

NATIONAL WESTERN LIFE INSURANCE CO  
Form 10-Q  
November 09, 2006

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, 2006

**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, 2006, the number of shares of Registrant's common stock outstanding was: Class A - 3,420,824 and Class B - 200,000.

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|                                   |              |           |
|-----------------------------------|--------------|-----------|
| Cash and short-term investments   | 125,243      | 31,355    |
| Deferred policy acquisition costs | 634,832      | 620,129   |
| Deferred sales inducements        | 90,903       | 80,450    |
| Accrued investment income         | 61,898       | 61,283    |
| Federal income tax receivable     | -            | 2,107     |
| Other assets                      | 45,483       | 37,791    |
|                                   | \$ 6,601,681 | 6,369,008 |

Note: The condensed consolidated balance sheet at December 31, 2005, has been derived from the audited consolidated financial statements as of that date.

See accompanying notes to condensed consolidated financial statements.

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

| LIABILITIES AND STOCKHOLDERS' EQUITY   | (Unaudited)<br>September 30,<br>2006 | December 31,<br>2005 |
|--|--------------------------------------|----------------------|
|  | <u>2006</u>                          | <u>2005</u>          |
| <b>LIABILITIES:</b>                    |                                      |                      |
| Future policy benefits:                |                                      |                      |
| Traditional life and annuity contracts | \$ 138,697                           | 139,309              |
| Universal life and annuity contracts   | 5,325,787                            | 5,176,610            |
| Other policyholder liabilities         | 116,471                              | 100,557              |
| Federal income tax liability:          |                                      |                      |
| Current                                | 534                                  | -                    |
| Deferred                               | 32,146                               | 37,735               |
| Other liabilities                      | 70,030                               | 40,789               |
| Total liabilities                      | <u>5,683,665</u>                     | <u>5,495,000</u>     |

COMMITMENTS AND CONTINGENCIES (Notes 5 and 8)

STOCKHOLDERS' EQUITY:

Common stock:

Class A - \$1 par value; 7,500,000 shares authorized; 3,420,824

|   |                     |                  |
|---|---------------------|------------------|
| issued and outstanding in 2006 and 3,412,839 issued<br>and outstanding in 2005                  | 3,421               | 3,413            |
| Class B - \$1 par value; 200,000 shares authorized, issued,<br>and outstanding in 2006 and 2005 | 200                 | 200              |
| Additional paid-in capital  | 37,222              | 37,923           |
| Accumulated other comprehensive income  | 4,188               | 10,564           |
| Retained earnings   | 872,985             | 821,908          |
| Total stockholders' equity  | 918,016             | 874,008          |
|   | <u>\$ 6,601,681</u> | <u>6,369,008</u> |

Note: The condensed consolidated balance sheet at December 31, 2005, has been derived from the audited consolidated financial statements as of that date.

See accompanying notes to condensed consolidated financial statements.

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

For the Three Months Ended September 30, 2006 and 2005

(Unaudited)

(In thousands, except per share amounts)

|   | 2006     | 2005    |
|---|----------|---------|
| Premiums and other revenue:                       |          |         |
| Traditional life and annuity premiums             | \$ 3,654 | 3,378   |
| Universal life and annuity contract revenues      | 26,923   | 24,756  |
| Net investment income                             | 96,049   | 87,893  |
| Other income                                      | 3,064    | 2,570   |
| Realized gains on investments                     | 190      | 1,430   |
| Total premiums and other revenue                  | 129,880  | 120,027 |
| Benefits and expenses:                            |          |         |
| Life and other policy benefits                    | 9,212    | 9,278   |
| Amortization of deferred policy acquisition costs | 24,430   | 24,298  |
| Universal life and annuity contract interest      | 59,065   | 43,237  |
| Other operating expenses                          | 12,513   | 12,340  |

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|                                      |           |        |
|--------------------------------------|-----------|--------|
| Total benefits and expenses          | 105,220   | 89,153 |
| Earnings before Federal income taxes | 24,660    | 30,874 |
| Provision for Federal income taxes:  |           |        |
| Current                              | 8,214     | 9,157  |
| Deferred                             | 374       | 1,548  |
| Total Federal income taxes           | 8,588     | 10,705 |
| Net earnings                         | \$ 16,072 | 20,169 |
| Basic Earnings Per Share             | \$ 4.44   | 5.59   |
| Diluted Earnings Per Share           | \$ 4.40   | 5.53   |

See accompanying notes to condensed consolidated financial statements.

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

For the Nine Months Ended September 30, 2006 and 2005

(Unaudited)

(In thousands, except per share amounts)

|   | 2006      | 2005    |
|---|-----------|---------|
| Premiums and other revenue:                       |           |         |
| Traditional life and annuity premiums             | \$ 11,742 | 10,791  |
| Universal life and annuity contract revenues      | 79,477    | 73,346  |
| Net investment income                             | 261,059   | 230,127 |
| Other income                                      | 11,271    | 7,122   |
| Realized gains on investments                     | 3,229     | 10,014  |
| Total premiums and other revenue                  | 366,778   | 331,400 |
| Benefits and expenses:                            |           |         |
| Life and other policy benefits                    | 28,300    | 29,938  |
| Amortization of deferred policy acquisition costs | 69,443    | 65,697  |
| Universal life and annuity contract interest      | 138,678   | 109,764 |
| Other operating expenses                          | 51,611    | 34,481  |

|   |                             |                             |
|---|-----------------------------|-----------------------------|
| Total benefits and expenses                   | 288,032                     | 239,880                     |
|   | <u>                    </u> | <u>                    </u> |
| Earnings before Federal income taxes          | 78,746                      | 91,520                      |
|   | <u>                    </u> | <u>                    </u> |
| Provision (benefit) for Federal income taxes: |                             |                             |
| Current                                       | 28,987                      | 27,041                      |
| Deferred                                      | (2,585)                     | 4,010                       |
|   | <u>                    </u> | <u>                    </u> |
| Total Federal income taxes                    | 26,402                      | 31,051                      |
|   | <u>                    </u> | <u>                    </u> |
| Net earnings                                  | \$ 52,344                   | 60,469                      |
|   | <u>                    </u> | <u>                    </u> |
|   | <u>                    </u> | <u>                    </u> |
| Basic Earnings Per Share                      | \$ 14.46                    | 16.80                       |
|   | <u>                    </u> | <u>                    </u> |
|   | <u>                    </u> | <u>                    </u> |
| Diluted Earnings Per Share                    | \$ 14.32                    | 16.64                       |
|   | <u>                    </u> | <u>                    </u> |
|   | <u>                    </u> | <u>                    </u> |

See accompanying notes to condensed consolidated financial statements.

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

For the Three Months Ended September 30, 2006 and 2005

(Unaudited)

(In thousands)

|   | 2006                        | 2005                        |
|---|-----------------------------|-----------------------------|
|   | <u>                    </u> | <u>                    </u> |
| Net earnings  | \$ 16,072                   | 20,169                      |
|   | <u>                    </u> | <u>                    </u> |
| Other comprehensive income (loss) net of effects of<br>deferred policy acquisition costs and taxes: |                             |                             |
| Unrealized gains (losses) on securities:  |                             |                             |
| Unrealized holding gains (losses) arising during period   | 15,866                      | (10,854)                    |
| Reclassification adjustment for gains included in net earnings                                      | (42)                        | (799)                       |
| Amortization of net unrealized losses<br>related to transferred securities                          | 6                           | 219                         |
|   | <u>                    </u> | <u>                    </u> |
| Net unrealized gains (losses) on securities   | 15,830                      | (11,434)                    |
|   | <u>                    </u> | <u>                    </u> |
| Foreign currency translation adjustments  | (317)                       | 150                         |
|   | <u>                    </u> | <u>                    </u> |

|                                   |                  |                 |
|-----------------------------------|------------------|-----------------|
| Other comprehensive income (loss) | <u>15,513</u>    | <u>(11,284)</u> |
| Comprehensive income              | <u>\$ 31,585</u> | <u>8,885</u>    |

See accompanying notes to condensed consolidated financial statements.

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

For the Nine Months Ended September 30, 2006 and 2005

(Unaudited)

(In thousands)

|  | <u>2006</u>      | <u>2005</u>     |
|--|------------------|-----------------|
| Net earnings   | <u>\$ 52,344</u> | <u>60,469</u>   |
| Other comprehensive income (loss), net of effects of<br>deferred policy acquisition costs and taxes: |                  |                 |
| Net unrealized losses on securities:   |                  |                 |
| Net unrealized holding losses arising during period  | (4,394)          | (9,584)         |
| Reclassification adjustment for gains included in net earnings                                       | (1,740)          | (1,331)         |
| Amortization of net unrealized losses (gains)<br>related to transferred securities                   | <u>(90)</u>      | <u>231</u>      |
| Net unrealized losses on securities  | (6,224)          | (10,684)        |
| Foreign currency translation adjustments   | <u>(152)</u>     | <u>335</u>      |
| Other comprehensive loss   | <u>(6,376)</u>   | <u>(10,349)</u> |
| Comprehensive income   | <u>\$ 45,968</u> | <u>50,120</u>   |

See accompanying notes to condensed consolidated financial statements.

NATIONAL WESTERN LIFE INSURANCE COMPANY AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

For the Nine Months Ended September 30, 2006 and 2005

(Unaudited)



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(In thousands)

|  | <u>2006</u>    | <u>2005</u>    |
|--|----------------|----------------|
| Common stock:  |                |                |
| Balance at beginning of year                                 | \$ 3,613       | 3,584          |
| Shares exercised under stock option plan                     | 8              | 28             |
| Balance at end of period                                     | <u>3,621</u>   | <u>3,612</u>   |
| Additional paid-in capital:                                  |                |                |
| Balance at beginning of year                                 | 37,923         | 33,834         |
| Shares exercised under stock option plan                     | 1,615          | 2,918          |
| Adjustment for stock option liability classification         | (2,316)        | -              |
| Stock option expense   | -              | 746            |
| Balance at end of period                                     | <u>37,222</u>  | <u>37,498</u>  |
| Accumulated other comprehensive income:                      |                |                |
| Unrealized gains on securities:                              |                |                |
| Balance at beginning of year                                 | 10,401         | 25,032         |
| Change in unrealized losses during period                    | (6,224)        | (10,684)       |
| Balance at end of period                                     | <u>4,177</u>   | <u>14,348</u>  |
| Foreign currency translation adjustments:                    |                |                |
| Balance at beginning of year                                 | 3,300          | 3,170          |
| Change in translation adjustments during period              | (152)          | 335            |
| Balance at end of period                                     | <u>3,148</u>   | <u>3,505</u>   |
| Minimum pension liability adjustment:                        |                |                |
| Balance at beginning of year                                 | (3,137)        | (2,783)        |
| Change in minimum pension liability adjustment during period | -              | -              |
| Balance at end of period                                     | <u>(3,137)</u> | <u>(2,783)</u> |
| Accumulated other comprehensive income at end of period      | <u>4,188</u>   | <u>15,070</u>  |
| Retained earnings:   |                |                |
| Balance at beginning of year                                 | 821,908        | 745,835        |
| Net earnings   | 52,344         | 60,469         |
| Stockholder dividends  | (1,267)        | -              |

|                            |                |                |
|----------------------------|----------------|----------------|
| Balance at end of period   | 872,985        | 806,304        |
|                            | <u>872,985</u> | <u>806,304</u> |
| Total stockholders' equity | \$ 918,016     | 862,484        |
|                            | <u>918,016</u> | <u>862,484</u> |

See accompanying notes to condensed consolidated financial statements.

