

NATIONAL WESTERN LIFE INSURANCE CO
Form 10-Q
November 10, 2008

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

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2008

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

For the transition period from _____ to _____

Commission File Number: 2-17039

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

COLORADO
(State of Incorporation)

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

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

(512) 836-1010
(Telephone Number)

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

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

As of November 6, 2008, the number of shares of Registrant's common stock outstanding was: Class A – 3,425,966 and Class B - 200,000.

TABLE OF CONTENTS

	Page
<u>Part I. Financial Information:</u>	3
<u>Item 1. Financial Statements</u>	3
<u>Condensed Consolidated Balance Sheets</u> September 30, 2008 (Unaudited) and December 31, 2007	3
<u>Condensed Consolidated Statements of Earnings</u> For the Three Months Ended September 30, 2008 and 2007 (Unaudited)	5
<u>Condensed Consolidated Statements of Earnings</u> For the Nine Months Ended September 30, 2008 and 2007 (Unaudited)	6
<u>Condensed Consolidated Statements of Comprehensive Income</u> For the Three Months Ended September 30, 2008 and 2007 (Unaudited)	7
<u>Condensed Consolidated Statements of Comprehensive Income</u> For the Nine Months Ended September 30, 2008 and 2007 (Unaudited)	8
<u>Condensed Consolidated Statements of Stockholders' Equity</u> For the Nine Months Ended September 30, 2008 and 2007 (Unaudited)	9
<u>Condensed Consolidated Statements of Cash Flows</u> For the Nine Months Ended September 30, 2008 and 2007 (Unaudited)	10
<u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>	12
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	33
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	58
<u>Item 4. Controls and Procedures</u>	58
<u>Part II. Other Information:</u>	58
<u>Item 1. Legal Proceedings</u>	58
<u>Item 1A. Risk Factors</u>	59
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	59
<u>Item 6. Exhibits</u>	59

Signatures

60

2

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

ASSETS	(Unaudited) September 30, 2008	December 31, 2007
Investments:		
Securities held to maturity, at amortized cost	\$ 3,850,139	3,778,603
Securities available for sale, at fair value	1,793,722	1,900,714
Mortgage loans, net of allowance for possible losses		
(\$3,571 and \$3,567)	87,789	99,033
Policy loans	80,937	83,772
Derivatives, index options	6,095	25,907
Other long-term investments	23,523	16,562
Total investments	5,842,205	5,904,591
Cash and short-term investments	34,851	45,206
Deferred policy acquisition costs	688,973	664,805
Deferred sales inducements	117,177	104,029
Accrued investment income	67,503	65,034
Federal income tax receivable	5,184	10,010
Other assets	44,975	41,651
	\$ 6,800,868	6,835,326

See accompanying notes to condensed consolidated financial statements.

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share amounts)

LIABILITIES AND STOCKHOLDERS' EQUITY	(Unaudited) September 30, 2008	December 31, 2007
LIABILITIES:		
Future policy benefits:		
Traditional life and annuity contracts	\$ 137,978	138,672
Universal life and annuity contracts	5,419,282	5,441,871
Other policyholder liabilities	129,078	120,400
Federal income tax liability:		
Current	-	-
Deferred	36,428	61,720
Other liabilities	81,833	60,978
Total liabilities	5,804,599	5,823,641
COMMITMENTS AND CONTINGENCIES (Notes 5 and 9)		
STOCKHOLDERS' EQUITY:		
Common stock:		
Class A - \$1 par value; 7,500,000 shares authorized; 3,425,966 and 3,422,324 issued and outstanding in 2008 and 2007	3,426	3,422
Class B - \$1 par value; 200,000 shares authorized, issued, and outstanding in 2008 and 2007	200	200
Additional paid-in capital	36,680	36,236
Accumulated other comprehensive loss	(44,448)	(7,065)
Retained earnings	1,000,411	978,892
Total stockholders' equity	996,269	1,011,685
	\$ 6,800,868	6,835,326

Note: The condensed consolidated balance sheet at December 31, 2007, has been derived from the audited consolidated financial statements as of that date.

See accompanying notes to condensed consolidated financial statements.

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS

For the Three Months Ended September 30, 2008 and 2007

(Unaudited)

(In thousands, except per share amounts)

	2008	2007
Premiums and other revenue:		
Life and annuity premiums	\$ 4,057	4,755
Universal life and annuity contract revenues	32,885	30,025
Net investment income	69,582	75,075
Other income	3,056	3,786
Net investment losses	(21,620)	(1,505)
Total premiums and other revenue	87,960	112,136
Benefits and expenses:		
Life and other policy benefits	10,794	11,337
Amortization of deferred policy acquisition costs	37,188	25,238
Universal life and annuity contract interest	38,339	38,219
Other operating expenses	17,905	12,871
Total benefits and expenses	104,226	87,665
Earnings (loss) before Federal income taxes	(16,266)	24,471
Provision (benefit) for Federal income taxes:		
Current	3,488	(2,836)
Deferred	(9,954)	11,685
Total Federal income taxes	(6,466)	8,849
Net earnings (loss)	\$ (9,800)	15,622
Basic Earnings (Loss) Per Share:		
Class A	\$ (2.78)	4.44
Class B	\$ (1.39)	2.22
Diluted Earnings (Loss) Per Share:		
Class A	\$ (2.78)	4.38
Class B	\$ (1.39)	2.22

See accompanying notes to condensed consolidated financial statements.

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS

For the Nine Months Ended September 30, 2008 and 2007

(Unaudited)

(In thousands, except per share amounts)

	2008	2007
Premiums and other revenue:		
Life and annuity premiums	\$ 12,575	14,074
Universal life and annuity contract revenues	98,696	87,474
Net investment income	201,290	260,033
Other income	9,348	10,461
Net investment gains (losses)	(21,931)	2,901
Total premiums and other revenue	299,978	374,943
Benefits and expenses:		
Life and other policy benefits	28,905	32,748
Amortization of deferred policy acquisition costs	93,699	74,660
Universal life and annuity contract interest	98,511	143,037
Other operating expenses	45,962	43,354
Total benefits and expenses	267,077	293,799
Earnings before Federal income taxes	32,901	81,144
Provision (benefit) for Federal income taxes:		
Current	15,307	6,551
Deferred	(5,194)	18,448
Total Federal income taxes	10,113	24,999
Net earnings	\$ 22,788	56,145
Basic Earnings Per Share:		
Class A	\$ 6.47	15.94
Class B	\$ 3.23	7.97
Diluted Earnings Per Share:		
Class A	\$ 6.42	15.74
Class B	\$ 3.23	7.97

See accompanying notes to condensed consolidated financial statements.

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
For the Three Months Ended September 30, 2008 and 2007
(Unaudited)
(In thousands)

	2008	2007
Net earnings (loss)	\$ (9,800)	15,622
Other comprehensive income (loss), net of effects of		
deferred costs and taxes:		
Unrealized losses on securities:		
Net unrealized holding gains (losses) arising during period	(34,258)	4,860
Reclassification adjustment for net losses included in net earnings	11,707	16
Amortization of net unrealized gains related to transferred securities	11	25
Net unrealized gains (losses) on securities	(22,540)	4,901
Foreign currency translation adjustments	(8)	47
Benefit plans:		
Amortization of net prior service cost and net loss	342	308
Other comprehensive income (loss)	(22,206)	5,256
Comprehensive income (loss)	\$ (32,006)	20,878

See accompanying notes to condensed consolidated financial statements.

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
For the Nine Months Ended September 30, 2008 and 2007
(Unaudited)
(In thousands)

	2008	2007
Net earnings	\$ 22,788	56,145
Other comprehensive income (loss), net of effects of deferred costs and taxes:		
Unrealized losses on securities:		
Net unrealized holding losses arising during period	(49,353)	(3,745)
Reclassification adjustment for net losses (gains) included in net earnings	11,097	(2,848)
Amortization of net unrealized gains (losses) related to transferred securities	(3)	79
Net unrealized losses on securities	(38,259)	(6,514)
Foreign currency translation adjustments	(150)	(139)
Benefit plans:		
Amortization of net prior service cost and net loss	1,026	926
Other comprehensive loss	(37,383)	(5,727)
Comprehensive income (loss)	\$ (14,595)	50,418

See accompanying notes to condensed consolidated financial statements.

