

NATIONAL WESTERN LIFE INSURANCE CO  
Form 10-Q  
May 08, 2013

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

FORM 10-Q

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

For the Quarterly Period Ended March 31, 2013  
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)

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 R No £

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

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

Large accelerated filer £ Accelerated filer R Non-accelerated filer £

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

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As of May 5, 2013, the number of shares of Registrant's common stock outstanding was: Class A – 3,434,763 and Class B - 200,000.

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## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

| ASSETS   | (Unaudited)<br>March 31,<br>2013 | December 31,<br>2012 |
|--|----------------------------------|----------------------|
| Investments:   |                                  |                      |
| Securities held to maturity, at amortized cost (fair value: \$6,588,874 and \$6,503,627) | \$6,078,141                      | 5,962,120            |
| Securities available for sale, at fair value (cost: \$2,656,308 and \$2,658,512)         | 2,904,202                        | 2,826,001            |
| Mortgage loans, net of allowance for possible losses (\$650 and \$650)                   | 125,539                          | 142,170              |
| Policy loans   | 71,143                           | 71,549               |
| Derivatives, index options   | 130,967                          | 57,890               |
| Other long-term investments  | 39,136                           | 41,439               |
| Total investments  | 9,349,128                        | 9,101,169            |
| Cash and short-term investments  | 86,816                           | 124,561              |
| Deferred policy acquisition costs  | 709,329                          | 705,397              |
| Deferred sales inducements   | 154,673                          | 152,844              |
| Accrued investment income  | 96,355                           | 92,665               |
| Federal income tax receivable  | —                                | 5,655                |
| Other assets   | 80,200                           | 81,567               |
| Total assets   | \$10,476,501                     | 10,263,858           |

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

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CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share amounts)

|   | (Unaudited)<br>March 31,<br>2013 | December 31,<br>2012 |
|---|----------------------------------|----------------------|
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                                  |                      |
| <b>LIABILITIES:</b>   |                                  |                      |
| Future policy benefits:   |                                  |                      |
| Universal life and annuity contracts  | \$8,587,555                      | 8,430,545            |
| Traditional life reserves   | 137,826                          | 138,309              |
| Other policyholder liabilities  | 155,482                          | 148,561              |
| Deferred Federal income tax liability   | 36,556                           | 55,054               |
| Federal income tax payable  | 19,861                           | —                    |
| Other liabilities   | 132,283                          | 99,709               |
| <b>Total liabilities</b>  | <b>9,069,563</b>                 | <b>8,872,178</b>     |
| <b>COMMITMENTS AND CONTINGENCIES (Note 8)</b>   |                                  |                      |
| <b>STOCKHOLDERS' EQUITY:</b>  |                                  |                      |
| Common stock:   |                                  |                      |
| Class A - \$1 par value; 7,500,000 shares authorized; 3,434,763 issued and outstanding in 2013 and 2012 | 3,435                            | 3,435                |
| Class B - \$1 par value; 200,000 shares authorized, issued, and outstanding in 2013 and 2012            | 200                              | 200                  |
| Additional paid-in capital  | 37,767                           | 37,767               |
| Accumulated other comprehensive income  | 75,412                           | 76,786               |
| Retained earnings   | 1,290,124                        | 1,273,492            |
| <b>Total stockholders' equity</b>   | <b>1,406,938</b>                 | <b>1,391,680</b>     |
| <b>Total liabilities and stockholders' equity</b>   | <b>\$10,476,501</b>              | <b>10,263,858</b>    |

Note: The Condensed Consolidated Balance Sheet at December 31, 2012, has been derived from the audited Consolidated Financial Statements as of that date.

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

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CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS

For the Three Months Ended March 31, 2013 and 2012

(Unaudited)

(In thousands, except per share amounts)

|   | 2013     | 2012     |
|---|----------|----------|
| Premiums and other revenues:  |          |          |
| Universal life and annuity contract charges                             | \$37,899 | 36,199   |
| Traditional life premiums   | 3,864    | 4,083    |
| Net investment income   | 180,814  | 149,558  |
| Other revenues  | 6,142    | 5,655    |
| Net realized investment gains (losses):                                 |          |          |
| Total other-than-temporary impairment ("OTTI") gains (losses)           | 382      | (277 )   |
| Portion of OTTI (gains) losses recognized in other comprehensive income | (443     | ) 78     |
| Net OTTI losses recognized in earnings                                  | (61      | ) (199 ) |
| Other net investment gains (losses)                                     | 2,374    | 1,366    |
| Total net realized investment gains (losses)                            | 2,313    | 1,167    |
| Total revenues  | 231,032  | 196,662  |
| Benefits and expenses:  |          |          |
| Life and other policy benefits  | 12,690   | 13,678   |
| Amortization of deferred policy acquisition costs                       | 30,804   | 31,711   |
| Universal life and annuity contract interest                            | 140,300  | 101,543  |
| Other operating expenses  | 21,924   | 20,018   |
| Total benefits and expenses   | 205,718  | 166,950  |
| Earnings before Federal income taxes                                    | 25,314   | 29,712   |
| Federal income taxes  | 8,682    | 9,971    |
| Net earnings  | \$16,632 | 19,741   |
| Basic earnings per share:   |          |          |
| Class A   | \$4.71   | 5.58     |
| Class B   | \$2.35   | 2.79     |
| Diluted earnings per share:   |          |          |
| Class A   | \$4.70   | 5.58     |
| Class B   | \$2.35   | 2.79     |

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



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CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

For the Three Months Ended March 31, 2013 and 2012

(Unaudited)

(In thousands)

|   | 2013     | 2012       |
|---|----------|------------|
| Net earnings  | \$16,632 | 19,741     |
| Other comprehensive income, net of effects of deferred costs and taxes:         |          |            |
| Unrealized gains (losses) on securities:  |          |            |
| Net unrealized holding gains arising during period                              | (1,125   | ) 7,752    |
| Net unrealized liquidity gains (losses)   | 138      | (24 )      |
| Reclassification adjustment for net amounts included in net earnings            | (1,359   | ) (1,040 ) |
| Amortization of net unrealized (gains) losses related to transferred securities | —        | 1          |
| Net unrealized gains (losses) on securities                                     | (2,346   | ) 6,689    |
| Foreign currency translation adjustments  | 590      | 386        |
| Benefit plans:  |          |            |
| Amortization of net prior service cost and net gain (loss)                      | 381      | 223        |
| Other comprehensive income  | (1,375   | ) 7,298    |
| Comprehensive income  | \$15,257 | 27,039     |

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



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CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

For the Three Months Ended March 31, 2013 and 2012

(Unaudited)

(In thousands)

|  | 2013    | 2012     |   |
|--|---------|----------|---|
| Common stock:  |         |          |   |
| Balance at beginning of period                               | \$3,635 | 3,635    |   |
| Shares exercised under stock option plan                     | —       | —        |   |
| Balance at end of period                                     | 3,635   | 3,635    |   |
| Additional paid-in capital:                                  |         |          |   |
| Balance at beginning of period                               | 37,767  | 37,767   |   |
| Shares exercised under stock option plan                     | —       | —        |   |
| Balance at end of period                                     | 37,767  | 37,767   |   |
| Accumulated other comprehensive income:                      |         |          |   |
| Unrealized gains on non-impaired securities:                 |         |          |   |
| Balance at beginning of period                               | 91,972  | 69,116   |   |
| Change in unrealized gains during period, net of tax         | (2,483  | ) 6,713  |   |
| Balance at end of period                                     | 89,489  | 75,829   |   |
| Unrealized losses on impaired held to maturity securities:   |         |          |   |
| Balance at beginning of period                               | (1,426  | ) (2,320 | ) |
| Amortization   | —       | 6        |   |
| Other-than-temporary impairments, non-credit, net of tax     | —       | (51      | ) |
| Additional credit loss on previously impaired securities     | 25      | —        |   |
| Change in shadow deferred policy acquisition costs           | (17     | ) 21     |   |
| Balance at end of period                                     | (1,418  | ) (2,344 | ) |
| Unrealized losses on impaired available for sale securities: |         |          |   |
| Balance at beginning of period                               | (196    | ) (608   | ) |
| Other-than-temporary impairments, non-credit, net of tax     | —       |          |   |
| Change in shadow deferred policy acquisition costs           | (133    | )        |   |
| Recoveries, net of tax                                       | 263     | —        |   |
| Balance at end of period                                     | (66     | ) (608   | ) |



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NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (continued)  
 For the Three Months Ended March 31, 2013 and 2012  
 (Unaudited)  
 (In thousands)

|   | 2013        | 2012        |
|---|-------------|-------------|
| Foreign currency translation adjustments:                       |             |             |
| Balance at beginning of period                                  | 2,589       | 2,368       |
| Change in translation adjustments during period                 | 590         | 386         |
| Balance at end of period  | 3,179       | 2,754       |
| Benefit plan liability adjustment:                              |             |             |
| Balance at beginning of period                                  | (16,153     | ) (15,380   |
| Amortization of net prior service cost and net gain, net of tax | 381         | 223         |
| Balance at end of period  | (15,772     | ) (15,157   |
| Accumulated other comprehensive income at end of period         | 75,412      | 60,474      |
| Retained earnings:  |             |             |
| Balance at beginning of period                                  | 1,273,492   | 1,182,207   |
| Net earnings  | 16,632      | 19,741      |
| Stockholder dividends   | —           | —           |
| Balance at end of period  | 1,290,124   | 1,201,948   |
| Total stockholders' equity                                      | \$1,406,938 | \$1,303,824 |

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

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Three Months Ended March, 2013 and 2012

(Unaudited)

(In thousands)

|   | 2013      | 2012       |   |
|---|-----------|------------|---|
| Cash flows from operating activities:   |           |            |   |
| Net earnings  | \$ 16,632 | 19,741     |   |
| Adjustments to reconcile net earnings to net cash from operating activities:  |           |            |   |
| Universal life and annuity contract interest                                  | 140,300   | 101,543    |   |
| Surrender charges and other policy revenues                                   | (3,605    | ) (3,500   | ) |
| Realized (gains) losses on investments  | (2,313    | ) (1,167   | ) |
| Accrual and amortization of investment income                                 | (447      | ) (708     | ) |
| Depreciation and amortization   | 1,406     | 1,417      |   |
| (Increase) decrease in value of index options                                 | (74,432   | ) (42,355  | ) |
| (Increase) decrease in deferred policy acquisition and sales inducement costs | (453      | ) 2,427    |   |
| (Increase) decrease in accrued investment income                              | (4,933    | ) (4,200   | ) |
| (Increase) decrease in other assets   | (500      | ) (4,734   | ) |
| Increase (decrease) in liabilities for future policy benefits                 | 2,748     | 1,923      |   |
| Increase (decrease) in other policyholder liabilities                         | 6,921     | (740       | ) |
| Increase (decrease) in Federal income taxes                                   | 8,281     | 3,298      |   |
| Increase (decrease) in other liabilities                                      | (7,324    | ) 2,932    |   |
| Other, net  | —         | 127        |   |
| Net cash provided by operating activities                                     | 82,281    | 76,004     |   |
| Cash flows from investing activities:   |           |            |   |
| Proceeds from sales of:   |           |            |   |
| Securities available for sale   | 609       | 418        |   |
| Other investments   | 2,884     | 477        |   |
| Proceeds from maturities and redemptions of:                                  |           |            |   |
| Securities held to maturity   | 403,974   | 384,604    |   |
| Securities available for sale   | 66,052    | 79,767     |   |
| Index options   | 14,980    | 260        |   |
| Purchases of:   |           |            |   |
| Securities held to maturity   | (509,924  | ) (406,536 | ) |
| Securities available for sale   | (121,242  | ) (173,237 | ) |
| Index options   | (12,169   | ) (10,672  | ) |
| Other investments   | (15       | ) (1,503   | ) |
| Principal payments on mortgage loans  | 17,000    | 4,536      |   |
| Cost of mortgage loans acquired   | (253      | ) (390     | ) |
| Decrease (increase) in policy loans   | 406       | 318        |   |
| Other, net  | (2        | ) 3        |   |
| Net cash used in investing activities   | (137,700  | ) (121,955 | ) |

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS, CONTINUED

For the Three Months Ended March 31, 2013 and 2012

(Unaudited)

(In thousands)

|   | 2013      | 2012      |
|---|-----------|-----------|
| Cash flows from financing activities:                                 |           |           |
| Deposits to account balances for universal life and annuity contracts | 231,749   | 212,423   |
| Return of account balances on universal life and annuity contracts    | (214,665) | (210,657) |
| Issuance of common stock under stock option plan                      | —         | —         |
| Net cash provided by financing activities                             | 17,084    | 1,766     |
| Effect of foreign exchange  | 590       | 386       |
| Net increase (decrease) in cash and short-term investments            | (37,745)  | (43,799)  |
| Cash and short-term investments at beginning of period                | 124,561   | 119,290   |
| Cash and short-term investments at end of period                      | \$86,816  | \$75,491  |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:                    |           |           |
| Cash paid during the period for:                                      |           |           |
| Interest  | \$20      | \$10      |
| Income taxes  | \$2,484   | \$6,539   |
| Noncash operating activities:   |           |           |
| Deferral of sales inducements   | \$714     | \$1,314   |

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

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

(1) CONSOLIDATION AND BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for annual financial statements. In the opinion of management, the accompanying condensed consolidated financial statements contain all adjustments necessary to present fairly the financial position of National Western Life Insurance Company and its subsidiaries ("Company" or "National Western") as of March 31, 2013, and the results of its operations and its cash flows three months ended March 31, 2013. The results of operations for the three months ended March 31, 2013 and 2012 are not necessarily indicative of the results to be expected for the full year. It is recommended that these condensed consolidated financial statements be read in conjunction with the audited consolidated financial statements and notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012 accessible free of charge through the Company's internet site at [www.nationalwesternlife.com](http://www.nationalwesternlife.com) or the Securities and Exchange Commission internet site at [www.sec.gov](http://www.sec.gov). The condensed consolidated balance sheet at December 31, 2012 has been derived from the audited consolidated financial statements as of that date.

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

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

Certain amounts in the prior year condensed consolidated financial statements have been reclassified to conform to the current year presentation.

(2) NEW ACCOUNTING PRONOUNCEMENTS

During February 2013, the FASB issued new guidance related to the presentation of amounts reclassified out of accumulated other comprehensive income. The new guidance requires disclosure on the statement of income amounts reclassified. As the Company already reports reclassifications on its Income Statement and Statement of Comprehensive Income the new guidance will not have a significant impact on the Company's consolidated financial statements and results of operations.

During October 2010, the Financial Accounting Standards Board ("FASB") issued new guidance affecting insurance companies that incur costs in the acquisition of new and renewal insurance contracts. The guidance addresses the

diversity in practice regarding the interpretation for which costs relating to the acquisition of new or renewal business qualifies for deferral. The new guidance specifies the acquisition costs which are capitalizable and those which must be expensed. The effective date is for interim and annual periods ending after December 15, 2011. The adoption of this guidance was effective January 1, 2012. See Note 1, Summary of Significant Accounting Policies, of the accompanying consolidated financial statements for additional disclosures.

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



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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(UNAUDITED)

## (3) STOCKHOLDERS' EQUITY

The Company is restricted by state insurance laws as to dividend amounts which may be paid to stockholders without prior approval from the Colorado Division of Insurance. The restrictions are based on the greater of statutory earnings from operations excluding capital gains or 10% of statutory capital and surplus of the Company. The maximum dividend payment which may be made without prior approval in 2013 is \$100.5 million. The Company did not declare or pay cash dividends on common stock during the three months ended March 31, 2013 and 2012.