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

For the Nine Months Ended September 30, 2006 and 2005

(Unaudited)

(In thousands)

|  | <u>2006</u>    | <u>2005</u>    |
|--|----------------|----------------|
| Cash flows from operating activities:  |                |                |
| Net earnings   | \$ 52,344      | 60,469         |
| Adjustments to reconcile net earnings to net cash from operating activities: |                |                |
| Universal life and annuity contract interest                                 | 138,678        | 109,764        |
| Surrender charges and other policy revenues                                  | (24,226)       | (22,031)       |
| Realized gains on investments  | (3,229)        | (10,014)       |
| Accrual and amortization of investment income                                | (3,793)        | (3,033)        |
| Depreciation and amortization  | 1,030          | 1,153          |
| Decrease (increase) in value of derivatives                                  | (7,901)        | 9,131          |
| Increase in deferred policy acquisition and sale inducement costs            | (6,479)        | (12,130)       |
| Increase in accrued investment income  | (615)          | (2,281)        |
| Increase in other assets   | (7,126)        | (2,989)        |
| Decrease in liabilities for future policy benefits                           | (612)          | (1,869)        |
| Increase in other policyholder liabilities                                   | 15,913         | 15,392         |
| Increase in Federal income tax liability                                     | 987            | 79             |
| Increase (decrease) in other liabilities                                     | 14,941         | (743)          |
| Other  | (72)           | 350            |
|  | <u>169,840</u> | <u>141,248</u> |
| Net cash provided by operating activities                                    |                |                |
| Cash flows from investing activities:  |                |                |
| Proceeds from sales of:  |                |                |
| Securities held to maturity  | -              | 10,337         |
| Securities available for sale  | 21,502         | 24,242         |
| Other investments  | 32,951         | 44,515         |

|  |                   |                   |
|--|-------------------|-------------------|
| Proceeds from maturities and redemptions of: |                   |                   |
| Securities held to maturity                  | 199,590           | 266,714           |
| Securities available for sale                | 86,848            | 112,376           |
| Purchases of:                                |                   |                   |
| Securities held to maturity                  | (254,994)         | (466,563)         |
| Securities available for sale                | (160,576)         | (250,498)         |
| Other investments                            | (33,039)          | (28,226)          |
| Principal payments on mortgage loans         | 8,867             | 17,828            |
| Cost of mortgage loans acquired              | (3,999)           | (6,836)           |
| Decrease (increase) in policy loans          | (29)              | 2,221             |
| Other  | (247)             | (278)             |
|  | <u>          </u> | <u>          </u> |
| Net cash used in investing activities        | <u>(103,126)</u>  | <u>(274,168)</u>  |

(Continued on next page)

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

For the Nine Months Ended September 30, 2006 and 2005

(Unaudited)

(In thousands)

|  | <u>2006</u>       | <u>2005</u>       |
|--|-------------------|-------------------|
| Cash flows from financing activities:                                    |                   |                   |
| Deposits to account balances for universal life<br>and annuity contracts | \$ 419,003        | 476,761           |
| Return of account balances on universal life<br>and annuity contracts    | (393,077)         | (343,846)         |
| Issuance of common stock under stock option plan                         | 510               | 1,835             |
|  | <u>          </u> | <u>          </u> |
| Net cash provided by financing activities                                | <u>26,436</u>     | <u>134,750</u>    |
| Effect of foreign exchange   | <u>738</u>        | <u>567</u>        |
| Net increase in cash and cash equivalents                                | 93,888            | 2,397             |
| Cash and cash equivalents at beginning of year                           | <u>31,355</u>     | <u>50,194</u>     |
| Cash and cash equivalents at end of period                               | <u>\$ 125,243</u> | <u>52,591</u>     |

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

Cash paid during the nine month period for:

|              |    |        |        |
|--------------|----|--------|--------|
| Interest     | \$ | 30     | 30     |
| Income taxes |    | 24,990 | 30,900 |

See accompanying notes to condensed consolidated financial statements.

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 the Company as of September 30, 2006, and the results of its operations and its cash flows for the three months and nine months ended September 30, 2006 and 2005. The results of operations for the three months and nine months ended September 30, 2006 and 2005 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, 2005 accessible free of charge through the Company's internet site at [www.nationalwesternlife.com](http://www.nationalwesternlife.com) or the Securities and Exchange Commission internet site at [www.sec.gov](http://www.sec.gov).

The 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., and NWL Financial, Inc. All significant intercorporate transactions and accounts have been eliminated in consolidation.

Certain reclassifications have been made to the prior periods to conform to the reporting categories used in 2006.

(2) CHANGES IN ACCOUNTING PRINCIPLES

In May of 2005, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standard ("SFAS") No. 154, *Accounting Changes and Error Correction*. This standard is a replacement of Accounting Policy Board Opinion No. 20, *Accounting Changes*, and FASB Standard No. 3, *Reporting Accounting Changes in Interim Financial Statements*. Under the new standard, any voluntary changes in accounting principles are to be adopted via a retrospective application of the accounting principle in the financial statements presented and an opinion obtained from the auditors that the new principle is preferred. In addition, adoption of a change in accounting principle required by the issuance of a new accounting standard will also require retroactive restatement, unless the new standard includes explicit transition guidelines. This standard was effective for fiscal years beginning after December 15, 2005. Adoption of this standard did not have an impact on the consolidated financial statements of the Company.

In March 2004, the Emerging Issues Task Force ("EITF") reached a final consensus on Issue 03-1, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments*. This Issue establishes impairment models for determining whether to record impairment losses associated with investments in certain equity and debt securities and requires expanded disclosures related to securities with unrealized losses. It also requires income to be accrued on a level-yield basis following an impairment of debt securities, where reasonable estimates of the timing and amount of future cash flows can be made. The Company's current policy has generally been to record income only as cash is received following an impairment of a debt security. The application of this Issue was required for reporting periods beginning after June 15, 2004. In September 2004, the FASB approved FASB Staff Position EITF 03-1-1, which deferred the effective date for the recognition and measurement guidance contained in EITF 03-1 until certain issues were resolved. On November 3, 2005, the FASB issued FASB Staff Position ("FSP") Nos. SFAS 115-1 and SFAS 124-1 titled *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. This FSP nullifies certain requirements of EITF 03-1 and carries forward certain requirements and disclosures. The guidance in this FSP is to be applied to reporting periods beginning after December 15, 2005. The Company has adopted the disclosure provisions and has included the required disclosures. The Company did adopt FSP Nos. SFAS 115-1 and SFAS 124-1 as of the beginning of fiscal year 2006, and the FSP did not have a material impact on the consolidated financial statements of the Company.

The Company adopted Statement No. 123(R), *Share-Based Payments* ("SFAS 123(R)") as of January 1, 2006. However, because the Company began recognizing stock-based employee compensation cost using the fair value based method of accounting in 2003, the adoption did not have a material impact on the consolidated financial statements of the Company.

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"). 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. SOP 05-1 is effective for internal replacements occurring in fiscal years beginning after December 15, 2006, with earlier adoption encouraged. The Company is currently assessing the impact related to the adoption of SOP 05-1 on the consolidated financial statements of the Company.

The FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* ("FIN 48"), dated June, 2006. The interpretation requires public companies to recognize the tax benefits of uncertain tax positions only where the position is "more likely than not" to be sustained assuming examination by tax authorities. The amount recognized would be the amount that represents the largest amount of tax benefit that is greater than 50% likely of being ultimately realized. A liability would be recognized for any benefit claimed, or expected to be claimed, in a tax return in excess of the benefit recorded in the financial statements, along with any interest and penalty (if applicable) on the excess. FIN 48 will require a tabular reconciliation of the change in the aggregate unrecognized tax benefits claimed, or expected to be claimed, in tax returns and disclosure relating to accrued interest and penalties for unrecognized tax benefits. Discussion will also be required for those uncertain tax positions where it is reasonably possible that the estimate of the tax benefit will change significantly in the next 12 months. FIN 48 is effective for fiscal years beginning after December 15, 2006. Adoption of FIN 48 is not expected to have a material impact on the Company's consolidated financial statements.

On February 16, 2006, the FASB issued SFAS 155, *Accounting for Certain Hybrid Financial Instruments*, which amends SFAS 133, *Accounting for Derivatives and Hedging Activities*, and SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. Hybrid financial instruments are single financial instruments that contain an embedded derivative. Under SFAS 155, entities can elect to record certain hybrid financial instruments at fair value as individual financial instruments. Prior to this amendment, certain hybrid financial instruments were required to be separated into two instruments - a derivative and host - and generally only the

derivative was recorded at fair value. SFAS 155 also requires that beneficial interests in securitized assets be evaluated for either freestanding or embedded derivatives. SFAS 155 is effective for all financial instruments acquired or issued after January 1, 2007. SFAS 155 is not expected to have a material effect on the Company's consolidated financial statements on the date of adoption.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and requires additional disclosures about fair value measurements. This Statement does not require any new fair value measurements, but the application of this Statement could change current practices in determining fair value. The Company plans to adopt this guidance effective January 1, 2008. The Company is currently assessing the impact of SFAS No. 157 on the Company's consolidated financial position and results of operations.

In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* an amendment of FASB Statements No. 87, 88, 106 and 132(R). This statement requires an employer on a prospective basis to recognize the overfunded or underfunded status of its defined benefit pension and postretirement plans as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. This requirement, along with the required disclosures, is effective for fiscal years ending after December 15, 2006. SFAS No. 158 also requires an employer on a prospective basis to measure the funded status of its plans as of its fiscal year-end, and is effective for fiscal years ending after December 15, 2008. The Company is currently assessing the impact of this new standard.

In September 2006, the staff of the SEC issued Staff Accounting Bulletin ("SAB") No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*. The interpretations in this SAB express the staff's views regarding the process of quantifying financial statement misstatements. Specifically, the SEC staff believes that registrants must quantify the impact on current period financial statements of correcting all misstatements, including both those occurring in the current period and the effect of reversing those that have accumulated from prior periods. This SAB should be applied beginning with the first fiscal year ending after November 15, 2006, with early adoption encouraged. The adoption of SAB No. 108 is not expected to impact the financial position and results of operations of the Company.

### (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, 2006 and 2005. However, the Company declared a cash dividend on August 18, 2006 payable November 29, 2006 to stockholders on record as of October 31, 2006. 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.

### (4) EARNINGS PER SHARE

Basic earnings per share of common stock are computed by dividing net income by the weighted-average number of common shares outstanding during the period. Diluted earnings per share assumes the issuance of common shares applicable to stock options. Refer to Exhibit 11 of this report for further information concerning the computation of earnings per share.

## (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"). The following summarizes the components of net periodic benefit costs.

|                                       | Three Months Ended September<br>30, |       | Nine Months Ended September 30, |       |
|---------------------------------------|-------------------------------------|-------|---------------------------------|-------|
|                                       | 2006                                | 2005  | 2006                            | 2005  |
|                                       | (In thousands)                      |       |                                 |       |
| Service cost                          | \$ 175                              | 171   | 518                             | 514   |
| Interest cost                         | 279                                 | 243   | 766                             | 730   |
| Expected return on plan<br>assets     | (255)                               | (227) | (710)                           | (682) |
| Amortization of prior<br>service cost | 1                                   | 1     | 3                               | 3     |
| Amortization of net loss              | 99                                  | 83    | 264                             | 248   |
| Net periodic benefit cost             | \$ 299                              | 271   | 841                             | 813   |

The Company has contributed \$1.0 million to the qualified plan in 2006. No further contributions are expected in 2006.

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.

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

The following summarizes the components of net periodic benefit costs.

|                                    | Three Months Ended September 30, |      | Nine Months Ended September 30, |       |
|------------------------------------|----------------------------------|------|---------------------------------|-------|
|                                    | 2006                             | 2005 | 2006                            | 2005  |
|                                    | (In thousands)                   |      |                                 |       |
| Service cost                       | \$ 574                           | 535  | 1,222                           | 746   |
| Interest cost                      | 385                              | 95   | 531                             | 184   |
| Amortization of prior service cost | 457                              | 246  | 780                             | 392   |
| Amortization of net loss           | 137                              | (1)  | 137                             | 1     |
| Net periodic benefit cost          | \$ 1,553                         | 875  | 2,670                           | 1,323 |

The Company expects to contribute \$1.1 million to the non-qualified plans in 2006. As of September 30, 2006, the Company has contributed \$0.9 million to the plan.

(B) Defined Benefit Postretirement Plans

The Company sponsors two healthcare plans that were amended in 2004 to provide postretirement benefits to certain fully-vested individuals. The following summarizes the components of net periodic benefit cost.

|                                    | Three Months Ended September 30, |      | Nine Months Ended September 30, |      |
|------------------------------------|----------------------------------|------|---------------------------------|------|
|                                    | 2006                             | 2005 | 2006                            | 2005 |
|                                    | (In thousands)                   |      |                                 |      |
| Interest cost                      | \$ 38                            | 25   | 88                              | 75   |
| Amortization of prior service cost | 26                               | 26   | 77                              | 77   |
| Net periodic benefit cost          | \$ 64                            | 51   | 165                             | 152  |

As previously disclosed in its financial statements for the year ended December 31, 2005, the Company expects to contribute minimal amounts to the healthcare plans in 2006.

(6) SEGMENT AND OTHER OPERATING INFORMATION



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Under Statement of Financial Accounting Standards ("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 for the quarters ended September 30, 2006 and 2005 is provided below.

