Fortitude Reinsurance Company Ltd.

Financial Statements

For the year ended December 31, 2018

Fortitude Reinsurance Company Ltd.
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December 31, 2018

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Report of Independent Auditors

To the Board of Directors of Fortitude Reinsurance Company, Ltd.

We have audited the accompanying financial statements of Fortitude Reinsurance Company, Ltd. (the "Company"), which comprise the balance sheet as of December 31, 2018 and the related statements of income (loss), comprehensive income (loss), shareholders' equity and cash flows for the year then ended.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of the 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 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 financial statements based on our audit. We conducted our audit 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 financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the 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 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 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 financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2018 and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter

As discussed in Note 1 to the financial statements, the Company is a member of a group of affiliated companies and has entered into significant transactions with members of the group. Our opinion is not modified with respect to this matter.

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Other Matter

Accounting principles generally accepted in the United States of America require that insurance companies with short-duration insurance contracts present claims development information for the number of years for which claims incurred typically remain outstanding and paid claims to supplement the basic financial statements. Such information, although not part of the basic financial statements, is required by the Financial Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

As discussed in Note 7, management has omitted eight of the required ten years of incurred and paid claims developments for short-duration insurance contracts disclosure that accounting principles generally accepted in the United States of America require to be presented to supplement the basic financial statements. Such missing information, although not a part of the basic financial statements, is required by the Financial Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. Our opinion on the financial statements is not affected by this missing information.

PricewaterhouseCoopers LLP

New York, New York
March 22, 2019

Fortitude Reinsurance Company Ltd.
Balance Sheet
(in millions except par value and shares)

		December 31, 2018
Assets:		
Investments:		
Funds withheld by ceding companies	$	37,605
Fixed maturities available for sale, at fair value		1,678
Other invested assets, at fair value		1,285
Short term investments		27
Total investments		40,595
Cash		86
Deferred income taxes		468
Current tax receivable		20
Other assets		11
Total assets	$	**41,180**
Liabilities:		
Future policy benefits for life insurance and annuity contracts	$	26,391
Policyholder contract deposits		4,791
Liability for unpaid losses and loss adjustment expenses		4,022
Unearned premiums		251
Payable to affiliates		659
Deferred gain from reinsurance contracts		2,886
Other liabilities		55
Total liabilities		39,055
Contingencies, commitments and guarantees (Note 8)		
Shareholders' equity:		
Common stock (1.00 par value, authorized and issued 1.25 million shares)		1
Additional paid-in capital		2,619
Retained earnings (deficit)		(507)
Accumulated other comprehensive income		12
Total shareholders' equity		2,125
Total liabilities and shareholders' equity	$	**41,180**

See accompanying Notes to Financial Statements

Fortitude Reinsurance Company Ltd.
Statement of Income (Loss)
(in millions)

		Year Ended December 31, 2018
Revenues:		
Premiums	$	325
Policy fees		89
Interest earned on reinsurance receivable		12
Net investment income		1,646
Change in value of funds withheld embedded derivative		(925)
Investment gains (losses)		(182)
Total revenues		**965**
Benefits, losses and expenses:		
Policyholder benefits and losses incurred		1,228
Interest credited to policyholder account balances		205
General operating expenses		160
Interest expense on reinsurance payable		15
Total benefits, losses and expenses		**1,608**
Income (loss) from continuing operations before income tax expense		**(643)**
Income tax expense (benefit):		
Current		424
Deferred		(560)
Income tax expense (benefit)		**(136)**
Net loss	**$**	**(507)**

See accompanying Notes to Financial Statements

Fortitude Reinsurance Company Ltd.
Statement of Comprehensive Income (Loss)
(in millions)

	Year Ended December 31, 2018	
Net loss	**$**	**(507)**
Other comprehensive loss, net of tax		
Accumulated other comprehensive income		12
Comprehensive loss	**$**	**(495)**

See accompanying Notes to Financial Statements

Fortitude Reinsurance Company Ltd.
Statement of Shareholders' Equity
(in millions)

	Common Stock	Additional Paid-in Capital	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income	Total Shareholders' Equity
Balance, January 1, 2018	$ 1	$ 1	$ —	$ —	$ 2
Contributed capital	—	2,618	—	—	2,618
Net loss	—	—	(507)	—	(507)
Other comprehensive income	—	—	—	12	12
Balance, December 31, 2018	**$ 1**	**$ 2,619**	**$ (507)**	**$ 12**	**2,125**

See accompanying Notes to Financial Statements

Fortitude Reinsurance Company Ltd.
Statement of Cash Flows
(in millions)

		Year Ended December 31, 2018
Cash Flows from operating activities		
Net loss	$	(507)
Adjustments to reconcile net income to net cash provided (used) by operating activities:		
Change in fair value, Other invested assets		(169)
Accretion of net premiums, discounts, and other		13
Investment (gains) / losses, Other invested assets		2
Non-cash changes related to mod-co reinsurance arrangements:		
Funds withheld by ceding companies		(38,039)
Future policy benefits for life insurance and annuity contracts		26,391
Policyholder contract deposits		4,791
Liability for unpaid losses and loss adjustment expenses		4,022
Unearned premiums		251
Deferred gain from reinsurance contracts		2,886
Other liabilities		53
Other changes in operating assets and liabilities:		
Current and deferred income taxes - net		(580)
Payable to affiliates		659
Other net		(3)
Net Cash used by operating activities		(230)
Cash flows from investing activities		
Sales, maturities, and repayments of:		
Fixed maturities available for sale		549
Other invested assets		22
Purchases of:		
Fixed maturities available for sale		(533)
Other invested assets		(20)
Short term investments		(27)
Net cash used by investing activities		(9)
Cash flows from financing activities		
Capital contributions		324
Net cash provided by financing activities		324
Net increase in cash and cash equivalents		85
Cash and cash equivalents at the beginning of the year		1
Cash and cash equivalents at the end of the year	$	86

See accompanying Notes to Financial Statements

Fortitude Reinsurance Company Ltd.
Statement of Cash Flows, continued
(in millions)

		Year Ended December 31, 2018
Supplementary information		
Cash paid for interest	$	—
Cash paid for taxes		444
Non-cash transactions:		
Day one consideration deposited to funds withheld by ceding companies		39,865
Day one reinsurance liabilities assumed		36,769
Premiums and deposits on policies reinsured through mod-co arrangements		271
Claims and surrenders on policies reinsured through mod-co arrangements		2,431
Non-cash capital contributions		2,640
Settlement profit contributions in securities[1]		434

[1]Profit withdrawals from our funds withheld reinsurance and mod-co arrangements are based on statutory earnings of the associated assets and liabilities. The profit (loss) under these agreements is settled on a quarterly basis and can be settled in either cash or securities depending on the specific reinsurance agreement. The portion settled in securities of $434 million is reflected as a non-cash transaction.

Fortitude Reinsurance Company Ltd.

Notes to Financial Statements
December 31, 2018

1. Organization and Nature of Operations

Fortitude Reinsurance Company Ltd. (the Company or Fortitude Re) was incorporated under the laws of Bermuda on January 1, 2017 (originally registered as SAM Reinsurance Company Ltd., changed its name to DSA Reinsurance Company, Ltd. on October 27, 2017, and it changed to its current name on September 17, 2018). The Company is licensed and registered as a Class 4 and Class E reinsurance company in Bermuda and is primarily a reinsurer of general insurance and life insurance run-off business.

Fortitude Re is a wholly-owned subsidiary of Fortitude Group Holdings, LLC (Fortitude Holdings), a subsidiary of American International Group Inc. (AIG) which is an SEC-registered company incorporated in the state of Delaware, USA. TC Group Cayman Investment Holdings, L.P. (TCG), an affiliate of The Carlyle Group L.P. (Carlyle), holds a minority ownership interest in Fortitude Holdings. AIG and TCG hold 80.1 and 19.9 percent ownership interest in Fortitude Holdings, respectively.

<u>Reinsurance Agreements</u>

On February 12, 2018, (the “execution date”), Fortitude Re entered into a series of reinsurance transactions with various AIG subsidiaries. These transactions were designed to consolidate the bulk of AIG’s legacy insurance runoff lines into a single legal entity.

- AIG’s US domestic life insurance companies (American General Life Insurance Company (AGL), The Variable Annuity Life Insurance Company (VALIC) and The United States Life Insurance Company in the City of New York (USL)) (collectively affiliated "life insurance companies") and Fortitude Re entered into modified coinsurance (mod-co) agreements, whereby the affiliated life insurance companies transferred certain run-off life and retirement policies in-force as of January 1, 2017 to Fortitude Re. These agreements include the transfer of both mortality (life insurance) and longevity (pension risk transfer annuity) risks. The business includes structured settlements, single premium immediate annuities (SPIAs) and longevity (pension risk transfer annuities) and encompass both life and non-life contingent business. *Refer to Note 7 Insurance liabilities for additional information.*

- AIG’s US domestic property and casualty insurance companies are direct wholly-owned subsidiaries of AIG Property Casualty U.S., Inc. (“AIG PC US”), a Delaware corporation, and participate in an intercompany pooling agreement (“Combined Pool Companies”). The Combined Pool Companies include National Union Fire Insurance Company of Pittsburgh, Pa., American Home Assurance Company, Lexington Insurance Company, Commerce and Industry Insurance Company, AIG Property Casualty Company, New Hampshire Insurance Company, The Insurance Company of The State of Pennsylvania, AIG Specialty Insurance Company, AIU Insurance Company, AIG Assurance Company, Granite State Insurance Company, and Illinois National Insurance Co.

