

NATIONAL WESTERN LIFE INSURANCE CO  
Form 10-Q  
November 07, 2014

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended September 30, 2014

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 2-17039

NATIONAL WESTERN LIFE INSURANCE COMPANY  
(Exact name of Registrant as specified in its charter)

COLORADO  
(State of Incorporation)

84-0467208  
(I.R.S. Employer Identification Number)

850 EAST ANDERSON LANE  
AUSTIN, TEXAS 78752-1602  
(Address of Principal Executive Offices)

(512) 836-1010  
(Telephone Number)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days: Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). :  
Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated file" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Edgar Filing: NATIONAL WESTERN LIFE INSURANCE CO - Form 10-Q

As of November 6, 2014, the number of shares of Registrant's common stock outstanding was: Class A – 3,436,166 and Class B - 200,000.

---

TABLE OF CONTENTS

	Page
<u>Part I. Financial Information:</u>	<u>3</u>
<u>Item 1. Financial Statements</u>	<u>3</u>
<u>Condensed Consolidated Balance Sheets</u> September 30, 2014 (Unaudited) and December 31, 2013	<u>3</u>
<u>Condensed Consolidated Statements of Earnings</u> For the Three Months Ended September 30, 2014 and 2013 (Unaudited)	<u>5</u>
<u>Condensed Consolidated Statements of Earnings</u> For the Nine Months Ended September 30, 2014 and 2013 (Unaudited)	<u>6</u>
<u>Condensed Consolidated Statements of Comprehensive Income (Loss)</u> For the Three Months Ended September 30, 2014 and 2013 (Unaudited)	<u>7</u>
<u>Condensed Consolidated Statements of Comprehensive Income</u> For the Nine Months Ended September 30, 2014 and 2013 (Unaudited)	<u>8</u>
<u>Condensed Consolidated Statements of Stockholders' Equity</u> For the Nine Months Ended September 30, 2014 and 2013 (Unaudited)	<u>9</u>
<u>Condensed Consolidated Statements of Cash Flows</u> For the Nine Months Ended September 30, 2014 and 2013 (Unaudited)	<u>11</u>
<u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>	<u>13</u>
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>48</u>
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	<u>47</u>
<u>Item 4. Controls and Procedures</u>	<u>47</u>
<u>Part II. Other Information:</u>	<u>84</u>
<u>Item 1. Legal Proceedings</u>	<u>84</u>
<u>Item 1A. Risk Factors</u>	<u>84</u>
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>85</u>
<u>Item 4. Removed and Reserved</u>	<u>85</u>
<u>Item 6. Exhibits</u>	<u>85</u>
<u>Signatures</u>	<u>86</u>



Table of Contents

## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

ASSETS	(Unaudited) September 30, 2014	December 31, 2013
Investments:		
Securities held to maturity, at amortized cost (fair value: \$7,195,441 and \$6,656,144)	\$6,898,038	6,510,320
Securities available for sale, at fair value (cost: \$2,576,805 and \$2,535,264)	2,724,880	2,651,544
Mortgage loans, net of allowance for possible losses (\$650 and \$650)	152,740	132,765
Policy loans	63,746	65,969
Derivatives, index options	109,812	169,314
Other long-term investments	29,006	30,991
Total investments	9,978,222	9,560,903
Cash and short-term investments	121,482	120,859
Deferred policy acquisition costs	795,452	785,706
Deferred sales inducements	160,614	169,570
Accrued investment income	100,256	95,367
Federal income tax receivable	5,650	—
Other assets	97,400	98,011
Total assets	\$11,259,076	10,830,416

See accompanying notes to condensed consolidated financial statements (unaudited).

Table of ContentsNATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share amounts)

	(Unaudited) September 30, 2014	December 31, 2013
LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES:		
Future policy benefits:		
Universal life and annuity contracts	\$9,267,144	8,987,062
Traditional life reserves	137,501	138,072
Other policyholder liabilities	142,175	142,587
Deferred Federal income tax liability	36,421	7,199
Federal income tax payable	—	10,067
Other liabilities	141,697	97,481
Total liabilities	9,724,938	9,382,468
COMMITMENTS AND CONTINGENCIES (Note 8)		
STOCKHOLDERS' EQUITY:		
Common stock:		
Class A - \$1 par value; 7,500,000 shares authorized; 3,436,166 issued and outstanding in 2014 and 3,434,765 in 2013	3,436	3,435
Class B - \$1 par value; 200,000 shares authorized, issued, and outstanding in 2014 and 2013	200	200
Additional paid-in capital	38,116	37,767
Accumulated other comprehensive income	47,717	38,080
Retained earnings	1,444,669	1,368,466
Total stockholders' equity	1,534,138	1,447,948
Total liabilities and stockholders' equity	\$11,259,076	10,830,416

Note: The Condensed Consolidated Balance Sheet at December 31, 2013 has been derived from the audited Consolidated Financial Statements as of that date.

See accompanying notes to condensed consolidated financial statements (unaudited).

Table of ContentsNATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS

For the Three Months Ended September 30, 2014 and 2013

(Unaudited)

(In thousands, except per share amounts)

	2014	2013
Premiums and other revenues:		
Universal life and annuity contract charges	\$36,602	33,523
Traditional life premiums	4,506	4,159
Net investment income	110,966	141,403
Other revenues	5,377	5,822
Net realized investment gains (losses):		
Total other-than-temporary impairment (“OTTI”) gains (losses)	—	214
Portion of OTTI (gains) losses recognized in other comprehensive income	—	(227 )
Net OTTI losses recognized in earnings	—	(13 )
Other net investment gains (losses)	2,169	3,298
Total net realized investment gains (losses)	2,169	3,285
 Total revenues	 159,620	 188,192
Benefits and expenses:		
Life and other policy benefits	13,163	16,941
Amortization of deferred policy acquisition costs	23,467	24,244
Universal life and annuity contract interest	59,211	87,486
Other operating expenses	20,451	22,675
 Total benefits and expenses	 116,292	 151,346
 Earnings before Federal income taxes	 43,328	 36,846
 Federal income taxes	 14,862	 12,064
 Net earnings	 \$28,466	 24,782
Basic earnings per share:		
Class A	\$8.05	\$7.01
Class B	\$4.03	\$3.51
Diluted earnings per share:		
Class A	\$8.05	\$7.00
Class B	\$4.03	\$3.51

See accompanying notes to condensed consolidated financial statements (unaudited).

Table of Contents

## NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS

For the Nine Months Ended September 30, 2014 and 2013

(Unaudited)

(In thousands, except per share amounts)

	2014	2013
Premiums and other revenues:		
Universal life and annuity contract charges	\$112,824	111,785
Traditional life premiums	13,946	13,241
Net investment income	374,596	451,904
Other revenues	16,351	17,954
Net realized investment gains (losses):		
Total other-than-temporary impairment (“OTTI”) gains (losses)	(32	) 524
Portion of OTTI (gains) losses recognized in other comprehensive income	(3	) (776 )
Net OTTI losses recognized in earnings	(35	) (252 )
Other net investment gains (losses)	6,782	7,451
Total net realized investment gains (losses)	6,747	7,199
 Total revenues	 524,464	 602,083
Benefits and expenses:		
Life and other policy benefits	40,922	48,081
Amortization of deferred policy acquisition costs	79,304	83,900
Universal life and annuity contract interest	224,576	299,224
Other operating expenses	63,414	69,442
 Total benefits and expenses	 408,216	 500,647
 Earnings before Federal income taxes	 116,248	 101,436
 Federal income taxes	 38,773	 33,031
 Net earnings	 \$77,475	 68,405
Basic earnings per share:		
Class A	\$21.92	\$19.35
Class B	\$10.95	\$9.68
Diluted earnings per share:		
Class A	\$21.91	\$19.32
Class B	\$10.95	\$9.68

See accompanying notes to condensed consolidated financial statements (unaudited).



Table of ContentsNATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

For the Three Months Ended September 30, 2014 and 2013

(Unaudited)

(In thousands)

	2014	2013	
Net earnings	\$28,466	24,782	
Other comprehensive income (loss), net of effects of deferred costs and taxes:			
Unrealized gains (losses) on securities:			
Net unrealized holding gains (losses) arising during period	(7,793	) (1,833	)
Net unrealized liquidity gains (losses)	(23	) (92	)
Reclassification adjustment for net amounts included in net earnings	(958	) (261	)
Amortization of net unrealized (gains) losses related to transferred securities	—	—	
Net unrealized gains (losses) on securities	(8,774	) (2,186	)
Foreign currency translation adjustments	(3	) (38	)
Benefit plans:			
Amortization of net prior service cost and net gain (loss)	(176	) 373	
Other comprehensive income (loss)	(8,953	) (1,851	)
Comprehensive income (loss)	\$19,513	22,931	

See accompanying notes to condensed consolidated financial statements (unaudited).

Table of ContentsNATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

For the Nine Months Ended September 30, 2014 and 2013

(Unaudited)

(In thousands)

	2014	2013
Net earnings	\$77,475	68,405
Other comprehensive income, net of effects of deferred costs and taxes:		
Unrealized gains (losses) on securities:		
Net unrealized holding gains (losses) arising during period	14,101	(36,065 )
Net unrealized liquidity gains (losses)	28	66
Reclassification adjustment for net amounts included in net earnings	(3,329	) (2,657 )
Amortization of net unrealized (gains) losses related to transferred securities	—	—
Net unrealized gains (losses) on securities	10,800	(38,656 )
Foreign currency translation adjustments	(636	) 555
Benefit plans:		
Amortization of net prior service cost and net gain (loss)	(527	) 1,127
Other comprehensive income (loss)	9,637	(36,974 )
Comprehensive income	\$87,112	31,431

See accompanying notes to condensed consolidated financial statements (unaudited).

Table of ContentsNATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

For the Nine Months Ended September 30, 2014 and 2013

(Unaudited)

(In thousands)

	2014	2013	
Common stock:			
Balance at beginning of period	\$3,635	3,635	
Shares exercised under stock option plan	1	—	
Balance at end of period	3,636	3,635	
Additional paid-in capital:			
Balance at beginning of period	37,767	37,767	
Shares exercised under stock option plan	349	—	
Balance at end of period	38,116	37,767	
Accumulated other comprehensive income:			
Unrealized gains on non-impaired securities:			
Balance at beginning of period	46,693	91,972	
Change in unrealized gains (losses) during period, net of tax	10,772	(38,860)	)
Balance at end of period	57,465	53,112	
Unrealized losses on impaired held to maturity securities:			
Balance at beginning of period	(1,287	) (1,426	)
Amortization	80	77	
Other-than-temporary impairments, non-credit, net of tax	—	90	
Additional credit loss on previously impaired securities	—	—	
Change in shadow deferred policy acquisition costs	(53	) (149	)
Balance at end of period	(1,260	) (1,408	)
Unrealized losses on impaired available for sale securities:			
Balance at beginning of period	(2	) (196	)
Other-than-temporary impairments, non-credit, net of tax	—	—	
Change in shadow deferred policy acquisition costs	(1	) (188	)
Recoveries, net of tax	2	374	
Balance at end of period	(1	) (10	)



Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY(continued)  
 For the Nine Months Ended September 30, 2014 and 2013  
 (Unaudited)  
 (In thousands)

	2014	2013
Foreign currency translation adjustments:		
Balance at beginning of period	3,241	2,589
Change in translation adjustments during period	(636	) 555
Balance at end of period	2,605	3,144
Benefit plan liability adjustment:		
Balance at beginning of period	(10,565	) (16,153
Amortization of net prior service cost and net loss, net of tax	(527	) 1,127
Balance at end of period	(11,092	) (15,026
Accumulated other comprehensive income at end of period	47,717	39,812
Retained earnings:		
Balance at beginning of period	1,368,466	1,273,492
Net earnings	77,475	68,405
Stockholder dividends	(1,272	) (1,273
Balance at end of period	1,444,669	1,340,624
Total stockholders' equity	\$1,534,138	\$1,421,838

See accompanying notes to condensed consolidated financial statements (unaudited).

Table of ContentsNATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Nine Months Ended September 30, 2014 and 2013

(Unaudited)

(In thousands)

	2014	2013
Cash flows from operating activities:		
Net earnings	\$77,475	68,405
Adjustments to reconcile net earnings to net cash from operating activities:		
Universal life and annuity contract interest	224,576	299,224
Surrender charges and other policy revenues	(9,531)	(10,450)
Realized (gains) losses on investments	(7,225)	(7,199)
Accretion/amortization of discounts and premiums, investments	(831)	(2,040)
Depreciation and amortization	2,522	3,742
(Increase) decrease in value of derivatives	(49,278)	(126,739)
(Increase) decrease in deferred policy acquisition and sales inducement costs	(16,197)	(15,433)
(Increase) decrease in accrued investment income	(4,889)	(3,792)
(Increase) decrease in other assets	28	(20,271)
Increase (decrease) in liabilities for future policy benefits	3,956	8,960
Increase (decrease) in other policyholder liabilities	(412)	11,261
Increase (decrease) in Federal income taxes	7,691	(14,151)
Increase (decrease) in other liabilities	1,848	2,390
Other, net	1	—
Net cash provided by operating activities	229,734	193,907
Cash flows from investing activities:		
Proceeds from sales of:		
Securities held to maturity	—	1,980
Securities available for sale	19,511	10,246
Other investments	3,247	10,520
Proceeds from maturities and redemptions of:		
Securities held to maturity	591,536	1,028,476
Securities available for sale	213,260	191,833
Derivatives, index options	164,059	109,816
Purchases of:		
Securities held to maturity	(933,997)	(1,380,732)
Securities available for sale	(275,751)	(247,375)
Derivatives, index options	(53,174)	(45,629)
Other investments	(376)	(15)
Principal payments on mortgage loans	14,112	30,649
Cost of mortgage loans acquired	(33,985)	(5,271)
Decrease (increase) in policy loans	2,223	3,242
Other, net	(1)	(2)
Net cash used in investing activities	(289,336)	(292,262)

Continued on Next Page



Table of ContentsNATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS, (continued)

For the Nine Months Ended September 30, 2014 and 2013

(Unaudited)

(In thousands)

	2014	2013
Cash flows from financing activities:		
Deposits to account balances for universal life and annuity contracts	715,705	732,745
Return of account balances on universal life and annuity contracts	(655,195	) (665,048
Issuance of common stock under stock option plan	350	—
Net cash provided by (used in) financing activities	60,860	67,697
Effect of foreign exchange	(635	) 555
Net increase (decrease) in cash and short-term investments	623	(30,103
Cash and short-term investments at beginning of period	120,859	124,561
Cash and short-term investments at end of period	\$121,482	\$94,458
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid during the period for:		
Interest	\$30	\$40
Income taxes	\$30,515	\$48,658
Noncash operating activities:		
Deferral of sales inducements	\$(6,066	) \$1,261

See accompanying notes to condensed consolidated financial statements (unaudited).



Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

## (1) CONSOLIDATION AND BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for annual financial statements. In the opinion of management, the accompanying condensed consolidated financial statements contain all adjustments necessary to present fairly the financial position of National Western Life Insurance Company and its subsidiaries ("Company" or "National Western") as of September 30, 2014, and the results of its operations and its cash flows for the three and nine months ended September 30, 2014 and 2013. The results of operations for the nine months ended September 30, 2014 are not necessarily indicative of the results to be expected for the full year. It is recommended that these condensed consolidated financial statements be read in conjunction with the audited consolidated financial statements and notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013 accessible free of charge through the Company's internet site at [www.nationalwesternlife.com](http://www.nationalwesternlife.com) or the Securities and Exchange Commission internet site at [www.sec.gov](http://www.sec.gov). The condensed consolidated balance sheet at December 31, 2013 has been derived from the audited consolidated financial statements as of that date.

The accompanying unaudited condensed consolidated financial statements include the accounts of National Western Life Insurance Company and its wholly-owned subsidiaries: The Westcap Corporation, NWL Investments, Inc., NWL Services, Inc., NWL Financial, Inc., NWLSM, Inc. and Regent Care San Marcos Holdings, LLC. All significant intercorporate transactions and accounts have been eliminated in consolidation.

The preparation of financial statements in accordance with U.S. generally accepted accounting principles ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent assets and liabilities, and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates. Significant estimates in the accompanying condensed consolidated financial statements include (1) liabilities for future policy benefits, (2) valuation of derivative instruments, (3) recoverability and amortization of deferred policy acquisition costs, (4) valuation allowances for deferred tax assets, (5) other-than-temporary impairment losses on debt securities, (6) commitments and contingencies, and (7) valuation allowances for mortgage loans and real estate.

The table below shows the unrealized gains and losses on available-for-sale securities that were reclassified out of accumulated other comprehensive income for the three and nine months ended September 30, 2014 and 2013.

Affected Line Item in the Statements of Earnings	Amount Reclassified From Accumulated Other Comprehensive Income			
	Three Months Ended September 30, 2014		Nine months ended September 30, 2013	
	(In thousands)			
Other net investment gains (losses)	\$1,474	413	5,156	4,247
Net OTTI losses recognized in earnings	—	(12)	(35)	(160)
Earnings before Federal income taxes	1,474	401	5,121	4,087

Edgar Filing: NATIONAL WESTERN LIFE INSURANCE CO - Form 10-Q

Federal income taxes	516	140	1,792	1,430
Net earnings	\$958	261	3,329	2,657

13

---

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(UNAUDITED)

(2) NEW ACCOUNTING PRONOUNCEMENTS

During February 2013, the Financial Accounting Standards Board ("FASB") issued new guidance related to the presentation of amounts reclassified out of accumulated other comprehensive income. The new guidance requires disclosure regarding the statement of income amounts affected by the reclassification. This information is provided in Note 1 of the condensed consolidated financial statements. Implementation of the new guidance did not have an impact on the Company's condensed consolidated financial statements and results of operations.

In July 2013, the FASB issued guidance to amend the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. The new guidance states that an unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as reduction to deferred tax assets for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward. This guidance is effective for annual reporting periods beginning on or after December 15, 2013 and interim periods within those annual periods. The Company adopted this guidance as of January 1, 2014 and the adoption did not have an effect on the deferred tax asset or liability classification on the Company's balance sheet and did not result in any additional disclosures to the financial statements.

In June 2014, the FASB issued guidance that applies to all reporting entities that grant their employees share-based payments in which the terms of the award provide that a performance target that affects vesting could be achieved after the requisite service period. It requires that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition and follows existing accounting guidance for the treatment of performance conditions. The standard will be effective for annual periods and interim periods within those annual periods beginning after December 15, 2015, with early adoption permitted. The Company's current employee share-based plans do not require performance targets and the adoption of this guidance is not expected to have a material impact on the Company's financial position or results of operations.

Other recent accounting pronouncements issued by the FASB (including its Emerging Issues Task Force), the American Institute of Certified Public Accountants ("AICPA"), and the SEC did not, or are not believed by management to, have a material impact on the Company's present or future condensed consolidated financial statements.

(3) STOCKHOLDERS' EQUITY

The Company is restricted by state insurance laws as to dividend amounts which may be paid to stockholders without prior approval from the Colorado Division of Insurance. The restrictions are based on the greater of statutory earnings from operations excluding capital gains or 10% of statutory capital and surplus of the Company. The maximum dividend payment which may be made without prior approval in 2015 is \$112.3 million.

The Company did declare a cash dividend on August 22, 2014 payable December 4, 2014 to stockholders on record as of October 31, 2014. The dividends declared were \$0.36 per common share to Class A stockholders and \$0.18 per common share to Class B stockholders. A dividend in the same amounts per share on Class A and Class B common stock was declared in August, 2013 and paid in December of 2013.



Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

## (4) EARNINGS PER SHARE

Basic earnings per share of common stock are computed by dividing net income by the weighted-average basic common shares outstanding during the period. Diluted earnings per share assumes the issuance of common shares applicable to stock options in the denominator.

	Three Months Ended September 30,			
	2014		2013	
	Class A	Class B	Class A	Class B
	(In thousands except per share amounts)			
Numerator for Basic and Diluted Earnings Per Share:				
Net income	\$28,466		24,782	
Dividends - Class A shares	(1,236	)	(1,237	)
Dividends - Class B shares	(36	)	(36	)
Undistributed income	\$27,194		23,509	
Allocation of net income:				
Dividends	\$1,236	36	1,237	36
Allocation of undistributed income	26,425	769	22,844	665
Net income	\$27,661	805	24,081	701
Denominator:				
Basic earnings per share - weighted-average shares	3,436	200	3,435	200
Effect of dilutive stock options	2	—	4	—
Diluted earnings per share - adjusted weighted-average shares for assumed conversions	3,438	200	3,439	200
Basic Earnings Per Share	\$8.05	4.03	7.01	3.51
Diluted Earnings Per Share	\$8.05	4.03	7.00	3.51

Stock options that were outstanding during the three months ended September 30, 2014 and 2013, but were not included in the computation of diluted earnings per share because the effect was anti-dilutive were approximately 22,200 and 23,000, respectively.