## (4) EARNINGS PER SHARE

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

|   | Three Months Ended March 31,            |         |         |         |
|---|---|---------|---------|---------|
|   | 2013                                    |         | 2012    |         |
|   | Class A                                 | Class B | Class A | Class B |
|   | (In thousands except per share amounts) |         |         |         |
| Numerator for Basic and Diluted Earnings Per Share:                                   |   |         |         |         |
| Net income  | \$16,632                                |         | 19,741  |         |
| Dividends - Class A shares  | —                                       |         | —       |         |
| Dividends - Class B shares  | —                                       |         | —       |         |
| Undistributed income  | \$16,632                                |         | 19,741  |         |
| Allocation of net income:   |   |         |         |         |
| Dividends   | \$—                                     | —       | —       | —       |
| Allocation of undistributed income  | 16,162                                  | 470     | 19,183  | 558     |
| Net income  | \$16,162                                | 470     | 19,183  | 558     |
| Denominator:  |   |         |         |         |
| Basic earnings per share - weighted-average shares                                    | 3,435                                   | 200     | 3,435   | 200     |
| Effect of dilutive stock options  | 5                                       | —       | —       | —       |
| Diluted earnings per share - adjusted weighted-average shares for assumed conversions | 3,440                                   | 200     | 3,435   | 200     |
| Basic Earnings Per Share  | \$4.71                                  | 2.35    | 5.58    | 2.79    |
| Diluted Earnings Per Share  | \$4.70                                  | 2.35    | 5.58    | 2.79    |



Table of ContentsNATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(UNAUDITED)

## (5) PENSION AND OTHER POSTRETIREMENT PLANS

## (A) Defined Benefit Pension Plans

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

|                                    | Three Months Ended<br>March 31,<br>2013 |   | 2012 |
|------------------------------------|---|---|------|
|                                    | (In thousands)                          |   |      |
| Service cost                       | \$47                                    |   | 44   |
| Interest cost                      | 218                                     |   | 232  |
| Expected return on plan assets     | (283                                    | ) | (268 |
| Amortization of prior service cost | 1                                       |   | 1    |
| Amortization of net loss           | 203                                     |   | 196  |
| Net periodic benefit cost          | \$186                                   |   | 205  |

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

The Company's minimum required contribution for the 2013 plan year is \$0.7 million of which it expects to contribute approximately \$0.4 million during 2013 with the remainder to be contributed in 2014. In addition, the Company had a remaining contribution payable for the 2012 plan year of \$0.1 million which it paid during the first quarter of 2013. As of March 31, 2013, the Company had contributed a total of \$0.1 million to the plan for the 2012 and 2013 plan years.

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

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

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

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

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

|                                    | Three Months Ended<br>March 31, |      |
|------------------------------------|---------------------------------|------|
|                                    | 2013                            | 2012 |
|                                    | (In thousands)                  |      |
| Service cost                       | \$44                            | 42   |
| Interest cost                      | 200                             | 228  |
| Amortization of prior service cost | 15                              | 15   |
| Amortization of net loss           | 294                             | 285  |
| Net periodic benefit cost          | \$553                           | 570  |

The Company expects to contribute \$2.0 million to these plans in 2013. As of March 31, 2013, the Company has contributed \$0.4 million to the plans.

**(B) Defined Benefit Postretirement Healthcare Plans**

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

|                                    | Three Months Ended<br>March 31, |      |
|------------------------------------|---------------------------------|------|
|                                    | 2013                            | 2012 |
|                                    | (In thousands)                  |      |
| Interest cost                      | \$29                            | 32   |
| Amortization of prior service cost | 26                              | 26   |
| Amortization of net loss           | 8                               | 11   |
| Net periodic benefit cost          | \$63                            | 69   |

The Company expects to contribute minimal amounts to the plan in 2013.

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## (6) SEGMENT AND OTHER OPERATING INFORMATION

The Company defines its reportable operating segments as domestic life insurance, international life insurance, and annuities. These segments are organized based on product types and geographic marketing areas. A summary of segment information for the quarters ended March 31, 2013 and March 31, 2012 is provided below.

## Selected Segment Information:

|  | Domestic<br>Life<br>Insurance | International<br>Life<br>Insurance | Annuities      | All<br>Others | Totals     |
|--|-------------------------------|------------------------------------|----------------|---------------|------------|
|  |                               |                                    |                |               |            |
|  |                               |                                    | (In thousands) |               |            |
| March 31, 2013   |                               |                                    |                |               |            |
| Selected Condensed Consolidated<br>Balance Sheet Items:    |                               |                                    |                |               |            |
| Deferred policy acquisition costs<br>and sales inducements | \$41,026                      | 227,263                            | 595,713        | —             | 864,002    |
| Total segment assets                                       | 496,778                       | 1,148,773                          | 8,418,536      | 257,309       | 10,321,396 |
| Future policy benefits                                     | 427,006                       | 861,854                            | 7,436,521      | —             | 8,725,381  |
| Other policyholder liabilities                             | 12,547                        | 10,139                             | 132,796        | —             | 155,482    |
| Three Months Ended<br>March 31, 2013                       |                               |                                    |                |               |            |
| Condensed Consolidated Income<br>Statements:               |                               |                                    |                |               |            |
| Premiums and contract revenues                             | \$9,610                       | 28,019                             | 4,134          | —             | 41,763     |
| Net investment income                                      | 7,773                         | 18,630                             | 150,378        | 4,033         | 180,814    |
| Other revenues   | 12                            | 43                                 | 39             | 6,048         | 6,142      |
| Total revenues   | 17,395                        | 46,692                             | 154,551        | 10,081        | 228,719    |
| Life and other policy benefits                             | 3,030                         | 3,645                              | 6,015          | —             | 12,690     |
| Amortization of deferred acquisition<br>costs              | 2,035                         | 5,787                              | 22,982         | —             | 30,804     |
| Universal life and annuity contract<br>interest            | 7,191                         | 21,991                             | 111,118        | —             | 140,300    |
| Other operating expenses                                   | 3,767                         | 6,708                              | 6,086          | 5,363         | 21,924     |
| Federal income taxes (benefit)                             | 470                           | 2,930                              | 2,857          | 1,615         | 7,872      |
| Total expenses   | 16,493                        | 41,061                             | 149,058        | 6,978         | 213,590    |
| Segment earnings (loss)                                    | \$902                         | 5,631                              | 5,493          | 3,103         | 15,129     |



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## Selected Segment Information:

|  | Domestic<br>Life<br>Insurance | International<br>Life<br>Insurance | Annuities      | All<br>Others | Totals    |
|--|-------------------------------|------------------------------------|----------------|---------------|-----------|
|  |                               |                                    | (In thousands) |               |           |
| March 31, 2012   |                               |                                    |                |               |           |
| Selected Condensed Consolidated<br>Balance Sheet Items:    |                               |                                    |                |               |           |
| Deferred policy acquisition costs<br>and sales inducements | \$36,432                      | 230,753                            | 601,414        | —             | 868,599   |
| Total segment assets                                       | 413,630                       | 1,076,573                          | 8,100,477      | 226,709       | 9,817,389 |
| Future policy benefits                                     | 351,915                       | 796,354                            | 7,116,918      | —             | 8,265,187 |
| Other policyholder liabilities                             | 10,738                        | 18,457                             | 121,373        | —             | 150,568   |
| Three Months Ended<br>March 31, 2012                       |                               |                                    |                |               |           |
| Condensed Consolidated Income<br>Statements:               |                               |                                    |                |               |           |
| Premiums and contract revenues                             | \$10,539                      | 23,431                             | 6,312          | —             | 40,282    |
| Net investment income                                      | 5,818                         | 15,397                             | 124,389        | 3,954         | 149,558   |
| Other revenues   | 7                             | 32                                 | 61             | 5,555         | 5,655     |
| Total revenues   | 16,364                        | 38,860                             | 130,762        | 9,509         | 195,495   |
| Life and other policy benefits                             | 1,648                         | 3,480                              | 8,550          | —             | 13,678    |
| Amortization of deferred acquisition<br>costs              | 2,391                         | 5,608                              | 23,712         | —             | 31,711    |
| Universal life and annuity contract<br>interest            | 7,213                         | 14,812                             | 79,518         | —             | 101,543   |
| Other operating expenses                                   | 4,768                         | 5,818                              | 4,028          | 5,404         | 20,018    |
| Federal income taxes (benefit)                             | 115                           | 3,063                              | 5,010          | 1,375         | 9,563     |
| Total expenses   | 16,135                        | 32,781                             | 120,818        | 6,779         | 176,513   |
| Segment earnings (loss)                                    | \$229                         | 6,079                              | 9,944          | 2,730         | 18,982    |



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

|  | Three Months Ended March 31,<br>2013 |  | 2012    |
|--|--------------------------------------|--|---------|
|  | (In thousands)                       |  |         |
| Premiums and Other Revenues:                             |                                      |  |         |
| Premiums and contract revenues                           | \$41,763                             |  | 40,282  |
| Net investment income                                    | 180,814                              |  | 149,558 |
| Other revenues   | 6,142                                |  | 5,655   |
| Realized gains (losses) on investments                   | 2,313                                |  | 1,167   |
| Total condensed consolidated premiums and other revenues | \$231,032                            |  | 196,662 |
|  |                                      |  |         |
|  | Three Months Ended March 31,<br>2013 |  | 2012    |
|  | (In thousands)                       |  |         |
| Federal Income Taxes:                                    |                                      |  |         |
| Total segment Federal income taxes                       | \$7,872                              |  | 9,563   |
| Taxes on realized gains (losses) on investments          | 810                                  |  | 408     |
| Total condensed consolidated Federal income taxes        | \$8,682                              |  | 9,971   |
|  |                                      |  |         |
|  | Three Months Ended March 31,<br>2013 |  | 2012    |
|  | (In thousands)                       |  |         |
| Net Earnings:  |                                      |  |         |
| Total segment earnings                                   | \$15,129                             |  | 18,982  |
| Realized gains (losses) on investments, net of taxes     | 1,503                                |  | 759     |
| Total condensed consolidated net earnings                | \$16,632                             |  | 19,741  |

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|                                     | March 31,<br>2013<br>(In thousands) | 2012      |
|-------------------------------------|-------------------------------------|-----------|
| Assets:                             |                                     |           |
| Total segment assets                | \$ 10,321,396                       | 9,817,389 |
| Other unallocated assets            | 155,105                             | 67,216    |
| Total condensed consolidated assets | \$ 10,476,501                       | 9,884,605 |

## (7) SHARE-BASED PAYMENTS

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

All of the employees of the Company and its subsidiaries are eligible to participate in the current 2008 Plan (as well as previously in the expired 1995 Plan). In addition, directors of the Company are eligible to receive the same types of awards as employees except that they are not eligible to receive incentive stock options. Company directors, including members of the Compensation and Stock Option Committee, are eligible for nondiscretionary stock options. The directors' grants vest 20% annually following one full year of service to the Company from the date of grant. The employees' grants vest 20% annually following three full years of service to the Company from the date of grant. All grants issued expire after ten years. No awards were issued during the first quarter of 2013 or 2012.

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

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

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The Company uses the current fair value method to measure compensation cost. As of March 31, 2013 and 2012, the liability balance was \$4.1 million and \$1.6 million, respectively. A summary of shares available for grant and stock option activity is detailed below.

|                            | Shares<br>Available<br>For Grant | Options Outstanding<br>Shares                   | Weighted-<br>Average<br>Exercise<br>Price |
|----------------------------|----------------------------------|---|---|
| Stock Options:             |                                  |   |   |
| Balance at January 1, 2013 | 291,000                          | 82,468  | \$ 186.19                                 |
| Exercised                  | —                                | (2,850  | ) 150.00                                  |
| Forfeited                  | —                                | (400  | ) 255.13                                  |
| Expired                    | —                                | —   | —   |
| Stock options granted      | —                                | —   | —   |
| Balance at March 31, 2013  | 291,000                          | 79,218  | \$ 187.14                                 |
|                            |                                  | Stock Appreciation Rights Outstanding<br>Awards | Weighted-<br>Average<br>Exercise<br>Price |
| Stock Appreciation Rights: |                                  |   |   |
| Balance at January 1, 2013 | 66,461                           |   | \$ 125.03                                 |
| Exercised                  | (800                             | )   | 114.64                                    |
| Forfeited                  | (400                             | )   | 251.49                                    |
| Granted                    | —                                |   | —   |
| Balance at March 31, 2013  | 65,261                           |   | \$ 124.38                                 |

Stock options and stock appreciation rights (SARs) shown as forfeited in the above tables represent vested and unvested awards not exercised by plan participants prior to their termination from the Company. Forfeited stock options during the three months ended March 31, 2013 were awarded under the 1995 Plan. As the 1995 Plan terminated during calendar year 2010, the forfeited shares are not shown as being added back to the "Shares Available For Grant" balance.

The total intrinsic value of options exercised was \$0.1 million and \$0 for the three months ended March 31, 2013 and 2012, respectively. The total share-based liabilities paid were \$126,337 and \$17,000 for the three months ended March 31, 2013 and 2012, respectively. The total fair value of shares vested during the three months ended March 31, 2013 and 2012 was \$0.3 million and \$0.3 million, respectively. For the quarters ended March 31, 2013 and 2012, the total cash received from the exercise of options under the Plans was \$0 and \$0, respectively.



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The following table summarizes information about stock options and SARs outstanding at March 31, 2013.

|  | Options/SARs Outstanding | Weighted-Average Remaining Contractual Life | Options Exercisable |
|--|--------------------------|---|---------------------|
|  | Number Outstanding       |   |                     |
| Exercise prices:                         |                          |   |                     |
| \$150.00                                 | 47,200                   | 1.1 years                                   | 47,200              |
| 255.13                                   | 23,018                   | 5.1 years                                   | 9,208               |
| 208.05                                   | 9,000                    | 5.2 years                                   | 7,200               |
| 236.00                                   | 250                      | 5.4 years                                   | 100                 |
| 114.64                                   | 31,243                   | 5.8 years                                   | 15,558              |
| 132.56                                   | 33,768                   | 8.7 years                                   | 1,800               |
| Totals                                   | 144,479                  |   | 81,066              |
| Aggregate intrinsic value (in thousands) | \$4,611                  |   | \$2,260             |

The aggregate intrinsic value in the table above is based on the closing stock price of \$176.00 per share on March 31, 2013.

In estimating the fair value of the options outstanding at March 31, 2013 and December 31, 2012, the Company employed the Black-Scholes option pricing model with assumptions as detailed below.

|                          | March 31, 2013   | December 31, 2012 |
|--------------------------|------------------|-------------------|
| Expected term of options | 1 to 9 years     | 0 to 9 years      |
| Expected volatility:     |                  |                   |
| Range                    | 18.86% to 33.49% | 19.54% to 34.93%  |
| Weighted-average         | 24.93            | 25.96             |
| Expected dividend yield  | 20.20            | 23.00             |
| Risk-free rate:          |                  |                   |
| Range                    | 0.42% to 1.64%   | 0.39% to 1.49%    |
| Weighted-average         | 0.84             | 0.84              |

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

The pre-tax compensation cost (benefit) recognized in the financial statements related to the two plans defined above was \$1.5 and \$0 million for the three months ended March 31, 2013 and 2012, respectively. The related tax expense (benefit) recognized was \$0.5 million and \$0.0 million for the three months ended March 31, 2013 and 2012, respectively.

As of March 31, 2013, the total compensation cost related to nonvested options not yet recognized was \$1.8 million. This amount is expected to be recognized over a weighted-average period of 1.4 years. The Company recognizes compensation cost over the graded vesting periods.

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(8) COMMITMENTS AND CONTINGENCIES

(A) Legal Proceedings

In the normal course of business, the Company is involved or may become involved in various legal actions in which claims for alleged economic and punitive damages have been or may be asserted, some for substantial amounts. In recent years, carriers offering life insurance and annuity products have faced litigation, including class action lawsuits, alleging improper product design, improper sales practices, and similar claims. 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 is currently a defendant in a 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 March 31, 2013 for this matter. The trial date has been vacated and a pretrial conference is scheduled for May 31, 2013.

In addition to the class action lawsuit 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 Company vigorously defended this case and appealed the Final Judgment to the Court of Appeals Second District of Texas in Fort Worth. The Court of Appeals on August 11, 2011, reversed the trial court judgment in its entirety and rendered a take nothing verdict in favor of National Western. Plaintiffs (Appellees) filed a motion for a rehearing which the Court ruled on October 13, 2011, that the trial court's judgment was still reversed and judgment was still entered that Newman take nothing, all in favor of National Western. The Plaintiffs (Appellees) filed a Motion for Reconsideration En Banc which the Court of Appeals denied on October 27, 2011. The Plaintiffs (Appellees) then filed a Motion for Rehearing of the Court's amended decision, which the Court of Appeals denied on December 22, 2011. On March 21, 2012, Plaintiffs (Appellees) filed a petition for review with the Texas Supreme Court and the Company filed its response on April 20, 2012. The Supreme Court asked the parties for briefs on the issues before deciding on whether to hear the case and both parties submitted their briefs. On February 14, 2013, the Supreme Court denied the Plaintiffs petition for review. On April 3, 2013, Plaintiff filed a Motion for Rehearing.

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

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.



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## (B) Financial Instruments

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

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

The Company had \$5.7 million of commitments to extend credit relating to mortgage loans at March 31, 2013. The Company evaluates each customer's creditworthiness on a case-by-case basis.

## (9) INVESTMENTS

## (A) Investment Gains and Losses

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

|   | Three Months Ended March 31, |        |
|---|------------------------------|--------|
|   | 2013                         | 2012   |
|   | (In thousands)               |        |
| Available for sale debt securities:       |                              |        |
| Realized gains on disposal                | \$1,796                      | 1,628  |
| Realized losses on disposal               | —                            | —      |
| Held to maturity debt securities:         |                              |        |
| Realized gains on disposal                | 329                          | 116    |
| Realized losses on disposal               | (69                          | ) (374 |
| Equity securities realized gains (losses) | 318                          | (4     |
| Real estate gains (losses)                | —                            | —      |
| Mortgage loans write-downs                | —                            | —      |
| Other                                     | —                            | —      |
| Totals                                    | \$2,374                      | 1,366  |

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The Company uses the specific identification method in computing realized gains and losses. Approximately 15.5% of the gains on bonds are due to calls of securities rather than sales. This includes calls out of the Company's available for sale portfolio of debt securities.

