

NATIONAL WESTERN LIFE INSURANCE CO  
Form 10-K  
March 15, 2012

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

FORM 10-K

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

For the Fiscal Year Ended December 31, 2011

o 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)

Securities registered pursuant to Section 12 (b) of the Act:

Title of each class to be so registered:	Name of each exchange on which each class is to be registered:
Class A Common Stock, \$1.00 par value	The NASDAQ Stock Market LLC

Securities registered pursuant to Section 12 (g) of the Act:

None  
(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
Yes o No R

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes o No R

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 Web site, 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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. (Check One)

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

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

The aggregate market value of the common stock (based upon the closing price) held by non-affiliates of the Registrant on June 30, 2011 was \$360,612,879.

As of March 13, 2012, the number of shares of Registrant's common stock outstanding was: Class A - 3,434,766 and Class B - 200,000.

#### DOCUMENTS INCORPORATED BY REFERENCE

Documents incorporated by reference: Portions of the registrant's definitive proxy statement for the annual meeting of shareholders to be held June 21, 2012, which will be filed within 120 days after December 31, 2011 are incorporated by reference into Part III of this report.

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Cautionary Statement Regarding Forward Looking Information

This Form 10-K includes statements pertaining to anticipated financial performance, business endeavors, product development, and other similar matters. These statements which may include words such as "expect," "anticipate," "believe," "intend," and other like expressions, constitute forward-looking statements under the Private Securities Litigation Reform Act of 1995. A variety of factors could cause actual results and experiences to differ materially from the anticipated results or other expectations expressed in forward-looking statements. The risks and uncertainties that may affect the operations, performance, and results of business include, but are not limited to, the following:

Difficult conditions globally and in the U.S. economy may materially and adversely affect our business and results of operations.

Our investment portfolio is subject to several risks which may lessen the value of our invested assets and the amounts credited to policyholders.

The determination of valuation and impairments of fixed income securities include estimations and assumptions that are subjective and prone to differing interpretations and could materially impact our results of operations or financial condition.

Changing interest rates and credit spreads, market volatility and general economic conditions affect the risks and the returns on both our investment portfolio and our products.

We are subject to incurring difficulties in marketing and distributing our products through our current and future distribution channels.

We are subject to a downgrade in our financial strength ratings which may negatively affect our ability to attract and retain independent distributors, make our products less attractive to consumers, and may have an adverse effect on our operations.

We are subject to competition from new sources as well as companies having substantially greater financial resources, higher ratings, and more expansive product offerings which could have an adverse impact upon our business levels and profitability.

We are subject to regulation and changes to existing laws which may affect our profitability or means of operation.

Changes in accounting standards issued by standard-setting bodies may adversely affect our financial statements and affect the management of business operations.

We may be subject to unfavorable judicial developments, including the time and expense of litigation, which potentially could affect our financial position and results.

We could be liable with respect to liabilities ceded to reinsurers if the reinsurers fail to meet the obligations assumed by them.

We are subject to policy claims experience which can fluctuate from period to period and vary from past results or expectations.

We are subject to assumption inaccuracies regarding future mortality, persistency, and interest rates used in determining deferred policy acquisition costs which may require us to accelerate our amortization.

Occurrence of natural or man-made disasters and catastrophes could adversely affect our ability to conduct business operations and the financial condition and results of operations.

We are dependent upon effective information technology systems and on development and implementation of new technologies.

The Company could be adversely affected by changes to tax law or interpretations of existing tax law which reduce the demand for certain insurance products.

The Company may be required to establish a valuation allowance against its deferred tax assets which could materially affect the Company's results of operations and financial condition.

Competition for employees is intense and the Company may not be able to attract and retain highly skilled people needed to support its business.

See Part 1A, Risk Factors, for additional information.

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PART I

ITEM 1. BUSINESS

General

National Western Life Insurance Company (hereinafter referred to as "National Western", "Company", or "Registrant") is a stock life insurance company, chartered in the State of Colorado in 1956, and doing business in forty-nine states, the District of Columbia, and four U.S. territories or possessions. National Western is also licensed in Haiti, and although not otherwise licensed, accepts applications from and issues policies to residents of various countries in Central and South America, the Caribbean, the Pacific Rim, Eastern Europe and Asia. Such policies are underwritten, accepted, and issued in the United States upon applications submitted by independent contractors. The Company provides life insurance products for the savings and protection needs of approximately 137,000 policyholders and for the asset accumulation and retirement needs of 140,000 annuity contract holders.

The Company's total assets increased to \$9.7 billion at December 31, 2011, from \$8.8 billion at December 31, 2010. The Company generated revenues of \$572.7 million, \$576.0 million and \$568.4 million in 2011, 2010 and 2009, respectively. In addition, National Western generated net income of \$55.6 million, \$72.9 million and \$45.5 million in 2011, 2010 and 2009, respectively.

The Company's financial information, including information in this report filed on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to the above reports, are accessible free of charge through the Company's Internet site at [www.nationalwesternlife.com](http://www.nationalwesternlife.com) or may be viewed at the United States Securities and Exchange Commission ("SEC") Public Reference Room in Washington, D.C. or at the SEC's Internet site at [www.sec.gov](http://www.sec.gov).

Products

National Western offers a broad portfolio of individual whole life, universal life and term insurance plans, and annuities, including supplementary riders. In the following discussion, the Company reports sales and other statistical information. These statistics are derived from various sales tracking and administrative systems and are not derived from the Company's financial reporting systems or financial statements. These statistics are used to measure the relative progress of our marketing and acquisition efforts. Sales data for traditional life insurance is based upon annualized premiums, while universal life sales are based on annualized "target" premiums which are those premiums upon which full first year commissions are paid. Sales of annuities are measured based on the amount of deposits received. These statistics attempt to measure only some of the many factors that may affect future profitability, and therefore, are not intended to be predictive of future profitability.

**Life Products.** The Company's life products provide protection for the life of the insured and, in some cases, allow for cash value accumulation on a tax-deferred basis. These product offerings include universal life insurance ("UL"), interest-sensitive whole life, and traditional products such as term insurance coverage. Interest sensitive products such as UL accept premiums that are applied to an account value. Deducted from the account value are costs of insurance charges which vary by age, gender, plan, and class of insurance, as well as various expense charges. Interest is credited to account values at a fixed interest rate generally determined in advance and guaranteed for a policy year at a time, subject to minimum guaranteed rates specified in the policy contract. A slight variation to this general interest crediting practice involves equity-indexed universal life ("EIUL") policies whose credited interest may be linked in part to an outside index such as the S&P 500<sup>®</sup> Composite Stock Price Index ("S&P 500 Index<sup>®</sup>") at the election of the policyholder. These products offer both flexible and fixed premium modes and provide policyholders with flexibility

in the available coverage, the timing and amount of premium payments and the amount of the death benefit, provided there are sufficient policy funds to cover all policy charges for the coming year. Traditional products generally provide for a fixed death benefit payable in exchange for regular premium payments.

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Annuity Products. Annuity products sold include flexible premium and single premium deferred annuities, fixed-indexed annuities, and single premium immediate annuities. These products can be tax qualified or nonqualified annuities. A fixed single premium deferred annuity ("SPDA") provides for a single premium payment at the time of issue, an accumulation period, and an annuity payout period commencing at some future date. A flexible premium deferred annuity ("FPDA") provides the same features but allows, generally with some conditions, additional payments into the contract. Interest is credited to the account value of the annuity initially at a current rate of interest which is guaranteed for a period of time, typically the first year. After this period, the interest credited is subject to change based upon market rates and product profitability subject to a minimum guaranteed rate specified in the contract. Interest accrues during the accumulation period generally on a tax-deferred basis to the contract holder. After a number of years specified in the annuity contract, the owner may elect to have the proceeds paid as a single payment or as a series of payments over a period of time. The owner is permitted at any time during the accumulation period to withdraw all or part of the annuity account balance subject to contract provisions such as surrender charges and market value adjustments. A fixed-indexed deferred annuity performs essentially in the same manner as SPDAs and FPDAs with the exception that, in addition to a fixed interest crediting option, the contract holder has the ability to elect an interest crediting mechanism that is linked, in part, to an outside index such as the S&P 500 Index®. A single premium immediate annuity ("SPIA") foregoes the accumulation period and immediately commences an annuity payout period.

The following table sets forth information regarding the Company's sales activity by product type. Life insurance sales are measured by annualized first year premiums.

	Years Ended December 31,		
	2011	2010	2009
	(In thousands)		
Annuities:			
Fixed-indexed deferred	\$916,188	915,883	486,262
Other deferred	431,839	494,094	324,138
Single premium immediate	40,925	21,353	24,907
Total annuities	\$1,388,952	1,431,330	835,307
Life:			
Universal life insurance	\$33,221	30,819	28,950
Traditional life and other	3,370	3,147	4,212
Total life	\$36,591	33,966	33,162

### Operating Segments

The Company manages its business between Domestic Insurance Operations and International Insurance Operations. For segment reporting purposes, the Company's annuity business, which is predominantly domestic, is separately identified. The Company also has a Corporate segment, which consists of the assets and activities that have not been allocated to any other operating segment.

Domestic Insurance Operations. 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, and traditional life insurance, which include both term and whole life products. The majority of domestic sales are the Company's



annuities. 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. At December 31, 2011, the Company's NMO relationships had contracted approximately 13,000 independent agents with the Company. More than 27% of these contracted agents submitted policy applications to the Company in the past twelve months. At December 31, 2011, the Company had nearly 63,000 domestic life insurance policies in force representing \$2.3 billion in face amount of coverage and 140,000 annuity contracts representing account balances of \$7.0 billion.

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The following table sets forth the Company's domestic life insurance sales as measured in annualized first year premium for the past three years.

	Years Ended December 31,		
	2011	2010	2009
	(In thousands)		
Fixed-indexed life	\$5,315	1,738	2,576
Universal life	117	486	848
Traditional life	44	53	135
Total	\$5,476	2,277	3,559

International Insurance Operations. National Western's international operations generally focus on foreign nationals in upper socioeconomic classes. Insurance products are issued primarily to residents of countries in Central and South America, the Caribbean, the Pacific Rim, Eastern Europe, and Asia. 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 December 31, 2011, the Company had in excess of 74,000 international life insurance policies in force representing over \$18.6 billion in face amount of coverage.

International applications are submitted by independent contractors, consultants and broker-agents, many of whom have been submitting policy applications to National Western for 20 or more years. The Company had relationships with approximately 3,500 of these independent international individuals at December 31, 2011, 37% of which submitted policy applications to the Company in the past twelve months.

The following table sets forth the Company's international life insurance sales as measured in annualized first year premium for the past three years.

	Years Ended December 31,		
	2011	2010	2009
	(In thousands)		
Fixed-indexed life	\$19,962	20,235	17,970
Universal life	7,827	8,393	7,559
Traditional life	3,326	3,062	4,075
Total	\$31,115	31,690	29,604

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 National Western'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 and claims in United States dollars. In addition, experience with the international products for over forty years and the Company's longstanding business relationships further

serve to minimize risks.

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Geographical Distribution of Business. The following table depicts the distribution of the Company's premium revenues and deposits.

	Years Ended December 31,		
	2011	2010	2009
	(In thousands)		
United States domestic products:			
Annuities	\$1,381,057	1,381,057	821,361
Life insurance	71,635	55,465	58,825
Total domestic products	1,452,692	1,436,522	880,186
International products:			
Annuities	49,954	49,954	16,215
Life insurance	152,118	143,602	133,923
Total international products	202,072	193,556	150,138
Total direct premiums and deposits collected	\$1,654,764	1,630,078	1,030,324

Although many agents sell National Western's products, the Company's annuity sales in any year typically reflect several NMOs whose contracted independent agents sold 10% or more of the Company's total annuity sales. In 2011, there was one NMO that accounted for approximately 15% of the Company's annuity sales. Similarly, domestic life insurance sales in any year may include several NMOs who accounted for 10% or more of total domestic life insurance sales. In 2011, there were two NMOs who generated 46% and 12%, respectively, of total domestic life insurance sales. Given the lower level of domestic life insurance sales relative to international life sales and annuity sales, the larger percentage of domestic life sales for these particular NMOs is not considered a significant concentration of business within the total context of new business. In addition, with the independent distribution model the Company employs, the concentration of sales within a particular NMO is not as an acute concern as with other distribution channels given that the underlying agents are free to contract with the Company through any NMO the Company has a relationship with.

International life insurance sales are much more diversified by independent consultants and contractors and in 2011 were geographically attributed to Latin America (88%), the Pacific Rim (11%), and Eastern Europe (1%). In terms of international countries, Brazil, Taiwan, and Venezuela were the only countries exceeding 10% of total international sales with shares of 38%, 10%, and 13%, respectively.

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Segment Financial Information. A summary of financial information for the Company's segments is as follows:

	Domestic Life Insurance (In thousands)	International Life Insurance	Annuities	All Others	Totals
Revenues, excluding realized gains (losses):					
2011	\$47,436	135,181	343,267	40,800	566,684
2010	45,015	137,117	348,020	40,365	570,517
2009	53,937	148,624	343,502	27,510	573,573
Segment earnings (losses): (A)					
2011	\$460	17,674	20,253	13,299	51,686
2010	(912	) 21,722	34,316	14,212	69,338
2009	426	14,663	25,460	8,294	48,843
Segment assets: (B)					
2011	\$403,868	1,023,942	7,997,407	225,716	9,650,933
2010	387,873	1,025,103	7,101,720	209,179	8,723,875
2009	383,844	1,056,087	5,955,734	107,581	7,503,246

Notes to Table:

(A) Amounts exclude realized gains and losses on investments, net of taxes.

(B) Amounts exclude other unallocated assets.

Additional information concerning these industry segments is included in Note 13, Segment and Other Operating Information, of the accompanying consolidated financial statements.

### Competition and Ratings

National Western operates in a mature and highly competitive industry. We compete with hundreds of life and health insurance company groups in the United States as well as other financial intermediaries such as banks and securities firms who market insurance products. Competitors in our international markets include Pan-American Life Insurance, American Fidelity Life Insurance, Manhattan Life Insurance Company and Best Meridian Insurance while domestic market competitors include, among others, American Equity Investment Life, Sammons Financial Group (Midland, NACOLAH), AVIVA, Allstate (Lincoln Benefit), Lincoln National Life, Equitrust Life Insurance Company and Old Mutual Financial Network (F&G). Competitive factors are primarily the breadth and quality of products offered, established positions in niche markets, pricing, relationships with distribution channels, commission structures, the perceived stability of the insurer, quality of underwriting and customer service, scale and cost efficiency. Operating results of life insurers are subject to fluctuations not only from this competitive environment but also due to economic conditions, interest rate levels and changes, performance of investments, and the maintenance of strong insurance ratings from independent rating agencies.

In order to compete successfully, life insurers focus initiatives toward distribution, technology, defined end market targets, speed to the market in terms of product development, and customer relationship management as ways of gaining a competitive edge. The Company's management believes that it competes primarily on the basis of its

longstanding reputation for commitment in serving international markets, its financial strength and stability, and its ability to attract and retain distribution based upon product and compensation. With respect to international markets, the Company is of the opinion that the home office infrastructure to support languages other than English, and the knowledge needed to effectively underwrite risks outside of the United States is a significant barrier to entry for potential competitors.

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Ratings with respect to financial strength are an important factor in establishing the competitive position of insurance companies. Financial strength ratings are generally defined as a rating agency’s opinion as to a company’s financial strength and ability to meet ongoing obligations to policyholders. Accordingly, ratings are important to maintaining public confidence and impact the ability to market products. The following summarizes the Company's current financial strength ratings.

Rating Agency	Rating	Outlook
A.M. Best	A (Excellent)	Stable
Standard & Poor's	A (Strong)	Stable

A.M. Best has 13 financial strength ratings assigned to solvent insurance companies which currently range from A++ (Superior) to D (Poor). Standard & Poor’s has eight financial strength ratings assigned to solvent insurance companies, ranging from “AAA” (Extremely Strong) to “CC” (Extremely Weak). Both rating agencies further qualify their current ratings with outlook designations of “Positive”, “Stable”, and “Negative”.

A.M. Best and Standard & Poor’s ratings are an independent consideration of the Company’s claims paying ability and are not a rating of the Company’s investment worthiness. The rating agencies formally review the Company and its rating on an annual basis with interim analysis performed as necessary. In June 2009, A.M. Best upgraded the Company’s rating to “A” from “A-“. This was particularly noteworthy given the financial crisis backdrop that framed this time period and the number of companies that were negatively impacted, often significantly, during this time. In June 2010, Standard & Poor’s upgraded its outlook of the Company from “negative” to “stable”. Generally speaking, there is no assurance that the Company's ratings will continue for a certain period of time. In the event the Company's ratings are subsequently downgraded, the Company's business may be negatively impacted.