  The Combined Pool Companies and Fortitude Re entered into loss portfolio transfer (LPT) reinsurance agreements, whereby the Combined Pool Companies reinsured with Fortitude Re their net exposures for existing and future liabilities for certain run-off business effective January 1, 2017. In addition, Fortitude Re assumed excess workers compensation run off business through a novation agreement between the Combined Pool Companies, Fortitude Re and Eaglestone Reinsurance Company, an affiliated insurance company, effective January 1, 2017. Pursuant to the LPT and novation agreements and subject to their limits, the Combined Pool Companies have ceded 100% of their net insurance liabilities and obligations on certain blocks of insurance, including excess workers compensation, pollution liability products, environmental losses from incidental liability, healthcare (including physicians and surgeons, pharmaceutical equipment, product recall and other health care coverages), commercial auto (buffer trucking) and other casualty (including primarily certain occupational accident and public entity excess liability and exposures from run-off).

- AIG Life of Bermuda, Ltd. (AIG Bermuda) its Bermuda-based affiliated insurance company, American International Reinsurance Company, Ltd. (AIRCO) and Fortitude Re, signed an agreement novating AIG Bermuda's rights and obligations under its November 30, 2010 retrocession agreement with AIRCO to Fortitude Re. These agreements include the transfer of longevity (pension risk transfer annuity) risks.

In addition to the balances transferred on the execution date, the reinsurance transactions described above also included the effects of the net underwriting results experienced by the ceding companies from the underlying insurance policies subject to the reinsurance transactions from January 1, 2017 through the execution date.

The consideration paid to Fortitude Re for assuming the net insurance liabilities described above was in the form of a funds held arrangement, where a portfolio of invested assets held by the ceding companies as of January 1, 2017 was identified, and the fair value of those invested assets as well as subsequent investment returns on the identified assets from January 1, 2017 through the execution date comprises the consideration paid to Fortitude Re. Under the terms of the agreements, all future realized and unrealized gains and losses and net investment income related to the portfolio inure to the benefit of Fortitude Re, and the funds held will be drawn down by the ceding companies to settle claims liabilities subject to the reinsurance transactions and settle the excess (or deficiency) of assets over the claim liabilities with Fortitude Re on a periodic basis.

Capital Contributed

Also on the execution date, AIG contributed capital in the form of cash and securities of $2.6 billion to Fortitude Re to support Fortitude Re's operations and local capital requirements. *Refer to Note 11 shareholders' equity for additional information.*

Organization and Ownership of Parent, Fortitude Holdings

On November 13, 2018, AIG completed the sale of a 19.9 percent ownership interest in Fortitude Holdings to TCG (the Fortitude Re Closing). Fortitude Holdings owns 100 percent of the outstanding common shares of Fortitude Re and AIG has an 80.1 percent ownership interest in Fortitude Holdings. In addition to its holding in Fortitude Re, Fortitude Holdings also owns Fortitude Life & Annuity Solutions, Inc. (Fortitude Life), a third party administrator for life and annuities business, DSA P&C Solutions, Inc. (Fortitude General), a third party administrator for property and casualty business, and Fortitude Group Services, Inc. (Fortitude Services), a management company. Fortitude Life, Fortitude General, and Fortitude Services were not operational during the year ended December 31, 2018.

Subject to certain adjustments specified in the Purchase Agreement, AIG will receive total consideration of $476 million, which is based on Fortitude Re's total shareholders' equity of $2.9 billion as of March 31, 2018 excluding planned distributions that the parties will seek to cause to be paid to us on a non-pro rata basis prior to the end of the 18th month following the Fortitude Re Closing, subject to regulatory approvals (the Target Distribution).

At the Fortitude Re Closing, $381 million of the purchase price was paid and up to $95 million will be paid following December 31, 2023 (the Deferred Payment), subject to the purchase price adjustment described below. To the extent AIG does not receive all or a portion of the Target Distribution within 18 months of the Fortitude Re Closing, TCG will pay AIG up to an additional $100 million. *Refer to Notes 10 Related party and 11 Shareholders' equity for additional information on agreements with Carlyle.*

For purposes of the financial statements and as used hereinafter, unless otherwise indicated, the term "reinsurance transactions" refer to all the reinsurance contracts between Fortitude Re and the AIG affiliated ceding companies above. Unless the context indicates otherwise, the terms "the Company," "we," "us" or "our" mean Fortitude Re.

2. Basis of Presentation

The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP), which differ in certain respects to those followed in reports to the Bermuda Monetary Authority (BMA), Fortitude Re's insurance regulatory authority.

Although Fortitude Re was incorporated on January 1, 2017, transactions for the year ended December 31, 2017 solely related to the establishment and initial capitalization of the Company. As a result, comparatives for the year ended December 31, 2017 are not meaningful and were not included in the accompanying financial statements and notes thereto.

The consolidated financial statements reflect the reinsurance transactions entered into between Fortitude Re and its affiliates on February 12, 2018, *as described in Note 1, Organization and Nature of Operations and Note 10, Related party transactions as well as the capital contribution made by AIG as described in Note 11, Shareholders' equity.*

The preparation of financial statements in accordance with GAAP requires the application of accounting policies that often involve a significant degree of judgment. The Company's accounting policies that are most dependent on the application of estimates and assumptions are those related to the determination of:

- Fair value measurements of investments and funds withheld;
- Impairment charges, including other-than-temporary investment impairments;
- Valuation of future policy benefit liabilities and timing and extent of loss recognition;
- Estimates of Liability for unpaid losses and loss adjustment expenses (loss reserves);
- Estimates of gross profits, which is used as the basis for amortizing deferred gain for the long duration reinsurance contracts;
- Estimates with respect to the loss settlement period, which is used as a basis for amortizing the deferred gain resulting from the short duration reinsurance contracts;
- Estimates with respect to income taxes, including recoverability of deferred income tax assets; and
- Liabilities for legal contingencies.

Additional details regarding these principal estimates and assumptions are discussed in the significant accounting policies that follow and the related disclosures. 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, the Company's consolidated financial condition, results of operations and cash flows could be materially affected.

Our operations are influenced by many factors, including general economic conditions, financial condition of AIG, monetary and fiscal policies of the government of Bermuda and policies of the BMA. We are exposed to the market risks normally associated with a portfolio of fixed income securities, which include interest rate, liquidity, and credit spread risks as well as risks impacting reserves. *Refer to Note 5, Investments and Note 7, Insurance liabilities for additional information regarding these risks.*

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3. Summary of Significant Accounting Policies

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

Note 4. Fair Value Measurements

- Funds withheld (host contract and embedded derivative)
- Other invested assets

Note 5. Investments

- Fixed maturity and equity securities
- Other invested assets

- Net investment income
- Investment gains (losses)
- Other-than-temporary impairments

Note 6. Reinsurance

- Assumed reinsurance

Note 7. Insurance Liabilities

- Future policy benefits for life and accident and health insurance contracts
- Policyholder contract deposits
- Liability for unpaid losses and loss adjustment expenses
- Discounting of reserves
- Amortization of deferred gain liability

Note 8. Contingencies, Commitments and Guarantees

Note 9. Income Taxes

Note 10. Related Party Transactions

Note 11. Shareholders' Equity

Note 12. Statutory Requirements

Note 13. Subsequent Events

Other significant accounting policies

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.

Foreign currency: Financial statement accounts expressed in foreign currencies are translated into U.S. dollars. Functional currency assets and liabilities are translated into U.S. dollars generally using rates of exchange prevailing at the balance sheet date and the related translation adjustments are recorded as a separate component of other comprehensive income, net of any related taxes. Functional currencies are generally the currencies of the local operating environment.

Premiums and Policy Fees: Under the affiliated reinsurance transactions, we assume Premiums and Policy Fee revenues from the ceding insurance companies. Premiums for short-duration contracts are recorded as written on the inception date of the policy. For short-duration insurance contracts, premiums are reported as earned income generally on a pro-rata basis over the terms of the related policies. For traditional long-duration insurance contracts (including term and whole life contracts and annuities), premiums are earned when due. Estimates for premiums due but not yet collected are accrued. For annuities and structured settlements without significant mortality or morbidity risk (investment contracts) and universal life contracts (long-duration contracts with terms that are not fixed or guaranteed), premiums received are reported as policyholder contract deposits. Policy fees represent revenues recognized from insurance contracts consisting of policy charges for cost of insurance and policy administration charges. 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 the services to be provided in the future.

Other assets: Other assets consist primarily of accrued interest on fixed maturity securities and other investment-related receivables.

Other liabilities: Other liabilities consist of interest on funds on deposit under various assumed reinsurance contracts and other payables.

Statement of Cash Flows: Profit withdrawals from our funds withheld reinsurance and mod-co arrangements are based on statutory earnings of the associated assets and liabilities. The profit (loss) under these agreements is settled on a quarterly basis and can be settled in either cash or securities depending on the specific reinsurance agreement. The portion settled in cash is reflected in cash from operations with the securities portion being reflected as a non-cash transaction. Fortitude Re presents activity within funds withheld by ceding companies as well as activities related to the mod-co arrangements as operating cash flows. We believe that this is the best representation of Fortitude Re's operations and business.