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

|   | Three Months Ended March 31, |        |
|---|------------------------------|--------|
|   | 2013                         | 2012   |
|   | (In thousands)               |        |
| Total other-than-temporary impairment gains (losses) on debt securities | \$382                        | (253   |
| Portion of loss (gain) recognized in comprehensive income               | (443                         | ) 78   |
| Net impairment losses (gains) on debt securities recognized in earnings | (61                          | ) (175 |
| Equity securities impairments   | —                            | (24    |
| Totals  | \$(61                        | ) (199 |

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

|   | Three months<br>ended March 31,<br>2013 | Twelve Months<br>Ended<br>December 31,<br>2012 |
|---|---|--|
| Beginning balance, cumulative credit losses related to other-than-temporary impairments   | \$2,247                                 | 1,122  |
| Reductions for securities sold during current period                                      | \$—                                     | (118   |
| Additions for credit losses not previously recognized in other-than-temporary impairments | 61                                      | 1,243  |
| Ending balance, cumulative credit losses related to other-than-temporary impairment       | \$2,308                                 | 2,247  |

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## (B) Debt and Equity Securities

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

|                                   | Securities Held to Maturity |                        |                         | Fair Value  |
|-----------------------------------|-----------------------------|------------------------|-------------------------|-------------|
|                                   | Amortized Cost              | Gross Unrealized Gains | Gross Unrealized Losses |             |
|                                   | (In thousands)              |                        |                         |             |
| Debt securities:                  |                             |                        |                         |             |
| U.S. agencies                     | \$23,107                    | 2,551                  | —                       | 25,658      |
| U.S. Treasury                     | 1,909                       | 617                    | —                       | 2,526       |
| States and political subdivisions | 415,553                     | 40,932                 | (718)                   | ) 455,767   |
| Foreign governments               | 9,990                       | 507                    | —                       | 10,497      |
| Public utilities                  | 778,321                     | 86,375                 | (181)                   | ) 864,515   |
| Corporate                         | 3,052,451                   | 260,064                | (5,675)                 | ) 3,306,840 |
| Mortgage-backed                   | 1,766,021                   | 121,769                | (484)                   | ) 1,887,306 |
| Home equity                       | 21,057                      | 4,556                  | (359)                   | ) 25,254    |
| Manufactured housing              | 9,732                       | 779                    | —                       | 10,511      |
| Totals                            | \$6,078,141                 | 518,150                | (7,417)                 | ) 6,588,874 |

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

|                                   | Securities Available for Sale |                              |                               |               |
|-----------------------------------|-------------------------------|------------------------------|-------------------------------|---------------|
|                                   | Amortized<br>Cost             | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|                                   | (In thousands)                |                              |                               |               |
| Debt securities:                  |                               |                              |                               |               |
| States and political subdivisions | \$598                         | —                            | (32                           | ) 566         |
| Foreign governments               | 9,925                         | 570                          | —                             | 10,495        |
| Public utilities                  | 257,807                       | 25,107                       | (9                            | ) 282,905     |
| Corporate                         | 2,259,238                     | 211,922                      | (1,915                        | ) 2,469,245   |
| Mortgage-backed                   | 101,497                       | 8,789                        | —                             | 110,286       |
| Home equity                       | 12,222                        | 17                           | (394                          | ) 11,845      |
| Manufactured housing              | 4,695                         | 223                          | —                             | 4,918         |
|                                   | 2,645,982                     | 246,628                      | (2,350                        | ) 2,890,260   |
| Equity public                     | 10,326                        | 3,654                        | (38                           | ) 13,942      |
| Totals                            | \$2,656,308                   | 250,282                      | (2,388                        | ) 2,904,202   |

The table below presents amortized costs and fair values of securities held to maturity at December 31, 2012.

|                                   | Securities Held to Maturity |                              |                               |               |
|-----------------------------------|-----------------------------|------------------------------|-------------------------------|---------------|
|                                   | Amortized<br>Cost           | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|                                   | (In thousands)              |                              |                               |               |
| Debt securities:                  |                             |                              |                               |               |
| U.S. agencies                     | \$23,114                    | 2,748                        | —                             | 25,862        |
| U.S. Treasury                     | 1,907                       | 648                          | —                             | 2,555         |
| States and political subdivisions | 391,062                     | 41,150                       | (431                          | ) 431,781     |
| Foreign governments               | 9,988                       | 616                          | —                             | 10,604        |
| Public utilities                  | 781,239                     | 89,162                       | (103                          | ) 870,298     |
| Corporate                         | 2,887,572                   | 273,431                      | (3,753                        | ) 3,157,250   |
| Mortgage-backed                   | 1,835,051                   | 133,684                      | (261                          | ) 1,968,474   |
| Home equity                       | 21,545                      | 4,443                        | (549                          | ) 25,439      |
| Manufactured housing              | 10,642                      | 722                          | —                             | 11,364        |
| Totals                            | \$5,962,120                 | 546,604                      | (5,097                        | ) 6,503,627   |

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The table below presents amortized costs and fair values of securities available for sale at December 31, 2012.

|                                   | Securities Available for Sale |            |            |             |
|-----------------------------------|-------------------------------|------------|------------|-------------|
|                                   | Amortized                     | Gross      | Gross      | Fair        |
|                                   | Cost                          | Unrealized | Unrealized | Value       |
|                                   |                               | Gains      | Losses     |             |
|                                   | (In thousands)                |            |            |             |
| Debt securities:                  |                               |            |            |             |
| States and political subdivisions | \$599                         | —          | (28        | ) 571       |
| Foreign governments               | 15,134                        | 932        | —          | 16,066      |
| Public utilities                  | 254,853                       | 26,621     | (47        | ) 281,427   |
| Corporate                         | 2,157,706                     | 222,587    | (2,981     | ) 2,377,312 |
| Mortgage-backed                   | 113,488                       | 8,905      | (64        | ) 122,329   |
| Home equity                       | 12,242                        | —          | (1,483     | ) 10,759    |
| Manufactured housing              | 5,030                         | 240        | —          | 5,270       |
|                                   | 2,559,052                     | 259,285    | (4,603     | ) 2,813,734 |
| Equity public                     | 9,460                         | 2,865      | (58        | ) 12,267    |
| Totals                            | \$2,568,512                   | 262,150    | (4,661     | ) 2,826,001 |

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

|                                       | Securities Held to Maturity |            |                      |            |           |            |   |
|---------------------------------------|-----------------------------|------------|----------------------|------------|-----------|------------|---|
|                                       | Less than 12 Months         |            | 12 Months or Greater |            | Total     |            |   |
|                                       | Fair                        | Unrealized | Fair                 | Unrealized | Fair      | Unrealized |   |
|                                       | Value                       | Losses     | Value                | Losses     | Value     | Losses     |   |
|                                       | (In thousands)              |            |                      |            |           |            |   |
| Debt securities:                      |                             |            |                      |            |           |            |   |
| U.S. agencies                         | \$—                         | —          | —                    | —          | —         | —          |   |
| U.S. Treasury                         | —                           | —          | —                    | —          | —         | —          |   |
| States and political subdivisions     | 21,683                      | (712       | ) 579                | (6         | ) 22,262  | (718       | ) |
| Foreign governments                   | —                           | —          | —                    | —          | —         | —          |   |
| Public utilities                      | 23,292                      | (181       | ) —                  | —          | 23,292    | (181       | ) |
| Corporate                             | 381,377                     | (3,924     | ) 28,235             | (1,751     | ) 409,612 | (5,675     | ) |
| Mortgage-backed                       | 30,917                      | (484       | ) —                  | —          | 30,917    | (484       | ) |
| Home equity                           | —                           | —          | 6,386                | (359       | ) 6,386   | (359       | ) |
| Manufactured housing                  | —                           | —          | —                    | —          | —         | —          |   |
| Total temporarily impaired securities | \$457,269                   | (5,301     | ) 35,200             | (2,116     | ) 492,469 | (7,417     | ) |



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

|                                       | Securities Available for Sale |                   |                      |                   |            |                   |
|---------------------------------------|-------------------------------|-------------------|----------------------|-------------------|------------|-------------------|
|                                       | Less than 12 Months           |                   | 12 Months or Greater |                   | Total      |                   |
|                                       | Fair Value                    | Unrealized Losses | Fair Value           | Unrealized Losses | Fair Value | Unrealized Losses |
|                                       | (In thousands)                |                   |                      |                   |            |                   |
| Debt securities:                      |                               |                   |                      |                   |            |                   |
| U.S. agencies                         | \$—                           | —                 | —                    | —                 | —          | —                 |
| U.S. Treasury                         | —                             | —                 | —                    | —                 | —          | —                 |
| States and political subdivisions     | 566                           | (32 )             | —                    | —                 | 566        | (32 )             |
| Foreign governments                   | —                             | —                 | —                    | —                 | —          | —                 |
| Public utilities                      | 1,008                         | (9 )              | —                    | —                 | 1,008      | (9 )              |
| Corporate                             | 116,702                       | (1,428 )          | 14,475               | (487 )            | 131,177    | (1,915 )          |
| Mortgage-backed                       | —                             | —                 | —                    | —                 | —          | —                 |
| Home equity                           | —                             | —                 | 6,913                | (394 )            | 6,913      | (394 )            |
| Manufactured housing                  | —                             | —                 | —                    | —                 | —          | —                 |
|                                       | 118,276                       | (1,469 )          | 21,388               | (881 )            | 139,664    | (2,350 )          |
| Equity public                         | 214                           | (21 )             | 159                  | (17 )             | 373        | (38 )             |
| Total temporarily impaired securities | \$118,490                     | (1,490 )          | 21,547               | (898 )            | 140,037    | (2,388 )          |

Liquidity in the bond market improved in 2012 and 2013 as economic and market conditions stabilized. Although the unrealized losses declined substantially in 2012 and held at the 2012 level through the first quarter of 2013, there continues to be uncertainty in the bond markets regarding the economic recovery and some unrealized losses remain in the Company's portfolio. The Company does not consider these investments to be other-than-temporarily impaired as the Company does not intend to sell these securities nor does it think it will be forced to sell until recovery in fair value or maturity, and expects to receive all amounts due relative to principal and interest.

The Company does not consider securities to be other-than-temporarily impaired when the market decline is attributable to factors such as market volatility, liquidity, spread widening and credit quality and when recovery of all amounts due under the contractual terms of the security is anticipated. Based on the review and the Company's ability and intent not to sell these securities until maturity, the Company does not consider these investments to be other-than-temporarily impaired at March 31, 2013. The Company will monitor the investment portfolio for future changes in issuer facts and circumstances that could result in future impairments beyond those currently identified.

During the first quarter of 2013, the Company recorded an other-than-temporary impairment on two asset-backed securities. The securities had \$0.1 million of credit impairment which is reported in the Condensed Consolidated Statements of Earnings and \$0.4 million of liquidity gains which did not affect current earnings. The Company intends

to hold the securities until recovery of fair market value or maturity.



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Debt securities. The gross unrealized losses for debt securities are made up of 96 individual issues, or 7.6% of the total debt securities held by the Company. The market value of these bonds as a percent of amortized cost averages 98.5%. Of the 96 securities, 10, or approximately 10.3%, fall in the 12 months or greater aging category; and 91 were rated investment grade at March 31, 2013. Additional information on debt securities by investment category is summarized below.

U.S. Treasury. No securities had a gross unrealized loss.

U.S. government agencies. No securities had a gross unrealized loss.

State and political subdivisions. The unrealized losses on these investments are the result of holdings in 14 securities. Of these securities, all are rated A or above except 1 which is rated BBB+ and 1 is rated BB. Based on these facts and the Company's intent to hold to maturity, no other-than-temporary loss was recognized as of March 31, 2013.

Foreign governments. No securities had a gross unrealized loss.

Public utilities. Of the 3 securities, all are rated BBB- or above. At this time, the Company does not consider any of these unrealized losses as other-than-temporary.

Corporate. Corporate securities with unrealized losses are reviewed based on monitoring procedures described previously, including review of the amount of the unrealized loss, the length of time that the issue has been in an unrealized loss position, credit ratings, analyst reports, and recent issuer financial information. A total of 70 securities had unrealized losses, with 2 issues rated below investment grade. More extensive analysis was performed on these 2 issues. Based on the analysis performed, none of these securities are considered other-than-temporarily impaired at March 31, 2013.

Mortgage-backed securities. Of the 4 securities, all are rated AA+. The Company generally purchases these investments at a discount relative to their face amount and it is expected that the securities will not be settled at a price less than the stated par. Based on cash flow analysis, none of the unrealized losses are considered other-than-temporary at March 31, 2013.

Home equity. Of the 5 securities, all are rated B or above except 1 which is rated CC. The Company performs a quarterly cash flow analysis on asset-backed securities that are rated below AA. Based on cash flow analysis, 1 security was other-than-temporarily impaired at March 31, 2013.

Manufactured housing. No securities had a gross unrealized loss.

Equity securities. The gross unrealized losses for equity securities are made up of 9 individual issues. These holdings are reviewed quarterly for impairment. None of the equity securities were considered other-than-temporarily impaired at March 31, 2013, in accordance with Company policy.

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The following table shows the gross unrealized losses and fair values of the Company's held to maturity investments by investment category and length of time the individual securities have been in a continuous unrealized loss position at December 31, 2012.

|  | Securities Held to Maturity |                      |                      |                      | Total<br>Fair<br>Value | Unrealized<br>Losses |
|--|-----------------------------|----------------------|----------------------|----------------------|------------------------|----------------------|
|  | Less than 12 Months         |                      | 12 Months or Greater |                      |                        |                      |
|  | Fair<br>Value               | Unrealized<br>Losses | Fair<br>Value        | Unrealized<br>Losses |                        |                      |
|  | (In thousands)              |                      |                      |                      |                        |                      |
| Debt securities:                         |                             |                      |                      |                      |                        |                      |
| U.S. agencies                            | \$—                         | —                    | —                    | —                    | —                      | —                    |
| U.S. Treasury                            | —                           | —                    | —                    | —                    | —                      | —                    |
| States and political<br>subdivisions     | 19,745                      | (401 )               | 1,470                | (31 )                | 21,215                 | (432 )               |
| Foreign governments                      | —                           | —                    | —                    | —                    | —                      | —                    |
| Public utilities                         | 24,271                      | (80 )                | 1,982                | (23 )                | 26,253                 | (103 )               |
| Corporate                                | 303,645                     | (1,776 )             | 38,078               | (1,977 )             | 341,723                | (3,753 )             |
| Mortgage-backed                          | 15,010                      | (261 )               | —                    | —                    | 15,010                 | (261 )               |
| Home equity                              | —                           | —                    | 6,435                | (548 )               | 6,435                  | (548 )               |
| Manufactured housing                     | —                           | —                    | —                    | —                    | —                      | —                    |
| Total temporarily impaired<br>securities | \$362,671                   | (2,518 )             | 47,965               | (2,579 )             | 410,636                | (5,097 )             |

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The following table shows the gross unrealized losses and fair values of the Company's available for sale investments by investment category and length of time that the individual securities have been in a continuous unrealized loss position at December 31, 2012.

|                                       | Securities Available for Sale |                   |                      |                   |            |                   |
|---------------------------------------|-------------------------------|-------------------|----------------------|-------------------|------------|-------------------|
|                                       | Less than 12 Months           |                   | 12 Months or Greater |                   | Total      |                   |
|                                       | Fair Value                    | Unrealized Losses | Fair Value           | Unrealized Losses | Fair Value | Unrealized Losses |
|                                       | (In thousands)                |                   |                      |                   |            |                   |
| Debt securities:                      |                               |                   |                      |                   |            |                   |
| U.S. agencies                         | \$—                           | —                 | —                    | —                 | —          | —                 |
| U.S. Treasury                         | —                             | —                 | —                    | —                 | —          | —                 |
| States and political subdivisions     | 571                           | (28 )             | —                    | —                 | 571        | (28 )             |
| Foreign governments                   | —                             | —                 | —                    | —                 | —          | —                 |
| Public utilities                      | 10,949                        | (47 )             | —                    | —                 | 10,949     | (47 )             |
| Corporate                             | 64,383                        | (713 )            | 14,713               | (2,268 )          | 79,096     | (2,981 )          |
| Mortgage-backed                       | 3,839                         | (64 )             | —                    | —                 | 3,839      | (64 )             |
| Home equity                           | 4,698                         | (216 )            | 6,062                | (1,267 )          | 10,760     | (1,483 )          |
| Manufactured housing                  | —                             | —                 | —                    | —                 | —          | —                 |
|                                       | 84,440                        | (1,068 )          | 20,775               | (3,535 )          | 105,215    | (4,603 )          |
| Equity public                         | 756                           | (8 )              | 295                  | (50 )             | 1,051      | (58 )             |
| Total temporarily impaired securities | \$85,196                      | (1,076 )          | 21,070               | (3,585 )          | 106,266    | (4,661 )          |

## (C) Transfer of Securities

During the three months ended March 31, 2013 and 2012, the Company made no transfers to the held to maturity category from securities available for sale. Lower holdings of securities available for sale reduces the Company's exposure to market price volatility while still providing securities available for liquidity and asset/liability management purposes.