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

	Nine Months Ended September 30,			
	2014		2013	
	Class A	Class B	Class A	Class B
	(In thousands except per share amounts)			
Numerator for Basic and Diluted Earnings Per Share:				
Net income	\$77,475		68,405	
Dividends - Class A shares	(1,236	)	(1,237	)
Dividends - Class B shares	(36	)	(36	)
Undistributed income	\$76,203		67,132	
Allocation of net income:				
Dividends	\$1,236	36	1,237	36
Allocation of undistributed income	74,048	2,155	65,233	1,899
Net income	\$75,284	2,191	66,470	1,935
Denominator:				
Basic earnings per share - weighted-average shares	3,435	200	3,435	200
Effect of dilutive stock options	2	—	5	—
Diluted earnings per share - adjusted weighted-average shares for assumed conversions	3,437	200	3,440	200
Basic Earnings Per Share	\$21.92	10.95	19.35	9.68
Diluted Earnings Per Share	\$21.91	10.95	19.32	9.68

Stock options that were outstanding during the nine months ended September 30, 2014 and 2013, but were not included in the computation of diluted earnings per share because the effect was anti-dilutive were approximately 22,200 and 23,000, respectively.

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

## (5) PENSION AND OTHER POSTRETIREMENT PLANS

## (A) Defined Benefit Pension Plans

The Company sponsors a qualified defined benefit pension plan covering substantially all employees. The plan provides benefits based on the participants' years of service and compensation. The Company makes annual contributions to the plan that complies with the minimum funding provisions of the Employee Retirement Income Security Act of 1974 ("ERISA"). On October 19, 2007, the Company's Board of Directors approved an amendment to freeze the Pension Plan as of December 31, 2007. The freeze ceased future benefit accruals to all participants and closed the plan to any new participants. In addition, all participants became immediately 100% vested in their accrued benefits as of that date. Going forward, future pension expense is projected to be minimal. Fair values of plan assets and liabilities are measured as of the prior December 31 for each respective year. The following table summarizes the components of net periodic benefit cost.

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2013	2013	2013	2013
	(In thousands)			
Service cost	\$42	48	126	142
Interest cost	239	218	718	654
Expected return on plan assets	(320	) (284	) (959	) (850
Amortization of prior service cost	1	1	3	3
Amortization of net loss	106	203	317	609
Net periodic benefit cost	\$68	186	205	558

The service costs shown in the above table represent plan expenses expected to be paid out of plan assets. Under clarification provided by the Pension Protection Act, plan expenses paid from plan assets are to be included in the plan's service cost component.

The Company's minimum required contribution for the 2014 plan year is \$0.0 million. In addition, the Company had a remaining contribution payable for the 2013 plan year of \$0.0 million as of September 30, 2014. As of September 30, 2014, the Company had contributed a total of \$0.3 million to the plan for the 2014 and 2013 plan years.

The Company also sponsors a non-qualified defined benefit plan primarily for senior officers. The plan provides benefits based on the participants' years of service and compensation. The pension obligations and administrative responsibilities of the plan are maintained by a pension administration firm, which is a subsidiary of American National Insurance Company ("ANICO"). ANICO has guaranteed the payment of pension obligations under the plan. However, the Company has a contingent liability with respect to the plan should these entities be unable to meet their obligations under the existing agreements. Also, the Company has a contingent liability with respect to the plan in the event that a plan participant continues employment with the Company beyond age seventy, the aggregate average annual participant salary increases exceed 10% per year, or any additional employees become eligible to participate in the plan. If any of these conditions are met, the Company would be responsible for any additional pension obligations resulting from these items. Amendments were made to the plan to allow an additional employee to participate and to

change the benefit formula for the Chairman of the Company. As previously mentioned, these additional obligations are a liability to the Company. Effective December 31, 2004, this plan was frozen with respect to the continued accrual of benefits of the Chairman and the President of the Company in order to comply with law changes under the American Jobs Creation Act of 2004 ("Act").

Effective July 1, 2005, the Company established a second non-qualified defined benefit plan for the benefit of the Chairman of the Company. This plan is intended to provide for post-2004 benefit accruals that mirror and supplement the pre-2005 benefit accruals under the previously discussed non-qualified defined benefit plan, while complying with the requirements of the Act.



Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

Effective November 1, 2005, the Company established a third non-qualified defined benefit plan for the benefit of the President of the Company. This plan is intended to provide for post-2004 benefit accruals that supplement the pre-2005 benefit accruals under the first non-qualified defined benefit plan as previously discussed, while complying with the requirements of the Act.

The following table summarizes the components of net periodic benefit costs for the Chairman and President non-qualified defined benefit plans.

	Three Months Ended		Nine Months Ended	
	September 30, 2014	2013	September 30, 2014	2013
	(In thousands)			
Service cost	\$74	44	222	133
Interest cost	250	201	752	601
Amortization of prior service cost	15	15	44	44
Amortization of net loss	323	293	970	880
Net periodic benefit cost	\$662	553	1,988	1,658

The Company expects to contribute \$2.0 million to these plans in 2014. As of September 30, 2014, the Company has contributed \$1.3 million to the plans.

## (B) Defined Benefit Postretirement Healthcare Plans

The Company sponsors two healthcare plans to provide postretirement benefits to certain fully-vested individuals. The following table summarizes the components of net periodic benefit costs.

	Three Months Ended		Nine Months Ended	
	September 30, 2014	2013	September 30, 2014	2013
	(In thousands)			
Interest cost	\$28	29	83	88
Amortization of prior service cost	26	26	78	77
Amortization of net loss	(1	) 9	(3	) 25
Net periodic benefit cost	\$53	64	158	190

The Company expects to contribute minimal amounts to the plan in 2014.

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

## (6) SEGMENT AND OTHER OPERATING INFORMATION

The Company defines its reportable operating segments as domestic life insurance, international life insurance, and annuities. These segments are organized based on product types and geographic marketing areas. A summary of segment information for the quarters ended September 30, 2014 and September 30, 2013 is provided below.

## Selected Segment Information:

	Domestic Life Insurance	International Life Insurance	Annuities	All Others	Totals
	(In thousands)				
September 30, 2014					
Condensed Consolidated Balance Sheet Items:					
Deferred policy acquisition costs and sales inducements	\$61,087	242,124	652,855	—	956,066
Total segment assets	705,156	1,223,571	8,871,276	251,905	11,051,908
Future policy benefits	611,550	944,505	7,848,590	—	9,404,645
Other policyholder liabilities	12,742	12,226	117,207	—	142,175
Three Months Ended					
September 30, 2014					
Condensed Consolidated Income Statements:					
Premiums and contract revenues	\$6,847	29,135	5,126	—	41,108
Net investment income	6,859	8,273	90,835	4,999	110,966
Other revenues	19	20	23	5,315	5,377
Total revenues	13,725	37,428	95,984	10,314	157,451
Life and other policy benefits	3,353	9,672	138	—	13,163
Amortization of deferred acquisition costs	1,166	2,525	19,776	—	23,467
Universal life and annuity contract interest	5,803	6,956	46,452	—	59,211
Other operating expenses	2,314	6,307	7,045	4,785	20,451
Federal income taxes (benefit)	379	4,143	7,681	1,899	14,102
Total expenses	13,015	29,603	81,092	6,684	130,394
Segment earnings (loss)	\$710	7,825	14,892	3,630	27,057



Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

	Domestic Life Insurance	International Life Insurance	Annuities	All Others	Totals
			(In thousands)		
Nine months ended September 30, 2014 Condensed Consolidated Income Statements:					
Premiums and contract revenues	\$22,077	87,906	16,787	—	126,770
Net investment income	24,044	35,902	300,118	14,532	374,596
Other revenues	40	321	63	15,927	16,351
<b>Total revenues</b>	<b>46,161</b>	<b>124,129</b>	<b>316,968</b>	<b>30,459</b>	<b>517,717</b>
Life and other policy benefits	7,268	16,375	17,279	—	40,922
Amortization of deferred acquisition costs	5,346	18,078	55,880	—	79,304
Universal life and annuity contract interest	19,066	32,820	172,690	—	224,576
Other operating expenses	10,585	18,167	19,965	14,697	63,414
Federal income taxes (benefit)	1,295	12,865	17,010	5,241	36,411
<b>Total expenses</b>	<b>43,560</b>	<b>98,305</b>	<b>282,824</b>	<b>19,938</b>	<b>444,627</b>
<b>Segment earnings (loss)</b>	<b>\$2,601</b>	<b>25,824</b>	<b>34,144</b>	<b>10,521</b>	<b>73,090</b>

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

## Selected Segment Information:

	Domestic Life Insurance	International Life Insurance	Annuities	All Others	Totals
	(In thousands)				
September 30, 2013					
Condensed Consolidated Balance Sheet Items:					
Deferred policy acquisition costs and sales inducements	\$50,067	235,922	650,526	—	936,515
Total segment assets	559,824	1,161,517	8,487,915	253,097	10,462,353
Future policy benefits	485,754	899,090	7,549,441	—	8,934,285
Other policyholder liabilities	13,177	16,778	129,867	—	159,822
Three Months Ended					
September 30, 2013					
Condensed Consolidated Income Statements:					
Premiums and contract revenues	\$3,944	28,865	4,873	—	37,682
Net investment income	6,928	10,957	118,521	4,997	141,403
Other revenues	12	60	22	5,728	5,822
Total revenues	10,884	39,882	123,416	10,725	184,907
Life and other policy benefits	4,003	11,040	1,898	—	16,941
Amortization of deferred acquisition costs	1,015	3,287	19,942	—	24,244
Universal life and annuity contract interest	2,261	8,525	76,700	—	87,486
Other operating expenses	2,782	5,987	8,565	5,341	22,675
Federal income taxes (benefit)	268	3,596	5,298	1,751	10,913
Total expenses	10,329	32,435	112,403	7,092	162,259
Segment earnings (loss)	\$555	7,447	11,013	3,633	22,648

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

	Domestic Life Insurance	International Life Insurance	Annuities	All Others	Totals
			(In thousands)		
Nine months ended September 30, 2013 Condensed Consolidated Income Statements:					
Premiums and contract revenues	\$22,967	87,061	14,998	—	125,026
Net investment income	22,943	43,224	371,704	14,033	451,904
Other revenues	21	211	52	17,670	17,954
Total revenues	45,931	130,496	386,754	31,703	594,884
Life and other policy benefits	8,129	17,910	22,042	—	48,081
Amortization of deferred acquisition costs	5,260	17,000	61,640	—	83,900
Universal life and annuity contract interest	17,320	39,760	242,144	—	299,224
Other operating expenses	11,496	18,820	23,117	16,009	69,442
Federal income taxes (benefit)	1,206	11,982	12,242	5,081	30,511
Total expenses	43,411	105,472	361,185	21,090	531,158
Segment earnings (loss)	\$2,520	25,024	25,569	10,613	63,726

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

Reconciliations of segment information to the Company's condensed consolidated financial statements are provided below.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(In thousands)			
<b>Premiums and Other Revenues:</b>				
Premiums and contract revenues	\$41,108	37,682	126,770	125,026
Net investment income	110,966	141,403	374,596	451,904
Other revenues	5,377	5,822	16,351	17,954
Realized gains (losses) on investments	2,169	3,285	6,747	7,199
Total condensed consolidated premiums and other revenues	\$159,620	188,192	524,464	602,083

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(In thousands)			
<b>Federal Income Taxes:</b>				
Total segment Federal income taxes	\$14,102	10,913	36,411	30,511
Taxes on realized gains (losses) on investments	760	1,151	2,362	2,520
Total condensed consolidated Federal income taxes	\$14,862	12,064	38,773	33,031

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(In thousands)			
<b>Net Earnings:</b>				
Total segment earnings	\$27,057	22,648	73,090	63,726
Realized gains (losses) on investments, net of taxes	1,409	2,134	4,385	4,679
Total condensed consolidated net earnings	\$28,466	24,782	77,475	68,405

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

	September 30, 2014 (In thousands)	2013
Assets:		
Total segment assets	\$11,051,908	10,462,353
Other unallocated assets	207,168	206,115
Total condensed consolidated assets	\$11,259,076	\$10,668,468

**(7) SHARE-BASED PAYMENTS**

The Company had a stock and incentive plan ("1995 Plan") which provided for the grant of any or all of the following types of awards to eligible employees: (1) stock options, including incentive stock options and nonqualified stock options; (2) stock appreciation rights, in tandem with stock options or freestanding; (3) restricted stock; and, (4) performance awards. The 1995 Plan began on April 21, 1995, and was amended on June 25, 2004 to extend the termination date to April 20, 2010. The number of shares of Class A, \$1.00 par value, common stock which were allowed to be issued under the 1995 Plan, or as to which stock appreciation rights or other awards were allowed to be granted, could not exceed 300,000. Effective June 20, 2008, the Company's shareholders approved a 2008 Incentive Plan ("2008 Plan"). The 2008 Plan is substantially similar to the 1995 Plan and authorized an additional number of Class A, \$1.00 par value, common stock shares eligible for issue not to exceed 300,000. These shares may be authorized and unissued shares. The Company has issued only nonqualified stock options and stock appreciation rights under these plans.

All of the employees of the Company and its subsidiaries are eligible to participate in the current 2008 Plan (as well as previously in the expired 1995 Plan). In addition, directors of the Company are eligible to receive the same types of awards as employees except that they are not eligible to receive incentive stock options. Company directors, including members of the Compensation and Stock Option Committee, are eligible for nondiscretionary stock options. The directors' grants vest 20% annually following one full year of service to the Company from the date of grant. The employees' grants vest 20% annually following three full years of service to the Company from the date of grant. All grants issued expire after ten years. No awards were issued during the first nine months of 2014 or the first nine months of 2013.

Effective during March 2006, the Company adopted and implemented a limited stock buy-back program with respect to the 1995 Plan which provides option holders the additional alternative of selling shares acquired through the exercise of options directly back to the Company. Option holders may elect to sell such acquired shares back to the Company at any time within ninety (90) days after the exercise of options at the prevailing market price as of the date of notice of election. The buy-back program did not alter the terms and conditions of the 1995 Plan; however, the program necessitated a change in accounting from the equity classification to the liability classification.

In August 2008, the Company implemented another limited stock buy-back program, substantially similar to the 2006 program, for shares issued under the 2008 Plan.





Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

The Company uses the current fair value method to measure compensation cost. As of September 30, 2014 and December 31, 2013, the liability balance was \$7.7 million and \$5.9 million, respectively. A summary of shares available for grant and activity during the nine months ended September 30, 2014 is detailed below.

	Shares Available For Grant	Options Outstanding Shares	Weighted- Average Exercise Price
Stock Options:			
Balance at January 1, 2014	291,000	36,668	\$229.24
Exercised	—	(5,000)	) \$150.00
Forfeited	—	(500)	) \$255.13
Expired	—	—	\$—
Stock options granted	—	—	\$—
Balance at September 30, 2014	291,000	31,168	\$241.54
		Stock Appreciation Rights Outstanding Awards	Weighted- Average Exercise Price
Stock Appreciation Rights:			
Balance at January 1, 2014	99,461		\$156.93
Exercised	(1,825)		) \$114.64
Forfeited	(3,350)		) \$165.46
Granted	—		\$—
Balance at September 30, 2014	94,286		\$157.45

Stock options and stock appreciation rights (SARs) shown as forfeited in the above tables represent vested and unvested awards not exercised by plan participants prior to their termination from the Company. Forfeited stock options during the nine months ended September 30, 2014 were awarded under the 1995 Plan. As the 1995 Plan terminated during calendar year 2010, the forfeited shares are not shown as being added back to the "Shares Available For Grant" balance.

The total intrinsic value of options exercised was \$0.8 million and \$2.1 million for the nine months ended September 30, 2014 and 2013, respectively. The total share-based liabilities paid were \$0.6 million and \$2.1 million for the nine months ended September 30, 2014 and 2013, respectively. The total fair value of shares vested during the nine months ended September 30, 2014 and 2013 was \$0.7 million and \$0.4 million, respectively. For the nine months ended September 30, 2014 and 2013, the total cash received from the exercise of options under the Plans was \$0.2 million and \$0, respectively.



Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

The following table summarizes information about stock options and SARs outstanding at September 30, 2014.

	Options/SARs Outstanding		
	Number Outstanding	Weighted-Average Remaining Contractual Life	Number Exercisable
Exercise prices:			
255.13 (options)	22,168	3.6 years	17,815
208.05 (options)	9,000	3.7 years	9,000
236.00 (SARs)	250	3.9 years	200
114.64 (SARs)	26,518	4.4 years	17,761
132.56 (SARs)	31,518	7.2 years	3,600
210.22 (SARs)	36,000	9.2 years	—
Totals	125,454		48,376
Aggregate intrinsic value (in thousands)	\$7,471		\$3,116

The aggregate intrinsic value in the table above is based on the closing stock price of \$247.01 per share on September 30, 2014.

In estimating the fair value of the options outstanding at September 30, 2014 and December 31, 2013, the Company employed the Black-Scholes option pricing model with assumptions as detailed below.

	September 30, 2014	December 31, 2013	
Expected term of options	3.6 to 9.2 years	0 to 10 years	
Expected volatility:			
Range	18.16% to 38.35%	21.03% to 42.71%	
Weighted-average	22.24	% 30.50	%
Expected dividend yield	0.15	% 0.16	%
Risk-free rate:			
Range	0.11% to 1.63%	0.12% to 3.93%	
Weighted-average	0.55	% 2.10	%

The Company reviewed the contractual term relative to the options as well as perceived future behavior patterns of exercise. Volatility is based on the Company's historical volatility over the expected term of the option's expected exercise date.

The pre-tax compensation cost recognized in the financial statements related to the two plans defined above was \$0.0 million and \$2.5 million for the three and nine months ended September 30, 2014 compared to \$0.6 million and \$4.0 million for the three and nine months ended September 30, 2013. The related tax expense recognized was \$0.0 million

and \$0.8 million for the three and nine months ended September 30, 2014 compared to \$0.2 million and \$1.4 million for the three and nine months ended September 30, 2013.

As of September 30, 2014, the total compensation cost related to nonvested options not yet recognized was \$2.7 million. This amount is expected to be recognized over a weighted-average period of 2.3 years. The Company recognizes compensation cost over the graded vesting periods.

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(UNAUDITED)

(8) COMMITMENTS AND CONTINGENCIES

(A) Legal Proceedings

In the normal course of business, the Company is involved or may become involved in various legal actions in which claims for alleged economic and punitive damages have been or may be asserted, some for substantial amounts. In recent years, carriers offering life insurance and annuity products have faced litigation, including class action lawsuits, alleging improper product design, improper sales practices, and similar claims. The Company has been a defendant over the past several years in two such class action lawsuits. Given the uncertainty involved in these types of actions, the ability to make a reliable evaluation of the likelihood of an unfavorable outcome or an estimate of the amount of or range of potential loss is endemic to the particular circumstances and evolving developments of each individual matter on its own merits.

The Company resolved a class action lawsuit pending since June 12, 2006, in the U.S. District Court for the Southern District of California. The case is titled In Re National Western Life Insurance Deferred Annuities Litigation. The complaint asserted claims for RICO violations, Financial Elder Abuse, Violation of Cal. Bus. & Prof. Code 17200, et seq, Violation of Cal. Bus. & Prof. Code 17500, et seq, Breach of Fiduciary Duty, Aiding and Abetting Breach of Fiduciary Duty, Fraudulent Concealment, Cal. Civ. Code 1710, et seq, Breach of the Duty of Good Faith and Fair Dealing, and Unjust Enrichment and Imposition of Constructive Trust. On July 12, 2010 the Court certified a nationwide class of policyholders under the RICO allegation and a California class under all of the remaining causes of action except breach of fiduciary duty. The parties entered into a Settlement and Release Agreement in August of 2013 ("Settlement") which was finally approved by the Court on February 11, 2014. On February 12, 2014, the Court issued a redacted final approval order granting the Motion for Final Approval of Class Action Settlement. The Settlement became final and non-appealable on April 12, 2014. The Settlement Agreement and Plaintiffs' Request for Attorneys' Fees and Costs were approved by the Court, and the Company paid the Court-approved amount of attorneys' fees and costs in April 2014. The Company also made certain payments to surrendered and annuitized policyholders in June 2014. In addition, the Company agreed to provide bonuses on annuitization for active policyholders who choose a 10-year or a 20-year certain and life settlement option. The Company had held reserves of \$6.5 million for the matter which approximated the ultimate settlement amounts described above.