Accounting Standards Adopted During 2018

Revenue Recognition:

In May 2014, the Financial Accounting Standards Board (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.

As all of our revenue sources were excluded from the scope of the standard, this did not have a material effect on our reported financial condition or required disclosures.

Recognition and Measurement of Financial Assets and Financial Liabilities:

In January 2016, the FASB issued an accounting standard that requires 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 also permits companies to elect 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 adopted this standard on its effective date of January 1, 2018. Substantially all of our assets and liabilities are not within the scope of the standard. The adoption of the standard did not have any effect on our reported financial condition or required disclosures as 2018 is the first period presented.

Classification of Certain Cash Receipts and Cash Payments:

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 have adopted the standard retrospectively on its effective date of January 1, 2018. The standard addresses presentation in the statement of cash flows only and did not have any material impact on our reported consolidated financial condition, results of operations or required disclosures as 2018 is the first period presented.

Future Application of Accounting Standards

Financial Instruments - Credit Losses:

In June 2016, the FASB issued an accounting standard that will change how entities account for credit losses for most financial assets, trade receivables and reinsurance receivables. 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 of 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 to assess the impact of the standard on our reported financial condition and required disclosures. While we expect an increase in our allowances for credit losses for the financial instruments within the 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.

Premium Amortization on Purchased Callable Debt Securities:

In December 2017, the FASB issued an accounting standard that shortens the amortization period for certain callable debt securities held at a premium by requiring the premium to be amortized to the earliest call date. The standard does not require an accounting change for securities held at a discount, which continue to be amortized to maturity. We plan to adopt the standard retrospectively on its effective date, January 1, 2019. We do not expect the standard to have a material impact on our reported financial condition or required disclosures.

Derivatives and Hedging:

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 footnotes, and simplify the application of hedge accounting treatment. The standard is effective on January 1, 2019, with early adoption permitted. We will adopt the standard on its effective date. The standard’s impact is not material to our reported consolidated financial condition, results of operations, cash flows and required disclosures.

Targeted Improvements to the Accounting for Long-Duration Contracts:

In August 2018, the FASB issued an accounting standard update with the objective of making targeted improvements to the existing recognition, measurement, presentation, and disclosure requirements for long-duration contracts issued by an insurance entity. The changes to the measurement, recognition, presentation and disclosure as provided by the new accounting standard update are summarized below:

- Requires the review and if necessary update of future policy benefit assumptions at least annually for traditional and limited pay long duration contracts, with the recognition and separate presentation of any resulting re-measurement gain or loss (except for discount rate changes as noted below) in the income statement;
- Requires the discount rate assumption to be updated at the end of each reporting period using an upper medium grade (low-credit risk) fixed income instrument yield that maximizes the use of observable market inputs and recognizes the impact of changes to discount rates in other comprehensive income;

- Requires the measurement of all market risk benefits associated with deposit (or account balance) contracts at fair value through the income statement with the exception of instrument-specific credit risk changes, which will be recognized in other comprehensive income; and
- Increased disclosures of disaggregated roll-forwards of policy benefits, account balances, market risk benefits, separate account liabilities and information about significant inputs, judgments and methods used in measurement and changes thereto and impact of those changes.

We plan to adopt the standard on its effective date, January 1, 2021. We are evaluating the method of adoption and impact of the standard on our reported financial condition, results of operations, cash flows and required disclosures. The adoption of this standard is expected to have a significant impact on our results of operations and required disclosures, as well as systems, processes and controls.

4. Fair Value Measurements

Fair Value Measurements on a Recurring Basis

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

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

- 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 of Financial Instruments Measured at Fair Value

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.

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 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.

Other invested assets

Other invested assets include our investments in Maiden Lane III B Notes (MLIII B Notes), which are the subordinate tranches in the Maiden Lane III securitizations. The MLIII B Notes consist of sixteen securities representing the subordinated tranche of sixteen separate securitizations of ABS securities. Our interest in MLIII B Notes are valued using third-party prices on the underlying ABS CDOs and senior tranches in the securitization to determine the implied B Note price. The prices received are validated, to the extent possible, using market observable information for securities with similar asset pools, structure and terms. The sum of the parts methodology used assumes that the underlying collateral in the Maiden Lane III securitization will continue to be held and generate cash flows into the foreseeable future and does not assume a current liquidation of the assets underlying the Maiden Lane III securitization. We elected the fair value option for other invested assets which include our investments in MLIII B Notes.

Funds withheld by ceding companies

Funds withheld by ceding companies represents a reinsurance receivable supported by pools of invested assets, as well as certain stand-alone derivatives. Due to the reinsurance agreements discussed in Note 1, Organization and nature of operations, Note 2, Basis of Presentation, Note, 6, Reinsurance, and Note 7 Insurance liabilities, there is an obligation of Fortitude Re to fund any shortfall between U.S. statutory book value and U.S. statutory reserves. Likewise if there is an excess between U.S. statutory book value and U.S. statutory reserves, the ceding companies are required to fund the excess to the company's mod-co accounts. Because the underlying reinsurance agreements contain an embedded derivative as discussed below, the carrying value of funds withheld by ceding companies is equal to the fair value of the underlying assets and is classified as a Level 2 security.

The reinsurance agreements written on a funds withheld or modified coinsurance basis (mod-co) contain embedded derivatives. The embedded derivatives are considered to exist because the ceding companies are paying Fortitude Re an interest rate attributable to the returns on the assets supporting the reinsured policies (funds withheld) that is not associated with the ceding companies own credit risk. The fair value of the embedded derivatives on funds withheld and mod-co agreements is included in Funds withheld by ceding companies on the balance sheet. As the change in fair value of the funds withheld assets are settled on a quarterly basis, the fair value of the embedded derivatives is equal to the unrealized gain or loss on the underlying assets in the funds withheld or mod-co segregated accounts.

Assets 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, 2018 *(in millions)*	**Level 1**	**Level 2**	**Level 3**	**Total**
Assets:				
Fixed maturity securities, available for sale:				
U.S. government and government sponsored entities	$ —	$ —	$ —	$ —
Obligations of states, municipalities and political subdivisions	—	429	—	429
Non-U.S. governments	—	5	—	5
Corporate debt	—	898	—	898
Residential mortgage-backed securities (RMBS)	—	210	13	223
Commercial mortgage-backed securities (CMBS)	—	100	—	100
Collateralized debt obligations (CDO) / Asset backed securities (ABS)	—	7	16	23
Total fixed maturity securities available for sale	—	1,649	29	1,678
Short term investments	27	—	—	27
Other invested assets	—	—	1,285	1,285
Funds withheld by ceding companies[1]	—	38,530	(925)	37,605
Total	**$ 27**	**$ 40,179**	**$ 389**	**$ 40,595**

1 - Comprised of host contract of $38,530 million and embedded derivative of ($925) million. The host contract at inception of the reinsurance arrangement represented the fair value of the non-cash consideration. The embedded derivative represents the difference between the fair value of the underlying assets and the carrying value of the host contract at the balance sheet date.

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 relating to fixed maturity securities and other invested assets, which 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:

December 31, 2018 *(in millions)*	**Fair Value**	**Valuation Technique**	**Unobservable Input**	**Range (Weighted Average)**
Assets:				
RMBS	$ 13	Discounted cash flow	Constant prepayment rate	5.58% - 9.48% (7.53%)
			Severity	37.96% - 56.84% (47.40%)
			Constant default rate	3.00% - 4.62% (3.81%)
			Yield	3.67% - 4.02% (3.85%)
CDO/ABS	16	Discounted cash flow	Yield	3.11% - 3.33% (3.23%)
Other invested assets	1,264	Implied valuation	Discount rate	0.00% - 8.28% (3.26%)

Level 3 Financial Instruments – The following is a reconciliation for all the Level 3 assets measured at fair value on a recurring basis:

Year ended December 31, 2018

(in millions)	Beginning balance	Purchases	Sales, maturities, redemptions	Investment gains / (losses)	Change in fair value	Transfers in	Transfers out	Ending balance
Assets								
Total fixed maturity securities available for sale	$ —	$ —	$ —	$ —	$ —	$ 29	$ —	$ 29
Funds withheld by ceding companies, embedded derivative	—	—	—	—	(925)	—	—	(925)
Other invested assets	—	20	(22)	—	169	1,118	—	1,285
Total Level 3 assets	**$ —**	**$ 20**	**$ (22)**	**$ —**	**$ (756)**	**$ 1,147**	**$ —**	**$ 389**

Fair Value Information About Financial Instruments Not Measured at Fair Value

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:

December 31, 2018	**Estimated Fair Value**				
(in millions)	Level 1	Level 2	Level 3	Total	Carrying Value
Assets:					
Cash	$ 86	$ —	$ —	$ 86	$ 86
Liabilities:					
Policyholder contract deposits associated with investment-type contracts	$ —	$ —	$ 4,791	$ 4,791	$ 4,791

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

Cash: The carrying amounts of these assets approximate fair values.

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 in the industry 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. 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.

5. Investments

Securities Held to Maturity

Fixed maturity securities 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, 2018.

Securities Available for Sale

Fixed maturity securities classified as available for sale are carried at fair value. Unrealized gains and losses from available for sale investments in fixed maturity securities are reported as a separate component of accumulated other comprehensive income, net of deferred income taxes, in shareholder's equity. Investments in fixed maturity securities are recorded on a trade-date basis.