## (D) Mortgage Loans and Real Estate

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

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

with any premium or discount amortized over the life of the loan. Prepayment and late fees are recorded on the date of collection.

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Loans in foreclosure, loans considered impaired or loans past due 90 days or more are placed on a non-accrual status. If a mortgage loan is determined to be on non-accrual status, the mortgage loan does not accrue any revenue into the Condensed Consolidated Statements of Earnings. The loan is independently monitored and evaluated as to potential impairment or foreclosure. If delinquent payments are made and the loan is brought current, then the Company returns the loan to active status and accrues income accordingly. The Company has no loans past due 90 days which are accruing interest.

The following table represents the loan-to-value ratio using the most recent appraised value.

|  | March 31, 2013           |       | December 31, 2012        |           |      |   |      |    |
|--|--------------------------|-------|--------------------------|-----------|------|---|------|----|
|  | Amount<br>(In thousands) | %     | Amount<br>(In thousands) | %         |      |   |      |    |
| Mortgage Loans by Loan-to-Value Ratio (1): |                          |       |                          |           |      |   |      |    |
| Less than 50%                              | \$51,365                 | 40.7  | %                        | \$58,754  | 41.1 | % |      |    |
| 50% to 60%                                 | 20,133                   | 16.0  | %                        | 27,832    | 19.5 | % |      |    |
| 60% to 70%                                 | 22,912                   | 18.2  | %                        | 23,518    | 16.5 | % |      |    |
| 70% to 80%                                 | 8,619                    | 6.8   | %                        | 9,431     | 6.6  | % |      |    |
| 80% to 90%                                 | —                        | —     | %                        | —         | —    | % |      |    |
| Greater than 90%                           | 23,160                   | 18.3  | %                        | 23,285    | 16.3 | % |      |    |
| Gross balance                              | 126,189                  | 100.0 | %                        | 142,820   | 100  | % |      |    |
| Allowance for possible losses              | (650                     | )     | (0.5                     | )%        | (650 | ) | (0.5 | )% |
| Totals                                     | \$125,539                | 99.5  | %                        | \$142,170 | 99.5 | % |      |    |

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

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

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

Mortgage loans are considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. When it is determined that a loan is impaired, a loss is recognized for the difference between the carrying amount of the mortgage loan and the estimated value reduced by the cost to sell. Estimated value is typically based on the loan's

observable market price or the fair value of the collateral less cost to sell. Impairments and changes in the valuation allowance are reported in net realized capital gains (losses) in the Condensed Consolidated Statements of Earnings.

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The following table represents the mortgage loan allowance for the three months ended March 31, 2013 and the year ended December 31, 2012:

|                              | March 31, 2013 | December 31,<br>2012 |
|------------------------------|----------------|----------------------|
|                              | (In thousands) |                      |
| Balance, beginning of period | \$650          | 4,571                |
| Provision                    | —              | 650                  |
| Releases                     | —              | (4,571)              |
| Balance, end of period       | \$650          | 650                  |

The mortgage loan allowance released in the second quarter of 2012 pertained to a property forced into bankruptcy which the Company subsequently acquired in a bankruptcy auction. The mortgage loan was closed and the property reclassified as a real estate investment included in other long-term investments on the Company's balance sheet. The property was subsequently sold in the third quarter of 2012 for a net gain of \$2.7 million.

## (10) FAIR VALUES OF FINANCIAL INSTRUMENTS

Effective January 1, 2008, the Company adopted FASB guidance which defines fair value, establishes a framework for measuring fair value under GAAP, and requires additional disclosures about fair value measurements. In compliance with this GAAP guidance, the Company has categorized its financial instruments, based on the priority of the inputs to the valuation technique, into a three level hierarchy. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). If the inputs used to measure fair value fall within different levels of the hierarchy, the category level is based on the lowest priority level input that is significant to the fair value measurement of the instrument.

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

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

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

preferred stock, certain equity securities, and over-the-counter derivative contracts. The Company's Level 2 liabilities consist of certain product-related embedded derivatives. Valuations are generally obtained from third party pricing services for identical or comparable assets or determined through use of valuation methodologies using observable market inputs.

Level 3: Fair value is based on significant unobservable inputs which reflect the entity's or third party pricing service's assumptions about the assumptions market participants would use in pricing an asset or liability. The Company's Level 3 assets include certain equity securities and certain less liquid or private fixed maturity debt securities where significant valuation inputs cannot be corroborated with market observable data. The Company's Level 3 liabilities consist of share-based compensation obligations. Valuations are estimated based on non-binding broker prices or internally developed valuation models or methodologies, discounted cash flow models and other similar techniques.



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

|                                       | March 31, 2013          |         |           |         |
|---------------------------------------|-------------------------|---------|-----------|---------|
|                                       | Total<br>(In thousands) | Level 1 | Level 2   | Level 3 |
| Debt securities, available for sale   | \$2,890,260             | —       | 2,890,260 | —       |
| Equity securities, available for sale | 13,942                  | 13,389  | 553       | —       |
| Derivatives, index options            | 130,967                 | —       | 130,967   | —       |
| Total assets                          | \$3,035,169             | 13,389  | 3,021,780 | —       |
| Policyholder account balances (a)     | \$149,895               | —       | 149,895   | —       |
| Other liabilities (b)                 | 4,073                   | —       | —         | 4,073   |
| Total liabilities                     | \$153,968               | —       | 149,895   | 4,073   |

During the three months ended March 31, 2013, the Company had no transfers into or out of Levels 1, 2 or 3, equity securities available for sale. The security is held at its equity value and was transferred to other long-term investments. The Company did not make any other transfers of assets into or out of levels 1, 2 or 3 during the period reported.

|                                       | December 31, 2012       |         |           |         |
|---------------------------------------|-------------------------|---------|-----------|---------|
|                                       | Total<br>(In thousands) | Level 1 | Level 2   | Level 3 |
| Debt securities, available for sale   | \$2,813,734             | —       | 2,813,734 | —       |
| Equity securities, available for sale | 12,267                  | 11,968  | 299       | —       |
| Derivatives, index options            | 57,890                  | —       | 57,890    | —       |
| Total assets                          | \$2,883,891             | 11,968  | 2,871,923 | —       |
| Policyholder account balances (a)     | \$72,470                | —       | 72,470    | —       |
| Other liabilities (b)                 | 2,718                   | —       | —         | 2,718   |
| Total liabilities                     | \$75,188                | —       | 72,470    | 2,718   |

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

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

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

|  | March 31, 2013 |         |           |         |
|--|----------------|---------|-----------|---------|
|  | Total          | Level 1 | Level 2   | Level 3 |
|  | (In thousands) |         |           |         |
| Debt securities, available for sale:   |                |         |           |         |
| Priced by third-party vendors          | \$2,890,260    | —       | 2,890,260 | —       |
| Priced internally                      | —              | —       | —         | —       |
| Subtotal                               | 2,890,260      | —       | 2,890,260 | —       |
| Equity securities, available for sale: |                |         |           |         |
| Priced by third-party vendors          | 13,942         | 13,389  | 553       | —       |
| Priced internally                      | —              | —       | —         | —       |
| Subtotal                               | 13,942         | 13,389  | 553       | —       |
| Derivatives, index options:            |                |         |           |         |
| Priced by third-party vendors          | 130,967        | —       | 130,967   | —       |
| Priced internally                      | —              | —       | —         | —       |
| Subtotal                               | 130,967        | —       | 130,967   | —       |
| Total                                  | \$3,035,169    | 13,389  | 3,021,780 | —       |
| Percent of total                       | 100.0          | % 0.4   | % 99.6    | % —     |

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|  | December 31, 2012       |         |           |         |
|--|-------------------------|---------|-----------|---------|
|  | Total<br>(In thousands) | Level 1 | Level 2   | Level 3 |
| Debt securities, available for sale:   |                         |         |           |         |
| Priced by third-party vendors          | \$2,813,734             | —       | 2,813,734 | —       |
| Priced internally                      | —                       | —       | —         | —       |
| Subtotal                               | 2,813,734               | —       | 2,813,734 | —       |
| Equity securities, available for sale: |                         |         |           |         |
| Priced by third-party vendors          | 12,267                  | 11,968  | 299       | —       |
| Priced internally                      | —                       | —       | —         | —       |
| Subtotal                               | 12,267                  | 11,968  | 299       | —       |
| Derivatives, index options:            |                         |         |           |         |
| Priced by third-party vendors          | 57,890                  | —       | 57,890    | —       |
| Priced internally                      | —                       | —       | —         | —       |
| Subtotal                               | 57,890                  | —       | 57,890    | —       |
| Total                                  | \$2,883,891             | 11,968  | 2,871,923 | —       |
| Percent of total                       | 100.0                   | % 0.4   | % 99.6    | % —     |

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

|   | For the Three Months Ended March 31, 2013             |                                       |              |                   |
|---|---|---------------------------------------|--------------|-------------------|
|   | Debt Securities, Available for Sale<br>(In thousands) | Equity Securities, Available for Sale | Total Assets | Other Liabilities |
| Balance at January 1, 2013  | \$—   | —                                     | —            | 2,718             |
| Total realized and unrealized gains (losses):   |   |                                       |              |                   |
| Included in net income  | —   | —                                     | —            | 1,481             |
| Included in other comprehensive income  | —   | —                                     | —            | —                 |
| Purchases, sales, issuances and settlements, net  | —   | —                                     | —            | (126)             |
| Transfers into (out of) Level 3   | —   | —                                     | —            | —                 |
| Balance at end of period  | \$—   | —                                     | —            | 4,073             |
| Amount of total gains (losses) for the period included in net income attributable to the change in unrealized gains (losses) relating to assets still held at end of period | \$—   | —                                     | —            | 1,551             |



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|  | For the Three months ended March 31, 2012                      |  |                 |                      |
|--|--|--|-----------------|----------------------|
|  | Debt<br>Securities,<br>Available<br>for Sale<br>(In thousands) | Equity<br>Securities,<br>Available<br>for Sale | Total<br>Assets | Other<br>Liabilities |
| Balance at January 1, 2012   | \$—  | 8,118  | 8,118           | 1,647                |
| Total realized and unrealized gains (losses):  |  |  |                 |                      |
| Included in net income   | —  | —  | —               | (7 )                 |
| Included in other comprehensive income   | —  | 897  | 897             | —                    |
| Purchases, sales, issuances and settlements, net   | —  | —  | —               | (17 )                |
| Transfers into (out of) Level 3  | —  | (9,015 )                                       | (9,015 )        | —                    |
| Balance at end of period   | \$—  | —  | —               | 1,623                |
| Amount of total gains (losses) for the period<br>included in net income attributable to the change in<br>unrealized gains (losses) relating to assets still held<br>at end of period | \$—  | —  | —               | 30                   |

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

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

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

|  | March 31, 2013     |                | December 31, 2012  |                |
|--|--------------------|----------------|--------------------|----------------|
|  | Carrying<br>Values | Fair<br>Values | Carrying<br>Values | Fair<br>Values |
| (In thousands)                               |                    |                |                    |                |
| <b>ASSETS</b>                                |                    |                |                    |                |
| Investments in debt and equity securities:   |                    |                |                    |                |
| Securities held to maturity                  | \$6,078,141        | 6,588,874      | 5,962,120          | 6,503,627      |
| Securities available for sale                | 2,904,202          | 2,904,202      | 2,826,001          | 2,826,001      |
| Cash and short-term investments              | 86,816             | 86,816         | 124,561            | 124,561        |
| Mortgage loans                               | 125,539            | 132,063        | 142,170            | 147,365        |
| Policy loans                                 | 71,143             | 71,143         | 71,549             | 71,549         |
| Other loans                                  | 12,169             | 12,490         | 14,997             | 15,273         |
| Derivatives, index options                   | 130,967            | 130,967        | 57,890             | 57,890         |
| Life interest in Libbie Shearn Moody Trust   | —                  | 12,775         | —                  | 12,775         |
| <b>LIABILITIES</b>                           |                    |                |                    |                |
| Deferred annuity contracts                   | \$7,020,784        | 6,734,914      | 6,907,055          | 6,624,111      |
| Immediate annuity and supplemental contracts | 489,011            | 526,909        | 492,853            | 531,857        |

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

**(11) DERIVATIVE INVESTMENTS**

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

The Company purchases over-the-counter index options, which are derivative financial instruments, to hedge the equity return component of its fixed-indexed annuity and life products. The index options act as hedges to match closely the returns on the underlying index or indices. The amounts which may be credited to policyholders are linked, in part, to the returns of the underlying index or indices. As a result, changes to policyholders' liabilities are

substantially offset by changes in the value of the options. Cash is exchanged upon purchase of the index options and no principal or interest payments are made by either party during the option periods. Upon maturity or expiration of the options, cash may be paid to the Company depending on the performance of the underlying index or indices and terms of the contract.

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

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

The tables below present the fair value of derivative instruments as of March 31, 2013 and December 31, 2012, respectively.

|   | March 31, 2013             |                | Liability Derivatives                |                |
|---|----------------------------|----------------|--------------------------------------|----------------|
|   | Asset Derivatives          |                | Balance                              | Fair           |
|   | Balance                    | Fair           | Sheet                                | Value          |
|   | Sheet                      | Value          | Location                             |                |
|   | Location                   | (In thousands) |                                      | (In thousands) |
| Derivatives not designated as hedging instruments |                            |                |                                      |                |
| Equity index options                              | Derivatives, Index Options | \$ 130,967     |                                      |                |
| Fixed-indexed products                            |                            |                | Universal Life and Annuity Contracts | \$ 149,895     |
| Total   |                            | \$ 130,967     |                                      | \$ 149,895     |
|   | December 31, 2012          |                | Liability Derivatives                |                |
|   | Asset Derivatives          |                | Balance                              | Fair           |
|   | Balance                    | Fair           | Sheet                                | Value          |
|   | Sheet                      | Value          | Location                             |                |
|   | Location                   | (In thousands) |                                      | (In thousands) |
| Derivatives not designated as hedging instruments |                            |                |                                      |                |
| Equity index options                              | Derivatives, Index Options | \$ 57,890      |                                      |                |



|                        |          |   |          |
|------------------------|----------|---|----------|
| Fixed-indexed products |          | Universal Life and<br>Annuity Contracts | \$72,470 |
| Total                  | \$57,890 |   | \$72,470 |

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The table below presents the effect of derivative instruments in the Condensed Consolidated Statements of Earnings for the three months ended March 31, 2013 and 2012.

| Derivatives Not Designated<br>As Hedging Instruments | Location of Gain<br>or (Loss) Recognized<br>In Income on Derivative | March 31,   | March 31,   |
|--|---|---|-------------|
|  |   | 2013  | 2012        |
|  |   | Amount of Gain or<br>(Loss) Recognized in<br>Income on Derivative<br>(In thousands) |             |
| Equity index options                                 | Net investment income   | \$74,432  | 42,437      |
| Fixed-index products                                 | Universal life and annuity contract<br>interest                     | (70,084   | ) (47,615 ) |
|  |   | \$4,348   | (5,178 )    |

## (12) SUBSEQUENT EVENTS

Subsequent events have been evaluated through May 8, 2013, which is the date that the financial statements have been issued, and no reportable items were identified.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES  
ABOUT MARKET RISK

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

ITEM 4. CONTROLS AND PROCEDURES

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

There have been no changes in the Company's internal controls over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended March 31, 2013 that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting. Internal controls over financial reporting change as the Company modifies or enhances its systems and processes to meet business needs. Any significant changes in controls are evaluated prior to implementation to help ensure continued effectiveness of internal controls and the control environment.

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

FORWARD-LOOKING STATEMENTS

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

Management's discussion and analysis of the financial condition and results of operations (“MD&A”) of National Western Life Insurance Company for the three months ended March 31, 2013 follows. This discussion should be read in conjunction with the Company's condensed consolidated financial statements and related notes beginning on page 3 of this report and with the 2012 Annual Report filed on Form 10-K with the SEC.