Selected Segment Information.

|   | <u>Domestic<br/>Life<br/>Insurance</u> | <u>International<br/>Life<br/>Insurance</u> | <u>Annuities</u> | <u>All<br/>Others</u> | <u>Totals</u>  |
|---|--|---|------------------|-----------------------|----------------|
|   | (In thousands)                         |   |                  |                       |                |
| September 30, 2006:                                     |  |   |                  |                       |                |
| Selected Balance Sheet Items:                           |  |   |                  |                       |                |
| Deferred policy acquisition costs and sales inducements | \$ 49,041                              | 177,482                                     | 499,212          | -                     | 725,735        |
| Total segment assets                                    | 377,777                                | 691,455                                     | 5,414,024        | 98,269                | 6,581,525      |
| Future policy benefits                                  | 312,671                                | 479,838                                     | 4,671,975        | -                     | 5,464,484      |
| Other policyholder liabilities                          | 9,702                                  | 21,680                                      | 85,089           | -                     | 116,471        |
| Three Months Ended September 30, 2006:                  |  |   |                  |                       |                |
| C o n d e n s e d I n c o m e Statements:               |  |   |                  |                       |                |
| Premiums and contract revenues                          | \$ 5,932                               | 19,364                                      | 5,281            | -                     | 30,577         |
| Net investment income                                   | 4,545                                  | 6,771                                       | 83,900           | 833                   | 96,049         |
| Other income  | <u>10</u>                              | <u>21</u>                                   | <u>106</u>       | <u>2,927</u>          | <u>3,064</u>   |
| Total revenues  | <u>10,487</u>                          | <u>26,156</u>                               | <u>89,287</u>    | <u>3,760</u>          | <u>129,690</u> |
| Life and other policy benefits                          | 3,505                                  | 4,984                                       | 723              | -                     | 9,212          |
| Amortization of deferred policy acquisition costs       | 1,496                                  | 6,951                                       | 15,983           | -                     | 24,430         |

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|  |                   |                   |                   |                   |                   |
|--|-------------------|-------------------|-------------------|-------------------|-------------------|
| Universal life and annuity contract interest | 2,293             | 7,185             | 49,587            | -                 | 59,065            |
| Other operating expenses                     | 2,533             | 3,131             | 4,027             | 2,822             | 12,513            |
| Federal income taxes                         | 212               | 1,376             | 6,598             | 336               | 8,522             |
|  | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Total expenses                               | <u>10,039</u>     | <u>23,627</u>     | <u>76,918</u>     | <u>3,158</u>      | <u>113,742</u>    |
| Segment earnings                             | \$ <u>448</u>     | <u>2,529</u>      | <u>12,369</u>     | <u>602</u>        | <u>15,948</u>     |

|  |                         |                              |                   |                   |                   |
|--|-------------------------|------------------------------|-------------------|-------------------|-------------------|
|  | Domestic Life Insurance | International Life Insurance | Annuities         | All Others        | Totals            |
|  | <u>          </u>       | <u>          </u>            | <u>          </u> | <u>          </u> | <u>          </u> |
|  |                         |                              | (In thousands)    |                   |                   |

Nine Months Ended  
September 30, 2006:  
Condensed Income  
Statements:

|   |               |               |                |               |                |
|---|---------------|---------------|----------------|---------------|----------------|
| Premiums and contract revenues                    | \$ 17,465     | 57,448        | 16,306         | -             | 91,219         |
| Net investment income                             | 14,761        | 18,958        | 223,307        | 4,033         | 261,059        |
| Other income                                      | <u>25</u>     | <u>66</u>     | <u>2,968</u>   | <u>8,212</u>  | <u>11,271</u>  |
| Total revenues                                    | <u>32,251</u> | <u>76,472</u> | <u>242,581</u> | <u>12,245</u> | <u>363,549</u> |
| Life and other policy benefits                    | 11,536        | 14,204        | 2,560          | -             | 28,300         |
| Amortization of deferred policy acquisition costs | 4,868         | 16,462        | 48,113         | -             | 69,443         |
| Universal life and annuity contract interest      | 6,836         | 16,399        | 115,443        | -             | 138,678        |
| Other operating expenses                          | 9,995         | 14,956        | 18,987         | 7,673         | 51,611         |
| Federal income taxes (benefit)                    | <u>(328)</u>  | <u>4,836</u>  | <u>19,235</u>  | <u>1,529</u>  | <u>25,272</u>  |

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|                           |    |               |               |                |              |                |
|---------------------------|----|---------------|---------------|----------------|--------------|----------------|
| Total expenses            |    | <u>32,907</u> | <u>66,857</u> | <u>204,338</u> | <u>9,202</u> | <u>313,304</u> |
| Segment earnings (losses) | \$ | <u>(656)</u>  | <u>9,615</u>  | <u>38,243</u>  | <u>3,043</u> | <u>50,245</u>  |

Selected Segment Information.

|  |  | <u>Domestic<br/>Life<br/>Insurance</u> | <u>International<br/>Life<br/>Insurance</u> | <u>Annuities</u> | <u>All<br/>Others</u> | <u>Totals</u> |
|--|--|--|---|------------------|-----------------------|---------------|
|  |  |  |   | (In thousands)   |                       |               |

September 30, 2005:

Selected Balance Sheet Items:

Deferred policy acquisition

|                             |    |        |         |         |   |         |
|-----------------------------|----|--------|---------|---------|---|---------|
| costs and sales inducements | \$ | 44,750 | 158,686 | 482,773 | - | 686,209 |
|-----------------------------|----|--------|---------|---------|---|---------|

|                      |  |         |         |           |        |           |
|----------------------|--|---------|---------|-----------|--------|-----------|
| Total segment assets |  | 362,219 | 611,318 | 5,211,284 | 90,998 | 6,275,819 |
|----------------------|--|---------|---------|-----------|--------|-----------|

|                        |  |         |         |           |   |           |
|------------------------|--|---------|---------|-----------|---|-----------|
| Future policy benefits |  | 303,579 | 432,320 | 4,520,866 | - | 5,256,765 |
|------------------------|--|---------|---------|-----------|---|-----------|

|                                |  |        |        |        |   |        |
|--------------------------------|--|--------|--------|--------|---|--------|
| Other policyholder liabilities |  | 10,972 | 13,053 | 66,604 | - | 90,629 |
|--------------------------------|--|--------|--------|--------|---|--------|

Three Months Ended

September 30, 2005:

C o n d e n s e d I n c o m e  
Statements:

Premiums and contract

|          |    |       |        |       |   |        |
|----------|----|-------|--------|-------|---|--------|
| revenues | \$ | 5,984 | 17,566 | 4,584 | - | 28,134 |
|----------|----|-------|--------|-------|---|--------|

|                       |  |       |       |        |     |        |
|-----------------------|--|-------|-------|--------|-----|--------|
| Net investment income |  | 5,239 | 6,215 | 75,709 | 730 | 87,893 |
|-----------------------|--|-------|-------|--------|-----|--------|

|              |  |          |           |            |              |              |
|--------------|--|----------|-----------|------------|--------------|--------------|
| Other income |  | <u>9</u> | <u>23</u> | <u>285</u> | <u>2,253</u> | <u>2,570</u> |
|--------------|--|----------|-----------|------------|--------------|--------------|

|                |  |               |               |               |              |                |
|----------------|--|---------------|---------------|---------------|--------------|----------------|
| Total revenues |  | <u>11,232</u> | <u>23,804</u> | <u>80,578</u> | <u>2,983</u> | <u>118,597</u> |
|----------------|--|---------------|---------------|---------------|--------------|----------------|

|                                |  |       |       |     |   |       |
|--------------------------------|--|-------|-------|-----|---|-------|
| Life and other policy benefits |  | 3,628 | 4,670 | 980 | - | 9,278 |
|--------------------------------|--|-------|-------|-----|---|-------|

Amortization of deferred

|                          |  |       |       |        |   |        |
|--------------------------|--|-------|-------|--------|---|--------|
| policy acquisition costs |  | 3,421 | 3,502 | 17,375 | - | 24,298 |
|--------------------------|--|-------|-------|--------|---|--------|

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|                                 |                                |                                     |                  |                   |               |
|---------------------------------|--------------------------------|-------------------------------------|------------------|-------------------|---------------|
| Universal life and annuity      |                                |                                     |                  |                   |               |
| contract interest               | 2,227                          | 4,557                               | 36,453           | -                 | 43,237        |
| Other operating expenses        | 2,325                          | 3,921                               | 4,231            | 1,863             | 12,340        |
| Federal income taxes (benefits) | <u>(109)</u>                   | <u>2,461</u>                        | <u>7,446</u>     | <u>406</u>        | <u>10,204</u> |
| Total expenses                  | <u>11,492</u>                  | <u>19,111</u>                       | <u>66,485</u>    | <u>2,269</u>      | <u>99,357</u> |
| Segment earnings (losses)       | \$ <u>(260)</u>                | <u>4,693</u>                        | <u>14,093</u>    | <u>714</u>        | <u>19,240</u> |
|                                 | <u>Domestic Life Insurance</u> | <u>International Life Insurance</u> | <u>Annuities</u> | <u>All Others</u> | <u>Totals</u> |
|                                 |                                |                                     | (In thousands)   |                   |               |

Nine Months Ended  
September 30, 2005:

C o n d e n s e d I n c o m e  
Statements:

|   |               |               |                |               |                |
|---|---------------|---------------|----------------|---------------|----------------|
| Premiums and contract revenues                    | \$ 18,100     | 51,908        | 14,129         | -             | 84,137         |
| Net investment income                             | 15,066        | 17,305        | 191,867        | 5,889         | 230,127        |
| Other income                                      | <u>25</u>     | <u>55</u>     | <u>467</u>     | <u>6,575</u>  | <u>7,122</u>   |
| Total revenues                                    | <u>33,191</u> | <u>69,268</u> | <u>206,463</u> | <u>12,464</u> | <u>321,386</u> |
| Life and other policy benefits                    | 11,898        | 15,721        | 2,319          | -             | 29,938         |
| Amortization of deferred policy acquisition costs | 5,253         | 14,347        | 46,097         | -             | 65,697         |
| Universal life and annuity contract interest      | 6,596         | 13,140        | 90,028         | -             | 109,764        |
| Other operating expenses                          | 6,624         | 10,022        | 12,181         | 5,654         | 34,481         |
|   | 953           | 5,420         | 18,871         | 2,302         | 27,546         |

## Federal income taxes

|                  |    |                             |                             |                             |                             |                             |
|------------------|----|-----------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
|                  |    | <u>                    </u> | <u>                    </u> | <u>                    </u> | <u>                    </u> | <u>                    </u> |
| Total expenses   |    | <u>31,324</u>               | <u>58,650</u>               | <u>169,496</u>              | <u>7,956</u>                | <u>267,426</u>              |
| Segment earnings | \$ | <u>1,867</u>                | <u>10,618</u>               | <u>36,967</u>               | <u>4,508</u>                | <u>53,960</u>               |

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

|  |  |   |             |  |             |
|--|--|---|-------------|--|-------------|
|  |  | <u>Three Months Ended September 30,</u> |             | <u>Nine Months Ended September 30,</u> |             |
|  |  | <u>2006</u>                             | <u>2005</u> | <u>2006</u>                            | <u>2005</u> |
|  |  | (In thousands)                          |             |  |             |

## Premiums and Other Revenue

|   |    |                             |                             |                             |                             |
|---|----|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
| :   |    |                             |                             |                             |                             |
| Premiums and contract revenues                | \$ | 30,577                      | 28,134                      | 91,219                      | 84,137                      |
| Net investment income                         |    | 96,049                      | 87,893                      | 261,059                     | 230,127                     |
| Other income                                  |    | 3,064                       | 2,570                       | 11,271                      | 7,122                       |
| Realized gains on investments                 |    | 190                         | 1,430                       | 3,229                       | 10,014                      |
|   |    | <u>                    </u> | <u>                    </u> | <u>                    </u> | <u>                    </u> |
| Total consolidated premiums and other revenue | \$ | <u>129,880</u>              | <u>120,027</u>              | <u>366,778</u>              | <u>331,400</u>              |

|  |  |   |             |  |             |
|--|--|---|-------------|--|-------------|
|  |  | <u>Three Months Ended September 30,</u> |             | <u>Nine Months Ended September 30,</u> |             |
|  |  | <u>2006</u>                             | <u>2005</u> | <u>2006</u>                            | <u>2005</u> |
|  |  | (In thousands)                          |             |  |             |

## Federal Income Taxes

|   |    |                             |                             |                             |                             |
|---|----|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
| :                                       |    |                             |                             |                             |                             |
| Total segment Federal income taxes      | \$ | 8,522                       | 10,204                      | 25,272                      | 27,546                      |
| Taxes on realized gains on investments  |    | 66                          | 501                         | 1,130                       | 3,505                       |
|   |    | <u>                    </u> | <u>                    </u> | <u>                    </u> | <u>                    </u> |
| Total consolidated Federal income taxes | \$ | <u>8,588</u>                | <u>10,705</u>               | <u>26,402</u>               | <u>31,051</u>               |

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|  | Three Months Ended September 30, |        | Nine Months Ended September 30, |        |
|--|----------------------------------|--------|---------------------------------|--------|
|  | 2006                             | 2005   | 2006                            | 2005   |
|  | (In thousands)                   |        |                                 |        |
| Net Earnings                                   |                                  |        |                                 |        |
| :  |                                  |        |                                 |        |
| Total segment earnings                         | \$ 15,948                        | 19,240 | 50,245                          | 53,960 |
| Realized gains on investments,<br>net of taxes | 124                              | 929    | 2,099                           | 6,509  |
| Total consolidated net earnings                | \$ 16,072                        | 20,169 | 52,344                          | 60,469 |

|                           | September 30,  |           |
|---------------------------|----------------|-----------|
|                           | 2006           | 2005      |
|                           | (In thousands) |           |
| Assets                    |                |           |
| :                         |                |           |
| Total segment assets      | \$ 6,581,525   | 6,275,819 |
| Other unallocated assets  | 20,156         | 18,668    |
| Total consolidated assets | \$ 6,601,681   | 6,294,487 |

(7) SHARE-BASED PAYMENTS

The Company has a stock and incentive plan ("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; (4) incentive awards; and (5) performance awards. The Plan began on April 21, 1995, and was to terminate on April 20, 2005, unless terminated earlier by the Board of Directors. The Plan 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 Plan, or as to which stock appreciation rights or other awards may be granted, may not exceed 300,000. These shares may be authorized and unissued shares or treasury shares. The Company has only issued nonqualified stock options.