In addition to the class action lawsuit described above, the Company was the named defendant in the case of Sheila Newman vs. National Western Life Insurance Company, which alleged mishandling of policyholder funds by an agent. On February 3, 2010, the 415th Judicial District Court of Parker County in Weatherford, Texas, entered a Final Judgment against the Company of approximately \$208,000 including actual damages of \$113,000 and amounts for attorney's fees, and prejudgment interest on the actual damages. In addition, the Final Judgment included \$150 million for exemplary damages. The Company vigorously defended this case and appealed the Final Judgment to the Court of Appeals Second District of Texas in Fort Worth. The Court of Appeals on August 11, 2011, reversed the trial court judgment in its entirety and rendered a take nothing verdict in favor of National Western. Plaintiffs (Appellees) filed a motion for a rehearing which the Court ruled on October 13, 2011, that the trial court's judgment was still reversed and judgment was still entered that Newman take nothing, all in favor of National Western. The Plaintiffs (Appellees) filed a Motion for Reconsideration En Banc which the Court of Appeals denied on October 27, 2011. The Plaintiffs (Appellees) then filed a Motion for Rehearing of the Court's amended decision, which the Court of Appeals denied on December 22, 2011. On March 21, 2012, Plaintiffs (Appellees) filed a petition for review with the Texas Supreme Court and the Company filed its response on April 20, 2012. The Supreme Court asked the parties for briefs on the issues before deciding on whether to hear the case and both parties submitted their briefs. On February 14,

2013, the Supreme Court denied the Plaintiffs petition for review. On April 3, 2013, Plaintiff filed a Motion for Rehearing. The Supreme Court denied Plaintiff's Motion for Rehearing on June 7, 2013 thus ending the matter.

On October 26, 2011 the Brazilian Superintendence of Private Insurance (“SUSEP”) attempted to serve the Company with a subpoena regarding an administrative proceeding initiated by SUSEP in which it alleged that the Company was operating as an insurance company in Brazil without due authorization. The Company had been informed that SUSEP was attempting to impose a penal fine of approximately \$6.0 billion on the Company. SUSEP unsuccessfully attempted to serve the Company with notice regarding this matter. The Company does not transact business in Brazil and has no officers, employees, property, or assets in Brazil. The Company and its legal advisors believe that SUSEP has no jurisdiction over the Company, that SUSEP's attempts at service of process were invalid, and that any penal fine would be unenforceable. For the reasons described above, the Company does not believe that this matter meets the definition of a material pending legal proceeding as such term is defined in Item 103 of Regulation S-K but has included the foregoing description solely due to the purported amount of the fine sought at that time.

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

Although there can be no assurances, at the present time, the Company does not anticipate that the ultimate liability arising from such other potential, pending, or threatened legal actions will have a material adverse effect on the financial condition or operating results of the Company.

## (B) Financial Instruments

In order to meet the financing needs of its customers in the normal course of business, the Company is a party to financial instruments with off-balance sheet risk. These financial instruments are commitments to extend credit which involve elements of credit and interest rate risk in excess of the amounts recognized in the condensed consolidated balance sheet.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit is represented by the contractual amounts, assuming that the amounts are fully advanced and that collateral or other security is of no value. Commitments to extend credit are legally binding agreements to lend to a customer that generally have fixed expiration dates or other termination clauses and may require payment of a fee. Commitments do not necessarily represent future liquidity requirements, as some could expire without being drawn upon. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. The Company controls the credit risk of these transactions through credit approvals, limits, and monitoring procedures.

The Company had \$3.0 million of commitments to extend credit relating to mortgage loans at September 30, 2014. The Company evaluates each customer's creditworthiness on a case-by-case basis.

## (9) INVESTMENTS

## (A) Investment Gains and Losses

The table below presents realized investment gains and losses, excluding impairment losses, for the periods indicated.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(In thousands)			
Available for sale debt securities:				
Realized gains on disposal	\$ 1,467	415	5,144	3,739
Realized losses on disposal	—	(3	) (22	) (3
Held to maturity debt securities:				
Realized gains on disposal	353	2,831	1,167	3,221
Realized losses on disposal	—	—	(17	) (72
Equity securities realized gains (losses)	7	—	34	511
Real estate gains (losses)	820	55	954	55
Mortgage loans write-downs	—	—	—	—
Other	(478	) —	(478	) —



Totals	\$2,169	3,298	6,782	7,451
--------	---------	-------	-------	-------

28

---

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

The Company uses the specific identification method in computing realized gains and losses. Approximately 87% of the gains on bonds are due to calls of securities rather than sales. This includes calls out of the Company's available for sale portfolio of debt securities.

The table below presents net impairment losses recognized in earnings for the periods indicated.

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014		2013		
	(In thousands)						
Total other-than-temporary impairment gains (losses) on debt securities	\$—	214	(4	)	538		
Portion of loss (gain) recognized in comprehensive income	—	(227	)	(3	)	(776	)
Net impairment losses on debt securities recognized in earnings	—	(13	)	(7	)	(238	)
Equity securities impairments	—	—	(28	)	(14	)	
Totals	\$—	(13	)	(35	)	(252	)

The table below presents a roll forward of credit losses on securities for which the Company also recorded non-credit other-than-temporary impairments in other comprehensive loss.

	Three months ended September 30, 2014	Nine months ended September 30, 2014 (In thousands)	Twelve Months Ended December 31, 2013	
Beginning balance, cumulative credit losses related to other-than-temporary impairments	\$2,479	2,472	2,247	
Reductions for securities sold during current period	—	—	(17	)
Additions for credit losses not previously recognized in other-than-temporary impairments	—	7	242	
Ending balance, cumulative credit losses related to other-than-temporary impairments	\$2,479	2,479	2,472	

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

## (B) Debt and Equity Securities

The table below presents amortized costs and fair values of securities held to maturity at September 30, 2014.

	Securities Held to Maturity			Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
	(In thousands)			
Debt securities:				
U.S. agencies	\$23,069	913	—	23,982
U.S. Treasury	1,918	407	—	2,325
States and political subdivisions	430,243	27,854	(1,051)	) 457,046
Foreign governments	—	—	—	—
Public utilities	915,761	63,842	(1,558)	) 978,045
Corporate	3,834,631	181,422	(26,026)	) 3,990,027
Mortgage-backed	1,667,528	59,881	(13,457)	) 1,713,952
Home equity	19,348	4,841	—	24,189
Manufactured housing	5,540	335	—	5,875
Totals	\$6,898,038	339,495	(42,092)	) 7,195,441

The table below presents amortized costs and fair values of securities available for sale at September 30, 2014.

	Securities Available for Sale			Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
	(In thousands)			
Debt securities:				
States and political subdivisions	\$591	—	(38)	) 553
Foreign governments	9,937	313	—	10,250
Public utilities	189,636	11,994	(406)	) 201,224
Corporate	2,296,848	135,520	(8,955)	) 2,423,413
Mortgage-backed	52,270	4,541	—	56,811
Home equity	11,817	237	(3)	) 12,051
Manufactured housing	2,877	86	—	2,963
	2,563,976	152,691	(9,402)	) 2,707,265
Equity public	12,829	5,215	(429)	) 17,615
Totals	\$2,576,805	157,906	(9,831)	) 2,724,880



Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

The table below presents amortized costs and fair values of securities held to maturity at December 31, 2013.

	Securities Held to Maturity			Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
	(In thousands)			
Debt securities:				
U.S. agencies	\$23,088	1,700	—	24,788
U.S. Treasury	1,913	434	—	2,347
States and political subdivisions	423,286	13,433	(10,944)	425,775
Foreign governments	9,997	159	—	10,156
Public utilities	864,324	53,222	(9,687)	907,859
Corporate	3,463,521	153,442	(81,760)	3,535,203
Mortgage-backed	1,696,887	54,035	(33,376)	1,717,546
Home equity	20,179	4,738	(32)	24,885
Manufactured housing	7,125	460	—	7,585
Totals	\$6,510,320	281,623	(135,799)	6,656,144

The table below presents amortized costs and fair values of securities available for sale at December 31, 2013.

	Securities Available for Sale			Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
	(In thousands)			
Debt securities:				
States and political subdivisions	\$594	—	(110)	484
Foreign governments	9,931	—	(156)	9,775
Public utilities	233,788	15,014	(1,397)	247,405
Corporate	2,195,124	124,519	(30,732)	2,288,911
Mortgage-backed	68,799	5,040	—	73,839
Home equity	12,079	245	(7)	12,317
Manufactured housing	3,803	132	—	3,935
	2,524,118	144,950	(32,402)	2,636,666
Equity public	11,146	4,489	(757)	14,878
Totals	\$2,535,264	149,439	(33,159)	2,651,544



Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

The following table shows the gross unrealized losses and fair values of the Company's held to maturity investments by investment category and length of time the individual securities have been in a continuous unrealized loss position at September 30, 2014.

	Securities Held to Maturity		12 Months or Greater		Total	
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
Debt securities:						
States and political subdivisions	\$—	—	33,440	(1,051)	33,440	(1,051)
Public utilities	73,039	(231)	68,585	(1,327)	141,624	(1,558)
Corporate	328,940	(1,478)	845,310	(24,548)	1,174,250	(26,026)
Mortgage-backed	67,440	(437)	309,267	(13,020)	376,707	(13,457)
Total temporarily impaired securities	\$469,419	(2,146)	1,256,602	(39,946)	1,726,021	(42,092)

The following table shows the gross unrealized losses and fair values of the Company's available for sale investments by investment category and length of time the individual securities have been in a continuous unrealized loss position at September 30, 2014.

	Securities Available for Sale		12 Months or Greater		Total	
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
Debt securities:						
States and political subdivisions	\$—	—	553	(38)	553	(38)
Public utilities	—	—	18,556	(406)	18,556	(406)
Corporate	180,872	(1,269)	248,901	(7,686)	429,773	(8,955)
Home equity	—	—	4,832	(3)	4,832	(3)
	180,872	(1,269)	272,842	(8,133)	453,714	(9,402)
Equity public	1,997	(116)	3,620	(313)	5,617	(429)
Total temporarily impaired securities	\$182,869	(1,385)	276,462	(8,446)	459,331	(9,831)

Unrealized losses for securities held to maturity and securities available for sale decreased during the first nine months of 2014 due primarily to the decline in market interest rates. The Company does not consider investments with unrealized losses to be other-than-temporarily impaired since it does not anticipate selling these securities prior to

maturity and expects to receive all amounts due relative to principal and interest.

The Company does not consider securities to be other-than-temporarily impaired when the market decline is attributable to factors such as interest rate movements, market volatility, liquidity, spread widening and credit quality and when recovery of all amounts due under the contractual terms of the security is anticipated. Based on the review and the Company's ability and intent not to sell these securities until maturity, the Company does not consider these investments to be other-than-temporarily impaired at September 30, 2014. The Company will monitor the investment portfolio for future changes in issuer facts and circumstances that could result in future impairments beyond those currently identified.



Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

During the first quarter of 2014, the Company recorded an other-than-temporary impairment on one asset-backed security. The security had a \$7 thousand credit impairment which is reported in the Condensed Consolidated Statements of Earnings and there were minimal liquidity gains which did not affect current earnings. The Company intends to hold the security until recovery of fair market value or maturity.

Debt securities. The gross unrealized losses for debt securities are made up of 259 individual issues, or 19.7% of the total debt securities held by the Company. The market value of these bonds as a percent of amortized cost averages 97.7%. Of the 259 securities, 190, or 71.2%, fall in the 12 months or greater aging category; and 254 were rated investment grade at September 30, 2014.

Equity securities. The gross unrealized losses for equity securities are made up of 17 individual issues. These holdings are reviewed quarterly for impairment. One equity security was other-than-temporarily impaired during the nine months ended September 30, 2014, in accordance with Company policy.

The following table shows the gross unrealized losses and fair values of the Company's held to maturity investments by investment category and length of time the individual securities have been in a continuous unrealized loss position at December 31, 2013.

	Securities Held to Maturity					
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
Debt securities:						
States and political subdivisions	\$128,711	(9,249)	8,080	(1,695)	136,791	(10,944)
Public utilities	260,982	(8,998)	7,821	(689)	268,803	(9,687)
Corporate	1,335,088	(71,330)	117,179	(10,430)	1,452,267	(81,760)
Mortgage-backed	581,373	(32,043)	13,861	(1,333)	595,234	(33,376)
Home equity	—	—	2,617	(32)	2,617	(32)
Total temporarily impaired securities	\$2,306,154	(121,620)	149,558	(14,179)	2,455,712	(135,799)

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

The following table shows the gross unrealized losses and fair values of the Company's available for sale investments by investment category and length of time that the individual securities have been in a continuous unrealized loss position at December 31, 2013.

	Securities Available for Sale		12 Months or Greater		Total	
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
Debt securities:						
States and political subdivisions	—	—	484	(110)	484	(110)
Foreign governments	\$9,775	(156)	—	—	9,775	(156)
Public utilities	20,090	(1,343)	962	(54)	21,052	(1,397)
Corporate	532,310	(26,376)	46,187	(4,356)	578,497	(30,732)
Home equity	4,833	(7)	—	—	4,833	(7)
	567,008	(27,882)	47,633	(4,520)	614,641	(32,402)
Equity public	3,707	(757)	—	—	3,707	(757)
Total temporarily impaired securities	\$570,715	(28,639)	47,633	(4,520)	618,348	(33,159)

**(C) Transfer of Securities**

During the nine months ended September 30, 2014 and 2013, the Company made no transfers to the held to maturity category from securities available for sale.

**(D) Mortgage Loans and Real Estate**

A financing receivable is a contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset in a company's statement of financial position. Mortgage, equity, participation and mezzanine loans on real estate are considered financing receivables reported by the Company.

Credit and default risk is minimized through strict underwriting guidelines and diversification of underlying property types and geographic locations. In addition to being secured by the property, mortgage loans with leases on the underlying property are often guaranteed by the lease payments and also by the borrower. This approach has proven to result in quality mortgage loans with few defaults. Mortgage loan interest income is recognized on an accrual basis with any premium or discount amortized over the life of the loan. Prepayment and late fees are recorded on the date of collection.

Loans in foreclosure, loans considered impaired or loans past due 90 days or more are placed on a non-accrual status. If a mortgage loan is determined to be on non-accrual status, the mortgage loan does not accrue any revenue into the Condensed Consolidated Statements of Earnings. The loan is independently monitored and evaluated as to potential impairment or foreclosure. If delinquent payments are made and the loan is brought current, then the Company returns

the loan to active status and accrues income accordingly. The Company had no mortgage loans past due 90 days or more at September 30, 2014 or 2013 and as a result all interest income was recognized at September 30, 2014 or 2013.

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

The following table represents the mortgage loan portfolio by loan-to-value ratio.

	September 30, 2014		December 31, 2013	
	Amount	%	Amount	%
	(In thousands)		(In thousands)	
Mortgage Loans by Loan-to-Value Ratio (1):				
Less than 50%	\$49,514	32.3	\$57,445	43.0
50% to 60%	56,530	36.9	23,339	17.5
60% to 70%	18,932	12.3	20,120	15.1
70% to 80%	8,476	5.5	9,723	7.3
80% to 90%	—	—	—	—
Greater than 90%	19,938	13.0	22,788	17.1
Gross balance	153,390	100.0	133,415	100.0
Allowance for possible losses	(650)	(0.4)	(650)	(0.5)
Totals	\$152,740	99.6	\$132,765	99.5

(1) Loan-to-Value Ratio determined using the most recent appraised value. Appraisals are required at the time of funding and may be updated if a material change occurs from the original loan agreement.

The mortgage loans in the greater than 90% category relate to loans made with a long standing borrower. The loans are backed by the investment property, contracted leases, as well as a separate and additional guarantee of the long standing borrower.

The Company does not consider its mortgage loans to be a separate portfolio segment. The Company considers its primary class to be property type and primarily uses loan-to-value as its credit risk quality indicator. All loans within the portfolio are analyzed quarterly in order to monitor the financial quality of these assets. Based on ongoing monitoring, mortgage loans with a likelihood of becoming delinquent are identified and placed on an internal “watch list”. Among the criteria that would indicate a potential problem are: major tenant vacancies or bankruptcies, late payments, and loan relief/restructuring requests. The mortgage loan portfolio is analyzed for the need for a valuation allowance on any loan that is on the internal watch list, in the process of foreclosure or that currently has a valuation allowance.

Mortgage loans are considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. When it is determined that a loan is impaired, a loss is recognized for the difference between the carrying amount of the mortgage loan and the estimated value reduced by the cost to sell. Estimated value is typically based on the loan's observable market price or the fair value of the collateral less cost to sell. Impairments and changes in the valuation allowance are reported in net realized investment gains (losses) in the Condensed Consolidated Statements of Earnings.

The following table represents the mortgage loan allowance.

September 30, 2014      December 31, 2013

Edgar Filing: NATIONAL WESTERN LIFE INSURANCE CO - Form 10-Q

(In thousands)

Balance, beginning of period	\$650	650
Provision	—	—
Releases	—	—
Balance, end of period	\$650	650

35

---

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(UNAUDITED)

(10) FAIR VALUES OF FINANCIAL INSTRUMENTS

For financial instruments the FASB provides guidance which defines fair value, establishes a framework for measuring fair value under GAAP, and requires additional disclosures about fair value measurements. In compliance with this GAAP guidance, the Company has categorized its financial instruments, based on the priority of the inputs to the valuation technique, into the required three level hierarchy. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). If the inputs used to measure fair value fall within different levels of the hierarchy, the category level is based on the lowest priority level input that is significant to the fair value measurement of the instrument.

Financial assets and liabilities recorded at fair value on the Condensed Consolidated Balance Sheets are categorized as follows:

Level 1: Fair value is based on unadjusted quoted prices in active markets that are accessible to the Company for identical assets or liabilities. Active markets are those in which transactions for the asset or liability occur in sufficient frequency and volume to provide pricing information on an ongoing basis. These generally provide the most reliable evidence and are used to measure fair value whenever available. The Company's Level 1 assets are equity securities that are traded in an active exchange market. Valuations are obtained from readily available pricing sources for market transactions involving identical assets.

Level 2: Fair value is based upon significant inputs other than quoted prices in active markets included in Level 1, which are either directly or indirectly observable for substantially the full term of the asset or liability through corroboration with observable market data as of the reporting date. Level 2 inputs include quoted market prices in active markets for similar assets and liabilities, quoted market prices in markets that are not active for identical or similar assets or liabilities, model-derived valuations whose inputs are observable or whose significant value drivers are observable and other observable inputs. The Company's Level 2 assets include fixed maturity debt securities (corporate and private bonds, government or agency securities, asset-backed and mortgage-backed securities), and preferred stock. Valuations are generally obtained from third party pricing services for identical or comparable assets or determined through use of valuation methodologies using observable market inputs.

Level 3: Fair value is based on significant unobservable inputs which reflect the entity's or third party pricing service's assumptions about the assumptions market participants would use in pricing an asset or liability. The Company's Level 3 assets are over-the-counter derivative contracts and the Company's Level 3 liabilities consist of share-based compensation obligations and certain product-related embedded derivatives. Valuations are estimated based on non-binding broker prices or internally developed valuation models or methodologies, discounted cash flow models and other similar techniques.

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

The following tables set forth the Company's assets and liabilities that are measured at fair value on a recurring basis as of the date indicated:

	September 30, 2014			
	Total (In thousands)	Level 1	Level 2	Level 3
Debt securities, available for sale	\$2,707,265	—	2,707,265	—
Equity securities, available for sale	17,615	16,405	1,210	—
Derivatives, index options	109,812	—	—	109,812
Total assets	\$2,834,692	16,405	2,708,475	109,812
Policyholder account balances (a)	\$127,622	—	—	127,622
Other liabilities (b)	7,704	—	—	7,704
Total liabilities	\$135,326	—	—	135,326

During the three and nine months ended September 30, 2014, the Company had no transfers into or out of Levels 1, 2 or 3.

	December 31, 2013			
	Total (In thousands)	Level 1	Level 2	Level 3
Debt securities, available for sale	\$2,636,666	—	2,636,666	—
Equity securities, available for sale	14,878	13,802	1,076	—
Derivatives, index options	169,314	—	—	169,314
Total assets	\$2,820,858	13,802	2,637,742	169,314
Policyholder account balances (a)	\$187,399	—	—	187,399
Other liabilities (b)	5,939	—	—	5,939
Total liabilities	\$193,338	—	—	193,338

(a) Represents the fair value of certain product-related embedded derivatives that were recorded at fair value.

(b) Represents the liability for share-based compensation.