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

December 31, 2018 *(in millions)*	Amortized Cost or Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Bonds available for sale:				
U.S. government and government sponsored entities	$ —	$ —	$ —	$ —
Obligations of states, municipalities and political subdivisions	421	10	(2)	429
Non-U.S. governments	5	—	—	5
Corporate debt	900	11	(13)	898
Mortgage-backed, asset-backed and collateralized:				
RMBS	224	1	(2)	223
CMBS	102	—	(2)	100
CDO / ABS	23	—	—	23
Total mortgage-backed, asset-backed and collateralized	349	1	(4)	346
Total fixed maturities for available for sale	**$ 1,675**	**$ 22**	**$ (19)**	**$ 1,678**

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:

December 31, 2018 (in millions)	Less than 12 Months Fair Value	Less than 12 Months Gross Unrealized Losses	Greater than 12 Months Fair Value	Greater than 12 Months Gross Unrealized Losses	Total Fair Value	Total Gross Unrealized Losses
Bonds available for sale:						
U.S. government and government sponsored entities	$ —	$ —	$ —	$ —	$ —	$ —
Obligations of states and municipalities and other political	62	(1)	17	(1)	79	(2)
Non-U.S. governments	5	—	—	—	5	—
Corporate debt	448	(12)	61	(1)	509	(13)
Mortgage-backed, asset-backed and collateralized:						
RMBS	151	(2)	14	—	165	(2)
CMBS	14	—	72	(2)	86	(2)
CDO / ABS	16	—	—	—	16	—
Total mortgage-backed, asset-backed and collateralized:	181	(2)	86	(2)	267	(4)
Total fixed maturities available for sale	**$ 696**	**$ (15)**	**$ 164**	**$ (4)**	**$ 860**	**$ (19)**

At December 31, 2018, we held 166 individual fixed maturity securities that were in an unrealized loss position, of which 36 of the 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, 2018 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 perform fundamental credit analysis on a security-by-security basis, which includes 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:

December 31, 2018 (in millions)	Total Fixed Maturity Securities Available for Sale Amortized Cost	Total Fixed Maturity Securities Available for Sale Fair Value	Fixed Maturity Securities in a Loss Position Available for Sale Amortized Cost	Fixed Maturity Securities in a Loss Position Available for Sale Fair Value
Due in one year or less	$ 21	$ 21	$ 3	$ 3
Due after one year through five years	512	512	218	215
Due after five years through ten years	225	218	172	164
Due after ten years	568	581	215	211
Mortgage-backed, asset-backed and collateralized	349	346	271	267
Total	**$ 1,675**	**$ 1,678**	**$ 879**	**$ 860**

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.

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 net investment income. We elected the fair value option for other invested assets which include our investments in MLIII B Notes. The MLIII B Notes consist of sixteen securities representing the subordinated tranche of sixteen separate securitizations of ABS securities.

Net Investment Income

Net investment income represents income primarily from the following sources:

- Coupon interest, amortization accretion, and dividends from Funds withheld by ceding companies;
- 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 stocks;
- Earnings from alternative investments and commercial mortgage loans; and
- Offset by investment expenses

The following table presents the components of Net investment income:

Year Ended December 31,		
(in millions)		**2018**
Available for sale fixed maturity securities		
Obligations of states, municipalities and political subdivisions		1
Corporate debt		22
RMBS		11
CMBS		6
CDO / ABS		1
Total investment income for available for sale fixed maturity securities		41
Other Invested Assets		169
Funds withheld by ceding companies		1,490
Total investment income		1,700
Investment expenses		(54)
Net investment income	**$**	**1,646**

Investment Gains (Losses)

Investment gains and (losses) include sales or full redemptions of available for sale fixed maturity securities, other invested assets as well as total return on derivative contracts and changes in fair value of embedded derivatives (unrealized on funds withheld by ceding companies). The portion related to changes in fair value of embedded derivatives was a loss of $(925) for the year ended December 31, 2018.

The following table presents the components of Net investment gains (losses):

Year Ended December 31, (in millions)		2018
Available for sale fixed maturity securities		
U.S. government and government sponsored entities	$	(3)
Obligations of states, municipalities and political subdivisions		1
Total available for sale fixed maturity securities		(2)
Funds withheld by ceding companies		(180)
Net realized losses	$	**(182)**

Funds Withheld by Ceding Companies

Funds withheld by ceding companies represents a receivable for amounts contractually withheld by ceding companies in accordance with reinsurance agreements in which we act as reinsurer. While the assets in funds withheld and modified coinsurance segregated accounts are legally owned by the respective ceding companies, the assets are separately identified from the general accounts of our cedants and all economic rights and obligations on the assets accrue to us. The assets in the funds held segregated accounts are managed by AIG Asset Management (U.S.) LLC, a registered investment advisor affiliated with AIG and an investment affiliate of TCG. We periodically settle the total return from those assets. *Refer to Note 10, Related party transactions for additional information on agreements with related parties*.

The underlying agreements contain embedded derivatives as discussed above, and as a result the carrying value of funds withheld by ceding companies consists of the fair value of the underlying invested assets and related derivatives.

In the event of a ceding company's insolvency, Fortitude Re would need to assert a claim on the assets supporting its reserve liabilities. However, Fortitude Re has the ability to offset amounts it owes to the ceding company, which reduces its risk of loss. Interest generally accrues on these assets based upon the investment earnings on the underlying investments. Fortitude Re is subject to the investment performance and has all economic rights and obligations on the invested assets withheld by the ceding companies with the same risk as if Fortitude Re held the investments directly.

Information on the underlying assets within the funds withheld by ceding companies is presented below:

December 31, 2018 *(in millions)*	Level 1[1]	Level 2[1]	Level 3[1]	Total
Fixed maturity securities				
Corporate debt	$ —	$ 21,293	$ 67	$ 21,360
Obligations of states, municipalities and political subdivisions	—	2,038	504	2,542
Non-U.S. governments	—	1,167	—	1,167
U.S government and agencies	53	241	—	294
Mortgage-backed, asset-backed and collateralized:				
RMBS	—	1,955	1,531	3,486
CMBS	—	1,491	105	1,596
CDO/ABS	—	147	669	816
Total Fixed maturity securities	53	28,332	2,876	31,261
Commercial mortgage loans	—	—	3,162	3,162
Real estate investments	—	—	822	822
Private equity funds	—	37	554	591
Hedge funds	—	155	351	506
Policy loans			457	457
Equity securities	19	—	—	19
Total Investments	$ 72	$ 28,524	$ 8,222	$ 36,818
Derivative assets, net				372
Accrued interest				346
Cash				129
Net receivable from ceding companies				30
Other payable				(9)
Broker payable				(81)
Total funds withheld by ceding companies, at fair value				$ 37,605

1 - Supplemental information on the underlying securities within the funds withheld by ceding companies.

97% of the fixed maturity securities within the funds withheld by ceding companies are investment grade by National Association of Insurance Commissioners (NAIC) designation as of December 31, 2018.

Embedded Derivatives

The reinsurance agreements written on a funds withheld or modified coinsurance basis contain embedded derivatives, which are required to be separated from their host contracts and reported as derivatives.

The host contract relates to the reinsurance receivable from ceding companies under the funds withheld arrangement underlying the reinsurance transactions *as described in Note 1, Organization and nature of operations, Note 2, Basis of presentation Note 6, Reinsurance and Note 7, Insurance liabilties*. The host contract at inception of the reinsurance arrangement represented the fair value of the non-cash consideration. The embedded derivative represents the difference between the fair value of the underlying assets and the carrying value of the host contract at the balance sheet date. The fair value of the embedded derivative is included in the funds withheld by ceding companies on the balance sheet.

As the change in fair value of the funds withheld assets are settled on a quarterly basis, the fair value of the embedded derivative is equal to the unrealized gain or loss on the underlying assets in the funds withheld or mod-co segregated accounts.

The following fair value of embedded derivatives is reflected in the funds withheld by ceding companies table above.

Year Ended December 31, 2018 *(in millions)*	Host Contract	Embedded Derivative	Funds withheld by ceding companies
Short duration run-off business	$ 4,821	$ (33)	$ 4,788
Long duration run-off business	33,709	(892)	32,817
Total fair value	**$ 38,530**	**$ (925)**	**$ 37,605**

Market Risks

Liquidity, interest rate, and credit spread risks are all market risks. Liquidity risk is the risk that Fortitude Re's financial condition will be adversely affected by the inability or perceived inability to meet short-term cash, collateral or other obligations. Interest rate risk can arise from a mismatch in the interest rate exposure of assets compared to liabilities. Changes in interest rates can affect the valuation of fixed maturity securities, financial liabilities, insurance contracts and derivative contracts. Credit spreads measure an instrument's risk premium or yield relative to that of a comparable duration, default-free instrument. Changes in credit spreads can affect the valuation of fixed maturity securities, including but not limited to corporate bonds, asset-backed securities, mortgage-backed securities, credit derivatives and derivative credit valuation adjustments.

Market risk is monitored and managed using an asset-liability management framework. For both assets and liabilities, market risk exposures are measured in terms of sensitivities to changes in the relevant risk factors. In addition, Fortitude Re performs stress testing on these market risk factors to capture concentration risks to a single market risk factor change as well as simultaneous multiple market risk factor changes, to understand the net impact on exposure from impacts on both assets and liabilities.