All of the employees of the Company and its subsidiaries are eligible to participate in the Plan. In addition, directors of the Company, other than Compensation and Stock Option Committee members, 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. No awards were issued in 2006 or 2005.

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Through December 31, 2005, the Company classified the Plan as equity awards, and as such, utilized the grant date fair value method to measure compensation. Effective March 10, 2006, as more fully described below, the Company's Plan classification was changed to liability and accordingly, the Company began using the current fair value method to measure compensation cost. A summary of shares available for grant and stock option activity is detailed below.

|                               | Shares<br>Available<br>For Grant | Options Outstanding |   |
|-------------------------------|----------------------------------|---------------------|---|
|                               |                                  | Shares              | Weighted-<br>Average<br>Exercise<br>Price |
| Balance at January 1, 2006    | 21,207                           | 156,959             | \$ 117.62                                 |
| Stock Options:                |                                  |                     |   |
| Exercised                     | -                                | (22,224)            | 80.78                                     |
| Forfeited                     | 5,270                            | (5,270)             | 144.29                                    |
| Balance at September 30, 2006 | <u>26,477</u>                    | <u>129,465</u>      | <u>\$ 122.86</u>                          |

The total intrinsic value of options exercised was \$1.1 million and \$3.2 million for the nine months ended September 30, 2006 and 2005, respectively. The total share-based liabilities paid were \$2.0 million for the nine months ended September 30, 2006. The total fair value of shares vested during the nine months ended September 30, 2006 and 2005 was \$2.6 million and \$3.3 million, respectively.

The following table summarizes information about stock options outstanding at September 30, 2006.

|   | Options Outstanding   |  |                        |
|---|-----------------------|--|------------------------|
|   | Number<br>Outstanding | Weighted-<br>Average<br>Remaining<br>Contractual<br>Life | Options<br>Exercisable |
| Exercise prices:                            |                       |  |                        |
| \$ 85.13                                    | 1,581                 | 0.6 years  | 1,581                  |
| 105.25                                      | 21,630                | 1.5 years  | 21,630                 |
| 112.38                                      | 6,800                 | 1.7 years  | 6,800                  |
| 92.13                                       | 30,954                | 4.6 years  | 16,218                 |
| 95.00                                       | 7,200                 | 4.7 years  | 7,200                  |
| 150.00                                      | 61,300                | 7.6 years  | 3,800                  |
| Totals                                      | <u>129,465</u>        |  | <u>57,229</u>          |
| Aggregate intrinsic value<br>(in thousands) | \$ <u>13,857</u>      |  | \$ <u>7,233</u>        |

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The aggregate intrinsic value in the table above is based on the closing stock price of \$229.89 per share on September 30, 2006.

In estimating the fair value of the options outstanding at September 30, 2006, the Company employed the Black-Scholes option pricing model with assumptions as detailed below.

|                          |                  |
|--------------------------|------------------|
| Expected term of options | 2 to 6 years     |
| Expected volatility:     |                  |
| Range                    | 15.31% to 24.73% |
| Weighted-average         | 19.73%           |
| Expected dividends       | -                |
| Risk-free rate:          |                  |
| Range                    | 4.49% to 4.85%   |
| Weighted-average         | 4.61%            |

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 \$12.7 million and \$0.7 million for the nine months ended September 30, 2006 and 2005, respectively. The related tax benefit recognized was \$4.4 million and \$0.3 million for the nine months ended September 30, 2006 and 2005, respectively.

Effective March 10, 2006, the Company adopted and implemented a limited stock buy-back program which provides option holders the additional alternative of selling shares acquired through the exercise of options directly back to the Company. Option holders may elect to sell such acquired shares back to the Company at any time within ninety (90) days after the exercise of options at the prevailing market price as of the date of notice of election. The buy-back program did not alter the terms and conditions of the Plan, however the program necessitated a change in accounting from the equity classification to the liability classification. The modification affected 35 plan participants who had options outstanding on the date of modification and resulted in \$11.7 million of total incremental pre-tax compensation cost due to the change from the equity to liability classification.

As of September 30, 2006, the total compensation cost related to nonvested options not yet recognized was \$3.3 million. This amount is expected to be recognized over a weighted-average period of 2 years. The Company recognizes compensation cost over the graded vesting periods.

For the nine months ended September 30, 2006 and 2005, the total cash received from the exercise of options under the Plan was \$0.5 million and \$1.8 million, respectively. The related tax benefit realized for the nine months ended September 30, 2006 and 2005 was \$1.1 million, respectively.

The Plan offers two alternatives to option holders for exercising options. In the first alternative, option holders have the choice of either holding shares acquired through exercising options, selling the acquired shares in the open market, or requesting a broker-assisted cashless exercise of all or part of the options exercised. A broker-assisted cashless exercise simultaneously executes the exercise of the options and the sale of acquired shares in the open market with the net proceeds payable to the option holder.

In the second alternative, option holders have the option 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 set forth in the notice of election.



## (8) LEGAL PROCEEDINGS

In the course of an audit of a charitable tax-exempt foundation, the Internal Revenue Service ("IRS") raised an issue under the special provisions of the Internal Revenue Code ("IRC") governing tax-exempt private foundations as to certain interest-bearing loans from the Company to another corporation in which the tax-exempt foundation owns stock. The issue is whether such transactions constitute indirect self-dealing by the foundation, the result of which would be excise taxes on the Company by virtue of its participation in such transactions. By letter to the Company dated August 21, 2003, the IRS proposed an initial excise tax liability in the total amount approximating one million dollars as a result of such transactions. The Company disagrees with the IRS analysis. The Company is contesting the matter and expects to prevail on the merits. On October 14, 2003, in response to the IRS letter, the Company requested that this issue instead be referred to the IRS National Office for technical advice. The IRS audit team agreed and the matter was referred in November of 2003 to the IRS National Office. Such technical advice when issued by the IRS National Office will be in the form of a memorandum analyzing the issue which will be binding on the IRS audit team.

The Company is a defendant in several class action lawsuits, however, no class has been certified to date on any of these suits. Management believes that the Company has good and meritorious defenses and intends 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.

## 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 is or may be viewed as forward-looking. Although the Company has used 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 filings with the Securities and Exchange Commission ("SEC") 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, equity-indexed annuities and universal life insurance and traditional life insurance, which include both term and whole life products. The majority of domestic sales are the Company's annuities, which include single and flexible premium deferred annuities, single premium immediate annuities, and equity-indexed annuities. Most of these annuities can be sold as tax qualified or nonqualified products. At September 30, 2006, the Company maintained approximately 123,800 annuity policies in force.

National Western markets and distributes its domestic products through independent national marketing organizations ("NMOs"). These NMOs assist the Company in recruiting, contracting, and managing independent agents. The Company currently has approximately 9,600 independent agents contracted. Roughly 20% 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 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, 2006, the Company had approximately 67,200 international life insurance policies in force representing approximately \$12.9 billion in face amount of coverage.

International applications are submitted by independent contractor consultants and broker-agents. The Company has approximately 3,800 independent international consultants and brokers currently contracted, nearly 48% 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 socio-economic classes who have substantial financial resources. This targeted customer base coupled with National Western's conservative underwriting practices have historically resulted in claims experience, due to natural causes, similar to that in the United States. The Company minimizes exposure to foreign currency risks by requiring payment of premiums, claims, and other benefits almost entirely in United States dollars. Finally, the Company's nearly forty years of experience with the international products and its longstanding independent consultant and broker-agent relationships further serve to minimize risks.

## 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.

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|                     | Three Months Ended September 30, |              | Nine Months Ended September 30, |               |
|---------------------|----------------------------------|--------------|---------------------------------|---------------|
|                     | 2006                             | 2005         | 2006                            | 2005          |
|                     | (In thousands)                   |              |                                 |               |
| International:      |                                  |              |                                 |               |
| Universal life      | \$ 1,858                         | 1,881        | 5,329                           | 4,429         |
| Traditional life    | 969                              | 787          | 3,105                           | 2,458         |
| Equity-indexed life | 4,673                            | 4,836        | 12,875                          | 12,874        |
|                     | <u>7,500</u>                     | <u>7,504</u> | <u>21,309</u>                   | <u>19,761</u> |
| Domestic:           |                                  |              |                                 |               |
| Universal life      | 2,074                            | 752          | 3,231                           | 2,182         |
| Traditional life    | 109                              | 108          | 259                             | 301           |
| Equity-indexed life | 1,233                            | -            | 2,659                           | -             |
|                     | <u>3,416</u>                     | <u>860</u>   | <u>6,149</u>                    | <u>2,483</u>  |
| Totals              | \$ <u>10,916</u>                 | <u>8,364</u> | <u>27,458</u>                   | <u>22,244</u> |

Life insurance sales as measured by annualized first year premiums increased 31% in the third quarter of 2006 as compared to the third quarter of 2005. While the Company's international life line of business experienced level sales in the third quarter of 2006 versus 2005, the Company's domestic life line of business posted nearly a 300% increase over the comparable results in the third quarter of 2005. For the first nine months of the year, total life insurance sales increased 23% in 2006 over the same period in 2005 with the domestic and international life lines of business registering increases of 148% and 8%, respectively.

Company management has placed considerable emphasis on building domestic life insurance sales as a strategic focus and in response to comments from outside rating agencies reviewing the Company. Domestic life insurance sales have increased from 11% of total life insurance sales in the first three quarters of 2005 to 22% in the same period of 2006. Domestic operations have 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 equity-indexed universal life ("EIUL") product for its domestic markets at the end of the third quarter of 2005 and began receiving applications. This product accounted for 43% of domestic life insurance sales in the first nine months of 2006 and management anticipates this share to grow throughout the remainder of 2006. With the introduction of the EIUL and SPUL products and the discontinued marketing of smaller premium and volume life insurance policies, the Company has seen 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, 2002 | \$ 68,100                      | 222,000       |
| Year ended December 31, 2003 | 76,100                         | 219,600       |

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|                                      |         |         |
|--------------------------------------|---------|---------|
| Year ended December 31, 2004         | 101,700 | 234,500 |
| Year ended December 31, 2005         | 137,900 | 245,900 |
| Nine months ended September 30, 2006 | 290,200 | 244,800 |

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. 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. While business is still in a formative phase, sales from these countries have gradually become a larger percentage of overall international sales as shown below.

|                                    | Nine Months Ended September 30, |         |
|------------------------------------|---------------------------------|---------|
|                                    | 2006                            | 2005    |
| Percentage of International Sales: |                                 |         |
| Latin America                      | 75.2 %                          | 84.9 %  |
| Pacific Rim                        | 11.7                            | 10.5    |
| Eastern Europe                     | 13.1                            | 4.6     |
| 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 (40%), Taiwan (10%), and Venezuela (9%) making up the largest markets.

