchased Credit Impaired (PCI) Securities

We purchase certain RMBS securities that have experienced deterioration in credit quality since their issuance. We determine whether it is probable at acquisition that we will not collect all contractually required payments for these PCI securities, including both principal and interest. At acquisition, the timing and amount of the undiscounted future cash flows expected to be received on each PCI security is determined based on our best estimate using key assumptions, such as interest rates, default rates and prepayment speeds. At acquisition, the difference between the undiscounted expected future cash flows of the PCI securities and the recorded investment in the securities represents the initial accretable yield, which is accreted into Net investment income over their remaining lives on an effective yield basis. Additionally, the difference between the contractually required payments on the PCI securities and the undiscounted expected future cash flows represents the non-accretable difference at acquisition. The accretable yield and the non-accretable difference will change over time, based on actual payments received and changes in estimates of undiscounted expected future cash flows, which are discussed further below.

On a quarterly basis, the undiscounted expected future cash flows associated with PCI securities are re-evaluated based on updates to key assumptions. Declines in undiscounted expected future cash flows due to further credit deterioration as well as changes in the expected timing of the cash flows can result in the recognition of an other-than-temporary impairment charge, as PCI securities are subject to our policy for evaluating investments for other-than-temporary impairment. Changes to undiscounted expected future cash flows due solely to the changes in the contractual benchmark interest rates on variable rate PCI securities will change the accretable yield prospectively. Significant increases in undiscounted expected future cash flows for reasons other than interest rate changes are recognized prospectively as adjustments to the accretable yield.

The following tables present information on our PCI securities, which are included in bonds available for sale:

<i>(in millions)</i>	At Date of Acquisition	
Contractually required payments (principal and interest)	\$	4,119
Cash flows expected to be collected*		3,505
Recorded investment in acquired securities		2,423

\* Represents undiscounted expected cash flows, including both principal and interest

<i>(in millions)</i>	December 31,		
	2017		2016
Outstanding principal balance	\$	1,749	\$ 1,908
Amortized cost		1,331	1,460
Fair value		1,486	1,503

The following table presents activity for the accretable yield on PCI securities:

<i>(in millions)</i>	Years Ended December 31,		
	2017		2016
Balance, beginning of year	\$	812	\$ 689
Newly purchased PCI securities		48	137
Accretion		(84)	(81)
Effect of changes in interest rate indices		(3)	12
Net reclassification from non-accretable difference, including effects of prepayments		90	55
Balance, end of year	\$	863	\$ 812

#### Pledged Investments

##### Secured Financing and Similar Arrangements

We enter into secured financing transactions whereby certain securities are sold under agreements to repurchase (repurchase agreements), in which we transfer securities in exchange for cash, with an agreement by us to repurchase the same or substantially similar securities. Our secured financing transactions also include those that involve the transfer of securities to financial institutions in exchange for cash (securities lending agreements). In all of these secured financing transactions, the securities transferred by us (pledged collateral) may be sold or repledged by the



## THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

counterparties. These agreements are recorded at their contracted amounts plus accrued interest, other than those that are accounted for at fair value.

Pledged collateral levels are monitored daily and are generally maintained at an agreed-upon percentage of the fair value of the amounts borrowed during the life of the transactions. In the event of a decline in the fair value of the pledged collateral under these secured financing transactions, we may be required to transfer cash or additional securities as pledged collateral under these agreements. At the termination of the transactions, we and our counterparties are obligated to return the amounts borrowed and the securities transferred, respectively.

**The following table presents the fair value of securities pledged to counterparties under secured financing transactions, including repurchase and securities lending agreements:**

<i>(in millions)</i>	December 31,	
	2017	2016
Fixed maturity securities available for sale	\$ 254	\$ 238
Other bond securities, at fair value	220	231

Amounts borrowed under repurchase and securities lending agreements totaled \$468 million and \$465 million at December 31, 2017 and 2016, respectively.

**The following table presents the fair value of securities pledged under our repurchase and securities lending agreements by collateral type and by remaining contractual maturity:**

<i>(in millions)</i>	Remaining Contractual Maturity of the Agreements				Total
	Overnight and Continuous	Up to 30 days	31-90 days	Greater Than 90 days	
<b>December 31, 2017</b>					
<b>Repurchase agreements:</b>					
Bonds available for sale:					
Non U.S. government	\$ -	\$ 3	\$ 4	\$ -	7
Corporate debt	-	-	6	-	6
Other bond securities:					
Non-U.S. government	-	-	7	-	7
Corporate debt	-	40	173	-	213
Total repurchase agreements	-	43	190	-	233
<b>Securities lending agreements:</b>					
Bonds available for sale:					
Corporate debt	-	89	152	-	241
Total securities lending agreements	-	89	152	-	241
Total secured financing transactions	\$ -	\$ 132	\$ 342	\$ -	474
<b>December 31, 2016</b>					
<b>Repurchase agreements:</b>					
Other bond securities:					
Non-U.S. government	\$ -	\$ -	\$ -	\$ 7	7
Corporate debt	-	47	106	71	224
Total repurchase agreements	-	47	106	78	231
<b>Securities lending agreements:</b>					
Bonds available for sale:					
Non-U.S. government	-	-	16	-	16
Corporate debt	-	-	217	-	217
CMBS	-	-	5	-	5
Total securities lending agreements	-	-	238	-	238
Total secured financing transactions	\$ -	\$ 47	\$ 344	\$ 78	469

# THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### Insurance – Statutory and Other Deposits

Total carrying values of cash and securities we deposited under requirements of regulatory authorities were \$4 million and \$3 million at December 31, 2017 and 2016, respectively.

### Other Pledges

We are members of the FHLB of Dallas and such membership requires the members to own stock in the FHLB. We owned \$9 million of stock in the FHLB at both December 31, 2017 and 2016. Pursuant to the membership terms, we have elected to pledge such stock to the FHLB. In addition, we had pledged securities with a fair value of \$136 million and \$164 million at December 31, 2017 and 2016, respectively, to provide adequate collateral for potential advances from the FHLB.

## 5. LENDING ACTIVITIES

Mortgage and other loans receivable include commercial mortgages, residential mortgages, life insurance policy loans, commercial loans, and other loans and notes receivable. Commercial mortgages, residential mortgages, commercial loans, and other loans and notes receivable are carried at unpaid principal balances less allowance for credit losses and plus or minus adjustments for the accretion or amortization of discount or premium. Interest income on such loans is accrued as earned.

Direct costs of originating commercial mortgages, commercial loans, and other loans and notes receivable, net of nonrefundable points and fees, are deferred and included in the carrying amount of the related receivables. The amount deferred is amortized to income as an adjustment to earnings using the interest method. Premiums and discounts on purchased residential mortgages are also amortized to income as an adjustment to earnings using the interest method.

Life insurance policy loans are carried at unpaid principal balances. There is no allowance for policy loans because these loans serve to reduce the death benefit paid when the death claim is made and the balances are effectively collateralized by the cash surrender value of the policy.

The following table presents the composition of mortgages and other loans receivable:

<i>(in millions)</i>	December 31,	
	2017	2016
Commercial mortgages	\$ 5,474	\$ 4,712
Residential mortgages	708	535
Life insurance policy loans	653	683
Commercial loans, other loans and notes receivable	59	198
Total mortgage and other loans receivable	6,894	6,128
Allowance for losses	(44)	(45)
Mortgage and other loans receivable, net	\$ 6,850	\$ 6,083

\* Commercial mortgages primarily represent loans for office, apartments and retail, with exposures in New York and California representing the largest geographic concentrations (24 percent and 14 percent, respectively, at December 31, 2017 and 25 percent and 12 percent, respectively, at December 31, 2016).

Nonperforming loans are generally those loans where payment of contractual principal or interest is more than 90 days past due. Nonperforming mortgages were not significant for all periods presented.

# THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table presents the credit quality performance indicators for commercial mortgages:

<i>(dollars in millions)</i>	Number of Loans	Class						Total <sup>(c)</sup>	Percent of Total \$
		Apartments	Offices	Retail	Industrial	Hotel	Others		
<b>December 31, 2017</b>									
<b>Credit Quality Indicator:</b>									
In good standing	253	\$ 1,586	\$ 1,606	\$ 1,315	\$ 237	\$ 530	\$ 181	\$ 5,455	100 %
Restructured <sup>(a)</sup>	2	-	15	4	-	-	-	19	-
Total <sup>(b)</sup>	255	\$ 1,586	\$ 1,621	\$ 1,319	\$ 237	\$ 530	\$ 181	\$ 5,474	100 %
Allowance for losses		\$ 12	\$ 19	\$ 9	\$ 1	\$ 2	\$ 1	\$ 44	1 %
<b>December 31, 2016</b>									
<b>Credit Quality Indicator:</b>									
In good standing	252	\$ 1,197	\$ 1,366	\$ 1,164	\$ 314	\$ 460	\$ 162	\$ 4,663	99 %
Restructured <sup>(a)</sup>	2	-	49	-	-	-	-	49	1
Total <sup>(b)</sup>	254	\$ 1,197	\$ 1,415	\$ 1,164	\$ 314	\$ 460	\$ 162	\$ 4,712	100 %
Allowance for losses		\$ 6	\$ 16	\$ 10	\$ 7	\$ 2	\$ 1	\$ 42	1 %

(a) Loans that have been modified in troubled debt restructurings and are performing according to their restructured terms. See discussion of troubled debt restructurings below.