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

The following tables present, by pricing source and fair value hierarchy level, the Company's assets that are measured at fair value on a recurring basis:

	September 30, 2014			
	Total	Level 1	Level 2	Level 3
	(In thousands)			
Debt securities, available for sale:				
Priced by third-party vendors	\$2,707,265	—	2,707,265	—
Priced internally	—	—	—	—
Subtotal	2,707,265	—	2,707,265	—
Equity securities, available for sale:				
Priced by third-party vendors	17,615	16,405	1,210	—
Priced internally	—	—	—	—
Subtotal	17,615	16,405	1,210	—
Derivatives, index options:				
Priced by third-party vendors	109,812	—	—	109,812
Priced internally	—	—	—	—
Subtotal	109,812	—	—	109,812
Total	\$2,834,692	16,405	2,708,475	109,812
Percent of total	100.0	% 0.6	% 95.5	% 3.9
				%
	December 31, 2013			
	Total	Level 1	Level 2	Level 3
	(In thousands)			
Debt securities, available for sale:				
Priced by third-party vendors	\$2,636,666	—	2,636,666	—
Priced internally	—	—	—	—
Subtotal	2,636,666	—	2,636,666	—
Equity securities, available for sale:				
Priced by third-party vendors	14,878	13,802	1,076	—
Priced internally	—	—	—	—
Subtotal	14,878	13,802	1,076	—
Derivatives, index options:				
Priced by third-party vendors	169,314	—	—	169,314
Priced internally	—	—	—	—
Subtotal	169,314	—	—	169,314



Edgar Filing: NATIONAL WESTERN LIFE INSURANCE CO - Form 10-Q

Total	\$2,820,858	13,802	2,637,742	169,314	
Percent of total	100.0	% 0.5	% 93.5	% 6.0	%

38

---

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

The following tables provide additional information about fair value measurements for which significant unobservable (Level 3) inputs were utilized to determine fair value.

	For the Three Months Ended September 30, 2014				
	Debt Securities, Available for Sale (In thousands)	Equity Securities, Available for Sale	Derivatives, Index Options	Total Assets	Other Liabilities
Balance at July 1, 2014	\$—	—	146,514	146,514	171,428
Total realized and unrealized gains (losses):					
Included in net income	—	—	3,479	3,479	4,099
Included in other comprehensive income	—	—	—	—	—
Purchases, sales, issuances and settlements, net	—	—	(40,181)	(40,181)	(40,201)
Transfers into (out of) Level 3	—	—	—	—	—
Balance at end of period	\$—	—	109,812	109,812	135,326
Change in unrealized gains or losses for the period included in earnings (or changes in net assets) for assets held at the end of the reporting period:					
Net investment income	\$—	—	747	747	—
Other operating expenses	—	—	—	—	175
Total	\$—	—	747	747	175

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

	For the Three Months ended September 30, 2013				
	Debt Securities, Available for Sale	Equity Securities, Available for Sale	Derivatives, Index Options	Total Assets	Other Liabilities
	(In thousands)				
Balance at July 1, 2013	\$—	—	—	—	4,370
Total realized and unrealized gains (losses):					
Included in net income	—	—	—	—	1,010
Included in other comprehensive income	—	—	—	—	—
Purchases, sales, issuances and settlements, net	—	—	—	—	(827 )
Transfers into (out of) Level 3	—	—	—	—	—
Balance at end of period	\$—	—	—	—	4,553
Change in unrealized gains or losses for the period included in earnings (or changes in net assets) for assets held at the end of the reporting period:					
Net investment income	\$—	—	—	—	—
Other operating expenses	—	—	—	—	1,601
Total	\$—	—	—	—	1,601
	Nine Months Ended September 30, 2014				
	Debt Securities, Available for Sale	Equity Securities, Available for Sale	Derivatives, Index Options	Total Assets	Other Liabilities
	(In thousands)				
Beginning balance, January 1, 2014	\$—	—	169,314	169,314	193,338
Total realized and unrealized gains (losses):					
Included in net income	—	—	49,278	49,278	51,529
Included in other comprehensive income	—	—	—	—	—
Purchases, sales, issuances and settlements, net	—	—	(108,780 )	(108,780 )	(109,541 )
Transfers into (out of) Level 3	—	—	—	—	—
Balance at end of period	\$—	—	109,812	109,812	135,326
Change in unrealized gains or losses for the period included in earnings (or changes in net assets) for assets held at the end of the reporting period:					
Net investment income	\$—	—	29,895	29,895	—

Edgar Filing: NATIONAL WESTERN LIFE INSURANCE CO - Form 10-Q

Other operating expenses	—	—	—	—	3,266
Total	\$—	—	29,895	29,895	3,266

40

---

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

	Nine Months Ended September 30, 2013				
	Debt Securities, Available for Sale	Equity Securities, Available for Sale	Derivatives, Index Options	Total Assets	Other Liabilities
	(In thousands)				
Beginning balance, January 1, 2013	\$—	—	—	—	2,718
Total realized and unrealized gains (losses):					
Included in net income	—	—	—	—	3,976
Included in other comprehensive income	—	—	—	—	—
Purchases, sales, issuances and settlements, net	—	—	—	—	(2,141)
Transfers into (out of) Level 3	—	—	—	—	—
Balance at end of period	\$—	—	—	—	4,553
Change in unrealized gains or losses for the period included in earnings (or changes in net assets) for assets held at the end of the reporting period:					
Net investment income	\$—	—	—	—	—
Other operating expenses	—	—	—	—	5,343
Total	\$—	—	—	—	5,343

The following tables show the quantitative information about the Company's level 3 assets and liabilities.

	September 30, 2014		
	Fair Value	Valuation Technique	Unobservable Input
	(In thousands)		
Derivatives, index options	\$109,812	Broker prices	Implied volatility Inputs from broker proprietary models
Total assets	\$109,812		
Policyholder account balances	\$127,622	Deterministic cash flow model	Projected option cost
Other liabilities	7,704	Black Scholes	Expected term Forfeiture assumptions
Total liabilities	\$135,326		

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

	December 31, 2013		
	Fair Value	Valuation Technique	Unobservable Input
	(In thousands)		
Derivatives, index options	\$ 169,314	Broker prices	Implied volatility Inputs from broker proprietary models
Total assets	\$ 169,314		
Policyholder account balances	\$ 187,399	Deterministic cash flow model	Projected option cost
Other liabilities	5,939	Black Scholes	Expected term Forfeiture assumptions
Total liabilities	\$ 193,338		

Realized gains (losses) on debt and equity securities are reported in the Condensed Consolidated Statements of Earnings as net investment gains (losses). Unrealized gains (losses) on available for sale debt and equity securities are reported as other comprehensive income (loss) within stockholders' equity of the Condensed Consolidated Balance Sheet.

The fair value hierarchy classifications are reviewed each reporting period. Reclassification of certain financial assets and liabilities may result based on changes in the observability of valuation attributes. Reclassifications are reported as transfers into and out of Level 3 at the beginning fair value for the reporting period in which the changes occur.

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

The carrying amounts and fair values of the Company's financial instruments are as follows:

	September 30, 2014		Fair Value Hierarchy Level		
	Carrying	Fair	Level 1	Level 2	Level 3
	Values (In thousands)	Values			
<b>ASSETS</b>					
Investments in debt and equity securities:					
Securities held to maturity	\$6,898,038	7,195,441	—	7,195,441	—
Securities available for sale	2,724,880	2,724,880	16,405	2,708,475	—
Cash and short-term investments	121,482	121,482	121,482	—	—
Mortgage loans	152,740	159,845	—	—	159,845
Policy loans	63,746	63,746	—	—	63,746
Other loans	2,318	2,462	—	—	2,462
Derivatives, index options	109,812	109,812	—	—	109,812
Life interest in Libbie Shearn Moody Trust	—	12,775	—	—	12,775
<b>LIABILITIES</b>					
Deferred annuity contracts	\$7,471,884	7,102,374	—	—	7,102,374
Immediate annuity and supplemental contracts	448,892	472,485	—	—	472,485
<b>December 31, 2013</b>					
	December 31, 2013		Fair Value Hierarchy Level		
	Carrying	Fair	Level 1	Level 2	Level 3
	Values (In thousands)	Values			
<b>ASSETS</b>					
Investments in debt and equity securities:					
Securities held to maturity	\$6,510,320	6,656,144	—	6,656,144	—
Securities available for sale	2,651,544	2,651,544	13,802	2,637,742	—
Cash and short-term investments	120,859	120,859	120,859	—	—
Mortgage loans	132,765	138,159	—	—	138,159
Policy loans	65,969	65,969	—	—	65,969
Other loans	2,986	3,143	—	—	3,143
Derivatives, index options	169,314	169,314	—	—	169,314
Life interest in Libbie Shearn Moody Trust	—	12,775	—	—	12,775
<b>LIABILITIES</b>					
Deferred annuity contracts	\$7,288,861	6,941,902	—	—	6,941,902
Immediate annuity and supplemental contracts	463,276	483,690	—	—	483,690





Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(UNAUDITED)

Fair value estimates are made at a specific point in time based on relevant market information and information about the financial instruments. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because no market exists for a portion of the Company's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

(11) DERIVATIVE INVESTMENTS

Fixed-index products provide traditional fixed annuities and universal life contracts with the option to have credited interest rates linked in part to an underlying equity index or a combination of equity indices. The equity return component of such policy contracts is identified separately and accounted for in future policy benefits as embedded derivatives on the Condensed Consolidated Balance Sheet. The remaining portions of these policy contracts are considered the host contracts and are recorded separately as fixed annuity or universal life contracts. The host contracts are accounted for under debt instrument type accounting in which future policy benefits are recorded as discounted debt instruments that are accreted, using the effective yield method, to their minimum account values at their projected maturities or termination dates.

The Company purchases over-the-counter index options, which are derivative financial instruments, to hedge the equity return component of its fixed-index annuity and life products. The index options act as hedges to match closely the returns on the underlying index or indices. The amounts which may be credited to policyholders are linked, in part, to the returns of the underlying index or indices. As a result, changes to policyholders' liabilities are substantially offset by changes in the value of the options. Cash is exchanged upon purchase of the index options and no principal or interest payments are made by either party during the option periods. Upon maturity or expiration of the options, cash may be paid to the Company depending on the performance of the underlying index or indices and terms of the contract.

The Company does not elect hedge accounting relative to these derivative instruments. The index options are reported at fair value in the accompanying condensed consolidated financial statements. The changes in the values of the index options and the changes in the policyholder liabilities are both reflected in the Condensed Consolidated Statements of Earnings. Any changes relative to the embedded derivatives associated with policy contracts are reflected in contract interest in the Condensed Consolidated Statements of Earnings. Any gains or losses from the sale or expiration of the options, as well as period-to-period changes in values, are reflected as net investment income in the Condensed Consolidated Statements of Earnings.

Although there is credit risk in the event of nonperformance by counterparties to the index options, the Company does not expect any of its counterparties to fail to meet their obligations, given their high credit ratings. In addition, credit support agreements are in place with all counterparties for option holdings in excess of specific limits, which may further reduce the Company's credit exposure.

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

The tables below present the fair value of derivative instruments as of September 30, 2014 and December 31, 2013, respectively.

	September 30, 2014		Liability Derivatives	
	Asset Derivatives		Balance	Fair
	Balance	Fair	Sheet	Value
	Sheet	Value	Location	
	Location	(In thousands)		(In thousands)
Derivatives not designated as hedging instruments				
Equity index options	Derivatives, Index Options	\$ 109,812		
Fixed-index products			Universal Life and Annuity Contracts	\$ 127,622
Total		\$ 109,812		\$ 127,622

	December 31, 2013		Liability Derivatives	
	Asset Derivatives		Balance	Fair
	Balance	Fair	Sheet	Value
	Sheet	Value	Location	
	Location	(In thousands)		(In thousands)
Derivatives not designated as hedging instruments				
Equity index options	Derivatives, Index Options	\$ 169,314		
Fixed-index products			Universal Life and Annuity Contracts	\$ 187,399
Total		\$ 169,314		\$ 187,399

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED)

The table below presents the effect of derivative instruments in the Condensed Consolidated Statements of Earnings for the three months ended September 30, 2014 and 2013.

Derivatives Not Designated As Hedging Instruments	Location of Gain or (Loss) Recognized In Income on Derivatives	September 30,	September 30,
		2014	2013
		Amount of Gain or (Loss) Recognized in Income on Derivatives (In thousands)	
Equity index options	Net investment income	\$3,479	35,615
Fixed-index products	Universal life and annuity contract interest	(4,033	) (36,857 )
		\$(554	) (1,242 )

The table below presents the effect of derivative instruments in the Condensed Consolidated Statement of Earnings for the nine months ended September 30, 2014 and 2013.

Derivatives Not Designated As Hedging Instruments	Location of Gain or (Loss) Recognized In Income on Derivatives	September 30,	September 30,
		2014	2013
		Amount of Gain or (Loss) Recognized in Income on Derivatives (In thousands)	
Equity index options	Net investment income	\$49,278	126,739
Fixed-index products	Universal life and annuity contract interest	(49,003	) (129,625 )
		\$275	(2,886 )

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES  
ABOUT MARKET RISK

This information is included in Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations, in the Investments in Debt and Equity Securities section.

ITEM 4. CONTROLS AND PROCEDURES

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures are effective in recording, processing, summarizing, and reporting, on a timely basis, information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act.

There have been no changes in the Company's internal controls over financial reporting (as defined in Rules 13a-15(f) and 15d-15(e) under the Exchange Act) during the quarter ended September 30, 2014 that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting. Internal controls over financial reporting change as the Company modifies or enhances its systems and processes to meet business needs. Any significant changes in controls are evaluated prior to implementation to help ensure continued effectiveness of internal controls and the control environment.

Table of Contents

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS  
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FORWARD-LOOKING STATEMENTS

The Private Securities Litigation Reform Act of 1995 provides a “safe harbor” for forward-looking statements. Certain information contained herein or in other written or oral statements made by or on behalf of National Western Life Insurance Company or its subsidiaries are or may be viewed as forward-looking. Although the Company has taken appropriate care in developing any such information, forward-looking information involves risks and uncertainties that could significantly impact actual results. These risks and uncertainties include, but are not limited to, matters described in the Company's SEC filings such as exposure to market risks, anticipated cash flows or operating performance, future capital needs, and statutory or regulatory related issues. However, National Western, as a matter of policy, does not make any specific projections as to future earnings, nor does it endorse any projections regarding future performance that may be made by others. Whether or not actual results differ materially from forward-looking statements may depend on numerous foreseeable and unforeseeable events or developments. Also, the Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future developments, or otherwise.

Management's discussion and analysis of the financial condition and results of operations (“MD&A”) of National Western Life Insurance Company for the three and nine months ended September 30, 2014 follows. This discussion should be read in conjunction with the Company's condensed consolidated financial statements and related notes beginning on page 3 of this report and with the 2013 Annual Report filed on Form 10-K with the SEC.

Overview

The Company provides life insurance products on a global basis for the savings and protection needs of policyholders and annuity contracts for the asset accumulation and retirement needs of contract holders, both domestically and internationally. The Company accepts funds from policyholders or contract-holders and establishes a liability representing future obligations to pay the policy or contract-holders and their beneficiaries. To ensure the Company will be able to pay these future commitments, the funds received as premium payments and deposits are invested in high quality investments, primarily fixed income securities.

Due to the business of accepting funds to pay future obligations in later years and the underlying economics, the relevant factors affecting the Company's business and profitability include the following:

- the level of sales and premium revenues collected
- persistency of policies and contracts
- returns on investments sufficient to produce acceptable spread margins over interest crediting rates
- investment credit quality which minimizes the risk of default or impairment
- levels of policy benefits and costs to acquire business
- the level of operating expenses
- effect of interest rate changes on revenues and investments including asset and liability matching
- maintaining adequate levels of capital and surplus
- actual levels of surrenders, withdrawals, claims and interest spreads
- changes in assumptions for amortization of deferred policy acquisition expenses and deferred sales inducements
- changes in the fair value of derivative index options and embedded derivatives pertaining to fixed-index life and annuity products
- pricing and availability of adequate reinsurance
- litigation subject to unfavorable judicial development, including the time and expense of litigation

The Company monitors these factors continually as key business indicators. The discussion that follows in this Item 2 includes these indicators and presents information useful to an overall understanding of the Company's business performance in 2014, incorporating required disclosures in accordance with the rules and regulations of the Securities and Exchange Commission.

48

---

Table of Contents

Insurance Operations - Domestic

The Company is currently licensed to do business in all states and the District of Columbia except for New York. Products marketed are annuities, universal life insurance, fixed-index universal life, and traditional life insurance, which include both term and whole life products. The Company's domestic sales have historically been more heavily weighted toward annuity products, which include single and flexible premium deferred annuities, single premium immediate annuities, and fixed-index annuities. Most of these annuities can be sold as tax qualified or nonqualified products. At September 30, 2014, the Company maintained approximately 139,100 annuity contracts in force and 56,200 domestic life insurance policies in force representing \$3.0 billion in face amount of coverage.

National Western markets and distributes its domestic products primarily through independent national marketing organizations ("NMOs"). These NMOs assist the Company in recruiting, contracting, and managing independent agents. The Company's agents are independent contractors who are compensated on a commission basis. The Company currently has approximately 17,900 domestic independent agents contracted. Roughly 15% of these contracted agents have submitted policy applications to the Company in the past twelve months.

Insurance Operations - International

The Company's international clientèle consists mainly of foreign nationals in upper socioeconomic classes. Insurance products are issued primarily to residents of countries in Central and South America, the Caribbean, Eastern Europe, Asia and the Pacific Rim based upon applications received in the Company's home office in Austin, Texas. Issuing policies to residents of countries in these different regions provides diversification that helps to minimize large fluctuations that could arise due to various economic, political, and competitive pressures that may occur from one country to another. Products issued to international residents are almost entirely universal life and traditional life insurance products. However, certain annuity and investment contracts are also available. At September 30, 2014, the Company had approximately 70,800 international life insurance policies in force representing approximately \$19.7 billion in face amount of coverage.

International applications are submitted by independent contractor consultants and broker-agents. The Company has approximately 2,200 independent international consultants and brokers currently contracted, 43% of which have submitted policy applications to the Company in the past twelve months.

There are some inherent risks of accepting international applications, which are not present within the domestic market, that are reduced substantially by the Company in several ways. As previously described, the Company accepts applications from foreign nationals in upper socioeconomic classes who have substantial financial resources. This targeted customer base coupled with the Company's conservative underwriting practices have historically resulted in claims experience, due to natural causes, similar to that in the United States. The Company minimizes exposure to foreign currency risks by requiring payment of premiums, claims and other benefits almost entirely in United States dollars. The Company's excess of fifty years of experience with the international products and its longstanding independent consultant and broker-agent relationships further serve to minimize risks.

Table of Contents

## SALES

## Life Insurance

The following table sets forth information regarding the Company's life insurance sales activity as measured by annualized first year premiums. While the figures shown below are in accordance with industry practice and represent the amount of new business sold during the periods indicated, they are considered a non-GAAP financial measure. The Company believes sales are a measure of distribution productivity and are a leading indicator of future revenue trends. However, revenues are driven by sales in prior periods as well as in the current period and therefore, a reconciliation of sales to revenues is not meaningful or determinable.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(In thousands)			
International:				
Universal life	\$935	1,143	3,135	3,366
Traditional life	854	731	2,724	2,298
Equity-index life	3,785	5,452	10,327	11,051
	5,574	7,326	16,186	16,715
Domestic:				
Universal life	23	42	89	201
Traditional life	(38	) 12	44	40
Equity-index life	4,826	5,387	12,617	14,326
	4,811	5,441	12,750	14,567
Totals	\$10,385	12,767	28,936	31,282

Life insurance sales as measured by annualized first year premiums decreased 19% in the third quarter of 2014 as compared to the third quarter of 2013. By market segment, the domestic life insurance line of business posted a 12% decrease over the comparable results during the third quarter of 2013 while international life sales decreased 24% during the same time frame. For the nine months ended September 30th, total life insurance sales were 7.5% lower in the current period as international life insurance sales decreased 3% during this period while domestic life insurance sales declined 12.5%.

The Company's domestic life insurance sales in 2013 represented a record year for new business. The decline thus far in 2014 in comparison to the prior year reflects the high level attained during 2013 combined with a waning consumer demand for life insurance products in the current economic environment.

The Company's international life business consists of applications accepted from residents of various regions outside of the United States, the volume of which typically varies based upon changes in the socioeconomic climates of these regions. Historically, the Company has experienced a simultaneous combination of rising and declining sales in various countries; however, the appeal of the Company's dollar-denominated life insurance products overcomes many of the local and national difficulties.