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, |           |
|--------------------|--|-----------|
|                    | 2006                                   | 2005      |
|                    | (\$ in thousands)                      |           |
| Universal life:    |  |           |
| Number of policies | 77,160                                 | 80,440    |
| Face amounts       | \$ 8,034,930                           | 8,109,900 |
| Traditional life:  |  |           |
| Number of policies | 53,440                                 | 55,530    |
| Face amounts       | \$ 1,752,000                           | 1,713,900 |

Equity-indexed life:

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|                       |    |            |            |
|-----------------------|----|------------|------------|
| Number of policies    |    | 18,700     | 14,430     |
| Face amounts          | \$ | 3,937,350  | 2,923,500  |
| Rider face amounts    | \$ | 1,695,190  | 1,522,100  |
| Total life insurance: |    |            |            |
| Number of policies    |    | 149,300    | 150,400    |
| Face amounts          | \$ | 15,419,470 | 14,269,400 |
| 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, |                       |
|------------------------------|----------------------------------|-----------------------|---------------------------------|-----------------------|
|                              | 2006                             | 2005                  | 2006                            | 2005                  |
|                              | (In thousands)                   |                       |                                 |                       |
| Equity-indexed annuities     |                                  |                       |                                 |                       |
| and other deferred annuities | \$ 122,647                       | 134,765               | 355,388                         | 410,402               |
| Immediate annuities          | <u>2,160</u>                     | <u>6,197</u>          | <u>9,910</u>                    | <u>21,216</u>         |
| Totals                       | \$ <u><u>124,807</u></u>         | <u><u>140,962</u></u> | <u><u>365,298</u></u>           | <u><u>431,618</u></u> |

Annuity sales for the third quarter of 2006 were 11% lower than the comparable period in 2005 continuing a trend that began in the first quarter of 2004. Annuity sales in the first quarter of 2004 represented the tail end of the increase in fixed annuity sales that began in 2003 when the Company achieved nearly \$1.2 billion in sales. Annuity sales began trending 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 2005 and 2006, the interest rate levels experienced an infrequent occurrence where the yield curve was inverted, that is, longer term interest rate levels were below shorter term interest rate levels. In such an environment, consumers opt for short-term investment vehicles such as bank certificates of deposits rather than longer term choices which include fixed rate annuities. Annuity sales in the first nine months of 2006 were 15% lower than the comparable period in 2005.

The Company's mix of annuity sales shifts depending upon interest rate levels and equity market performance. With a stronger performance in the equity market, sales of equity-indexed annuity products became more prevalent beginning in 2004 and have continued thus far in 2006. Sales of equity-indexed products have generally accounted for one-half of all annuity sales. For all equity-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), less any asset fees and participation rate limits, is credited to the contract holders electing the equity feature at the beginning of the contract year. The Company does not deliberately mismatch or under hedge for the equity feature of these products.

The sizable increase in 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.

Despite the amounts of new business, the Company's capital level remains substantially above industry averages and regulator targets.

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

|                          | Annuities In Force as of September 30, |           |
|--------------------------|--|-----------|
|                          | 2006                                   | 2005      |
|                          | (\$ in thousands)                      |           |
| Equity-indexed annuities |  |           |
| Number of policies       | 29,690                                 | 26,310    |
| GAAP annuity reserves    | \$ 1,730,620                           | 1,532,810 |
| Other deferred annuities |  |           |
| Number of policies       | 81,260                                 | 84,720    |
| GAAP annuity reserves    | \$ 2,690,100                           | 2,736,860 |
| Immediate annuities      |  |           |
| Number of policies       | 12,850                                 | 12,480    |
| GAAP annuity reserves    | \$ 248,270                             | 248,190   |
| Total annuities          |  |           |
| Number of policies       | 123,800                                | 123,510   |
| GAAP annuity reserves    | \$ 4,668,990                           | 4,517,860 |

#### 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, which for debt securities may be maturity. 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. Upon impairment, a net realized loss is recorded 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, the Company is not permitted to increase the basis of impaired securities for subsequent recoveries in value.

#### Deferred Policy 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.

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.

#### 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, 2005, and the discussions under Investments in Item 3 of the annual report.

#### Pension Plans and Other Postretirement Benefits.

The Company sponsors a qualified defined benefit pension plan covering substantially all employees and three non-qualified defined benefit plans covering certain senior officers. In addition, the Company also has postretirement healthcare benefits for certain senior officers.

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 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. These assumptions involve uncertainties and judgment, and therefore actual performance may not be reflective of the assumptions.

Other postretirement benefit assumptions include future events affecting retirement age, mortality, dependency status, per capita claims costs by age, healthcare trend rates, and discount rates. Per capita claims cost by age is the current cost of providing postretirement healthcare 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. Healthcare trend rates involve assumptions about the annual rate(s) of change in the cost of healthcare 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 healthcare 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 include 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

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, 2005.

## RESULTS OF OPERATIONS

The Company's consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles ("GAAP"). In addition, the Company regularly evaluates operating performance using non-GAAP financial measures which exclude or segregate 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.

|  | <u>Three Months Ended September 30,</u> |              | <u>Nine Months Ended September 30,</u> |              |
|--|---|--------------|--|--------------|
|  | <u>2006</u>                             | <u>2005</u>  | <u>2006</u>                            | <u>2005</u>  |
|  | (In thousands)                          |              |  |              |
| Traditional life and annuity \$ premiums     | 3,654                                   | 3,378        | 11,742                                 | 10,791       |
| Universal life and annuity contract revenues | 26,923                                  | 24,756       | 79,477                                 | 73,346       |
| Net investment income excluding derivatives  | 80,217                                  | 81,549       | 247,379                                | 240,183      |
| Other income                                 | <u>3,064</u>                            | <u>2,570</u> | <u>11,271</u>                          | <u>7,122</u> |

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|                               |                             |                             |                             |                             |
|-------------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
| Operating revenues            | 113,858                     | 112,253                     | 349,869                     | 331,442                     |
| Derivative income (loss)      | 15,832                      | 6,344                       | 13,680                      | (10,056)                    |
| Realized gains on investments | 190                         | 1,430                       | 3,229                       | 10,014                      |
|                               | <u>                    </u> | <u>                    </u> | <u>                    </u> | <u>                    </u> |
| Total revenues                | \$ <u>129,880</u>           | <u>120,027</u>              | <u>366,778</u>              | <u>331,400</u>              |

Traditional life insurance premiums for products such as whole life and term life are recognized as revenues over the premium-paying period. Sales of these products increased almost 9% for the nine months ended September 30, 2006.

Revenues for universal life and annuity contract revenues consist of policy charges for the cost of insurance, administration charges, and surrender charges assessed against policyholder account balances. Product sales have increased from 2005 to 2006 relative to the block of business in force, and notably international universal life products continue growing steadily. This contributes to higher revenues in the form of cost of insurance charges which were \$17.1 million and \$50.2 million for the three and nine months ended of 2006 compared to \$16.0 million and \$47.1 million for the three and nine months ended September 30, 2005. Surrender charges assessed against policyholder account balances upon withdrawal totaled approximately \$7.2 million for the three months ended September 30, 2006 and \$6.7 million for the same period in 2005. These amounts totaled \$21.9 million and \$19.8 million for the nine months ended September 30, 2006 and 2005, respectively.

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 debt securities, which accounted for 91.8% and 90.5% of gross investment income for the nine months ended September 30, 2006 and 2005. These investments are closely monitored by the Company due to its significant impact on revenues and profitability.

A detail of net investment income is provided below.

|                          | Three Months Ended                |                             | Nine Months Ended September 30, |              |                             |              |
|--------------------------|-----------------------------------|-----------------------------|---------------------------------|--------------|-----------------------------|--------------|
|                          | September 30,                     |                             | % of                            |              | % of                        |              |
|                          | 2006                              | 2005                        | 2006                            | Total        | 2005                        | Total        |
|                          | (In thousands except percentages) |                             |                                 |              |                             |              |
| Gross investment income: |                                   |                             |                                 |              |                             |              |
| Debt securities          | \$ 76,037                         | 73,907                      | 229,151                         | 91.8         | 218,993                     | 90.5         |
| Mortgage loans           | 1,837                             | 2,360                       | 6,513                           | 2.6          | 7,326                       | 3.0          |
| Policy loans             | 1,564                             | 1,608                       | 4,711                           | 1.9          | 4,784                       | 2.0          |
| Other investment income  | 1,542                             | 4,465                       | 9,263                           | 3.7          | 10,934                      | 4.5          |
|                          | <u>                    </u>       | <u>                    </u> | <u>                    </u>     | <u>100.0</u> | <u>                    </u> | <u>100.0</u> |
| Total investment income  | 80,980                            | 82,340                      | 249,638                         |              | 242,037                     |              |
| Investment expenses      | <u>763</u>                        | <u>791</u>                  | <u>2,259</u>                    |              | <u>1,854</u>                |              |
| Net investment income    |                                   |                             |                                 |              |                             |              |

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|                          |                  |               |                |                |
|--------------------------|------------------|---------------|----------------|----------------|
| (excluding derivatives)  | 80,217           | 81,549        | 247,379        | 240,183        |
| Derivative income (loss) | 15,832           | 6,344         | 13,680         | (10,056)       |
| Net investment income    | <u>\$ 96,049</u> | <u>87,893</u> | <u>261,059</u> | <u>230,127</u> |

Income from other invested assets for the three and nine months ended September 30, 2005 includes profit participation interest of \$2.7 million and \$5.0 million. The nine months ended September 30, 2006 includes \$1.6 million of profit participation interest and \$1.1 million of residual profits from the sale of equity loans during the current year. Derivative gains 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<sup>®</sup> Composite Stock Price Index ("S&P 500 Index<sup>®</sup>"). See the discussion that follows this section relating to index options and derivatives. Despite the drop in interest rate levels over the past several years, the Company still generated higher overall net investment income, excluding derivatives, for the nine months ended September 30, 2006, due to higher levels of invested assets.

Net investment income performance is summarized as follows:

|  | Nine Months Ended September 30,   |           |
|--|-----------------------------------|-----------|
|  | 2006                              | 2005      |
|  | (In thousands except percentages) |           |
| <u>Excluding derivatives:</u>              |                                   |           |
| Net investment income                      | \$ 247,379                        | 240,183   |
| Average invested assets, at amortized cost | \$ 5,430,366                      | 5,163,516 |
| Annual yield on average invested assets    | 6.07%                             | 6.20%     |
| <u>Including derivatives:</u>              |                                   |           |
| Net investment income                      | \$ 261,059                        | 230,127   |
| Average invested assets, at amortized cost | \$ 5,462,464                      | 5,210,141 |
| Annual yield on average invested assets    | 6.37%                             | 5.89%     |

The year-to-date yield on average invested assets has decreased from 6.20% in 2005 to 6.07% in 2006, excluding derivatives, due to yields on current investments being at lower levels. Net investment income performance is also analyzed excluding derivative income, a common practice in the insurance industry, in order to assess underlying profitability and results from ongoing operations.

Other income primarily pertains to the Company's operations involving a nursing home. Revenues associated with this operation were \$8.2 million and \$6.6 million for the nine months ended September 30, 2006 and 2005, respectively. Included in other income for the nine months ended September 30, 2006 is \$2.6 million from partial lawsuit settlements in relation to the Company's litigation against Enron and related parties.

Index options are derivative financial instruments used to properly hedge the equity return component of the Company's equity-indexed products. Index options are intended to act as hedges to match closely the returns on equity-indexed products. With an increase or decline in this index, the index option values likewise increase or decline. Any gains or losses from the sale or expiration of the options, as well as period-to-period changes in fair values, are reflected as a component of net investment income. However, increases or decreases in income from these options are substantially offset by corresponding increases or decreases in amounts credited to equity-indexed policyholders as contract interest.

Derivative components included in net investment income and the corresponding contract interest amounts are detailed below for each date presented.

|   | Three Months Ended September<br>30, |               | Nine Months Ended September 30, |                 |
|---|-------------------------------------|---------------|---------------------------------|-----------------|
|   | <u>2006</u>                         | <u>2005</u>   | <u>2006</u>                     | <u>2005</u>     |
|   | (In thousands)                      |               |                                 |                 |
| Derivatives:  |                                     |               |                                 |                 |
| Unrealized income (loss)                              | \$ 14,807                           | 147           | 7,902                           | (9,131)         |
| Realized income (loss)                                | <u>1,025</u>                        | <u>6,197</u>  | <u>5,778</u>                    | <u>(925)</u>    |
| Total income (loss) included in net investment income | \$ <u>15,832</u>                    | <u>6,344</u>  | <u>13,680</u>                   | <u>(10,056)</u> |
| Total contract interest                               | \$ <u>59,065</u>                    | <u>43,237</u> | <u>138,678</u>                  | <u>109,764</u>  |

Net realized gains of \$0.2 million and \$1.4 million were recorded in the three months ended September 30, 2006 and 2005, respectively. The net gains for 2006 include gains on the sale of real estate of \$0.2 million, and net gains on sales and calls of bonds and stocks of \$0.1 million offset by a realized loss from an additional impairment writedown during the quarter of an asset backed security of \$0.1 million. The net gains reported in 2005 for the three months ended September 30, resulted from transactions on airline bonds incurring \$2.8 million of gains netted against an impairment loss of \$1.4 million. Net gains of \$3.2 million and \$10.0 million were recorded for the nine months ended September 30, 2006 and 2005, respectively. For 2006 gains on sales of real estate of \$0.4 million, sales and tenders of stock and bonds of \$1.8 million and payments or stock exchanges related to several previously unimpaired default bond securities of \$0.8 million were recorded. For 2005 net gains included sales of real estate of \$6.5 million, sales, tenders and calls of bonds and stocks of \$2.3 million offset additionally by an impairment writedown on one bond issuer of \$0.2 million due to a reduction in the market value.