(b) Does not reflect allowance for credit losses.

(c) Our commercial loan portfolio is current as to payments of principal and interest. There were no significant amounts of nonperforming commercial mortgages (defined as those loans where payment of contractual principal or interest is more than 90 days past due) during any of the periods presented.

### Methodology Used to Estimate the Allowance for Credit Losses

Mortgage and other loans receivable are considered impaired when collection of all amounts due under contractual terms is not probable. Impairment is measured using either i) the present value of expected future cash flows discounted at the loan's effective interest rate, ii) the loan's observable market price, if available, or iii) the fair value of the collateral if the loan is collateral dependent. Impairment of commercial mortgages is typically determined using the fair value of collateral while impairment of other loans is typically determined using the present value of cash flows or the loan's observable market price. An allowance is typically established for the difference between the impaired value of the loan and its current carrying amount. Additional allowance amounts are established for incurred but not specifically identified impairments, based on statistical models primarily driven by past due status, debt service coverage, loan-to-value ratio, property type and location, loan term, profile of the borrower and of the major property tenants, and loan seasoning. When all or a portion of a loan is deemed uncollectible, the uncollectible portion of the carrying amount of the loan is charged off against the allowance.

Interest income is not accrued when payment of contractual principal and interest is not expected. Any cash received on impaired loans is generally recorded as a reduction of the current carrying amount of the loan. Accrual of interest income is generally resumed when delinquent contractual principal and interest is repaid or when a portion of the delinquent contractual payments are made and the ongoing required contractual payments have been made for an appropriate period.

A significant majority of commercial mortgages in the portfolio are non-recourse loans and, accordingly, the only guarantees are for specific items that are exceptions to the non-recourse provisions. It is therefore extremely rare for us to have cause to enforce the provisions of a guarantee on a commercial real estate or mortgage loan.

# THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table presents a rollforward of the changes in the allowance for credit losses on mortgage and other loans receivable:

Years Ended December 31, (in millions)	2017			2016			2015		
	Commercial Mortgages	Other Loans	Total	Commercial Mortgages	Other Loans	Total	Commercial Mortgages	Other Loans	Total
Allowance, beginning of year	\$ 42	\$ 3	\$ 45	\$ 50	\$ 2	\$ 52	\$ 36	\$ -	\$ 36
Additions (reductions) to allowance	8	(3)	5	(3)	1	(2)	19	2	21
Charge-offs, net of recoveries	(6)	-	(6)	(5)	-	(5)	(5)	-	(5)
Allowance, end of year	\$ 44	\$ -	\$ 44	\$ 42	\$ 3	\$ 45	\$ 50	\$ 2	\$ 52

The following table presents information on mortgage loans individually assessed for credit losses:

(in millions)	Years Ended December 31,		
	2017	2016	2015
Impaired loans with valuation allowances	\$ 4	\$ 57	\$ 125
Impaired loans without valuation allowances	15	49	83
Total impaired loans	19	106	208
Valuation allowances on impaired loans	(1)	(8)	(20)
Impaired loans, net	\$ 18	\$ 98	\$ 188
Interest income on impaired loans	\$ 5	\$ 11	\$ 8

### Troubled Debt Restructurings

We modify loans to optimize their returns and improve their collectability, among other things. When we undertake such a modification with a borrower that is experiencing financial difficulty and the modification involves us granting a concession to the troubled debtor, the modification is a troubled debt restructuring (TDR). We assess whether a borrower is experiencing financial difficulty based on a variety of factors, including the borrower's current default on any of its outstanding debt, the probability of a default on any of its debt in the foreseeable future without the modification, the insufficiency of the borrower's forecasted cash flows to service any of its outstanding debt (including both principal and interest), and the borrower's inability to access alternative third-party financing at an interest rate that would be reflective of current market conditions for a non-troubled debtor. Concessions granted may include extended maturity dates, interest rate changes, principal or interest forgiveness, payment deferrals and easing of loan covenants.

For the twelve-month period ended December 31, 2017, loans with a carrying value of \$25 million were modified in troubled debt restructurings. There were no commercial mortgage loans that had been modified in a TDR at December 31, 2016.

### 6. REINSURANCE

We assume reinsurance from other insurance companies. We are also a reinsurer for the guaranteed minimum income benefit (GMIB), guaranteed minimum withdrawal benefit (GMWB) and guaranteed minimum death benefit (GMDB) on certain variable annuities issued in Japan by MetLife Insurance K.K. (formerly American Life Insurance Company, a former subsidiary of AIG Parent). New business under this reinsurance arrangement was no longer accepted after March 31, 2009. We recorded liabilities for the amount of reserves calculated for the GMIB, GMWB and GMDB provisions of this reinsurance arrangement, which totaled \$25 million and \$30 million at December 31, 2017 and 2016, respectively.

### 7. DERIVATIVES AND HEDGE ACCOUNTING

We use derivatives and other financial instruments as part of our financial risk management programs and as part of our investment operations. Interest rate derivatives (such as interest rate swaps) are used to manage interest rate risk associated with embedded derivatives in insurance contract liabilities and with fixed maturity securities, as well as other interest rate sensitive assets and liabilities. Foreign exchange derivatives (principally foreign exchange swaps and forwards) are used to economically mitigate risk associated with non U.S. dollar denominated transactions, primarily investments.

## THE VARIABLE ANNUITY LIFE INSURANCE COMPANY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

We hedge our economic exposure to market risk related to variable annuity products with riders that guarantee a certain level of benefits. Our variable annuity hedging program is designed to offset certain changes in the economic value of these guarantee features, within established thresholds. The hedging program is designed to provide additional protection against large and combined movements in interest rates, equity prices, credit spreads and market volatility under multiple scenarios. In addition to risk-mitigating features in our variable annuity product design, and the use of certain fixed income securities with a fair value option election to manage interest rate and credit spread exposures, our variable annuity hedging program utilizes various derivative instruments, including but not limited to equity options, futures contracts, interest rate swaps and swaption contracts, as well as other hedging instruments. Our exchange-traded index futures contracts have no recorded fair value as they are cash settled daily. In addition to hedging activities, we also enter into derivative instruments as a part of our investment operations, which may include, among other things, purchases of investments with embedded derivatives, such as equity-linked notes and convertible bonds.

Interest rate, currency and equity swaps, swaptions, options and forward transactions are accounted for as derivatives, recorded on a trade-date basis and carried at fair value. Unrealized gains and losses are reflected in income, when appropriate. Aggregate asset or liability positions are netted on the Consolidated Balance Sheets only to the extent permitted by qualifying master netting arrangements in place with each respective counterparty. Cash collateral posted with counterparties in conjunction with transactions supported by qualifying master netting arrangements is reported as a reduction of the corresponding net derivative liability, while cash collateral received in conjunction with transactions supported by qualifying master netting arrangements is reported as a reduction of the corresponding net derivative asset.

We have elected to present all derivative receivables and derivative payables, and the related cash collateral received and paid, on a net basis on our Consolidated Balance Sheets when a legally enforceable International Swaps and Derivative Association, Inc. (ISDA) Master Agreement exists between us and our derivative counterparty. An ISDA Master Agreement is an agreement governing multiple derivative transactions between two counterparties. The ISDA Master Agreement generally provides for the net settlement of all, or a specified group, of these derivative transactions, as well as transferred collateral, through a single payment, and in a single currency, as applicable. The net settlement provisions apply in the event of a default on, or affecting any, one derivative transaction or a termination event affecting all, or a specified group of, derivative transactions governed by the ISDA Master Agreement.

Derivatives, with the exception of embedded derivatives, are measured at fair value and presented within other assets and other liabilities in the Consolidated Balance Sheets. Embedded derivatives are generally presented with the host contract in the Consolidated Balance Sheets. A bifurcated embedded derivative is measured at fair value and accounted for in the same manner as a free standing derivative contract. The corresponding host contract is accounted for according to the accounting guidance applicable for that instrument. See Notes 3 and 11 for additional information on our embedded derivatives, which are primarily related to guarantee features in variable annuity products, and include equity and interest rate components.

We believe our economic hedging instruments have been and remain economically effective, but for the most part they have not been designated as hedges receiving hedge accounting treatment. Changes in the fair value of derivatives not designated as hedges are reported within net realized capital gains and losses. Certain swaps associated with available-for-sale investments have been designated as fair value hedges. Changes in fair value hedges of available-for-sale securities are reported in net realized capital gains (losses) along with changes in the hedged item.

# THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table presents the notional amounts and the fair value of derivative assets and liabilities, excluding embedded derivatives:

<i>(in millions)</i>	December 31, 2017				December 31, 2016			
	Gross Derivative Assets		Gross Derivative Liabilities		Gross Derivative Assets		Gross Derivative Liabilities	
	Notional Amount	Fair Value	Notional Amount	Fair Value	Notional Amount	Fair Value	Notional Amount	Fair Value
<b>Derivatives designated as hedging instruments:<sup>(a)</sup></b>								
Interest rate contracts	\$ -	\$ -	\$ 4	\$ -	\$ -	\$ -	\$ 39	\$ -
Foreign exchange contracts	204	16	608	48	508	56	119	6
<b>Derivatives not designated as hedging instruments:<sup>(a)</sup></b>								
Interest rate contracts	2,974	66	288	31	4,959	122	101	-
Foreign exchange contracts	201	12	529	12	613	40	125	1
Equity contracts	4,423	303	729	67	2,181	28	308	-
<b>Total derivatives, gross</b>	<b>\$ 7,802</b>	<b>397</b>	<b>\$ 2,158</b>	<b>158</b>	<b>\$ 8,261</b>	<b>246</b>	<b>\$ 692</b>	<b>7</b>
Counterparty netting <sup>(b)</sup>		(158)		(158)		(7)		(7)
Cash collateral <sup>(c)</sup>		(235)		-		(191)		-
<b>Total derivatives included in Other Assets and Other Liabilities, respectively<sup>(d)</sup></b>		<b>\$ 4</b>		<b>\$ -</b>		<b>\$ 48</b>		<b>\$ -</b>

(a) Fair value amounts are shown before the effects of counterparty netting adjustments and offsetting cash collateral.

(b) Represents netting of derivative exposures covered by a qualifying master netting agreement.

(c) Represents cash collateral posted and received that is eligible for netting.

(d) Excludes embedded derivatives. Fair value of assets related to bifurcated embedded derivatives was zero at both December 31, 2017 and 2016. Fair value of liabilities related to bifurcated embedded derivatives was \$439 million and \$209 million, respectively, at December 31, 2017 and 2016.

The following table presents the changes in the fair value of derivative instruments and the classification of these changes in the Consolidated Statements of Income:

<i>(in millions)</i>	Years Ended December 31,		
	2017	2016	2015
Derivative instruments in fair value hedging relationships*:			
Foreign exchange contracts	\$ (2)	\$ (11)	\$ 4
Total	\$ (2)	\$ (11)	\$ 4
Derivatives not designated as hedging instruments by derivative type:			
Interest rate contracts	\$ 3	\$ (36)	\$ 66
Foreign exchange contracts	(53)	64	48
Equity contracts	(56)	(97)	(28)
Embedded derivatives	(41)	39	102
Total	\$ (147)	\$ (30)	\$ 188
By classification:			
Net realized capital gains (losses)	\$ (149)	\$ (41)	\$ 192
Total	\$ (149)	\$ (41)	\$ 192

\* The amounts presented do not include periodic net coupon settlements of derivative contract or coupon income (expense) related to the hedged item.

# THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### 8. DEFERRED POLICY ACQUISITION COSTS AND DEFERRED SALES INDUCEMENTS

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#### Deferred Policy Acquisition Costs

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Deferred policy acquisition costs (DAC) represent those costs that are incremental and directly related to the successful acquisition of new or renewal of existing insurance contracts. We defer incremental costs that result directly from, and are essential to, the acquisition or renewal of an insurance contract. Such deferred policy acquisition costs generally include agent or broker commissions and bonuses, and medical and inspection fees that would not have been incurred if the insurance contract had not been acquired or renewed. Each cost is analyzed to assess whether it is fully deferrable. We partially defer costs, including certain commissions, when we do not believe that the entire cost is directly related to the acquisition or renewal of insurance contracts.

We also defer a portion of employee total compensation and payroll-related fringe benefits directly related to time spent performing specific acquisition or renewal activities, including costs associated with the time spent on underwriting, policy issuance and processing, and sales force contract selling. The amounts deferred are derived based on successful efforts for each distribution channel and/or cost center from which the cost originates.

**Long-duration insurance contracts:** Policy acquisition costs for life-contingent products are generally deferred and amortized, with interest, over the premium paying period. The assumptions used to calculate the benefit liabilities and DAC for these traditional products are set when a policy is issued and do not change with changes in actual experience, unless a loss recognition event occurs. These “locked-in” assumptions include mortality, morbidity, persistency, maintenance expenses and investment returns, and include margins for adverse deviation to reflect uncertainty given that actual experience might deviate from these assumptions. A loss recognition event occurs when there is a shortfall between the carrying amount of future policy benefit liabilities, net of DAC, and what the future policy benefit liabilities, net of DAC, would be when applying updated current assumptions. When we determine a loss recognition event has occurred, we first reduce any DAC related to that block of business through amortization of acquisition expense, and after DAC is depleted, we record additional liabilities through a charge to policyholder benefits. Groupings for loss recognition testing are consistent with our manner of acquiring, servicing and measuring the profitability of the business and applied by product groupings. Once loss recognition has been recorded for a block of business, the old assumption set is replaced and the assumption set used for the loss recognition would then be subject to the lock-in principle.

**Investment-oriented contracts:** Policy acquisition costs and policy issuance costs related to universal life and investment-type products (collectively, investment-oriented products) are deferred and amortized, with interest, in relation to the incidence of estimated gross profits to be realized over the estimated lives of the contracts. Estimated gross profits include net investment income and spreads, net realized capital gains and losses, fees, surrender charges, expenses, and mortality gains and losses. In each reporting period, current period amortization expense is adjusted to reflect actual gross profits. If estimated gross profits change significantly, DAC is recalculated using the new assumptions, and any resulting adjustment is included in income. If the new assumptions indicate that future estimated gross profits are higher than previously estimated, DAC will be increased resulting in a decrease in amortization expense and increase in income in the current period; if future estimated gross profits are lower than previously estimated, DAC will be decreased resulting in an increase in amortization expense and decrease in income in the current period. Updating such assumptions may result in acceleration of amortization in some products and deceleration of amortization in other products. DAC is grouped consistent with the manner in which the insurance contracts are acquired, serviced and measured for profitability and is reviewed for recoverability based on the current and projected future profitability of the underlying insurance contracts.

To estimate future estimated gross profits for variable annuity products, a long-term annual asset growth assumption is applied to determine the future growth in assets and related asset-based fees. In determining the asset growth rate, the effect of short-term fluctuations in the equity markets is partially mitigated through the use of a “reversion to the mean” methodology whereby short-term asset growth above or below long-term annual rate assumptions impacts the growth assumption applied to the five-year period subsequent to the current balance sheet date. The reversion to the mean methodology allows us to maintain our long-term growth assumptions, while also giving consideration to the effect of actual investment performance. When actual performance significantly deviates from the annual long-term growth



## THE VARIABLE ANNUITY LIFE INSURANCE COMPANY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

assumption, as evidenced by growth assumptions in the five-year reversion to the mean period falling below a certain rate (floor) or above a certain rate (cap) for a sustained period, judgment may be applied to revise or “unlock” the growth rate assumptions to be used for both the five-year reversion to the mean period as well as the long-term annual growth assumption applied to subsequent periods.

**Shadow DAC and Shadow Loss Recognition:** DAC related to investment-oriented products is also adjusted to reflect the effect of unrealized gains or losses on fixed maturity and equity securities available for sale on estimated gross profits, with related changes recognized through other comprehensive income (shadow DAC). The adjustment is made at each balance sheet date, as if the securities had been sold at their stated aggregate fair value and the proceeds reinvested at current yields. Similarly, for long-duration traditional insurance contracts, if the assets supporting the liabilities are in a net unrealized gain position at the balance sheet date, loss recognition testing assumptions are updated to exclude such gains from future cash flows by reflecting the impact of reinvestment rates on future yields. If a future loss is anticipated under this basis, any additional shortfall indicated by loss recognition tests is recognized as a reduction in accumulated other comprehensive income (shadow loss recognition). Similar to other loss recognition on long-duration insurance contracts, such shortfall is first reflected as a reduction in DAC and secondly as an increase in liabilities for future policy benefits. The change in these adjustments, net of tax, is included with the change in net unrealized appreciation of investments that is credited or charged directly to other comprehensive income.

**Internal Replacements of Long-duration and Investment-oriented Products:** For some products, policyholders can elect to modify product benefits, features, rights or coverages by exchanging a contract for a new contract or by amendment, endorsement, or rider to a contract, or by the election of a feature or coverage within a contract. These transactions are known as internal replacements. If the modification does not substantially change the contract, we do not change the accounting and amortization of existing DAC and related actuarial balances. If an internal replacement represents a substantial change, the original contract is considered to be extinguished and any related DAC or other policy balances are charged or credited to income, and any new deferrable costs associated with the replacement contract are deferred.

The following table presents a rollforward of DAC:

<i>(in millions)</i>	Years Ended December 31,		
	2017	2016	2015
Balance, beginning of year	\$ 955	\$ 964	\$ 800
Acquisition costs deferred	80	80	78
Accretion of interest/amortization	(96)	(105)	(91)
Effect of unlocking assumptions used in estimating future gross profits	11	(43)	41
Effect of realized gains/loss on securities	(5)	13	30
Effect of unrealized gains/loss on securities	(57)	45	106
Increase due to foreign exchange	-	1	-
Balance, end of year	\$ 888	\$ 955	\$ 964

### Deferred Sales Inducements

We offer sales inducements, which include enhanced crediting rates or bonus payments to contract holders (bonus interest) on certain annuity and investment contract products. Sales inducements provided to the contract holder are recognized in policyholder contract deposits in the Consolidated Balance Sheets. Such amounts are deferred and amortized over the life of the contract using the same methodology and assumptions used to amortize DAC. To qualify for such accounting treatment, the bonus interest must be explicitly identified in the contract at inception. We must also demonstrate that such amounts are incremental to amounts we credit on similar contracts without bonus interest, and are higher than the contract’s expected ongoing crediting rates for periods after the bonus period. The amortization expense associated with these assets is reported within interest credited to policyholder account balances in the Consolidated Statements of Income.

# THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table presents a rollforward of deferred sales inducements:

<i>(in millions)</i>	Years Ended December 31,		
	2017	2016	2015
Balance, beginning of year	\$ 196	\$ 195	\$ 162
Acquisition costs deferred	14	14	14
Accretion of interest/amortization	(19)	(23)	(17)
Effect of unlocking assumptions used in estimating future gross profits	2	(4)	8
Effect of realized gains/loss on securities	-	4	6
Effect of unrealized gains/loss on securities	(13)	10	22
Balance, end of year	\$ 180	\$ 196	\$ 195

The asset management operations defer distribution costs that are directly related to the sale of mutual funds that have a 12b-1 distribution plan and/or contingent deferred sales charge feature (collectively, Distribution Fee Revenue). We amortize these deferred distribution costs on a straight-line basis, adjusted for redemptions, over a period ranging from one year to eight years depending on share class. Amortization of these deferred distribution costs is increased if at any reporting period the value of the deferred amount exceeds the projected Distribution Fee Revenue. The projected Distribution Fee Revenue is impacted by estimated future withdrawal rates and the rates of market return. Management uses historical activity to estimate future withdrawal rates and average annual performance of the equity markets to estimate the rates of market return.

### 9. 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 relating to the entity's operations through voting rights or do not substantively participate in the gains and losses of the entity. Consolidation of a VIE by its primary beneficiary is not based on majority voting interest, but is based on other criteria discussed below.

We enter into various arrangements with VIEs in the normal course of business and consolidate the VIEs when we determine we are the primary beneficiary. This analysis includes a review of the VIE's capital structure, related contractual relationships and terms, nature of the VIE's operations and purpose, nature of the VIE's interests issued and our involvement with the entity. When assessing the need to consolidate a VIE, we evaluate the design of the VIE as well as the related risks the entity was designed to expose the variable interest holders to.

The primary beneficiary is the entity that has both (1) the power to direct the activities of the VIE that most significantly affect the entity's economic performance and (2) the obligation to absorb losses or the right to receive benefits that could be potentially significant to the VIE. While also considering these factors, the consolidation conclusion depends on the breadth of our decision-making ability and our ability to influence activities that significantly affect the economic performance of the VIE.

# THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table presents the total assets and total liabilities associated with our variable interests in consolidated VIEs, as classified in the Consolidated Balance Sheets:

<i>(in millions)</i>	Securitization Vehicles <sup>(a)</sup>	
<b>December 31, 2017</b>		
Assets:		
Bonds available for sale	\$	2,241
Other bond securities		374
Mortgage and other loans receivable		114
Other <sup>(b)</sup>		467
<b>Total assets<sup>(c)</sup></b>	<b>\$</b>	<b>3,196</b>
Liabilities:		
Notes payable - to affiliates	\$	241
Notes payable - to third parties		50
Other <sup>(d)</sup>		41
<b>Total liabilities</b>	<b>\$</b>	<b>332</b>
<b>December 31, 2016</b>		
Assets:		
Bonds available for sale	\$	2,913
Other bond securities		365
Mortgage and other loans receivable		198
Other <sup>(b)</sup>		350
<b>Total assets<sup>(c)</sup></b>	<b>\$</b>	<b>3,826</b>
Liabilities:		
Notes payable - to affiliates	\$	183
Notes payable - to third parties		50
Other <sup>(d)</sup>		6
<b>Total liabilities</b>	<b>\$</b>	<b>239</b>

(a) At December 31, 2017 and 2016, \$2.8 billion and \$3.4 billion, respectively, of the total assets of consolidated vehicles were owed to VALIC Parent or its subsidiaries

(b) Comprised primarily of short-term investments and other assets at both December 31, 2017 and 2016.

(c) The assets of each VIE can be used only to settle specific obligations of that VIE.

(d) Comprised primarily of amounts due to related parties and other liabilities, at fair value, at both December 31, 2017 and 2016.

We calculate our maximum exposure to loss to be (i) the amount invested in the debt or equity of the VIE, (ii) the notional amount of VIE assets or liabilities where we have also provided credit protection to the VIE with the VIE as the referenced obligation, and (iii) other commitments and guarantees to the VIE. Interest holders in VIEs sponsored by us generally have recourse only to the assets and cash flows of the VIEs and do not have recourse to us, except in limited circumstances when we have provided a guarantee to the VIE's interest holders.

The following table presents total assets of unconsolidated VIEs in which we hold a variable interest, as well as our maximum exposure to loss associated with these VIEs:

<i>(in millions)</i>	Total VIE Assets	Maximum Exposure to Loss		Total
		On-Balance Sheet <sup>(a)</sup>	Off-Balance Sheet	
<b>December 31, 2017</b>				
Real estate and investment entities <sup>(b)</sup>	\$ 85,455	\$ 671	\$ 110	\$ 781
Securitization vehicles	3,445	675	-	675
<b>Total</b>	<b>\$ 88,900</b>	<b>\$ 1,346</b>	<b>\$ 110</b>	<b>\$ 1,456</b>
<b>December 31, 2016</b>				
Real estate and investment entities <sup>(b)</sup>	\$ 87,089	\$ 977	\$ 133	\$ 1,110
Securitization vehicles	2,114	530	-	530
<b>Total</b>	<b>\$ 89,203</b>	<b>\$ 1,507</b>	<b>\$ 133</b>	<b>\$ 1,640</b>

(a) At December 31, 2017 and 2016, \$671 million and \$977 million, respectively, of our total unconsolidated VIE assets were recorded as other invested assets and \$675 million and \$530 million, respectively, were recorded as bonds available for sale.

(b) Comprised primarily of hedge funds and private equity funds.

# THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### Real Estate and Investment Entities

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Through an affiliate, AIG Global Real Estate, we are an investor in various real estate investment entities, some of which are VIEs. These investments are typically with unaffiliated third-party developers via a partnership or limited liability company structure. The VIEs' activities consist of the development or redevelopment of commercial, industrial and residential real estate. Our involvement varies from being a passive equity investor or finance provider.

We participate as passive investors in the equity issued by certain third-party-managed hedge and private equity funds that are VIEs. Typically, we are not involved in the design or establishment of these VIEs, nor do they actively participate in the management of the VIEs.

### Securitization Vehicles

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We created certain VIEs that hold investments, primarily in investment-grade debt securities, residential mortgage loans and commercial mortgage loans, and issued beneficial interests in these investments. We own the majority of these beneficial interests and we maintain the power to direct the activities of the VIEs that most significantly impact their economic performance and bear the obligation to absorb losses or receive benefits from the entities that could potentially be significant to the entities. Accordingly, we consolidate these entities, and beneficial interests issued to third-parties or affiliates by these entities are reported as notes payable. For certain VIEs where we participate as passive investors and determined that we are not the primary beneficiary of these entities, our maximum exposure is limited to our investments in securities issued by these VIEs.

### RMBS, CMBS, Other ABS and CDOs

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We are passive investors in RMBS, CMBS, other ABS and CDOs, the majority of which are issued by domestic special purpose entities. We generally do not sponsor or transfer assets to, or act as the servicer to these asset-backed structures, and were not involved in the design of these entities.

Our maximum exposure in these types of structures is limited to our investment in securities issued by these entities. Based on the nature of our investments and our passive involvement in these types of structures, we have determined that we are not the primary beneficiary of these entities. We have not included these entities in the tables above; however, the fair values of our investments in these structures are reported in Note 3 and Note 4.

## 10. INSURANCE LIABILITIES

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### Future Policy Benefits

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Future policy benefits primarily include reserves for life-contingent annuity payout contracts and are based on estimates of cost of future policy benefits. Included in future policy benefits are liabilities for annuities issued in structured settlement arrangements whereby a claimant has agreed to settle a general insurance claim in exchange for fixed payments over a fixed determinable period of time with a life contingency feature. In addition, reserves for contracts in loss recognition are adjusted to reflect the effect of unrealized gains on fixed maturity and equity securities available for sale, with related changes recognized through Other comprehensive income.

### Policyholder Contract Deposits

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The liability for policyholder contract deposits is primarily recorded at accumulated value (deposits received and net transfers from separate accounts, plus accrued interest credited at rates ranging from 1.0 percent to 9.0 percent at December 31, 2017, less withdrawals and assessed fees). Deposits collected on investment-oriented products are not reflected as revenues, because they are recorded directly to policyholder contract deposits upon receipt. Amounts assessed against the contract holders for mortality, administrative, and other services are included in revenues.

In addition to liabilities for fixed annuities, fixed options within variable annuities and annuities without life contingencies, policyholder contract deposits also include our liability for (a) certain guaranteed benefits and indexed features

## THE VARIABLE ANNUITY LIFE INSURANCE COMPANY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

accounted for as embedded derivatives at fair value and (b) annuities issued in a structured settlement arrangement with no life contingency. See Note 3 for discussion of the fair value measurement of embedded policy derivatives and Note 11 for additional discussions of guaranteed benefits accounted for as embedded derivatives.