Table of Contents

Applications submitted from residents of Latin America and the Pacific Rim perennially have comprised the majority of the Company's international life insurance sales. As noted previously, the Company's international sales by geographic market tend to fluctuate with the socio and economic climates in these regions. The Company's mix of international sales by geographic region is as follows.

	Nine Months Ended September 30,			
	2014		2013	
Percentage of International Sales:				
Latin America	86.6	%	91.8	%
Pacific Rim	9.9		5.8	
Eastern Europe	3.5		2.4	
Totals	100.0	%	100.0	%

During the first nine months of 2014, the Company has accepted new business from residents outside of the United States in over thirty different countries with Brazil (24%), Peru (14%), and Venezuela (14%) comprising the largest contributions. Sales to residents of Brazil and Peru increased in the first nine months of 2014 compared to the same period in 2013 while sales to residents of Venezuela declined during the same period. Sales during the third quarter of 2013 included atypically large policies to residents of Chile which bolstered the figures for this reporting period.

The Company's domestic operations have historically been skewed toward annuity sales rather than life insurance sales. Several years ago the Company revamped its domestic life product portfolio to include single premium universal life ("SPUL") and equity-index universal life ("EIUL") products. These product offerings were further developed into hybrids of the EIUL and SPUL products, combining features of these core products. The Company's product development emphasis in creating SPUL, EIUL, and single or limited pay EIUL products was to take advantage of the changing demographic in the marketplace as the "Baby Boomer" generation began moving into their retirement years. These life insurance products were designed to facilitate the wealth transfer of accumulated savings of this segment of the population, often held in deferred annuity products, via systematic funding mechanisms such as single premium immediate annuities. The wealth transfer life products have been valuable offerings for the Company's distributors as evidenced by comprising 99% of total domestic life sales in the first nine months of 2014.

The Company's revised domestic life product portfolio including the wealth transfer products has gradually increased the average new policy face amount since the Company implemented commission caps on domestic policies in 2009. The Company's sales to international residents witnessed a steady growth in the average face amount of insurance coverage per policy over the same time period and has leveled off at its current figure over the past several years as shown in the following table.

	Average New Policy Face Amount	
	Domestic	International
Year ended December 31, 2008	455,200	272,000
Year ended December 31, 2009	201,400	315,300
Year ended December 31, 2010	164,800	338,600
Year ended December 31, 2011	178,500	363,600
Year ended December 31, 2012	254,900	380,200
Year ended December 31, 2013	286,000	384,000
Nine months ended September 30, 2014	287,700	379,800

After several challenging years of life insurance sales in the wake of the global financial crisis, life insurers have looked to international markets to rebuild premium levels. The Company's efforts are directed toward maintaining its competitive advantages in selling to residents in international markets and to its wealth transfer strategies for domestic life sales. In both of these strategies the Company's portfolio of fixed-index (equity indexed) life insurance products plays an important role. Fixed-index life products accounted for 79% of total life sales in the first nine months of 2014, as compared to 81% for the same period in 2013.

Table of Contents

The table below sets forth information regarding the Company's life insurance in force for each date presented.

	Insurance In Force as of September 30,	
	2014	2013
	(\$ in thousands)	
Universal life:		
Number of policies	51,660	54,860
Face amounts	\$6,856,780	7,102,460
Traditional life:		
Number of policies	37,730	39,520
Face amounts	\$3,553,990	3,329,160
Fixed-index life:		
Number of policies	37,540	35,780
Face amounts	\$9,404,140	8,904,050
Rider face amounts	\$2,902,200	2,669,260
Total life insurance:		
Number of policies	126,930	130,160
Face amounts	\$22,717,110	22,004,930

At September 30, 2014, the Company's face amount of life insurance in force was comprised of \$19.7 billion from the international line of business and \$3.0 billion from the domestic line of business. At September 30, 2013, these amounts were \$19.3 billion and \$2.7 billion for the international and domestic lines of business, respectively.

Table of Contents

## Annuities

The following table sets forth information regarding the Company's annuity sales activity as measured by single and annualized first year premiums. Similar to life insurance sales, these figures are considered a non-GAAP financial measure but are shown in accordance with industry practice and depict the Company's sales productivity.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(In thousands)			
Fixed-index annuities	\$182,315	186,526	535,203	538,854
Other deferred annuities	20,053	10,777	53,015	56,349
Immediate annuities	4,138	1,909	8,855	8,782
Totals	\$206,506	199,212	597,073	603,985

Annuity sales in the third quarter of 2014 were 4% higher than in the third quarter of 2013. For the first nine months of the year, annuity sales trailed the level in 2013 by approximately 1%. Annuity sales in the first nine months of 2014 are generally in line with the Company's projected sales goal for the year of \$800 million.

The recessionary contraction and financial market crisis that began in the latter half of 2007 and persisted into 2009 impacted many annuity carriers. Losses from investment impairments and equity exposure (for insurers with variable annuity product offerings) crippled the capital position of numerous companies and limited their ability to write new business. In contrast, the Company's substantial capital position attained through profitable operations and limited investment loss exposure positioned it to write additional levels of annuity business. During 2010 and 2011, the Company sold approximately \$1.4 billion of annuity products per year indicative of the Company's enhanced competitive position in the marketplace.

Under the auspices of the Company's enterprise risk management (ERM) processes, in 2012 Company management evaluated the potential ramifications of continuing a high level of annuity sales in the depressed interest rate environment precipitated by the "quantitative easing" programs enacted by the Federal Reserve and the European debt crisis. Taken into consideration has been the Federal Reserve's ongoing announced intention to maintain interest rates at historically reduced levels over several years. While the Company does not subsidize its interest crediting rates on new policies in order to obtain market share, the Company's ERM considerations determined that managing to a lower level of annuity sales was prudent given the environment.

The Company's mix of annuity sales have historically shifted with interest rate levels and the relative performance of the equity market. Over the past several years, sales of fixed-index products have accounted for 60% to 90% of all annuity sales. During the first nine months of 2014 this percentage reached 90% reflecting the ongoing bull market run in equities since bottoming out in 2009 and the persisting low level of fixed interest rates. For all fixed-index products, the Company purchases over the counter options to hedge the equity return feature. The options are purchased relative to the issuance of the annuity contracts in such a manner to minimize timing risk. Generally, the index return during the indexing period (if the underlying index increases) becomes a component in a formula (set forth in the annuity), the result of which is credited as interest to contract holders electing the index formula crediting method at the beginning of the indexing period. The formula result can never be less than zero with these products. The Company does not deliberately mismatch or under hedge for the equity feature of the products. Fixed-index products also provide the contract holder the alternative to elect a fixed interest rate crediting option.

The level of annuity business in force requires a focused discipline on asset/liability analysis. The Company monitors its asset/liability matching within the self-constraints of desired capital levels and risk tolerance. Despite the amounts of new business generated over the past several years, the Company's capital level remains substantially above industry averages and regulatory targets. Management has performed analyses of the capital strain associated with incrementally higher levels of annuity new business and determined that the Company's capital position is more than sufficient to handle increased sales activity.

Table of Contents

The following table sets forth information regarding annuities in force for each date presented.

	Annuities In Force as of September 30,	
	2014	2013
	(\$ in thousands)	
Fixed-index annuities		
Number of policies	67,650	63,460
GAAP annuity reserves	\$5,100,262	4,606,831
Other deferred annuities		
Number of policies	55,310	59,470
GAAP annuity reserves	\$2,336,844	2,521,551
Immediate annuities		
Number of policies	16,170	17,390
GAAP annuity reserves	\$371,904	391,531
Total annuities		
Number of policies	139,130	140,320
GAAP annuity reserves	\$7,809,010	7,519,913

## Impact of Recent Business Environment

The Company's business is generally aided by an economic environment undergoing expansion, whether moderate or vibrant. Conversely, a muted economic recovery could adversely impact the demand for the Company's products. The recent announcement of preliminary third quarter U.S. GDP growth of 3.5% portrayed a domestic economy well on the road to financial stability. Sentiment surveys of consumers and investors have also trended in the upward direction with some of the optimism attributed to anticipated changes in the state and federal government representatives in the November election.

In the U.S., equity markets have climbed into record territories based upon the easy money policies of the Federal Reserve and the rebound in certain sectors of the economy. The leadership of the Federal Reserve has indicated confidence in the economy's strength and direction by ceasing one of their quantitative easing initiatives involving the purchase of long-term treasury securities. There is some trepidation with regard to equity market levels given the Federal Reserve's cessation of a program that served to augment the valuation of financial assets. This fear has manifested itself with increased instances of volatility not seen for some time. The equity market's five year run has certainly provided support to sales of the Company's equity-index insurance products.

The fixed income market, the Company's primary investment source, has persisted through both lower interest rate levels and generally tighter spreads of corporate securities over comparable duration Treasury instruments. Contrary to the majority opinion of credit market prognosticators at the beginning of the year, the ten year U.S. Treasury yield has decreased approximately 60 to 70 basis points from the end of the year 2013 during the first nine months of 2014. The low overall interest rate environment presents a challenging scenario for obtaining yields to support crediting rates on interest sensitive products and avert the compression on interest spreads. The Company continues to manage new annuity sales levels cautiously at current rate levels.





Table of Contents

Industry analysts and observers generally agree that a sudden jump in interest rate levels would be harmful to life insurers with interest-sensitive products as it could provide an impetus for abnormal levels of product surrenders and withdrawals at the same time fixed debt securities held by insurers declined in market value. It is generally held that a move up to 100 basis points would not be sufficient to drive the policyholder behavior in this direction. However, a relatively quick expansion of 200 to 300 basis points in rates may increase the potential for incremental policy lapses. Observers of credit markets increasingly predict an eventual rise in yields and speculate as to what may be the circumstance reversing the course of lower rates. Sentiment at the present time is that the conditions for a sudden increase in rates are not evident or on the near-term horizon. Irrespective, it is uncertain what direction and at what pace interest rate movements may occur in the future and what impact, if any, such movements would have on the Company's business, results of operations, cash flows or financial condition.

Our operating strategy continues to include a focus on maintaining capital levels substantially above regulatory and rating agency requirements. The Company maintains resources more than adequate to fund future growth and absorb abnormal periods of cash outflows.

## RESULTS OF OPERATIONS

The Company's condensed consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles ("GAAP"). In addition, the Company regularly evaluates operating performance using non-GAAP financial measures which exclude or segregate derivative and realized investment gains and losses from operating revenues. Similar measures are commonly used in the insurance industry in order to assess profitability and results from ongoing operations. The Company believes that the presentation of these non-GAAP financial measures enhances the understanding of the Company's results of operations by highlighting the results from ongoing operations and the underlying profitability factors of the Company's business. The Company excludes or segregates derivative and realized investment gains and losses because such items are often the result of events which may or may not be at the Company's discretion and the fluctuating effects of these items could distort trends in the underlying profitability of the Company's business. Therefore, in the following sections discussing condensed consolidated operations and segment operations, appropriate reconciliations have been included to report information management considers useful in enhancing an understanding of the Company's operations to reportable GAAP balances reflected in the condensed consolidated financial statements.

## Consolidated Operations

Revenues. The following details Company revenues.

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2013	2013	2013	2013
	(In thousands)			
Universal life and annuity contract charges	\$36,602	33,523	112,824	111,785
Traditional life premiums	4,506	4,159	13,946	13,241
Net investment income (excluding derivatives)	107,487	105,788	325,318	325,165
Other revenues	5,377	5,822	16,351	17,954
Operating revenues	153,972	149,292	468,439	468,145
Derivative gain (loss)	3,479	35,615	49,278	126,739
Net realized investment gains (losses)	2,169	3,285	6,747	7,199

Total revenues	\$ 159,620	188,192	524,464	602,083
----------------	------------	---------	---------	---------

55

---

Table of Contents

Universal life and annuity contract charges - Revenues for universal life and annuity contracts were level for the first nine months in 2014 compared to 2013 primarily due to higher cost of insurance and administrative charges resulting from growth in the amount of business in force being offset by lower administrative charge revenue from lower domestic life and annuity sales in the first quarter of 2014. Revenues for universal life and annuity products consist of policy charges for the cost of insurance, administration charges, and surrender charges assessed against policyholder account balances, less reinsurance premiums, as shown in the following table.

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2013	2013	2014	2013
	(In thousands)			
Contract Revenues:				
Cost of insurance and administrative charges	\$32,349	28,778	95,903	96,079
Surrender charges	8,687	9,591	29,723	27,615
Other charges	(303)	) (795	) (1,160	) (385
Gross contract revenues	40,733	37,574	124,466	123,309
Reinsurance premiums	(4,131	) (4,051	) (11,642	) (11,524
Net contract revenues	\$36,602	33,523	112,824	111,785

Cost of insurance charges typically trend with the size of the life insurance block in force and the amount of new business issued during the period. Life insurance in force during the nine months ended September 30, 2014 averaged approximately \$22.5 billion while for the same period of 2013 averaged \$21.7 billion. Accordingly, for the nine months ended September 30, 2014, cost of insurance charges increased to \$75.9 million from \$74.2 million at September 30, 2013. For the third quarter ended September 30th, cost of insurance charges recognized increased to \$25.4 million in 2014 from \$24.9 million in the same period of 2013. Administrative charges pertaining to new business issued decreased to \$20.0 million from \$21.9 million for the nine months ended September 30, 2014 versus September 30, 2013. Due to the substantial increase in the Company's single premium life insurance sales, the Company began deferring the premium load associated with this product in the third quarter of 2013, thus decreasing contract revenues, and set the deferred amount up as an unearned revenue balance to be earned over future periods of the policy life. While reducing administrative charge revenue during the third quarter of 2013, the amounts were largely offset by corresponding changes to deferred policy acquisition costs and death benefit reserve liabilities. For the three months ended September 30, 2014 and 2013, administrative charges from new business issued were \$6.9 million and \$3.9 million, respectively.

Surrender charges assessed against policyholder account balances upon withdrawal declined 9% in the third quarter of 2014 over the comparable prior year period and incurred an 8% increase for the nine months ended September 30th. While the Company earns surrender charge income that is assessed upon policy terminations, the Company's overall profitability is enhanced when policies remain in force, additional contract revenues are realized and the Company continues to make an interest rate spread on outstanding policyholder account balances (the difference between what is earned on invested assets and the amount credited to policyholders). In the first nine months of 2014, lapse rates on life insurance policies were consistent with the prior year while annuity lapse rates increased marginally over the 2013 level.

Traditional life and annuity premiums - Traditional life and annuity premiums increased slightly in the first nine months of 2014 compared to the same period in 2013. Traditional life insurance premiums for products such as whole life and term life are recognized as revenues over the premium-paying period. The Company's life insurance sales

focus has been primarily centered around universal life products. Universal life products, especially the Company's equity indexed universal life products which offer the opportunity for consumers to acquire life insurance protection and receive credited interest linked in part to an outside market index such as the S&P 500 Index<sup>®</sup>, have been more popular product offerings in the Company's markets. The Company began offering graded death benefit whole life and term products in its domestic markets during 2014.

Table of Contents

Net investment income - To ensure the Company will be able to honor future commitments to policyholders and provide a financial return, the funds received as premium payments and deposits are invested in high quality investments, primarily fixed maturity debt securities. The income from these investments is closely monitored by the Company due to its significant impact on the business. A detail of net investment income (with and without index option gains and losses) is provided below.

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2013		2013	
	(In thousands)			
Gross investment income:				
Debt securities	\$ 102,499	102,171	307,708	308,364
Mortgage loans	2,595	2,117	7,306	7,076
Policy loans	1,060	1,094	3,198	3,412
Short-term investments	147	59	268	220
Other invested assets	1,469	664	7,703	6,873
Total investment income	107,770	106,105	326,183	325,945
Less: investment expenses	283	317	865	780
Net investment income (excluding derivatives)	107,487	105,788	325,318	325,165
Derivative gain (loss)	3,479	35,615	49,278	126,739
Net investment income	\$ 110,966	141,403	374,596	451,904

For the nine months ended September 30, 2014, debt securities generated approximately 95% of total investment income, excluding derivative gain (loss). The stable level of investment income from debt securities through the third quarter of 2014 versus 2013 despite higher portfolio balances in the current period reflects higher yielding debt securities maturing or being called by borrowers and being replaced with lower yielding securities in the current interest rate environment. Investment yields on new bond purchases during 2014 remain below the portfolio's weighted average yield. Mortgage loan investment income for the nine months ended September 30, 2014 increased over the comparable period in 2013 reflecting incremental new loan volume. The Company's new mortgage loan activity has been relatively low by historical standards in recent years given the low level of rates and the higher level of risk associated with commercial properties in the current economic environment. During the three and nine months ended September 30, 2014 the Company originated new mortgage loans in the amount of \$4.4 million and \$34.0 million, respectively.

In order to evaluate underlying profitability and results from ongoing operations, net investment income performance is analyzed excluding derivative gain (loss), which is a common practice in the insurance industry. Net investment income performance is summarized as follows.

	Nine Months Ended September 30, 2014		2013
	(In thousands)		
Excluding derivatives:			
Net investment income	\$ 325,318		325,165
Average invested assets, at amortized cost	\$9,609,481		9,083,333

Edgar Filing: NATIONAL WESTERN LIFE INSURANCE CO - Form 10-Q

Annual yield on average invested assets	4.51	% 4.77	%
Including derivatives:			
Net investment income	\$374,596	451,904	
Average invested assets, at amortized cost	\$9,749,043	9,171,916	
Annual yield on average invested assets	5.12	% 6.57	%

57

---

Table of Contents

The lower yield on average invested assets, excluding derivatives, through the third quarter of 2014 compared to 2013 is due to progressively lower yields obtained on new fixed maturity debt securities investments. During 2013, the average yield on bond purchases to fund insurance operations was 3.53% representing a 1.21% spread over treasury rates. Insurance operation bond purchases through the third quarter of 2014 had an average yield of 3.74% with spreads decreasing slightly to 1.08% over treasury rates. The yield rates during both 2013 and 2014 are below the weighted average bond portfolio rate which approximated 4.50% at September 30, 2014. The weighted average quality of new purchases during the first nine months was "A-", which was slightly lower than the overall "A" quality rating of purchases during 2013. The composite duration of purchases during the first nine months of 2014 matched that for 2013 purchases. The Company's general investment strategy is to purchase securities with maturity dates approximating ten years in the future. Accordingly, an appropriate measure for benchmarking the direction of interest rate levels for the Company's debt security purchases is the ten year treasury bond rate. After ending 2013 at a rate of 3.03%, the daily closing yield of the ten year treasury bond ranged from a low of approximately 2.3% to a high of 3.0% during the first nine months of 2014, and ended the third calendar quarter at 2.49%.

Other revenues - Other revenues primarily pertain to the Company's two nursing home operations in Reno, Nevada and San Marcos, Texas. Revenues associated with these operations were \$15.9 million and \$17.7 million for the nine months ended September 30, 2014 and 2013, respectively. Lower nursing home revenues reflect lower census figures at the facilities thus far in 2014.

Derivative gain (loss) - Index options are derivative financial instruments used to hedge the equity return component of the Company's fixed-index products. Derivative gain or loss includes the amounts realized from the sale or expiration of the options. Since the index options do not meet the requirements for hedge accounting under GAAP, they are marked to fair value on each reporting date and the resulting unrealized gain or loss is also reflected as a component of net investment income.

Gains and losses from index options are due to changes in equity market conditions. Index options are intended to act as hedges to match the returns on the product's underlying reference index and the rise or decline in the index relative to the index level at the time of the option purchase which causes option values to likewise rise or decline. As income from index options fluctuates with the underlying index, the contract interest expense to policyholder accounts for the Company's fixed-index products also fluctuates in a similar manner and direction. For the quarter ended September 30, 2014, the reference indices slightly increased and the Company recorded an overall gain from index options with substantially a corresponding increase in contract interest expense during this period.

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2013	
	2014	2013	2014	2013
	(In thousands)			
Derivatives:				
Unrealized gain (loss)	\$(39,294	) (3,385	) (67,520	) 58,165
Realized gain (loss)	42,773	39,000	116,798	68,574
Total gain (loss) included in net investment income	\$3,479	35,615	49,278	126,739
Total contract interest	\$59,211	87,486	224,576	299,224

The economic impact of option performance in the Company's financial statements is not generally determined solely by the option gain or loss included in net investment income as there is a corresponding amount recorded in the contract interest expense line. Rather, the Company's profitability with respect to these options is dependent upon the purchase cost of the option remaining within the financial budget for purchasing options embedded in the product pricing. Option prices vary with interest rates, volatility, and dividend yields among other things. As option prices vary, the Company manages for the variability by making offsetting adjustments to product caps, participation rates, and management fees. For the periods shown, the Company's option costs have been within the product pricing budgets.