#### Benefits and Expenses.

The following details benefits and expenses.

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|   | Three Months Ended September 30, |        | Nine Months Ended September 30, |         |
|---|----------------------------------|--------|---------------------------------|---------|
|   | 2006                             | 2005   | 2006                            | 2005    |
|   | (In thousands)                   |        |                                 |         |
| Life and other policy benefits                    | \$ 9,212                         | 9,278  | 28,300                          | 29,938  |
| Amortization of deferred policy acquisition costs | 24,430                           | 24,298 | 69,443                          | 65,697  |
| Universal life and annuity contract interest      | 59,065                           | 43,237 | 138,678                         | 109,764 |
| Other operating expenses                          | 12,513                           | 12,340 | 51,611                          | 34,481  |
| Totals  | \$ 105,220                       | 89,153 | 288,032                         | 239,880 |

Life and other policy benefits reflect death claims reported of \$7.5 million and \$6.9 million for the three months ended and \$21.7 million and \$23.7 million for the nine months ended, September 30, 2006 and 2005, respectively. While death claim amounts are subject to variation from period to period, the Company's mortality experience has generally been consistent with its product pricing assumptions.

Life insurance companies are required to defer certain expenses associated with acquiring new business. The majority of these acquisition expenses consist of commissions paid to agents, underwriting costs, and certain marketing expenses and sales inducements. The Company defers sales inducements in the form of first year interest bonuses on annuity and universal life products that are directly related to the production of new business. These charges are deferred and amortized using the same methodology and assumptions used to amortize other capitalized acquisition costs and the amortization is included in contract interest. Recognition of these deferred policy acquisition costs in the financial statements occurs over future periods in relation to the emergence of profits priced into the products sold. This emergence of profits is based upon assumptions regarding premium payment patterns, mortality, persistency, investment performance, and expense patterns. Companies are required to review these assumptions periodically to ascertain whether actual experience has deviated significantly from that assumed. If it is determined that a significant deviation has occurred, the emergence of profits pattern is to be "unlocked" and reset based upon the actual experience. While the Company is required to evaluate its emergence of profits continually, management believes that the current amortization patterns of deferred policy acquisition costs are reflective of actual experience.

Amortization of deferred policy acquisition costs increased to \$69.4 million for the nine months ended September 30, 2006 compared to \$65.7 million reported in 2005. The increase in life sales, particularly internationally, has caused an increase in life insurance in force since 2001 from \$10.0 billion to \$15.4 billion at September 30, 2006. In addition, annuity sales activity has increased the number of active annuity contracts from approximately 123,500 at September 30, 2005, to 123,800 at September 30, 2006. Deferred acquisition costs associated with this growth in business are being amortized currently in conjunction with the emergence of profits from these blocks of policies.

The Company closely monitors its credited interest rates on interest sensitive policies, taking into consideration such factors as profitability goals, policyholder benefits, product marketability, and economic market conditions. As long-term interest rates change, the Company's credited interest rates are often adjusted accordingly, taking into consideration the factors as described above. The difference between yields earned over policy credited rates is often referred to as the "interest spread". Raising policy credited rates can typically have more of an immediate impact than higher market rates on the Company's investment portfolio yield, making it more difficult to maintain the current interest spread.



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Nine months ended:

|                       |       |        |        |       |        |
|-----------------------|-------|--------|--------|-------|--------|
| September 30, 2006 \$ | (656) | 9,615  | 38,243 | 3,043 | 50,245 |
| September 30, 2005 \$ | 1,867 | 10,618 | 36,967 | 4,508 | 53,960 |

Domestic Life Insurance Operations

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

|   | Three Months Ended September 30, |        | Nine Months Ended September 30, |        |
|---|----------------------------------|--------|---------------------------------|--------|
|   | 2006                             | 2005   | 2006                            | 2005   |
|   | (In thousands)                   |        |                                 |        |
| Premiums and other revenue:                           |                                  |        |                                 |        |
| Premiums and contract revenues                        | \$ 5,932                         | 5,984  | 17,465                          | 18,100 |
| Net investment income                                 | 4,545                            | 5,239  | 14,761                          | 15,066 |
| Other income  | 10                               | 9      | 25                              | 25     |
| Total premiums and other revenue                      | 10,487                           | 11,232 | 32,251                          | 33,191 |
| Benefits and expenses:                                |                                  |        |                                 |        |
| Life and other policy benefits                        | 3,505                            | 3,628  | 11,536                          | 11,898 |
| Amortization of deferred policy acquisition costs     | 1,496                            | 3,421  | 4,868                           | 5,253  |
| Universal life insurance contract interest            | 2,293                            | 2,227  | 6,836                           | 6,596  |
| Other operating expenses                              | 2,533                            | 2,325  | 9,995                           | 6,624  |
| Total benefits and expenses                           | 9,827                            | 11,601 | 33,235                          | 30,371 |
| Segment earnings (losses) before Federal income taxes | 660                              | (369)  | (984)                           | 2,820  |
| Provision (benefit) for Federal income taxes          | 212                              | (109)  | (328)                           | 953    |
| Segment earnings                                      | \$ 448                           | (260)  | (656)                           | 1,867  |

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

|                                     | Three Months Ended September 30, |       | Nine Months Ended September 30, |        |
|-------------------------------------|----------------------------------|-------|---------------------------------|--------|
|                                     | 2006                             | 2005  | 2006                            | 2005   |
|                                     | (In thousands)                   |       |                                 |        |
| Universal life insurance revenues   | \$ 4,714                         | 4,499 | 13,371                          | 13,402 |
| Traditional life insurance premiums | 1,617                            | 1,944 | 5,286                           | 5,633  |
| Reinsurance premiums                | (399)                            | (459) | (1,192)                         | (935)  |
| Totals                              | \$ 5,932                         | 5,984 | 17,465                          | 18,100 |

The Company's U.S. operations have historically generated annuity product sales substantially greater than life product sales. In recent years, the Company has strategically focused on increasing domestic life product sales and continuing to attract new sources of distribution. The face amount of domestic life insurance in force has remained at \$2.5 billion as of September 30, 2005 and 2006.

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

|                                | Three Months Ended September 30, |       | Nine Months Ended September 30, |        |
|--------------------------------|----------------------------------|-------|---------------------------------|--------|
|                                | 2006                             | 2005  | 2006                            | 2005   |
|                                | (In thousands)                   |       |                                 |        |
| Universal life insurance:      |                                  |       |                                 |        |
| First year and single premiums | \$ 4,244                         | 3,153 | 10,463                          | 10,542 |
| Renewal premiums               | 3,620                            | 3,531 | 10,628                          | 10,847 |
| Totals                         | \$ 7,864                         | 6,684 | 21,091                          | 21,389 |

Other operating expenses were \$10.0 million and \$6.6 million for the nine months ended September 30, 2006 and 2005. The increase in 2006 is due to an increase in compensation costs resulting from the change to liability classification for the Company's stock option plan in the first quarter.

#### International Life Insurance Operations

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



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|   | Three Months Ended September 30, |        | Nine Months Ended September 30, |        |
|---|----------------------------------|--------|---------------------------------|--------|
|   | 2006                             | 2005   | 2006                            | 2005   |
|   | (In thousands)                   |        |                                 |        |
| Premiums and other revenue:                       |                                  |        |                                 |        |
| Premiums and contract revenues                    | \$ 19,364                        | 17,566 | 57,448                          | 51,908 |
| Net investment income                             | 6,771                            | 6,215  | 18,958                          | 17,305 |
| Other income                                      | 21                               | 23     | 66                              | 55     |
| Total premiums and other revenue                  | 26,156                           | 23,804 | 76,472                          | 69,268 |
| Benefits and expenses:                            |                                  |        |                                 |        |
| Life and other policy benefits                    | 4,984                            | 4,670  | 14,204                          | 15,721 |
| Amortization of deferred policy acquisition costs | 6,951                            | 3,502  | 16,462                          | 14,347 |
| Universal life insurance contract interest        | 7,185                            | 4,557  | 16,399                          | 13,140 |
| Other operating expenses                          | 3,131                            | 3,921  | 14,956                          | 10,022 |
| Total benefits and expenses                       | 22,251                           | 16,650 | 62,021                          | 53,230 |
| Segment earnings before Federal income taxes      | 3,905                            | 7,154  | 14,451                          | 16,038 |
| Provision for Federal income taxes                | 1,376                            | 2,461  | 4,836                           | 5,420  |
| Segment earnings                                  | \$ 2,529                         | 4,693  | 9,615                           | 10,618 |

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

|  | Three Months Ended September 30, |        | Nine Months Ended September 30, |        |
|--|----------------------------------|--------|---------------------------------|--------|
|  | 2006                             | 2005   | 2006                            | 2005   |
|  | (In thousands)                   |        |                                 |        |
|  | \$ 19,729                        | 18,368 | 58,165                          | 53,431 |

|                                     |                  |                |                |                |
|-------------------------------------|------------------|----------------|----------------|----------------|
| Universal life insurance revenues   |                  |                |                |                |
| Traditional life insurance premiums | 2,560            | 2,040          | 8,021          | 6,514          |
| Reinsurance premiums                | <u>(2,925)</u>   | <u>(2,842)</u> | <u>(8,738)</u> | <u>(8,037)</u> |
| Totals                              | <u>\$ 19,364</u> | <u>17,566</u>  | <u>57,448</u>  | <u>51,908</u>  |

International operations have emphasized universal life policies over traditional life insurance products. Premiums collected on universal life products are not reflected as revenues in the Company's statements of earnings in accordance with GAAP. Actual universal life premiums collected are detailed below.

|                                | Three Months Ended September 30, |               | Nine Months Ended September 30, |               |
|--------------------------------|----------------------------------|---------------|---------------------------------|---------------|
|                                | 2006                             | 2005          | 2006                            | 2005          |
|                                | (In thousands)                   |               |                                 |               |
| Universal life insurance:      |                                  |               |                                 |               |
| First year and single premiums | \$ 9,473                         | 9,681         | 26,405                          | 25,377        |
| Renewal premiums               | <u>20,854</u>                    | <u>17,677</u> | <u>59,356</u>                   | <u>50,170</u> |
| Totals                         | <u>\$ 30,327</u>                 | <u>27,358</u> | <u>85,761</u>                   | <u>75,547</u> |

The international life operations have been a significant part of the Company's business based upon its long-standing reputation in the international market. The Company reported increased sales of equity-indexed universal life products for international life operations with premiums approximating \$43.0 million and \$33.8 million for the nine months ended September 30, 2006 and 2005, respectively.

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

|   | Three Months Ended September 30, |              | Nine Months Ended September 30, |               |
|---|----------------------------------|--------------|---------------------------------|---------------|
|   | 2006                             | 2005         | 2006                            | 2005          |
|   | (In thousands)                   |              |                                 |               |
| Net investment income (excluding derivatives) | \$ 5,954                         | 6,234        | 18,508                          | 17,927        |
| Derivative income (loss)                      | <u>817</u>                       | <u>(19)</u>  | <u>450</u>                      | <u>(622)</u>  |
| Net investment income                         | <u>\$ 6,771</u>                  | <u>6,215</u> | <u>18,958</u>                   | <u>17,305</u> |

Net investment income excluding derivatives increased for the nine months in 2006 compared to 2005 in conjunction with greater investment balances associated with the Company's growth in business. As the international life insurance in force continues to grow, the Company anticipates operating earnings to similarly increase. The amount of international life insurance in force has grown from \$11.8 billion at September 30, 2005, to \$12.9 billion at September

30, 2006.

Amortization of deferred policy acquisition costs has increased from \$3.5 million and \$14.3 million for the three and nine months of 2005 to \$7.0 million and \$16.5 million for the same periods in 2006. Amortization changes result from the actuarial changes of profit assumption regarding premiums, mortality, persistency, investment performance and expense patterns. As previously noted, contract interest includes an increase due to the S&P 500 Index<sup>®</sup> performance relative to equity-indexed products, increasing in the current quarter of 2006 compared to the same period in 2005.

Other operating expenses were \$15.0 million and \$10.0 million for the nine months ended September 30, 2006 and 2005. The increase in 2006 is due to an increase in compensation costs resulting from the change in liability classification for the Company's stock option plan in the first quarter.