Risk Management

Similar to other insurers, the Company is exposed to a wide spectrum of financial, operational, and other risks as described in Item 1A “Risk Factors”. Effective enterprise risk management is a key concern for identifying, monitoring, measuring, communicating, and managing risks within limits and risk tolerances. The Company’s Board of Directors and senior management are knowledgeable of and accountable for key risks. The full Board of Directors meets at least every other month and regularly hears reports from the President and Chief Operating Officer, the Chief Financial Officer, the Chief Actuary, the Chief Investment Officer, and the Chief Compliance Officer. In addition, the Board has several committees which include the Audit Committee, the Investment Committee, and the Compensation and Stock Option Committee that regularly convene to address various aspects of risk.

Enterprise Risk Management (ERM) Governance Framework

Board of Directors and Sub-Committees of the Board

o

Company Senior Management

o

ERM Committees

o	o	o	o	o
Disclosure Committee	Asset/Liability Matching	Product Pricing/Development	Compliance/Fraud Unit	Underwriting/Claims
o	o	o	o	o

Corporate Risk Function

Insurance Risk

Market Risk

Credit Risk

Operational Risk

Strategy Risk

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Lines of Business / Functional Areas

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The Company maintains several management groups and committees that meet regularly to monitor, discuss and manage a variety of issues and risks associated with the business. These groups and committees include numerous areas such as regulatory compliance, financial reporting process and controls, fraud unit investigations, product spread management, and business strategy. Key members of senior management are involved with these groups and committees providing direction and oversight and serve as a reporting liaison with the Company's Board of Directors and sub-committees.

The Company maintains a system of disclosure controls and procedures, including internal controls designed to provide reasonable assurance that assets are safeguarded and transactions are properly authorized, executed and recorded. The Company recognizes the importance of full and open presentation of its financial position and operating results and to this end maintains a Disclosure Controls and Procedures Committee comprised of senior executives who possess comprehensive knowledge of the Company's business and operations. This Committee is responsible for evaluating disclosure controls and procedures and for the gathering, analyzing, and disclosing of information as required to be disclosed under the securities laws. It assists the Chief Executive Officer and Chief Financial Officer in their responsibilities for making the certifications required under the securities laws regarding the Company's disclosure controls and procedures. It ensures that material financial information is properly communicated up the Company's hierarchy to the appropriate person or persons and that all disclosures are made in a timely fashion. This Committee reports directly to the Audit Committee of the Company.

The Company's product designs, underwriting standards and risk management techniques are utilized to protect against disintermediation risk and greater than expected mortality and morbidity risk. Disintermediation risk is limited through the use of surrender charges, certain provisions not allowing discretionary withdrawals, and market value adjustment features. Investment guidelines including duration targets, asset allocation tolerances and return objectives help to ensure that disintermediation risk is managed within the constraints of profitability criteria. Prudent underwriting is applied to select and price insurance risks and the Company regularly monitors mortality experience relative to its product pricing assumptions. Enforcement of disciplined claims management serves to further protect against greater than expected mortality.

A significant aspect of the Company's business is managing the linkage of its asset characteristics with the anticipated behavior of its policy obligations and liabilities, a process commonly referred to as asset-liability matching. The Company maintains an Asset-Liability Committee ("ALCO") consisting of senior level members of the Company who assist and advise the Company's Board of Directors in monitoring the level of risk the Company is exposed to in managing its assets and liabilities in order to attain the risk-return profile desired. Certain members of the ALCO meet as frequently as necessary, to review and recommend for Board of Director ratification, current period interest crediting rates to policyholders based upon existing and anticipated investment opportunities. These rates apply to new sales and to products after an initial guaranteed period, if applicable. Rates are established after the initial guaranteed period based upon asset portfolio yields and each product's required interest spread, taking into consideration current competitive market conditions.

Substantially all international products contain a currency clause stating that premium and claim "dollars" refer to lawful currency of the United States. Policy applications submitted by international insurance brokers are generally associated with individuals in upper socioeconomic classes who desire the stability and inflationary hedge of dollar denominated insurance products issued by the Company. The favorable demographics of this group typically results in a higher average policy size, and persistency and claims experience (from natural causes) similar to that in the United States. By accepting applications submitted on residents outside the United States, the Company is able to further diversify its revenue, earnings and insurance risk.



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## Reinsurance

The Company follows the industry practice of reinsuring (ceding) portions of its insurance risks with a variety of reinsurance companies. All reinsurance is yearly renewable term. We do not use financial or surplus relief reinsurance. The use of reinsurance allows the Company to underwrite policies larger than the risk it is willing to retain on any single life and to continue writing a larger volume of new business. New sales of life insurance products are reinsured above prescribed limits and do not require the reinsurer's prior approval within certain guidelines. The maximum amount of life insurance the Company normally retains is \$500,000 on any one life. However, the use of reinsurance does not relieve the Company of its primary liability to pay the full amount of the insurance benefit in the event of the failure of a reinsurer to honor its contractual obligation. Consequently, the Company avoids concentrating reinsurance risk with any one reinsurer and only participates in reinsurance treaties with reputable carriers. No reinsurer of business ceded by the Company has failed to pay policy claims (individually or in the aggregate) with respect to our ceded business. The Company continuously monitors the financial strength of our reinsurers and has been able to obtain replacement coverages from financially responsible reinsurers when making changes. The Company's primary reinsurers as of December 31, 2011 were as follows.

Reinsurer	A.M. Best Rating	Amount of In Force Ceded (\$000's)
Hannover Life Reassurance Company	A	\$1,930,768
Transamerica Life Insurance Company	A+	910,912
SCOR Rueckversicherung (Cologne)	A	177,923
SCOR Global Life America Reinsurance (Texas)	A	245,603
SCOR Global Life S.E. (Paris)	A	809,075
Mapfre Re (Madrid)	A	812,715
Canadian Life Assurance Co. (US)	A+	401,456
RGA Reinsurance Co.	A+	209,940
All others		59,711
		\$5,558,103

## Regulatory and Other Issues

**Regulation.** The Company's insurance business is subject to comprehensive state regulation in each of the states it is licensed to conduct business. The laws enforced by the various state insurance departments provide broad administrative powers with respect to licensing to transact business, licensing and appointing agents, approving policy forms, regulating unfair trade and claims practices, establishing solvency standards, fixing minimum interest rates for the accumulation of surrender values, and regulating the type, amounts, and valuations of permitted investments, among other things. The Company is required to file detailed annual statements with each of the state insurance supervisory departments in which it does business. Annually, the Company's board-appointed qualified actuary must submit an opinion to state insurance regulators where the Company is licensed to do business on whether the statutory assets held backing the statutory reserves are sufficient to meet contractual obligations and related expenses of the insurer. If an opinion cannot be rendered noting the sufficiency of assets, the Company is required to establish additional statutory reserves which draw from available statutory surplus until the time such an opinion can be furnished.

The Company's operations and financial records are subject to examination by these departments at regular intervals. Statutory financial statements are prepared in accordance with accounting practices prescribed or permitted by the

Colorado Division of Insurance, the Company's principal insurance regulator. Prescribed statutory accounting practices are largely dictated by the Statutory Accounting Principles adopted by the National Association of Insurance Commissioners ("NAIC"). The NAIC, as well as state regulators, continually evaluates existing laws and regulations pertaining to the operations of life insurers. To the extent that initiatives result as a part of this process, they may be adopted in the various states in which the Company is licensed to do business. It is not possible to predict the ultimate content and timing of new statutes and regulations adopted by state insurance departments and the related impact upon the Company's operations although it is conceivable that they may be more restrictive.

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Each state has insurance guaranty association laws under which insurers doing business in a state can be assessed contributions, up to prescribed limits, in order to cover contractual benefit obligations of insolvent insurance companies. The state guaranty associations levy assessments on each insurer on the basis of their proportionate share of the premiums written in the lines of business in which the insolvent insurer had been engaged. Some states permit the member insurers to recover the assessments paid through full or partial premium tax offsets.

The Company's business is also affected by U.S. federal, state and local tax laws. Although the federal government does not directly regulate the life insurance industry, federal measures previously considered or enacted by Congress, if revisited, could affect the insurance industry and the Company's business. These measures include the tax treatment of life insurance companies and life insurance products, as well as changes in individual income tax structures and rates. Even though the ultimate impact of any of these changes, if implemented, is uncertain, the persistency of the Company's existing products and the ability to sell products could be materially affected.

**Risk-Based Capital Requirements.** In order to enhance the regulation of insurer solvency, 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. For each category, the RBC requirements are determined by applying specified factors to various assets, premiums, reserves, and other items, with the factor being higher for items with greater underlying risk and lower for items with less risk. The standards require life insurers to submit a report to state regulators on an annual basis regarding their risk-based capital. The Company's statutory capital and surplus at December 31, 2011, was significantly in excess of the threshold RBC requirements.

**Effects of Inflation.** The rate of inflation as measured by the change in the average consumer price index has not had a material effect on the revenues or operating results of the Company during the three most recent fiscal years.

**Employees.** The Company had 278 employees as of December 31, 2011 substantially all of which worked in the Company's home office in Austin, Texas. None of the employees are subject to collective bargaining agreements governing their employment with the Company.

**ITEM 1A. RISK FACTORS**

Company performance is subject to varying risk factors. This section provides an overview of possible risk exposures at this point in time that could impact Company performance in the future. While these scenarios do not represent expectations of future experience, they are intended to illustrate the potential impacts if any of the following risks were to manifest into actual occurrences.

Current difficult conditions globally and in the U.S. economy may materially adversely affect our business and results of operations.

The Company's results from operations are materially affected by economic conditions both in the U.S. and elsewhere around the world. The stress experienced by financial markets beginning in the second half of 2007 manifested itself in various economic quarters. Consumer confidence declined as home values and the stock market decreased and unemployment and energy costs increased. The volatility and disruption in the financial markets reached unfamiliar

levels such that the availability and cost of credit was materially impacted. The market for fixed income securities experienced decreased liquidity, increased price volatility, credit downgrades, and an increasing probability of default. Consequently, these securities became less liquid, more difficult to value, and potentially harder to dispose of if situations dictate. Although the recession ended in mid-2009, economic and employment growth have remained weak and several sectors, most notably the housing industry, continue to underperform. Impediments to financial recovery include U.S. federal deficit, the European debt crisis, and the specter of slower growth in robust economies such as China, India and Brazil.

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The Company's business benefits from steady economic growth. Demand for our products and ultimately the profitability of our business may be adversely affected by anemic economic activity consisting of factors such as lower consumer spending, negative investor sentiment, higher unemployment, lower corporate earnings and business investment, lackluster consumer confidence, and ongoing volatility in capital markets. We may also experience a higher incidence of claims, lapses or surrenders of policies. Our policyholders may opt to defer or stop paying insurance premiums. Adverse changes as detailed above could negatively affect our net income and have a material effect on our business, results of operations and financial condition.

Economic trends could take a turn for the worse in 2012 providing increased volatility and reduced prospects for markets and financial asset classes. The Company cannot foretell the occurrence of economic trends or the timing of changes in such trends.

Our investment portfolio is subject to several risks which may lessen the value of invested assets and the amounts credited to policyholders.

The Company primarily invests monies received in investment grade, fixed income investment securities in order to meet its obligations to policyholders and provide a return on its deployed capital. Consequently, we are subject to the risk that issuers of these securities may default on principal and interest payments, particularly in the event of an ongoing downturn in the economic and/or business climate. At December 31, 2011, approximately 2% of the Company's \$8.3 billion fixed income securities portfolio was comprised of issuers who were investment grade at the time the Company acquired them but were subsequently downgraded for various reasons. A substantial increase in defaults from these or other issuers could negatively impact the Company's financial position and results.

For the Company's fixed-indexed products, over the counter derivative instruments (index options) are purchased from a number of highly rated counterparties to fund the index credit to policyholders. In the event that any of these counterparties fails to meet their contractual obligations under these derivative instruments, the Company would be financially at risk for providing the credits due that the counterparty reneged on. The Company attempts to offset this risk through careful credit evaluation of counterparties, diversification of holdings among numerous institutions, and use of credit support agreements requiring counterparties to provide collateral at specified threshold levels. The failure of counterparties to perform could negatively impact the Company's financial strength and reduce the Company's profitability.

Significant continued financial and credit market volatility, changes in interest rates and credit spread margins, credit defaults, market illiquidity, declines in equity prices, ratings downgrades of the issuers of debt securities, and declines in general economic conditions, either singularly or in combination, could have a material adverse impact on the Company's results of operations and financial condition through realized losses, impairments, and changes in unrealized loss positions.

The determination of valuation and impairments of fixed income securities include estimations and assumptions that are subjective and prone to differing interpretations and could materially impact our results of operations or financial condition.

The Company makes assumptions regarding the fair value and expected performance of its investments. During periods of market disruption and volatility, it becomes more difficult to evaluate securities particularly if trading becomes less frequent or market data becomes less observable. As a result, valuations may include inputs and assumptions that are less observable or require greater estimation and judgment as well as valuation methods which are more complex. We also consider a wide range of factors about security issuers in evaluating the cause of a decline in the estimated fair value of a security and in assessing the prospects for recovery. The decision on whether to record

an other-than-temporary impairment is determined by our assessment of the financial condition and prospects of a particular issuer, projections of future cash flows and recoverability as well as our ability and intent to hold the securities to recovery or maturity. Expectations that the Company's investments in corporate debt securities will continue to perform in accordance with their contractual terms are based on evidence gathered through our normal credit surveillance process. Our conclusions concerning the recoverability of any particular security's market price could ultimately prove to be invalid as facts and circumstances change. It is possible that issuers of the Company's investments in corporate securities and/or debt obligations will perform worse than current expectations. Consequently, there can be no assurance that we have accurately assessed the level of impairments in our financial statements or that additional impairments may not need to be taken in the future. It is also possible that unanticipated events may lead the Company to dispose of such investments and recognize the effects of any market movements in its financial statements.

We are subject to changing interest rates and credit spreads, market volatility, and general economic conditions which may affect the risk and returns on both our investment portfolio and our products.



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We are exposed to significant capital market risk related to changes in interest rates. Substantial and sustained changes, up or down, in market interest rate levels can materially affect the profitability of our products, the market value of our investments, and ultimately the reported amount of stockholders' equity.

A rise in interest rates will increase the net unrealized loss position of our investment portfolio and may subject the Company to disintermediation risk. Disintermediation risk is the risk that policyholders may surrender their contracts in a rising interest rate environment, requiring the Company to liquidate investments in an unrealized loss position (i.e. the market value less than the carrying value of the investments). The Company manages its liabilities and configures its investment portfolio so as to provide and maintain sufficient liquidity to support expected withdrawal demands. If the Company experiences unexpected withdrawal or surrender activity, it could exhaust liquid assets and be forced to liquidate other assets at a loss or on other unfavorable terms. With respect to fixed income security investments the Company maintains in an "Available for Sale" category, rising interest rates will cause declines in the market value of these securities. These declines are reported in our financial statements as an unrealized investment loss and a reduction of stockholders' equity.

There may be occasions, especially in the current climate, where the Company could encounter difficulty selling some of its investments due to a lack of liquidity in the marketplace. If the Company required significant amounts of cash on short notice during such a period, it may have difficulty selling investments at attractive prices, in a timely manner or both.

Significant changes in interest rates expose insurance companies to the risk of not realizing the anticipated spread between the interest rates earned on investments and the credited rates paid on in force policies and contracts. A decline in interest rates could expose the Company to reduced profitability due to minimum interest rate guarantees that are required in our products by regulation. A key component of profitability is investment spread, or the difference between the yield on our investments and the rates we credit to policyholders on our products. A narrowing of investment spreads ("spread compression") could negatively affect operating results. Although the Company has the ability to adjust the rates credited on products in order to maintain our required investment spread, a significant decline in interest rate levels could affect investment yields to the point where the investment spread is compromised due to minimum interest rate guarantees. In addition, the potential for increased policy surrenders and cash withdrawals, competitor activities, and other factors could further limit the Company's ability to maintain crediting rates on its products at levels necessary to avoid sacrificing investment spread.

Changes in interest rates may also impact the Company's business in other ways. The Company's expectation for future interest earnings and spreads is an important component in determining the amortization of deferred policy acquisition costs ("DPAC"). Significantly lower interest earnings or spreads may cause the Company to accelerate its amortization of DPAC thereby reducing net income in a reporting period. Additionally, during periods of declining interest rates, life insurance and annuity products may be relatively more attractive savings alternatives to consumers resulting in increased premium payments on products with flexible premium features, repayment of policy loans, or otherwise a higher persistency of policies remaining in force from year-to-year during a period when the Company's investments carry lower returns.

The profitability of the Company's fixed-indexed products linked in part to market indices is significantly affected by the cost of underlying call options purchased to fund the credits owed to contract holders selecting this form of interest crediting. If there are little or no gains on the call options purchased over the expected life of these fixed-indexed products, the Company would incur expenses for credited interest over and above the option costs. In addition, if the Company does not successfully match the terms of the underlying call options purchased with the terms of the fixed-indexed products, the index credits could exceed call option proceeds. This would serve to reduce the Company's spread on the products and decrease profits.

