Annual Financial Update Call - June 03, 2020, 1:00 p.m. ET
Follow-Up Questions Received from Call Participants

1. The statutory statements for National Life Insurance Company (NLIC) show net income (loss) of $(42) million in first quarter 2020 versus $15.3 million last year. The major driver was net investment income (NII) of $4.7 million versus $75.9 million. How much of that was unrealized versus realized? And are any specific asset classes the cause of this?

   NLG Response: The decrease in NLIC's 1Q20 net investment income compared to 1Q19 was primarily due to the unrealized mark-to-market on derivatives used to economically hedge our indexed products. Derivative values reflected the significant decline in the value of the S&P 500 in 1Q20 vs. the market recovery in 1Q19. The same issue also caused a decrease in NII and net income in the 1Q20 statutory results of operations of Life Insurance Company of the Southwest.

2. Please discuss the scenario testing conducted around your portfolios and liabilities at the start of the financial markets' disruption.

   NLG Response: We have conducted a series of targeted stress tests to evaluate the potential impact of the COVID-19 event and associated market disruptions on our balance sheet, growth, capital and earnings. Out of a large set of possible scenarios, we focused on a limited number of economic scenarios with varying degrees of severity, ranging from a 3-6 month recession to an extreme tail scenario including associated stresses to Gross Domestic Product growth, unemployment, default probabilities, policyholder behavior and mortality. These scenarios provide an understanding of the potential impact to our business of specified economic and market shocks.

3. What is the current state of those portfolios and liabilities vis-à-vis those scenarios in terms of portfolio losses?

   NLG Response: To date, our impairments, rating migrations, mortality and lapse activity have not been outside of historical experience and are within both our long-term pricing expectations and the assumptions of our 3-6 month recession scenario.

4. What level of portfolio losses do you anticipate going forward?

   NLG Response: Impairments and realized losses going forward will depend upon several factors, including the timing and path of the economic recovery, the evolution of the COVID-19 pandemic, and the impact of Federal Reserve stimulus. For context, our impairments in 2019 were approximately 10 basis points of assets under management, compared to a long-term average of 20 basis points. Year-to- date in 2020 we have had minimal impairments.

5. Are there any changes to portfolio strategy that may have resulted from the pandemic for the longer term?

   NLG Response: We continue to evaluate the potential longer-term implications of the pandemic upon the potential risk-adjusted returns of the asset classes and sectors in which we invest. In 2020, we exited completely out of our position in emerging markets debt, reducing our exposure to that asset class from 1.4% of assets under management to 0.0%. We remain cautious in our approach to the energy, transportation (particularly airlines), and consumer cyclical (primarily retail) sectors within credit, as well as riskier structured assets and commercial real estate mortgages.

6. Can you provide more detail on the underlying quality of your $2 billion collateralized loan obligation (CLO) portfolio, the breakdown of the ratings in the CLOs (not by NAIC classifications but by ratings) and what are the vintage and structure types static or managed?

   NLG Response: As of June 5, 2020, our CLO exposure is 20% AAA Rated, 61% AA Rated, 16% A Rated and 3% BBB Rated. As for vintage, 4% of our CLO were closed in 2020, 30% in 2019, 44% in 2018, 22% in 2017 and 0.2% in 2013. 100% of our CLO holdings are managed.

7. Please provide a breakdown of your non-Agency commercial mortgage-backed securities (CMBS) exposure by underlying credit quality.

   NLG Response: Our total exposure to non-Agency CMBS is $353 million. As of June 5, 2020, our Non-Agency CMBS portfolio is 28% AAA Rated, 20% AA Rated, 19% A Rated, 18% BBB Rated, 13% BB Rated and 2% B Rated and below. 85.1% of our non-agency CMBS portfolio is NAIC 1 rated.

8. Within your energy portfolio can you breakdown the subsector i.e. integrated, exploration & production, etc. and what are the ratings breakdowns of your energy exposure.

   NLG Response: Of our $1.2 billion energy sector exposure, 45% is midstream, 24% independent, 15% integrated, 9% oilfield services and 7% refining. As of June 5, 2020, our energy sector holdings were 22% A Rated, 66% BBB Rated, and 12% Rated BB and below.