#### Annuity Operations

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

|   | Three Months Ended September<br>30, |        | Nine Months Ended September 30, |         |
|---|-------------------------------------|--------|---------------------------------|---------|
|   | 2006                                | 2005   | 2006                            | 2005    |
|   | (In thousands)                      |        |                                 |         |
| Premiums and other<br>revenue:                          |                                     |        |                                 |         |
| Premiums and contract<br>revenues                       | \$ 5,281                            | 4,584  | 16,306                          | 14,129  |
| Net investment income                                   | 83,900                              | 75,709 | 223,307                         | 191,867 |
| Other income  | 106                                 | 285    | 2,968                           | 467     |
| Total premiums and other<br>revenue                     | 89,287                              | 80,578 | 242,581                         | 206,463 |
| Benefits and expenses:                                  |                                     |        |                                 |         |
| Policy benefits   | 723                                 | 980    | 2,560                           | 2,319   |
| Amortization of deferred<br>policy<br>acquisition costs | 15,983                              | 17,375 | 48,113                          | 46,097  |
| Annuity contract interest                               | 49,587                              | 36,453 | 115,443                         | 90,028  |
| Other operating expenses                                | 4,027                               | 4,231  | 18,987                          | 12,181  |
| Total benefits and expenses                             | 70,320                              | 59,039 | 185,103                         | 150,625 |
| Segment earnings before<br>Federal<br>income taxes      | 18,967                              | 21,539 | 57,478                          | 55,838  |

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|                                    |                   |                   |                   |                   |
|------------------------------------|-------------------|-------------------|-------------------|-------------------|
| Provision for Federal income taxes | 6,598             | 7,446             | 19,235            | 18,871            |
|                                    | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Segment earnings                   | \$ 12,369         | 14,093            | 38,243            | 36,967            |
|                                    | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |

Revenues from annuity operations primarily include surrender charges and recognition of deferred revenues relating to immediate or payout annuities. A comparative detail of the components of premiums and annuity contract revenues is provided below.

|                                   | Three Months Ended September 30, |                   | Nine Months Ended September 30, |                   |
|-----------------------------------|----------------------------------|-------------------|---------------------------------|-------------------|
|                                   | 2006                             | 2005              | 2006                            | 2005              |
|                                   | (In thousands)                   |                   |                                 |                   |
| Surrender charges                 | \$ 4,320                         | 3,733             | 13,176                          | 11,628            |
| Payout annuity and other revenues | 952                              | 841               | 3,107                           | 2,474             |
| Traditional annuity premiums      | 9                                | 10                | 23                              | 27                |
|                                   | <u>          </u>                | <u>          </u> | <u>          </u>               | <u>          </u> |
| Totals                            | \$ 5,281                         | 4,584             | 16,306                          | 14,129            |
|                                   | <u>          </u>                | <u>          </u> | <u>          </u>               | <u>          </u> |

Deposits collected on annuity contracts are not reflected as revenues in the Company's statements of earnings in accordance with GAAP. Actual annuity deposits collected for the quarter ended September 30, 2006 and 2005 are detailed below.

|                          | Three Months Ended September 30, |                   | Nine Months Ended September 30, |                   |
|--------------------------|----------------------------------|-------------------|---------------------------------|-------------------|
|                          | 2006                             | 2005              | 2006                            | 2005              |
|                          | (In thousands)                   |                   |                                 |                   |
| Equity-indexed annuities | \$ 82,599                        | 75,994            | 229,590                         | 235,082           |
| Other deferred annuities | 44,398                           | 50,801            | 137,939                         | 167,350           |
| Immediate annuities      | 1,384                            | 3,701             | 7,645                           | 18,720            |
|                          | <u>          </u>                | <u>          </u> | <u>          </u>               | <u>          </u> |
| Totals                   | \$ 128,381                       | 130,496           | 375,174                         | 421,152           |
|                          | <u>          </u>                | <u>          </u> | <u>          </u>               | <u>          </u> |

Amounts collected from equity-indexed annuities decreased 2.3% comparing the nine months of September 30, 2005 quarter-end deposits collected to the nine months of 2006. Equity-indexed product sales typically follow the stock market in that sales are higher when confidence is high in the stock market and low if the stock market is showing poor performance. Since the Company does not offer variable products or mutual funds, these equity-indexed products provide an interest crediting alternative to the Company's existing fixed annuity products.

Other deferred annuity deposits decreased during the three and nine months ended September 30, 2006 versus the same periods of September 30, 2005. As a selling inducement, many of the deferred products include a first year interest bonus in addition to a base interest rate. These bonus rates are deferred in conjunction with other capitalized policy acquisition costs. The amount deferred and amortized over future periods amounted to approximately \$4.9

million and \$5.5 million during the third quarter of 2006 and 2005, respectively.

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

|  | Three Months Ended September 30, |        | Nine Months Ended September 30, |         |
|--|----------------------------------|--------|---------------------------------|---------|
|  | 2006                             | 2005   | 2006                            | 2005    |
|  | (In thousands)                   |        |                                 |         |
| Net investment income<br>(excluding derivatives) | \$ 68,885                        | 69,346 | 210,077                         | 201,301 |
| Derivative income (loss)                         | 15,015                           | 6,363  | 13,230                          | (9,434) |
| Net investment income                            | \$ 83,900                        | 75,709 | 223,307                         | 191,867 |

Net investment income excluding derivatives increased for the nine months of September 30, 2006 compared to 2005 due to a larger block of assets under management. Derivative income and loss fluctuate from period to period based on the S&P 500 Index<sup>®</sup> performance.

The Company is required to periodically adjust deferred policy acquisition amortization factors for actual experience that varies from assumptions. In the third quarter of 2006, a true-up adjustment of \$1.8 million increased amortization reported during the current period. Deferred policy amortization was \$16.0 million and \$17.4 million for the three months ended and \$48.1 million and \$46.1 million for the nine months ended, September 30, 2006 and 2005. No assumption changes were made in the third quarter of 2005.

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

|   | Three Months Ended September 30, |         | Nine Months Ended September 30, |          |
|---|----------------------------------|---------|---------------------------------|----------|
|   | 2006                             | 2005    | 2006                            | 2005     |
|   | (In thousands)                   |         |                                 |          |
| Equity-indexed annuities                | \$ 27,993                        | 13,065  | 48,577                          | 20,174   |
| All other annuities                     | 24,856                           | 27,005  | 75,825                          | 80,763   |
| Gross contract interest                 | 52,849                           | 40,070  | 124,402                         | 100,937  |
| Bonus interest deferred and capitalized | (4,883)                          | (5,504) | (15,582)                        | (15,826) |
| Bonus interest amortization             | 1,621                            | 1,887   | 6,623                           | 4,917    |
| Total contract interest                 | \$ 49,587                        | 36,453  | 115,443                         | 90,028   |

As previously noted, contract interest includes an increase due to the S&P 500 Index<sup>®</sup> performance relative to equity-indexed products increasing in the current quarter and the nine months of 2006 compared to the same period in 2005.

Other operating expenses were \$19.0 million and \$12.2 million for the nine months ended September 30, 2006 and 2005, respectively. The increase in 2006 is due to an increase in compensation costs as a result of liability classification related to the Company's stock option plan recorded in the first quarter.

#### Other Operations

National Western's primary business encompasses its domestic and international life insurance operations and its annuity operations. However, National Western also has small real estate, nursing home, and other investment operations through its wholly-owned subsidiaries. Nursing home operations generated \$0.5 million and \$0.9 million of operating earnings in the first nine months of 2006 and 2005, respectively.

## INVESTMENTS

#### General

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

The Company's overall conservative investment philosophy is reflected in the allocation of its investments, which is detailed below as of September 30, 2006 and December 31, 2005. The Company emphasizes investment grade debt securities, with smaller holdings in mortgage loans and policy loans.

|                   | Composition of Investments |              |                     |              |
|-------------------|----------------------------|--------------|---------------------|--------------|
|                   | September 30, 2006         |              | December 31, 2005   |              |
|                   | Amount                     | %            | Amount              | %            |
|                   | (In thousands)             |              | (In thousands)      |              |
| Debt securities   | \$ 5,354,339               | 94.9         | \$ 5,249,156        | 94.8         |
| Mortgage loans    | 105,894                    | 1.9          | 110,639             | 2.0          |
| Policy loans      | 85,806                     | 1.5          | 86,385              | 1.6          |
| Derivatives       | 52,147                     | 0.9          | 39,405              | 0.7          |
| Equity securities | 20,681                     | 0.4          | 20,295              | 0.4          |
| Real estate       | 13,251                     | 0.2          | 13,436              | 0.2          |
| Other             | 11,204                     | 0.2          | 16,577              | 0.3          |
| Totals            | <u>\$ 5,643,322</u>        | <u>100.0</u> | <u>\$ 5,535,893</u> | <u>100.0</u> |

#### Debt and Equity Securities

The Company maintains a diversified portfolio which consists primarily of corporate, mortgage-backed, and public utilities fixed income securities. Investments in mortgage-backed securities include primarily U.S. government agency pass-through securities and collateralized mortgage obligations ("CMOs"). As of September 30, 2006 and December

31, 2005, the Company's debt securities portfolio consisted of the following:

|                                 | Composition of Debt Securities |       |                   |       |
|---------------------------------|--------------------------------|-------|-------------------|-------|
|                                 | September 30, 2006             |       | December 31, 2005 |       |
|                                 | Amount                         | %     | Amount            | %     |
|                                 | (In thousands)                 |       | (In thousands)    |       |
| Corporate                       | \$ 2,359,024                   | 44.1  | \$ 2,320,306      | 44.2  |
| Mortgage-backed securities      | 1,800,113                      | 33.6  | 1,715,245         | 32.7  |
| Public utilities                | 605,488                        | 11.3  | 661,333           | 12.6  |
| U.S. government/agencies        | 371,313                        | 6.9   | 306,260           | 5.8   |
| Asset-backed securities         | 128,641                        | 2.4   | 161,324           | 3.1   |
| States & political subdivisions | 59,214                         | 1.1   | 53,940            | 1.0   |
| Foreign governments             | 30,546                         | 0.6   | 30,748            | 0.6   |
| Totals                          | \$ 5,354,339                   | 100.0 | \$ 5,249,156      | 100.0 |

The Company's investment guidelines prescribe limitations by type and based on quality of each security and all holdings were within these threshold limits at September 30, 2006. The Company has expanded its holdings of U.S. agency mortgage-backed securities over the past several years given attractive yields and spreads. However, in conjunction with rating agency observations, the Company has a target for holdings in these securities of no more than 35% of the overall portfolio. Because the Company's holdings of mortgage-backed securities are subject to prepayment and extension risk, the Company has substantially reduced these risks by investing primarily in collateralized mortgage obligations, which have more predictable cash flow patterns than pass-through securities. These securities, known as planned amortization class I ("PAC I") and sequential tranches are designed to amortize in a more predictable manner than other CMO classes or pass-throughs. Using this strategy, the Company can more effectively manage and reduce prepayment and extension risks, thereby helping to maintain the appropriate matching of the Company's assets and liabilities.

In addition to diversification, an important aspect of the Company's investment approach is managing the credit quality of its investments in debt securities. As of September 30, 2006, 97.5% of the Company's debt securities were investment grade quality. Thorough credit analysis is performed on potential corporate investments including examination of a company's credit and industry outlook, financial ratios and trends, and event risks. This emphasis is reflected in the high average credit rating of the Company's portfolio. In the table below, investments in debt securities are classified according to credit ratings by Standard and Poors ("S&P®"), or other nationally recognized statistical rating organizations if securities were not rated by S&P®.

|                         | September 30, 2006 |      | December 31, 2005 |      |
|-------------------------|--------------------|------|-------------------|------|
|                         | Amount             | %    | Amount            | %    |
|                         | (In thousands)     |      | (In thousands)    |      |
| AAA and U.S. government | \$ 2,413,146       | 45.0 | \$ 2,285,094      | 43.5 |

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|                                     |                     |              |                     |              |
|-------------------------------------|---------------------|--------------|---------------------|--------------|
| AA                                  | 292,216             | 5.5          | 202,092             | 3.9          |
| A                                   | 1,286,380           | 24.0         | 1,360,716           | 25.9         |
| BBB                                 | 1,229,515           | 23.0         | 1,230,799           | 23.5         |
| BB and other below investment grade | <u>133,082</u>      | <u>2.5</u>   | <u>170,455</u>      | <u>3.2</u>   |
| Totals                              | <u>\$ 5,354,339</u> | <u>100.0</u> | <u>\$ 5,249,156</u> | <u>100.0</u> |

The Company does not purchase below investment grade securities. Investments held in debt securities below investment grade are the result of subsequent downgrades of the securities. The Company's percentage of below investment grade securities remained constant from the end of the second quarter. The Company's holdings of below investment grade securities as a percentage of total invested assets is relatively small compared to industry averages. These holdings are summarized below.

| Below Investment Grade Debt Securities |                                   |                   |                            |                            |
|--|-----------------------------------|-------------------|----------------------------|----------------------------|
|  | Amortized<br>Cost                 | Carrying<br>Value | Estimated<br>Fair<br>Value | % of<br>Invested<br>Assets |
|  | (In thousands except percentages) |                   |                            |                            |
| September 30, 2006                     | \$ 129,839                        | 133,082           | 131,672                    | 2.4%                       |
| December 31, 2005                      | \$ 168,423                        | 170,455           | 167,770                    | 3.1%                       |
| December 31, 2004                      | \$ 132,617                        | 137,930           | 137,503                    | 2.6%                       |

For the three and nine months ended September 30, 2006 one other-than temporary writedown was recorded totaling \$0.1 million, representing a further writedown on an asset-backed security impaired in the previous year. For the nine months ended September 30, 2005, other-than temporary writedowns totaled \$1.8 million. Of this amount \$1.4 million was an impairment recorded on the Company's Delta Airlines holdings during the third quarter of 2005. The remainder of the 2005 writedowns included an impairment writedown of \$0.2 million on an asset-backed security and an impairment writedown of \$0.2 million on a previously impaired issuer due to continued market decline.