### 11. VARIABLE ANNUITY CONTRACTS

We report variable contracts within the separate accounts when investment income and investment gains and losses accrue directly to, and investment risk is borne by, the contract holder and the separate account meets additional accounting criteria to qualify for separate account treatment. The assets supporting the variable portion of variable annuity contract that qualifies 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.

Policy values for variable products and investment contracts are expressed in terms of investment units. Each unit is linked to an asset portfolio. The value of a unit increases or decreases based on the value of the linked asset portfolio. The current liability at any time is the sum of the current unit value of all investment units in the separate accounts, plus any liabilities for guaranteed minimum death benefits or guaranteed minimum withdrawal benefits included in future policy benefits or policyholder contract deposits, respectively.

Amounts assessed against the contract holders for mortality, administrative, and other services are included in revenue. Net investment income, net investment gains and losses, changes in fair value of assets, and policyholder account deposits and withdrawals related to separate accounts are excluded from the Consolidated Statements of Income, Comprehensive Income (Loss) and Cash Flows.

Variable annuity contracts may include certain contractually guaranteed benefits to the contract holder. These guaranteed features include guaranteed minimum death benefits (GMDB) that are payable in the event of death, and living benefits that are payable in the event of annuitization, or, in other instances, at specified dates during the accumulation period. Living benefits primarily include guaranteed minimum withdrawal benefits (GMWB). A variable annuity contract may include more than one type of guaranteed benefit feature; for example, it may have both a GMDB and a GMWB. However, a policyholder can only receive payout from one guaranteed feature on a contract containing a death benefit and a living benefit, because the features are mutually exclusive, so the exposure to the guaranteed amount for each feature is independent of the exposure from other features (except a surviving spouse who has a rider to potentially collect both a GMDB upon their spouse's death and a GMWB during their lifetime). A policyholder cannot purchase more than one living benefit on one contract. The net amount at risk for each feature is calculated irrespective of the existence of other features, and as a result, the net amount at risk for each feature is not additive to that of other features.

In addition, we record liabilities for assumed reinsurance of certain GMDB and GMWB features in variable annuity contracts issued by another insurer, under coinsurance and modified coinsurance agreements. Amounts related to guaranteed benefits shown below exclude such assumed reinsurance. See Note 6 for additional information on assumed reinsurance.

**Account balances of variable annuity contracts with guarantees were invested in separate account investment options as follows:**

<i>(in millions)</i>	December 31,	
	2017	2016
Equity funds	\$ 27,385	\$ 24,206
Bond funds	3,412	3,174
Balanced funds	4,948	4,435
Money market funds	423	459
Total	\$ 36,168	\$ 32,274

## THE VARIABLE ANNUITY LIFE INSURANCE COMPANY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### GMDB

Depending on the contract, the GMDB feature may provide a death benefit of either (a) total deposits made to the contract less any partial withdrawals plus a minimum return (and in rare instances, no minimum return) or (b) the highest contract value attained, typically on any anniversary date minus any subsequent withdrawals following the contract anniversary. GMDB is our most widely offered benefit.

The liability for GMDB, which are recorded in future policyholder benefits, represent the expected value of benefits in excess of the projected account value, with the excess recognized ratably over the accumulation period based on total expected assessments, through policyholder benefits. The net amount at risk for GMDB represents the amount of benefits in excess of account value if death claims were filed on all contracts on the balance sheet date.

The following table presents the details concerning our GMDB exposures, excluding assumed reinsurance:

	December 31,	
	2017	2016
	Net Deposits Plus a Minimum Return	Net Deposits Plus a Minimum Return
<i>(dollars in millions)</i>		
Account value	\$ 61,061	\$ 56,946
Net amount at risk	379	471
Average attained age of contract holders	61	61
Range of guaranteed minimum return rates	0%-3%	0% - 3%

The following table presents a rollforward of the GMDB liability related to variable annuity contracts:

	Years Ended December 31,		
	2017	2016	2015
<i>(in millions)</i>			
Balance, beginning of year	\$ 19	\$ 17	\$ 17
Reserve increase	8	2	2
Benefits paid	-	-	(2)
Balance, end of year	\$ 27	\$ 19	\$ 17

Assumptions used to determine the GMDB liability include interest rates, which vary by year of issuance and products; mortality rates, which are based upon actual experience modified to allow for variations in policy form; lapse rates, which are based upon actual experience modified to allow for variations in policy form; investment returns, using assumptions from a randomly generated model; and asset growth assumptions, which include a reversion to the mean methodology, similar to that applied for DAC.

We regularly evaluate estimates used to determine the GMDB liability and adjust the liability balance, with a related charge or credit to policyholder benefits, if actual experience or other evidence suggests that earlier assumptions should be revised.

### GMWB

Guaranteed benefit and equity index features, which are recorded in policyholder contract deposits, are bifurcated from the host contract and accounted for separately as embedded policy derivatives at fair value, with changes in fair value recognized in net realized capital gains (losses). These include GMWB and index annuities, which offer a guaranteed minimum interest rate plus a contingent return based on some internal or external equity index.

Certain of our variable annuity contracts contain optional GMWB benefits. With a GMWB, the contract holder can monetize the excess of the guaranteed amount over the account value of the contract only through a series of withdrawals that do not exceed a specific percentage per year of the guaranteed amount. If, after the series of withdrawals, the account value is exhausted, the contract holder will receive a series of annuity payments equal to the remaining guaranteed amount, and, for lifetime GMWB products, the annuity payments continue as long as the covered person(s) is living.

## THE VARIABLE ANNUITY LIFE INSURANCE COMPANY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The fair value of these embedded policy derivatives was a net liability of \$186 million and \$165 million at December 31, 2017 and 2016, respectively. We had account values subject to GMWB that totaled \$3.3 billion and \$3.2 billion at December 31, 2017 and 2016, respectively. The net amount at risk for GMWB represents the present value of minimum guaranteed withdrawal payments, in accordance with contract terms, in excess of account value, assuming no lapses. The net amount at risk related to the GMWB guarantees was \$45 million and \$112 million at December 31, 2017 and 2016, respectively. We use derivative instruments and other financial instruments to mitigate a portion of our exposure that arises from GMWB benefits.

### 12. DEBT

Notes payable are carried at the principal amount borrowed, including unamortized discounts, except for certain notes payable – to affiliates, for which we have elected the fair value option. The change in fair value of notes for which the fair value option has been elected is recorded in other income in the Consolidated Statements of Income. See Note 3 for discussion of fair value measurements.

The following table lists our total debt outstanding. The interest rates presented in the following table are the range of contractual rates in effect at December 31, 2017, including fixed and variable-rates:

<i>(in millions)</i>	Range of Interest Rate(s)	Maturity Date(s)	Balance at December 31,	
			2017	2016
Notes payable - to affiliates:				
Notes payable of consolidated VIEs, at fair value	10.60%-12.44%	2060	\$ 241	\$ 183
Total notes payable - to affiliates			241	183
Notes payable - to third parties:				
Notes payable of consolidated VIEs	4.22%-4.42%	2060	50	50
Debt of consolidated investments	LIBOR + 2.15%	2024	90	-
Total notes payable - to third parties			140	50
Total notes payable			\$ 381	\$ 233

The following table presents maturities of long-term debt, including fair value adjustments, when applicable:

<i>(in millions)</i>	Total	Year Ending					
		2018	2019	2020	2021	2022	Thereafter
December 31, 2017							
Notes payable - to affiliates:							
Notes payable of consolidated VIEs, at fair value	\$ 241	\$ -	\$ -	\$ -	\$ -	\$ -	241
Total notes payable - to affiliates	241	-	-	-	-	-	241
Notes payable - to third parties:							
Notes payable of consolidated VIEs	50	-	-	-	-	-	50
Debt of consolidated investments	90	3	3	3	3	3	75
Total notes payable - to third parties	140	3	3	3	3	3	125
Total notes payable	\$ 381	\$ 3	\$ 3	\$ 3	\$ 3	\$ 3	\$ 366

### FHLB Borrowings

Membership with the FHLB provides us with collateralized borrowing opportunities, primarily as an additional source of contingent liquidity, or for other uses deemed appropriate by management. The purpose of our FHLB Advance Facility operational plan is to effectively utilize the FHLB facility to manage short-term cash management and/or liquidity needs. Pursuant to the plan, we may periodically obtain cash advances on a same-day basis, up to an internally approved limit. To provide adequate collateral for potential advances under the Advance Facility, we pledge securities to the FHLB. The fair value of all collateral pledged to secure advances from the FHLB included the value of our pledged FHLB common stock. Upon any event of default, the FHLB's recovery would generally be limited to the amount of our liability under advances borrowed.



# THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### Intercompany Loan Facility

On January 1, 2015, we and certain of our affiliates entered into a revolving loan facility with AIG Parent, pursuant to which we and each such affiliate can, on a several basis, borrow monies from AIG Parent (as lender) subject to the terms and conditions stated therein. Principal amounts borrowed under this facility may be repaid and re-borrowed, in whole or in part, from time to time, without penalty. However, the total aggregate amount of loans borrowed by all borrowers under the facility cannot exceed \$500 million. The loan facility also sets forth individual borrowing limits for each borrower, with our maximum borrowing limit being \$500 million.

At December 31, 2017 and 2016, we had no outstanding balance under this facility.