9. Given the volatility in the equity markets in the first quarter and lending into the second quarter, how are your derivative positions going to affect the index credits and ability for the company to generate investment returns. Can you confirm if your firm uses a static or dynamic hedge strategy, and is it month-to-month on the index credit or over longer periods?

   NLG Response: As of June 1, 2020, more than 95% of our equity-indexed life and annuity product exposure was statically hedged, which entails purchasing equity options with matched terms that directly offset the risk from the product liabilities. Our year-to-date hedge effectiveness for equity-indexed products is over 99%. Index crediting currently occurs on an annual point-to-point basis for all our products.

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10. Can you discuss the reserve balances (both on a cash-flow testing statutory basis and best estimates GAAP basis) ?
    a. What is your long-term view of the grading of investment rate (IR)?

    NLG Response: For our indexed life and annuity products, which are the majority of our product liabilities, GAAP requires us to treat the equity indexing feature as an embedded derivative measured at fair value, for which we assume that external interest rates stay level at the values observed at the valuation date; there is no grading.

    b. With the current IR at 60 bps, and the changes to the economic assessment of liabilities, can you describe your current best estimate philosophy on IR and behavioral and biometric assumptions (i.e. covid) and how can that negatively affect reserves and your current excess capital position? (If possible, please provide your excess capital position).

    NLG Response: With current rates and credit spreads, we have not identified a need for additional statutory reserves. If rates and spreads decline and remain low for an extended period, additional reserves may need to be established.

    We are closely monitoring policyholder behavior, and the changes in policyholder lapse/ surrender behavior we have seen thus far have not indicated a need for an increase in statutory reserves. Lapse sensitivity tests used in our annual statutory asset adequacy testing are higher that what we are currently observing, and those lapse sensitivity tests did not indicate the need for higher asset adequacy reserves at December 31, 2019.

    For statutory asset adequacy testing, we perform a 10% mortality sensitivity test for the entire 30 year projection period, which did not indicate the need for higher asset adequacy reserves at December 31, 2019. Through the end of May 2020, COVID-19 related death claims are less than 10% of our total life insurance claims, net of reserves released and net of reinsurance.

With respect to excess capital, we continue to target a ratio of approximately 450% for statutory total adjusted capital to NAIC Risk-based Capital Company Action Level.

c. Can you give some color as to your STAT asset adequacy testing (AAT) results?

NLG Response: The year-end 2019 asset adequacy testing used 12/31/2019 values for the starting yield curve and S&P 500 level. Both of our insurance subsidiaries had positive ending surplus in all scenarios modeled.

d. Any unlocking or best estimate changes contemplated?

NLG Response: At least annually, and typically in the third quarter, we review and update our long-term GAAP assumptions, including investment-related returns and spreads, product fees and expenses, mortality, policyholder behavior and other factors. We are currently performing experience studies, which will help inform which of our models and assumptions may be impacted by assumption updates.

11. On your variable annuity (VA) block can you highlight if you implemented Actuarial Guideline 43 (AG 43) or are electing to utilize the 1-2 year implementation. And what conditional tail expectation (CTE) are you managing the book at?

    NLG Response: Variable annuities are a very small portion of our business (about $190 million or 1.2% of total statutory annuity reserves at 12/31/19). We do not currently sell, and have never sold, variable annuities with guarantee features other than guaranteed minimum death benefits. We expect to adopt principles-based reserving for variable annuities (revisions to AG 43 which incorporate NAIC valuation manual VM-21 requirements) by December 31, 2020. Due to a relatively low anticipated reserve increase from this adoption, we have not yet made a decision on the phase-in period. We manage the block at CTE 70.

12. Any insight in terms of your leverage and ability to reduce from liability management?

    NLG Response: National Life Group's leverage ratio increased as a result of our surplus note issuances in 2018 and 2019, but is within our targeted levels. We continue to pursue opportunistic repurchases of our 10.5% surplus notes. Of the original $200 million of 10.5% notes issued in 2009, $166 million remained outstanding as of December 31, 2019.

13. Can you please describe your latest thinking around your existing high coupon surplus notes (10.5% due 9/15/2039)? What is your priority on addressing those?

    NLG Response: As of December 31, 2019, $166 million of principal remained outstanding from the original $200 million of 10.5% surplus notes issued in 2009. We continue to pursue opportunistic repurchases of the 10.5% surplus notes.