# Management's Discussion and Analysis

## NYLIFE INSURANCE COMPANY OF ARIZONA
## December 31, 2016

Management's Discussion and Analysis of Financial Condition and Results of Operations ("**MD&A**") addresses the financial condition of NYLIFE Insurance Company of Arizona ("**the Company**") at December 31, 2016, compared with December 31, 2015, and its results of operations for the years ended December 31, 2016 and 2015. This discussion should be read in conjunction with the Statutory Financial Statements.

### FORWARD-LOOKING INFORMATION

This MD&A contains forward-looking statements that are intended to enhance the reader's ability to assess the Company's future financial and business performance. Forward-looking statements include, but are not limited to, statements that represent the Company's beliefs concerning future operations, strategies, financial results or other developments, and contain words and phrases such as "may," "expects," "should" or similar expressions. Because these forward-looking statements are based on estimates and assumptions that are subject to significant business, economic and competitive uncertainties, many of which are beyond the Company's control or are subject to change, actual results could be materially different and the value of the Company's investments, its financial condition and its liquidity could be adversely affected. The following uncertainties, among others, may have such an effect:

- Difficult conditions in the global capital markets and the economy.
- Significant financial and capital market risks affecting the Company's businesses, including interest rate risk, credit risk, and risk of fluctuations in credit spreads.
- Adverse regulatory developments.
- Adverse capital and credit market conditions.
- Significant market valuation fluctuations of the Company's investments.
- Downgrades or potential downgrades in the Company's ratings.
- The sensitivity of the amount of statutory capital the Company must hold to factors outside of its control.
- Subjectivity in determining the amount of allowances and impairments taken on certain of the Company's investments.
- Deviations from assumptions regarding future mortality and interest rates used in calculating reserve amounts.
- The effectiveness of the Company's risk management policies and procedures.
- Losses due to defaults by, or deteriorating credit of, third parties, including issuers of investment securities or reinsurance counterparties.
- The impact of natural or man-made disasters on the Company's operations, results of operations and financial condition.
- Changes in tax laws and the interpretation thereof.
- Litigation and regulatory investigations.
- A computer system failure or security breach.

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

**INDEX**



## OVERVIEW

The Company, a direct, wholly owned subsidiary of New York Life Insurance Company ("New York Life") was incorporated in Arizona on July 23, 1987 for the purpose of engaging in non-participating life and health insurance and annuity business. The Company currently services a ten-year guaranteed term life insurance product called "Term to Age 90". Key features of this product include annual renewable term rates after ten years, a 10-year attained age term conversion privilege and a partially levelized agent commission structure. The Company stopped new sales of the Term to Age 90 product in May of 2011.

The Company is authorized to conduct life insurance and annuity business in 48 states (the Company is not authorized in New York and Maine) and the District of Columbia.

### Income, Benefits and Expenses

The Company derives its income principally from renewal premiums on its term life product and net investment income. The Company's benefits and expenses consist principally of insurance benefits paid to policyholders and beneficiaries, reserves for future policy holder benefits, and operating expenses, including administrative costs and commissions.

The Company's profitability depends primarily on the adequacy of its product pricing, which is a function of its ability to select underwriting risk, its mortality and persistency experience, its ability to generate earnings and manage credit risk on the investments supporting its products and its ability to control expenses in accordance with its pricing assumptions.

## CRITICAL ACCOUNTING ESTIMATES

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements. Actual results could differ from those estimates.

The Company has identified the following estimates as critical in that they involve a higher degree of judgment and are subject to a significant degree of variability: valuation of investments, and reserves. In developing these estimates, management makes subjective and complex judgments that are inherently uncertain and subject to material change as facts and circumstances develop. Although variability is inherent in these estimates, management believes the amounts provided are appropriate based upon the facts available as of the date of the financial statements.