Net realized investment gains (losses) - Realized gains on investments in 2014 primarily resulted from bond calls and sales. The net gains reported for the nine months ended September 30, 2014 consisted of gross gains of \$7.3 million offset by gross losses of \$0.1 million, which included other-than-temporary impairment losses.



Table of Contents

The Company records impairment write-downs when a decline in value is considered to be other-than-temporary and full recovery of the investment is not expected. Impairments due to credit factors are recorded in the Company's Condensed Consolidated Statements of Earnings while non-credit (liquidity) impairment losses are included in other comprehensive income (loss). Impairment and valuation write-downs reflected in the Company's Condensed Consolidated Statements of Earnings are summarized in the following table.

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2014	2013	2014	2013
	(In thousands)			
Impairment or valuation write-downs:				
Bonds	\$—	13	7	238
Equities	—	—	28	14
Total	\$—	13	35	252

As shown in the table above, the Company did not incur impairment or valuation write-downs during the quarter ended September 30, 2014. Bond impairments during the nine months ended September 30, 2014 pertained to an asset-backed security whose cash flow and fair value did not support the amortized cost basis at which the instrument was recorded in the financial records. Equity impairments represent a mark-to-market write-down on a common stock security in which the market discount to book value was significant and had been maintained for several reporting periods. Equity securities (common stocks) represent 0.1% of invested assets and individual common stock holdings have an average cost basis of approximately \$44,000.

Benefits and Expenses. The following table details benefits and expenses.

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2014	2013	2014	2013
	(In thousands)			
Life and other policy benefits	\$ 13,163	16,941	40,922	48,081
Amortization of deferred policy acquisition costs	23,467	24,244	79,304	83,900
Universal life and annuity contract interest	59,211	87,486	224,576	299,224
Other operating expenses	20,451	22,675	63,414	69,442
Totals	\$ 116,292	151,346	408,216	500,647

Life and other policy benefits - Death claim benefits, the largest component of policy benefits, decreased marginally to \$24.6 million year-to-date in 2014 compared to \$28.3 million for the first nine months of 2013. Death claim amounts are generally subject to variation from period to period and the Company's mortality experience has generally been consistent with or better than its product pricing assumptions. For the quarter ended September 30th, death claim expense declined to \$7.3 million from \$10.7 million from the comparable 2013 period.

Although not utilized previously, the Company initiated a process beginning in 2012 to identify unreported death claims by researching the Social Security Administration master database for deceased individuals which matches with insureds under in force policies of the Company. The results were not substantial given that most of the claims

identified were lower face insurance policies issued many years ago by the Company. However, the claim activity for 2013 includes incremental amounts associated with this effort.

In the second quarter of 2013, annuity policy benefit obligations were increased \$4.0 million pertaining to the market value adjustment feature on annuity contracts for surrenders and partial withdrawals transacted over a number of prior years. The amount of the market value adjustment for any single reporting period was not material given the length of time over which the transactions occurred.

Table of Contents

Amortization of deferred policy acquisition costs - Life insurance companies are required to defer certain expenses that vary with, and are primarily related to, the cost of acquiring new business. The majority of these acquisition expenses consist of commissions paid to agents, underwriting costs, and certain marketing expenses. Recognition of these deferred policy acquisition costs ("DPAC") as an expense in the condensed consolidated financial statements occurs over future periods in relation to the expected emergence of profits priced into the products sold. This emergence of profits is based upon assumptions regarding premium payment patterns, mortality, persistency, investment performance, and expense patterns. Companies are required to review universal life and annuity contract assumptions periodically to ascertain whether actual experience has deviated significantly from that assumed. If it is determined that a significant deviation has occurred, the emergence of profits pattern is to be "unlocked" and reset based upon the actual experience. DPAC balances are also adjusted each period to reflect current policy lapse or termination rates, expense levels and credited rates on policies compared to anticipated experience ("true-up") with the adjustment reflected in current period amortization expense. In accordance with GAAP guidance, the Company must also write-off deferred acquisition costs and unearned revenue liabilities upon internal replacement of certain contracts as well as annuitizations of deferred annuities.

The following table identifies the effects of unlocking and true-up adjustments on DPAC balances recorded through amortization expense three and nine months ended September 30, 2014 and 2013.

Increase (Decrease) in DPAC Balance	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(In thousands)			
Unlocking	\$1,430	—	1,430	—
True-up	3,121	3,326	7,219	13,055
Totals	\$4,551	3,326	8,649	13,055

True-up adjustments were recorded in 2014 and 2013 relative to partial surrender rates, mortality rates, credited interest rates and earned rates for the current year's experience. This resulted in a \$3.1 million decrease in amortization expense for the three months ended September 30, 2014, and a \$3.3 million decrease for the three months ended September 30, 2013. The true-up adjustments for the life insurance lines of business were positive (decrease to amortization expense) by \$12.9 million in the first nine months of 2014 whereas the true-up adjustments for the annuity line of business during the same period were negative by \$5.7 million incrementally adding to amortization expense. For the nine months ended September 30, 2013, true-up adjustments for the life insurance lines of business were positive (decrease to amortization expense) by \$15.0 million while true-up adjustments for the annuity line of business increased amortization expense by approximately \$1.9 million.

No unlocking adjustments were made by the Company in the first nine months of 2013. In the quarter ended September 30, 2014, the Company unlocked the DPAC balance associated with its International Life segment for premium load increases implemented on several international universal life products. The effect of the prospective unlocking was to increase DPAC balances by \$1.4 million (and decrease amortization expense). While the Company is required to evaluate its emergence of profits continually, management believes that the current amortization patterns of deferred policy acquisition costs are reflective of actual experience.

Universal life and annuity contract interest - The Company closely monitors its credited interest rates on interest sensitive policies, taking into consideration such factors as profitability goals, policyholder benefits, product marketability, and economic market conditions. As long term interest rates change, the Company's credited interest rates are often adjusted accordingly, taking into consideration the factors as described above. The difference between

yields earned on investments over policy credited rates is often referred to as the "interest spread".

Table of Contents

The Company's approximated average credited rates through the first nine months, excluding and including fixed-index (derivative) products, were as follows:

	September 30, 2014		September 30, 2013		
	(Excluding fixed-index products)		(Including fixed-index products)		
Annuity	2.52	% 2.66	% 3.41	% 4.18	%
Interest sensitive life	3.78	% 3.90	% 5.78	% 7.51	%

Contract interest including fixed-index products also encompasses the performance of the index options associated with the Company's fixed-index products. As previously noted, the market performance of these derivative features resulted in net realized and unrealized gains of \$49.3 million and \$126.7 million for the nine months ended September 30, 2014 and 2013, respectively.

Similar to deferred policy acquisition costs, the Company defers sales inducements in the form of first year credited interest bonuses on annuity products that are directly related to the production of new business. These bonus interest charges are deferred and amortized using the same methodology and assumptions used to amortize other capitalized acquisition costs and the amortization is included in contract interest. In addition, deferred sales inducement balances are also reviewed periodically to ascertain whether actual experience has deviated significantly from that assumed (unlock) and are adjusted to reflect current policy lapse or termination rates, expense levels and credited rates on policies compared to anticipated experience (true-up). These adjustments, plus or minus, are included in contract interest expense. For the nine months ended September 30, 2014 and 2013, the Company recorded true-up adjustments of its deferred sales inducement balances resulting in decreased balance sheet amounts of \$1.2 million and \$0.4 million, respectively, which thereby increased contract interest expense by a like amount. No unlocking adjustments were made in either period.

Other operating expenses - Other operating expenses consist of general administrative expenses, licenses and fees, commissions not subject to deferral, nursing home expenses and compensation costs. These expenses for the three and nine months ended September 30, 2014 and 2013 are summarized in the table that follows.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(In thousands)			
General insurance expenses	\$4,978	4,538	14,693	19,935
Nursing home expenses	4,784	5,340	14,696	16,009
Compensation expenses	6,006	7,266	20,386	21,156
Commission expenses	3,264	3,938	8,545	6,677
Taxes, licenses and fees	1,419	1,593	5,094	5,665
Totals	\$20,451	22,675	63,414	69,442

General insurance expenses include legal expenses and amounts provided for various legal matters and outstanding litigation. During the second quarter of 2013, the Company accrued \$3.5 million pertaining to a class action lawsuit, in which it was the defendant, that ultimately was settled in the first quarter of 2014. Refer to Note 8 in the accompanying notes to condensed consolidated financial statements for further discussion. With the resolution of this

matter early in 2014, the Company's legal expenses, excluding the class action lawsuit accrual, have declined in the first nine months of 2014 approximately \$1.2 million compared with the same period in 2013.

Nursing home expenses reflect the operations of the two facilities owned by the Company. Expenses during 2014 have decreased as a result of discontinuing higher acuity services at the homes. The decline in expenses as a result of discontinuing these services has similarly decreased the revenue associated with these operations.

Table of Contents

Compensation expenses include share-based compensation costs for the Company's stock option plans related to outstanding vested and nonvested stock options. These costs move in tandem with the number of stock options outstanding as well as the market price of the Company's Class A common share as a result of marking the stock options to fair value under the liability method of accounting. Consequently, the related expense amount varies positively or negatively in any given period. For the three months ended September 30, 2014 share based compensation expense was \$0.1 million while for the comparable period in 2013 share based compensation expense was \$1.0 million. For the nine months ended September 30, 2014 share based compensation expense was \$2.5 million while for the comparable period in 2013 share based compensation expense was \$4.0 million. Compensation costs related to share-based compensation declined during the three and nine months ended September 30, 2014 compared to the same periods in 2013 due to the number of outstanding options declining as a result of stock option exercises and forfeitures between September 30, 2013 and September 30, 2014.

Taxes, licenses and fees include premium taxes and licensing fees paid to state insurance departments, guaranty fund assessments, the company portion of social security and Medicare taxes, and other state and municipal taxes. For the nine months ended September 30, 2014 these amounts decreased from the comparable period in 2013 largely due to lower premium taxes which were \$2.2 million in the current year compared to \$2.6 million in the prior year.

Federal Income Taxes. Federal income taxes on earnings from operations reflect an effective tax rate of 33.4% for the nine months ended September 30, 2014 compared to 32.6% for the nine months ended September 30, 2013. The Company's effective tax rate is typically lower than the Federal rate of 35% due to tax-exempt investment income related to municipal securities and dividends-received deductions on income from stocks.

Table of Contents

## Segment Operations

## Summary of Segment Earnings

A summary of segment earnings for the three and nine months ended September 30, 2014 and 2013 is provided below. The segment earnings exclude realized gains and losses on investments, net of taxes.

	Domestic Life Insurance (In thousands)	International Life Insurance	Annuities	All Others	Totals
Segment earnings (losses):					
Three months ended:					
September 30, 2014	\$710	7,825	14,892	3,630	27,057
September 30, 2013	\$555	7,447	11,013	3,633	22,648
Nine months ended:					
September 30, 2014	\$2,601	25,824	34,144	10,521	73,090
September 30, 2013	\$2,520	25,024	25,569	10,613	63,726

## Domestic Life Insurance Operations

A comparative analysis of results of operations for the Company's domestic life insurance segment is detailed below.

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2013	2013	2013	2013
	(In thousands)			
Premiums and other revenues:				
Premiums and contract charges	\$6,847	3,944	22,077	22,967
Net investment income	6,859	6,928	24,044	22,943
Other revenues	19	12	40	21
Total revenues	13,725	10,884	46,161	45,931
Benefits and expenses:				
Life and other policy benefits	3,353	4,003	7,268	8,129
Amortization of deferred policy acquisition costs	1,166	1,015	5,346	5,260
Universal life insurance contract interest	5,803	2,261	19,066	17,320
Other operating expenses	2,314	2,782	10,585	11,496
Total benefits and expenses	12,636	10,061	42,265	42,205
Segment earnings (loss) before Federal income taxes	1,089	823	3,896	3,726
Provision (benefit) for Federal income taxes	379	268	1,295	1,206



Segment earnings (loss)	\$710	555	2,601	2,520
-------------------------	-------	-----	-------	-------

63

---

Table of Contents

Revenues from domestic life insurance operations include life insurance premiums on traditional type products and contract revenues from universal life insurance. Revenues from traditional products are simply premiums collected, while revenues from universal life insurance consist of policy charges for the cost of insurance, policy administration fees, and surrender charges assessed during the period. A comparative detail of premiums and contract revenues is provided below.

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2013		2013	
	(In thousands)			
Universal life insurance revenues	\$6,985	4,939	22,955	24,108
Traditional life insurance premiums	1,241	559	3,548	3,111
Reinsurance premiums	(1,379)	) (1,554	) (4,426	) (4,252
Totals	\$6,847	3,944	22,077	22,967

The Company's domestic life insurance in force in terms of policy counts has been declining for several years resulting in lower universal life contract revenue charges. The pace of new policies issued has lagged the number of policies terminating from death or surrender by roughly a three-to-one rate over the past several years causing a declining level of insurance in force from which contract charge revenue is received. Consequently, the number of domestic life insurance policies in force has declined from 60,000 at December 31, 2012 to 57,700 at December 31, 2013, and to 56,200 at September 30, 2014. Universal life insurance revenues are also generated with the issuance of new business based upon amounts per application and percentages of the face amount (volume) of insurance issued. Revenues associated with issuing new business are typically greater than that realized in a renewal period for in force policies. The number of domestic life policies issued in the first nine months of 2014 was 14% lower than in the comparable period for 2013 and the volume of insurance issued was 13% less than that in 2013.

As noted in the discussion of Consolidated Operations results, in the third quarter of 2013 the Company began deferring the premium load on its most popular selling domestic product, single pay life insurance. This resulted in a decrease in universal life insurance revenues during the third quarter of 2013.

Premiums collected on universal life products are not reflected as revenues in the Company's Condensed Consolidated Statements of Earnings in accordance with GAAP. Actual domestic universal life premiums collected are detailed below.

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2013		2013	
	(In thousands)			
Universal life insurance:				
First year and single premiums	\$32,674	36,071	84,833	96,245
Renewal premiums	5,345	4,883	15,251	15,259
Totals	\$38,019	40,954	100,084	111,504

During the past couple of years the Company has achieved some success in growing its domestic life insurance business with the number of new policies issued trending higher. Sales have been substantially weighted toward single

premium policies which do not have recurring premium payments. These products are targeting wealth transfer strategies involving the movement of accumulated wealth in alternative investment vehicles, including annuities, into life insurance products. As a result, renewal premium levels have not been exhibiting a corresponding increase.

Table of Contents

Net investment income for this segment of business has been gradually increasing due to the increased new business activity described above and a higher level of investments needed to support the corresponding growth in policy obligations. The increase in net investment income has been partially muted by lower investment yields from debt security investment purchases during this time frame. Net investment income also includes the gains and losses on index options purchased to back the index crediting mechanism on fixed-index universal products.

A detail of net investment income for domestic life insurance operations is provided below.

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2013		2013	
	(In thousands)			
Net investment income (excluding derivatives)	\$6,494	5,394	19,851	19,013
Derivative gain (loss)	365	1,534	4,193	3,930
Net investment income	\$6,859	6,928	24,044	22,943

Life and policy benefits for a smaller block of business are subject to variation from quarter to quarter. Claim activity during the first nine months of 2014 was consistent compared to historical trends. The Company's overall mortality experience for this segment is in line with pricing assumptions.

As noted previously in the discussion of Results of Operations, the Company records true-up adjustments to DPAC balances each period to reflect current policy lapse or termination rates, expense levels and credited rates on policies as compared to anticipated experience with the adjustment reflected in current period amortization expense. To the extent required, the Company may also record unlocking adjustments to DPAC balances. The following table identifies the effects of unlocking and true-up adjustments on domestic life insurance DPAC balances recorded through amortization expense three and nine months ended September 30, 2014 and 2013.

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2013		2013	
	(In thousands)			
Increase (Decrease) in DPAC Balance				
Unlocking	\$—	—	—	—
True-up	2,418	1,362	6,696	5,742
Totals	\$2,418	1,362	6,696	5,742

As noted in the table above, the true-up adjustments recorded increased the DPAC balance on the balance sheet which conversely reduced amortization expense in current earnings by a like amount for the periods shown.

#### International Life Insurance Operations

The Company's international life operations have been a significant factor in the Company's overall earnings performance and represents a niche where the Company believes it has a competitive advantage. A stable population of distribution relationships has been developed given the Company's longstanding reputation for supporting its international life products coupled with the instability of competing companies in international markets.



Table of Contents

A comparative analysis of results of operations for the Company's international life insurance segment is detailed below.

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2013	2013	2013	2013
	(In thousands)			
Premiums and other revenues:				
Premiums and contract revenues	\$29,135	28,865	87,906	87,061
Net investment income	8,273	10,957	35,902	43,224
Other revenues	20	60	321	211
<b>Total revenues</b>	<b>37,428</b>	<b>39,882</b>	<b>124,129</b>	<b>130,496</b>
Benefits and expenses:				
Life and other policy benefits	9,672	11,040	16,375	17,910
Amortization of deferred policy acquisition costs	2,525	3,287	18,078	17,000
Universal life insurance and annuity contract interest	6,956	8,525	32,820	39,760
Other operating expenses	6,307	5,987	18,167	18,820
<b>Total benefits and expenses</b>	<b>25,460</b>	<b>28,839</b>	<b>85,440</b>	<b>93,490</b>
Segment earnings (losses) before Federal income taxes	11,968	11,043	38,689	37,006
Provision (benefit) for Federal income taxes	4,143	3,596	12,865	11,982
<b>Segment earnings (loss)</b>	<b>\$7,825</b>	<b>7,447</b>	<b>25,824</b>	<b>25,024</b>

As with domestic life operations, revenues from the international life insurance segment include both premiums on traditional type products and contract revenues from universal life insurance. A comparative detail of premiums and contract revenues is provided below.

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2013	2013	2013	2013
	(In thousands)			
Universal life insurance revenues	\$27,671	27,922	84,009	84,386
Traditional life insurance premiums	3,263	3,600	10,397	10,130
Reinsurance premiums	(1,799)	) (2,657	) (6,500	) (7,455
<b>Totals</b>	<b>\$29,135</b>	<b>28,865</b>	<b>87,906</b>	<b>87,061</b>



Table of Contents

In general, universal life revenues and operating earnings are anticipated to emerge with growth in the amount of international life insurance in force fueled by a steady growth in new sales. The volume of insurance in force grew from \$19.2 billion at December 31, 2012 to \$19.6 billion at December 31, 2013 and leveled off to slightly below \$19.7 billion at September 30, 2014. Universal life insurance revenues are also generated with the issuance of new business based upon amounts per application and percentages of the face amount (volume) of insurance issued. The number of international life policies issued in the first nine months of 2014 was 1% lower than in the first nine months of 2013 while the volume of insurance issued was 2% greater than that issued in 2013 during the same period.

International universal life revenues also include surrender charges assessed upon surrender of contracts by policyholders. In the midst of the financial crisis the past few years, the Company's international policyholders, in particular, exhibited concern regarding the developments in U.S. financial markets. This evidenced itself in the Company's termination activity in its international life policies in force. During 2009, the Company incurred higher termination experience than is typical which resulted in recognition of increased surrender charge fee income. This level of termination activity subsequently subsided. However, ongoing global uncertainties may cause a re-emerging concern with international policyholders. The following table illustrates the Company's recent international life termination experience.

	Amount in \$'s (millions)	Annualized Termination Rate	
Volume In Force Terminations			
Year ended December 31, 2009	\$2,423.2	13.0	%
Year ended December 31, 2010	1,721.8	9.0	%
Year ended December 31, 2011	1,465.1	7.3	%
Year ended December 31, 2012	1,828.4	8.7	%
Year ended December 31, 2013	1,838.5	8.6	%
Nine months ended September 30, 2014	1,380.7	8.5	%

As noted previously, premiums collected on universal life products are not reflected as revenues in the Company's Condensed Consolidated Statements of Earnings in accordance with GAAP. Actual international universal life premiums collected are detailed below.

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2014	2013	2014	2013
	(In thousands)			
Universal life insurance:				
First year and single premiums	\$6,337	8,174	19,242	19,420
Renewal premiums	29,877	29,651	84,623	86,720
Totals	\$36,214	37,825	103,865	106,140

The Company's most popular international products have been its fixed-index universal life products in which the policyholder can elect to have the interest rate credited to their policy account values linked in part to the performance of the S&P 500 Index<sup>®</sup>. Included in the totals in the above table are collected premiums for fixed-index universal life products of approximately \$67.3 million and \$66.9 million for the first nine months of 2014 and 2013, respectively.