6. Reinsurance

We assume short duration and long duration insurance and investment contracts under funds withheld and mod-co arrangements. We follow reinsurance accounting for transactions that provide indemnification against loss or liability relating to insurance risk (risk transfer). To meet risk transfer requirements, a reinsurance agreement must include both insurance risk consisting of both underwriting and timing risks, and a reasonable possibility of a significant loss.

Long Duration Run-off Business

On February 12, 2018, certain insurance affiliates entered into mod-co arrangements with Fortitude Re to cede run-off life and annuity liabilities. The mortality and timing risks related to certain life blocks of business, such as whole life, universal life, and pension risk transfer annuities with life contingencies were transferred to Fortitude Re and are subject to reinsurance accounting. The total consideration (net of commissions of $39 million) received for these blocks of business was $27,592 million and the amount of assumed future policy benefit liabilities was $25,545 million. The remaining blocks of life business, such as fixed annuities and structured settlements without life contingencies, lacked mortality risks, and thus could not achieve risk transfer. Accordingly, these reinsured contracts are subject to deposit, rather than reinsurance accounting. The total consideration received for these deposit blocks of business was $5,421 million and the amount of assumed deposit liabilities was $5,022 million.

On February 12, 2018, we also entered into a tri-party novation agreement with certain Bermuda affiliates, AIG Life of Bermuda and AIRCO. Pursuant to this agreement, AIRCO retroceded, on a 100% quota share basis, business associated with the termination of occupational pension programs in the United Kingdom, which AIRCO had previously assumed from Phoenix Life Limited (Phoenix Life, formerly ALBA Life, Ltd.) and retroceded to AIG Life of Bermuda.

The total consideration (net of ceding commissions of $75 million) received for these blocks of business was $1,255 million and the amount of assumed reserves was $1,250 million. Under the terms of the retrocession agreement with AIRCO, AIRCO retained assets and other derivatives in a funds withheld account that would otherwise have been paid to us, which is included in funds withheld by ceding companies in our Balance Sheet. These funds withheld by AIRCO are supported by a specified portfolio of assets, subject to a security agreement between AIRCO and Phoenix Life. Under the contractual terms of the retrocession agreement, the realized and unrealized gains and losses and net investment income related to the specified portfolio of assets inure to our benefit.

In connection with AIRCO's reinsurance agreement with Phoenix Life, AIRCO entered into a series of interest rate and currency swap agreements. Gains and losses associated with these derivatives inure to our benefit via the retrocession agreement and are recorded in investment gains (losses). Amounts due from AIRCO associated with these swap agreements at December 31, 2018 is $376 million which is included in funds withheld by ceding companies in our Balance Sheet.

The Company has made an accounting policy election to designate GBP as the functional currency related to the ALBA business. We translate the financial balances of the assumed business from AIRCO from the functional currency designated for these operations, generally the currency of the primary economic environment in which that operation does its business (i.e., in Great Britain Pounds) into U.S. dollars (USD). Assets and liabilities are translated into USD at period-end exchange rates, while income and expenses are translated using average rates for the period. Translation adjustments are recorded as a separate component of accumulated other comprehensive income, net of tax, to the extent applicable. Total assets and total liabilities exposed to the foreign currency translation risk are GBP 665 million and GBP 900 million respectively as of December 31, 2018.

For the run-off life and annuity reinsurance transactions, the difference between the fair value of assets and the sum of the reserves reinsured, other liabilities reinsured, and ceding commission payable or receivable is deferred and recognized as a net cost of reinsurance liability (i.e., a deferred gain) The deferred gain is amortized over the lives of the reinsured policies in relation to premiums, expected benefit payments, or insurance inforce for insurance contracts and using an effective interest method for investment contracts.

The following summarizes the day one gains related to future policy benefits and policyholder contract deposits which are reported in Deferred gain from reinsurance contracts on the balance sheet.

(in millions)	**Future Policy Benefits**	**Policyholder contract deposits**	**Total**
Development of Deferred Gain on Long-Duration Business			
Consideration received	$ 28,847	$ 5,421	$ 34,268
Assumed reserves related to long duration contracts	26,795	5,022	31,817
Deferred gain as of February 12, 2018	2,052	399	2,451
Amortization of deferred gain	79	17	96
Deferred gain liability on long-duration business reflected in Fortitude Re's December 31, 2018 Balance Sheet	$ 1,973	$ 382	$ 2,355

Long duration run-off business assumed subjects us to mortality, longevity and morbidity risks. Life benefit reserves are established using assumptions for investment yields, mortality, morbidity, lapses and expenses, including a provision for adverse deviation. We establish and review our life reserves regularly based upon cash flow projections. We establish and maintain our life reinsurance reserves at a level that we estimate will, when taken together with future premium payments and investment income expected to be earned on associated premiums, be sufficient to support all future cash flow benefit obligations and third-party servicing obligations as they become payable. If financial performance significantly deteriorates to the point where a premium deficiency exists, then we would record additional liabilities.

Short Duration Run-off Business

On February 12, 2018, the Combined Pool Companies entered into 13 LPT reinsurance agreements with Fortitude Re to cede run-off property and casualty insurance (P&C) liabilities on a funds withheld basis effective January 1, 2017. In addition, on February 12, 2018, Fortitude Re assumed excess workers compensation run off business through a novation agreement among itself and Eaglestone Reinsurance Company, an affiliated insurance company effective, January 1, 2017. At the inception of these reinsurance and novation agreements, we received consideration of $5,041 million on a funds withheld basis and recorded loss and loss adjustment expenses incurred of $4,505 million, resulting in a deferred gain of $536 million on the date of the transaction.

The reinsurance assumed under various LPTs and the novation agreements qualify to be accounted for as retroactive reinsurance as they provide indemnification of losses and loss adjustment expenses of these run off short-duration insurance contracts with respect to underlying loss events that occurred prior to January 1, 2017. In the absence of US GAAP guidance specific to the accounting for retroactive reinsurance contracts entered into by assuming reinsurance companies, the Company has made an accounting policy election to account for the retroactive reinsurance consistent with guidance specific to ceding companies. Under this accounting model, the retroactive reinsurance is considered to be a financing of an existing obligation, with no immediate gain recognition. For these agreements, the excess of the consideration received over the ultimate payout of the future claims is recognized as a deferred gain liability and amortized into income over the settlement period of the assumed reserves using an effective interest rate method. In applying the interest method, an effective interest rate is derived for these retroactive reinsurance contracts based on the expected timing and amount of the ultimate loss and loss adjustment expense payments such that the present value of these estimated payments equals the premium consideration received. The Company subsequently monitors and adjusts the deferred gain balance to reflect differences between the actual and the estimated timing and amount of the loss payments, as well as to reflect revisions to the estimated remaining undiscounted liability for unpaid losses due to favorable or unfavorable reserve developments. The revised deferred gain balance is determined using the retrospective method so that the adjusted balance reflects the amount that would have existed had the revised estimates been available at the inception of the reinsurance transactions. The amortization of the revised deferred gain is calculated on a retrospective basis with a catch up adjustment recorded in the income statement during the period of change.

The table below shows the calculation of the deferred gain on the P&C run-off reinsurance agreements as of December 31, 2018, showing the effect of discounting of loss reserves and amortization of the deferred gain.

(in millions)		**Deferred gain**
Development of deferred gain on short duration business		
Consideration received as of February 12, 2018	$	5,041
Assumed losses (net of discount)		4,505
Pre-tax deferred gain before amortization and other changes		536
Amortization of deferred gain		(47)
Change in discount		47
Prior year development		(5)
Deferred gain liability on short-duration business reflected in Fortitude Re's December 31, 2018 Balance Sheet	$	531

In establishing retroactive reinsurance claim liabilities, we analyze historical aggregate loss paid patterns and project losses into the future under various probability-weighted scenarios. We expect the paid claim-tail to be very long for many contracts, with some lasting several decades. We monitor claim payment activity and review ceding company reports and other information concerning the underlying losses. We reassess and revise the expected timing and amounts of ultimate losses periodically or when significant events are revealed through our monitoring and review processes.

7. Insurance Liabilities

Liabilities for long-duration contracts are classified as either future policy benefits or policyholder contract deposits. Future policy benefits include retirement products whose payments depend on contract holder's survival such as structured settlements with life contingencies, single premium immediate annuities (SPIA) with life contingencies, and pension risk transfer annuities; and traditional life insurance products such as whole life (WL) and return of premium (RoP) term, accident & health (A&H) and long term care (LTC). Policyholder contract deposits apply to investment contracts such as structured settlements and SPIA with non-life contingent benefits, and the fund values of universal life insurance contracts.

Longevity risk is the risk of a change in value of a policy or benefit as a result of actual mortality experience being lower than the expected mortality assumed at the time of underwriting. Fortitude Re manages this risk through ongoing monitoring and assessment of mortality, longevity and morbidity experience relative to underlying assumptions.

Future Policy Benefits

Future Policy Benefits relate to lines of business where the main risk factor is mortality, morbidity, or longevity risk and the liability cash flows are long-duration and relatively stable. Assumed reserves for traditional life, A&H, and life-contingent annuity payout contracts represent an estimate of the present value of future benefits less the present value of future net premiums. Assumed reserves also include 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.