We are subject to incurring difficulties in marketing and distributing our products through our current and future distribution channels.

The Company distributes its life and annuity products through independent broker-agents and consultants. There is substantial competition, particularly in the Company's domestic market, for independent broker-agents with the demonstrated ability to market and sell insurance products. Competition for these individuals or organizations typically centers on company reputation, products, compensation, home office support and the insurer's financial strength ratings. The Company's future sales and financial condition are dependent upon avoiding significant interruptions in attracting and retaining independent broker-agents.

As technology continues to evolve, comparison of a particular product of any company for a particular customer with competing products for that customer will become more readily available, which could also lead to increased competition as well as affecting agent and customer behavior.

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We are subject to a downgrade in our financial strength ratings which may negatively affect our ability to attract and retain independent distributors, make our products less attractive to consumers, and may have an adverse effect on our operations.

Financial strength ratings are important criteria in establishing the competitive position of insurers. While financial strength ratings are not a recommendation to buy the Company's products, these ratings are important to maintaining public confidence in the Company, its products, and its competitive position. Ratings generally reflect the rating agencies' view of a particular company's financial strength, operating performance, and ability to meet its obligations to policyholders. However, some of the rating factors often relate to the particular views of the rating agency, their independent economic modeling, the general economic climate, and other circumstances outside of the insurer's control. Accordingly, we cannot predict with any certainty what actions rating agencies may take. A downgrade in our financial strength rating, or an announced potential downgrade, could affect our competitive position and make it more difficult to market our products vis-à-vis competitors with higher financial strength ratings. In extreme situations, a significant downgrade action by one or more rating agencies could induce existing policyholders to cancel their policies and withdraw funds from the Company. Currently, the major rating agencies, including A.M. Best and Standard & Poor's, maintain stable outlooks on the U.S. life insurance industry. Irrespective, these rating agencies could revise their benchmarks regarding levels of capital, earnings, and other metrics that align with particular rating levels and impact their rating assessments of U.S. life insurance companies. These events could have a material adverse effect on our financial position and liquidity.

We are subject to competition from new sources as well as companies having substantially greater financial resources, higher ratings, and more expansive product offerings which could have an adverse impact upon our business levels and profitability.

Our ability to compete is based upon a variety of factors including financial strength ratings, competitive products, service, scale, and distribution capacity. In recent years, there has been considerable consolidation among companies in the insurance and financial sectors resulting in large, well-capitalized entities that offer products comparable to the Company. Frequently, these larger organizations are not domiciled in the United States or are financial services entities attempting to establish a position in the insurance industry. These larger competitors often enjoy economies of scale which produce lower operating costs and the wherewithal to absorb greater risk allowing them to price products more competitively and, in turn, attract independent distributors. Such competition could result in lower sales or higher lapses of existing products. Consequently, the Company may encounter additional product pricing pressures and be challenged to maintain profit margin targets and profitability criteria. Because of these competitive presences, the Company may not be able to effectively compete without negative affects on our financial position and results.

We are subject to regulation and changes to existing laws that may affect our profitability or means of operations.

The Company is subject to extensive laws and regulations which are complex and subject to change. In addition, these laws and regulations are enforced by a number of different authorities including, but not limited to, state insurance regulators, the Securities and Exchange Commission (SEC), state attorney generals, and the U.S. Department of Justice. Compliance with these laws and regulations is time consuming and any changes may materially increase our compliance costs and other expenses of doing business. The regulatory framework at the state and, increasingly, federal level pertaining to insurance products and practices is advancing and could affect not only the design of our products but our ability to continue to sell certain products.

The Company is subject to government regulation in each of the states in which it conducts business with such regulation vested in state agencies having broad administrative power dealing with many aspects of the Company's business. At any given time, the Company may be subject to a number of financial, market conduct, or other

examinations or audits. These examinations or audits may result in payment of fines and penalties as well as changes in systems or procedures, any of the which could have a material adverse effect on the Company's financial condition or results of operations.

Life insurer products generally offer tax advantages to policyholders via the deferral of income tax on policy earnings during the accumulation phase of the product, be it an annuity or a life insurance product. Taxes, if any, are payable on income attributable to a distribution under a policy/contract for the year in which the distribution is made. Periodically, Congress has considered legislation that would reduce or eliminate this tax deferral advantage inherent to the life insurance industry and subject the industry's products to treatment more equivalent with other investments. In the event that the tax-deferred status of life insurance products is revised or reduced by Congress all life insurers would be adversely impacted.

Insurance companies that do business in a particular state are subject to assessment up to certain prescribed limits by that state's insurance guaranty association to provide funds to help pay for policyholder losses or liabilities of insolvent insurance companies. The financial crisis of 2008 and 2009 weakened the financial condition of numerous insurers, including insurers already in the state of receivership, thus increasing the risk of sparking guaranty fund assessments. As the amount and timing of assessments by state insurance guaranty associations is outside of the Company's control, the liabilities provided for these potential assessments in our financial statements may differ from the amounts ultimately assessed.

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A number of U.S. jurisdictions are currently investigating life insurer practices for compliance with unclaimed property laws. In recent highly publicized incidents, the practice by certain companies of using data available on the U.S. Social Security Administration's Death Master File or a similar data base in order to avoid paying periodic benefits under annuity contracts was disclosed. As a result, a number of jurisdictions are requiring life insurers to use this same data to identify instances where amounts under life insurance policies and annuity contracts are payable and to locate and pay beneficiaries under such contracts. The National Conference of Insurance Legislators ("NCOIL") has adopted the Model Unclaimed Life Insurance Benefits Act ("Act") and legislation is currently pending in several states that is substantially similar to the Act adopted by NCOIL. As proposed, the Act would impose new requirements on insurers to periodically compare their in force life insurance and annuity policies against the Death Master File, investigate any identified matches to confirm the death of the insured and determine whether benefits are due and attempt to locate the beneficiaries or, if no beneficiary can be located, escheat the policy benefit to the respective state government as unclaimed property. It is possible that enactment of state laws similar to the Act could result in additional payments to beneficiaries, additional escheatment of funds deemed abandoned under state laws, and/or administrative penalties. It is also possible that life insurers may be subject to claims regarding their business practices as a result given the legal uncertainty in this area. Any additional payments or costs could be significant and have a material adverse effect on the Company's financial condition or results from operations.

On July 21, 2010, the Dodd-Frank Act ("Dodd-Frank") was enacted into law. Dodd-Frank calls for expansive changes in the regulation and oversight of the financial industry intended to provide for greater supervision of financial industry entities, reduction of risk in banking practices and in securities and derivatives trading, enhancement of public company corporate governance practices and executive compensation disclosures, and greater protections to individual consumers and investors. Numerous provisions of Dodd-Frank require adoption of implementing rules and/or regulations. The process of adopting these have been delayed beyond the timeframes imposed by Dodd-Frank. Until various final regulations are defined the full impact of the regulations on the Company will remain unclear. Legislative or regulatory requirements imposed may impact the Company in a variety of ways including placing the Company at a competitive disadvantage relative to its competition or other financial service entities, changing the competitive framework of the financial services sector and/or life insurance industry, making it more expensive for the Company to conduct its business, or requiring the reallocation of Company resources to legal and compliance-related activities. Consequently, the impact of Dodd-Frank on the Company, as well as that on the financial industry and economy cannot be determined until all the rules and regulations called for under the Act have been finalized and implemented.

The Company's operations are centralized at its Austin, Texas location and it is licensed to do business in forty-nine states (except New York) and various other U.S. territories and possessions and is regulated by the insurance departments in each of these locations. Although not otherwise licensed, the Company also accepts applications from and issues dollar-denominated policies to residents outside of the United States. From time to time insurance regulators in these non-U.S. locations have sought to exercise regulatory authority over the Company including the imposition of substantial penal fines. Although these non-U.S. regulators have no jurisdiction over the Company and any actions, including fines, would be unenforceable against the Company, the threat of regulatory action could impede the submission of future application from residents in these locations. The Company's future sales and financial condition are dependent upon avoiding significant interruptions in receiving applications from residents outside of the United States.

Changes in accounting standards issued by standard-setting bodies may adversely affect our financial statements and affect the management of business operations.

The Company's financial statements are prepared in accordance with generally accepted accounting principles ("GAAP") as delineated in the FASB Accounting Standards Codification ("FASB ASC"). GAAP is subject to constant review by various policy-setting organizations to address emerging accounting rules and issue interpretative accounting guidance. From time to time, the Company is required to adopt new or revised accounting standards or guidance that has been integrated into the FASB ASC. Future accounting standards required to be adopted could possibly change the current accounting treatment that the Company uses in its consolidated financial statements and such changes could possibly have a material adverse effect on our financial position and results of operations.

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In addition, the Financial Accounting Standards Board ("FASB") is in the process of working on several projects with the International Accounting Standards Board ("IASB") which could produce significant changes as GAAP converges with International Financial Reporting Standards ("IFRS"). These projects include how the Company accounts for its insurance contracts and financial instruments and how its financial statements are prepared and presented. The SEC has proposed that filers in the U.S. be required to report financial results in accordance with IFRS as issued by the IASB rather than GAAP. Despite the gradual working toward convergence of GAAP and IFRS, adoption of IFRS would be a complete change to the Company's accounting and reporting. The changes to GAAP and the ultimate conversion to IFRS will invoke new demands on public companies in the areas of governance, internal controls, employee training, and disclosure and will likely affect how business operations are managed. The Company is unable to predict whether, and if so, when this proposal will be adopted and/or implemented.

The Company is also required to comply with statutory accounting principles ("SAP") which are subject to constant review by the NAIC and related task forces and committees. Various proposals either are currently or have been previously pending before the NAIC including comprehensive reforms relating to life insurance reserves and the accounting for such reserves. The Company cannot predict whether or in what form reforms will be enacted by state legislatures and whether the enacted reforms will positively or negatively affect the Company.

We may be subject to unfavorable judicial developments, including the time and expense of litigation, which potentially could affect our financial position and results.

Financial services companies are frequently targets of legal proceedings, including class action litigation. In the ordinary course of business, we are involved in various legal actions common to the life insurance industry, some of which may occasionally assert claims for large amounts. Companies in the life insurance and annuity lines of business have encountered litigation pertaining to allegations of improper sales practices in connection with the sale of life insurance, improper product design and disclosures, marketing unsuitable products to customers especially in the senior market, bad faith in the handling of insurance claims, and other similar pleas. In addition, life insurance companies are subject to risk of errors and misconduct of the agents selling their products for fraud, non-compliance with policies and recommending products or transactions that are not suitable in a particular situation. Often these legal proceedings have resulted in the award of substantial amounts disproportionate to the actual damages including material amounts of punitive compensatory damages. In some states, judges and juries have substantial discretion in awarding punitive and compensatory damages which creates the potential for material adverse judgments or awards. Given the inherent unpredictability of litigation, there can be no assurance that such litigation, current or in the future, will not have such a material adverse effect on the Company's results of operation or cash flows in any particular reporting period. In addition, the occurrence of such matters may become more frequent and/or severe in the event that general economic conditions deteriorate.

We could be liable with respect to liabilities ceded to reinsurers if the reinsurers fail to meet the obligations assumed by them.

The Company cedes material amounts of insurance to other unaffiliated insurance companies through reinsurance. However, these reinsurance arrangements do not fully discharge the Company's obligation to pay benefits on the reinsured business. If a reinsurer fails to meet its obligations, the Company would be forced to cover these claims. In addition, if a reinsurer becomes insolvent, it may cause the Company to lose its reserve credits on the ceded business which require the establishment of additional reserves. To mitigate the risks associated with the use of reinsurance, the Company carefully monitors the ratings and financial condition of its reinsurers on a regular basis and attempts to avoid concentration of credit risks by spreading its business among several reinsurers in order to diversify its risk exposure.

The Company's ability to be competitive is affected by the availability of reinsurance. In recent years, the number of life reinsurers has decreased as the reinsurance industry has consolidated. The lower number of life reinsurers has resulted in increased concentration of risk for insurers. If the cost of reinsurance were to increase or become unavailable, the Company could be adversely impacted.

We are subject to policy claims experience which can fluctuate from period to period and vary from past results or expectations.

The Company's earnings are significantly influenced by policy claims received and will vary from period to period depending upon the amount of claims incurred. In any given quarter or year, there is very limited predictability of claims experience. The liability established for future policy benefits is based upon a number of different factors. Our mortality experience could be adversely impacted by a catastrophic event such as a natural disaster, terrorist attack or pandemic event. In the event our future claim experience does not match our past results or pricing assumptions, our operating results could be materially and adversely affected.

We are subject to assumption inaccuracies regarding future mortality, persistency, and interest rates used in determining deferred policy acquisition costs which may require us to accelerate our amortization.



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In the course of business, the Company makes certain assumptions regarding mortality, policy persistency, expenses, interest rates, business mix, investment performance and other factors concerning the type of business experience expected in future periods. Deferred policy acquisition costs (and deferred sales inducement amounts) are calculated using a number of these assumptions. They represent costs that vary with and are primarily related to the acquisition of new insurance and annuity contracts. Amortization of deferred policy acquisition expenses is dependent upon actual and expected profits generated by the lines of business that incurred the related expenses and are amortized over the expected lives of the corresponding contracts. The deferred policy acquisition costs recorded on the balance sheet are tested to determine if they are recoverable under current assumptions. The estimates and assumptions used to amortize deferred policy acquisition costs proportional to expected gross profits are also regularly reviewed. Due to the uncertainty associated with establishing these assumptions, the Company cannot, with precision, determine the exact pattern of profit emergence. Increases in actual or future withdrawals or surrenders or investment losses, often associated with severe economic recessions, could result in an acceleration of amortization. Accordingly, actual results could differ from the related assumptions which could have a material and adverse impact on the Company's operating results.

Assumptions and estimates involve judgment, and by their nature are imprecise and subject to changes and revisions over time. The Company's results may be affected, positively or negatively, by actual results differing from assumptions, by changes in estimates, and by changes resulting from implementing more sophisticated administrative systems and procedures that facilitate the calculation of more precise estimates.

Occurrence of natural or man-made disasters and catastrophes could adversely affect our ability to conduct business operations and the financial condition and results of operations.

The occurrence of natural disasters and catastrophes, including earthquakes, floods, tornadoes, fires, explosions, pandemic disease and man-made disasters, including acts of terrorism and military actions, could adversely affect the financial condition or results of operations of the Company. Such disasters and catastrophes could impact the Company directly by damaging our facilities, preventing employees from performing their duties or otherwise disturbing the Company's ordinary business operations, as well as indirectly by changing the condition and behaviors of consumers, business counterparties and regulators and potentially causing declines or volatility in economic and financial markets. In addition, such events and conditions could result in a decrease or halt in economic activity in large geographic regions, adversely impacting the marketing of the Company's business within such geographic areas which in turn could have an adverse effect on the Company.

The effects of natural and man-made disasters and catastrophes on the Company's business include, but are not limited to: an acceleration of the timing in which benefits are paid under the Company's insurance policies due to catastrophic loss of life; the harm to the financial condition of the Company's reinsurers due to an increase in claims thereby impacting the cost and availability of reinsurance and possibly increasing the probability of default on reinsurance recoveries; and heightened volatility, loss of liquidity, and credit impairment in the financial markets resulting in harm to the Company's financial condition.

We are dependent upon effective information technology systems and on development and implementation of new technologies.

The Company's business operations are technology dependent for maintaining accurate records, administering complex contract provisions, and complying with increasingly demanding regulation. While systems developments can streamline many processes and in the long term reduce the cost of doing business, these initiatives can present short-term cost and implementation risks. Projections of expenses, implementation time frames and the ultimate

enhancement values may be different from expectations and escalate over time. The Company also faces rising costs and time constraints in meeting data security compliance requirements of new and proposed regulations. These increased risks and expanding requirements expose the Company to potential data loss and damages and significant increases in compliance and litigation costs.

The Company relies on its computer systems to conduct business and produce financial statements. While policies, procedures and back-up plans designed to prevent or minimize the effect of incapacity or failure are maintained, the Company's computer systems may be vulnerable to disruptions or breaches as a result of natural disasters, man-made disasters, criminal activity or other events beyond the Company's control. A computer virus, information security breach, disaster or unanticipated event could affect the data storage and processing systems of the Company, or its service providers, destroying or compromising valuable data or making it difficult to conduct business. The Company's computer systems may be inaccessible to its employees, business partners, and customers for an extended period of time. Even if employees of the Company are able to report to work, they may be unable to perform their duties if the Company's data or systems are disabled or destroyed. The failure or incapacity of any of the Company's computer systems could disrupt operations and adversely impact our profitability.