### 13. COMMITMENTS AND CONTINGENCIES

#### Commitments

##### Leases

We occupy leased space in many locations under various long-term leases, and have entered into various leases covering long-term use of data processing equipment.

The following table presents the future minimum lease payments under operating leases at December 31, 2017:

<i>(in thousands)</i>	
2018	\$ 2,942
2019	2,777
2020	2,490
2021	1,441
2022	933
Remaining years after 2022	687
Total	\$ 11,270

##### Commitments to Fund Partnership Investments

In the normal course of business, we enter into commitments to invest in limited partnerships, private equity funds and hedge funds. These commitments totaled \$241 million at December 31, 2017.

##### Mortgage Loan Commitments

We have \$166 million and \$110 million in commitments related to commercial and residential mortgage loans, respectively, at December 31, 2017.

#### Contingencies

##### Legal Matters

Various lawsuits against us have arisen in the ordinary course of business. Except as discussed below, we believe it is unlikely that contingent liabilities arising from litigation, income taxes and other matters will have a material adverse effect on our financial position, results of operations or cash flows.

At December 31, 2017, the Company was defending an appeal in respect of a lawsuit filed in the Circuit Court of Kanawha County, West Virginia on November 12, 2009 by The West Virginia Investment Management Board and The West Virginia Consolidated Public Retirement Board (the "WV Boards"). The litigation concerns a contractual dispute

## THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

regarding whether the WV Boards were entitled in 2008 to the immediate and complete withdrawal of funds invested in an annuity product issued by VALIC. The WV Boards asserted damages in excess of \$100,000,000. In 2016, the parties stipulated to resolve the matter through final and non-appealable arbitration before an arbitration panel composed of three West Virginia Business Court judges. The panel issued its decision on April 28, 2017, and no recovery was awarded to the WV Boards. Thereafter, the claims against VALIC were dismissed and the Company's accrual for this contingent liability was reversed. In May 2017, notwithstanding the parties' stipulation that the arbitral decision would be final and non-appealable, the WV Boards appealed the arbitration decision to the West Virginia Supreme Court of Appeals. The appeal remains pending.

#### Regulatory Matters

All fifty states and the District of Columbia have laws requiring solvent life insurance companies, through participation in guaranty associations, to pay assessments to protect the interests of policyholders of insolvent life insurance companies. These state insurance guaranty associations generally levy assessments, up to prescribed limits, on member insurers in a particular state based on the proportionate share of the premiums written by member insurers in the lines of business in which the impaired, insolvent or failed insurer is engaged. Such assessments are used to pay certain contractual insurance benefits owed pursuant to insurance policies issued by impaired, insolvent or failed insurers. Some states permit member insurers to recover assessments paid through full or partial premium tax offsets. We accrue liabilities for guaranty fund assessments (GFA) when an assessment is probable and can be reasonably estimated. We estimate the liability using the latest information available from the National Organization of Life and Health Insurance Guaranty Associations. While we cannot predict the amount and timing of any future GFA, we have established reserves we believe are adequate for assessments relating to insurance companies that are currently subject to insolvency proceedings. Our liability for these guaranty fund assessments was \$5 million at December 31, for both 2017 and 2016, net of amounts recoverable through premium tax offsets.

Various federal, state and other regulatory agencies may from time to time review, examine or inquire into our operations, practices and procedures, such as through financial examinations, subpoenas, market conduct exams or regulatory inquiries. Based on the current status of pending regulatory examinations and inquiries involving us, we believe it is not likely that these regulatory examinations or inquiries will have a material adverse effect on our consolidated financial position, results of operations or cash flows.

## 14. EQUITY

#### Accumulated Other Comprehensive Income

The following table presents the components of accumulated other comprehensive income:

<i>(in millions)</i>	December 31,	
	2017	2016
Unrealized appreciation of fixed maturity and equity securities, available for sale	\$ 1,325	\$ 934
Net unrealized gains on other invested assets	160	172
Adjustments to DAC and deferred sales inducements	(121)	(51)
Shadow loss recognition	(41)	(26)
Foreign currency translation adjustments	(6)	(7)
Deferred income tax	(109)	(150)
Accumulated other comprehensive income	\$ 1,208	\$ 872

# THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table presents the other comprehensive income (loss) reclassification adjustments:

<i>(in millions)</i>	Unrealized Appreciation (Depreciation) of Fixed Maturity Investments on Which Other- Than- Temporary Credit Impairments were Recognized	Unrealized Appreciation (Depreciation) of All Other Investments	Adjustments to DAC and Deferred Sales Inducements	Unrealized Insurance Loss Recognition	Foreign Currency Translation Adjustments	Total
<b>Year ended December 31, 2015</b>						
Unrealized change arising during period	\$ (12)	\$ (1,214)	\$ 164	\$ 84	\$ (2)	(980)
Less: Reclassification adjustments included in net income	65	21	36	-	-	122
Total other comprehensive income (loss), before income tax expense (benefit)	(77)	(1,235)	128	84	(2)	(1,102)
Less: Income tax expense (benefit)	(28)	(297)	46	30	(1)	(250)
Total other comprehensive income (loss), net of income tax expense (benefit)	\$ (49)	\$ (938)	\$ 82	\$ 54	\$ (1)	(852)
<b>Year ended December 31, 2016</b>						
Unrealized change arising during period	\$ (29)	\$ (39)	\$ 72	\$ (26)	\$ 1	(21)
Less: Reclassification adjustments included in net income	16	(13)	17	-	-	20
Total other comprehensive income (loss), before income tax expense (benefit)	(45)	(26)	55	(26)	1	(41)
Less: Income tax expense (benefit)	(16)	(2)	21	(9)	1	(5)
Total other comprehensive income (loss), net of income tax expense (benefit)	\$ (29)	\$ (24)	\$ 34	\$ (17)	\$ -	(36)
<b>Year ended December 31, 2017</b>						
Unrealized change arising during period	\$ 81	\$ 269	\$ (75)	\$ (15)	\$ 1	261
Less: Reclassification adjustments included in net income	8	(37)	(5)	-	-	(34)
Total other comprehensive income (loss), before income tax expense (benefit)	73	306	(70)	(15)	1	295
Less: Income tax expense (benefit)	26	22	(16)	(15)	1	18
Total other comprehensive income (loss), net of income tax expense (benefit)	\$ 47	\$ 284	\$ (54)	\$ -	\$ -	277

The following table presents the effect of the reclassification of significant items out of accumulated other comprehensive income on the respective line items in the Consolidated Statements of Income:

<i>(in millions)</i>	Amount Reclassified from Accumulated Other Comprehensive Income			Affected Line Item in the Statements of Income
	December 31,			
	2017	2016	2015	
Unrealized appreciation of fixed maturity investments on which other-than-temporary credit impairments were recognized	\$ 8	\$ 16	\$ 65	Net realized capital gains (losses)
Unrealized (depreciation) of all other investments	(37)	(13)	21	Net realized capital gains (losses)
Adjustments to DAC and deferred sales inducements	(5)	17	36	Amortization of deferred policy acquisition costs
Total reclassifications for the period	\$ (34)	\$ 20	\$ 122	

# THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### 15. STATUTORY FINANCIAL DATA AND RESTRICTIONS

The following table presents our statutory net income and capital and surplus:

<i>(in millions)</i>	<b>2017</b>		2016		2015	
<b>Years Ended December 31,</b>						
Statutory net income	\$	<b>640</b>	\$	758	\$	757
<b>At December 31,</b>						
Statutory capital and surplus	\$	<b>2,800</b>	\$	2,388		
Aggregate minimum required statutory capital and surplus	<b>656</b>		662			

We file financial statements prepared in accordance with statutory accounting practices prescribed or permitted by state insurance regulatory authorities. The principal differences between statutory financial statements and financial statements prepared in accordance with U.S. GAAP are that statutory financial statements do not reflect DAC, some bond portfolios may be carried at amortized cost, investment impairments are determined in accordance with statutory accounting practices, assets and liabilities are presented net of reinsurance, policyholder liabilities are generally valued using more conservative assumptions and certain assets are non-admitted. In addition, state insurance regulatory authorities have the right to permit specific practices that deviate from prescribed statutory practices.

The aggregate minimum required statutory capital and surplus is based on the greater of the Risk-based Capital (RBC) level that would trigger regulatory action or minimum requirements per state insurance regulation. At both December 31, 2017 and 2016, we exceeded the minimum required statutory capital and surplus requirements and all RBC minimum required levels.

In 2017, we adopted a permitted statutory accounting practice to report certain derivatives used to hedge interest rate risk on product-related embedded derivatives at amortized cost instead of fair value. The initial adoption of the permitted practice resulted in a decrease in our statutory surplus of \$23 million at December 31, 2017. Other than the adoption of this permitted practice, the use of prescribed or permitted statutory accounting practices did not result in reported statutory surplus or risk-based capital that was significantly different from the statutory surplus or risk-based capital that would have been reported had NAIC statutory accounting practices or the prescribed regulatory accounting practices been followed in all respects.