For long duration traditional products, a "locked-in" assumption applies. The assumptions used to calculate benefit liabilities are set when a contract 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. Periodically, we evaluate these "locked-in" assumptions used in establishing assumed liabilities for long duration insurance contracts. A loss recognition event occurs when there is a shortfall between the carrying amount of future policy benefit liabilities and estimated future policy benefit liabilities determined by applying current best estimate assumptions. If we determine a loss recognition event has occurred, we would record additional liabilities through a charge to future benefits. We would then replace the old "locked-in" assumption set with the current best estimate. Future reserves would be set by reviewing the updated best estimate assumptions periodically and making further adjustments where necessary. Other adjustments include unearned premium liabilities, incurred but not reported claims, and disabled lives reserves where A&H products such as disability income have claimants receiving ongoing benefits.

The following table presents future policy benefits by product line:

Future policy benefits for life insurance and annuity contracts		**At December 31, 2018** *(in millions)*
Structured settlements	$	14,991
Traditional whole life		3,563
Pension risk transfer annuities		3,504
Single premium immediate annuities		2,100
Term life insurance		1,451
Long term care		422
Accident and health		360
Total	$	26,391

Policyholder Contract Deposits

Policyholder contract deposits include investment contracts such as SPIA and structured settlements contracts with period certain payment streams (i.e., not depending on longevity) and the fund values of universal life insurance contracts.

- Non-life contingent structured settlement cash flows consist of certain payments with set payment patterns such as level payment, compound increase, fixed amount increase or one-time lump sum payments. The non-life contingent cash flows are thus highly predictable;
- Non-life contingent SPIA cash flows also consist of certain level payments over a specified duration with a range from five to thirty years or more; and
- Universal life products provide permanent coverage for life insurance with the potential to accumulate cash value.

The liability for policyholder contract deposits is primarily recorded at accumulated or fund value (deposits received, plus accrued interest credited, less withdrawals and cost of insurance fees). Deposits collected on investment-oriented products are not reflected as revenues, because they are recorded directly to Policyholder contract deposits upon receipt.

For universal life contracts that are determined to have profits in earlier years and losses in subsequent years from the insurance benefits, an additional liability is established in addition to the fund value to recognize the portion of amounts assessed against the contract holder (costs of insurance and all other charges and margins) that compensates us for benefits to be provided in future periods.

Policyholder contract deposits also include annuities issued in structured settlement arrangements and SPIA contracts with no life contingent features. The liability for assumed non-life contingent SPIA contracts and structured settlement arrangements represents an estimate of the present value of future benefits using an interest rate determined at the treaty inception date.

The following table presents Policyholder contract deposits by product line:

Policyholder contract deposits		**At December 31, 2018** *(in millions)*
Structured settlements – non-life contingent	$	2,687
Interest sensitive universal life		1,925
Single premium immediate annuities – non-life contingent		179
Total	$	4,791

Liability for Unpaid Losses and Loss Adjustment Expenses

Loss reserves and loss adjustment expense (LAE) represent estimates of unpaid claims, including estimates for claims incurred but not reported and loss adjustment expenses (IBNR), less applicable discount. We regularly review and update the methods used to determine loss reserve estimates. Because these estimates are subject to the outcome of future events, changes in estimates are common given that loss trends vary and time is often required for changes in trends to be recognized and confirmed. Reserve changes that increase previous estimates of ultimate loss are referred to as either unfavorable development, adverse development, or reserve strengthening. Reserve changes that decrease previous estimates of ultimate cost are referred to as favorable development. Prior year development can refer to either favorable or unfavorable development.

Reserve risk is the potential inadequacy of the liabilities that Fortitude Re establishes for unpaid losses and loss adjustment expenses. Fortitude Re manages this uncertainty through internal controls and oversight of the loss reserve setting process.

Loss reserves include Excess workers' compensation (34%) of total unpaid losses and loss adjustment expenses), Environmental Impairment Liability (32%), Legacy Environmental (13%), and All other lines (21%). All Other Lines consist of other casualty run-off exposures, including workers' compensation, general liability, medical malpractice, product liability, and accident and health exposures.

Premium Deficiency

The Company recognizes a premium deficiency if the sum of future accident year present value expected loss and loss adjustment expenses and unamortized acquisition costs exceeds related unearned premium and related investment income. Any future expected loss on the related unearned premium is recorded first by impairing any unamortized acquisition costs on the related unearned premium followed by an increase to loss and loss adjustment expense reserves on additional expected loss in excess of unamortized acquisition costs. Fortitude Re includes $40 million of interest earned on deposits received from policyholders in the assessment of premium deficiency. This amount is reported in Other liabilities. As of December 31, 2018, the Company recorded no unamortized acquisition costs or premium deficiency.

Discounting of Loss Reserves

At December 31, 2018, the loss reserves reflect a net loss reserve discount of $973 million, including both tabular and non-tabular worker's compensation discount. Fortitude Re generally follows the discounting used by its U.S. domiciled ceding company affiliates. The discount is based upon the following assumptions:

The tabular workers' compensation discount is calculated based on a 3.5 percent interest rate and the mortality rate used in the 2007 U.S. Life Table.

The non-tabular workers' compensation discount is calculated by subtracting tabular workers' compensation discount from total workers' compensation discount. To calculate total workers' compensation discount, the Company uses a consistent discount rate (U.S. Treasury rates plus a liquidity premium), along with the use of payout patterns specific to our primary and excess workers' compensation portfolios, to discount our workers' compensation reserves. The discount rates and payout patterns are updated periodically.

Roll Forward of Liability for Unpaid Losses and Loss Adjustment Expenses

The following table provides a roll forward of loss and loss adjustment expense reserves from February 12, 2018 to December 31, 2018, including detail on paid incurred losses from prior accident years and the current accident year.

Liability for unpaid losses and loss adjustment expenses		
(in millions)		
Balance at February 12, 2018	$	4,471
Prior year development[1]		5
Change in discount		(47)
Current accident year incurred loss		76
Paid losses		
Prior year		(440)
Current year		(43)
Total paid losses		(483)
Balance at December 31, 2018	$	4,022

1 - $5M of prior year development is reflected in the deferred gain under the Company's accounting policy – refer to Note 6 Reinsurance.

The Liabilities for Unpaid Loss and Loss Adjustment Expenses as of December 31, 2018 and prior year development in 2018, by segment, are as follows:

December 31, 2018 *(in millions)*		**Liability for unpaid losses and loss adjustment expenses**		**(Favorable) / Unfavorable prior year development**
Excess workers compensation	$	2,289	$	—
Environmental impairment liabilities		1,274		(38)
Legacy environmental		518		150
All other lines		914		(107)
Liabilities for unpaid loss and allocated LAE, net of reinsurance		4,995		5
Discount		(973)		—
Total liability for unpaid loss and loss adjustment expenses	$	4,022	$	5

During 2018, Fortitude Re recognized unfavorable prior year loss reserve development of $5 million. This unfavorable development was comprised of $150 million in Legacy Environmental related to higher than expected loss experience in recent years, partially offset by $(38) million of favorable development in Environmental Impairment Liability related to pollution legal liability and environmental contractors liability and $(107) million of favorable development in All Other Lines, which was largely due to reduction in our estimates of commercial auto and medical malpractice losses. Favorable or unfavorable developments in liability for unpaid loss and loss adjustment expenses increase or decrease the deferred gain and are amortized. *Refer to Note 6, Reinsurance for additional information on the amortization of deferred gain.*

Excess Workers' Compensation

Excess workers' compensation has a long tail and is one of the most challenging lines of business from an actuarial reserving perspective, particularly when the excess coverage is provided above a self-insured retention layer. The class is highly sensitive to small changes in assumptions (for example in the rate of medical inflation or the longevity of injured workers) which can have a significant effect on the ultimate reserve cost estimate. Excess Workers' Compensation business was written over qualified self-insurance from the 1980's through 2012. In this book of business, the claims are not handled (or administered) by the ceding company personnel, but are administered by the client's designated third party administrators (TPAs). However, claims personnel affilated with Fortitude Re, maintain an oversight role over these TPAs and claims.

Loss and loss adjustment expense liability estimates for excess workers' compensation exposures are subject to additional uncertainties, due to the following:

- Claim settlement time is longer than most other casualty lines, due to the lifetime benefits that can be expected to pay out on certain claims;
- Coverage statutes that vary by state; and
- Future medical inflation costs are difficult to estimate.

For this business, a combination of traditional methods (paid and incurred loss development) and non-traditional methods (individual claim annuity model, report year incurred loss development, and IBNR count/ severity methods) are used to estimate loss and loss expense liability estimates. Loss data is segmented so as to reflect the anomalies in the historical data due to the various loss mitigation initiatives employed over the last several years.

For excess workers' compensation, incurred claims are typically paid out over 50 years or more. The last claim related to this business occurred in 2011, and there has been no significant prior year development since 2010. The total actual paid losses were $83 million for the year ending December 31, 2018.