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The Company retains confidential information on its systems, including customer information and proprietary business information, and relies on sophisticated commercial technologies to maintain the security of those systems. The increasing volume and sophistication of computer viruses, hackers and other external threats may increase the vulnerability of the Company's systems to data breaches. Anyone who is able to circumvent the Company's security measures could access, view, misappropriate, alter, or delete any information in the systems, including personally identifiable customer information, customer financial information, and proprietary business information. An increasing number of states require customers to be notified of any unauthorized access, use, or disclosure of their information. Any compromise of the security of the Company's technology systems that results in the disclosure of personally identifiable customer information could damage the Company's reputation, expose it to litigation, and result in significant technical, legal and other expenses.

Some of the Company's information technology systems are older legacy-type systems and require an ongoing commitment of resources to maintain current standards. These legacy systems are written in older programming languages with which fewer and fewer individuals are knowledgeable of and trained in. The Company's success is in large part dependent on maintaining and enhancing the effectiveness of existing legacy systems until converting to newer technologies and failure of these systems for any reason could disrupt our operations, result in the loss of business and adversely impact our profitability.

The Company could be adversely affected by changes to tax law or interpretations of existing tax law which reduce the demand for certain insurance products.

The Internal Revenue Code (the "IRC") provides that income tax payable on investment earnings of certain life insurance and annuity products is deferred during the accumulation period of the policies/contracts giving certain of the Company's products a competitive advantage over other non-insurance products. If the IRC were amended to reduce the tax-deferred status of life insurance and annuity products, all life insurance companies, including the Company, would be adversely affected with respect to the ability to sell these products. Such changes in tax law could make the tax advantages of investing in certain life insurance and annuity products less attractive.

In addition, the Company is subject to federal corporate income taxes but benefits from certain tax provisions, including but not limited to, dividends-received deductions and insurance reserve deductions. Due to a variety of factors including the current Federal budget deficit and ongoing proposals from the U.S Department of Treasury, there is a risk that federal tax legislation could be enacted lessening or eliminating some or all of the tax advantages currently benefiting the Company and result in higher taxes. The Company cannot predict what changes to tax laws or interpretations of existing tax law that may ultimately be enacted or adopted, or whether such changes will adversely affect the Company.

The Company may be required to establish a valuation allowance against its deferred tax assets which could materially affect the Company's results of operations and financial condition.

Differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases give rise to deferred tax assets. These deferred tax assets represent future tax savings that would otherwise be paid in cash. GAAP requires that such deferred tax assets be analyzed for their future realizability which is dependent upon the generation of sufficient future taxable income with which to offset the deferred tax assets. If it is determined that all or a portion of the deferred tax assets cannot be realized, an offsetting valuation allowance must be established with a corresponding charge to net income.

The Company's current assessment of future taxable income in combination with the consideration of available tax planning opportunities has determined that it is more likely than not that it will generate sufficient taxable income to

realize its deferred tax assets. If future events deviate from the Company's current assessment, a valuation allowance may need to be established which could have a material adverse effect on the Company's results of operations and financial condition.

Competition for employees is intense and the Company may not be able to attract and retain highly skilled people needed to support its business.

The Company's success and ability to reach goals is dependent upon its ability to attract and retain qualified personnel. The market for qualified personnel is extremely competitive and the Company may not be able to hire or retain key people. The unexpected loss of services of one or more of the company's key personnel could have a material adverse effect on the Company's operations due to their skills, unique knowledge of our business, years of industry experience and the potential difficulty of quickly finding qualified replacements. Sales in our lines of business and our results of operations and financial condition could be materially adversely affected if the Company is unsuccessful in attracting and retaining qualified individuals or its recruiting and retention costs increase significantly.

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ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

The Westcap Corporation, a wholly owned subsidiary, owns the Company's principal office location in Austin, Texas and two buildings adjacent to it, totaling approximately 93,000 square feet that are leased and utilized by the Company. The Company's affiliate, Regent Care Building, LP, owns a 65,000 square foot building in Reno, Nevada, which is leased and utilized by another of the Company's affiliates, Regent Care Operations, LP, for use in its nursing home operations. The Company's subsidiary, Regent Care San Marcos A-3 LP, completed construction of a 74,000 square foot building in San Marcos, Texas in 2009 which is used in nursing home operations. Lease costs and related operating expenses for facilities of the Company's subsidiaries are currently not significant in relation to the Company's consolidated financial statements. The intercompany lease costs related to The Westcap Corporation and the nursing homes have been eliminated for consolidated reporting purposes.

ITEM 3. 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. As discussed below, 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 was a defendant in a class action lawsuit initially filed on September 17, 2004, in the Superior Court of the State of California for the County of Los Angeles. The California state court certified a class consisting of certain California policyholders age 65 and older alleging violations under California Business and Professions Code section 17200. The court additionally certified a subclass of 36 policyholders alleging fraud against their agent, and vicariously against the Company. The California Insurance Department intervened in this case asserting that the Company violated California insurance laws. The parties to this case became involved in court-ordered mediation and ongoing negotiations. On February 22, 2010, the Company reported in a Form 8-K filing a settlement agreement with the plaintiffs and plaintiff in intervention providing a settlement benefit of approximately \$17 million which was included in the Company's legal accrual provision at December 31, 2009. The settlement agreement was given final court approval at a Fairness Hearing on August 20, 2010. Including attorney's fees, policy benefits and other considerations, the Company paid out approximately \$22.4 million in the third and fourth quarters of 2010.

The Company is currently a defendant in a second class action lawsuit pending as of 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 asserts 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 Company believes that it has meritorious defenses in this cause and intends to vigorously defend itself against the asserted claims. In addition, given the speculative and

vague damage theories presented by the plaintiffs in the matter, the inability to ascertain any financial harm to the class of policyholders, and the current status of the case before the Court, the Company is unable to reasonably estimate a possible range of loss for disclosure in the accompanying financial statements. Therefore, no amounts have been provided in the financial statements of the Company as of December 31, 2011 for this matter.

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In addition to the two class action lawsuits described above, the Company is 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 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.

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.

The Company was involved in litigation as the plaintiff in a matter pending in the United States District Court for the Western District of Texas ("District Court") against defendant, Western National Life Insurance Company and its parent company, AGC Life Insurance Company. The matter dealt with the alleged infringement of registered trademarks held by the Company. On March 25, 2011, the parties executed a Memorandum of Understanding on Settlement ("Memorandum") under which the Company was to receive a settlement payment of \$4 million. This amount has been received and was included in Other revenues, net of attorney fees, in the financial statements in the second quarter, 2011. The parties entered into a final written confidential settlement agreement originally dated May 2, 2011 and amended August 15, 2011.

Brazilian insurance regulators have sought to impose substantial penal fines against National Western. The Company firmly believes that Brazilian insurance regulators have no jurisdiction over the Company and that any such fines would be unenforceable against it.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

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## PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY,  
RELATED STOCKHOLDER MATTERS AND ISSUER  
PURCHASES OF EQUITY SECURITIES

## Market Information

The principal market on which the Class A common stock of the Company trades is The NASDAQ - Stock Market<sup>®</sup> under the symbol "NWLI". The high and low sales prices for the Class A common stock for each quarter during the last two years and the cash dividends declared per common share are shown in the following table.

Class A Common Stock Data (per share)	1 <sup>st</sup> Quarter	2 <sup>nd</sup> Quarter	3 <sup>rd</sup> Quarter	4 <sup>th</sup> Quarter
2011:				
High	\$ 175.88	164.13	178.82	153.02
Low	173.00	163.00	175.99	130.00
Dividends Declared	—	—	0.36	—
2010:				
High	\$ 193.86	194.35	160.19	179.81
Low	148.79	149.10	128.06	142.80
Dividends Declared	—	—	0.36	—

There is no established public trading market for the Company's Class B common stock.

## Equity Security Holders

The number of stockholders of record on March 13, 2012 was as follows:

Class A Common Stock	3,916
Class B Common Stock	2

## Dividends

Class B common stockholders receive dividends at one-half the rate declared on Class A common stock. During 2011, the Company paid cash dividends on its Class A and Class B common stock in the amounts of \$1,236,515 and \$36,000, respectively. During 2010, the Company also paid cash dividends on its Class A and Class B common stock in the amounts of \$1,234,418 and \$36,000, respectively. Payment of dividends is within the discretion of the Company's Board of Directors. The Company's general policy is to reinvest earnings internally to finance the development of new business.

## Securities Authorized For Issuance Under Equity Compensation Plans

The Company has two equity compensation plans that were approved by security holders. Under the two plans, a total of 86,118 shares of the Company's Class A common stock may be issued upon exercise of the outstanding options at December 31, 2011. The weighted average exercise price of the outstanding options is \$187.83 per option. Excluding the outstanding options, 291,000 shares of Class A common stock remain available for future issuance under the plans



at December 31, 2011.

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## Performance Graph

The following graph compares the change in the Company's cumulative total stockholder return on its common stock with the NASDAQ - U.S. Companies Index and the NASDAQ - Insurance Stock Index. The graph assumes that the value of the Company's Class A common stock and each index was \$100 at December 31, 2006, and that all dividends were reinvested.

## Issuer Purchases of Equity Securities

Effective March 10, 2006, the Company adopted and implemented a limited stock buy-back program associated with the Company's 1995 Stock Option and Incentive Plan ("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.

Effective August 22, 2008 the Company adopted and implemented another limited stock buy-back program substantially similar to the 2006 program for shares issued under the 2008 Incentive Plan.

The following table sets forth the Company's repurchase of its Class A common shares from Option Holders for the quarter ended December 31, 2011.

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
October 1, 2011 through October 31, 2011	—	\$—	N/A	N/A
November 1, 2011 through November 30, 2011	—	—	N/A	N/A
December 1, 2011 through December 31, 2011	—	\$—	N/A	N/A
Total	—	\$—	N/A	N/A

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

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## ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA

The following five-year financial summary includes comparative amounts derived from the audited consolidated financial statements.

	Years Ended December 31,				
	2011	2010	2009	2008	2007
	(In thousands except per share amounts)				
<b>Earnings Information:</b>					
<b>Revenues:</b>					
Universal life and annuity contract charges	\$ 132,133	127,192	145,651	133,424	119,677
Traditional life and annuity contract premiums	18,078	16,565	17,043	17,752	19,513
Net investment income	391,034	401,383	393,531	273,362	318,137
Other revenues	25,439	25,377	17,348	12,769	13,683
Net realized investment gains (losses)	6,063	5,475	(5,167)	(26,228)	3,497
<b>Total revenues</b>	<b>572,747</b>	<b>575,992</b>	<b>568,406</b>	<b>411,079</b>	<b>474,507</b>
<b>Benefits and expenses:</b>					
Life and other policy benefits	46,494	52,929	48,997	39,759	41,326
Amortization of deferred policy acquisition costs	133,088	96,449	115,163	127,161	88,413
Universal life and annuity contract interest	232,788	266,603	242,816	138,960	164,391
Other operating expenses	77,541	55,448	92,192	55,630	55,130
<b>Total benefits and expenses</b>	<b>489,911</b>	<b>471,429</b>	<b>499,168</b>	<b>361,510</b>	<b>349,260</b>
Earnings before Federal income taxes	82,836	104,563	69,238	49,569	125,247
Federal income taxes	27,209	31,666	23,754	15,927	39,876
<b>Net earnings</b>	<b>\$55,627</b>	<b>72,897</b>	<b>45,484</b>	<b>33,642</b>	<b>85,371</b>
<b>Basic Earnings Per Share:</b>					
Class A	\$ 15.74	20.67	12.90	9.54	24.24
Class B	\$ 7.87	10.33	6.45	4.77	12.12
<b>Diluted Earnings Per Share:</b>					
Class A	\$ 15.73	20.61	12.87	9.48	23.95
Class B	\$ 7.87	10.33	6.45	4.77	12.12
<b>Balance Sheet Information:</b>					
Total assets	\$9,727,999	8,773,948	7,518,735	6,786,480	6,835,326

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Total liabilities	\$8,451,214	7,555,157	6,404,682	5,800,267	5,823,641
Stockholders' equity	\$1,276,785	1,218,791	1,114,053	986,213	1,011,685
Book value per common share	\$351.27	335.83	307.24	271.99	279.29

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ITEM 7. 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 financial condition and results of operations ("MD&A") of National Western Life Insurance Company for the three years ended December 31, 2011 follows. This discussion should be read in conjunction with the Company's consolidated financial statements and related notes beginning on page 69 of this report.

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
- return on investments sufficient to produce acceptable and 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 and changes in assumptions for amortization of deferred policy acquisition expenses and deferred sales inducements
- change 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

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The Company monitors these factors continually as key business indicators. The discussion that follows in this Item 7 includes these indicators and presents information useful to an overall understanding of the Company's business performance in 2011, incorporating required disclosures in accordance with the rules and regulations of the Securities and Exchange Commission.

### Impact of Recent Business Environment

Economic data has shown mixed signs of improvement and backsliding over the past several quarters generating uncertainty about the direction of the economy at least in the near term. While corporate earnings have pleasantly surprised and interest rates remain at historic lows, the specter of higher inflation continues to be concerning given the acceleration of commodity prices combined with fiscal policies that have greatly depreciated the U.S. dollar. It is also uncertain whether the financial stresses of various countries in the European community will be contained or disrupt the economic expansion in core Europe. One school of thought holds that there is a lagged effect of two years of global stimulative macroeconomic policies yet to occur. At the same time, the compromises to fix the U.S. budget deficit may not be substantial enough to avoid eventual calamity in some future year.

In summary, no one's crystal ball provides enough foresight regarding the future to confidently predict the direction that the U.S. and global economies are headed. Strong economic expansion generally benefits the Company's business. Alternatively, a tepid economic recovery consisting of higher unemployment, lower personal income, muted consumer spending and lackluster corporate earnings and business investment could adversely impact the demand for the Company's products. Household financial income compression may also cause us to experience a higher incidence of claims, lapses or surrenders of policies. It is not possible to predict with certainty whether or when such activity may occur or what impact, if any, such actions could have on the Company's business, results of operations, cash flows or financial condition.

The financial duress in 2008 and 2009 did not have an adverse affect on our annuity line of business. Annuity sales in 2009 increased 106% over the levels attained in 2008. With the green shoots of recovery emerging in 2010, we witnessed annuity sales increase 71% over those of 2009 and 2011 annuity sales approximated 2010's record level. While there may be many underlying reasons for this expansion in our annuity business, we believe that at least the following factors may explain this outcome: (1) during uncertain economic periods, consumers follow a flight to safety toward lower risk assets such as annuity products; (2) the Company's strong financial position, upgrade in financial strength rating from A.M. Best during 2009 and ample capital resources enhanced our presence in the annuity marketplace with independent distributors and end market consumers; (3) many of the Company's competitors incurred reductions in their capital base due to a deterioration in the quality of their investment portfolios, including investment impairments and losses, which caused them to curtail sales activity and recruitment of independent distribution; and (4) the uncertainty surrounding the potential regulation of fixed-indexed annuities by the SEC was eliminated when the U.S. Court of Appeals vacated the proposed regulation (Rule 151A) and Congress passed the Dodd-Frank Act which exempted annuities under the Securities Act of 1933. Despite these factors and their impact on the growth in the Company's annuity sales, it is unclear what effect ongoing economic and political challenges may have upon future business levels.

The fixed income markets, our primary investment source, have experienced an improvement in fundamental credit quality on the heels of stronger liquidity, improving corporate profitability and modest economic growth. Credit downgrades of fixed income instruments by rating agencies were fairly prevalent during 2008 and 2009. However, credit default rates declined during 2010 and conditions during 2011 remained mostly similar to those in 2010. The Company experienced minimal impairment and degradation of quality in its fixed income holdings during the financial crisis and subsequent recovery. There is no certainty that future events may produce the same success in this

regard.

The unprecedented low U. S. Treasury yields combined with tightening credit spreads (difference between bond yields and riskfree interest rates) on fixed maturity securities has produced new challenges in managing Company profitability given the resulting “compression” on interest spreads (difference between the yield on investments and the amounts required to credit on associated policy values). 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 product surrenders and withdrawals at the same time fixed debt securities held by insurers declined in market value. The federal government's burgeoning deficit and initial “quantitative easing” initiatives served to put upward pressure on longer term interest rates. The more recent initiatives announced by the Federal Reserve, referred to as "Operation Twist", have targeted longer term yields in the hopes that lowering this end of the yield curve may prompt economic expansion particularly in the moribund housing sector. 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.

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Our operating strategy continues to be to maintain 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.

### Critical Accounting Policies

Accounting policies discussed below are those considered critical to an understanding of the Company's financial statements.