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
For the Nine Months Ended September 30, 2008 and 2007
(Unaudited)
(In thousands)

	2008	2007
Common stock:		
Balance at beginning of year	\$ 3,622	3,621
Shares exercised under stock option plan	4	1
Balance at end of period	3,626	3,622
Additional paid-in capital:		
Balance at beginning of year	36,236	36,110
Shares exercised under the stock option plan	444	126
Balance at end of period	36,680	36,236
Accumulated other comprehensive loss:		
Unrealized gains (losses) on securities:		
Balance at beginning of year	1,184	3,148
Change in unrealized losses during period	(38,259)	(6,514)
Balance at end of period	(37,075)	(3,366)
Foreign currency translation adjustments:		
Balance at beginning of year	3,078	3,122
Change in translation adjustments during period	(150)	(139)
Balance at end of period	2,928	2,983
Benefit plan liability adjustment:		
Balance at beginning of year	(11,327)	(10,001)
Amortization of net prior service cost and net gain	1,026	926
Balance at end of period	(10,301)	(9,075)
Accumulated other comprehensive loss at end of period	(44,448)	(9,458)
Retained earnings:		
Balance at beginning of year	978,892	896,984
Cumulative effect of change in accounting principle, net of tax	-	(2,195)
Net earnings	22,788	56,145
Stockholder dividends	(1,269)	(1,268)

Balance at end of period	1,000,411	949,666
Total stockholders' equity	\$ 996,269	980,066

See accompanying notes to condensed consolidated financial statements.

9

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Nine Months Ended September 30, 2008 and 2007

(Unaudited)

(In thousands)

	2008	2007
Cash flows from operating activities:		
Net earnings	\$ 22,788	56,145
Adjustments to reconcile net earnings to net cash from operating activities:		
Universal life and annuity contract interest	98,511	143,037
Surrender charges and other policy revenues	(30,324)	(26,776)
Net investment losses (gains)	21,931	(2,901)
Accrual and amortization of investment income	(3,715)	(3,829)
Depreciation and amortization	786	746
Decrease in value of derivatives	52,824	26,393
Decrease (increase) in deferred policy acquisition and sales inducement costs	14,508	(9,730)
(Increase) decrease in accrued investment income	(2,496)	924
Decrease in other assets	991	582
(Decrease) increase in liabilities for future policy benefits	(694)	338
Increase in other policyholder liabilities	8,678	4,893
(Decrease) increase in Federal income tax liability	(368)	6,861
Increase (decrease) in other liabilities	11,116	(5,924)
Other	844	167
Net cash provided by operating activities	195,380	190,926
Cash flows from investing activities:		
Proceeds from sales of:		
Securities held to maturity	-	5,175
Securities available for sale	1,522	28,418
Other investments	5,382	33,255
Proceeds from maturities and redemptions of:		
Securities held to maturity	417,933	106,023
Securities available for sale	190,284	268,999
Other investments	-	-
Purchases of:		
Securities held to maturity	(493,363)	(256,014)
Securities available for sale	(190,039)	(284,742)
Other investments	(47,195)	(35,619)
Principal payments on mortgage loans	12,308	21,623
Cost of mortgage loans acquired	(6,046)	(18,480)

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

Decrease in policy loans	2,835	2,309
Other	(4,316)	(6,624)
Net cash used in investing activities	(110,695)	(135,677)

(Continued on next page)

Table of Contents

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS, CONTINUED

For the Nine Months Ended September 30, 2008 and 2007

(Unaudited)
(In thousands)

	2008	2007
Cash flows from financing activities:		
Deposits to account balances for universal life and annuity contracts	\$ 346,119	380,708
Return of account balances on universal life and annuity contracts	(441,195)	(444,877)
Issuance of common stock under stock option plan	448	127
Net cash used in financing activities	(94,628)	(64,042)
Effect of foreign exchange	(412)	(72)
Net decrease in cash and short-term investments	(10,355)	(8,865)
Cash and short-term investments at beginning of period	45,206	49,901
Cash and short-term investments at end of period	\$ 34,851	41,036

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

Cash paid during the period for:

Interest	\$	30	30
Income taxes		10,481	19,155

See accompanying notes to condensed consolidated financial statements.

Table of Contents

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

(1) CONSOLIDATION AND BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for annual financial statements. In the opinion of management, the accompanying condensed consolidated financial statements contain all adjustments necessary to present fairly the financial position of National Western Life Insurance Company and its subsidiaries (the Company) as of September 30, 2008, and the results of their operations and their cash flows for the three months and nine months ended September 30, 2008 and 2007. The results of operations for the three months and nine months ended September 30, 2008 and 2007 are not necessarily indicative of the results to be expected for the full year. For further information, refer to the consolidated financial statements and notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2007 accessible free of charge through the Company's internet site at www.nationalwesternlife.com or the Securities and Exchange Commission ("SEC") internet site at www.sec.gov.

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

(2) CHANGES IN ACCOUNTING PRINCIPLES

In September 2005, the AICPA issued Statement of Position 05-1, Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts ("SOP 05-1") which was effective for internal replacements occurring in fiscal years beginning after December 15, 2006. SOP 05-1 provides guidance on accounting by insurance enterprises for deferred acquisition costs on internal replacements of insurance and investment contracts other than those specifically described in FASB No. 97. SOP 05-1 defines an internal replacement as a modification in product benefits, features, rights, or coverages that occurs by the exchange of a contract for a new contract, or by amendment, endorsement, or rider to a contract, or by the election of a feature or coverage within a contract. The Company had an impact related to the adoption of SOP 05-1 for contracts which annuitized and for reinstatements of contracts. The unamortized deferred acquisition costs and deferred sales inducement assets have to be written-off at the time of annuitization and can not be continued related to reinstatements. SOP 05-1 resulted in changes in assumptions relative to estimated gross profits which affected unamortized deferred acquisition costs, unearned revenue liabilities, and deferred sales inducement balances as of the beginning of 2007. The effect of this SOP on beginning retained earnings as of January 1, 2007 was a decrease of \$2.2 million, net of tax, as detailed below.

		Amounts (In thousands)
Write-off of deferred acquisition cost	\$	3,321
Adjustment to deferred annuity revenue		56
		3,377

Federal income tax		(1,182)
Cumulative effect of change in accounting for internal replacements and investment contracts	\$	2,195

12

Table of Contents

In September 2006, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standards (“SFAS”) No. 157, Fair Value Measurements. This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. The Company adopted SFAS 157 effective January 1, 2008, and the adoption did not have an impact on the Company’s consolidated financial statements. See Note 11 for additional disclosures concerning fair value measurement.

In February 2008, the FASB issued FSP FAS 157-2, Effective Date of FASB Statement No. 157. This FSP delays the effective date of SFAS 157 for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis, to fiscal years and interim periods beginning after November 15, 2008.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, which permits entities to choose to measure at fair value many financial instruments and certain other items that are not currently required to be measured at fair value. The Company adopted SFAS 159 effective January 1, 2008, and the adoption did not have an impact on the consolidated financial statements as no items were elected for measurement at fair value upon initial adoption.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements. SFAS 160 establishes accounting and reporting standards for entities that have equity investments that are not attributable directly to the parent, called noncontrolling interests or minority interests. Specifically, SFAS 160 states where and how to report noncontrolling interests in the consolidated statements of financial position and operations, how to account for changes in noncontrolling interests and provides disclosure requirements. The provisions of SFAS 160 are effective beginning January 1, 2009. The Company is currently evaluating the impact that the adoption of this statement will have on the consolidated financial position, results of operations and disclosures.