Environmental Impairment Liability

Environmental impairment includes pollution legal liability, contractors legal liability, errors and omissions, and underground storage tank policies written prior to 2005. The process of establishing reserves for environmental impairment claims is subject to greater uncertainty than the establishment of reserves for liabilities relating to other types of insurance claims. As a result of the significant uncertainty inherent in determining a company's environmental impairment liabilities and establishing related reserves, the use of conventional reserving methodologies frequently has to be supplemented by reviewing each of the outstanding claims on a claim-by-claim basis in establishing the reserves. Additional consideration is given by evaluating the exposure presented by each policyholder, the anticipated cost of resolution, if any, for each policyholder, available coverage, and the relevant judicial interpretations and historical value of similar exposures in establishing the reserves.

Environmental Impairment Incurred Losses and Allocated Loss Adjustment Expenses (LAE), Undiscounted and Net of Reinsurance are as follows:

Accident Year	December 31, 2017 (in millions) (unaudited)	December 31, 2018 (in millions)	Total of IBNR Liabilities Plus Expected Development on Reported Losses (in millions)	Cumulative Number of Reported Claims
2009	$ 52	$ 51	$ 27	133
2010	57	49	18	99
2011	76	66	31	159
2012	204	183	31	118
2013	130	121	34	205
2014	149	105	53	293
2015	219	187	71	431
2016	153	156	47	894
2017	149	195	96	545
2018	—	75	31	248
Total	$ 1,189	$ 1,188	$ 439	3,125
Cumulative Paid Losses and Allocated LAE, Net of Reinsurance during the above period		(351)		
Liabilities for losses and Allocated LAE before accident year 2009, net of reinsurance		437		
Liabilities for losses and LAE, net of reinsurance		$ 1,274		

Cumulative Paid Losses and Allocated Loss Adjustment Expenses, Net of Reinsurance:

Accident Year	December 31, 2017 (unaudited)	December 31, 2018
(in millions)		
2009	$ 7	$ 11
2010	3	8
2011	14	20
2012	6	31
2013	14	23
2014	11	20
2015	30	56
2016	62	78
2017	23	68
2018	—	36
Total	$ 170	$ 351

Legacy Environmental

Legacy Environmental exposure consists of indemnity claims asserting property damage from toxic waste, hazardous substances, and other environmental pollutants, and claims to cover the cleanup costs of hazardous waste and pollution sites. The vast majority of these Legacy Environmental claims emanate from policies written in 1985 and prior years. Commencing in 1985, standard general liability policies contained an absolute exclusion for pollution-related damage. Environmental Impairment Liability exposures underwritten on a claims-made basis, which were written generally starting 1986, are not included in this segment.

Loss and loss adjustment expense liability estimates for mass torts, such as Legacy Environmental exposures, are subject to additional uncertainties, due to the following:

- Case law is not fully developed;
- Coverage interpretation varies by state;
- The pool of plaintiffs and defendants is expanding significantly;
- The process of estimating provisions for premises and operations coverage is highly judgmental;
- “State of the art” analysis is a moving target; and
- Environmental reform could have a significant effect on ultimate liabilities.

To estimate loss and loss adjustment expenses reserve liability estimates, traditional methods (paid and incurred loss development, paid and incurred Cape Cod methods) are used to project historical report years to estimate incurred but not enough reported (IBNER) reserves, and count/severity methods are used to project future report years to estimate “pure” incurred but not reported reserves. For some large accounts and sites, reserves are based on claim department estimates and analysis.

The last claim related to this business occurred more than 10 years ago and there were no incurred losses and allocated loss adjustment expenses related to business written in the last 10 years. The total actual paid losses were $31 million for the year ending December 31, 2018.

All Other Lines

All Other Lines consist of various workers’ compensation, general liability, medical malpractice, products liability, commercial automobile liability, and accident and health exposures from profit centers/business units that have been put into runoff. In general, loss and loss adjustment expense liabilities are estimated separately. Traditional loss estimation methods include paid and incurred loss development methods and generalized paid and incurred Cape Cod methods. We also look at an IBNR-to-Case ratio method for all lines, a survival ratio method for the general liability line, and an annuity model approach for some of the larger workers’ compensation claims. Loss adjustment expense methods include both standard development methods and also calendar year paid to paid method, which applies the paid to paid ratio to the loss reserves.

Claims payout patterns

The following table presents the historical average annual percentage claims payout on an accident year basis at the same level of disaggregation as presented above.

Average Annual Percentage Payout of Incurred Losses by Age, Net of Reinsurance (Unaudited)

Year	1	2	3	4	5	6	7	8	9	10+
Excess workers compensation	3.4	3.3	3.1	3.1	3.2	3.3	3.5	3.4	3.0	70.7
Environmental impairment liabilities	16.7	15.2	12.0	10.1	8.6	7.1	5.9	4.9	4.0	15.5
Legacy Environmental	10.2	11.3	11.9	10.4	14.6	7.8	4.8	4.3	3.8	20.9
All Other Lines	17.7	13.9	10.9	9.0	7.1	5.7	4.7	3.8	3.3	23.9

8. Contingencies, Commitments and Guarantees

Fortitude Re has no material contingent liabilities arising from litigation, income taxes or other matters, other than liabilities arising in the normal course of its business of reinsurance.

9. Income Taxes

The income tax provision is calculated under the liability method. Fortitude Re recognizes deferred income tax assets and liabilities for the expected future tax effects attributable to temporary differences between the financial statement and tax return basis of assets and liabilities based on enacted tax rates and other provisions of the tax law.

Fortitude Re has elected to be treated as a U.S. domestic insurance company for U.S. federal tax purposes under section 953(d) of the U.S. Internal Revenue Code and is therefore subject to income taxation in the U.S. Fortitude Re is included in a U.S consolidated federal income tax return with AIG and Subsidiaries. As part of the consolidated group, Fortitude Re is subject to the AIG tax sharing agreement, effective January 1, 2018, whereby Fortitude Re is allocated its share of the consolidated tax liability based upon the tax it would have owed had it filed separately. Tax benefits are allocated to each company for its portion of net operating losses and tax credit carry forwards in the year they are used by the consolidated group.

On December 22, 2017, the U.S. enacted Public Law 115-97, known informally as the Tax Cuts and Jobs Act (the Tax Act). The Tax Act reduced the statutory rate of U.S. federal corporate income tax to 21 percent and enacted numerous other changes. 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 certain foreign subsidiaries and for Base Erosion and Anti-Abuse Tax (BEAT) under which taxes are imposed on certain base eroding payments to affiliated foreign companies. For domestic corporations, the Tax Act also provides a deduction for foreign-derived intangible income (FDII). Fortitude Re was not impacted by the GILTI, BEAT, and FDII provisions for the year ended December 31, 2018, however, if such provisions were applicable, we would treat them as a period tax charge in the period the tax is incurred.

The following table presents the income tax expense (benefit) attributable to income (loss) from continuing operations before income tax expense:

For the year Ended December 31, 2018 *(in millions)*		
Income tax expense (benefit) attributable to income from continuing operations		
Current	$	424
Deferred		(560)
Total	$	(136)

Our actual income tax expense (benefit) differs from the statutory U.S. federal amount computed by applying the federal income tax rate due to the following:

For the year Ended December 31, 2018 *(in millions)*		**Income (loss) before tax expense**		**Income tax expense (benefit)**	**Percent of income / (loss) before tax**
U.S. federal income tax at statutory rate	$	(643)	$	(135)	21.0%
Adjustments:					
Tax exempt interest, net of proration				(1)	0.1%
Amounts attributable to continuing operations	$	(643)	$	(136)	21.1%

Deferred Taxes

Deferred tax assets and liabilities are recognized for the timing differences between the financial statement carrying amounts of existing assets and liabilities and the respective tax basis at the balance sheet date. Deferred tax assets and liabilities are measured using the enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. Valuation allowances are established when necessary to reduce deferred tax assets to an amount that in management's opinion, is more likely than not to be realized.

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

Ended December 31, 2018 *(in millions)*	
Deferred tax assets:	
Deferred gain on reinsurance	$ 605
Life policy reserves	99
Loss reserve discount	29
Deferred policy acquisition costs	12
Unearned premium reserve	11
Employee Benefits	2
Total deferred tax assets	758
Deferred tax liabilities:	
Funds withheld	(238)
Basis differences in investments	(49)
Other	(3)
Total deferred tax liabilities	(290)
Net deferred tax assets before valuation allowance	468
Valuation allowance	—
Net deferred tax asset (liabilities)	$ 468

The difference between the deferred tax asset for the year ended December 31, 2018 of $468 million and the deferred tax benefit recognized for the year ended December 31, 2018 of $560 million relates to a deferred tax liability that accompanied the capital contribution of MLIII B notes on February 12, 2018.

Fortitude Re had no valuation allowance as December 31, 2018. See the section "Valuation Allowance on Deferred Tax Assets" below for further details.

As of December 31, 2018, Fortitude Re has no net operating loss carryforwards available to offset future net income subject to U.S. Federal income tax.

Valuation Allowance on Deferred Tax Assets

Fortitude Re evaluates the recoverability of deferred tax assets and establishes a valuation allowance, if necessary, to reduce the deferred tax asset to an amount that is more likely than not to be realized (a likelihood of more than 50 percent). The evaluation of the recoverability of the deferred tax asset and the need for a valuation allowance requires Fortitude Re 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.

Fortitude Re's framework for assessing the recoverability of deferred tax assets requires consideration of 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 carry forward periods for the net operating loss, capital loss and foreign tax credit carry forwards, 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 the deferred tax asset.