**Impairment of Investment Securities.** The Company's accounting policy requires that a decline in the value of a security below its amortized cost basis be evaluated to determine if the decline is other-than-temporary. The primary factors considered in evaluating whether a decline in value for fixed income and equity securities is other-than-temporary include: (a) the length of time and the extent to which the fair value has been less than cost, (b) the reasons for the decline in value (credit event, interest rate related, credit spread widening), (c) the overall financial condition as well as the near-term prospects of the issuer, (d) whether the debtor is current on contractually obligated principal and interest payments, and (e) the Company does not intend to sell the investment prior to recovery. In addition, certain securitized financial assets with contractual cash flows are evaluated periodically by the Company to update the estimated cash flows over the life of the security. If the Company determines that the fair value of the securitized financial asset is less than its carrying amount and there has been a decrease in the present value of the estimated cash flows since the previous purchase or prior impairment, then an other-than-temporary impairment charge is recognized. The Company would recognize impairment of securities due to changing interest rates or market dislocations only if the Company intended to sell the securities prior to recovery. When a security is deemed to be impaired a charge is recorded equal to the difference between the fair value and amortized cost basis of the security. In compliance with GAAP guidance the estimated credit versus the non-credit components are bifurcated, and the non-credit component is reclassified as unrealized losses in other comprehensive income. Once an impairment charge has been recorded, the fair value of the impaired investment becomes its new cost basis and the Company continues to review the other-than-temporarily impaired security for appropriate valuation on an ongoing basis. However, the new cost basis of an impaired security is not adjusted for subsequent increases in estimated fair value.

**Deferred Policy Acquisition Costs ("DPAC").** The Company is required to defer certain policy acquisition costs and amortize them over future periods. These costs include commissions and certain other expenses that vary with and are primarily associated with acquiring new business. The deferred costs are recorded as an asset commonly referred to as deferred policy acquisition costs. The DPAC asset balance is subsequently charged to income over the lives of the underlying contracts in relation to the anticipated emergence of revenue or profits. Actual revenue or profits can vary from Company estimates resulting in increases or decreases in the rate of amortization. The Company performs regular evaluations of its universal life and annuity contracts to determine if actual experience or other evidence suggests that earlier estimates should be revised. Assumptions considered significant include surrender and lapse rates, mortality, expense levels, investment performance, and estimated interest spread. Should actual experience dictate that the Company change its assumptions regarding the emergence of future revenues or profits (commonly referred to as "unlocking"), the Company would record a charge or credit to bring its DPAC balance to the level it would have been if using the new assumptions from the inception date of each policy.

DPAC is also subject to periodic recoverability and loss recognition testing. These tests ensure that the present value of future contract-related cash flows will support the capitalized DPAC balance to be amortized in the future. The present value of these cash flows, less the benefit reserve, is compared with the unamortized DPAC balance and if the DPAC balance is greater, the deficiency is charged to expense as a component of amortization and the asset balance is reduced to the recoverable amount. For more information about accounting for DPAC see Note 1, Summary of

Significant Accounting Policies, in the Notes to Consolidated Financial Statements.

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**Deferred Sales Inducements.** Costs related to sales inducements offered on sales to new customers, principally on investment type contracts and primarily in the form of additional credits to the customer's account value or enhancements to interest credited for a specified period, which are beyond amounts currently being credited to existing contracts, are deferred and recorded as other assets. All other sales inducements are expensed as incurred and included in interest credited to contract holders' funds. Deferred sales inducements are amortized to income using the same methodology and assumptions as DPAC, and are included in interest credited to contract holders' funds. Deferred sales inducements are periodically reviewed for recoverability. For more information about accounting for DPAC see Note 1, Summary of Significant Accounting Policies, in the Notes to Consolidated Financial Statements.

**Future Policy Benefits.** Because of the long-term nature of insurance contracts, the Company is liable for policy benefit payments many years into the future. The liability for future policy benefits represents estimates of the present value of the Company's expected benefit payments, net of the related present value of future net premium collections. For traditional life insurance contracts, this is determined by standard actuarial procedures, using assumptions as to mortality (life expectancy), morbidity (health expectancy), persistency, and interest rates, which are based on the Company's experience with similar products. The assumptions used are those considered to be appropriate at the time the policies are issued. An additional provision is made on most products to allow for possible adverse deviation from the assumptions assumed. For universal life and annuity products, the Company's liability is the amount of the contract's account balance. Account balances are also subject to minimum liability calculations as a result of minimum guaranteed interest rates in the policies. While management and Company actuaries have used their best judgment in determining the assumptions and in calculating the liability for future policy benefits, there is no assurance that the estimate of the liabilities reflected in the financial statements represents the Company's ultimate obligation. In addition, significantly different assumptions could result in materially different reported amounts. A discussion of the assumptions used to calculate the liability for future policy benefits is reported in Note 1, Summary of Significant Accounting Policies, in the Notes to Consolidated Financial Statements.

**Revenue Recognition.** Premium income for the Company's traditional life insurance contracts is generally recognized as the premium becomes due from policyholders. For annuity and universal life contracts, the amounts collected from policyholders are considered deposits and are not included in revenue. For these contracts, fee income consists of policy charges for policy administration, cost of insurance charges and surrender charges assessed against policyholders' account balances which are recognized in the period the services are provided.

Investment activities of the Company are integral to its insurance operations. Since life insurance benefits may not be paid until many years into the future, the accumulation of cash flows from premium receipts are invested with income reported as revenue when earned. Anticipated yields on investments are reflected in premium rates, contract liabilities, and other product contract features. These anticipated yields are implied in the interest required on the Company's net insurance liabilities (future policy benefits less deferred acquisition costs) and contractual interest obligations in its insurance and annuity products. The Company benefits to the extent actual net investment income exceeds the required interest on net insurance liabilities and manages the rates it credits on its products to maintain the targeted excess or "spread" of investment earnings over interest credited. The Company will continue to be required to provide for future contractual obligations in the event of a decline in investment yield. For more information concerning revenue recognition, investment accounting, and interest sensitivity, please refer to Note 1, Summary of Significant Accounting Policies, Note 3, Investments, in the Notes to Consolidated Financial Statements, and the discussions under Investments in Item 7 of this report.

**Pension Plans and Other Postretirement Benefits.** The Company sponsors a qualified defined benefit pension plan, which was frozen effective December 31, 2007, covering substantially all employees, and three nonqualified defined benefit plans covering certain senior officers. In addition, the Company has postretirement health care benefits for

certain senior officers. The freeze of the qualified benefit pension plan 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. In accordance with prescribed accounting standards, the Company annually reviews plan assumptions.

The Company annually reviews its pension benefit plans' assumptions which include the discount rate, the expected long-term rate of return on plan assets, and the compensation increase rate. The assumed discount rate is set based on the rates of return on high quality long-term fixed income investments currently available and expected to be available during the period to maturity of the pension benefits. The assumed long-term rate of return on plan assets is generally set at the rate expected to be earned based on the long-term investment policy of the plans, the various classes of the invested funds, input of the plan's investment advisors and consulting actuary, and the plan's historic rate of return. The compensation rate increase assumption is generally set at a rate consistent with current and expected long-term compensation and salary policy, including inflation. These assumptions involve uncertainties and judgment, and therefore actual performance may not be reflective of the assumptions.

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Other postretirement benefit assumptions include future events affecting retirement age, mortality, dependency status, per capita claims costs by age, health care trend rates, and discount rates. Per capita claims cost by age is the current cost of providing postretirement health care benefits for one year at each age from the youngest age to the oldest age at which plan participants are expected to receive benefits under the plan. Health care trend rates involve assumptions about the annual rate(s) of change in the cost of health care benefits currently provided by the plan, due to factors other than changes in the composition of the plan population by age and dependency status. These rates implicitly consider estimates of health care inflation, changes in utilization, technological advances, and changes in health status of the participants.

Share-Based Payments. Liability awards under a share-based payment arrangement have been measured based on the awards' fair value at the reporting date. The Black-Scholes valuation method is used to estimate the fair value of the options. This fair value calculation of the options includes assumptions relative to the following:

- exercise price
- expected term based on contractual term and perceived future behavior relative to exercise
- current price
- expected volatility
- risk-free interest rates
- expected dividends

These assumptions are continually reviewed by the Company and adjustments may be made based upon current facts and circumstances.

Other significant accounting policies, although not involving the same level of measurement uncertainties as those discussed above, but nonetheless important to an understanding of the financial statements, are described in Note 1, Summary of Significant Accounting Policies, in the Notes to Consolidated Financial Statements.

## RESULTS OF OPERATIONS

The Company's 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 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 consolidated financial statements.

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## Consolidated Operations

Revenues. The following details Company revenues:

	Years Ended December 31,		
	2011	2010	2009
	(In thousands)		
Universal life and annuity contract charges	\$ 132,133	127,192	145,651
Traditional life and annuity premiums	18,078	16,565	17,043
Net investment income (excluding derivatives)	424,369	384,771	348,186
Other revenues	25,439	25,377	17,348
Operating revenues	600,019	553,905	528,228
Derivative gain (loss)	(33,335	) 16,612	45,345
Net realized investment gains (losses)	6,063	5,475	(5,167
			)
Total revenues	\$572,747	575,992	568,406

Universal life and annuity contract revenues - Revenues for universal life and annuity contract charges increased 4% in 2011 compared to 2010 primarily due to higher cost of insurance and administrative charges resulting from growth in the amount of business in force. 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 depicted in the following table.

Contract Charges:	Years Ended December 31,		
	2011	2010	2009
	(In thousands)		
Cost of insurance and administrative charges	\$ 117,179	110,864	109,259
Surrender charges	31,368	35,897	50,000
Other charges	1,676	32	4,578
Gross contract revenues	150,223	146,793	163,837
Reinsurance premiums	(18,090	) (19,021	) (18,186
			)
Net contract charges	\$ 132,133	127,772	145,651

Cost of insurance charges were \$90.3 million in 2011 compared to \$86.4 million in 2010 and \$83.6 million in 2009. Cost of insurance charges typically trend with the size of the life insurance block in force. The increasing revenue from cost of insurance charges corresponds with the growth in life insurance in force primarily from international sales. At December 31, 2011 the volume of life insurance in force increased to \$20.9 billion from \$19.7 billion as of the end of 2010. Administrative charges were \$26.9 million, \$24.5 million and \$25.4 million for the years ended December 31, 2011, 2010 and 2009, respectively, and correlate with new life insurance business sales both in number of policies placed as well as the volume of insurance issued. Surrender charges assessed against policyholder account balances upon withdrawal were \$31.4 million in 2011 compared to \$35.9 million in 2010 and \$50.0 million in 2009. 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 and additional contract revenues are realized and the Company

continues to make an interest rate spread equivalent to the difference it earns on its investment and the amounts that it credits to policyholders.

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Traditional life and annuity premiums - Traditional life and annuity premiums increased 9.1% in 2011 compared to 2010. 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. However, the 2008 to 2009 financial crisis generated renewed interest in the Company's term life insurance products particularly with residents outside of the United States.

Net investment income (with and without derivatives) - A detail of net investment income is provided below.

	Years Ended December 31,		
	2011	2010	2009
	(In thousands)		
Gross investment income:			
Debt securities	\$400,431	\$363,483	332,207
Mortgage loans	12,123	9,191	6,346
Policy loans	5,143	5,352	5,901
Short-term investments	273	631	116
Other invested assets	7,438	8,494	6,982
Total investment income	425,408	387,151	351,552
Less: investment expenses	1,039	2,380	3,366
Net investment income (excluding derivatives)	424,369	384,771	348,186
Derivative gain (loss)	(33,335	) 16,612	45,345
Net investment income	\$391,034	401,383	393,531

Debt securities generated approximately 94.1% of total investment income, excluding derivative gains and losses, in 2011. The Company's strategy is to invest substantially all of its cash flows in fixed debt securities consistent with its guidelines for credit quality, duration, and diversification. In the wake of two record years in annuity sales, the Company experienced substantial cash flow for investing in debt securities which caused the portfolio to grow from \$6.2 billion at December 31, 2009 to \$7.4 billion at December 31, 2010 and to nearly \$8.2 billion at December 31, 2011. Despite the growth in the debt security portfolio, lower interest rate levels prevailed during 2011 and 2010, as evidenced by long-term U.S. Treasury rates, which combined with tightening spreads of corporate securities over U.S. Treasury rate levels resulted in lower yields on new investment purchases. The yield on debt security purchases to fund insurance operations declined to 4.18% in 2011 and 4.45% in 2010 from 5.92% in 2009.

Although there was more activity in mortgage loan lending in 2011 and 2010, the Company's new mortgage loan activity has been relatively low by historical standards given the low level of rates and the higher level of risk associated with commercial properties in the current economic environment. Policy loan and other invested asset balances outstanding have remained relatively stable over the past few years.





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In order to assess 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:

	Years Ended December 31,		
	2011	2010	2009
	(In thousands except percentages)		
Excluding derivatives:			
Net investment income	\$424,369	384,771	348,186
Average invested assets, at amortized cost	\$7,959,868	6,899,013	5,955,824
Yield on average invested assets	5.33	% 5.58	% 5.85
Including derivatives:			
Net investment income	\$391,034	401,383	393,531
Average invested assets, at amortized cost	\$8,032,099	6,975,806	5,984,069
Yield on average invested assets	4.87	% 5.75	% 6.58

The decline in average invested asset yield, excluding derivatives, from 2009 to 2010 and to 2011 is due to the Company obtaining lower yields on newly invested cash inflows. As described above, the Company invests substantially most of its net cash flows in debt securities whose yields have declined during this period. The pattern in average invested asset yield, including derivatives, incorporates increases and decreases in the fair value of index options purchased by the Company to support its fixed-indexed products. Fair values of the purchased call options increased markedly in 2009 due to the recovery in the equity markets. However fair values of options purchased the past two years have generally experienced unrealized losses due to intermittent declines in the S&P 500 Index during this period. Refer to the derivatives discussion following this section for a more detailed explanation.

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 \$21.8 million, \$22.9 million and \$15.7 million in 2011, 2010 and 2009, respectively. The San Marcos nursing home began operations during the middle of calendar year 2009 contributing to the revenue growth incurred from 2009 to 2010. Other revenues in 2011 also includes \$2.9 million received as net settlement of a lawsuit in which the Company was plaintiff. Other revenues also includes \$0.2 million and \$1.5 million received during 2011 and 2010, respectively, in relation to investment security lawsuit settlements.

Derivative gain (loss) - Index options are derivative financial instruments used to hedge the equity return component of the Company's fixed-indexed 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 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 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-indexed products also fluctuates in a similar manner and direction. In 2011, the Company incurred unrealized

losses on unexpired options in excess of the realized gains on expiring options thus resulting in an overall derivative loss for the period. In 2010 and 2009, the reference indices increased and the Company recorded an overall gain from index option with a corresponding increase in contract interest expenses.

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The table below summarizes the derivative gain (loss) amounts and total contract interest by year.

	Years Ended December 31,		
	2011	2010	2009
	(In thousands)		
Derivatives:			
Unrealized gain (loss)	\$(61,284	) (22,167	) 93,085
Realized gain (loss)	27,949	38,779	(47,740
			)
Total gain (loss) included in net investment income	\$(33,335	) 16,612	45,345
Total contract interest	\$232,788	266,603	242,816

Net realized investment gains (losses) - Realized gains (losses) on investments include impairment write-downs on real estate and investments in debt securities as well as valuation allowances recorded on mortgage loans. The net investment gains reported in 2011 consisted of gross gains of \$7.7 million, primarily from calls and sales of debt securities, offset by gross losses of \$1.7 million, which include other-than-temporary impairment losses.

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 consolidated statement of earnings while non-credit impairment losses are included in other comprehensive income (loss). Impairment and valuation write-downs reflected in the consolidated statements of earnings are summarized in the following table.

	Years Ended December 31,		
	2011	2010	2009
	(In thousands)		
Impairment or valuation write-downs:			
Debt securities	\$125	670	5,105
Equities	14	59	416
Mortgage loans	609	387	1,461
Real estate	(366	) 178	—
Total	\$382	1,294	6,982

Debt security impairments in 2011 primarily include write-downs on asset-backed securities whose cash flows and fair values did not support the amortized cost basis at which the instruments were recorded in the financial statements. Debt security impairments in 2010 and 2009 included similar impairment write-downs on certain asset-backed securities in addition to impairment losses on several corporate debt securities.

Equity impairments represent mark-to-market write-downs on various equity holdings. Since the Company's equity holdings are immaterial individually and in the aggregate, its administrative practice is to impair equity security holdings when market value declines are more than 50% below cost basis.

The mortgage loan valuation write-down in 2010 principally involves a New Orleans, Louisiana property whose value was negatively impacted by Hurricane Katrina. The write-down reflects an adjustment to a newly provided appraisal

of the property. The mortgage loan valuation write-down in 2009 relates to a property located in Steubenville, Ohio. The Company accepted a deed in lieu of foreclosure on this property during 2010 and converted the loan to foreclosed real estate as of December 31, 2010. The real estate valuation write-down principally pertains to property located in Fort Smith, Arkansas. The Company had a letter of intent to sell the property at December 31, 2010 and adjusted the carrying value associated with the offer. The Company subsequently sold the property in January 2011.