#### Dividend Restrictions

Dividends that we may pay to the Parent in any year without prior approval of the Texas Department of Insurance (TDI) are limited by statute. The maximum amount of dividends in a twelve-month period, measured retrospectively from the date of payment, which can be paid over a rolling twelve-month period to shareholders of Texas domiciled insurance companies without obtaining the prior approval of the TDI is limited to the greater of: (1) 10 percent of the statutory surplus as regards to policyholders at the preceding December 31; or (2) the preceding year's statutory net gain from operations. Additionally, unless prior approval of the TDI is obtained, dividends can only be paid out of unassigned surplus. Subject to the TDI requirements, the maximum dividend payout that may be made in 2018 without prior approval of the TDI is \$536 million. Dividend payments in excess of positive retained earnings in 2015, 2016 and 2017 were classified and reported as a return of capital.

### 16. BENEFIT PLANS

Effective January 1, 2002, our employees participate in various benefit plans sponsored by AIG Parent, including a noncontributory qualified defined benefit retirement plan, various stock option and purchase plans, a 401(k) plan and a post retirement benefit program for medical care and life insurance (the U.S. Plans). AIG's U.S. Plans do not separately identify projected benefit obligations and plan assets attributable to employees of participating affiliates.

## THE VARIABLE ANNUITY LIFE INSURANCE COMPANY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Effective January 1, 2016, the defined benefit plans were frozen by AIG. Consequently, these plans are closed to new participants and current participants no longer earn benefits. However, interest credits continue to accrue on the existing cash balance accounts and participants are continuing to accrue years of service for purposes of vesting and early retirement eligibility and subsidies as they continue to be employed by AIG Parent and its subsidiaries.

AIG Parent sponsors several defined contribution plans for U.S. employees that provide for pre-tax salary reduction contributions by employees. The most significant plan is the AIG Incentive Savings Plan, for which the matching contribution is 100 percent of the first six percent of a participant's contributions, subject to the IRS-imposed limitations. Effective January 1, 2016, participants in the AIG Incentive Savings Plan receive an additional fully vested, non-elective, non-discretionary employer contribution equal to three percent of the participant's annual base compensation for the plan year, paid each pay period regardless of whether the participant currently contributes to the plan, and subject to the Internal Revenue Service (IRS)-imposed limitations.

We are jointly and severally responsible with AIG Parent and other participating companies for funding obligations for the U.S. Plans, Employee Retirement Income Security Act (ERISA) qualified defined contribution plans and ERISA plans issued by other AIG subsidiaries (the ERISA Plans). If the ERISA Plans do not have adequate funds to pay obligations due participants, the Pension Benefit Guaranty Corporation or Department of Labor could seek payment of such amounts from the members of the AIG ERISA control group, including us. Accordingly, we are contingently liable for such obligations. We believe that the likelihood of payment under any of these plans is remote. Accordingly, we have not established any liability for such contingencies.

We also maintain a retirement plan for the benefit of our sales agents and managers. Investments in the plan consist of a deposit administration group annuity contract we issued. The liabilities and expenses associated with this plan were not material to our consolidated financial position and results of operations for the years presented.

### 17. INCOME TAXES

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#### U.S. Tax Reform Overview

On December 22, 2017, the U.S. enacted Public Law 115-97, known as the Tax Cuts and Jobs Act (the Tax Act). The Tax Act reduces the statutory rate of U.S. federal corporate income tax to 21 percent and enacts numerous other changes impacting the Company and the life insurance industry in tax years beginning January 1, 2018.

Provisions of the Tax Act include reductions or elimination of deductions for certain items, e.g., reductions to corporate dividends received deductions, disallowance of entertainment expenses, and limitations on the deduction of certain executive compensation costs. These provisions, generally, result in an increase in the Company's taxable income in the years beginning after December 31, 2017. Changes specific to the life insurance industry include the changes to the calculation of insurance tax reserves and related transition adjustments and computation of the separate accounts dividends received deduction.

The SEC staff issued SAB 118, which provides guidance on accounting for the tax effects of the Tax Act. SAB 118 addresses situations where accounting for certain income tax effects of the Tax Act under Accounting Standards Codification (ASC) 740 may be incomplete upon issuance of an entity's financial statements and provides a one-year measurement period from the enactment date to complete the accounting under ASC 740. In accordance with SAB 118, a company must reflect the following:

- Income tax effects of those aspects of the Tax Act for which accounting under ASC 740 is complete.
- Provisional estimate of income tax effects of the Tax Act to the extent accounting is incomplete but a reasonable estimate is determinable.
- If a provisional estimate cannot be determined, ASC 740 should still be applied on the basis of tax law provisions that were in effect immediately before the enactment of the Tax Act.

Consistent with current income tax accounting requirements, we have remeasured our deferred tax assets and liabilities with reference to the statutory income tax rate of 21 percent and taken into consideration other provisions of the Tax

## THE VARIABLE ANNUITY LIFE INSURANCE COMPANY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Act. As of December 31, 2017, we had not fully completed our accounting for the tax effects of the Tax Act. Our provision for income taxes for the period ended December 31, 2017, is based in part on a reasonable estimate of the effects on existing deferred tax balances and of certain provisions of the Tax Act. To the extent a reasonable estimate of the impact of certain provisions was determinable, we recorded provisional estimates as a component of our provision for income taxes. To the extent a reasonable estimate of the impact of certain provisions was not determinable, we have not recorded any adjustments and continued accounting for them in accordance with ASC 740 on the basis of the tax laws in effect before enactment of the Tax Act.

The Tax Act includes provisions for Global Intangible Low-Taxed Income (GILTI) under which taxes on foreign income are imposed on the excess of a deemed return on tangible assets of foreign corporations and for Base Erosion and Anti-Abuse Tax (BEAT) under which taxes are imposed on certain base eroding payments to affiliated foreign companies. Where applicable, consistent with accounting guidance, we will treat BEAT as an in period tax charge when incurred in future periods for which no deferred taxes need to be provided and made an accounting policy election to treat GILTI taxes in a similar manner. Accordingly, no provision for income tax related to GILTI or BEAT was recorded as of December 31, 2017.

For the period ended December 31, 2017, we recognized a provisional estimate of income tax effects of the Tax Act of \$36 million.

### Tax effects for which a reasonable estimate can be determined

#### *Provisions Impacting Life Insurance Companies*

The Tax Act modified computations of insurance reserves for life insurance companies. Specifically, the Act directs that tax reserves be computed with reference to NAIC reserves. Adjustments related to the differences in insurance reserves balances computed historically versus the Tax Act have to be taken into income over eight years.

#### *Provisions Impacting Projections of Taxable Income and Realizability of Deferred Tax Assets*

Certain provisions of the Tax Act impact our projections of future taxable income used in analyzing realizability of our deferred tax assets. In certain instances, provisional estimates have been included in our future taxable income projections for these specific provisions to reflect application of the new tax law. We do not currently anticipate that reliance on provisional estimates will have a material impact on the determination of realizability of our deferred tax assets.

### Tax effects for which no estimate can be determined

The Tax Act may affect the results in certain investments and partnerships in which we are the non-controlling interest owner. The information needed to determine a provisional estimate is not currently available (such as for interest deduction limitations in those entities and the changed definition of a U.S. Shareholder). Accordingly, no provisional estimates were recorded.

### The following table presents the income tax expense (benefit) attributable to pre-tax income (loss):

Years Ended December 31, (in millions)	2017		2016		2015
Current	\$	203	\$	201	\$ 243
Deferred		8		(57)	87
Total income tax expense	\$	211	\$	144	\$ 330

## THE VARIABLE ANNUITY LIFE INSURANCE COMPANY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The U.S. statutory income tax rate is 35 percent for 2017, 2016 and 2015. Actual income tax (benefit) expense differs from the statutory U.S. federal amount computed by applying the federal income tax rate, due to the following:

Years Ended December 31,			
<i>(in millions)</i>			
	2017	2016	2015
U.S federal income tax expense at statutory rate	\$ 324	\$ 231	\$ 387
Adjustments:			
Dividends received deduction	(39)	(42)	(39)
Reclassifications from accumulated other comprehensive income	(39)	(28)	(25)
Impact of Tax Act	(36)	-	-
State income tax	7	8	7
Capital loss carryover write-off	-	-	5
Other credits, taxes and settlements	(6)	(25)	(5)
Total income tax expense	\$ 211	\$ 144	\$ 330

Deferred tax assets and liabilities are established for temporary differences between the financial reporting basis and the tax basis of assets and liabilities, at the enacted tax rates expected to be in effect when the temporary differences reverse. The effect of a tax rate change is recognized in income in the period of enactment. State income taxes are included in income tax expense.

The following table presents the components of the net deferred tax assets (liabilities):

Years Ended December 31,			
<i>(in millions)</i>			
	2017	2016	
Deferred tax assets:			
Basis differences on investments	\$ 259	\$ 586	
Policy reserves	90	109	
Fixed assets	94	120	
Losses and tax credit carryforwards	62	66	
State deferred tax benefits	2	10	
Other	4	4	
Total deferred tax assets	511	895	
Deferred tax liabilities:			
Deferred policy acquisition costs	(241)	(404)	
Net unrealized gains on debt and equity securities available for sale	(277)	(367)	
Other	(2)	(5)	
Total deferred tax liabilities	(520)	(776)	
Net deferred tax (liability) asset before valuation allowance	(9)	119	
Valuation allowance	-	(102)	
Net deferred tax (liability) asset	\$ (9)	\$ 17	

The following table presents our tax losses and credit carryforwards on a tax return basis.