Overview

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

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

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

The Company monitors these factors continually as key business indicators. The discussion that follows in this Item 2 includes these indicators and presents information useful to an overall understanding of the Company's business performance in 2013, incorporating required disclosures in accordance with the rules and regulations of the Securities and Exchange Commission.

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Insurance Operations - Domestic

The Company is currently licensed to do business in all states and the District of Columbia except for New York. Products marketed are annuities, universal life insurance, fixed-indexed universal life, and traditional life insurance, which include both term and whole life products. The Company's domestic sales have historically been more heavily weighted toward annuity products, which include single and flexible premium deferred annuities, single premium immediate annuities, and fixed-indexed annuities. Most of these annuities can be sold as tax qualified or nonqualified products. At March 31, 2013, the Company maintained approximately 141,000 annuity contracts in force.

National Western markets and distributes its domestic products primarily through independent national marketing organizations ("NMOs"). These NMOs assist the Company in recruiting, contracting, and managing independent agents. The Company's agents are independent contractors who are compensated on a commission basis. The Company currently has approximately 15,200 domestic independent agents contracted. Roughly 18% of these contracted agents have submitted policy applications to the Company in the past twelve months.

Insurance Operations - International

The Company's international clientèle consists mainly of foreign nationals in upper socioeconomic classes. Insurance products are issued primarily to residents of countries in Central and South America, the Caribbean, Eastern Europe, Asia and the Pacific Rim based upon applications received in the Company's home office in Austin, Texas. Issuing policies to residents of countries in these different regions provides diversification that helps to minimize large fluctuations that could arise due to various economic, political, and competitive pressures that may occur from one country to another. Products issued to international residents are almost entirely universal life and traditional life insurance products. However, certain annuity and investment contracts are also available. At March 31, 2013, the Company had approximately 72,400 international life insurance policies in force representing approximately \$19.1 billion in face amount of coverage.

International applications are submitted by independent contractor consultants and broker-agents. The Company has approximately 3,560 independent international consultants and brokers currently contracted, 30% of which have submitted policy applications to the Company in the past twelve months.

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

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## SALES

## Life Insurance

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

|                     | Three Months Ended March 31, |       |
|---------------------|------------------------------|-------|
|                     | 2013                         | 2012  |
|                     | (In thousands)               |       |
| International:      |                              |       |
| Universal life      | \$1,056                      | 1,445 |
| Traditional life    | 737                          | 685   |
| Equity-indexed life | 2,363                        | 3,319 |
|                     | 4,156                        | 5,449 |
| Domestic:           |                              |       |
| Universal life      | 113                          | 34    |
| Traditional life    | 16                           | 11    |
| Equity-indexed life | 4,110                        | 1,624 |
|                     | 4,239                        | 1,669 |
| Totals              | \$8,395                      | 7,118 |

Life insurance sales as measured by annualized first year premiums increased 18% in the first quarter of 2013 as compared to the first quarter of 2012. By market segment, the domestic life insurance line of business posted a 154% increase over the comparable results during the first quarter of 2012 while international life sales decreased 24% during the same time frame.

The Company's international life business consists of applications accepted from residents of various regions outside of the United States, the volume of which typically varies based upon changes in the socioeconomic climates of these regions. Historically, the Company has experienced a simultaneous combination of rising and declining sales in various countries; however, the appeal of the Company's dollar-denominated life insurance products overcomes many of the local and national difficulties. In the "Great Recession" economic climate during 2008-2009, individuals in countries outside of the United States became increasingly leery of the U.S. economy and the stability of financial institutions and markets. These concerns resulted in reduced international sales during this time period. As fiscal and regulatory policies were enacted in response to the financial market turmoil, the ensuing level of relative stability served to recapture the confidence of international markets. Consequently, the Company witnessed an increased level of submitted life insurance applications beginning during the latter half of 2010.

As reported in the Company's Form 10-Q filing for the quarter ended September 30, 2011, Brazilian insurance regulators publicly stated their intention to curtail the sales activity of certain foreign multinational insurers, including

National Western, and attempt to levy fines. This public announcement has served to influence the demand for the Company's products resulting in a decrease in the number of new applications for insurance from residents of Brazil since that time.



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

|                                    | Three Months Ended March 31, |   |       |   |
|------------------------------------|------------------------------|---|-------|---|
|                                    | 2013                         |   | 2012  |   |
| Percentage of International Sales: |                              |   |       |   |
| Latin America                      | 89.7                         | % | 85.4  | % |
| Pacific Rim                        | 8.5                          |   | 13.8  |   |
| Eastern Europe                     | 1.8                          |   | 0.8   |   |
| Totals                             | 100.0                        | % | 100.0 | % |

Year-to-date, the Company has accepted new business from residents outside of the United States in over thirty different countries with Brazil (20%), Venezuela (18%), Peru (13%), and Columbia (10%) comprising the largest contributions. Sales to residents in Peru increased 37% in the first three months of 2013 compared to the same period in 2012.

The Company's domestic operations have historically been more heavily skewed toward annuity sales rather than life insurance sales. Partially in response to comments from outside rating agencies who expressed a preference for a greater proportion of overall Company earnings to derive from the life insurance line of business, management has been placing emphasis on building domestic life insurance sales as a strategic focus for future growth. The Company revamped its domestic life operations by changing the way it contracts distribution for life business, eliminating products and distribution that had not contributed significantly to earnings, and creating new and competitive products. These offerings included single premium universal life ("SPUL") and equity-indexed universal life ("EIUL") products.

More recently the Company has developed hybrids of its EIUL and SPUL products, combining features, and discontinued the marketing of smaller premium and volume life insurance policies. The Company's product development emphasis in creating SPUL, EIUL, and single or limited pay EIUL products has been positioned to take advantage of the changing demographic in the marketplace as the "Baby Boomer" generation began reaching 65 years of age in 2011. These products are designed to facilitate the wealth transfer of accumulated savings of this segment of the population via systematic funding mechanisms such as single premium immediate annuities. These life products have been valuable offerings for the Company's distributors as evidenced by the 153% increase in domestic EIUL sales in the first three months of 2013 versus 2012.

The Company's implementation of commission caps on domestic policies in 2009 served to discourage sales of larger face amounts resulting in lower sales levels and amounts of insurance per policy as shown below. While the average new policy face amounts subsequently declined, the increased sales activity in the past two years has produced a modest upward trend in this figure. Conversely, the Company's sales to international residents have witnessed a steady growth in the average face amount of insurance coverage per policy over the same time period.

| Average New Policy Face Amount |               |
|--------------------------------|---------------|
| Domestic                       | International |

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|                                   |         |         |
|-----------------------------------|---------|---------|
| Year ended December 31, 2007      | 416,800 | 251,000 |
| Year ended December 31, 2008      | 455,200 | 272,000 |
| Year ended December 31, 2009      | 201,400 | 315,300 |
| Year ended December 31, 2010      | 164,800 | 338,600 |
| Year ended December 31, 2011      | 178,500 | 363,600 |
| Year ended December 31, 2012      | 254,900 | 380,200 |
| Three months ended March 31, 2013 | 304,300 | 349,700 |

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After several challenging years of life insurance sales in the wake of the global financial crisis, life insurers are looking for new ways to rebuild premium levels. The Company's focus is directed toward its competitive advantages in international markets and wealth transfer strategies for domestic life sales. Critical to these strategies is the Company's portfolio of fixed-index (equity indexed) life insurance products. Fixed-index life products accounted for 77% of total life sales in the first three months of 2013, an increase from 69% for the same period in 2012.

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

|                       | Insurance In Force as of<br>March 31, |            |
|-----------------------|---------------------------------------|------------|
|                       | 2013                                  | 2012       |
|                       | (\$ in thousands)                     |            |
| Universal life:       |                                       |            |
| Number of policies    | 56,490                                | 59,620     |
| Face amounts          | \$7,260,430                           | 7,476,950  |
| Traditional life:     |                                       |            |
| Number of policies    | 40,470                                | 43,060     |
| Face amounts          | \$3,203,680                           | 2,977,890  |
| Fixed-indexed life:   |                                       |            |
| Number of policies    | 34,640                                | 33,060     |
| Face amounts          | \$8,620,960                           | 8,186,410  |
| Rider face amounts    | \$2,520,900                           | 2,350,480  |
| Total life insurance: |                                       |            |
| Number of policies    | 131,600                               | 135,740    |
| Face amounts          | \$21,605,970                          | 20,991,730 |

The Company's domestic in force business includes final expense policies and other smaller face amount traditional life policies written over the past several decades. As the Company's domestic product portfolio has changed to higher face amount universal life and fixed-indexed life policies, a decline in the number of traditional life policies in force has been steadily occurring.

At March 31, 2013, the Company's face amount of life insurance in force was comprised of \$19.1 billion from the international line of business and \$2.5 billion from the domestic line of business. At March 31, 2012, these amounts were \$18.7 billion and \$2.3 billion for the international and domestic lines of business, respectively.

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## Annuities

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

|                          | Three Months Ended March 31, |         |
|--------------------------|------------------------------|---------|
|                          | 2013                         | 2012    |
|                          | (In thousands)               |         |
| Fixed-indexed annuities  | \$163,919                    | 153,496 |
| Other deferred annuities | 31,787                       | 27,750  |
| Immediate annuities      | 2,813                        | 12,230  |
| Totals                   | \$198,519                    | 193,476 |

Annuity sales in the first quarter of 2013 were 3% higher than in the first quarter of 2012. Annuity sales in the first quarter of 2013 are in line with the Company's sales goals for the 2013 calendar year.

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

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

The Company's mix of annuity sales tends to shift with interest rate levels and the relative performance of the equity market. Over the past several years, sales of fixed-indexed products have accounted for 60% to 80% of all annuity sales. During the first three months of 2013 this percentage reached 83% reflecting the bull market run in equities since bottoming out in the first quarter of 2009 and the low level of fixed interest rates. For all fixed-indexed products, the Company purchases over the counter options to hedge the equity return feature. The options are purchased relative to the issuance of the annuity contracts in such a manner to minimize timing risk. Generally, the index return during the indexing period (if the underlying index increases) becomes a component in a formula (set forth in the annuity), the result of which is credited as interest to contract holders electing the index formula crediting method at the beginning of the indexing period. The formula result can never be less than zero with these products. The Company does not deliberately mismatch or under hedge for the equity feature of the products. Fixed-indexed products also provide the contract holder the alternative to elect a fixed interest rate crediting option.



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

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

|                          | Annuities In Force as of<br>March 31, |           |
|--------------------------|---------------------------------------|-----------|
|                          | 2013                                  | 2012      |
|                          | (\$ in thousands)                     |           |
| Fixed-indexed annuities  |                                       |           |
| Number of policies       | 61,130                                | 56,260    |
| GAAP annuity reserves    | \$4,364,583                           | 3,894,441 |
| Other deferred annuities |                                       |           |
| Number of policies       | 62,100                                | 66,270    |
| GAAP annuity reserves    | \$2,635,546                           | 2,777,666 |
| Immediate annuities      |                                       |           |
| Number of policies       | 17,760                                | 17,650    |
| GAAP annuity reserves    | \$412,683                             | 430,418   |
| Total annuities          |                                       |           |
| Number of policies       | 140,990                               | 140,180   |
| GAAP annuity reserves    | \$7,412,812                           | 7,102,525 |

## Impact of Recent Business Environment

The Company's business is generally aided by an economic environment undergoing expansion, whether moderate or vibrant. Conversely, a muted economic recovery could adversely impact the demand for the Company's products. Economic data through the first quarter of 2013 has not provided a clear indication of the economy's direction. There have been conflicting signals of both progress and retraction creating uncertainty about the direction of the economy at least in the near term. The episode in Cyprus served as a reminder of the fundamental fiscal problems embedded in the European block of countries, the effects of which threaten to spill over into other regions of the world. Worries of a slowdown in China associated with financial administrators there addressing market excesses that have been bubbling up for years merit further surveillance. The Japanese announced version of "quantitative easing" has raised the specter of currency imbalances and potential negative consequences on international commerce.

Recently, first quarter GDP for the U.S. was announced at a level lower than that anticipated by economists. More worrisome is the fact that this lower level of economic activity was propped up by inventory growth and incremental consumer spending at the beginning of the year fueled by 2012 year-end special distributions of income, dividends and bonuses to avoid higher taxation in 2013. Anecdotically, the consumer savings rate in the first quarter of 2013 dropped to the lowest level since the fourth quarter of 2007 reflecting a decline in real disposable income. Economists speculate the expiration of the "payroll tax holiday" at the beginning of the year and its expected dampening effect on

consumer spending will become more visible as the year progresses. Household financial income compression could adversely impact the demand for the Company's products and 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.

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The Financial Stability Oversight Council (FSOC) in recent weeks indicated that low interest rates were one of the serious risks confronting the insurance industry that regulators needed to closely monitor. The FSOC noted that low interest rates may cause insurers to "increase leverage, the duration of their investments and take on increased risk." Since life insurance products are mandated under state regulatory guidelines to provide minimum interest rate guarantees, the low interest rate levels engineered by the Federal Reserve present a challenge to carriers in maintaining profitability levels due to the "compression" on interest rate spreads -- the difference between what a company is able to attain in investment yield and the interest rate level it credits to policyholders of its products.

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 products surrenders and withdrawals at the same time fixed debt securities held by insurers declined in value. Currently, a sudden increase in rates does not appear likely given the Federal Reserve's announced intention of maintaining a low interest rate environment for an extended period of time through their quantitative easing programs. At the same time, junk debt yields have fallen to record lows and junk bond issuance thus far in 2013 is off to the fastest pace to start a calendar year on record. Such frothy conditions are typical of asset bubble scenarios and definitely require monitoring. It is uncertain what direction and at what pace interest rate movements may occur in the future and what impact, if any, such movements would have on the Company's business, results of operations, cash flows or financial condition.

Our operating strategy continues to 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.

## RESULTS OF OPERATIONS

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



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## Consolidated Operations

Revenues. The following details Company revenues.

|   | Three Months Ended March 31, |         |
|---|------------------------------|---------|
|   | 2013                         | 2012    |
|   | (In thousands)               |         |
| Universal life and annuity contract charges   | \$37,899                     | 36,199  |
| Traditional life and annuity premiums         | 3,864                        | 4,083   |
| Net investment income (excluding derivatives) | 106,382                      | 107,121 |
| Other revenues                                | 6,142                        | 5,655   |
| Operating revenues                            | 154,287                      | 153,058 |
| Derivative gain (loss)                        | 74,432                       | 42,437  |
| Net realized investment gains (losses)        | 2,313                        | 1,167   |
| Total revenues                                | \$231,032                    | 196,662 |

Universal life and annuity contract charges - Revenues for universal life and annuity contracts increased 4.7% for the first three months in 2013 compared to 2012 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 shown in the following table.

|  | Three Months Ended March 31, |          |
|--|------------------------------|----------|
|  | 2013                         | 2012     |
|  | (In thousands)               |          |
| Contract Revenues:                           |                              |          |
| Cost of insurance and administrative charges | \$33,382                     | 30,380   |
| Surrender charges                            | 8,474                        | 9,818    |
| Other charges                                | 18                           | 211      |
| Gross contract revenues                      | 41,874                       | 40,409   |
| Reinsurance premiums                         | (3,975                       | ) (4,210 |
| Net contract revenues                        | \$37,899                     | 36,199   |

Cost of insurance charges typically trend with the size of the life insurance block in force. Life insurance in force during the first quarter of 2013 averaged approximately \$21.6 billion while first quarter of 2012 averaged slightly less than \$21.0 billion. Cost of insurance charges recognized in the quarter ended March 31, 2013 increased to \$24.3 million from \$23.5 million in the first quarter of 2012. Administrative charges pertain to new business issued during the period. These revenues increased to \$9.2 million in the first quarter of 2013 from \$6.9 million in the same period of the prior year.

Traditional life and annuity premiums - Traditional life and annuity premiums were down slightly in the first three months of 2013 compared to the same period in 2012. 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.

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

|   | Three Months Ended March 31, |         |
|---|------------------------------|---------|
|   | 2013                         | 2012    |
|   | (In thousands)               |         |
| Gross investment income:                      |                              |         |
| Debt securities                               | \$102,078                    | 101,984 |
| Mortgage loans                                | 2,610                        | 2,926   |
| Policy loans                                  | 1,157                        | 1,348   |
| Short-term investments                        | 83                           | 235     |
| Other invested assets                         | 771                          | 915     |
| Total investment income                       | 106,699                      | 107,408 |
| Less: investment expenses                     | 317                          | 287     |
| Net investment income (excluding derivatives) | 106,382                      | 107,121 |
| Derivative gain (loss)                        | 74,432                       | 42,437  |
| Net investment income                         | \$180,814                    | 149,558 |

For the three months ended March 31, 2013, debt securities generated approximately 95.7% of total investment income, excluding derivative gain (loss). The growth in investment income from debt securities in the first quarter of 2013 versus 2012 reflects the increase in the size of the portfolio fueled by investable cash inflows from annuity and single premium life insurance sales. This increase is somewhat mitigated by higher yielding debt securities maturing or being called by borrowers and being replaced with lower yielding securities in the current interest rate environment. Mortgage loan investment income for the three months ended March 31, 2013 decreased over the comparable period in 2012 reflecting a reduction in the portfolio balance due to loan maturities and paydowns. The Company's new mortgage loan activity has been relatively low by historical standards in recent years given the low level of rates and the higher level of risk associated with commercial properties in the current economic environment.