In December 2007, the FASB issued SFAS No. 141(R), Business Combinations. SFAS 141(R) establishes how an entity accounts for the identifiable assets acquired, liabilities assumed, and any noncontrolling interests acquired, how to account for goodwill acquired and what disclosures are required as part of a business combination. SFAS 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The adoption of SFAS 141(R) is not expected to have a material impact on the Company’s consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133. This statement requires enhanced disclosures regarding an entity’s derivative and hedging activity to enable investors to better understand their effects on an entity’s financial position, financial performance, and cash flows. SFAS No. 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The adoption of SFAS No. 161 is not expected to have a material impact on the Company’s consolidated financial statements.

In April 2008, the FASB issued FSP No. FAS 142-3, Determination of the Useful Life of Intangible Assets. FSP FAS 142-3 amends the factors to be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS 142. The provisions of FSP FAS 142-3 are to be applied prospectively to intangible assets acquired after January 1, 2009 although the disclosure provisions are required for all intangible assets as of or subsequent to January 1, 2009. The adoption of FSP FAS 142-3 is not expected to impact the Company’s consolidated financial condition and results of operations.

In May 2008, the FASB issued SFAS No. 163, Accounting for Financial Guarantee Insurance Contracts—an interpretation of FASB Statement No. 60 (“SFAS 163”). The scope of SFAS 163 is limited to financial guarantee insurance (and reinsurance) contracts issued by enterprises that are included within the scope of SFAS No. 60,

“Accounting and Reporting by Insurance Enterprises” (“SFAS 60”) and that are not accounted for as derivative instruments. SFAS 163 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and all interim periods within those fiscal years. The Company does not have financial guarantee insurance products, and, accordingly does not expect the adoption of SFAS 163 to have an effect on the Company’s consolidated financial condition and results of operations.

Table of Contents

In September 2008, the FASB issued FSP No. FAS 133-1 and FIN 45-4, Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161. This FSP amends SFAS 133 to require disclosures by entities that assume credit risk through the sale of credit derivatives including credit derivatives embedded in a hybrid instrument to enable users of financial statements to assess the potential effect on its financial position, financial performance, and cash flows from these credit derivatives. This FSP also amends FASB Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, to require additional disclosure about the current status of the payment/performance risk of a guarantee. FSP FAS 133-1 and FIN 45-4 are effective for financial statements issued for fiscal years and interim periods ending after November 15, 2008. The Company does not expect the adoption of FSP FAS 133-1 and FIN 45-4 to have an effect on the Company's consolidated financial condition and results of operations.

In October 2008, the FASB issued FSP No. FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active. This FSP clarifies the application of SFAS 157 in a market that is not active and illustrates key considerations including the use of an entity's own assumptions about future cash flows and appropriately risk-adjusted discount rates, appropriate risk adjustments for nonperformance and liquidity risks, and the reliance that an entity should place on quotes that do not reflect the result of market transactions. This FSP was preceded by a press release that was jointly issued by the Office of the Chief Accountant of the SEC and the FASB staff on September 30, 2008 which provided immediate clarification on fair value accounting based on the measurement guidance of SFAS 157. The FSP was effective upon issuance and did not have a material impact on the Company's consolidated financial statements. See Note 11 for disclosures regarding the Company's fair value measurements.

(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 Company paid no cash dividends on common stock during the nine months ended September 30, 2008 and 2007. However, the Company declared a cash dividend on August 22, 2008 payable November 28, 2008 to stockholders on record as of October 31, 2008. The dividends declared were \$0.36 per common share to Class A stockholders and \$0.18 per common share to Class B stockholders. The dividend payment was approved by the Colorado Division of Insurance. A dividend in the same amounts per share on Class A and Class B shares was declared in August and paid in November of 2007.

Table of Contents

(4) EARNINGS PER SHARE

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

	Three Months Ended September 30,			
	2008		2007	
	Class A	Class B	Class A	Class B
	(In thousands except per share amounts)			
Numerator for Basic and Diluted Earnings Per Share:				
Net income (loss)	\$ (9,800)		15,622	
Dividends – Class A shares	(1,233)		(1,232)	
Dividends – Class B shares	(36)		(36)	
Undistributed income (loss)	\$ (11,069)		14,354	
Allocation of net income (loss):				
Dividends	\$ 1,233	36	1,232	36
Allocation of undistributed income (loss)	(10,755)	(314)	13,946	408
Net income (loss)	\$ (9,522)	(278)	15,178	444
Denominator:				
Basic earnings per share - weighted-average shares	3,426	200	3,422	200
Effect of dilutive stock options	-	-	42	-
Diluted earnings per share - adjusted weighted-average shares for assumed conversions				
Conversions	3,426	200	3,464	200
Basic Earnings (Loss) Per Share	\$ (2.78)	(1.39)	4.44	2.22
Diluted Earnings (Loss) Per Share	\$ (2.78)	(1.39)	4.38	2.22

Table of Contents

Nine Months Ended September 30,
2008
Class A Class B Class A Class B
2007
(In thousands except per share amounts)

Numerator for Basic and
Diluted Earnings Per Share:

Net income	\$	22,788		56,145	
Dividends – Class A shares		(1,233)		(1,232)	
Dividends – Class B shares		(36)		(36)	

Undistributed income	\$	21,519		54,877	
----------------------	----	--------	--	--------	--

Allocation of net income:

Dividends	\$	1,233	36	1,232	36
Allocation of undistributed income		20,909	610	53,319	1,558

Net income	\$	22,142	646	54,551	1,594
------------	----	--------	-----	--------	-------

Denominator:

Basic earnings per share - weighted-average shares		3,425	200	3,422	200
---	--	-------	-----	-------	-----

Effect of dilutive stock options		26	-	45	-
-------------------------------------	--	----	---	----	---

Diluted earnings per share - adjusted weighted-average shares for assumed conversions		3,451	200	3,467	200
--	--	-------	-----	-------	-----

Basic Earnings Per Share	\$	6.47	3.23	15.94	7.97
--------------------------	----	------	------	-------	------

Diluted Earnings Per Share	\$	6.42	3.23	15.74	7.97
----------------------------	----	------	------	-------	------

(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 comply 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. Using estimated assumptions, the cumulative estimated minimum required contribution for the next five years is \$2.1 million at which time the Plan is expected to be fully funded. Future pension expense is projected to be minimal.

Table of Contents

The following summarizes the components of net periodic benefit cost.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
	(In thousands)			
Service cost	\$ -	180	-	540
Interest cost	259	272	777	815
Expected return on plan assets	(285)	(275)	(855)	(825)
Amortization of prior service cost	1	1	3	3
Amortization of net loss	60	80	182	240
Net periodic benefit cost	\$ 35	258	107	773

The Company has contributed \$1.1 million to the plan in 2008. No further contributions are expected in 2008.

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 pension 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 plan, while complying with the requirements of the Act.

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 plan as previously discussed, while complying with the requirements of the Act.

The following summarizes the components of net periodic benefit costs for these non-qualified plans.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
	(In thousands)			
Service cost	\$ 146	194	439	580

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

Interest cost		298	240	893	721
Amortization of prior service cost		260	260	780	780
Amortization of net loss		177	101	530	303
Net periodic benefit cost	\$	881	795	2,642	2,384

The Company expects to contribute \$1.7 million to these plans in 2008. As of September 30, 2008, the Company has contributed \$1.2 million to the plans.

Table of Contents

(B) Defined Benefit Postretirement Plans

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
	(In thousands)			
Interest cost	\$ 34	36	101	106
Amortization of prior service cost	25	25	77	77
Amortization of net loss	1	7	4	22
Net periodic benefit cost	\$ 60	68	182	205

As previously disclosed in its financial statements for the year ended December 31, 2007, the Company expects to contribute minimal amounts to the plan in 2008.

Table of Contents

(6) SEGMENT AND OTHER OPERATING INFORMATION

Under SFAS No. 131, Disclosures About Segments of an Enterprise and Related 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 as of and for the periods ended September 30, 2008 and 2007 is provided below.