# Management's Discussion and Analysis

**Investments**

One significant estimate inherent in the valuation of investments is the evaluation of other-than-temporary impairments ("**OTTI**"). The evaluation of OTTI is a quantitative and qualitative process, which is subject to judgment in the determination of whether declines in the fair value of investments are other than temporary. The key judgment is the determination of when to recognize the impairment. For bonds, a company must demonstrate the ability and intent to hold a security for a period of time sufficient to allow for an anticipated recovery in value and needs to have a comprehensive process to review its portfolio on a regular basis to assess its holdings. The Company, as part of its impairment policy, performs both quantitative and qualitative analysis to determine if a decline in value is temporary. Factors considered in evaluating whether a decline in value is other than temporary include: (1) whether the decline is substantial; (2) duration that the fair value has been less than cost; (3) the financial condition and near-term prospects of the issuer; and (4) the Company's ability and intent to retain the investment for the period of time sufficient to allow for an anticipated recovery in value. For those securities where the decline is considered temporary, the Company does not recognize an impairment when it has the ability and intent to hold until recovery.

**Policy Reserves**

Reserves for life insurance contracts are based on mortality tables and valuation interest rates, which are consistent with statutory requirements. These reserves are expected to be sufficient to meet the Company's various policy and contract obligations as they become due. Changes in or deviations from the assumptions used for mortality, expected future premiums and interest can significantly affect the Company's reserve levels and related future operations.

In some situations, the Company may need to hold statutory reserves greater than those developed under the minimum statutory reserving rules. Annually, the Company's appointed actuary is required by the regulators to test the adequacy of the statutory reserves using asset adequacy analyses. The dominant asset adequacy analysis technique is cash flow testing, which utilizes prescribed interest rate scenarios using detailed actuarial models. If the appointed actuary determines that the statutory reserves being tested are inadequate, additional statutory reserves are established. At the end of the process, the appointed actuary must opine that the statutory reserves are adequate to support the anticipated liabilities when considered in light of the assets held by the Company.

Also, an estimate is used in the development of the liability for claims incurred but not reported ("**IBNR**"). IBNR refers to an estimate of losses for all potential claims that have occurred prior to the statement date, but have not yet been reported to the Company. The IBNR liability is developed based on historical experience.

# Management's Discussion and Analysis

**RESULTS OF OPERATIONS**

The following table illustrates the Company's results of operations for the years ended December 31, 2016 and 2015 ($ in thousands):

| | 2016 | 2015 | Change $ | Change % |
|---|---|---|---|---|
| Income: | | | | |
| Premiums | $ 18,497 | $ 23,306 | $ (4,809) | (20.6)% |
| Net investment income | 5,231 | 5,329 | (98) | (1.8) |
| Commissions and expense allowances on reinsurance ceded | 1,027 | 1,051 | (24) | (2.3) |
| Total income | 24,755 | 29,686 | (4,931) | (16.6) |
| Benefits and expenses: | | | | |
| Benefit payments | 17,499 | 20,622 | (3,123) | (15.1) |
| Reduction to policy reserves | (17,031) | (12,350) | (4,681) | 37.9 |
| Operating expenses | 3,792 | 4,568 | (776) | (17.0) |
| Total benefits and expenses | 4,260 | 12,840 | (8,580) | (66.8) |
| Gain from operations before federal income taxes | 20,495 | 16,846 | 3,649 | 21.7 |
| Federal income taxes | 8,127 | 4,823 | 3,304 | 68.5 |
| Net gain from operations | 12,368 | 12,023 | 345 | 2.9 |
| Net realized capital gains/(losses) after taxes and transfers to interest maintenance reserve ("IMR") | (1) | 10 | (11) | nm |
| Net income | $ 12,367 | $ 12,033 | $ 334 | 2.8 % |

nm = not meaningful

**Net Income**

The Company’s net income was primarily derived from net gain from operations, which was $345 thousand higher than the amount reported for 2015. See detail explanations below:

**Premiums**

The $4,809 thousand decrease in premiums from 2016 to 2015 was primarily due to the discontinuation of sales of new business. As a result, the Company will continue to experience a decline in premiums as existing policies inforce decline from lapses and deaths.