Table of Contents

As previously noted, net investment income and contract interest include period-to-period changes in fair values pertaining to call options purchased to hedge the interest crediting feature on the fixed-index universal life products. With the growth in the fixed-index universal life block of business, the period-to-period changes in fair values of the underlying options have had an increasingly greater impact on net investment income and universal life contract interest. A detail of net investment income for international life insurance operations is provided below.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(In thousands)			
Net investment income (excluding derivatives)	\$7,566	6,679	27,615	28,193
Derivative gain (loss)	707	4,278	8,287	15,031
Net investment income	\$8,273	10,957	35,902	43,224

For liability purposes, the embedded option in the Company's policyholder obligations for this feature is bifurcated and reserved for separately. Accordingly, a comparable impact for the derivative component in the equity-index universal life product is reflected in the contract interest expense for each respective period. Refer to Note 11, Derivative Investments, of the accompanying condensed consolidated financial statements for further discussion.

Life and policy benefits primarily consist of death claims on policies. The Company's clientele for international products are wealthy individuals with access to U.S. dollars and quality medical care. Consequently, the amounts of coverage purchased tend to be larger amounts. In the year ended December 31, 2013, the average face amount of insurance purchased was \$384,000, and in the first nine months of 2014, the average was approximately \$380,000. While life and policy benefit expense for the international life segment reflects the larger policies purchased, mortality due to natural causes is comparable to that in the United States. The Company's maximum risk exposure per insured life is capped at \$500,000 through reinsurance.

The Company records true-up adjustments to DPAC balances each period to reflect current policy lapse or termination rates, expense levels and credited rates on policies as compared to anticipated experience as well as unlocking adjustments as necessary. The following table identifies the effects of unlocking and true-up adjustments on international life insurance DPAC balances recorded through amortization expense for the three and nine months ended September 30, 2014 and 2013.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(In thousands)			
Increase (Decrease) in DPAC Balance				
Unlocking	\$1,430	—	1,430	—
True-up	2,449	1,999	6,215	9,210
Totals	\$3,879	1,999	7,645	9,210

True-up adjustments in the first nine months of 2014 and 2013 increased the DPAC balance on the balance sheet and decreased amortization expense in current earnings by a like amount. In the quarter ended September 30, 2014, the Company unlocked the DPAC balance associated with its International Life segment for premium load increases implemented on several international universal life products. The effect of the prospective unlocking was to increase DPAC balances by \$1.4 million (and decrease amortization expense).

As indicated in the discussion concerning net investment income, contract interest expense includes fluctuations that are the result of the performance of underlying equity indices associated with fixed-index universal life products. The derivative gain (loss) realized on purchased call options is included in the amounts the Company credits to policyholders.

Table of Contents

## Annuity Operations

The Company's annuity operations are almost exclusively with residents of the United States. Although some of the Company's investment contracts are available to international residents, current sales are small relative to total annuity sales. A comparative analysis of results of operations for the Company's annuity segment is detailed below.

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2013	2014	2013	2014
	(In thousands)			
Premiums and other revenues:				
Premiums and contract revenues	\$5,126	4,873	16,787	14,998
Net investment income	90,835	118,521	300,118	371,704
Other revenues	23	22	63	52
Total revenues	95,984	123,416	316,968	386,754
Benefits and expenses:				
Life and other policy benefits	138	1,898	17,279	22,042
Amortization of deferred policy acquisition costs	19,776	19,942	55,880	61,640
Annuity contract interest	46,452	76,700	172,690	242,144
Other operating expenses	7,045	8,565	19,965	23,117
Total benefits and expenses	73,411	107,105	265,814	348,943
Segment earnings (loss) before Federal income taxes	22,573	16,311	51,154	37,811
Provision (benefit) for Federal income taxes	7,681	5,298	17,010	12,242
Segment earnings (loss)	\$14,892	11,013	34,144	25,569

Premiums and contract charges primarily consist of surrender charge income recognized on terminated policies. The amount of the surrender charge income recognized is determined by the volume of surrendered contracts as well as the duration of each contract at the time of surrender given the pattern of declining surrender charge rates over time that is common to most annuity contracts. The Company's lapse rate for annuity contracts in the first nine months of 2014 was 6.7% compared to 6.6% during the same period in 2013.

Table of Contents

Deposits collected on annuity contracts are not reflected as revenues in the Company's Condensed Consolidated Statements of Earnings, in accordance with GAAP. Actual annuity deposits collected for the three and nine months ended September 30, 2014 and 2013 are detailed below.

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2013	2013	2013	2013
	(In thousands)			
Fixed-index annuities	\$188,129	181,727	544,435	539,809
Other deferred annuities	20,481	22,077	52,536	66,224
Immediate annuities	4,599	1,081	10,687	5,148
Totals	\$213,209	204,885	607,658	611,181

Fixed-index products are more attractive for consumers when interest rate levels remain low and equity markets produce positive returns. Since the Company does not offer variable products or mutual funds, fixed-index products provide an important alternative to the Company's existing fixed interest rate annuity products. Fixed-index annuity deposits as a percentage of total annuity deposits were 90% and 88% for the nine months ended September 30, 2014 and 2013, respectively. The increasing percentage of fixed-index products of total annuity sales reflects the low interest rate environment and the current bull market in equities.

As a selling inducement, some of the deferred products, as well as the fixed-index annuity products, include a first year interest bonus ranging from 1% to 7% depending upon the product, in addition to a base first year interest rate. Other products include a premium bonus ranging from 2% to 10% which is credited to the account balance when premiums are applied. These bonus rates are deferred in conjunction with other capitalized policy acquisition costs. The amount deferred to be amortized over future periods amounted to approximately \$13.6 million and \$20.9 million during the first nine months of 2014 and 2013, respectively. Amortization of deferred sales inducements is included as a component of annuity contract interest as described later in this discussion of Annuity Operations.

A detail of net investment income for annuity operations is provided below.

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2013	2013	2013	2013
	(In thousands)			
Net investment income (excluding derivatives)	\$88,428	88,718	263,320	263,926
Derivative gain (loss)	2,407	29,803	36,798	107,778
Net investment income	\$90,835	118,521	300,118	371,704

As previously described, derivatives are call options purchased to hedge the equity return component of the Company's fixed-index annuity products with any gains or losses from the sale or expiration of the options, as well as period-to-period changes in fair values, reflected in net investment income. Given the bifurcation of the embedded option in the determination of the contract reserve liability, a comparable impact for the derivative component in fixed-index annuity products is reflected in contract interest expense.



Table of Contents

Consistent with the domestic and international life segments, the Company records true-up adjustments to DPAC balances each period to reflect current policy lapse or termination rates, expense levels and credited rates on policies as compared to anticipated experience as well as unlocking adjustments as necessary. The following table identifies the effects of unlocking and true-up adjustments on annuity DPAC balances recorded through amortization expense for the three and nine months ended September 30, 2014 and 2013.

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2013		2013	
	(In thousands)			
Increase (Decrease) in DPAC Balance				
Unlocking	\$—	—	—	—
True-up	(1,746	) (35	) (5,691	) (1,897
Totals	\$ (1,746	) (35	) (5,691	) (1,897

As the true-up adjustments decreased the DPAC balances on the balance sheet for the nine months ended September 30, 2014 and 2013, a corresponding increase in DPAC amortization expense was recorded in the Company's Condensed Consolidated Statements of Earnings in each respective period. The larger true-up decrement to the DPAC balance for the three and nine months ended September 30, 2014 reflects the impact of spread compression upon the profitability of fixed deferred annuities and the change in fixed-index annuity spread returns based upon actual returns of maturing call option contracts.

Annuity contract interest includes the equity component return associated with the call options purchased to hedge the Company's fixed-index annuities. The detail of fixed-index annuity contract interest compared to contract interest for all other annuities is as follows:

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2013		2013	
	(In thousands)			
Fixed-index annuities	\$28,369	53,482	98,953	164,742
All other annuities	16,895	23,077	67,754	78,746
Gross contract interest	45,264	76,559	166,707	243,488
Bonus interest deferred and capitalized	(4,707	) (5,968	) (13,645	) (20,904
Bonus interest amortization	5,895	6,109	19,628	19,560
Total contract interest	\$46,452	76,700	172,690	242,144

The fluctuation in reported contract interest amounts for fixed-index annuities is driven by sales levels, the level of the business in force and the positive or negative performance of equity markets on option values. The derivative gain (loss) information included in the net investment income discussion above is largely reflected in the amounts shown for contract interest for fixed-index annuities.

True-up adjustments for the deferred sales inducement balance are made each period similar to that done with respect to DPAC balances. For the nine months ended September 30, 2014 and 2013, deferred sales inducement balances on

the balance sheet were reduced by \$1.2 million and \$0.4 million, respectively, for true-up adjustments. These adjustments are included in the above table as an addition to bonus interest amortization.



Table of Contents

## Other Operations

National Western Life Insurance Company's primary business encompasses its domestic and international life insurance operations and its annuity operations. However, National Western also has small real estate, nursing home, and other investment operations through its wholly-owned subsidiaries. Nursing home operations generated \$1.2 million and \$1.7 million of operating earnings in the first nine months of 2014 and 2013, respectively. The decrease in operating earnings from the two nursing homes reflects a lower census in 2014 and higher uncollectible amounts from Medicaid patients. The remaining earnings of \$9.3 million and \$8.9 million for the nine months ended September 30, 2014 and 2013, respectively, in Other Operations represent investment income from real estate, municipal bonds, and common and preferred equities held in subsidiary company portfolios principally for tax advantage purposes.

## INVESTMENTS

## General

The Company's investment philosophy emphasizes the careful handling of policyowners' and stockholders' funds to achieve security of principal, to obtain the maximum possible yield while maintaining security of principal, and to maintain liquidity in a measure consistent with current and long-term requirements of the Company.

The Company's overall conservative investment philosophy is reflected in the allocation of its investments, which is detailed below. The Company emphasizes investment grade debt securities with smaller holdings in mortgage loans.

	September 30, 2014		December 31, 2013	
	Carrying Value (In thousands)	%	Carrying Value (In thousands)	%
Debt securities	\$9,605,303	96.3	\$9,146,986	95.7
Mortgage loans	152,740	1.5	132,765	1.4
Policy loans	63,746	0.6	65,969	0.7
Derivatives, index options	109,812	1.1	169,314	1.8
Real estate	16,827	0.2	18,191	0.2
Equity securities	17,615	0.2	14,878	0.1
Other	12,179	0.1	12,800	0.1
Totals	\$9,978,222	100.0	\$9,560,903	100.0

Table of Contents

## Debt and Equity Securities

The Company maintains a diversified portfolio which consists mostly of corporate, mortgage-backed, and public utility fixed income securities. Investments in mortgage-backed securities primarily include U.S. Government agency pass-through securities and collateralized mortgage obligations ("CMO"). The Company's investment guidelines prescribe limitations by type of security as a percent of the total investment portfolio and all holdings were within these threshold limits. As of September 30, 2014 and December 31, 2013, the Company's debt securities portfolio consisted of the following classes of securities:

	September 30, 2014		December 31, 2013	
	Carrying Value (In thousands)	%	Carrying Value (In thousands)	%
Corporate	\$6,258,044	65.2	\$5,752,432	62.8
Mortgage-backed securities	1,724,339	18.0	1,770,726	19.4
Public utilities	1,116,985	11.6	1,111,729	12.2
State and political subdivisions	430,796	4.5	423,770	4.6
U.S. agencies	23,069	0.2	23,088	0.3
Asset-backed securities	39,902	0.4	43,556	0.5
Foreign governments	10,250	0.1	19,772	0.2
U.S. Treasury	1,918	—	1,913	—
Totals	\$9,605,303	100.0	\$9,146,986	100.0

Substantially all of the Company's investable cash flows are directed toward the purchase of long-term debt securities. The Company's investment policy calls for investing in debt securities that are investment grade, meet quality and yield objectives, and provide adequate liquidity for obligations to policyholders. Debt securities with intermediate maturities are targeted by the Company as they more closely match the intermediate nature of the Company's policy liabilities and provide an appropriate strategy for managing cash flows. Long-term debt securities purchased to fund insurance company operations are summarized below.

	Nine Months Ended September 30, 2014 (\$ In thousands)	Year Ended December 31, 2013	
Cost of acquisitions	\$804,509	\$1,691,809	
Average S&P® quality	A-	A	
Effective annual yield	3.74	% 3.53	%
Spread to treasuries	1.08	% 1.21	%
Effective duration	8.5 years	8.5 years	

The mortgage-backed securities portfolio consists predominantly of agency mortgage-backed securities. Because mortgage-backed securities are subject to prepayment and extension risk, the Company has substantially reduced these risks by investing in collateralized mortgage obligations ("CMO"), which have more predictable cash flow patterns than pass-through securities. These securities, known as planned amortization class I ("PAC I"), very accurately defined maturity ("VADM") and sequential tranches are designed to amortize in a more predictable manner than other CMO classes or pass-throughs. The Company does not purchase tranches, such as PAC II and support tranches, that

subject the portfolio to greater than average prepayment risk. Using this strategy, the Company can more effectively manage and reduce prepayment and extension risks, thereby helping to maintain the appropriate matching of the Company's assets and liabilities.

Table of Contents

In addition to diversification, an important aspect of the Company's investment approach is managing the credit quality of its investment in debt securities. Thorough credit analysis is performed on potential corporate investments including examination of a company's credit and industry outlook, financial ratios and trends, and event risks. This emphasis is reflected in the high average credit rating of the Company's debt securities portfolio with 98.3% held in investment grade securities. In the table below, investments in debt securities are classified according to credit ratings by Standard and Poor's ("S&P®"), or other nationally recognized statistical rating organizations if securities were not rated by S&P®.

	September 30, 2014		December 31, 2013	
	Carrying Value (In thousands)	%	Carrying Value (In thousands)	%
AAA	\$107,172	1.1	\$110,688	1.2
AA	2,604,345	27.1	2,608,156	28.5
A	2,992,417	31.2	2,848,866	31.1
BBB	3,737,807	38.9	3,400,650	37.2
BB and other below investment grade	163,562	1.7	178,626	2.0
Totals	\$9,605,303	100.0	\$9,146,986	100.0

The Company's investment strategy does not allow for the purchase of below investment grade securities. The investments held in debt securities below investment grade are the result of subsequent downgrades of the securities. These holdings are further summarized below.

	Below Investment Grade Debt Securities				% of Invested Assets
	Amortized Cost	Carrying Value	Fair Value		
	(In thousands, except percentages)				
September 30, 2014	\$162,286	163,562	169,091	1.6	%
December 31, 2013	\$173,974	178,628	183,874	1.9	%

The Company's percentage of below investment grade securities compared to total invested assets decreased slightly from December 31, 2013 due to bond calls and principal paydowns. The Company's holdings of below investment grade securities are relatively small and as a percentage of total invested assets low compared to industry averages.

Table of Contents

Holdings in below investment grade securities by category as of September 30, 2014 are summarized below, including September 30, 2014 and December 31, 2013 fair values for comparison. The Company continually monitors developments in these industries for issues that may affect security valuation.

Industry Category	Below Investment Grade Debt Securities			
	Amortized Cost	Carrying Value	Fair Value	Fair Value
	September 30, 2014 (In thousands)	September 30, 2014	September 30, 2014	December 31, 2013
Retail	\$14,968	15,488	15,488	18,188
Telecommunications	5,051	5,750	5,750	11,889
Asset-backed securities	6,201	6,201	8,077	8,863
Mortgage-backed	7,369	7,425	7,713	12,402
Transportation	—	85	85	171
Manufacturing	50,879	52,008	54,825	55,535
Banking/finance	33,464	33,582	31,979	32,312
Other	44,354	43,023	45,174	44,514
Totals	\$162,286	163,562	169,091	183,874

The Company closely monitors its below investment grade holdings by reviewing investment performance indicators, including information such as issuer operating performance, debt ratings, analyst reports and other economic factors that may affect these specific investments. While additional losses are not currently anticipated, based on the existing status and condition of these securities, continued credit deterioration of some securities or the markets in general is possible, which may result in further write-downs.

Certain European countries have experienced varying degrees of financial stress. Risks from the lingering debt crisis in Europe could potentially disrupt financial markets and have a detrimental impact on global conditions as well as on sovereign and non-sovereign obligations. The Company has no exposure to the sovereign debt of Portugal, Ireland, Italy, Greece or Spain. These countries in particular have been or are experiencing significant economic, fiscal and political strains that could increase the likelihood of default for these countries. Additionally, the Company has no exposure to the debt of financial institutions domiciled in these countries.

However, the Company does have exposure to the debt of non-financial companies in each of these countries except for Greece. The following tables show bond holdings at September 30, 2014 of non-financial companies that are domiciled in Portugal, Ireland, Italy, or Spain held in the available for sale and held to maturity debt security portfolios.

Securities Available for Sale		Amortized Cost	Fair Value	
Company	S&P Rating	September 30, 2014	September 30, 2014	Country Domiciled
(In thousands)				
Covidien	A	\$24,165	25,292	Ireland
CRH	BBB+	3,999	4,599	Ireland
Telefonica	BBB	11,772	13,046	Spain

Totals	\$39,936	42,937
--------	----------	--------

75

---

Table of Contents

Securities Held to Maturity		Amortized Cost	Fair Value	
Company	S&P Rating	September 30, 2014	September 30, 2014	Country Domiciled
		(In thousands)		
Covidien	A	\$4,990	4,829	Ireland
EDP	BB+	17,245	18,489	Portugal
Enel	BBB	19,935	22,356	Italy
Finmeccanica	BB+	15,019	16,200	Italy
Iberdrola Finance	BBB	2,922	3,320	Spain
Kerry Group	BBB+	21,954	21,190	Ireland
Telefonica	BBB	8,107	9,146	Spain
Perrigo	BBB	25,813	26,285	Ireland
Totals		\$115,985	121,815	

Generally accepted accounting principles require that investments in debt securities be written down to fair value when declines in value are judged to be other-than-temporary. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (an exit price methodology). Refer to Note 10, Fair Values of Financial Instruments, of the accompanying condensed consolidated financial statements for further discussion.

During the nine months ended September 30, 2014 the Company recorded minimal other-than-temporary impairment credit related write-downs on a debt security and on an equity security. The Company had no other-than-temporary impairment write-downs on debt securities other than on the one asset-backed security whose fair value and net present value of future cash flows fell below the amortized cost of the security. See Note 9, Investments, of the accompanying condensed consolidated financial statements for further discussion. Since the Company's adoption of the GAAP guidance on the recognition and accounting for other-than-temporary impairments due to credit loss versus non-credit loss, the Company has recognized a total of \$6.8 million of other-than-temporary impairments of which \$2.5 million was deemed credit related and recognized as realized investment losses in earnings, and \$4.3 million was deemed a non-credit related impairment and recognized in other comprehensive income.

Table of Contents

The Company is required to classify its investments in debt and equity securities into one of three categories: (a) trading securities; (b) securities available for sale; or (c) securities held to maturity. The Company purchases securities with the intent to hold to maturity and accordingly does not maintain a portfolio of trading securities. Of the remaining two categories, available for sale and held to maturity, the Company makes a determination on categorization based on various factors including the type and quality of the particular security and how it will be incorporated into the Company's overall asset/liability management strategy. As shown in the table below, at September 30, 2014, approximately 27.5% of the Company's total debt and equity securities, based on fair values, were classified as securities available for sale. The holdings in available for sale provide flexibility to the Company to react to market opportunities and conditions and to practice active management within the portfolio to provide adequate liquidity to meet policyholder obligations and other cash needs.

	September 30, 2014		
	Fair Value (In thousands)	Amortized Cost	Unrealized Gains (Losses)
Securities held to maturity:			
Debt securities	\$7,195,441	6,898,038	297,403
Securities available for sale:			
Debt securities	2,707,265	2,563,976	143,289
Equity securities	17,615	12,829	4,786
Totals	\$9,920,321	9,474,843	445,478

## Asset-Backed Securities

The Company holds approximately \$39.9 million in asset-backed securities as of September 30, 2014. This portfolio includes \$8.5 million of manufactured housing bonds and \$31.4 million of home equity loans (also referred to as subprime securities). The Company does not have any holdings in collateralized bond obligations ("CBO"s), collateralized debt obligations ("CDO"s), or collateralized loan obligations ("CLO"s). Principal risks in holding asset-backed securities are structural, credit, and capital market risks. Structural risks include the securities' priority in the issuer's capital structure, the adequacy of and ability to realize proceeds from collateral and the potential for prepayments. Credit risks include corporate credit risks or consumer credit risks for financing such as subprime mortgages. Capital market risks include the general level of interest rates and the liquidity for these securities in the marketplace.