Selected Segment Information.

	Domestic Life Insurance	International Life Insurance	Annuities (In thousands)	All Others	Totals
September 30, 2008:					
Selected Balance Sheet Items:					
Deferred policy acquisition					
costs and sales inducements	\$ 64,669	219,531	521,950	-	806,150
Total segment assets	398,277	837,859	5,385,733	138,787	6,760,656
Future policy benefits	318,080	592,887	4,646,293	-	5,557,260
Other policyholder liabilities	11,786	12,942	104,350	-	129,078
Three Months Ended					
September 30, 2008:					
Condensed Income Statements:					
Premiums and contract					
revenues	\$ 6,798	23,890	6,254	-	36,942
Net investment income	4,912	4,652	58,902	1,116	69,582
Other income	3	13	46	2,994	3,056
Total revenues	11,713	28,555	65,202	4,110	109,580
Life and other policy benefits	3,569	5,765	1,460	-	10,794
Amortization of deferred					
policy acquisition costs	3,219	8,877	25,092	-	37,188
Universal life and annuity					
contract interest	2,249	4,664	31,426	-	38,339
Other operating expenses	3,070	6,597	5,531	2,707	17,905
Federal income taxes (benefit)	(147)	694	158	396	1,101
Total expenses	11,960	26,597	63,667	3,103	105,327
Segment earnings (loss)	\$ (247)	1,958	1,535	1,007	4,253

Table of Contents

Selected Segment Information.

	Domestic Life Insurance	International Life Insurance	Annuities (In thousands)	All Others	Totals
Nine Months Ended September 30, 2008: Condensed Income Statements:					
Premiums and contract revenues	\$ 20,108	72,116	19,047	-	111,271
Net investment income	15,103	12,696	168,205	5,286	201,290
Other income	13	38	169	9,128	9,348
Total revenues	35,224	84,850	187,421	14,414	321,909
Life and other policy benefits	10,588	15,364	2,953	-	28,905
Amortization of deferred policy acquisition costs	7,574	27,278	58,847	-	93,699
Universal life and annuity contract interest	6,892	11,944	79,675	-	98,511
Other operating expenses	9,093	14,723	13,826	8,320	45,962
Federal income taxes	349	5,042	10,420	1,978	17,789
Total expenses	34,496	74,351	165,721	10,298	284,866
Segment earnings	\$ 728	10,499	21,700	4,116	37,043

Table of Contents

Selected Segment Information.

	Domestic Life Insurance	International Life Insurance	Annuities (In thousands)	All Others	Totals
September 30, 2007:					
Selected Balance Sheet Items:					
Deferred policy acquisition					
costs and sales inducements	\$ 57,063	189,866	508,852	-	755,781
Total segment assets	392,465	769,225	5,513,462	104,786	6,779,938
Future policy benefits	318,171	541,526	4,733,985	-	5,593,682
Other policyholder liabilities	10,915	17,225	89,202	-	117,342
Three Months Ended					
September 30, 2007:					
Condensed Income Statements:					
Premiums and contract					
revenues	\$ 6,875	21,826	6,079	-	34,780
Net investment income	4,774	6,460	62,833	1,008	75,075
Other income	7	19	543	3,217	3,786
Total revenues	11,656	28,305	69,455	4,225	113,641
Life and other policy benefits	3,969	6,353	1,015	-	11,337
Amortization of deferred					
policy acquisition costs	2,229	8,045	14,964	-	25,238
Universal life and annuity					
contract interest	2,396	6,131	29,692	-	38,219
Other operating expenses	2,877	3,616	3,593	2,785	12,871
Federal income taxes	42	1,457	7,314	563	9,376
Total expenses	11,513	25,602	56,578	3,348	97,041
Segment earnings	\$ 143	2,703	12,877	877	16,600

Table of Contents

	Domestic Life Insurance	International Life Insurance	Annuities (In thousands)	All Others	Totals
Nine Months Ended September 30, 2007: Condensed Income Statements:					
Premiums and contract revenues	\$ 19,522	64,061	17,965	-	101,548
Net investment income	13,967	21,075	220,263	4,728	260,033
Other income	34	106	909	9,412	10,461
Total revenues	33,523	85,242	239,137	14,140	372,042
Life and other policy benefits	12,727	17,330	2,691	-	32,748
Amortization of deferred policy acquisition costs	5,041	25,401	44,218	-	74,660
Universal life and annuity contract interest	7,028	19,227	116,782	-	143,037
Other operating expenses	9,084	12,388	13,673	8,209	43,354
Federal income taxes (benefit)	(109)	3,340	18,936	1,817	23,984
Total expenses	33,771	77,686	196,300	10,026	317,783
Segment earnings (loss)	\$ (248)	7,556	42,837	4,114	54,259

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
	(In thousands)			
Premiums and Other Revenue:				
Premiums and contract revenues	\$ 36,942	34,780	111,271	101,548
Net investment income	69,582	75,075	201,290	260,033
Other income	3,056	3,786	9,348	10,461
Net investment gains (losses)	(21,620)	(1,505)	(21,931)	2,901
Total consolidated premiums and other revenue	\$ 87,960	112,136	299,978	374,943

Table of Contents

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
	(In thousands)			
Federal Income Taxes:				
Total segment Federal income taxes	\$ 1,101	9,376	17,789	23,984
Taxes on net investment (losses) gains	(7,567)	(527)	(7,676)	1,015
Total consolidated Federal income taxes (benefit)	\$ (6,466)	8,849	10,113	24,999

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
	(In thousands)			
Net Earnings:				
Total segment earnings	\$ 4,253	16,600	37,043	54,259
Net investment (losses) gains, net of taxes	(14,053)	(978)	(14,255)	1,886
Total consolidated net earnings (loss)	\$ (9,800)	15,622	22,788	56,145

	2008	September 30, 2007
	(In thousands)	
Assets:		
Total segment assets	\$ 6,760,656	6,779,938
Other unallocated assets	40,212	35,245
Total consolidated assets	\$ 6,800,868	6,815,183

(7) SHARE-BASED PAYMENTS

The Company has a stock and incentive plan ("1995 Plan") which provides 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 may be issued under the 1995 Plan, or as to which stock appreciation rights or other awards may be granted, may 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 per value, common stock shares eligible for issue not to exceed 300,000. These shares may be authorized and unissued shares. The Company has only issued nonqualified stock options and stock appreciation rights.

All of the employees of the Company and its subsidiaries are eligible to participate in the two Plans. In addition, directors of the Company are eligible for restricted stock awards, incentive awards, and performance awards. Company directors, including members of the Compensation and Stock Option Committee, are eligible for nondiscretionary stock options. The directors' stock options vest 20% annually following one full year of service to the Company from the date of grant. The officers' stock options vest 20% annually following three full years of service to the Company from the date of grant. Options issued expire after ten years. During the third quarter of 2008, 2,750 stock appreciation rights were awarded to specified Company officers. Quantities awarded and market value prices on the dates of award are: (1) August 21, 2008, 1,250 awards at \$236.00 (2) September 2, 2008, 1,000 awards at \$251.49; and, (3) September 22, 2008, 500 awards at \$256.00. No awards were issued during the same period in 2007.

Table of Contents

In 2006, the Company adopted and implemented a limited stock buy-back program, which provides option holders under the 1995 Plan 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. Accordingly, the Company is using the current fair value method to measure compensation cost. 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 and therefore also follows the liability classification of accounting. A summary of shares available for grant, stock option, and stock appreciation right (“SAR”) activity is detailed below.