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

|  | Three Months Ended March 31, |           |   |
|--|------------------------------|-----------|---|
|  | 2013                         | 2012      |   |
|  | (In thousands)               |           |   |
| Excluding derivatives:                     |                              |           |   |
| Net investment income                      | \$106,382                    | 107,121   |   |
| Average invested assets, at amortized cost | \$9,259,294                  | 8,195,352 |   |
| Annual yield on average invested assets    | 4.60                         | % 5.23    | % |
| Including derivatives:                     |                              |           |   |
| Net investment income                      | \$180,814                    | 149,558   |   |
| Average invested assets, at amortized cost | \$9,302,983                  | 8,256,122 |   |
| Annual yield on average invested assets    | 7.77                         | % 7.25    | % |

The lower yield on average invested assets, excluding derivatives, through the first quarter of 2013 compared to 2012 is due to the progressively lower yields obtained on new fixed maturity debt securities investments. During 2012, the average yield on bond purchases to fund insurance operations was 3.37% representing a 1.59% spread over treasury rates. Insurance operation bond purchases through the first quarter of 2013 had an average yield of 3.10% with spreads decreasing to 1.17% over treasury rates. The weighted average quality of new purchases during the first quarter was "A-", which equaled the overall quality rating of purchases during 2012. In addition, the composite duration of purchases during the first quarter also approximated that of 2012 purchases. The Company's general investment strategy is to purchase securities with maturity dates approximating ten years in the future. Accordingly, an appropriate measure for benchmarking the direction of interest rate levels for the Company's debt security purchases is the ten year treasury bond rate. The ten year treasury bond rate ranged from a low of 1.80% to a high of 2.09% during the first quarter of 2013.

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 \$6.0 million and \$5.6 million for the three months ended 2013 and 2012, respectively.

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.

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Gains and losses from index options are due to changes in equity market conditions. Index options are intended to act as hedges to match the returns on the product's underlying reference index and the rise or decline in the index relative to the index level at the time of the option purchase which causes option values to likewise rise or decline. As income from index options fluctuates with the underlying index, the contract interest expense to policyholder accounts for the Company's fixed-indexed products also fluctuates in a similar manner and direction. For the quarter ended March 31, 2013, the reference indices increased and the Company recorded an overall gain from index options with a corresponding increase in contract interest expense during this period.

|   | Three Months Ended March 31, |          |
|---|------------------------------|----------|
|   | 2013                         | 2012     |
|   | (In thousands)               |          |
| Derivatives:  |                              |          |
| Unrealized gain (loss)                              | \$72,112                     | 54,217   |
| Realized gain (loss)                                | 2,320                        | (11,780) |
| Total gain (loss) included in net investment income | \$74,432                     | 42,437   |
| Total contract interest                             | \$140,300                    | 101,543  |

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

Net realized investment gains (losses) - Realized gains on investments in the first quarter of 2013 primarily resulted from bond calls and sales. The net gains reported for the three months ended March 31, 2013 consisted of gross gains of \$2.5 million offset by gross losses of \$0.2 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 Condensed Consolidated Statements of Earnings while non-credit (liquidity) impairment losses are included in other comprehensive income (loss). Impairment and valuation write-downs reflected in the Company's Condensed Consolidated Statements of Earnings are summarized in the following table.

|                                      | Three Months Ended March 31, |      |
|--------------------------------------|------------------------------|------|
|                                      | 2013                         | 2012 |
|                                      | (In thousands)               |      |
| Impairment or valuation write-downs: |                              |      |
| Bonds                                | \$61                         | 175  |
| Equities                             | —                            | 24   |
| Mortgage loans                       | —                            | —    |
| Real estate                          | —                            | —    |
| Total                                | \$61                         | 199  |



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Bond impairments during the three months ended March 31, 2013 pertained to asset-backed securities whose cash flows and fair values did not support the amortized cost basis at which the instrument was recorded in the financial records. Equity impairments in 2012 represent a mark-to-market write-down on securities in which the market discount to book value was significant and had been maintained for several reporting periods. Equity securities represent 0.1% of invested assets and individual holdings have an average cost basis of approximately \$50,000.

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

|   | Three Months Ended March 31, |         |
|---|------------------------------|---------|
|   | 2013                         | 2012    |
|   | (In thousands)               |         |
| Life and other policy benefits                    | \$ 12,690                    | 13,678  |
| Amortization of deferred policy acquisition costs | 30,804                       | 31,711  |
| Universal life and annuity contract interest      | 140,300                      | 101,543 |
| Other operating expenses                          | 21,924                       | 20,018  |
| Totals  | \$ 205,718                   | 166,950 |

Life and other policy benefits - Death claim benefits, the largest component of policy benefits, decreased to \$8.0 million during the first quarter of 2013 compared to \$9.6 million for the quarter ended March 31, 2012. Death claim amounts are generally subject to variation from period to period and the Company's mortality experience has generally been consistent with or better than its product pricing assumptions.

Although not utilized previously, the Company initiated a project during 2012 to identify unreported death claims by researching the Social Security Administration master database for deceased individuals which matches with insureds under in force policies of the Company. The results have not been substantial given that most of the claims identified are lower face insurance policies issued many years ago by the Company. However, the claim activity for 2013 and 2012 include incremental amounts associated with this project.

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 condensed consolidated financial statements occurs over future periods in relation to the expected emergence of profits priced into the products sold. This emergence of profits is based upon assumptions regarding premium payment patterns, mortality, persistency, investment performance, and expense patterns. Companies are required to review universal life and annuity contract assumptions periodically to ascertain whether actual experience has deviated significantly from that assumed. If it is determined that a significant deviation has occurred, the emergence of profits pattern is to be "unlocked" and reset based upon the actual experience. DPAC balances are also adjusted each period to reflect current policy lapse or termination rates, expense levels and credited rates on policies compared to anticipated experience ("true-up") with the adjustment reflected in current period amortization expense. In accordance with GAAP guidance the Company must also write-off deferred acquisition costs, 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 the three months ended March 31, 2013 and 2012.

| Increase (Decrease) in DPAC Balance | Three Months Ended March 31, |      |
|-------------------------------------|------------------------------|------|
|                                     | 2013                         | 2012 |
|                                     | (In thousands)               |      |
| Unlocking                           | \$—                          | —    |
| True-up                             | 4,206                        | 778  |
| Totals                              | \$4,206                      | 778  |

True-up adjustments were recorded in 2013 and 2012 relative to partial surrender rates, mortality rates, credited interest rates and earned rates for the current year's experience. This resulted in a \$4.2 million decrease in amortization expense for the three months ended March 31, 2013, and a \$0.8 million decrease for the three months ended March 31, 2012. The true-up adjustments for the life lines of business have been positive (decrease to amortization expense) by \$5.9 million in the first three months of 2013 whereas the true-up adjustments for the annuity line of business during the same periods were negative by \$1.7 million incrementally adding to amortization expense. For the three months ended March 31, 2012, true-up adjustments for the life lines of business were positive (decrease to amortization expense) by \$4.9 million while true-up adjustments for the annuity line of business increased amortization expense by \$4.1 million.

No unlocking adjustments were made by the Company in the first quarter of 2013 or 2012. While the Company is required to evaluate its emergence of profits continually, management believes that the current amortization patterns of deferred policy acquisition costs are reflective of actual experience.

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

The Company's approximated average credited rates, excluding and including fixed-indexed (derivative) products, were as follows:

|                         | March 31,                        |        | March 31,                        |        |   |
|-------------------------|----------------------------------|--------|----------------------------------|--------|---|
|                         | 2013                             | 2012   | 2013                             | 2012   |   |
|                         | (Excluding fixed-index products) |        | (Including fixed-index products) |        |   |
| Annuity                 | 2.73                             | % 2.96 | % 6.12                           | % 4.72 | % |
| Interest sensitive life | 3.98                             | % 4.11 | % 9.87                           | % 7.30 | % |

Contract interest including fixed-index products also encompasses the performance of the index options associated with the Company's fixed-index products. As previously noted, the market performance of these derivative features resulted in net realized and unrealized gains of \$74.4 million and \$42.4 million for the quarters ended March 31, 2013 and 2012, respectively.

Similar to deferred policy acquisition costs, the Company makes true-up adjustments pertaining to deferred sales inducements (first year interest bonuses) on a quarterly basis. In the quarters ended March 31, 2013 and 2012, these true-ups adjustments decreased the deferred sales inducement balance sheet amounts (increased contract interest expense) by \$0.6 million and \$0.9 million, respectively.

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Other operating expenses - Other operating expenses consist of general administrative expenses, licenses and fees, commissions not subject to deferral, nursing home expenses and compensation costs. These expenses for the three months ended March 31, 2013 and 2012 are summarized in the table that follows.

|                            | Three Months Ended March 31, |        |
|----------------------------|------------------------------|--------|
|                            | 2013                         | 2012   |
|                            | (In thousands)               |        |
| General insurance expenses | \$6,109                      | 6,962  |
| Nursing home expenses      | 5,363                        | 5,404  |
| Compensation expenses      | 6,852                        | 5,249  |
| Commission expenses        | 1,899                        | 2,041  |
| Taxes, licenses and fees   | 1,701                        | 362    |
| Totals                     | \$21,924                     | 20,018 |

General insurance expenses include 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 \$0.8 million and \$0.9 million in the first quarter of 2013 and 2012, respectively.

Compensation expenses include 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 varies positive or negative in any given period. For the three months ended March 31, 2013 share based compensation expense was \$1.5 million while for the comparable period in 2012 share based compensation expense was \$0.0 million. The market price of the Company's Class A common stock increased approximately 12% between December 2012 and March 2013 from \$157.74 to \$176.00.

Federal Income Taxes. Federal income taxes on earnings from operations reflect an effective tax rate of 34.3% for the three months ended March 31, 2013 compared to 33.6% for the three months ended March 31, 2012. The effective tax rate is lower than the Federal rate of 35% primarily due to tax-exempt investment income related to municipal securities and dividends-received deductions on income from stocks.

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## Segment Operations

## Summary of Segment Earnings

A summary of segment earnings for the three months ended March 31, 2013 and 2012 is provided below. The segment earnings exclude realized gains and losses on investments, net of taxes.

|                            | Domestic<br>Life<br>Insurance<br>(In thousands) | International<br>Life<br>Insurance | Annuities | All<br>Others | Totals |
|----------------------------|---|------------------------------------|-----------|---------------|--------|
| Segment earnings (losses): |   |                                    |           |               |        |
| Three months ended:        |   |                                    |           |               |        |
| March 31, 2013             | \$902   | 5,631                              | 5,493     | 3,103         | 15,129 |
| March 31, 2012             | \$229   | 6,079                              | 9,944     | 2,730         | 18,982 |

## Domestic Life Insurance Operations

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

|   | Three Months Ended March 31, |        |
|---|------------------------------|--------|
|   | 2013                         | 2012   |
|   | (In thousands)               |        |
| Premiums and other revenues:                        |                              |        |
| Premiums and contract charges                       | \$9,610                      | 10,539 |
| Net investment income                               | 7,773                        | 5,818  |
| Other revenues                                      | 12                           | 7      |
| Total revenues                                      | 17,395                       | 16,364 |
| Benefits and expenses:                              |                              |        |
| Life and other policy benefits                      | 3,030                        | 1,648  |
| Amortization of deferred policy acquisition costs   | 2,035                        | 2,391  |
| Universal life insurance contract interest          | 7,191                        | 7,213  |
| Other operating expenses                            | 3,767                        | 4,768  |
| Total benefits and expenses                         | 16,023                       | 16,020 |
| Segment earnings (loss) before Federal income taxes | 1,372                        | 344    |
| Provision (benefit) for Federal income taxes        | 470                          | 115    |
| Segment earnings (loss)                             | \$902                        | 229    |

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

|                                     | Three Months Ended March 31, |          |
|-------------------------------------|------------------------------|----------|
|                                     | 2013                         | 2012     |
|                                     | (In thousands)               |          |
| Universal life insurance revenues   | \$9,532                      | 10,381   |
| Traditional life insurance premiums | 1,471                        | 1,688    |
| Reinsurance premiums                | (1,393                       | ) (1,530 |
| Totals                              | \$9,610                      | 10,539   |

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 five-to-one rate over the past several years causing a declining level of insurance in force from which contract charge revenue is received. This ratio has improved somewhat in the first three months of 2013 to a three-to-one relationship. Nonetheless, the number of domestic life insurance policies has declined from 62,900 at December 31, 2011 to 60,000 at December 31, 2012, and to 59,200 at March 31, 2013. Universal life insurance revenues are also generated with the issuance of new business based upon amounts per application and percentages of the face amount (volume) of insurance issued. Revenues associated with issuing new business are typically greater than that realized in a renewal period for in force policies. The number of domestic life policies issued in the first three months of 2013 was 88% higher than in the comparable period for 2012 and the volume of insurance issued was 193% greater than that in 2012.

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

|                                | Three Months Ended March 31, |        |
|--------------------------------|------------------------------|--------|
|                                | 2013                         | 2012   |
|                                | (In thousands)               |        |
| Universal life insurance:      |                              |        |
| First year and single premiums | \$27,378                     | 10,034 |
| Renewal premiums               | 5,147                        | 4,722  |
| Totals                         | \$32,525                     | 14,756 |

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 the past couple of years the Company has achieved some success in this regard with the number of new policies issued trending higher. This trend continued through the first quarter of 2013 as noted above. Sales have been substantially weighted toward single premium policies which do not have recurring premium payments. These products are targeting wealth transfer strategies involving the movement of accumulated wealth in alternative investment vehicles, including annuities, into life insurance products.

Net investment income includes the gains and losses on index options purchased to back the index crediting mechanism on equity-indexed universal products. As noted previously in the Results of Operations discussion, option values have increased more rapidly in the first three months of 2013 as compared to 2012 incurring larger option value gains.

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Life and policy benefits for a smaller block of business are subject to variation from quarter to quarter. Claim activity during the first three months of 2013 was consistent compared to historical trends, although the Social Security Administration master data base project mentioned in the Consolidated Operations section of the discussion on Results of Operations resulted in incremental claims during the period. The Company's overall mortality experience for this segment is in line with pricing assumptions.

As noted previously in the discussion of Results of Operations, the Company records true-up adjustments to DPAC balances each period to reflect current policy lapse or termination rates, expense levels and credited rates on policies as compared to anticipated experience with the adjustment reflected in current period amortization expense. To the extent required, the Company may also record unlocking adjustments to DPAC balances. The following table identifies the effects of unlocking and true-up adjustments on domestic life insurance DPAC balances recorded through amortization expense for the three month ended March 31, 2013 and 2012.

|                                     | Three Months Ended March 31, |      |
|-------------------------------------|------------------------------|------|
|                                     | 2013                         | 2012 |
|                                     | (In thousands)               |      |
| Increase (Decrease) in DPAC Balance |                              |      |
| Unlocking                           | \$—                          | —    |
| True-up                             | 2,128                        | 593  |
| Totals                              | \$2,128                      | 593  |

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

#### International Life Insurance Operations

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

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

|   | Three Months Ended March 31, |        |
|---|------------------------------|--------|
|   | 2013                         | 2012   |
|   | (In thousands)               |        |
| Premiums and other revenues:                          |                              |        |
| Premiums and contract charges                         | \$28,019                     | 23,431 |
| Net investment income                                 | 18,630                       | 15,397 |
| Other revenues  | 43                           | 32     |
| Total revenues  | 46,692                       | 38,860 |
| Benefits and expenses:                                |                              |        |
| Life and other policy benefits                        | 3,645                        | 3,480  |
| Amortization of deferred policy acquisition costs     | 5,787                        | 5,608  |
| Universal life insurance contract interest            | 21,991                       | 14,812 |
| Other operating expenses                              | 6,708                        | 5,818  |
| Total benefits and expenses                           | 38,131                       | 29,718 |
| Segment earnings (losses) before Federal income taxes | 8,561                        | 9,142  |
| Provision (benefit) for Federal income taxes          | 2,930                        | 3,063  |
| Segment earnings (loss)                               | \$5,631                      | 6,079  |

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

|                                     | Three Months Ended March 31, |          |
|-------------------------------------|------------------------------|----------|
|                                     | 2013                         | 2012     |
|                                     | (In thousands)               |          |
| Universal life insurance revenues   | \$28,142                     | 23,716   |
| Traditional life insurance premiums | 2,393                        | 3,177    |
| Reinsurance premiums                | (2,516                       | ) (3,462 |
| Totals                              | \$28,019                     | 23,431   |

In general, universal life revenues and operating earnings are anticipated to emerge with the amount of international life insurance in force and a steady growth in new sales. The volume of insurance in force grew from \$18.6 billion at December 31, 2011 to \$19.2 billion at December 31, 2012 and leveled off to \$19.1 billion at March 31, 2013. Universal life insurance revenues are also generated with the issuance of new business based upon amounts per application and percentages of the face amount (volume) of insurance issued. The number of international life policies issued in the first three months of 2013 was 13% lower than in the first three months of 2012 and the volume of insurance issued was 24% less than that in 2012 during the same period.