**Net Investment Income**

Net investment income for the year ended December 31, 2016 decreased $98 thousand from 2015, primarily driven by lower asset balances.

**Benefit Payments**

Benefit payments decreased $3,123 thousand from 2015 primarily due to lower death benefits of $2,806 thousand driven by lower inforce and favorable mortality experience in 2016.

**Reduction to Policy Reserves**

The Company's policy reserves decreased from 2015 primarily due to an increase in lapses and conversions to permanent life insurance policies issued by New York Life and NYLIAC.

**Operating Expenses**

Operating expenses primarily include general insurance expenses, taxes, licenses and fees and commissions. For the year ended December 31, 2016 total operating expenses decreased $776 thousand from 2015. The majority of the general expenses are allocated from New York Life under a service agreement. Under the terms of the service agreement, the Company reimburses New York Life for certain services and facilities provided to the Company.

**Federal Income Taxes**

The following table reconciles the tax expense calculated at the statutory rate to the tax expense reflected in the Company's results of operations for the years ended December 31, 2016 and 2015 (in thousands):

| | 2016 | 2015 | Change |
|---|---|---|---|
| **Pre-tax gain from operations @ 35%** | **$ 7,173** | **$ 5,896** | **$ 1,277** |
| Deferred acquisition costs | (669) | (606) | (63) |
| Tax basis versus statutory basis reserves adjustment | 813 | (1,504) | 2,317 |
| Amortization of change in reserve valuation | 426 | 426 | — |
| Other | 384 | 611 | (227) |
| **Total federal income tax expense** | **$ 8,127** | **$ 4,823** | **$ 3,304** |

**FINANCIAL POSITION**

**ASSETS**

The following table illustrates the Company's statutory asset position at December 31, 2016 and 2015 ($ in thousands):

| | 2016 | 2015 | Change $ | Change % |
|---|---|---|---|---|
| Invested assets: | | | | |
| Bonds | $ 148,583 | $ 152,856 | $ (4,273) | (2.8) |
| Cash, cash equivalents and short-term investments | 3,818 | 13,166 | (9,348) | (71.0) |
| Other invested assets | — | 1 | (1) | (100.0) |
| Total cash and invested assets | 152,401 | 166,023 | (13,622) | (8.2) |
| Other than invested assets: | | | | |
| Deferred and uncollected premiums | 22,915 | 26,518 | (3,603) | (13.6) |
| Investment income due and accrued | 1,020 | 1,115 | (95) | (8.5) |
| Reinsurance recoverables | 471 | 781 | (310) | (39.7) |
| Net deferred tax assets | 5,474 | 5,939 | (465) | (7.8) |
| Other assets | 645 | 91 | 554 | nm |
| Total other than invested assets | 30,525 | 34,444 | (3,919) | (11.4) |
| **Total assets** | **$ 182,926** | **$ 200,467** | **$ (17,541)** | **(8.8)%** |

**Investment Portfolio**

Invested assets are managed to support the liabilities of the Company. The Company emphasizes asset/liability management and liquidity management. Quality and diversification are essential building blocks in portfolio construction. In addition, the Company's parent takes a comprehensive enterprise view, taking measures to mitigate overall risk exposures at the corporate level.

## Investment Risk Management

The Company is part of New York Life's enterprise wide investment risk management process.

New York Life follows a fundamental approach to credit analysis supporting bond purchase or sale decisions. Key factors include the stability and adequacy of cash flow in relation to debt service requirements and the outlook for growth in net income. Issuers of below investment grade bonds generally have relatively high levels of indebtedness and are thus more sensitive than issuers of investment grade bonds to adverse economic conditions or to increasing interest rates. Although private placements are relatively less liquid, they benefit from more comprehensive financial covenants and are more likely to be secured or senior in structure.