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Benefits and Expenses. The following details benefits and expenses.

	Years Ended December 31,		
	2011	2010	2009
	(In thousands)		
Life and other policy benefits	\$46,494	52,929	48,997
Amortization of deferred policy acquisition costs	133,088	96,449	115,163
Universal life and annuity contract interest	232,788	266,603	242,816
Other operating expenses	77,541	55,448	92,192
Totals	\$489,911	471,429	499,168

Life and other policy benefits - Life and other policy benefits include death claims of \$29.8 million, \$32.9 million and \$30.2 million for 2011, 2010 and 2009, respectively. While death claim amounts are subject to variation from period to period, the Company's mortality experience has generally been consistent with or better than its product pricing assumptions. In January 2010, the country of Haiti, where the Company is licensed to sell its products, sustained a severe earthquake in its major city of Port-au-Prince. Death claims received by the Company as a result of this incident approximated \$3.1 million after reinsurance and are included in life and other policy benefits for 2010.

The Company has been implementing new actuarial reserving systems the past several years that will enhance its ability to provide estimates used in establishing future policy liabilities, monitor the deferred acquisition costs and deferred sales inducement assets as well as support other actuarial processes within the Company. The Company has been installing a vendor software product for use in calculating the GAAP reserve liability for future policy benefits of its products. The vendor system provides actuarial formula calculations producing refined estimates of reserves in accordance with GAAP. The previous reserving system produced estimated liabilities on state regulated actuarial formulas which were supplemented with adjustments in order to produce GAAP reserve estimates. The Company elected to purchase and install the new reserving system as growth in its lines of businesses created a need for more refined and controlled actuarial reserve computations in accordance with GAAP. The implementation of these new reserving systems for specific blocks of business began in the second quarter of 2009 and the final blocks of business were completed in the fourth quarter of 2011. As the Company applied these new systems to a line of business, current reserving assumptions were reviewed and updated as appropriate.

During the year ended December 31, 2009, loss recognition testing was performed on certain products that were converted to the new reserving system leading to an unlocking of historical assumptions which resulted in an increase of \$11.6 million in reserves and policy benefit expenses. Specifically, the Company unlocked assumptions for discount interest rates which accounted for \$7.8 million of the increase as well as mortality assumptions which accounted for the remaining \$3.8 million.

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 and sales inducements. The Company defers sales inducements in the form of first year interest bonuses on annuity and universal life products that are directly related to the production of new business. These 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. Recognition of these deferred policy acquisition costs ("DPAC") as an expense in the 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 profit patterns 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 as 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, unearned revenue liabilities, and deferred sales inducement assets upon internal replacement of certain contracts as well as annuitizations of deferred annuities.

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The following table identifies the effects of unlocking and true-up adjustments on DPAC balances recorded through amortization expense for 2011, 2010 and 2009.

Increase (Decrease) in DPAC Balance	Years Ended December 31,		
	2011	2010	2009
	(In thousands)		
Unlocking	\$(9,143	) (2,700	) (5,243
True-up	(8,740	) (4,117	) (8,432
Totals	\$(17,883	) (6,817	) (13,675

As noted previously in the discussion of the Company's net investment income, investment yields have been declining precipitously the past several years in tandem with intervention by the Federal Reserve and its policies to aid the economy in recovering from the financial crisis of 2008-2009. These policies have depressed interest rate levels to historical lows. In the fourth quarter of 2011, the Federal Reserve announced it's intention to maintain interest rates at current levels for at least the next couple of years in order to promote further economic recovery. As a result of this announced intention, the Company reevaluated it's assumptions concerning future investment portfolio yield rates and concluded that an unlocking of assumptions was required to incorporate the anticipated lowering of investment yields and its impact upon future investment spreads and profitability. The unlocking adjustment increased DPAC amortization expense by \$9.1 million and reduced DPAC asset balances for deferred annuities and universal life by a like amount.

During 2010 a correction was made to a surrender charge assumption for future years on one deferred annuity product line. This change resulted in an unlocking adjustment that increased the current period's DPAC amortization expense (decreased DPAC balance) by \$2.7 million. As the amount of the correction was determined to have occurred over the course of multiple previously reported periods, it was concluded that the amount of the correction was immaterial to the financial results reported in any of these periods, as well as the current period.

An unlocking adjustment was recorded in 2009 which resulted in an increase to amortization expense of \$5.2 million. This unlocking adjustment was based upon changes to future mortality assumptions reflecting current experience studies and assumption changes regarding the level of future policy maintenance expenses. Mortality experience is monitored regularly and future mortality assumptions are unlocked when a continued trend in actual mortality experience deviates from current assumptions and is expected to continue. Although not a prediction of future impact, prior period mortality assumption unlocking experience of the Company has resulted in changes of the DPAC balance between \$2.0 million and \$(7.5) million in the period of the unlocking. Policy maintenance expenses are also reviewed regularly and future assumptions are unlocked when a continued trend in the actual policy maintenance expense deviates from the current assumptions. Although not a prediction of the impact of future changes in policy maintenance expense assumptions, similar unlocking of maintenance expense assumptions could result in DPAC balance changes between \$1.5 million and \$4.5 million.

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.





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True-up adjustments are recorded quarterly and the adjustments in 2011, 2010 and 2009 relate to changes in expense ratios, partial surrender rates, mortality rates, credited interest rates and earned rates for the current year's experience. The true-up adjustments by line of business were as shown in the following table.

True-up Adjustments	Years Ended December 31,			
	2011	2010	2009	
	(In thousands)			
Annuities	\$(7,777	) (6,454	) (5,056	)
International life	(582	) 2,910	(1,530	)
Domestic life	(381	) (573	) (1,846	)
Totals	\$(8,740	) (4,117	) (8,432	)

With the growth in the Company's annuity block of business over the past few years, the dollar amount of true-up adjustments for this line are larger on a nominal basis.

Universal life and annuity contract interest - The Company closely monitors 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 described above. The difference between yields earned on investments over policy credited rates is often referred to as the "interest spread".

The Company's approximated average credited rates, excluding and including equity-indexed products, were as follows:

	December 31,			December 31,			
	2011	2010	2009	2011	2010	2009	
	(Excluding equity-indexed products)			(Including equity-indexed products)			
Annuity	4.23	% 3.23	% 2.83	% 3.99	% 3.93	% 4.11	%
Interest sensitive life	3.17	% 4.01	% 3.80	% 5.04	% 5.25	% 6.83	%

Contract interest including equity-indexed products also encompasses the performance of the derivative component of the Company's equity-indexed products. As previously noted, the market performance of these derivative features resulted in net realized and unrealized loss of \$33.3 million in 2011 and net realized and unrealized gains of \$16.6 million and \$45.3 million in 2010 and 2009, respectively.

In the fourth quarter of 2011, the Company evaluated its excess benefit reserve calculations for a closed block of two-tier annuity contracts using the computational tools available with the upgraded reserving system discussed above. Changes in estimates for the block of business were implemented extending the benefit period and changing annuitization assumptions. As a result of these estimate changes, the Company recorded an additional contract reserve liability of \$19.2 million which is included in contract interest for the year ended December 31, 2011.

Contract interest in 2010 also includes \$16.7 million of policy credits added in conjunction with the settlement of a class action lawsuit. See additional comments in "Other Operating Expenses" below.

Other operating expenses - The levels of operating expenses shown for the three years in the table above vary due to the accounting for a lawsuit in 2009 and 2010. As discussed in Item 3. Legal Proceedings, during 2009 the Company recorded additional operating expense of \$22.4 million related to an accrual for pending legal matters involving a class action lawsuit. At the time of the accrual, the characteristics of an ultimate payout amount could not be determined. During 2010, the Company settled the lawsuit which defined the components of the settlement amount between policyholder benefits and operating expenses. This resulted in the Company decreasing operating expense by \$16.7 million and reclassifying the amount as annuity contract interest. As the amount had been entirely accrued, there was no net effect on pretax earnings but it did produce a reduction in other operating expense in the 2010 results.

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Other operating expenses consist of general administrative expenses, licenses and fees, commissions not subject to deferral, nursing home expenses and compensation costs. These are summarized in the table that follows.

	Years Ended December 31,		
	2011	2010	2009
	(In thousands)		
General insurance expense	\$21,282	4,694	45,758
Nursing home expenses	21,046	20,056	14,946
Compensation expense	19,285	20,210	21,442
Commission expense	11,279	6,781	6,395
Taxes, licenses and fees	4,649	3,707	3,651
Totals	\$77,541	55,448	92,192

In addition to legal expense activity, general insurance expense includes amortization expense associated with capitalized system costs. The Company has been involved in major information system initiatives to enhance actuarial, accounting, policy acquisition, and policy administration processes. Costs related to these systems are capitalized during the development process and then amortized once they are placed into service and used in operations. Amortization expense in association with these system implementations was \$3.3 million, \$2.6 million, and \$2.1 million in 2011, 2010, and 2009, respectively. The increasing trend in amortization expense is attributable to additional functionality being placed into operation during the period.

Nursing home expenses include the Company's two facilities in Reno, Nevada and San Marcos, Texas. The increase in nursing home expense between 2009 and 2010 reflects the commencement of operations for the San Marcos facility during the second quarter of 2009.

Compensation expense includes share based compensation costs for the Company's stock option plans related to outstanding vested and unvested stock options. As these costs vary in tandem with the Company's Class A common share price as a result of marking the stock options to fair value under the liability method of accounting, the related expense amount could be positive or negative in any given period. For the three years shown, share based compensation expense totaled \$(2.6) million in 2011, \$(0.1) million in 2010 and \$1.6 million in 2009. The fluctuation in expense reflects the market price decline in the Company's Class A common stock as of the reporting dates.

## Segment Operations

## Summary of Segment Earnings

A summary of segment earnings from continuing operations for the years ended December 31, 2011, 2010 and 2009 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 (loss):					
2011	\$460	17,674	20,253	13,299	51,686

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2010	(912	) 21,722	34,316	14,212	69,338
2009	426	14,663	25,460	8,294	48,843

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## Domestic Life Insurance Operations

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

	Years Ended December 31,		
	2011	2010	2009
	(In thousands)		
Premiums and other revenue:			
Premiums and contract charges	\$30,387	27,622	34,414
Net investment income	16,980	17,226	19,498
Other revenues	69	167	25
Total premiums and other revenue	47,436	45,015	53,937
Benefits and expenses:			
Life and other policy benefits	11,636	13,484	13,884
Amortization of deferred policy acquisition costs	11,467	9,352	16,423
Universal life insurance contract interest	9,760	10,643	9,014
Other operating expenses	13,890	12,839	13,968
Total benefits and expenses	46,753	46,318	53,289
Segment earnings (loss) before Federal income taxes	683	(1,303)	) 648
Federal income taxes (benefit)	223	(391)	) 222
Segment earnings (loss)	\$460	(912)	) 426

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.

	Years Ended December 31,		
	2011	2010	2009
	(In thousands)		
Universal life insurance revenues	\$29,607	26,787	32,993
Traditional life insurance premiums	5,509	5,960	6,378
Reinsurance premiums	(4,729)	) (5,125)	) (4,957)
Totals	\$30,387	27,622	34,414

The Company's domestic life insurance in force has been declining since 2008 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 six-to-one rate over the three years shown. The number of domestic life insurance policies has

declined from 69,700 at December 31, 2009 to 66,000 at December 31, 2010 and to 62,900 at December 31, 2011.

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As noted above, universal life insurance revenues include surrender charge fees assessed upon surrender of life insurance contracts. The higher level of universal life insurance revenues during 2009 is partially due to a higher level of surrender charge fees assessed. During the latter part of 2008, the Company's internal checking and monitoring procedures detected potential instances of rebating in certain geographic markets and instituted commission caps and other preventive procedures to discourage this practice. Although not illegal in these markets, the practice of rebating is particularly prone to large face amount policies not renewing premium payments beyond the initial year of the policy. The level of 2009 surrender charge fee revenues reflects some of this activity. The level of life insurance volume lapsed at a rate in excess of 18% during 2009. However, this rate declined to 11.2% in 2010 and further to 7.1% in 2011.

Premiums collected on universal life products are not reflected as revenues in the Company's consolidated statements of earnings in accordance with GAAP. Actual domestic universal life premiums are detailed below.

	Years Ended December 31,		
	2011	2010	2009
	(In thousands)		
Universal life insurance:			
First year and single premiums	\$27,571	11,672	13,640
Renewal premiums	19,643	21,025	21,978
Totals	\$47,214	32,697	35,618

The Company's efforts over the past several years have been to attract new independent agents and to promote life products to improve domestic life sales. During 2011, the Company achieved some success in this regard with the number of new policies issued increasing 76% over the prior year, reversing a multi-year trend of declining activity. Sales the past two years have been substantially weighted toward single premium policies which do not have recurring premium payments.

Net investment income for this segment of business has been decreasing due to a lower level of investments needed to support active policies as a result of the decline in insurance in force. In addition, lower investment yields attained from debt security investment purchases has contributed to a lower level of investment income. The increase in policies issued during 2011 has served to arrest this declining trend after factoring out the gains and losses on index options purchased to back the obligations associated with equity-indexed universal life policies. A detail of net investment income for domestic life insurance operations is provided below.

	Years Ended December 31,		
	2011	2010	2009
	(In thousands)		
Net investment income (excluding derivatives)	\$17,126	16,827	18,117
Derivative gain (loss)	(146)	) 389	1,381
Net investment income	\$16,980	17,216	19,498



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As noted previously in the discussion of results from consolidated 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 for 2009, 2010 and 2011.

	Years Ended December 31,		
	2011	2010	2009
	(In thousands)		
Increase (Decrease) in DPAC Balance			
Unlocking	\$(1,542	) —	(2,709
True-up	(381	) (573	) (1,846
Totals	\$(1,923	) (573	) (4,555

The unlocking adjustment in 2011 came about as the Company reevaluated its assumptions concerning future investment portfolio yield rates and concluded that an unlocking of assumptions was required to incorporate the anticipated lowering of investment yields and its impact upon future investment spreads and profitability. The unlocking adjustment in 2009 was made to adjust future assumptions concerning per policy maintenance expenses and mortality and accordingly increased DPAC amortization expense by \$2.7 million during the period.

## International Life Insurance Operations

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

	Years Ended December 31,		
	2011	2010	2009
	(In thousands)		
Premiums and other revenue:			
Premiums and contract charges	\$98,021	98,092	104,016
Net investment income	36,806	38,667	44,540
Other revenues	354	358	68
Total premiums and other revenue	135,181	137,117	148,624
Benefits and expenses:			
Life and other policy benefits	20,709	29,228	19,522
Amortization of deferred policy acquisition costs	29,415	21,828	41,849
Universal life insurance contract interest	36,674	36,369	45,868
Other operating expenses	22,131	18,651	19,048
Total benefits and expenses	108,929	106,076	126,287
Segment earnings before Federal income taxes	26,252	31,041	22,337

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Federal income taxes	8,578	9,319	7,674
Segment earnings	\$17,674	21,722	14,663

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

	Years Ended December 31,		
	2011	2010	2009
	(In thousands)		
Universal life insurance revenues	\$98,813	101,390	106,601
Traditional life insurance premiums	15,132	13,454	13,113
Reinsurance premiums	(15,924 )	(16,752 )	(15,698 )
Totals	\$98,021	98,092	104,016

The Company's international life operations have been a significant factor in the Company's overall earnings performance and represent a market niche where the Company believes it has a competitive advantage. A productive distribution force of independent broker agents and consultants 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. In general, universal life revenues and operating earnings are anticipated to emerge with the amount of international life insurance in force. Over the past three years, the volume of insurance in force has grown from \$16.2 billion at December 31, 2009 to \$17.3 billion at December 31, 2010 and over \$18.6 billion at December 31, 2011.

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 in force. During 2009, the Company incurred higher termination experience than is typical which resulted in recognition of increased surrender charge fee income. However, this level of termination activity has subsided over the past two years. The following table illustrates the Company's international life termination experience over the past five years.

Volume In Force Terminations	Amount in \$'s (millions)	Annualized Termination Rate	
			%
Year ended December 31, 2011	\$1,465.1	7.3	%
Year ended December 31, 2010	1,721.8	9.0	%
Year ended December 31, 2009	2,423.2	13.0	%
Year ended December 31, 2008	1,923.2	10.8	%
Year ended December 31, 2007	1,674.3	10.2	%

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

Years Ended December 31,		
2011	2010	2009

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(In thousands)

Universal life insurance			
First year and single premiums	\$38,240	36,628	35,147
Renewal premiums	117,391	110,358	102,403
Totals	\$155,631	146,986	137,550

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The Company's most popular international products have been its fixed-indexed universal life products in which policyholders 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 related premiums of \$98.1 million, \$90.2 million and \$81.9 million for the years ended 2011, 2010 and 2009, respectively, associated with these fixed-indexed products.