	Shares Available For Grant	Options Outstanding Shares	Weighted-Average Exercise Price
Balance at January 1, 2008	27,668	94,984	\$ 128.47
Stock Options:			
Exercised	-	(25,440)	105.77
Forfeited	1,000	(1,000)	150.00
Stock options granted April 18, 2008	(28,268)	28,268	255.13
2008 Plan addition	300,000	-	-
Stock options granted June 20, 2008	(9,000)	9,000	208.05
SARs granted August 21, 2008	(1,250)	1,250	236.00
SARs granted September 2, 2008	(1,000)	1,000	251.49
SARs granted September 22, 2008	(500)	500	256.00
Balance at September 30, 2008	288,650	108,562	\$ 176.13

The total intrinsic value of options exercised was \$2.7 million and \$4.6 million for the nine months ended September 30, 2008 and 2007, respectively. The total share-based liabilities paid were \$2.5 million for the nine months ended September 30, 2008. There were no shares vested during the third quarter of 2008.

The following table summarizes information about stock options and SARs outstanding at September 30, 2008.

Exercise prices:	Options Outstanding		
	Number Outstanding	Weighted-Average Remaining Contractual Life	Options Exercisable
\$ 92.13	10,194	2.6 years	10,194
95.00	6,000	2.7 years	6,000
150.00	52,350	5.6 years	21,450
255.13	28,268	9.6 years	-
208.05	9,000	9.7 years	-
236.00	1,250	9.9 years	-
251.49	1,000	9.9 years	-

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

256.00	500	9.9 years	-
Totals	108,562		37,644
Aggregate intrinsic value (in thousands)	\$ 7,545		\$ 4,386

The aggregate intrinsic value in the table above is based on the closing stock price of \$242.07 per share on September 30, 2008.

Table of Contents

In estimating the fair value of the options outstanding at September 30, 2008 and 2007, the Company employed the Black-Scholes option pricing model with assumptions as detailed below.

	2008	2007
Expected term of options	2 to 10 years	2 to 6 years
Expected volatility:		
Range	21.83% to 41.95%	16.21% to 23.19%
Weighted average	26.46%	19.55%
Expected dividends	\$0.36	\$0.36
Risk-free rate:		
Range	3.38% to 4.35%	3.95% to 4.35%
Weighted average	3.90%	4.12%

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

The pre-tax compensation cost recognized in the financial statements related to the Plan was \$2.6 million for each of the nine month periods ended September 30, 2008 and 2007. The related tax benefit recognized was \$0.9 million for each of the nine month periods ended September 30, 2008 and 2007.

As of September 30, 2008, the total compensation cost related to nonvested options not yet recognized was \$3.7 million. This amount is expected to be recognized over a weighted-average period of 2.4 years. The Company recognizes compensation cost over the graded vesting periods.

For the nine months ended September 30, 2008 and 2007, the total cash received from the exercise of options under the Plan was \$0.4 million and \$0.1 million, respectively.

(8) FEDERAL INCOME TAXES

During the second quarter of 2007, upon the completion of a detailed review of the deferred tax items, the Company identified a \$2.3 million error in the net deferred tax liability. The error, which occurred during various periods prior to 2005, was corrected in the second quarter of 2007 and resulted in a decrease in the net deferred tax liability and deferred tax expense. The adjustment was not material to the second quarter of 2007 or any prior period financial statements.

(9) LEGAL PROCEEDINGS

The Company is a defendant in two class action lawsuits. In one case, the Court has certified a class consisting of certain California policyholders age 65 and older alleging violations under California Business and Professions Code section 17200. The Court has additionally certified a subclass of 36 policyholders alleging fraud against their agent, and vicariously, against the Company but it is expected that a motion for class certification will be filed by February, 2009. A second class action lawsuit is in discovery with no class certification motion pending. Management believes that the Company has good and meritorious defenses and intends to continue to vigorously defend itself against these claims.

The Company is involved or may become involved in various other legal actions, in the normal course of business, in which claims for alleged economic and punitive damages have been or may be asserted, some for substantial amounts. Although there can be no assurances, at the present time, the Company does not anticipate that the ultimate liability arising from potential, pending, or threatened legal actions, will have a material adverse effect on the financial condition or operating results of the Company.

Table of Contents

On June 28, 2008, the SEC published for public comment until September 10, 2008, proposed Rule 151A which would require fixed-index annuity products to be regulated by the SEC. On October 10, 2008, the SEC republished the rule for public comment until November 17, 2008. The proposed rule indicates there would be 12 months between publication and the effective date of any final rule. Under this proposed rule, fixed-index annuities would be considered a type of security and all agents selling these products would have to be registered representatives affiliated with a licensed broker dealer. While there is uncertainty regarding the outcome of this proposed rule, it is possible the Company could have a more regulated environment in the future for its fixed-index annuity products with a likely increase in costs and possible decline in sales due to product redesign requirements.

(10) INVESTMENTS

(A) Debt and Equity Securities

The tables below present amortized cost and fair values of securities held to maturity and securities available for sale at September 30, 2008.

	Amortized Cost	Securities Held to Maturity		Fair Value
		Gross Unrealized Gains	Gross Unrealized Losses	
		(In thousands)		
Debt securities:				
U.S. Treasury and other U.S. government corporations and agencies	\$ 186,528	1,643	1,061	187,110
States and political subdivisions	23,179	3	737	22,445
Foreign governments	9,953	352	-	10,305
Public utilities	502,818	4,326	22,835	484,309
Corporate	1,306,443	7,174	96,576	1,217,041
Mortgage-backed	1,748,664	6,059	33,063	1,721,660
Asset-backed	72,554	212	9,969	62,797
Totals	\$ 3,850,139	19,769	164,241	3,705,667

Table of Contents

	Amortized Cost	Securities Available for Sale		Fair Value
		Gross Unrealized Gains	Gross Unrealized Losses	
(In thousands)				
Debt securities:				
U.S. Treasury and other U.S. government corporations and agencies	\$ -	-	-	-
States and political subdivisions	80,214	250	9,605	70,859
Foreign governments	10,432	669	-	11,101
Public utilities	284,356	136	21,275	263,217
Corporate	1,237,756	8,196	82,957	1,162,995
Mortgage-backed	258,060	1,978	12,592	247,446
Asset-backed	25,199	-	2,491	22,708
Equity securities	7,623	8,176	403	15,396
Totals	\$ 1,903,640	19,405	129,323	1,793,722

The tables below present amortized cost and fair values of securities held to maturity and securities available for sale at December 31, 2007.

	Amortized Cost	Securities Held to Maturity		Fair Value
		Gross Unrealized Gains	Gross Unrealized Losses	
(In thousands)				
Debt securities:				
U.S. Treasury and other U.S. government corporations and agencies	\$ 426,236	3,365	495	429,106
States and political subdivisions	13,287	24	40	13,271
Foreign governments	19,944	390	-	20,334
Public utilities	397,639	9,272	4,838	402,073
Corporate	1,194,260	16,984	19,039	1,192,205
Mortgage-backed	1,646,432	9,340	17,463	1,638,309

Asset-backed	80,805	692	2,602	78,895
Totals	\$ 3,778,603	40,067	44,477	3,774,193

27

Table of Contents

	Amortized Cost	Securities Available for Sale		Fair Value
		Gross Unrealized Gains	Gross Unrealized Losses	
(In thousands)				
Debt securities:				
U.S. Treasury and other U.S. government corporations and agencies	\$ 5,000	67	-	5,067
States and political subdivisions	48,280	1,134	907	48,507
Foreign governments	10,473	466	-	10,939
Public utilities	293,308	2,568	4,068	291,808
Corporate	1,242,402	18,730	25,639	1,235,493
Mortgage-backed	266,534	1,739	5,300	262,973
Asset-backed	26,227	412	425	26,214
Equity securities	12,275	8,851	1,413	19,713
Totals	\$ 1,904,499	33,967	37,752	1,900,714

The following table shows the gross unrealized losses and fair values of the Company's investments by investment category and length of time the individual securities have been in a continuous unrealized loss position at September 30, 2008.