New York Life actively manages and monitors its credit risk exposure. Through its affiliate, NYL Investors LLC (**"NYL Investors"**), credit risk is managed on an individual issuer and sector basis as well as for the aggregate corporate portfolio in accordance with New York Life's investment policy guidelines. Individual issuer limits are set based on the issuer's credit rating and other factors. Credit ratings for issuers used to monitor credit risk are either from credit rating providers, or internal ratings. A comparable internal rating is used if an externally provided rating is not available. The internal ratings are maintained and monitored by an experienced group of credit analysts specialized by industry and asset type. Factors involved in determining credit ratings include financial and operating ratios, industry outlook and priority of claim. Credit limits and guidelines are established and reviewed periodically. The bond portfolio is continuously examined to identify any potential problems or events that would result in the issuer not being able to comply with the contractual terms. These are included on a "watchlist" that is routinely monitored.

## Bonds

Bonds represented 97.5% and 92.1% of total invested assets at December 31, 2016 and 2015, respectively and consisted of publicly traded and private placement debt securities. At December 31, 2016 and 2015, publicly traded bonds comprised 91.0% and 90.3%, respectively, of the total bond portfolio.

It is New York Life's objective to maintain a high quality, well-diversified bond portfolio. The bond portfolio consists primarily of investment-grade corporate bonds.

An analysis of the credit quality, as determined by National Association of Insurance Commissioners **("NAIC")** designation, of the total bond portfolio at December 31, 2016 and 2015, is set forth in the following table ($ in thousands):

| | | 2016 | | 2015 | |
|---|---|---|---|---|---|
| **NAIC Designation** | **Approximate Rating Agency Equivalent Designation** | **Carrying Value** | **% of Total Carrying Value** | **Carrying Value** | **% of Total Carrying Value** |
| 1 | AAA to A- | $ 137,810 | 92.7 % | $ 144,917 | 94.8 % |
| 2 | BBB+ to BBB- | 9,292 | 6.3 | 6,471 | 4.2 |
| | Investment Grade | 147,102 | 99.0 | 151,388 | 99.0 |
| 3 | BB+ to BB- | 1,481 | 1.0 | 1,468 | 1.0 |
| 4 | B+ to B- | — | — | — | — |
| 5 | CCC+ to CCC- | — | — | — | — |
| 6 | CC to D | — | — | — | — |
| | Below Investment Grade | 1,481 | 1.0 | 1,468 | 1.0 |
| | **Total** | **$ 148,583** | **100.0%** | **$ 152,856** | **100.0%** |

The Company has investments that have been downgraded (i.e., fallen angels) from investment grade are included in this category and totaled $1,481 thousand and $1,468 thousand in 2016 and 2015, respectively. The Company applies the same prudent principles in managing its high yield portfolio, emphasizing diversification standards (such as limits on issuer, industry and geographic locations to minimize concentration risks), credit quality and liquidity. New York Life manages its aggregate risk exposure to investment risks against an approved risk budget and other internal limits and guidelines.

The following table presents the estimated fair value of the Company's total bond portfolio classified as performing or OTTI at December 31, 2016 and 2015. OTTI bonds are defined as bonds for which OTTI write-downs have been taken. The Company did not have any temporarily impaired bonds where the estimated fair value was below the carrying value by more than 20% as of the balance sheet date, but which continue to meet all their contractual obligations ($ in thousands):

| | 2016 | | | 2015 | | |
|---|---|---|---|---|---|---|
| | Carrying Value | Estimated Fair Value | % of Total Carrying Value | Carrying Value | Estimated Fair Value | % of Total Carrying Value |
| Performing | $ 148,392 | $ 149,578 | 99.9% | $ 152,619 | $ 154,896 | 99.8% |
| OTTI | 191 | 201 | 0.1 | 237 | 247 | 0.2 |
| Total | $ 148,583 | $ 149,779 | 100.0% | $ 152,856 | $ 155,143 | 100.0% |