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International universal life revenues also include surrender charges assessed upon surrender of contracts by policyholders. In the midst of the financial crisis the past few years, the Company's international policyholders in particular exhibited concern regarding the developments in U.S. financial markets. This evidenced itself in the Company's termination activity in its international life policies in force. During 2009, the Company incurred higher termination experience than is typical which resulted in recognition of increased surrender charge fee income. This level of termination activity subsequently subsided in 2011. However, the ongoing global concerns may be causing re-emerging concern as international policyholder terminations have been slowly trending higher. The following table illustrates the Company's recent international life termination experience.

|                                   | Amount in \$'s<br>(millions) | Annualized Termination<br>Rate |   |
|-----------------------------------|------------------------------|--------------------------------|---|
| Volume In Force Terminations      |                              |                                |   |
| Three months ended March 31, 2013 | \$459.9                      | 8.9                            | % |
| Year ended December 31, 2012      | 1,828.4                      | 8.7                            | % |
| 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      | 1,674.3                      | 10.8                           | % |

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

|                                | Three Months Ended March 31,<br>2013 | 2012   |
|--------------------------------|--------------------------------------|--------|
|                                | (In thousands)                       |        |
| Universal life insurance:      |                                      |        |
| First year and single premiums | \$5,419                              | 8,157  |
| Renewal premiums               | 27,365                               | 27,436 |
| Totals                         | \$32,784                             | 35,593 |

The Company's most popular international products have been its fixed-indexed universal life products in which the policyholder can elect to have the interest rate credited to their policy account values linked in part to the performance of the S&P 500 Index<sup>®</sup>. Included in the totals in the above table are collected premiums for fixed-indexed universal life products of approximately \$20.2 million and \$22.3 million for the first three months of 2013 and 2012, respectively.

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

|   | Three Months Ended March 31, |        |
|---|------------------------------|--------|
|   | 2013                         | 2012   |
|   | (In thousands)               |        |
| Net investment income (excluding derivatives) | \$10,166                     | 9,696  |
| Derivative gain (loss)                        | 8,464                        | 5,701  |
| Net investment income                         | \$18,630                     | 15,397 |

A comparable impact for the derivative component in the equity-indexed universal life product is reflected in the contract interest expense for each respective period.

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, 2012, the average face amount of insurance purchased was approximately \$380,000, and in the first three months of 2013 the average was \$350,000. While life and policy benefit expense for the international life segment reflects the larger policies purchased, mortality due to natural causes is comparable to that in the United States.

The Company records true-up adjustments to DPAC balances each period to reflect current policy lapse or termination rates, expense levels and credited rates on policies as compared to anticipated experience as well as unlocking adjustments as necessary. The following table identifies the effects of unlocking and true-up adjustments on international life insurance DPAC balances recorded through amortization expense for the three month ended March 31, 2013 and 2012.

|                                     | Three Months Ended March 31, |       |
|-------------------------------------|------------------------------|-------|
|                                     | 2013                         | 2012  |
|                                     | (In thousands)               |       |
| Increase (Decrease) in DPAC Balance |                              |       |
| Unlocking                           | \$—                          | —     |
| True-up                             | 3,769                        | 4,285 |
| Totals                              | \$3,769                      | 4,285 |

True-up adjustments in the first three months of 2013 and 2012 increased the DPAC balance and decreased amortization expense.

As indicated in the discussion concerning net investment income, contract interest expense includes fluctuations that are the result of the performance of underlying equity indices associated with fixed-index universal life products. The derivative gain (loss) realized on purchased call options is included in the amounts the Company credits to policyholders. 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 Condensed Consolidated Operations section of this Item 2.

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## Annuity Operations

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

|   | Three Months Ended March 31, |                |
|---|------------------------------|----------------|
|   | 2013                         | 2012           |
|   | (In thousands)               |                |
| Premiums and other revenues:                        |                              |                |
| Premiums and contract charges                       | \$4,134                      | 6,312          |
| Net investment income                               | 150,378                      | 124,389        |
| Other revenues                                      | 39                           | 61             |
| <b>Total revenues</b>                               | <b>154,551</b>               | <b>130,762</b> |
| Benefits and expenses:                              |                              |                |
| Life and other policy benefits                      | 6,015                        | 8,550          |
| Amortization of deferred policy acquisition costs   | 22,982                       | 23,712         |
| Annuity contract interest                           | 111,118                      | 79,518         |
| Other operating expenses                            | 6,086                        | 4,028          |
| <b>Total benefits and expenses</b>                  | <b>146,201</b>               | <b>115,808</b> |
| Segment earnings (loss) before Federal income taxes | 8,350                        | 14,954         |
| Provision (benefit) for Federal income taxes        | 2,857                        | 5,010          |
| <b>Segment earnings (loss)</b>                      | <b>\$5,493</b>               | <b>9,944</b>   |

A comparative detail of the components of premiums and annuity contract revenues is provided below.

|                                   | Three Months Ended March 31, |              |
|-----------------------------------|------------------------------|--------------|
|                                   | 2013                         | 2012         |
|                                   | (In thousands)               |              |
| Surrender charges                 | \$4,134                      | 6,308        |
| Payout annuity and other revenues | —                            | —            |
| Traditional annuity premiums      | —                            | 4            |
| <b>Totals</b>                     | <b>\$4,134</b>               | <b>6,312</b> |

The Company's lapse rate for annuity contracts in the first three months of 2013 was 6.0% compared to 5.9% during the same time frame in 2012. Surrender charge revenue is also dependent upon the duration of the policy at the time of termination as typical surrender charge provisions decrease during the tenure of the contract. Accordingly, the decrease in surrender charge revenue in the first three months of 2013 is primarily a function of the termination of contracts later in their duration.



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Deposits collected on annuity contracts are not reflected as revenues in the Company's Condensed Consolidated Statements of Earnings, in accordance with GAAP. Actual annuity deposits collected for the three month ended March 31, 2013 and 2012 are detailed below.

|                          | Three Months Ended March 31, |         |
|--------------------------|------------------------------|---------|
|                          | 2013                         | 2012    |
|                          | (In thousands)               |         |
| Fixed-indexed annuities  | \$ 171,779                   | 150,306 |
| Other deferred annuities | 26,118                       | 32,891  |
| Immediate annuities      | 1,902                        | 9,255   |
| Totals                   | \$ 199,799                   | 192,452 |

Fixed-index products are more attractive for consumers when interest rate levels remain low and equity markets produce positive returns. Since the Company does not offer variable products or mutual funds, fixed-index products provide an important alternative to the Company's existing fixed interest rate annuity products. Fixed-index annuity deposits as a percentage of total annuity deposits were 86% and 78% for the three months ended March 31, 2013 and 2012, respectively. The increasing percentage of fixed-index products of total annuity sales reflects the low interest rate environment and the current bull market in equities.

As a selling inducement, some of the deferred products, as well as the fixed-index annuity products, include a first year interest bonus ranging from 1% to 7% depending upon the product, in addition to a base first year interest rate. Other products include a premium bonus ranging from 2% to 10% which is credited to the account balance when premiums are applied. These bonus rates are deferred in conjunction with other capitalized policy acquisition costs. The amount deferred to be amortized over future periods amounted to approximately \$7.8 million and \$7.2 million during the first three months of 2013 and 2012, respectively. Amortization of deferred sales inducements is included as a component of annuity contract interest as described later in this discussion of Annuity operations.

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

|   | Three Months Ended March 31, |         |
|---|------------------------------|---------|
|   | 2013                         | 2012    |
|   | (In thousands)               |         |
| Net investment income (excluding derivatives) | \$ 86,194                    | 88,479  |
| Derivative gain (loss)                        | 64,184                       | 35,910  |
| Net investment income                         | \$ 150,378                   | 124,389 |

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

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Consistent with the domestic and international life segments, the Company records true-up adjustments to DPAC balances each period to reflect current policy lapse or termination rates, expense levels and credited rates on policies as compared to anticipated experience as well as unlocking adjustments as necessary. The following table identifies the effects of unlocking and true-up adjustments on annuity DPAC balances recorded through amortization expense for the three month ended March 31, 2013 and 2012.

|                                     | Three Months Ended March 31, |          |
|-------------------------------------|------------------------------|----------|
|                                     | 2013                         | 2012     |
|                                     | (In thousands)               |          |
| Increase (Decrease) in DPAC Balance |                              |          |
| Unlocking                           | \$—                          | —        |
| True-up                             | (1,691                       | ) (4,100 |
| Totals                              | \$(1,691                     | ) (4,100 |

As the true-up adjustments decreased the DPAC balances for the three months ended March 31, 2013 and 2012, a corresponding increase in DPAC amortization was recorded in the Company's Condensed Consolidated Statements of Earnings in each respective period.

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

|   | Three Months Ended March 31, |          |
|---|------------------------------|----------|
|   | 2013                         | 2012     |
|   | (In thousands)               |          |
| Fixed-index annuities                   | \$83,183                     | 60,751   |
| All other annuities                     | 30,047                       | 23,857   |
| Gross contract interest                 | 113,230                      | 84,608   |
| Bonus interest deferred and capitalized | (7,761                       | ) (7,156 |
| Bonus interest amortization             | 7,019                        | 5,815    |
| Total contract interest                 | \$112,488                    | 83,267   |

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

True-up adjustments for the deferred sales inducement balance are done each period similar to that done with respect to DPAC balances. For the three months ended March 31, 2013 and 2012, deferred sales inducement balances were reduced by \$0.6 million and \$0.9 million, respectively, for true-up adjustments. These decreases are included in the above table as an addition to bonus interest amortization.





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## Other Operations

National Western Life Insurance Company's primary business encompasses its domestic and international life insurance operations and its annuity operations. However, National Western also has small real estate, nursing home, and other investment operations through its wholly-owned subsidiaries. Nursing home operations generated \$0.7 million and \$0.2 million of operating earnings in the first three months of 2013 and 2012, respectively. The remaining earnings of \$2.4 million and \$2.5 million for the three months ended March 31, 2013 and 2012, respectively, in Other Operations represent investment income from real estate, municipal bonds, and common and preferred equities held in subsidiary company portfolios principally for tax-advantaged purposes.

## INVESTMENTS

## General

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

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

|                            | March 31, 2013                   |       | December 31, 2012                |       |   |
|----------------------------|----------------------------------|-------|----------------------------------|-------|---|
|                            | Carrying Value<br>(In thousands) | %     | Carrying Value<br>(In thousands) | %     |   |
| Debt securities            | \$8,968,401                      | 96.0  | % \$8,775,854                    | 96.5  | % |
| Mortgage loans             | 125,539                          | 1.3   | % 142,170                        | 1.6   | % |
| Policy loans               | 71,143                           | 0.8   | % 71,549                         | 0.8   | % |
| Derivatives, index options | 130,967                          | 1.4   | % 57,890                         | 0.6   | % |
| Real estate                | 18,691                           | 0.2   | % 18,800                         | 0.2   | % |
| Equity securities          | 13,942                           | 0.1   | % 12,267                         | 0.1   | % |
| Other                      | 20,445                           | 0.2   | % 22,639                         | 0.2   | % |
| Totals                     | \$9,349,128                      | 100.0 | % \$9,101,169                    | 100.0 | % |

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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 March 31, 2013 and December 31, 2012, the Company's debt securities portfolio consisted of the following classes of securities:

|                                  | March 31, 2013                   |       | December 31, 2012                |       |
|----------------------------------|----------------------------------|-------|----------------------------------|-------|
|                                  | Carrying Value<br>(In thousands) | %     | Carrying Value<br>(In thousands) | %     |
| Corporate                        | \$5,521,696                      | 61.7  | \$5,264,884                      | 60.0  |
| Mortgage-backed securities       | 1,876,307                        | 20.9  | 1,957,380                        | 22.3  |
| Public utilities                 | 1,061,226                        | 11.8  | 1,062,666                        | 12.1  |
| State and political subdivisions | 416,119                          | 4.6   | 391,633                          | 4.5   |
| U.S. agencies                    | 23,107                           | 0.3   | 23,114                           | 0.3   |
| Asset-backed securities          | 47,552                           | 0.5   | 48,216                           | 0.5   |
| Foreign governments              | 20,485                           | 0.2   | 26,054                           | 0.3   |
| U.S. Treasury                    | 1,909                            | —     | 1,907                            | —     |
| Totals                           | \$8,968,401                      | 100.0 | \$8,775,854                      | 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.

|                        | Three Months Ended<br>March 31,<br>2013<br>(\$ In thousands) | Year Ended<br>December 31,<br>2012 |   |
|------------------------|--|------------------------------------|---|
| Cost of acquisitions   | \$501,444  | \$1,419,730                        |   |
| Average S&P® quality   | A-   | A-                                 |   |
| Effective annual yield | 3.10   | % 3.37                             | % |
| Spread to treasuries   | 1.17   | % 1.59                             | % |
| Effective duration     | 8.6 years  | 8.2 years                          |   |

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

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

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In addition to diversification, an important aspect of the Company's investment approach is managing the credit quality of its investment in debt securities. Thorough credit analysis is performed on potential corporate investments including examination of a company's credit and industry outlook, financial ratios and trends, and event risks. This emphasis is reflected in the high average credit rating of the Company's debt securities portfolio with 98.0% 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®.

|                                     | March 31, 2013                   |       | December 31, 2012                |       |
|-------------------------------------|----------------------------------|-------|----------------------------------|-------|
|                                     | Carrying Value<br>(In thousands) | %     | Carrying Value<br>(In thousands) | %     |
| AAA                                 | \$108,706                        | 1.2   | \$111,859                        | 1.3   |
| AA                                  | 2,606,105                        | 29.1  | 2,646,017                        | 30.2  |
| A                                   | 2,775,367                        | 30.9  | 2,529,537                        | 28.8  |
| BBB                                 | 3,301,985                        | 36.8  | 3,322,674                        | 37.8  |
| BB and other below investment grade | 176,238                          | 2.0   | 165,767                          | 1.9   |
| Totals                              | \$8,968,401                      | 100.0 | \$8,775,854                      | 100.0 |

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

|                   | Below Investment Grade Debt Securities |                |            |     | % of Invested Assets |
|-------------------|--|----------------|------------|-----|----------------------|
|                   | Amortized Cost                         | Carrying Value | Fair Value |     |                      |
|                   | (In thousands, except percentages)     |                |            |     |                      |
| March 31, 2013    | \$169,765                              | 176,238        | 180,553    | 1.9 | %                    |
| December 31, 2012 | \$161,550                              | 165,767        | 168,671    | 1.8 | %                    |

The Company's percentage of below investment grade securities compared to total invested assets increased slightly from December 31, 2012 primarily due to several securities being downgraded during the first three months of 2013. 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 March 31, 2013 are summarized below, including March 31, 2013 and December 31, 2012 fair values for comparison. The Company continually monitors developments in these industries for issues that may affect security valuation.

| Industry Category       | Below Investment Grade Debt Securities |                |                |                   |
|-------------------------|--|----------------|----------------|-------------------|
|                         | Amortized Cost                         | Carrying Value | Fair Value     | Fair Value        |
|                         | March 31, 2013                         | March 31, 2013 | March 31, 2013 | December 31, 2012 |
|                         | (In thousands)                         |                |                |                   |
| Retail                  | \$19,146                               | 19,246         | 19,246         | 23,770            |
| Telecommunications      | 5,433                                  | 9,020          | 9,020          | 8,538             |
| Asset-backed securities | 9,803                                  | 9,803          | 11,392         | 9,989             |
| Mortgage-backed         | 7,379                                  | 7,725          | 7,725          | 7,775             |
| Banking/finance         | —                                      | 304            | 304            | 320               |
| Manufacturing           | 67,792                                 | 69,764         | 72,841         | 56,325            |
| Transportation          | 30,498                                 | 30,510         | 29,309         | 31,324            |
| Other                   | 29,714                                 | 29,866         | 30,716         | 30,630            |
| Totals                  | \$169,765                              | 176,238        | 180,553        | 168,671           |