	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. government agencies	\$ 89,549	713	25,865	348	115,414	1,061
State and political subdivisions	61,975	7,398	12,525	2,944	74,500	10,342
Public utilities	413,437	23,482	194,103	20,628	607,540	44,110
Corporate	1,151,033	81,333	653,584	98,200	1,804,617	179,533
Mortgage-backed	990,586	18,429	368,068	27,226	1,358,654	45,655
Asset-backed	36,939	2,681	37,849	9,779	74,788	12,460

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

Debt securities	2,743,519	134,036	1,291,994	159,125	4,035,513	293,161
Equity securities	3,247	364	114	39	3,361	403
Total temporarily impaired securities	\$ 2,746,766	134,400	1,292,108	159,164	4,038,874	293,564

28

Table of Contents

The following table shows the gross unrealized losses and fair values of the Company's investments by investment category and length of time the individual securities have been in a continuous unrealized loss position at December 31, 2007.

	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. government agencies	\$ -	-	44,207	495	44,207	495
State and political subdivisions	-	-	51,265	947	51,265	947
Public utilities	64,761	487	278,788	8,420	343,549	8,907
Corporate	183,923	3,131	1,049,803	41,545	1,233,726	44,676
Mortgage-backed	39,181	164	1,049,492	22,598	1,088,673	22,762
Asset-backed	18,780	877	34,537	2,152	53,317	3,029
Debt securities	306,645	4,659	2,508,092	76,157	2,814,737	80,816
Equity securities	-	-	12,247	1,413	12,247	1,413
Total temporarily impaired securities	\$ 306,645	4,659	2,520,339	77,570	2,826,984	82,229

Debt securities. The gross unrealized losses for debt securities at September 30, 2008 are made up of 538 individual issues, or 70.9% of the total debt securities held by the Company. The market value of these bonds as a percent of amortized cost averages 93.2%. Of the 538 securities, 183, or approximately 34.0%, fall in the 12 months or greater aging category; of the 538 debt securities, 522 were rated investment grade at September 30, 2008.

Equity securities. The gross unrealized losses for equity securities are made up of 42 individual issues. These holdings are reviewed for impairment quarterly. As of September 30, 2008, 15 equity securities were impaired.

Management believes the declines in value are temporary for all of the securities for which other-than-temporary impairment has not been recorded and the Company has the intent and ability to hold the securities until a market price recovery.

Table of Contents

(B) Investment Gains and Losses

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

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
	(In thousands)			
Available for sale debt securities:				
Realized gains on disposal	\$ 106	72	992	4,400
Realized losses on disposal	-	(239)	-	(256)
Held to maturity debt securities:				
Realized gains on disposal	4	-	154	19
Impairments on debt securities	(18,200)	-	(18,200)	(34)
Equity securities realized gains	39	128	118	238
Equity securities impairments	(3,435)	-	(4,885)	-
Mortgage loans	-	(1,466)	(4)	(1,466)
Other	(134)	-	(106)	-
Totals	\$ (21,620)	(1,505)	(21,931)	2,901

During the third quarter ended September 30, 2008, the Company recorded other-than-temporary impairment writedowns on debt securities including Washington Mutual (\$9.2 million), Clear Channel Communications (\$7.0 million) and GMAC (\$1.9 million) and on equity securities including Freddie Mac and Fannie Mae preferred stock (\$3.1 million). Due to the events leading to the writedowns also providing evidence of a significant deterioration in the issuers' credit worthiness, the Washington Mutual and GMAC securities were transferred from held to maturity to available for sale.

During the third quarter ended September 30, 2007, the Company recorded a valuation allowance of \$1.5 million pertaining to a mortgage loan with property damaged by Hurricane Katrina.

(11) FAIR VALUE MEASUREMENTS

As defined in SFAS 157, 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). SFAS 157 establishes a framework for measuring fair value that includes a hierarchy used to classify inputs used in measuring fair value. The hierarchy prioritizes inputs to valuation techniques used to measure fair value into three levels which are either observable or unobservable. Observable inputs reflect market data obtained from independent sources while unobservable inputs reflect an entity's view of market assumptions in the absence of observable market information. The level in the fair value hierarchy within which the fair value measurement falls is determined based on the lowest level input that is significant to the fair value measurement. The three levels of the fair value hierarchy defined by SFAS 157 are 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 or 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.

30

Table of Contents

Level 3: Fair value is based on significant unobservable inputs which reflect the entity's or third party pricing service 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.

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

Description	Total	September 30, 2008		
		Level 1	Level 2	Level 3
(In thousands)				
Debt securities, available for sale	\$ 1,778,326	-	1,765,357	12,969
Equity securities, available for sale	15,396	285	7,921	7,190
Derivatives	6,095	-	6,095	-
Total assets	\$ 1,799,817	285	1,779,373	20,159
Policyholder account balances				
(a)	\$ 13,114	-	13,114	-
Other liabilities (b)	7,837	-	-	7,837
Total liabilities	\$ 20,951	-	13,114	7,837

(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.

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

	For the Three Months Ended September 30, 2008			
	Debt Securities, Available For Sale	Equity Securities, Available For Sale	Total Assets	Other Liabilities
(In thousands)				
Beginning balance, July 1, 2008	\$ 12,819	7,190	20,009	6,303
Total realized and unrealized gains (losses):				
Included in net income	-	-	-	2,066
Included in other comprehensive loss	151	-	151	-
Purchases, sales, issuances and settlements, net	(1)	-	(1)	(532)

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

Transfers into (out of) Level 3	-	-	-	-
Ending balance, September 30, 2008	\$ 12,969	7,190	20,159	7,837
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 as of September 30, 2008	\$ -	-	-	2,066

Table of Contents

	For the Nine Months Ended September 30, 2008			
	Debt Securities, Available For Sale	Equity Securities, Available For Sale	Total Assets	Other Liabilities
	(In thousands)			
Beginning balance, January 1, 2008	\$ 1,618	7,147	8,765	7,712
Total realized and unrealized gains (losses):				
Included in net income	-	-	-	2,625
Included in other comprehensive loss	(48)	43	(5)	-
Purchases, sales, issuances and settlements, net	(525)	-	(525)	(2,500)
Transfers into (out of) Level 3	11,924	-	11,924	-
Ending balance, September 30, 2008	\$ 12,969	7,190	20,159	7,837
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 as of September 30, 2008	\$ -	-	-	2,625

Realized gains (losses) on Level 3 assets and liabilities are reported in the consolidated statements of earnings as net investment gains (losses) while unrealized gain (losses) are reported as other comprehensive income (loss) within stockholders' equity.

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

Table of Contents

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.

OVERVIEW

Insurance Operations - Domestic

The Company is currently licensed to do business in all states except for New York. Products marketed are annuities, universal life insurance, fixed-indexed annuities and 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 September 30, 2008, the Company maintained approximately 117,780 annuity policies 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 currently has approximately 4,600 independent agents contracted. Roughly 30% of these contracted agents have submitted policy applications to the Company in the past twelve months.

Insurance Operations - International

The Company's international operations focus on 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. Issuing policies to residents of countries in these different regions provides diversification that helps to minimize large fluctuations that could arise due to various economic, political, and competitive pressures that may occur from one country to another. Products issued to international residents are almost entirely universal life and traditional life insurance products. However, certain annuity and investment contracts are also available. At September 30, 2008, the Company had approximately 74,750 international life insurance policies in force representing approximately \$15.7 billion in face amount of coverage.

International applications are submitted by independent contractor consultants and broker-agents. The Company has approximately 4,400 independent international consultants and brokers currently contracted, 52% 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 over forty years of experience with the international products and its longstanding independent consultant and broker-agents relationships further serve to minimize risks.

Table of Contents

SALES

Life Insurance

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
	(In thousands)			
International:				
Universal life	\$ 2,346	2,544	5,988	6,695
Traditional life	1,404	1,454	4,137	4,946
Equity-indexed life	5,396	6,397	16,829	16,176
	9,146	10,395	26,954	27,817
Domestic:				
Universal life	2,848	1,826	5,780	3,158
Traditional life	45	66	116	194
Equity-indexed life	833	1,962	4,057	4,817
	3,726	3,854	9,953	8,169
Totals	\$ 12,872	14,249	36,907	35,986

Life insurance sales as measured by annualized first year premiums decreased 10% in the third quarter of 2008 as compared to the third quarter of 2007 but increased 3% for the first nine months of 2008 versus 2007. The Company's domestic life line of business posted a 22% increase for the first nine months of the year while international sales declined 3% from the amounts reported in 2007.