The Company's net unrealized gains on bonds of $1,196 thousand and $2,287 thousand at December 31, 2016 and 2015, respectively, are not reflected in the Company's Statutory Financial Statements since these bonds are held at amortized cost or the lower of amortized cost or fair value if in default (as defined by an NAIC designation 6) as required by Statutory Accounting Principles. Net unrealized gains were comprised of gross unrealized gains of $2,651 thousand and $3,641 thousand at December 31, 2016 and 2015, respectively, which were partially offset by gross unrealized losses totaling $1,455 thousand and $1,354 thousand at December 31, 2016 and 2015, respectively.

**Cash, Cash Equivalents and Short-term Investments**

Cash (and cash equivalents) includes cash on hand, amounts due from banks and highly liquid debt instruments that have original maturities of three months or less at the date of purchase and are carried at amortized cost, which approximates fair value. Short-term investments consist of securities that have remaining maturities of greater than three months and less than or equal to twelve months when purchased and are carried at amortized cost, which approximates fair value. At December 31, 2016, Cash, cash equivalents and short-term investments decreased by $9,348 thousand from 2015 primarily due to a reduction in money market exempt funds and US treasury bills.

**Other than Invested Assets**

The decrease of $3,919 thousand in other than invested assets is primarily driven by lower deferred and uncollected premium (resulting from the decline of policies inforce).

**Liabilities**

The following table illustrates the Company's statutory liabilities position at December 31, 2016 and 2015 ($ in thousands):

| | 2016 | 2015 | Change $ | Change % |
|---|---|---|---|---|
| Policy reserves | $ 70,335 | $ 89,608 | $ (19,273) | (21.5)% |
| Deposit funds | 2,294 | 2,944 | (650) | (22.1) |
| Policy claims | 2,901 | 2,212 | 689 | 31.1 |
| Payable to parent and affiliates | 2,635 | 3,656 | (1,021) | (27.9) |
| Other liabilities | 334 | 10,387 | (10,053) | (96.8) |
| Asset valuation reserve | 494 | 484 | 10 | 2.1 |
| Total liabilities | $ 78,993 | $ 109,291 | $ (30,298) | (27.7)% |

**Policy Reserves**

At December 31, 2016, total policy reserves were $19,273 thousand or 21.5% lower than the amount reported at December 31, 2015. (See "Results of Operations - Reductions to Policy Reserves").

**Deposit Funds**

The decrease is primarily attributable to a decline in the account balance as the Company ceased the opening of new continued interest accounts effective June 2012. Deposit fund contracts do not contain any mortality risk and consist entirely of continued interest accounts.

**Policy Claims**

Policy claims increased $689 thousand from the amount reported at December 31, 2015. Claims can be subject to volatility and as such there were more claims for this year as compared to 2015, as well as a disproportional increase in direct claims that were not reinsured in 2016.

**Payable to Parent and Affiliates**

The decrease is mainly attributable to lower expenses incurred by the Company. The majority of the general expenses are allocated from New York Life under a service agreement. Under the terms of the service agreement, the Company reimburses New York Life for certain services and facilities provided to the Company.

**Other Liabilities**

The decrease is primarily due to a decrease in payable for securities (which was caused by the timing of the settlement of one security) and a reduction in federal income taxes payable (the Company has a tax receivable in 2016).

# Management's Discussion and Analysis

## Statutory Capital and Surplus

Statutory capital and surplus was $103,933 thousand at December 31, 2016, an increase of $12,757 thousand or 14.0% from the $91,176 thousand at December 31, 2015. The main drivers of the change in surplus are presented in the following table ($ in thousands):

| | | 2016 |
|---|---|---|
| Beginning surplus | $ | 91,176 |
| Net income | | 12,367 |
| Change in nonadmitted assets* | | 411 |
| Change in deferred income tax | | (466) |
| Change in asset valuation reserve | | (10) |
| Prior period correction | | 455 |
| **Ending surplus** | **$** | **103,933** |

* Excludes $629 thousand related to deferred taxes nonadmitted, which is reclassified to "Change in deferred income tax".