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 March 31, 2013 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     | Amortized Cost | Fair Value     | Country Domiciled |
|----------------|----------------|----------------|----------------|-------------------|
|                |                | March 31, 2013 | March 31, 2013 |                   |
|                | (In thousands) |                |                |                   |
| Covidien       | A              | \$24,199       | 26,235         | Ireland           |
| CRH            | BBB+           | 10,998         | 11,623         | Ireland           |
| Telecom Italia | BBB            | 11,998         | 12,250         | Italy             |

|            |     |          |        |       |
|------------|-----|----------|--------|-------|
| Telefonica | BBB | 11,754   | 13,137 | Spain |
| Totals     |     | \$58,949 | 63,245 |       |

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## Securities Held to Maturity

| Company           | S&P Rating<br>(In thousands) | Book Value<br>March 31,<br>2013 | Fair Value<br>March 31,<br>2013 | Country<br>Domiciled |
|-------------------|------------------------------|---------------------------------|---------------------------------|----------------------|
| Coca-Cola HBC     | BBB                          | \$4,017                         | 4,354                           | Greece               |
| CRH               | BBB+                         | 3,007                           | 3,069                           | Ireland              |
| EDP               | BB+                          | 17,211                          | 18,066                          | Portugal             |
| Enel              | BBB+                         | 19,914                          | 22,047                          | Italy                |
| Finmeccanica      | BB+                          | 15,025                          | 15,453                          | Italy                |
| Iberdrola Finance | BBB                          | 2,899                           | 3,192                           | Spain                |
| Telecom Italia    | BBB                          | 2,996                           | 3,107                           | Italy                |
| Telefonica        | BBB                          | 8,140                           | 8,801                           | Spain                |
| Totals            |                              | \$73,209                        | 78,089                          |                      |

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

During the three months ended March 31, 2013 the Company recorded other-than-temporary impairment credit related write-downs on debt securities totaling less than \$0.1 million. The Company had no other-than-temporary impairment write-downs on debt securities other than on certain asset-backed securities whose fair value and net present value of future cash flows fell below the amortized cost of the security. See Note 9, Investments, of the accompanying condensed consolidated financial statements for further discussion. Since the Company's adoption of the GAAP guidance on the recognition and accounting for other-than-temporary impairments due to credit loss versus non-credit loss, the Company has recognized a total of \$7.0 million of other-than-temporary impairments of which \$2.4 million was deemed credit related and recognized as realized investment losses in earnings, and \$4.6 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 March 31, 2013, approximately 31% of the Company's total debt and equity securities, based on fair values, were classified as securities available for sale. The holdings in available for sale provide flexibility to the Company to react to market opportunities and conditions and to practice active management within the portfolio to provide adequate liquidity to meet policyholder obligations and other cash needs.

| Fair Value<br>(In thousands) | Amortized Cost | Unrealized Gains (Losses) |
|------------------------------|----------------|---------------------------|
|------------------------------|----------------|---------------------------|

Securities held to maturity:



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|                                |             |           |         |
|--------------------------------|-------------|-----------|---------|
| Debt securities                | \$6,588,874 | 6,078,141 | 510,733 |
| Securities available for sale: |             |           |         |
| Debt securities                | 2,890,260   | 2,645,982 | 244,278 |
| Equity securities              | 13,942      | 10,326    | 3,616   |
| Totals                         | \$9,493,076 | 8,734,449 | 758,627 |

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## Asset-Backed Securities

The Company holds approximately \$47.6 million in asset-backed securities as of March 31, 2013. This portfolio includes \$14.7 million of manufactured housing bonds and \$32.9 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 \$4.0 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 March 31, 2013 were underwritten prior to 2005 as noted in the table below.

| Investment Origination Year | March 31, 2013 |            | December 31, 2012 |            |
|-----------------------------|----------------|------------|-------------------|------------|
|                             | Carrying Value | Fair Value | Carrying Value    | Fair Value |
|                             | (In thousands) |            |                   |            |
| Subprime:                   |                |            |                   |            |
| 1998                        | \$4,856        | 4,741      | 5,310             | 5,014      |
| 2002                        | —              | —          | —                 | —          |
| 2003                        | 3,914          | 4,938      | 3,927             | 4,960      |
| 2004                        | 24,132         | 27,420     | 23,067            | 26,225     |
| Subtotal subprime           | \$32,902       | 37,099     | 32,304            | 36,199     |
| Alt A:                      |                |            |                   |            |
| 2004                        | \$3,960        | 3,960      | 3,839             | 3,839      |

As of March 31, 2013, 2 of the subprime securities were rated AAA, 2 were rated AA, 3 were rated BBB, 2 were rated B, and 2 were rated CC. The Company sold a subprime security in the current quarter and realized a gain on the previously impaired security.

## 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. During the past several years, the low interest rate environment has resulted in fewer loan opportunities being available that meet the Company's required rate of return. Mortgage loans originated by the Company totaled \$21.5 million for the year ended December 31, 2012 and \$0.3 million for the three months ended March 31, 2013. Principal repayments on mortgage loans for the three months ended March 31, 2013 were \$17.0 million.

Loans in foreclosure, loans considered impaired or loans past due 90 days or more are placed on a non-accrual status. If a mortgage loan is determined to be on non-accrual status, the mortgage loan does not accrue any revenue into the Condensed Consolidated Statements of Earnings. The loan is independently monitored and evaluated as to potential impairment or foreclosure. If delinquent payments are made and the loan is brought current, then the Company returns the loan to active status and accrues income accordingly. The Company has no loans past due 90 days which are accruing interest.

The Company held net investments in mortgage loans totaling \$125.5 million and \$142.2 million at March 31, 2013 and December 31, 2012, respectively. The diversification of the portfolio by geographic region and by property type was as follows:

|   | March 31, 2013 |        | December 31, 2012 |        |    |
|---|----------------|--------|-------------------|--------|----|
|   | Amount         | %      | Amount            | %      |    |
|   | (In thousands) |        | (In thousands)    |        |    |
| <b>Mortgage Loans by Geographic Region:</b> |                |        |                   |        |    |
| West South Central                          | \$68,029       | 53.9   | % \$78,010        | 54.6   | %  |
| New England                                 | 21,094         | 16.7   | % 21,160          | 14.8   | %  |
| Mountain                                    | 1,480          | 1.2    | % 2,180           | 1.5    | %  |
| Pacific                                     | 12,437         | 9.9    | % 18,178          | 12.7   | %  |
| East North Central                          | 9,701          | 7.7    | % 10,367          | 7.3    | %  |
| East South Central                          | 10,221         | 8.1    | % 10,261          | 7.2    | %  |
| South Atlantic                              | 1,148          | 0.9    | % 561             | 0.4    | %  |
| Middle Atlantic                             | 2,079          | 1.6    | % 2,103           | 1.5    | %  |
| Gross balance                               | 126,189        | 100.0  | % 142,820         | 100.0  | %  |
| Allowance for possible losses               | (650           | ) (0.5 | )% (650           | ) (0.5 | )% |
| Totals                                      | \$125,539      | 99.5   | % \$142,170       | 99.5   | %  |
|   | March 31, 2013 |        | December 31, 2012 |        |    |
|   | Amount         | %      | Amount            | %      |    |
|   | (In thousands) |        | (In thousands)    |        |    |
| <b>Mortgage Loans by Property Type:</b>     |                |        |                   |        |    |
| Retail                                      | \$88,936       | 70.5   | % \$98,180        | 68.7   | %  |
| Hotel/Motel                                 | 4,123          | 3.3    | % 4,139           | 2.9    | %  |
| Land/Lots                                   | 6,265          | 5.0    | % 12,618          | 8.8    | %  |
| Apartments                                  | 16,904         | 13.4   | % 16,919          | 11.9   | %  |
| Office                                      | 3,523          | 2.8    | % 4,354           | 3.1    | %  |
| All other                                   | 6,438          | 5.0    | % 6,610           | 4.6    | %  |
| Gross balance                               | 126,189        | 100.0  | % 142,820         | 100.0  | %  |

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|                               |           |   |      |    |           |   |      |    |
|-------------------------------|-----------|---|------|----|-----------|---|------|----|
| Allowance for possible losses | (650      | ) | (0.5 | )% | (650      | ) | (0.5 | )% |
| Totals                        | \$125,539 |   | 99.5 | %  | \$142,170 |   | 99.5 | %  |

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The Company's direct investments in real estate are not a significant portion of its total investment portfolio as most of these investments were acquired through mortgage loan foreclosures. The Company also participates in several real estate joint ventures, limited partnerships, and other loans that invest primarily in income-producing retail properties. These investments have enhanced the Company's overall investment portfolio returns. The Company's real estate investments totaled approximately \$18.7 million and \$18.8 million at March 31, 2013 and December 31, 2012, respectively. The Company recognized operating income on these properties of approximately \$0.4 million for the first three months of 2013. 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.

## Market Risk

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

## Interest Rate Risk

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

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

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

|   | March 31,<br>2013                 | December 31,<br>2012 |    |
|---|-----------------------------------|----------------------|----|
|   | (In thousands except percentages) |                      |    |
| Debt securities - fair value  | \$9,479,134                       | 9,317,361            |    |
| Debt securities - amortized cost  | \$8,724,123                       | 8,521,172            |    |
| Fair value as a percentage of amortized cost                              | 108.70                            | % 109.34             | %  |
| Unrealized gain balance   | \$755,011                         | 796,189              |    |
| Ten-year U.S. Treasury bond – (decrease) increase in yield for the period | 0.09                              | % (0.12              | )% |



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|                                    | Unrealized Gains Balance |                            | Change in<br>Unrealized<br>Balance |   |
|------------------------------------|--------------------------|----------------------------|------------------------------------|---|
|                                    | At<br>March 31, 2013     | At<br>December 31,<br>2012 |                                    |   |
| Debt securities held to maturity   | \$510,733                | 541,507                    | (30,774                            | ) |
| Debt securities available for sale | 244,278                  | 254,682                    | (10,404                            | ) |
| Totals                             | \$755,011                | 796,189                    | (41,178                            | ) |

Changes in interest rates typically have a sizable effect on the fair values of the Company's debt securities. The market interest rate of the ten-year U.S. Treasury bond increased approximately 9 basis points from year-end 2012 through the first three months of 2013 and the Company's unrealized gain position decreased \$41.2 million on a portfolio with an amortized cost basis of approximately \$8.7 billion. However, since the majority of the Company's debt securities are classified as held to maturity, which are recorded at amortized cost, changes in fair values have relatively small effects on the Company's Condensed Consolidated Balance Sheet.

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

The Company has the ability to adjust interest rates, participation rates, and asset fees and caps, as applicable, in response to changes in investment portfolio yields for a substantial portion of its business in force. The ability to adjust these rates is subject to competitive forces in the market for the Company's products. Surrender rates could increase and new sales could be negatively affected if crediting rates are not competitive with the rates 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 performed detailed sensitivity analysis as of December 31, 2012, for its interest rate-sensitive assets and liabilities. The changes in market values of the Company's debt securities in the first three months of 2013 were reasonable given the expected range of results of this analysis.

**Credit Risk**

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



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are regularly reviewed and approved by senior management and the Company's Board of Directors.

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In connection with the Company's use of call options to hedge the equity return component of its fixed-indexed annuity and life products, the Company is exposed to the risk that a counterparty fails to perform under terms of the option contract. The Company purchases one-year option contracts from multiple counterparties and evaluates the creditworthiness of all counterparties prior to the purchase of the contracts. For consideration in contracting with a counterparty the rating required by the Company is a Standard & Poor's credit rating of "A" or higher and a Moody's rating of "A2" or higher. Accordingly, all options are purchased from nationally recognized financial institutions with a demonstrated performance for honoring their financial obligations and possessing substantial financial capacity. In addition, each counterparty is required to execute a credit support agreement obligating the counterparty to provide collateral to the Company when the fair value of the Company's exposure to the counterparty exceeds specified amounts. The amount of collateral to be provided is based upon a sliding scale tied to the credit rating of the counterparty (the higher the credit rating of the counterparty the higher the threshold of exposure before collateral is to be provided). At the highest credit rating level the maximum counterparty net exposure not subject to collateral support is \$20 million. This net exposure level declines as the counterparty credit rating declines and ultimately is \$0 at a rating of "BBB+". Counterparty credit ratings and credit exposure are monitored continuously by the Company's Investment department with adjustments to collateral levels managed as incurred under the credit support agreements.

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

## 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 March 31, 2013.

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 actual amounts paid by product line in connection with surrenders and withdrawals for the periods ended March 31, are noted in the table below.

|  |
|--|
| Three Months Ended March 31,                 |
| 2013 <span style="float: right;">2012</span> |
| (In thousands)                               |

|                  |           |         |
|------------------|-----------|---------|
| Product Line:    |           |         |
| Traditional Life | \$1,168   | 1,367   |
| Universal Life   | 13,111    | 12,348  |
| Annuities        | 109,397   | 117,121 |
| Total            | \$123,676 | 130,836 |

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

In the past, cash flows from the Company's insurance operations have been sufficient to meet current needs. Cash flows from operating activities were \$82.3 million and \$76.0 million for the three months ended March 31, 2013 and 2012, respectively. The Company also has significant cash flows from both scheduled and unscheduled investment security maturities, redemptions, and prepayments. Investment related cash flows totaled \$470.0 million and \$464.4 million for the three months ended March 31, 2013 and 2011, respectively. These cash flow items could be reduced if interest rates rise. Net cash flows from the Company's universal life and investment annuity deposit product operations totaled \$17.1 million and \$1.8 million during the three months ended March 31, 2013 and 2012, respectively.

Capital Resources

The Company relies on stockholders' equity for its capital resources as there is no long-term debt outstanding and the Company does not anticipate the need for any long-term debt in the near future. As of March 31, 2013, the Company had no commitments beyond its normal operating and investment activities.

OFF-BALANCE SHEET ARRANGEMENTS AND CONTRACTUAL OBLIGATIONS

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

Insurance reserves are the means by which life insurance companies determine the liabilities that must be established to assure that future policy benefits are provided for and can be paid. These reserves are required by law and based upon standard actuarial methodologies to ensure fulfillment of commitments guaranteed to policyholders and their beneficiaries, even though the obligations may not be due for many years. Refer to Note (1) in the Notes to Condensed Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011 for a discussion of reserving methods.

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

|   | Payment Due by Period |                     |                |                |                      |
|---|-----------------------|---------------------|----------------|----------------|----------------------|
|   | Total                 | Less Than<br>1 Year | 1 - 3<br>Years | 3 - 5<br>Years | More Than<br>5 Years |
|   | (In thousands)        |                     |                |                |                      |
| Operating lease obligations   | \$112                 | 112                 | —              | —              | —                    |
| Life claims payable (1)   | 72,155                | 72,155              | —              | —              | —                    |
| Other long-term reserve liabilities<br>reflected on the balance sheet under<br>GAAP (2) | 11,569,684            | 1,117,509           | 1,973,536      | 1,788,482      | 6,690,157            |

|       |              |           |           |           |           |
|-------|--------------|-----------|-----------|-----------|-----------|
| Total | \$11,641,951 | 1,189,776 | 1,973,536 | 1,788,482 | 6,690,157 |
|-------|--------------|-----------|-----------|-----------|-----------|

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

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

## CHANGES IN ACCOUNTING PRINCIPLES AND CRITICAL ACCOUNTING POLICIES

### Changes in Accounting Principles

Refer to Note (1) of the Notes to Condensed Consolidated Financial Statements.

## REGULATORY AND OTHER ISSUES

### Statutory Accounting Practices

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

### Risk-Based Capital Requirements

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

## PART II. OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

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

### ITEM 1A. RISK FACTORS

There have been no changes relative to the risk factors disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

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

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

The following table sets forth the Company's repurchase of its Class A common shares from Option Holders for the quarter ended March 31, 2013.

| 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 |
|--|----------------------------------|------------------------------|--|--|
| January 1, 2013 through January 31, 2013   | —                                | —                            | N/A  | N/A  |
| February 1, 2013 through February 28, 2013 | —                                | —                            | N/A  | N/A  |
| March 1, 2013 through March 31, 2013       | 2,850                            | \$174.99                     | N/A  | N/A  |
| Total                                      | 2,850                            | \$174.99                     | N/A  | N/A  |

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

ITEM 4. Removed and Reserved.

## ITEM 6. EXHIBITS

(a) Exhibits

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

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

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



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SIGNATURES

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

NATIONAL WESTERN LIFE INSURANCE COMPANY  
(Registrant)

Date: May 8, 2013

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

Date: May 8, 2013

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

Date: May 8, 2013

/S/ Thomas F. Kopetic  
Thomas F. Kopetic  
Vice President,  
Controller and Assistant Treasurer  
(Principal Accounting Officer)