Table of Contents

During the second quarter of 2014 the Company sold its one remaining Alt-A security. The Alt-A sector is a sub-sector of the jumbo prime MBS sector. The Company's exposure to the Alt-A and subprime sectors has been limited to investments in the senior tranches of structured securities collateralized by Alt-A or subprime residential mortgage loans. The subprime sector is generally categorized under the asset-backed sector. This sector lends to borrowers who do not qualify for prime interest rates due to poor or insufficient credit history. The slowing housing market, rising interest rates, and relaxed underwriting standards for loans originated after 2005 resulted in higher delinquency rates and losses beginning in 2007. These events caused illiquidity in the market and volatility in the market prices of subprime securities. All of the loans classified as subprime in the Company's portfolio as of September 30, 2014 were underwritten prior to 2005 as noted in the table below.

Investment Origination Year	September 30, 2014		December 31, 2013	
	Carrying Value	Fair Value	Carrying Value	Fair Value
	(In thousands)			
Subprime:				
1998	\$3,528	3,564	4,033	4,161
2003	3,762	5,532	3,930	5,424
2004	24,109	27,145	24,533	27,617
Subtotal subprime	\$31,399	36,241	32,496	37,202
Alt A:				
2004	\$—	—	3,535	3,535

As of September 30, 2014, the Company held ten subprime issues of which 2 were rated AA, 4 were rated BBB, 1 was rated B, 2 were rated CC and 1 was not rated.

#### Mortgage Loans and Real Estate

In general, the Company originates loans on high quality, income-producing properties such as shopping centers, freestanding retail stores, office buildings, industrial and sales or service facilities, selected apartment buildings, motels, and health care facilities. The location of these properties is typically in major metropolitan areas that offer a potential for property value appreciation. Credit and default risk is minimized through strict underwriting guidelines and diversification of underlying property types and geographic locations. In addition to being secured by the property, mortgage loans with leases on the underlying property are often guaranteed by the lease payments and also by the borrower. This approach has proven to result in quality mortgage loans with few defaults. Mortgage loan interest income is recognized on an accrual basis with any premium or discount amortized over the life of the loan. Prepayment and late fees are recorded on the date of collection.

The Company requires a minimum specified yield on mortgage loan investments. During the past several years, the low interest rate environment has resulted in fewer loan opportunities being available that meet the Company's required rate of return. Mortgage loans originated by the Company totaled \$34.1 million for the year ended December 31, 2013 and \$34.0 million for the nine months ended September 30, 2014. Principal repayments on mortgage loans for the nine months ended September 30, 2014 were \$14.1 million.

Loans in foreclosure, loans considered impaired or loans past due 90 days or more are placed on a non-accrual status. If a mortgage loan is determined to be on non-accrual status, the mortgage loan does not accrue any revenue into the Condensed Consolidated Statements of Earnings. The loan is independently monitored and evaluated as to

potential impairment or foreclosure. If delinquent payments are made and the loan is brought current, then the Company returns the loan to active status and accrues income accordingly. The Company has no loans past due 90 days which are accruing interest.

Table of Contents

The Company held net investments in mortgage loans totaling \$152.7 million and \$132.8 million at September 30, 2014 and December 31, 2013, respectively. The diversification of the portfolio by geographic region and by property type was as follows:

	September 30, 2014		December 31, 2013	
	Amount	%	Amount	%
	(In thousands)		(In thousands)	
<b>Mortgage Loans by Geographic Region:</b>				
West South Central	\$94,620	61.7	\$79,702	59.7
New England	17,173	11.2	17,400	13.0
Mountain	3,073	2.0	3,239	2.4
Pacific	10,303	6.7	10,364	7.8
East North Central	10,726	7.0	10,607	8.0
East South Central	14,231	9.3	10,098	7.6
South Atlantic	1,339	0.9	—	—
Middle Atlantic	1,925	1.2	2,005	1.5
Gross balance	153,390	100.0	133,415	100.0
Allowance for possible losses	(650	) (0.4	) (650	) (0.5
Totals	\$ 152,740	99.6	\$ 132,765	99.5
	September 30, 2014		December 31, 2013	
	Amount	%	Amount	%
	(In thousands)		(In thousands)	
<b>Mortgage Loans by Property Type:</b>				
Retail	\$ 128,854	84.0	\$ 103,487	77.6
Hotel/Motel	1,621	1.1	3,742	2.8
Land/Lots	3,251	2.1	3,155	2.4
Apartments	12,300	8.0	15,275	11.4
Office	916	0.6	1,313	1.0
All other	6,448	4.2	6,443	4.8
Gross balance	153,390	100.0	133,415	100.0
Allowance for possible losses	(650	) (0.4	) (650	) (0.5
Totals	\$ 152,740	99.6	\$ 132,765	99.5

The Company's direct investments in real estate are not a significant portion of its total investment portfolio as most of these investments were acquired through mortgage loan foreclosures. The Company also participates in several real estate joint ventures, limited partnerships, and other loans that invest primarily in income-producing retail properties. These investments have enhanced the Company's overall investment portfolio returns. The Company's real estate investments totaled approximately \$16.8 million and \$18.2 million at September 30, 2014 and December 31, 2013, respectively. The Company recognized operating income on these properties of approximately \$1.2 million for the first nine months of 2014. The Company monitors the conditions and market values of these properties on a regular basis and makes repairs and capital improvements to keep the properties in good condition.



Table of Contents

## Market Risk

Market risk is the risk of change in market values of financial instruments due to changes in interest rates, currency exchange rates, commodity prices, or equity prices. The most significant market risk exposure for National Western is interest rate risk. Substantial and sustained increases and decreases in market interest rates can affect the profitability of insurance products and fair value of investments. The yield realized on new investments generally increases or decreases in direct relationship with interest rate changes. The fair values of fixed income debt securities correlate to external market interest rate conditions as market values typically increase when market interest rates decline and decrease when market interest rates rise. However, market values may fluctuate for other reasons, such as changing economic conditions, market dislocations or increasing event-risk concerns.

## Interest Rate Risk

A gradual increase in interest rates from current levels would generally be a positive development for the Company. Rate increases would be expected to provide incremental net investment income, produce increased sales of fixed rate products, and limit the potential erosion of the Company's interest rate spread on products due to minimum guaranteed crediting rates in products. Alternatively, a rise in interest rates would reduce the fair value of the Company's investment portfolio and if long-term rates rise dramatically within a relatively short time period could expose the Company to disintermediation risk. Disintermediation risk is the risk that policyholders will surrender their policies in a rising interest rate environment forcing the Company to liquidate assets when they are in an unrealized loss position.

A decline in interest rates could cause certain mortgage-backed securities in the Company's portfolio to be more likely to pay down or prepay. In this situation, the Company typically will be unable to reinvest the proceeds at comparable yields. Lower interest rates will likely also cause lower net investment income, subject the Company to reinvestment rate risks, and possibly reduce profitability through reduced interest rate margins associated with products with minimum guaranteed crediting rates. Alternatively, the fair value of the Company's investment portfolio will increase when interest rates decline.

The correlation between fair values and interest rates for debt securities is reflected in the tables below.

	September 30, 2014	June 30, 2014	December 31, 2013		
	(In thousands except percentages)				
Debt securities - fair value	\$9,902,706	9,762,294	9,292,810		
Debt securities - amortized cost	\$9,462,014	9,255,576	9,034,438		
Fair value as a percentage of amortized cost	104.66	% 105.47	% 102.86	%	
Net unrealized gain balance	\$440,692	506,718	258,372		
Ten-year U.S. Treasury bond – (decrease) increase in yield for the period	(0.04	)% (0.19	)% 1.27	%	

	Net Unrealized Gain Balance			Quarter Change in Unrealized Balance	Year-to-date Change in Unrealized Balance
	At September 30, 2014	At June 30, 2014	At December 31, 2013		
Debt securities held to maturity	\$297,403	338,262	145,824	(40,859	) 151,579
Debt securities available for sale	143,289	168,456	112,548	(25,167	) 30,741

Totals	\$440,692	506,718	258,372	(66,026	) 182,320
--------	-----------	---------	---------	---------	-----------

80

---

## Table of Contents

Changes in interest rates typically have a sizable effect on the fair values of the Company's debt securities. The market interest rate of the ten-year U.S. Treasury bond decreased approximately 54 basis points from 3.03% at year-end 2013 to 2.49% by the end of the first nine months of 2014 and the Company's unrealized gain position increased \$182.3 million on a portfolio with an amortized cost basis of approximately \$9.5 billion. However, since the majority of the Company's debt securities are classified as held to maturity, which are recorded at amortized cost, changes in fair values have a relatively small effect on the Company's Condensed Consolidated Balance Sheet.

The Company manages interest rate risk principally through ongoing cash flow testing as required for insurance regulatory purposes. Computer models are used to perform cash flow testing under various commonly used stress test interest rate scenarios to determine if existing assets would be sufficient to meet projected liability outflows. Sensitivity analysis allows the Company to measure the potential gain or loss in fair value of its interest-sensitive instruments and to protect its economic value and achieve a predictable spread between what is earned on invested assets and what is paid on liabilities. The Company seeks to minimize the impact of interest risk through surrender charges that are imposed to discourage policy surrenders. Interest rate changes can be anticipated in the computer models and the corresponding risk addressed by management actions affecting asset and liability instruments. However, potential changes in the values of financial instruments indicated by hypothetical interest rate changes will likely be different from actual changes experienced, and the differences could be significant.

The Company has the ability to adjust interest rates, participation rates, and asset fees and caps, as applicable, in response to changes in investment portfolio yields for a substantial portion of its business in force. The ability to adjust these rates is subject to competitive forces in the market for the Company's products. Surrender rates could increase and new sales could be negatively affected if crediting rates are not competitive with the rates on competing products offered by other insurance companies and financial service entities. The Company designs its products with features encouraging persistency. Interest sensitive life and annuity products have surrender and withdrawal penalty provisions. Depending on the products, surrender charge rates on annuity contracts sold or in force range up to 25% and surrender charge periods up to 15 years. Typically, surrender charge rates gradually decrease each year the contract is in force.

The Company performed detailed sensitivity analysis as of December 31, 2013, for its interest rate-sensitive assets and liabilities. The changes in market values of the Company's debt securities in the first nine months of 2014 were reasonable given the expected range of results of this analysis.

## Credit Risk

The Company is exposed to credit risk through counterparties and within its investment portfolio. Credit risk relates to the uncertainty associated with an obligor's continued ability to make timely payments of principal and interest in accordance with the contractual terms of an instrument or contract. As previously discussed, the Company manages credit risk through established investment credit policies and guidelines which address the quality of creditors and counterparties, concentration limits, diversification practices and acceptable risk levels. These policies and guidelines are regularly reviewed and approved by senior management and the Company's Board of Directors.

In connection with the Company's use of call options to hedge the equity return component of its fixed-indexed annuity and life products, the Company is exposed to the risk that a counterparty fails to perform under terms of the option contract. The Company purchases one-year option contracts from multiple counterparties and evaluates the creditworthiness of all counterparties prior to the purchase of the contracts. For consideration in contracting with a counterparty the rating required by the Company is a Standard & Poor's credit rating of "A" or higher and a Moody's rating of "A2" or higher. Accordingly, all options are purchased from nationally recognized financial institutions with a demonstrated performance for honoring their financial obligations and possessing substantial financial capacity. In addition, each counterparty is required to execute a credit support agreement obligating the counterparty to provide

collateral to the Company when the fair value of the Company's exposure to the counterparty exceeds specified amounts. The amount of collateral to be provided is based upon a sliding scale tied to the credit rating of the counterparty (the higher the credit rating of the counterparty the higher the threshold of exposure before collateral is to be provided). At the highest credit rating level the maximum counterparty net exposure not subject to collateral support is \$20 million. This net exposure level declines as the counterparty credit rating declines and ultimately is \$0 at a rating of "BBB+". Counterparty credit ratings and credit exposure are monitored continuously by the Company's Investment department with adjustments to collateral levels managed as incurred under the credit support agreements.

The Company is also exposed to credit spread risk related to market prices of investment securities and cash flows associated with changes in credit spreads. Credit spread tightening will reduce net investment income associated with new purchases of fixed debt securities and increase the fair value of the investment portfolio. Credit spread widening will reduce the fair value of the investment portfolio and will increase net investment income on new purchases.



Table of Contents

## LIQUIDITY AND CAPITAL RESOURCES

## Liquidity

Liquidity requirements are met primarily by funds provided from operations. Premium deposits and annuity considerations, investment income, and investment maturities and prepayments are the primary sources of funds while investment purchases, policy benefits in the form of claims, and payments to policyholders and contract holders in connection with surrenders and withdrawals as well as operating expenses are the primary uses of funds. To ensure the Company will be able to pay future commitments, the funds received as premium payments and deposits are invested in high quality investments, primarily fixed income securities. Funds are invested with the intent that the income from investments, plus proceeds from maturities, will meet the ongoing cash flow needs of the Company. The approach of matching asset and liability durations and yields requires an appropriate mix of investments. Although the Company historically has not been put in the position of having to liquidate invested assets to provide cash flow, its investments consist primarily of marketable debt securities that could be readily converted to cash for liquidity needs. The Company may also borrow up to \$40 million on its bank line of credit for short-term cash needs. There were no borrowings outstanding under the line of credit at September 30, 2014.

A primary liquidity concern for life insurers is the risk of an extraordinary level of early policyholder withdrawals as may occur in a rapidly increasing interest rate environment or other period of exceptional financial duress. The Company includes provisions within its annuity and universal life insurance policies, such as surrender and market value adjustments, that help limit and discourage early withdrawals.

The actual amounts paid by product line in connection with surrenders and withdrawals for the periods ended September 30, for each respective year, are noted in the table below.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
	(In thousands)			
Product Line:				
Traditional Life	\$1,074	1,146	3,189	4,346
Universal Life	16,764	13,021	49,790	39,787
Annuities	111,738	119,388	357,156	352,002
Total	\$129,576	133,555	410,135	396,135

The above contractual withdrawals, as well as the level of surrenders experienced, were generally consistent with the Company's assumptions in asset/liability management, and the associated cash outflows did not have an adverse impact on overall liquidity. Individual life insurance policies are less susceptible to withdrawal than annuity reserves and deposit liabilities because policyholders may incur surrender charges and undergo a new underwriting process in order to obtain a new insurance policy. Cash flow projections and tests under various market interest rate scenarios are also performed to assist in evaluating liquidity needs and adequacy. The Company currently expects available liquidity sources and future cash flows to be more than adequate to meet the demand for funds.

In the past, cash flows from the Company's insurance operations have been sufficient to meet current needs. Cash flows from operating activities were \$229.7 million and \$193.9 million for the nine months ended September 30, 2014 and 2013, respectively. The Company also has significant cash flows from both scheduled and unscheduled investment security maturities, redemptions, and prepayments. Investment related cash flows totaled \$804.8 million

and \$1,220.3 million for the nine months ended September 30, 2014 and 2013, respectively. These cash flow items could be reduced if interest rates rise. Net cash flows from the Company's universal life and investment annuity deposit product operations totaled \$60.5 million and \$67.7 million during the nine months ended September 30, 2014 and 2013, respectively.

Table of Contents

## Capital Resources

The Company relies on stockholders' equity for its capital resources as there is no long-term debt outstanding and the Company does not anticipate the need for any long-term debt in the near future. As of September 30, 2014, the Company had no commitments beyond its normal operating and investment activities.

## OFF-BALANCE SHEET ARRANGEMENTS AND CONTRACTUAL OBLIGATIONS

It is not Company practice to enter into off-balance sheet arrangements or to issue guarantees to third parties, other than in the normal course of issuing insurance contracts. Commitments related to insurance products sold are reflected as liabilities for future policy benefits. Insurance contracts guarantee certain performances by the Company.

Insurance reserves are the means by which life insurance companies determine the liabilities that must be established to assure that future policy benefits are provided for and can be paid. These reserves are required by law and based upon standard actuarial methodologies to ensure fulfillment of commitments guaranteed to policyholders and their beneficiaries, even though the obligations may not be due for many years. Refer to Note 1 in the Notes to the Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013 for a discussion of reserving methods.

The table below summarizes future estimated cash payments under existing contractual obligations.

	Payment Due by Period				
	Total	Less Than 1 Year	1 - 3 Years	3 - 5 Years	More Than 5 Years
	(In thousands)				
Loan commitments	\$3,000	3,000	—	—	—
Operating lease obligations	480	96	192	192	—
Life claims payable (1)	57,734	57,734	—	—	—
Other long-term reserve liabilities reflected on the balance sheet (2)	11,187,566	967,074	1,900,610	1,804,590	6,515,292
Total	\$11,248,780	1,027,904	1,900,802	1,804,782	6,515,292

(1) Life claims payable include benefit and claim liabilities for which the Company believes the amount and timing of the payment is essentially fixed and determinable. Such amounts generally relate to incurred and reported death and critical illness claims including an estimate of claims incurred but not reported.

(2) Other long-term liabilities include estimated life and annuity obligations related to death claims, policy surrenders, policy withdrawals, maturities and annuity payments based on mortality, lapse, annuitization, and withdrawal assumptions consistent with the Company's historical experience. The estimated life and annuity obligations shown are undiscounted projected cash outflows that assume interest crediting and market growth consistent with assumptions used in amortizing deferred acquisition costs. They do not include any offsets for future premiums or deposits. Other long-term liabilities also include determinable payout patterns related to immediate annuities. Due to the significance of the assumptions used, the actual cash outflows will differ both in amount and timing, possibly materially, from these estimates.



Table of Contents

CHANGES IN ACCOUNTING PRINCIPLES AND CRITICAL ACCOUNTING POLICIES

Changes in Accounting Principles

There were no changes in accounting principles during the periods reported in this Form 10-Q.

REGULATORY AND OTHER ISSUES

Statutory Accounting Practices

Regulations that affect the Company and the insurance industry are often the result of efforts by the National Association of Insurance Commissioners ("NAIC"). The NAIC routinely publishes new regulations as model acts or laws which states subsequently adopt as part of their insurance regulations. Currently, the Company is not aware of any NAIC regulatory matter material to its operations or reporting of financial results.

Risk-Based Capital Requirements

The NAIC established risk-based capital ("RBC") requirements to help state regulators monitor the financial strength and stability of life insurers by identifying those companies that may be inadequately capitalized. Under the NAIC's requirements, each insurer must maintain its total capital above a calculated threshold or take corrective measures to achieve the threshold. The threshold of adequate capital is based on a formula that takes into account the amount of risk each company faces on its products and investments. The RBC formula takes into consideration four major areas of risk which are: (i) asset risk which primarily focuses on the quality of investments; (ii) insurance risk which encompasses mortality and morbidity risk; (iii) interest rate risk which involves asset/liability matching issues; and (iv) other business risks. Statutory laws prohibit public dissemination of certain RBC information. However, the Company's current statutory capital and surplus is significantly in excess of the threshold RBC requirements.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Refer to Note 8(A) "Legal Proceedings" of the accompanying condensed consolidated financial statements included in this Form 10-Q.

ITEM 1A. RISK FACTORS

There have been no substantial changes relative to the risk factors disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

Table of Contents

## ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Effective August 22, 2008, the Company adopted and implemented a limited stock buy-back program associated with the Company's 2008 Incentive Plan which provides Option Holders the additional alternative of selling shares acquired through the exercise of options directly back to the Company. This program succeeded a similar buy-back program implemented March 10, 2006 associated with the Company's 1995 Stock Option and Incentive Plan. Option Holders may elect to sell such acquired shares back to the Company at any time within ninety (90) days after the exercise of options at the prevailing market price as of the date of notice of election.

The following table sets forth the Company's repurchase of its Class A common shares from Option Holders for the quarter ended September 30, 2014. There were no shares repurchased during the period.

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May yet Be Purchased Under the Plans or Programs
July 1, 2014 through July 31, 2014	—	—	N/A	N/A
August 1, 2014 through August 31, 2014	—	—	N/A	N/A
September 1, 2014 through September 30, 2014	—	—	N/A	N/A
Total	—	—	N/A	N/A

Purchased shares are reported in the Company's condensed consolidated financial statements as authorized and unissued.

ITEM 4. Removed and Reserved.

## ITEM 6. EXHIBITS

(a) Exhibits

Exhibit 31(a) - Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

Exhibit 31(b) - Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

Exhibit 32(a) - Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

NATIONAL WESTERN LIFE INSURANCE COMPANY  
(Registrant)

Date: November 7, 2014

/S/ Ross R. Moody  
Ross R. Moody  
President, Chief Operating Officer,  
and Director  
(Authorized Officer)

Date: November 7, 2014

/S/ Brian M. Pribyl  
Brian M. Pribyl  
Senior Vice President,  
Chief Financial Officer and Treasurer  
(Principal Financial Officer)

Date: November 7, 2014

/S/ Bruce E. Wood  
Bruce E. Wood  
Vice President,  
Controller and Assistant Treasurer  
(Principal Accounting Officer)