Net income of $12,367 thousand was the primary driver behind the increase in surplus in 2016 (see "Results of Operations - Net Income"). Other items impacting the Company's 2016 surplus position include the following:

## Change in Nonadmitted Assets

Certain assets are not allowed as admitted assets under SAP. Generally these are assets with economic value, but which cannot be readily used to pay policyholder obligations. The change in nonadmitted assets was primarily driven by a decrease in miscellaneous assets nonadmitted during 2016.

## Prior Period Correction

In 2016, the Company corrected an error related to waiver of premium benefits incurred but not reported ("**IBNR**") and in course of settlement ("**ICOS**") reserves. The Company calculated the prior year reserves based on claims experience data that incorrectly identified certain claims as IBNR. To correct this error, the Company reduced its reserves and recorded a prior period correction that increased statutory surplus by $455 thousand on an after-tax basis.

## LIQUIDITY SOURCES AND REQUIREMENTS

### Liquidity Sources

The Company's principal cash inflows from its insurance activities are derived from life insurance premiums. The Company's principal cash inflows from investment activities result from proceeds on sales, repayments of principal, maturities of invested assets, and investment income. The following table sets forth the total available liquidity of the Company from liquid assets and other funding sources at December 31, 2016 and December 31, 2015 ($ in thousands):

| | 2016 | 2015 |
|---|---|---|
| **Cash and short term investments:** | | |
| Cash & cash equivalents | $ 3,424 | $ 4,938 |
| Short term investments | 394 | 8,230 |
| Less: other short-term liabilities | — | (5,127) |
| **Net cash and short term investments** | **3,818** | **8,041** |
| | | |
| **Liquid Bonds:** | | |
| U.S government and agency bonds | 8,028 | 5,597 |
| Public corporate investment-grade bonds & collateralized mortgage obligations[1] | 121,526 | 122,718 |
| **Liquid bonds** | **129,554** | **128,315** |
| **Total liquid assets** | **133,372** | **136,356** |
| | | |
| **Other funding sources:** | | |
| Credit agreement with New York Life | 10,000 | 10,000 |
| **Total other funding sources** | **10,000** | **10,000** |
| **Total available liquidity** | **$ 143,372** | **$ 146,356** |

[1] Includes all public corporate investment-grade bonds & CMOs, which are stated at fair value.

### Liquidity Uses

The Company's principal cash outflows from its insurance activities relate to the benefit payments associated with its term product and operating expenses.

### Cash Flows

Net cash (used in) / from operating activities for the years ended December 31, 2016 and 2015 were ($7,726) thousand and $780 thousand, respectively, a decrease of $8,506 thousand from prior year. This decrease was primarily driven by an increase in income taxes paid during 2016.

Net cash (used in) / from investing activities for the years ended December 31, 2016 and 2015 were ($1,301) thousand and $8,314 thousand, respectively, a decrease of $9,615 thousand from prior year. This decrease was primarily due to the liquidation of STIF and maturity of certain fixed income securities during 2015.

Net cash applied to financing and miscellaneous activities was $321 thousand and $293 thousand for the years ended December 31, 2016 and 2015, respectively, an increase of $28 thousand from prior year.

# Management's Discussion and Analysis

**FINANCING**

**Credit Agreements**

The Company has a credit agreement with New York Life dated August 11, 2004 whereby the Company can borrow up to $10,000 thousand from New York Life. During 2016, the credit facility was not used, no interest was paid and there was no outstanding balance due.

**OUTLOOK**

As of May 2011, the Company discontinued selling insurance, but will maintain its current block of inforce term life policies. Current projections indicate that the Company will remain financially sound and will actually increase its financial strength over the next several years as the inforce continues to decline. There are no immediate plans to resume selling insurance although the Company may choose to do so at some point in the future.