Management has placed considerable emphasis on building domestic life insurance sales as a strategic focus for future growth. This focus was partly in response to comments from outside rating agencies who expressed a preference for a greater proportion of overall Company earnings to be derived from the life insurance line of business. Previously, the Company's domestic operations had generally focused more heavily on annuity sales than on life insurance sales. The Company spent the greater part of 2003 and 2004 revamping its domestic life operations by changing the way it contracts distribution for life business, eliminating products and distribution that have not contributed significantly to earnings, and creating new and competitive products. A single premium universal life ("SPUL") product was launched at the end of 2003 beginning a diversification of the Company's product portfolio away from smaller dollar face amount policies. The Company released its first fixed equity-indexed universal life ("EIUL") product for its domestic markets at the end of the third quarter of 2005. Since its introduction, this product has generally accounted for 40% to 50% of domestic life insurance sales. With the introduction of the EIUL and SPUL products and the discontinued marketing of smaller premium and volume life insurance policies, the Company has attracted new independent distributors with access to customers purchasing larger face amounts of insurance per policy. As a result, the Company has witnessed an increase in the average amount of per policy coverage purchased in its domestic markets as shown in the following table:

Average New Policy Face Amount

	Domestic	International
Year ended December 31, 2003	\$ 76,100	219,600
Year ended December 31, 2004	101,700	234,500
Year ended December 31, 2005	137,900	245,900
Year ended December 31, 2006	315,800	254,700
Year ended December 31, 2007	416,800	251,000
Nine months ended September 30, 2008	456,300	267,200

Table of Contents

The Company's international life business consists of applications submitted from residents in 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 current economic climate, which the media has frequently described as a "financial crisis," the Company has received indications of concern from individuals in countries outside of the United States regarding the state of the U.S. economy and stability of financial institutions and markets. These concerns were manifested particularly in the third quarter as international sales declined 12% from that reported in the third quarter of 2007.

Applications submitted from residents of Latin America and the Pacific Rim perennially have comprised the majority of the Company's international life insurance sales. Over the past few years, effort has been directed toward the sale of a traditional endowment form of life insurance product for residents of Eastern European and the Commonwealth of Independent States (former Soviet Union). More recently, the Company's universal life product offerings have been made available to residents of these countries.

	Nine Months Ended September 30,	
	2008	2007
Percentage of International Sales:		
Latin America	70.3%	68.7%
Pacific Rim	17.9	13.7
Eastern Europe	11.8	17.6
Totals	100.0%	100.0%

Year-to-date, the Company has recorded sales to residents outside of the United States in over thirty different countries with Brazil (30%), Taiwan (17%), and Colombia (10%) making up the largest markets.

Total life insurance in force increased by 10% during the one year period ended September 30, 2008. The table below sets forth information regarding the Company's life insurance in force for each date presented.

	Insurance In Force as of September 30,	
	2008	2007
	(\$ In thousands)	
Universal life:		
Number of policies	71,170	74,120
Face amounts	\$ 7,981,090	8,020,940
Traditional life:		
Number of policies	49,940	52,180
Face amounts	\$ 2,018,640	1,802,340
Equity-indexed life:		
Number of policies	28,040	22,880
Face amounts	\$ 6,449,450	5,161,250
Rider face amounts	\$ 2,187,710	1,946,640

Total life insurance:

Number of policies		149,150	149,180
Face amounts	\$	18,636,890	16,931,170

Table of Contents

Annuities

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
	(In thousands)			
Fixed-indexed annuities	\$ 51,069	90,895	208,056	245,163
Other deferred annuities	36,760	22,680	81,316	80,569
Immediate annuities	1,633	782	4,239	3,274
Totals	\$ 89,462	114,357	293,611	329,006

Annuity sales for the third quarter of 2008 were 22% lower than the comparable period in 2007, and were 11% lower in the first nine months of 2008 versus 2007. Since 2003, when the Company achieved nearly \$1.2 billion in sales, annuity sales have trended lower due to a combination of declining interest rates, investors returning to alternative investment vehicles and the Company managing its targeted levels of risk and statutory capital and surplus. During the past several years the interest rate yield curve has either been inverted (shorter term rates higher than longer term rates) or relatively flat. In such an interest rate environment, consumers tend toward short term investment vehicles such as bank certificates of deposits rather than longer term choices which include fixed rate annuities. The third quarter of 2008 was a particularly volatile quarter as steep declines in equity markets brought about by the liquidity and credit crisis in U.S. financial markets impacted sales of the Company's fixed-indexed products.

Over the past several years, sales of fixed-indexed products have consistently accounted for more than one-half of the Company's annuity sales and were 77% of total annuity sales during the first six months of 2008. During the third quarter of 2008, the percentage contribution to total sales dropped to 57% for fixed-indexed products as consumers gravitated to fixed interest rate products. In addition, many fixed-indexed contractholders converted the interest crediting option for their contracts to the fixed interest rate alternative available in their policies.

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.

The 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 regulator targets.

Table of Contents

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

	Annuities In Force as of	
	September 30,	
	2008	2007
	(\$ In thousands)	
Fixed-indexed annuities		
Number of policies	32,910	32,000
GAAP annuity reserves	\$ 1,987,660	1,937,730
Other deferred annuities		
Number of policies	70,760	75,970
GAAP annuity reserves	\$ 2,353,300	2,540,270
Immediate annuities		
Number of policies	14,200	13,320
GAAP annuity reserves	\$ 302,520	253,050
Total annuities		
Number of policies	117,870	121,290
GAAP annuity reserves	\$ 4,643,480	4,731,050

Critical Accounting Estimates

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

Impairment of Investment Securities. The Company's accounting policy requires that a decline in the value of a security below its amortized cost basis be evaluated to determine if the decline is other-than-temporary. The primary factors considered in evaluating whether a decline in value for fixed income and equity securities is other-than-temporary include: (a) the length of time and the extent to which the fair value has been less than cost, (b) the financial conditions and near-term prospects of the issuer, (c) whether the debtor is current on contractually obligated principal and interest payments, and (d) the intent and ability of the Company to retain the investment for a period of time sufficient to allow for any anticipated recovery. In addition, certain securitized financial assets with contractual cash flows are evaluated periodically by the Company to update the estimated cash flows over the life of the security. If the Company determines that the fair value of the securitized financial asset is less than its carrying amount and there has been a decrease in the present value of the estimated cash flows since the previous estimate, then an other-than-temporary impairment charge is recognized. When a security is deemed to be impaired, a charge is recorded as net realized losses equal to the difference between the fair value and amortized cost basis of the security. Once an impairment charge has been recorded, the fair value of the impaired investment becomes its new cost basis and the Company continues to review the other-than-temporarily impaired security for appropriate valuation on an ongoing basis. Under U.S. generally accepted accounting principles (GAAP), the Company is not permitted to increase the basis of impaired securities for subsequent recoveries in value.

Deferred Acquisition Costs ("DAC"). The Company is required to defer certain policy acquisition costs and amortize them over future periods. These costs include commissions and certain other expenses that vary with and are primarily associated with acquiring new business. The deferred costs are recorded as an asset commonly referred to as deferred policy acquisition costs. The DAC asset balance is subsequently charged to income over the lives of the

underlying contracts in relation to the anticipated emergence of revenue or profits. Actual revenue or profits can vary from Company estimates resulting in increases or decreases in the rate of amortization. The Company regularly evaluates to determine if actual experience or other evidence suggests that earlier estimates should be revised. Assumptions considered significant include surrender and lapse rates, mortality, expense levels, investment performance, and estimated interest spread. Should actual experience dictate that the Company change its assumptions regarding the emergence of future revenues or profits (commonly referred to as “unlocking”), the Company would record a charge or credit to bring its DAC balance to the level it would have been if using the new assumptions from the inception date of each policy.