December 31, 2017		
<i>(in millions)</i>		
	Tax Effectuated	Expiration Periods
Foreign tax credit carryforwards	\$ 42	2018-2024
Business credit carryforwards	20	2027-2036
Total carryforwards	\$ 62	

We are included in the consolidated federal income tax return of our ultimate parent, AIG Parent. Under the tax sharing agreement with AIG Parent, taxes are recognized and computed on a separate company basis. To the extent that benefits for net operating losses, tax credits or net capital losses are utilized on a consolidated basis, we will recognize tax benefits based upon the amount of the deduction and credits utilized in the consolidated federal income tax return.

We calculate current and deferred state income taxes using the actual apportionment and statutory rates for states in which we are required to file on a separate basis. In states that have a unitary regime, AIG Parent accrues and pays the taxes owed and does not allocate the provision or cash settle the expense with the members of the unitary group. Unlike for federal income tax purposes, AIG Parent does not have state tax sharing agreements. AIG Parent has



## THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

determined that because the unitary tax expense will never be borne by the subsidiaries, the state tax unitary liability is not included in this separate company expense.

#### Assessment of Deferred Tax Asset Valuation Allowance

The evaluation of the recoverability of the deferred tax asset and the need for a valuation allowance requires us to weigh all positive and negative evidence to reach a conclusion that it is more likely than not that all or some portion of the deferred tax asset will not be realized. The weight given to the evidence is commensurate with the extent to which it can be objectively verified. The more negative evidence that exists, the more positive evidence is necessary and the more difficult it is to support a conclusion that a valuation allowance is not needed.

Our framework for assessing the recoverability of deferred tax assets requires us to consider all available evidence, including:

- the nature, frequency and severity of cumulative financial reporting losses in recent years;
- the predictability of future operating profitability of the character necessary to realize the net deferred tax asset;
- the carryforward periods for the net operating loss, capital loss and foreign tax credit carryforwards, including the effect of reversing taxable temporary differences; and
- prudent and feasible tax planning strategies that would be implemented, if necessary, to protect against the loss of deferred tax assets.

Estimates of future taxable income, including income generated from prudent and feasible actions and tax planning strategies, could change in the near term, perhaps materially, which may require us to consider any potential impact to our assessment of the recoverability of the deferred tax asset. Such potential impact could be material to our consolidated financial condition or results of operations for an individual reporting period.

As of December 31, 2017, based on all available evidence we concluded that no valuation allowance should be established on a portion of the deferred tax asset. At December 31, 2017 and 2016, we released \$102 million and \$14 million, respectively, of valuation allowance associated with the unrealized tax losses, all of which was allocated to other comprehensive income.

#### Accounting For Uncertainty in Income Taxes

The following table presents a reconciliation of the beginning and ending balances of the total amounts of gross unrecognized tax benefits, excluding interest and penalties:

<i>(in millions)</i>	Years Ended December 31,	
	2017	2016
Gross unrecognized tax benefits, beginning of year	\$ 19	\$ 34
Increases in tax position for prior years	-	-
Decreases in tax position for prior years	(3)	(15)
Gross unrecognized tax benefits, end of year	\$ 16	\$ 19

At December 31, 2017 and 2016, the amounts of unrecognized tax benefits that, if recognized, would favorably affect the effective tax rate were \$16 million and \$19 million, respectively.

Interest and penalties related to unrecognized tax benefits are recognized in income tax expense. At December 31, 2017 and 2016, we had accrued liabilities of \$3 million and \$2 million, respectively, for the payment of interest (net of the federal benefit) and penalties. In 2017, 2016 and 2015, we recognized expense of \$1 million, income of \$4 million and income of less than \$1 million, respectively, for interest (net of the federal benefit) and penalties.

We regularly evaluate proposed adjustments by taxing authorities. At December 31, 2017, such proposed adjustments would not have resulted in a material change to our consolidated financial condition, although it is possible that the

## THE VARIABLE ANNUITY LIFE INSURANCE COMPANY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

effect could be material to our consolidated results of operations for an individual reporting period. Although it is reasonably possible that a change in the balance of unrecognized tax benefits may occur within the next twelve months, based on the information currently available, we do not expect any change to be material to our consolidated financial condition.

We are currently under IRS examination for the taxable years 2007 to 2010. Although the final outcome of possible issues raised in any future examination is uncertain, we believe that the ultimate liability, including interest, will not materially exceed amounts recorded in the consolidated financial statements. Taxable years 2001 to 2017 remain subject to examination by major tax jurisdictions.

### 18. RELATED PARTY TRANSACTIONS

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#### Events Related to AIG Parent

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On September 29, 2017, the Financial Stability Oversight Council (Council) rescinded its determination that material financial distress at AIG could pose a threat to U.S. financial stability and as a result, AIG is no longer designated as a nonbank systemically important financial institution (nonbank SIFI). With the rescission of its designation as a nonbank SIFI, AIG is no longer subject to the consolidated supervision of the Board of Governors of the Federal Reserve System or subject to the enhanced prudential standards set forth in the Dodd-Frank Wall Street Reform and Consumer Protection Act and its implementing regulations.

On September 25, 2017, AIG announced organizational changes designed to position AIG a growing, more profitable insurer that is focused on underwriting excellence. In the fourth quarter of 2017, AIG finalized its plan to reorganize its operating model. Commercial Insurance and Consumer Insurance segments transitioned to General Insurance and Life and Retirement, respectively. AIG's core businesses include General Insurance, Life and Retirement and Other Operations. General Insurance consists of two operating segments – North America and International. Life and Retirement consists of four operating segments – Individual Retirement, Group Retirement, Life Insurance and Institutional Markets. Blackboard U.S. Holdings, Inc. (Blackboard), AIG's technology-driven subsidiary, is reported within Other Operations. AIG also reports a Legacy Portfolio consisting of run-off insurance lines and legacy investments, which are considered non-core.

Additional information on AIG is publicly available in AIG Parent's regulatory filings with the U.S. Securities and Exchange Commission (SEC), which can be found at [www.sec.gov](http://www.sec.gov). Information regarding AIG Parent as described herein is qualified by regulatory filings AIG Parent files from time to time with the SEC.

#### Operating Agreements

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Pursuant to service and cost allocation agreements, we purchase administrative, investment management, accounting, marketing and data processing services from AIG Parent or its subsidiaries. The allocation of costs for investment management services is based on the level of assets under management. The allocation of costs for other services is based on estimated level of usage, transactions or time incurred in providing the respective services. The amount incurred for such services was approximately \$424 million in 2017 and \$418 million in both 2016 and 2015.

#### American Home and National Union Guarantees

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We have a General Guarantee Agreement with American Home Assurance Company (American Home), an indirect wholly owned subsidiary of AIG Parent. Pursuant to the terms of the agreement, American Home has unconditionally and irrevocably guaranteed insurance policies we issued between March 3, 2003 and December 29, 2006. American Home's audited statutory financial statements are filed with the SEC in our registration statements for variable products we issued that are subject to the Guarantee.

# THE VARIABLE ANNUITY LIFE INSURANCE COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### Other

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We purchase, sell or transfer securities, at fair market value, to or from our affiliates in the ordinary course of business.

In October 2017, through our wholly owned subsidiary, AIG Home Loan 3, we transferred a portfolio of U.S. residential mortgage loans to a newly formed special purpose vehicle, CSMC 2017-HL2 (the CSMC), which is a VIE that we do not consolidate. We received total cash consideration of \$166 million for the loans transferred. The transaction involved securitization of transferred loans and CSMC issued structured securities to the Company for cash consideration. Refer to Note 9 for additional information.

During 2017, we purchased commercial mortgage loans and investment grade private placement bonds from certain affiliated AIG domestic property and casualty companies for total cash consideration of \$417 million.

On September 27, 2016, we purchased securities from our affiliate American General Life Insurance Company, at fair market value, for total cash consideration of \$508 million.

During 2016, we transferred certain hedge fund and private equity investments at fair market value to American Home, in exchange for cash and marketable securities totaling \$421 million as part of an initiative to improve asset-liability management in AIG's domestic life and property casualty insurance companies.

### 19. SUBSEQUENT EVENTS

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We consider events or transactions that occur after the balance sheet date, but before the financial statements are issued to provide additional evidence relative to certain estimates or to identify matters that require additional disclosures. We have evaluated subsequent events through April 26, 2018, the date the financial statements were issued.

In February 2018, we and our affiliates, American General Life Insurance Company and The United States Life Insurance Company in the City of New York, each entered into respective Modified Coinsurance (ModCo) Agreements (The Agreements) with DSA Reinsurance Company Limited (DSA Re), a wholly owned AIG subsidiary and registered Class 4 and Class E reinsurer in Bermuda. The Agreements were executed as of February 12, 2018 in respect of certain closed blocks of business (including structured settlements and single premium immediate annuities). The initial consideration included the fair value of ModCo Assets held by the Company on behalf of DSA Re at the execution date, along with the net results experienced under the reinsurance agreement from the January 1, 2017 effective date in the agreement through the execution date. The initial consideration exceeded the ModCo Reserves ceded at contract inception. The excess consideration represents a net cost of reinsurance asset that will be amortized over the life of the reinsured contracts. Total returns on the ModCo Assets will inure to the benefit of DSA Re. The Company did not receive a ceding commission at contract inception. Management is still assessing the impact of the Agreements.