To support the index crediting rate feature on its fixed-indexed universal life products the Company purchases S&P 500 Index<sup>®</sup> call options. With the growth in the block of business of these policies, the period-to-period changes in fair values of the underlying options used to hedge this interest crediting feature 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.

	Years Ended December 31,		
	2011	2010	2009
	(In thousands)		
Net investment income (excluding derivatives)	\$39,528	36,205	34,130
Derivative gain (loss)	(2,722	) 2,462	10,410
Net investment income	\$36,806	38,667	44,540

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, 2011, the average face amount of insurance purchased was approximately \$364,000, an increase of approximately 6% over the previous year. Life and policy benefit expense for the international life segment reflects the larger policies purchased. In addition, the expense shown for 2010 includes death claims of approximately \$3.1 million, after reinsurance, associated with the Haiti earthquake in January 2010.

As noted previously, 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 2011, 2010 and 2009.

	Years Ended December 31,		
	2011	2010	2009
	(In thousands)		
Increase (Decrease) in DPAC Balance			
Unlocking	\$(1,926	) —	(2,535
True-up	(582	) 2,910	(1,530
Totals	\$(2,508	) 2,910	(4,065

Similar to domestic life results, the unlocking adjustment in 2011 came about as the Company reevaluated its assumptions concerning future investment portfolio yield rates and concluded that an unlocking of assumptions was required to incorporate the anticipated lowering of investment yields and its impact upon future investment spreads and profitability. In 2009, the Company recorded an unlocking adjustment of \$2.5 million relative to changes in

projected universal life per policy maintenance expenses and projected mortality assumptions that reduced the DPAC asset and increased amortization expense.

As indicated in the discussion concerning net investment income, contract interest expense includes fluctuations that are the result of underlying equity indices performance associated with fixed-indexed universal life products. The derivative gain (loss) realized on purchased call options is included in the amounts the Company credits to policyholders. For more details about the Company's use of index options to hedge the performance of equity indices refer to the derivative gain (loss) discussion in the Consolidated Operations section of Item 7.

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## Annuity Operations

The Company's annuity operations are almost exclusively in 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.

	Years Ended December 31,		
	2011	2010	2009
	(In thousands)		
Premiums and other revenue:			
Premiums and contract charges	\$21,803	18,043	24,264
Net investment income	318,294	327,975	317,703
Other revenues	3,170	2,002	1,535
Total premiums and other revenue	343,267	348,020	343,502
Benefits and expenses:			
Life and other policy benefits	14,149	10,217	15,666
Amortization of deferred policy acquisition costs	92,206	65,269	56,891
Annuity contract interest	186,354	219,591	187,934
Other operating expenses	20,474	3,905	44,227
Total benefits and expenses	313,183	298,982	304,718
Segment earnings before Federal income taxes	30,084	49,038	38,784
Federal income taxes	9,831	14,722	13,324
Segment earnings	\$20,253	34,316	25,460

Premiums and contract charges primarily include surrender charge income with lesser amounts for recognition of deferred revenues relating to immediate or payout annuities.

Deposits collected on annuity contracts are not reflected as revenues in the Company's consolidated statements of earnings in accordance with GAAP. Actual annuity deposits collected are detailed below.

	Years Ended December 31,		
	2011	2010	2009
	(In thousands)		
Fixed-indexed annuities	\$902,613	900,301	488,352
Other deferred annuities	458,692	510,332	325,959
Immediate annuities	29,685	20,378	23,266
Totals	\$1,390,990	1,431,011	837,577





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Fixed-indexed 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-indexed products provide an important alternative to the Company's existing fixed interest rate annuity products. Fixed-indexed annuity deposits as a percentage of total annuity deposits were 65%, 63% and 58% for the years ended December 31, 2011, 2010 and 2009, respectively. The recovery in equity markets that began during 2009 did not manifest itself in terms of increased fixed-indexed sales until the latter part of 2009.

As a selling inducement, many annuity products include a first year premium or interest rate bonus in addition to the base first year deposit interest rate. These bonuses are credited to the policyholder account but are deferred by the Company and amortized over future periods. The amount deferred was approximately \$46.7 million, \$51.1 million and \$36.8 million for the years ended December 31, 2011, 2010 and 2009, respectively.

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

	Years Ended December 31,		
	2011	2010	2009
	(In thousands)		
Net investment income (excluding derivatives)	\$348,761	314,214	284,149
Derivative gain (loss)	(30,467	) 13,761	33,554
Net investment income	\$318,294	327,975	317,703

As previously described, derivatives are call options purchased to hedge the equity return component of the Company's fixed-indexed 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. Generally, a comparable impact for the derivative component in fixed-indexed annuity products is reflected in contract interest expense.

Life and policy benefits for the annuity segment includes reserves established for contracts in a payout mode with or without life contingencies. The actuarial reserving systems that the Company implemented included this block of policies and they were converted to the new reserving system during 2009. As a part of this process historical assumptions pertaining to interest rates and mortality assumptions were "unlocked" for the block of policies resulting in an increase of \$11.6 million in reserves and policy benefit expenses in 2009. As the Company's block of annuity business grows more contracts convert to a payout status and reserves are established for those policies. Additionally, during the fourth quarter the Company added \$19.2 million of reserves to a closed block of annuity business with higher minimum guaranteed interest rates as a result of extending the assumed benefit period beyond that previously used.

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 2009, 2010 and 2011.

	Years Ended December 31,		
	2011	2010	2009
	(In thousands)		
Increase (Decrease) in DPAC Balance			

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Unlocking	\$ (5,675	) (2,700	) —	
True-up	(7,777	) (6,454	) (5,056	)
Totals	\$ (13,452	) (9,154	) (5,056	)

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As previously noted the unlocking adjustment in 2011 came about as the Company reevaluated its assumptions concerning future investment portfolio yield rates and concluded that an unlocking of assumptions was required to incorporate the anticipated lowering of investment yields and its impact upon future investment spreads and profitability. During 2010 the Company unlocked for a change in projected surrender charge rates on certain fixed rate annuities that reduced DPAC (and increased amortization expense) by \$2.7 million. Unlocking was not done during the year ended December 31, 2009.

The true-up adjustments in 2011, 2010 and 2009 relate to changes in policy lapse or termination rates, expense levels and credit rates compared to anticipated experience and are reflected in current period amortization expense.

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

	Years Ended December 31,		
	2011	2010	2009
	(In thousands)		
Fixed-indexed annuities	\$78,831	153,331	150,062
All other annuities	124,523	95,353	60,891
Gross contract interest	203,354	248,684	210,953
Bonus interest deferred and capitalized	(46,708)	(51,089)	(36,747)
Bonus interest amortization	29,708	21,996	13,728
Total contract interest	\$186,354	219,591	187,934

The fluctuation in reported contract interest amounts for fixed-indexed 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-indexed annuities.

Contract interest in 2010 includes an additional \$16.7 million for policy credits as part of the settlement of a class action lawsuit. This amount had been provided for in 2009 financial results but as an operating expense accrual since the character of the settlement amount was not known at that time. Accordingly, a reclassification was made in the 2010 consolidated financial statements to report the amounts as contract interest with a corresponding reduction in other operating expenses.

Other operating expenses in 2009 and 2010 are skewed for the class action lawsuit settlement accrual in 2009 of \$22.4 million of which \$16.7 million was reversed out of other operating expenses in 2010 and reported as contract interest.

## Other Operations

National Western's primary business encompasses its domestic and international life insurance operations and its annuity operations. However, the Company also has small real estate, nursing home, and other investment operations through its wholly-owned subsidiaries. Nursing home operations generated \$0.8 million, \$2.8 million and \$0.8 million of operating earnings in 2011, 2010, and 2009, respectively. The increase in earnings from 2009 to 2010 reflects the commencement of operations of the San Marcos, TX facility in the middle of calendar year 2009. The decline in

earnings in 2011 reflects reductions in Medicare and Medicaid reimbursement rates as governmental entities address their budget deficit conditions. Other operations revenue also includes gross income distributions from a life interest in a trust approximating \$4 million per year which is included in a subsidiary company.

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## 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 as of December 31, 2011 and 2010. The Company emphasizes investment grade debt securities, with smaller holdings in mortgage loans and policy loans.

	December 31, 2011		December 31, 2010	
	Carrying Value	%	Carrying Value	%
	(In thousands)		(In thousands)	
Debt securities	\$8,250,316	96.3	\$7,352,393	95.6
Mortgage loans	157,460	1.8	141,247	1.8
Policy loans	74,967	0.9	78,448	1.0
Derivatives, index options	30,844	0.4	80,284	1.0
Real estate	19,220	0.2	20,088	0.3
Equity securities	16,546	0.2	15,230	0.2
Other	15,252	0.2	9,481	0.1
Totals	\$8,564,605	100.0	\$7,697,171	100.0

The Company's investment portfolio increased 11% to \$8.6 billion at December 31, 2011 compared to \$7.7 billion at December 31, 2010 due to positive cash flows from operating and financing activities. The primary driver of the increase was another strong annuity sales year. As in 2010, approximately \$1.4 billion in annuity deposits were collected in 2011. Although lesser in scope, the increase in investments includes improved security fair market values (for debt securities categorized as "available for sale" and reported at fair value on the consolidated balance sheet) as a result of a decline in interest rates and, to a lesser extent, credit spread tightening. The unrealized gain position of the Company's securities available for sale portfolio, which is reported at fair market value, increased from \$168.5 million at December 31, 2010 to \$202.3 million at December 31, 2011.

Derivatives, index options are call options purchased to hedge the interest crediting mechanism associated with the Company's fixed-index universal life and annuity policies. These options are reported on the balance sheet at fair value in accordance with GAAP. As previously discussed in the Results of Operations section of this Item 7, the unrealized loss position of options held at December 31, 2011 (\$61.3 million) was approximately \$39 million larger than that at December 31, 2010 (\$22.2 million).

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## 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 December 31, the Company's debt securities portfolio consisted of the following:

	December 31, 2011		December 31, 2010	
	Carrying Value	%	Carrying Value	%
	(In thousands)		(In thousands)	
Corporate	\$4,289,680	52.0	\$3,559,508	48.4
Mortgage-backed securities	2,258,706	27.4	2,141,867	29.1
Public utilities	1,045,387	12.6	1,077,314	14.7
States & political subdivisions	362,252	4.4	331,731	4.5
U.S. Agencies	205,464	2.5	154,265	2.1
Asset-backed securities	56,178	0.7	64,878	0.9
Foreign governments	30,712	0.4	20,921	0.3
U.S. Treasury	1,937	—	1,909	—
Totals	\$8,250,316	100.0	\$7,352,393	100.0

Substantially all of the Company's investable cash flows are directed toward the purchase of 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. Debt securities purchased to fund insurance company operations are summarized below.

	Year Ended December 31		
	2011	2010	
	(Dollars in thousands)		
Cost of acquisitions	\$1,410,389	\$1,559,154	
Average S&P quality	AA-	AA-	
Effective annual yield	4.18	% 4.45	%
Spread to treasuries	1.43	% 1.35	%
Effective duration	7.1 years	6.8 years	

The Company holds predominantly 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, 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.

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In addition to diversification, an important aspect of the Company's investment approach is managing the credit quality of its investments 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 98.2% 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®.

	December 31, 2011		December 31, 2010	
	Carrying Value	%	Carrying Value	%
	(In thousands)		(In thousands)	
AAA and U.S. government	\$173,176	2.0	\$2,452,648	33.4
AA	3,067,454	37.2	551,572	7.5
A	2,078,808	25.2	1,722,300	23.4
BBB	2,784,711	33.8	2,482,373	33.7
BB and other below investment grade	146,167	1.8	143,500	2.0
Totals	\$8,250,316	100.0	\$7,352,393	100.0

As a result of rating agencies reducing the sovereign credit rating of the United States from "AAA" to "AA" during 2011, U.S. debt securities held by the Company and shown in the AAA level at December 31, 2010 have been moved to the AA level in the amounts shown for December 31, 2011. National Western does not purchase 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				
	Amortized Cost	Carrying Value	Fair Value	% of Invested Assets	
	(In thousands except percentages)				
December 31, 2011	\$144,131	146,466	140,590	1.7	%
December 31, 2010	\$136,076	143,500	139,306	1.9	%

The Company's percentage of below investment grade securities compared to total invested assets at December 31, 2011 decreased from the year-end 2010 percentage primarily due to certain issues held being upgraded to investment grade levels during the year and purchases of new securities. 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.



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Holdings in below investment grade securities by category as of December 31, 2011 are summarized below, including 2011 and 2010 fair values for comparison. The Company is continually monitoring developments in these industries that may affect security valuation issues.

Industry Category	Below Investment Grade Debt Securities			
	Amortized Cost 2011 (In thousands)	Carrying Value 2011	Fair Value 2011	Fair Value 2010
Retail	\$9,334	8,478	8,478	23,230
Telecommunications	5,688	7,863	7,863	9,050
Asset-backed securities	11,662	12,039	12,498	13,738
Mortgage-backed	8,354	8,173	8,173	8,607
Transportation	—	415	415	491
Manufacturing	54,742	54,792	55,210	22,680
Banking/finance	42,531	42,531	35,927	49,789
Other	11,820	11,875	12,026	11,721
Totals	\$144,131	146,166	140,590	139,306

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 continued debt crisis in Europe could continue to 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 are experiencing significant economic, fiscal and political strains that 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 these countries. The following table shows bond holdings at December 31, 2011 of non-financial companies that are domiciled in Portugal, Ireland, Italy, Greece or Spain held in the available for sale and held to maturity debt security portfolios.

## Securities Available for Sale

Company	S&P Rating	Book Value 2011 (In thousands)	Fair Value 2011	Country Domiciled
Covidien	A	\$14,258	15,357	Ireland
CRH	BBB+	19,011	19,514	Ireland
Telecom Italia	BBB	14,989	14,312	Italy
Telefonica	BBB+	19,899	20,023	Spain
Totals		\$68,157	69,206	



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## Securities Held to Maturity

Company	S&P Rating (In thousands)	Book Value 2011	Fair Value 2011	Country Domiciled
Coca-Cola HBC	A-	\$4,023	4,394	Greece
EDP	BBB	17,193	14,276	Portugal
Enel	A-	19,903	18,783	Italy
Finmeccanica	BBB-	15,028	12,280	Italy
Iberdrola Finance	A-	2,887	2,930	Spain
Totals		\$59,034	52,663	

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 14, Fair Values of Financial Instruments, of the accompanying consolidated financial statements for further discussion.

During the twelve months ended December 31, 2011 the Company recorded other-than-temporary impairment credit related write-downs on debt securities totaling \$0.1 million and \$0 million on equity securities. See Note 3, Investments Debt and Equity Securities, of the accompanying consolidated financial statements for further discussion.

As of April 1, 2009, the Company adopted the GAAP guidance on the recognition and accounting for other-than-temporary impairments due to credit loss versus non-credit loss. See Note 1, Summary of Significant Accounting Policies, and Note 3, Investments, in the accompanying consolidated financial statements for further discussion. Since adoption of this new guidance, the Company recognized \$10.4 million of other-than-temporary impairments; of which \$0.4 million was deemed credit related and recognized as realized investment losses in earnings, and \$10.0 million was deemed a non-credit related impairment and recognized in other comprehensive income.

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 December 31, 2011, approximately 30% of the Company's total debt and equity securities, based on fair values, were classified as securities available for sale. These 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.

December 31, 2011		
Fair Value	Amortized Cost	Unrealized Gains
(In thousands)		

Securities held to maturity:

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Debt securities	\$6,082,330	5,641,909	440,421
Securities available for sale:			
Debt securities	2,608,407	2,416,148	192,259
Equity securities	16,546	6,502	10,044
Totals	\$8,707,283	8,064,559	642,724

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## Asset-Backed Securities

The Company holds approximately \$56.2 million in asset-backed securities as of December 31, 2011. This portfolio includes \$23.5 million of manufactured housing bonds and \$32.7 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.

The Company holds one Alt-A security with a carrying value of \$4.2 million. The Alt-A sector is a sub-sector of the jumbo prime MBS sector. The average FICO for an Alt-A borrower is approximately 715 compared to a score of 730 for a jumbo prime borrower. The Company’s exposure to the Alt-A and subprime sectors is 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. Subprime borrowers generally have FICO scores of 660 or below. 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. With the government intervention initiatives in 2009, the housing market began to show signs of stabilizing. There was an improvement in the prices of subprime securities as the bond market also became more liquid. All of the loans classified as Alt-A or subprime in the Company’s portfolio as of December 31, 2011 were underwritten prior to 2005 as noted in the table below.

Investment Origination Year	December 31, 2011		December 31, 2010	
	Carrying Value	Fair Value	Carrying Value	Fair Value
	(In thousands)			
Subprime:				
1998	\$6,767	6,611	8,070	8,025
2002	492	740	480	576
2003	4,296	4,186	4,286	4,197
2004	21,123	19,931	21,941	21,043
Subtotal subprime	\$32,678	31,468	34,777	33,841
Alt A:				
2004	\$4,223	4,223	4,056	4,056

As of December 31, 2011, 5 of the subprime securities were rated AAA, 2 were rated AA, 1 was rated A, 1 was rated BBB+ and 3 were rated CC.