Table of Contents

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

Deferred Sales Inducements. Costs related to sales inducements offered on sales to new customers, principally on investment type contracts and primarily in the form of additional credits to the customer's account value or enhancements to interest credited for a specified period, which are beyond amounts currently being credited to existing contracts, are deferred and recorded as other assets. All other sales inducements are expensed as incurred and included in interest credited to contract holders' funds. Deferred sales inducements are amortized to income using the same methodology and assumptions as DAC, and are included in interest credited to contract holders' funds. Deferred sales inducements are periodically reviewed for recoverability. See the discussion of the adoption of Statement of Position ("SOP") 05-1, Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts on page 12 of this report.

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

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

Investment activities of the Company are integral to its insurance operations. Since life insurance benefits may not be paid until many years into the future, the accumulation of cash flows from premium receipts are invested with income reported as revenue when earned. Anticipated yields on investments are reflected in premium rates, contract liabilities, and other product contract features. These anticipated yields are implied in the interest required on the Company's net insurance liabilities (future policy benefits less deferred acquisition costs) and contractual interest obligations in its insurance and annuity products. The Company benefits to the extent actual net investment income exceeds the required interest on net insurance liabilities and manages the rates it credits on its products to maintain the targeted excess or "spread" of investment earnings over interest credited. The Company will continue to be required to provide for future contractual obligations in the event of a decline in investment yield. For more information concerning revenue recognition, investment accounting, and interest sensitivity, please refer to Note 1, Summary of Significant Accounting Policies, and Note 3, Investments, in the Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2007, and the discussions under Investments in Item 2 of this report.

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

Table of Contents

The Company annually reviews its pension benefit plan assumptions, which include the discount rate, the expected long-term rate of return on plan assets, and the compensation increase rate. The assumed discount rate is set based on the rates of return on high quality long-term fixed income investments currently available and expected to be available during the period to maturity of the pension benefits. The assumed long-term rate of return on plan assets is generally set at the rate expected to be earned based on the long-term investment policy of the plans and the various classes of the invested funds, based on the input of the plan's investment advisors and consulting actuary and the plan's historic rate of return. The compensation rate increase assumption is generally set at a rate consistent with current and expected long-term compensation and salary policy, including inflation. The freeze ceased future benefit accruals to all participants and closed the Plan to any new participants. In addition, all participants immediately became 100% vested in their accrued benefits as of that date.

Other postretirement benefit assumptions include future events affecting retirement age, mortality, dependency status, per capita claims costs by age, health care trend rates, and discount rates. Per capita claims cost by age is the current cost of providing postretirement health care benefits for one year at each age from the youngest age to the oldest age at which plan participants are expected to receive benefits under the plan. Health care trend rates involve assumptions about the annual rate(s) of change in the cost of health care benefits currently provided by the plan, due to factors other than changes in the composition of the plan population by age and dependency status. These rates implicitly consider estimates of health care inflation, changes in utilization, technological advances and changes in health status of the participants. These assumptions involve uncertainties and judgment, and therefore actual performance may not be reflective of the assumptions.

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

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

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

Other significant accounting policies, although not involving the same level of measurement uncertainties as those discussed above but nonetheless important to an understanding of the financial statements, are described in the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

Table of Contents

RESULTS OF OPERATIONS

The Company's consolidated financial statements are prepared in accordance with GAAP. In addition, the Company regularly evaluates operating performance using non-GAAP financial measures which exclude or segregate derivatives and realized investment gains and losses from operating revenues and earnings. 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 derivatives and realized investment gains and losses because such items are often the result of events which may or may not be at the Company's discretion and the fluctuating effects of these items could distort trends in the underlying profitability of the Company's business. Therefore, in the following sections discussing consolidated operations and segment operations, appropriate reconciliations have been included to report information management considers useful in enhancing an understanding of the Company's operations to reportable GAAP balances reflected in the consolidated financial statements.

Consolidated Operations

Revenues. The following details Company revenues.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
	(In thousands)			
Traditional life and annuity premiums	\$ 4,057	4,755	12,575	14,074
Universal life and annuity contract revenues	32,885	30,025	98,696	87,474
Net investment income (excluding derivatives)	84,093	82,821	254,114	249,095
Other income	3,056	3,786	9,348	10,461
Operating revenues	124,091	121,387	374,733	361,104
Derivative income (loss)	(14,511)	(7,746)	(52,824)	10,938
Net investment gains (losses)	(21,620)	(1,505)	(21,931)	2,901
Total revenues	\$ 87,960	112,136	299,978	374,943

Traditional life and annuity premiums - Traditional life and annuity premiums decreased 14.7% and 10.7% for the three and nine months ended September 30, 2008 compared to the same periods in 2007. Traditional life insurance premiums for products such as whole life and term life are recognized as revenues over the premium-paying period. These are products that the Company has de-emphasized in favor of universal life products, particularly equity-indexed universal life products.

Universal life and annuity contract revenues - Revenues for universal life and annuity contract revenues increased 9.5% and 12.8% for the three and nine months ended September 30, 2008 compared to the same periods in 2007, and consist of policy charges for the cost of insurance, administration charges, and surrender charges assessed against policyholder account balances. Revenues in the form of cost of insurance charges were \$20.9 million and \$61.4 million for the three and nine months ended September 30, 2008 compared to \$18.7 million and \$54.8 million for the three and nine months ended September 30, 2007, reflecting the growing block of life insurance in force. Surrender

charges assessed against policyholder account balances upon withdrawal increased to \$9.6 million and \$28.2 million for the three and nine months ended September 30, 2008 versus \$8.4 million and \$24.3 million for the three and nine months ended September 30, 2007.

Table of Contents

Net investment income - A detail of net investment income is provided below.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
	(In thousands)			
Gross investment income:				
Debt securities	\$ 80,958	77,843	240,118	231,418
Mortgage loans	1,827	2,206	5,727	6,540
Policy loans	1,539	1,582	4,593	4,698
Short-term investments	209	1,622	1,767	5,284
Other invested assets	311	556	3,968	3,565
Total investment income	84,844	83,809	256,173	251,505
Investment expenses	751	988	2,059	2,410
Net investment income (excluding derivatives)	84,093	82,821	254,114	249,095
Derivative income (loss)	(14,511)	(7,746)	(52,824)	10,938
Net investment income	\$ 69,582	75,075	201,290	260,033

Short-term investments contributed \$0.2 million and \$1.8 million to income for the three and nine months ended September 30, 2008 compared to \$1.6 million and \$5.3 million for the same periods in 2007. During the early part of 2007, the shape of the yield curve was inverted, or flat, offering value at the short end of the maturity range. With the decline in short-term rates as a result of Federal Reserve Board reductions, the yield curve steepened eliminating some of the value of the shorter maturities. Consequently, the Company began shifting short-term investment balances to long-term investment portfolios in 2008. Income from other invested assets for the nine months ended September 30, 2008 includes a settlement payment of \$0.9 million from a previously impaired and sold security. Derivative income and losses are recorded as a component of investment income but may fluctuate substantially from period to period based on the performance of the S&P 500® Composite Stock Price Index ("S&P 500 Index®"). See the discussion that follows this section relating to index options and derivatives.

To ensure the Company will be able to pay 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.

Net investment income performance is summarized as follows:

	Nine Months Ended September 30,	
	2008	2007
	(In thousands)	
Excluding derivatives:		
Net investment income	\$ 254,114	249,095
Average invested assets, at amortized cost	\$ 5,797,940	5,715,069
Annual yield on average invested assets	5.84%	5.81%

Including derivatives:			
Net investment income	\$	201,290	260,033
Average invested assets, at amortized cost	\$	5,849,156	5,769,681
Annual yield on average invested assets			