For the year ended December 31, 2018, recent changes in market conditions, including rising interest rates, impacted the embedded derivative associated with the securities in the Funds Withheld account. When assessing the overall realization of our deferred tax asset balance, we consider our ability and intent to hold the underlying securities to recovery. As of December 31, 2018, based on all available evidence, management believes that it is more likely than not that these assets will be realized. Therefore, Fortitude Re has not recorded a valuation allowance against its deferred tax assets.

Accounting for Uncertainty in Income Taxes

Fortitude Re evaluates uncertain tax positions in the normal course of the operations to determine whether the tax positions are more likely than not to be realized as a tax benefit or expense in the current year. Fortitude Re recognizes interest and penalties related to uncertain tax benefits in U.S. Federal income tax expense. At December 31, 2018, Fortitude Re has no uncertain tax positions and no accrual for interest and penalties.

10. Related Party Transactions

Because of the significant related-party transactions with AIG Parent and its affiliates, Fortitude Re's financial condition and results of operations may not necessarily be indicative of the financial condition or results of operations that would have occurred if Fortitude Re had been operating as an unaffiliated company. Significant related party arrangements include shared services and investment management as described below. *Refer to Note 6 Reinsurance for a description of material related party reinsurance transactions related to the mod-co agreements.*

The following table summarizes related party amounts included on the balance sheet and statement of income (loss) excluding payables to affiliates of $536 million associated with reinsurance activities.

December 31, 2018 *(in millions)*		
Balance Sheet		
Payable to affiliates		
General operating expenses - overhead and direct	$	113
Asset management fee		4
Other		6
Total		123
Statement of Income (Loss)		
General operating expenses - allocation		147
General operating expenses - other		13
Net investment income - asset management fee		6
Total	$	166

$160 million of related party expense relates to General operating expenses and $6 million is an expense against Net investment income.

Under a Service and Expense Agreement between Fortitude Re and various AIG affiliates, we purchase administrative, investment management, accounting, marketing and data processing services from AIG or its subsidiaries. The affiliated entities provide Fortitude Re with personnel, office space, equipment, computer processing and other services. 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. Fortitude Re reimburses its affiliates for these services at cost.

Fortitude Re has an asset management agreement with AIG Asset Management Company, an affiliate, which provides asset management and related accounting services for Fortitude Re. Fortitude Re records an investment management fee as a deduction from income from investments, which is paid quarterly, based on the value of the assets under management.

In addition, Fortitude Re entered into (1) Investment Management Agreements with an affiliate of TCG (the Investment Manager), pursuant to which the Investment Manager will provide certain investment management and advisory services with respect to certain asset classes and (2) Fortitude Re entered into an Exclusivity Agreement with TCG pursuant to which the Investment Manager will be the exclusive provider of investment management and advisory services with respect to certain asset classes and certain new business acquired by Fortitude Re following the Fortitude Re Closing. In connection with the Carlyle transaction, AIG agreed to certain investment commitment targets into various Carlyle strategies and to certain minimum investment management fee payments within thirty-six months following the closing. AIG will be required to pay a proportionate amount of an agreed make-whole fee if the commitment is not met.

We have an unconditional capital maintenance agreement (CMA) with AIG that shall continue until the earliest of: (a) AIG's applicable regulators no longer require the CMA; (b) AIG sells more than 50 percent of the voting share capital of Fortitude Re; and (c) the Company is wound up or the Company's registration as an insurer is canceled or surrendered, each pursuant to the laws of Bermuda. As long as the CMA is in force, AIG is obligated to make a capital contribution to Fortitude Re if the Company's available statutory economic capital and surplus in respect of its general business and long term business falls below the Stress Threshold Percentage of Fortitude Re's projected Enhanced Capital Requirement (ECR) pursuant to Bermuda Monetary Authority (BMA) regulation. If there are any CMA funding obligations that occur within 18 months of the Fortitude Re Closing, AIG will fund those obligations on a non-dilutive basis to TCG, but only if, and to the extent that, AIG actually receives a dividend prior to the expiration of such period.

Fortitude Re reinsures run-off business from its AIG affiliates through the various reinsurance transactions described in Notes 1 Organization and Nature of Operations, 2 Basis of Presentation, 6 Reinsurance and 7 Insurance Liabilities.

Refer to Note 12 Statutory Requirements for discussion regarding $550 million letter of credit provided by AIG. Refer to Note 13 Subsequent Events for discussion regarding a loan to affiliate companies in January 2019.

Significant cash flows from related party mod-co reinsurance are included in cash from operations and are disclosed below, along with non-cash profit settlements in the form of security transfers.

Year Ended December 31, 2018 *(in millions)*		
Cash settlements	$	368
Non-cash profit settlements in the form of securities		434
Total	$	802

11. Shareholders' equity

All authorized and issued shares of Fortitude Re are owned by Fortitude Holdings. On February 12, 2018, AIG contributed capital of $2,620 million to Fortitude Re to support Fortitude Re's operations and local capital requirements. The contributed capital included fixed income securities of $1,270 million, MLIII B notes of $1,118 million with associated deferred tax liability of $92 million and cash of $324 million.

On July 31, 2018 Fortitude Re entered into a membership interest purchase agreement with AIG and TCG. TCG purchased a 19.9 percent ownership interest in Fortitude Holdings on November 14, 2018. Fortitude Holdings owns 100 percent of the outstanding common shares of Fortitude Re and AIG holds a 80.1 percent ownership interest in Fortitude Holdings.

As of December 31, 2018, we have not declared any dividends and no dividends are currently planned.

Accumulated Other Comprehensive Income

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

December 31, 2018 *(in millions)*		
Unrealized appreciation of fixed maturity securities, available for sale	$	3
Foreign currency translation adjustments		12
Less:		
Deferred income tax		3
Accumulated other comprehensive income	$	12

12. Statutory Requirements

Under the Bermuda Insurance Act 1978 and related regulations, as amended, Fortitude Re is subject to capital requirements calculated using the Bermuda Solvency and Capital Requirement ("BSCR") model, which is a standardized statutory risk-based capital model used to measure the risk associated with Fortitude Re's assets, liabilities and premiums. Fortitude Re's required statutory capital and surplus under the BSCR model is referred to as the enhanced capital requirement ("ECR"). The Company is required to calculate and submit the ECR to the Bermuda Monetary Authority ("BMA") annually. Following receipt of the submission of the Company's ECR the BMA has the authority to impose additional capital requirements (capital add-ons) if it deems necessary.

If a Company fails to maintain or meet its ECR, the BMA may take various degrees of regulatory action. Under the economic balance sheet ("EBS") framework, assets and liabilities are mainly assessed and included on the EBS at fair value, with the insurer's U.S. GAAP balance sheet serving as a starting point. The model also requires insurers to estimate insurance technical provisions, which consist of the insurer's insurance related balances valued based on best-estimate cash flows, adjusted to reflect the time value of money using a risk-free discount rate, with the addition of a risk margin to reflect the uncertainty in the underlying cash flows. As of December 31, 2018, the statutory capital and surplus of Fortitude Re is $2,675 million, which is greater than the required minimum margin of solvency of $1,136 million. Included in the statutory capital and surplus are letters of credit (LOCs) which provide additional capital flexibility for Bermuda statutory purposes. The LOCs are subject to reimbursement by AIG in the event of a drawdown. There are two outstanding LOCs at December 31, 2018. A three year letter of credit for $400 million expires February 6, 2021 and a five year letter of credit for $150 million expires February 6, 2023.

Under the Bermuda Insurance Act, Fortitude Re is prohibited from paying a dividend in amount exceeding 25% of the prior year's statutory capital and surplus, unless at least two members of Fortitude Re's board of directors and its principal representative in Bermuda sign and submit to the BMA an affidavit attesting that a dividend in excess of this amount would not cause Fortitude re to fail to meet its relevant margins. In certain instances, Fortitude would also be required to provide prior notice to the BMA in advance of the payment of dividends. In the event that such an affidavit is submitted to the BMA in accordance with the Bermuda Insurance Act, and further subject to Fortitude Re meeting its Minimum Margin of Solvency and ECR, Fortitude Re is permitted to distribute up to the sum of 100% of statutory surplus and an amount less than 15% of statutory capital. Distributions in excess of this amount require the approval of the BMA. As of December 31, 2018, Fortitude Re was not permitted to pay a dividend since the Company did not file a prior year Capital and Solvency Return with the BMA as the execution date of the series of reinsurance transactions was not until February 12, 2018.

13. Subsequent Events

Fortitude Re has evaluated the impact of subsequent events through March 22, 2019 the date at which the financial statements were available to be issued.

Three companies owned by Fortitude Holdings, Fortitude Life, Fortitude General, and Fortitude Services commenced operations on January 1, 2019. On February 21, 2019, Fortitude Re provided loans to the three subsidiaries as follows: Fortitude Life ($10 million), Fortitude General ($5 million), and Fortitude Services ($10 million). One related party loan has a term of 10 years and the other two have a term of 20 years.

On February 19, 2019, Fortitude Re made payments of $60 million and $56 million to VALIC and USL, respectively, in order to fund an obligation related to collateral funding requirements. Fortitude Re has an obligation to fund any shortfall in U.S. statutory book value in conjunction with the reinsurance agreements *described in Note 1, Organization and nature of operations*.

On March 11, 2019, Fortitude Re paid a net reinsurance settlement of $536 million with cash in connection with the mod-co and reinsurance agreements.