## 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.

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The Company requires a minimum specified yield on mortgage loan investments. The historically low interest rate environment of the past couple of years has resulted in fewer loan opportunities being available which met the Company's required rate of return. Consequently, new mortgage loan origination activity has been less significant in this time frame with \$37.3 million and \$68.5 million in total loans for the years 2011 and 2010, respectively.

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 Consolidated Statements of Income. 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.

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. Due to bankruptcy filing in 2009, the Company foreclosed on one Circuit City related mortgage loan each during 2010 and 2009. The Company also participates in several real estate joint ventures and limited partnerships that invest primarily in income-producing retail properties. These investments have enhanced the Company's overall investment portfolio returns.

The Company held net investments in mortgage loans totaling \$157.5 million and \$141.2 million at December 31, 2011 and 2010, respectively. The diversification of the portfolio by geographic region, property type, and loan-to-value ratio was as follows:

	December 31, 2011		December 31, 2010	
	Amount	%	Amount	%
	(In thousands)		(In thousands)	
Mortgage Loans by Geographic Region:				
West South Central	\$84,903	53.9	\$69,222	49.0
New England	21,401	13.6	19,731	14.0
Mountain	15,922	10.1	16,632	11.8
Pacific	12,001	7.6	6,973	4.9
East South Central	10,411	6.6	5,468	3.9
East North Central	10,018	6.4	17,349	12.3
Middle Atlantic	2,195	1.4	2,280	1.6
South Atlantic	609	0.4	3,592	2.5
Totals	\$157,460	100.0	\$141,247	100.0
	December 31, 2011		December 31, 2010	
	Amount	%	Amount	%
	(In thousands)		(In thousands)	
Mortgage Loans by Property Type:				
Retail	\$93,310	59.3	\$85,920	60.8
Hotel/Motel	25,679	16.3	24,334	17.2
Land/Lots	13,604	8.6	12,585	8.9
Apartments	11,103	7.1	9,181	6.5
Office	8,858	5.6	9,029	6.4

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All other	4,906	3.1	198	0.2
Totals	\$157,460	100.0	\$141,247	100.0

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	December 31, 2011		December 31, 2010	
	Amount (In thousands)	%	Amount (In thousands)	%
Mortgage Loans by Loan-to-Value Ratio (1):				
Less than 50%	\$68,048	43.2	\$48,966	34.7
50% to 60%	32,091	20.4	29,746	21.0
60% to 70%	25,692	16.3	22,769	16.1
70% to 80%	5,505	3.5	1,923	1.4
80% to 90%	—	0.0	—	0.0
Greater than 90%	26,124	16.6	37,843	26.8
Totals	\$157,460	100.0	\$141,247	100.0

## (1) Loan-to-Value Ratio using the most recent appraised value

The greater than 90% category is related to loans made with a long standing borrower which are backed by the investment property, contracted leases and the guarantee of the 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 capital gains (losses) in the consolidated statements of earnings.

The Company recognized valuation losses of \$0.6 million, \$0.4 million and \$1.4 million for the years ended December 31, 2011, 2010 and 2009, respectively. The principal mortgage loan balance requiring the valuation allowance was \$7.0 million, \$7.0 million and \$9.2 million in 2011, 2010, and 2009, respectively. The amount of interest recorded while these loans were impaired was \$0.3 million, \$0.1 million and \$0.3 million in 2011, 2010, and 2009, respectively. The impairments were based on information which indicated that the Company may not collect all amounts in accordance with the mortgage agreement. While the Company closely monitors its mortgage loan portfolio, future changes in economic conditions can result in impairments beyond those currently identified.

The following table represents the mortgage loan allowance for the years ended December 31, 2011 and 2010:

2011	2010
(In thousands)	

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Balance, beginning of period	\$3,962	5,033
Provision	609	385
Releases	—	(1,456 )
Balance, end of period	\$4,571	3,962

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The Company does not recognize interest income on loans past due ninety days or more. The Company had one mortgage loan past due six months or more with a principal balance totaling \$7.0 million at December 31, 2011 and 2010. There was no interest income not recognized in 2011, 2010 and 2009.

The contractual maturities of mortgage loan principal balances at December 31, 2011 and 2010 were as follows:

	December 31, 2011		December 31, 2010	
	Amount	%	Amount	%
	(In thousands)		(In thousands)	
Principal Balance by Contractual Maturity:				
Due in one year or less	\$17,661	10.8	\$3,724	2.5
Due after one year through five years	62,851	38.6	53,330	36.5
Due after five years through ten years	51,720	31.8	50,341	34.5
Due after ten years through fifteen years	9,423	5.8	17,075	11.7
Due after fifteen years	21,188	13.0	21,595	14.8
Totals	\$162,843	100.0	\$146,065	100.0

The Company's real estate investments total approximately \$19.2 million at December 31, 2011 and \$20.1 million at December 31, 2010, and consist primarily of income-producing properties which are being operated by a wholly-owned subsidiary of the Company. The Company recognized operating income on these properties of approximately \$1.6 million, \$1.6 million and \$1.2 million for the years ended December 31, 2011, 2010 and 2009, respectively. 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. The Company recorded net realized investment losses of \$0.1 million in both 2011 and 2010 associated with these properties. There was no recorded gain or loss in 2009.

#### Derivatives, Index Options

The Company offers fixed-indexed universal life and annuity products that guarantee the return of principal to policyholders and, at the policyholder's election, credit interest based on a percentage gain in a specified market index, typically the S&P 500 Index® (policyholders may alternatively elect a fixed interest rate). Premiums and deposits received on these products are predominantly invested in investment grade fixed income securities with a portion used to purchase derivatives consisting of call options on the applicable market index to fund the index credits due to fixed-indexed policyholders. The call options purchased are one-year over-the-counter option contracts coinciding with the initial issuance of the policy and annual renewal periods in order to match the Company's funding requirements for the underlying policies. On the respective anniversary dates of the index policies, the index used to compute the annual index credit is reset and a new one-year call option is purchased to fund the next annual index credit.

Although the call options are employed to be effective hedges against the Company's policyholder obligations from an economic standpoint, they do not meet the requirements for hedge accounting under GAAP. Accordingly, the call options are marked to fair value on each reporting date with the change in fair value, plus or minus, included as a component of net investment income. The change in fair value of the call options includes the gains or losses recognized at the expiration of the option term and the changes in fair value for open contracts.

The Company's design of its fixed-indexed products incorporates a budget for the purchase of over-the-counter call options to fund the index credits due to policyholders. Management monitors current prices of these call options and manages the cost of purchases through the terms of the policy contracts. These terms permit the Company to change caps, participation rates, and asset fees, subject to guaranteed minimums, thus managing the cost of the call options quoted by counterparties. In addition, the Company's product terms allow for the Company to withdraw from offering a particular index option at any time effective on the next policy anniversary date.

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The fair value of derivative instruments presented in the Company's consolidated financial statements totaling \$30.8 million at December 31, 2011 and \$80.3 million at December 31, 2010 pertain to notional policyholder account values of \$1.95 billion and \$1.46 billion at December 31, 2011 and 2010, respectively, electing interest credits based upon applicable market index performance.

## 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 will 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 rates 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 the past two years is reflected in the tables below.

	December 31,			
	2011	2010		
	(In thousands except percentages)			
Debt securities - fair value	\$8,690,737	7,634,209		
Debt securities - amortized cost	\$8,058,057	7,193,040		
Fair value as a percentage of amortized cost	107.85	% 106.13		%
Unrealized gains at year-end	\$632,680	441,169		
Ten-year U.S. Treasury bond - increase (decrease) in yield for the year	(1.42	)% (0.54		)%

Unrealized Gains Balance

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	Net Balance at December 31, 2011 (In thousands)	Net Balance at December 31, 2010	Change in Net Balance
Debt securities held to maturity	\$440,421	281,816	158,605
Debt securities available for sale	192,259	159,353	32,906
Totals	\$632,680	441,169	191,511

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Changes in interest rates typically have a sizable effect on the fair values of the Company's debt securities. During 2011, market interest rates of the ten-year U.S. Treasury bond decreased roughly 142 basis points from year end 2010. Liquidity in the corporate bond market during 2011 did not vary significantly from that in the previous year. As a result, the spread between corporate bonds and treasury securities remained relatively the same and did not influence the prices of the Company's corporate bonds to further rise. However, the decrease in interest rate levels did insignificantly increase the unrealized gains by \$191.5 million on a portfolio of approximately \$8.3 billion at December 31, 2011. The Company would expect similar results in the future from a significant upward or downward movement in market rates. 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 relatively small effects on the Company's financial results.

The Company manages interest rate risk principally through ongoing cash flow testing required for insurance regulatory purposes. Business 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 offered 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 seeks to minimize the impact of interest rate risk through surrender charges that are imposed to discourage policy surrenders and to offset unamortized acquisition costs. Certain products, such as supplementary contracts with life contingencies, are not subject to surrender or discretionary withdrawal. The Company also includes a market value adjustment ("MVA") feature on many of its annuity products which may increase or decrease the amount paid to contract holders upon surrender of their contract as a means to further mitigate interest rate risk. The MVA is a mathematical formula which uses changes in interest rates since the inception of a contract (typically linked to U.S Treasury interest rates) to the date of surrender and will decrease the amount paid upon surrender when interest rates rise or increase the amounts paid when interest rates decline. As noted above, the value of the Company's fixed debt securities decline in a rising interest rate environment and the MVA feature which decreases amounts paid upon surrender in a rising rate environment serves to discourage this activity. Conversely, in a decreasing interest rate environment surrender activity poses less of a risk to the Company as the value of its fixed debt securities backing the contracts increases. If necessary, the securities backing the contracts surrendered could be sold at a gain offsetting the increased amount paid upon surrender due to the MVA.





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The following table profiles the Company's insurance liabilities at December 31, 2011 for annuities, deposit-type contracts and supplementary contracts with life contingencies by surrender and discretionary withdrawal characteristics.

	December 31, 2011	
	Amount	%
	(In thousands)	
Subject to discretionary withdrawal:		
With market value adjustment	\$1,869,974	28.6
With surrender charge of 5% or more	3,854,855	58.8
With surrender charge of 5% or less	354,215	5.4
Not subject to discretionary withdrawal	472,000	7.2
Total	\$6,551,044	100.0

## Interest Rate Sensitivity

The following table illustrates the market risk sensitivity of the Company's interest rate-sensitive assets. The table shows the effect of a change in interest rates on the fair value of the portfolio using models that measure the change in fair value arising from an immediate and sustained change in interest rates in increments of 100 basis points.

	Fair Values of Assets				
	Changes in Interest Rates in Basis Points				
	-100	0	+100	+200	+300
	(In thousands)				
Debt and equity securities	\$9,065,694	8,707,283	8,322,180	7,922,643	7,529,301
Mortgage loans	165,251	158,958	153,129	147,716	142,674
Other loans	17,352	16,780	16,239	15,726	15,240
Derivatives	29,818	30,844	31,876	32,906	33,933

The selection of the 100 basis point parallel shift in the yield curve was made only as an illustration of the potential hypothetical impact of such an event and should not be construed as a prediction of future market events. Actual results could vary materially from those illustrated due to the nature of the estimates and assumptions used in the above analysis. Expected maturities of debt securities may differ from contractual maturities due to call or prepayment provisions. The models assume that prepayments on mortgage-backed securities are influenced by agency and pool types, the level of interest rates, loan age, refinancing incentive, month of the year, and underlying coupon. During periods of declining interest rates, principal payments on mortgage-backed securities and collateralized mortgage obligations tend to increase as the underlying mortgages are prepaid. Conversely, during periods of rising interest rates, the rate of prepayment slows. Both of these situations can expose the Company to the possibility of asset-liability cash flow and yield mismatch. The model uses a proprietary method of sampling interest rate paths along with a mortgage prepayment model to derive future cash flows. The initial interest rates used are based on the current U.S. Treasury yield curve as well as current mortgage rates for the various types of collateral in the portfolio.

Mortgage and other loans were modeled by discounting scheduled cash flows through the scheduled maturities of the loans, starting with interest rates currently being offered for similar loans to borrowers with similar credit ratings. Policy loans were modeled by discounting estimated cash flows using U.S. Treasury Bill interest rates as the

base rates at December 31, 2011. The estimated cash flows include assumptions as to whether such loans will be repaid by the policyholders or settled upon payment of death or surrender benefits on the underlying insurance contracts and incorporate both Company experience and mortality assumptions associated with such contracts.

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In addition to the securities analyzed above, the Company invests in index options which are derivative financial instruments used to hedge the equity return component of the Company's indexed annuity and life products. The values of these options are primarily impacted by equity price risk, as the options' fair values are dependent on the performance of the underlying reference index. However, increases or decreases in investment returns from these options are substantially offset by corresponding increases or decreases in amounts paid to indexed policyholders, subject to minimum guaranteed policy interest rates.

The Company's market risk liabilities, which include policy liabilities for annuity and supplemental contracts, are managed for interest rate risk through cash flow testing as previously described. As part of this cash flow testing, the Company has analyzed the potential impact on net earnings of a 100 basis point decrease and increases in increments of 100 basis points in the U.S. Treasury yield curve as of December 31, 2011. The potential impact on net earnings from these interest rate changes are summarized below.

	Changes in Interest Rates in Basis Points			
	-100	+100	+200	+300
	(In thousands)			
Impact on net earnings	\$(1,505	) 1,576	2,285	2,423

These estimated impacts in earnings are net of tax effects and the estimated effects of deferred policy acquisition costs.

The above described scenarios produce estimated changes in cash flows as well as cash flow reinvestment projections. Estimated cash flows in the Company's model assume cash flow reinvestments, which are representative of the Company's current investment strategy. Calls and prepayments include scheduled maturities and those expected to occur which would benefit the security issuers. Assumed policy surrenders consider differences and relationships between credited interest rates and market interest rates as well as surrender charges on individual policies. The impact to earnings also includes the expected effects on amortization of deferred policy acquisition costs. The model considers only annuity and supplemental contracts in force at December 31, 2011, and does not consider new product sales or the possible impact of interest rate changes on sales.

**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.

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The Company's net exposure to loss due to credit risk if the option counterparties failed to completely perform according to the terms of the one-year contracts is as follows at December 31, 2011 and 2010.

Counterparty	Moody/ S&P Rating	December 31, 2011		
		Fair Value (In thousands)	Collateral Held	Net Exposure
Credit Suisse	Aa1/A+	\$ 8,881	8,472	409
Wells Fargo	Aa3/AA-	8,106	—	8,106
Bank of America	A2/A	7,192	1,824	5,368
Barclays Bank	Aa3/A+	2,585	—	2,585
BNP Paribas	Aa3/AA-	2,312	—	2,312
JPMorgan Chase	Aa1/A+	1,768	1	1,767
		\$ 30,844	10,297	20,547
Counterparty	Moody/ S&P Rating	December 31, 2010		
		Fair Value (In thousands)	Collateral Held	Net Exposure
Credit Suisse	Aa1/A+	\$27,261	21,901	5,360
Wells Fargo	Aa2/AA	14,554	—	14,554
Barclays Bank	Aa3/AA-	14,266	4,182	10,084
Bank of America	Aa3/A+	11,997	7,198	4,799
JPMorgan Chase	Aa1/AA-	7,230	2,180	5,050
BNP Paribas	Aa2/AA	4,950	—	4,950
SunTrust Bank	A3/BBB+	26	500	—
		\$80,284	35,961	44,797

The Company has never incurred a loss on index options due to counterparty default.

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.

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## 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 December 31, 2011.

A primary liquidity concern for life insurers is the risk of an extraordinary level of early policyholder withdrawals. 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 following table sets forth withdrawal characteristics of the Company's annuity reserves and deposit liabilities (based on statutory liability values) as of the dates indicated.

	December 31, 2011		December 31, 2010		
	Amount	% of Total	Amount	% of Total	
	(In thousands except percentages)				
Not subject to discretionary withdrawal provisions	\$472,000	7.2	% \$452,689	7.8	%
Subject to discretionary withdrawal, with adjustment:					
With market value adjustment	1,869,974	28.6	% 1,713,174	29.6	%
At contract value less current surrender charge of 5% or more	3,854,855	58.8	% 3,254,810	56.1	%
Subtotal	6,196,829	94.6	% 5,420,673	93.5	%
Subject to discretionary withdrawal at contract value with no surrender charge or surrender charge of less than 5%	354,215	5.4	% 376,006	6.5	%
Total annuity reserves and deposit liabilities	\$6,551,044	100.0	% \$5,796,679	100.0	%

The actual amounts paid by product line in connection with surrenders and withdrawals for the years ended December 31 are noted in the table below.