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

| Below Investment Grade Debt Securities as of September 30, 2006 |                           |                           |                       |                       |
|---|---------------------------|---------------------------|-----------------------|-----------------------|
| Category  | Amortized<br>Cost<br>2006 | Carrying<br>Value<br>2006 | Fair<br>Value<br>2006 | Fair<br>Value<br>2005 |
|   | (In thousands)            |                           |                       |                       |
| Retail  | \$ 35,860                 | 35,910                    | 35,881                | 36,223                |



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|                   |                             |                             |                             |                             |
|-------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
| Utilities/Energy  | 34,539                      | 35,973                      | 36,166                      | 36,700                      |
| Asset-backed      | 13,012                      | 13,012                      | 11,829                      | 11,050                      |
| Telecommunication | 9,995                       | 9,975                       | 9,975                       | 9,875                       |
| Transportation    | 6,614                       | 8,140                       | 8,140                       | 8,143                       |
| Manufacturing     | 6,017                       | 8,344                       | 8,330                       | 7,132                       |
| Auto finance      | 6,161                       | 6,161                       | 5,993                       | 5,423                       |
| Other             | 17,641                      | 15,567                      | 15,358                      | 15,181                      |
|                   | <u>                    </u> | <u>                    </u> | <u>                    </u> | <u>                    </u> |
| Totals            | \$ 129,839                  | 133,082                     | 131,672                     | 129,727                     |
|                   | <u>                    </u> | <u>                    </u> | <u>                    </u> | <u>                    </u> |

The Company is required to classify its investments in debt and equity securities into one of three categories: (a) trading securities, (b) securities available for sale, or (c) securities held to maturity. The Company purchases securities with the intent to hold to maturity and accordingly does not maintain a portfolio of trading securities. Of the remaining two categories, available for sale and held to maturity, the Company makes a determination based on various factors including the type and quality of the particular security and how it will be incorporated into the Company's overall asset/liability management strategy. As shown in the table below, at September 30, 2006, approximately 33% of the Company's total debt and equity securities, based on fair values, were classified as securities available for sale. These holdings provide the Company flexibility to react to market opportunities and conditions and to practice active management within the portfolio to provide adequate liquidity to meet policyholder obligations and other cash needs.

|                                | Fair<br>Value               | Amortized<br>Cost           | Unrealized<br>Gains (Losses) |
|--------------------------------|-----------------------------|-----------------------------|------------------------------|
|                                | <u>                    </u> | <u>                    </u> | <u>                    </u>  |
|                                |                             | (In thousands)              |                              |
| Securities held to maturity:   |                             |                             |                              |
| Debt securities                | \$ 3,554,885                | 3,588,868                   | (33,983)                     |
| Securities available for sale: |                             |                             |                              |
| Debt securities                | 1,765,471                   | 1,774,727                   | (9,256)                      |
| Equity securities              | 20,681                      | 12,436                      | 8,245                        |
|                                | <u>                    </u> | <u>                    </u> | <u>                    </u>  |
| Totals                         | \$ 5,341,037                | 5,376,031                   | (34,994)                     |
|                                | <u>                    </u> | <u>                    </u> | <u>                    </u>  |

Proceeds from sales of securities available for sale totaled \$0.1 million with minimal realized gains and \$12.4 million with realized gains of \$2.7 million for the three months ended September 30, 2006 and 2005, respectively. Proceeds from sales of securities available for sale totaled \$21.5 million and \$24.2 million, which resulted in realized gains of \$1.7 million and \$3.8 million during the nine months of 2006 and 2005, respectively. During the first nine months of 2005, two securities were sold from the held to maturity portfolio, in accordance with the provisions of SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, due to credit deterioration with an amortized cost of \$10.0 million resulting in a realized gain of \$0.9 million. During the three and nine months ended September 30, 2005 the Company transferred debt securities due to credit deterioration from the held to maturity portfolio to the available for sale portfolio in the amount of \$7.0 million with an unrealized gain of \$0.2 million which was recorded as a component of accumulated other comprehensive income, net of deferred acquisition costs and taxes. There were no securities sold or transferred from the held to maturity portfolio during the first nine months of 2006.

#### Mortgage Loans and Real Estate

In general, the Company originates loans on high quality, income-producing properties such as shopping centers, freestanding retail stores, office buildings, industrial and sales or service facilities, selected apartment buildings,

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hotels, and healthcare facilities. The location of these loans is typically in major metropolitan areas that offer a potential for property value appreciation. Credit and default risk is minimized through strict underwriting guidelines and diversification of underlying property types and geographic locations. In addition to being secured by the property, mortgage loans with leases on the underlying property are often guaranteed by the leasee. This approach has proven to result in higher quality mortgage loans with fewer defaults.

The Company's direct investments in real estate are not a significant portion of its total investment portfolio as many of these investments were acquired through mortgage loan foreclosures. The Company also participates in several real estate joint ventures and limited partnerships that invest primarily in income-producing retail properties. These investments have enhanced the Company's overall investment portfolio returns.

The Company held net investments in mortgage loans totaling \$105.9 million and \$110.6 million at September 30, 2006 and December 31, 2005, respectively. The diversification of the portfolio by geographic region and by property type was as follows:

| Geographic Region: | September 30, 2006 |              | December 31, 2005 |              |
|--------------------|--------------------|--------------|-------------------|--------------|
|                    | Amount             | %            | Amount            | %            |
|                    | (In thousands)     |              | (In thousands)    |              |
| West South Central | \$ 69,340          | 65.5         | \$ 68,413         | 61.8         |
| Mountain           | 10,880             | 10.3         | 15,831            | 14.3         |
| Pacific            | 10,854             | 10.2         | 11,342            | 10.3         |
| South Atlantic     | 4,749              | 4.5          | 4,838             | 4.4          |
| All other          | 10,071             | 9.5          | 10,215            | 9.2          |
| Totals             | <u>\$ 105,894</u>  | <u>100.0</u> | <u>\$ 110,639</u> | <u>100.0</u> |

| Property Type: | September 30, 2006 |              | December 31, 2005 |              |
|----------------|--------------------|--------------|-------------------|--------------|
|                | Amount             | %            | Amount            | %            |
|                | (In thousands)     |              | (In thousands)    |              |
| Retail         | \$ 72,603          | 68.6         | \$ 75,545         | 68.3         |
| Office         | 23,333             | 22.0         | 24,536            | 22.2         |
| Land/Lots      | 3,263              | 3.1          | 3,725             | 3.4          |
| Hotel/Motel    | 6,687              | 6.3          | 6,797             | 6.1          |
| All other      | 8                  | -            | 36                | -            |
| Totals         | <u>\$ 105,894</u>  | <u>100.0</u> | <u>\$ 110,639</u> | <u>100.0</u> |

The Company does not recognize interest income on impaired loans which is deemed to be uncollectible. There was one loan at September 30, 2006 with interest income unrecognized in the amount of \$0.3 million. There was no unrecognized interest income at September 30, 2005. During the first quarter of 2005, an allowance was released due

to the sale of the impaired loan for which the allowance had been established. The Company holds a mortgage loan in the amount of \$6.9 million related to a New Orleans property, which is nine months past due on principal and interest payments as of the reporting date of this filing. The Company has not recorded an impairment related to this loan as of September 30, 2006, pending further review and evaluation. It is possible, though not certain, the forthcoming review could result in an impairment writedown when the evaluation is complete.

The Company's real estate investments totaled approximately \$13.2 million and \$13.4 million at September 30, 2006 and December 31, 2005, respectively, and consist primarily of income-producing properties which are being operated by a wholly-owned subsidiary of the Company. The Company monitors the condition and market values of these properties on a regular basis and makes repairs and capital improvements to keep the properties in good condition. There were no writedowns in the third quarters of 2006 or 2005 associated with these properties.

#### Market Risk

Market risk is the risk of change in market values of financial instruments due to changes in interest rates, currency exchange rates, commodity prices, or equity prices. The most significant market risk exposure for National Western is interest rate risk. The fair values of fixed income debt securities correlate to external market interest rate conditions. Because interest rates are fixed on almost all of the Company's debt securities, market values typically increase when market interest rates decline, and decrease when market interest rates rise. However, market values may fluctuate for other reasons, such as changing economic conditions or increasing event-risk concerns.

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

|   | September<br>30,<br>2006          | June 30,<br>2006 | December 31,<br>2005 |
|---|-----------------------------------|------------------|----------------------|
|   | (In thousands except percentages) |                  |                      |
| Debt securities - fair value                                  | \$ 5,320,356                      | 5,194,162        | 5,248,425            |
| Debt securities - amortized cost                              | \$ 5,363,595                      | 5,374,559        | 5,238,120            |
| Fair value as a percentage of amortized cost                  | 99.19 %                           | 96.64 %          | 100.20 %             |
| Unrealized gains (losses)                                     | \$ (43,239)                       | (180,397)        | 10,305               |
| Ten-year U.S. Treasury bond - change in yield for the quarter | (0.51) %                          | 0.29 %           |                      |

| Unrealized Gains (Losses) Balance |                             |                               |   |   |
|-----------------------------------|-----------------------------|-------------------------------|---|---|
| At<br>September<br>30,<br>2006    | At<br>June 30,<br>2006      | At<br>December<br>31,<br>2005 | Qtr<br>Change in<br>Unrealized<br>Gains<br>(Losses) | YTD<br>Change in<br>Unrealized<br>Gains<br>(Losses) |
| <u>                    </u>       | <u>                    </u> | <u>                    </u>   | <u>                    </u>                         | <u>                    </u>                         |
|                                   |                             | (In thousands)                |   |   |

|                                    |    |                        |                         |                      |                       |                        |
|------------------------------------|----|------------------------|-------------------------|----------------------|-----------------------|------------------------|
| Debt securities held to maturity   | \$ | (33,983)               | (125,425)               | (731)                | 91,442                | (33,252)               |
| Debt securities available for sale |    | <u>(9,256)</u>         | <u>(54,972)</u>         | <u>11,036</u>        | <u>45,716</u>         | <u>(20,292)</u>        |
| Totals                             | \$ | <u><u>(43,239)</u></u> | <u><u>(180,397)</u></u> | <u><u>10,305</u></u> | <u><u>137,158</u></u> | <u><u>(53,544)</u></u> |

The market interest rate of ten-year U.S. Treasury bonds decreased an additional 51 basis points from the second quarter of 2006, resulting in a reduction in the gross unrealized loss for the third quarter of 2006 in the amount of \$137.2 million on a portfolio of approximately \$5.4 billion. The increase in rates resulted in an unrealized loss balance of \$43.2 million as of September 30, 2006, a change of \$53.5 million from the year-end, 2005. However, since the majority of the Company's debt securities are classified as held to maturity, which are recorded at amortized cost, changes in fair values have relatively small effects on the Company's consolidated balance sheet.

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

The Company performed detailed sensitivity analysis as of December 31, 2005, for its interest rate-sensitive assets and liabilities. The changes in market values of the Company's debt securities in the third quarter of 2006 were reasonable given the expected range of results of this analysis.

## LIQUIDITY AND CAPITAL RESOURCES

### Liquidity

Liquidity requirements are met primarily by funds provided from operations. Premium deposits and revenues, investment income, and investment maturities are the primary sources of funds while investment purchases, policy benefits, and operating expenses are the primary uses of funds. Although the Company historically has not been put in the position of liquidating invested assets to provide cash flow, its investments consist primarily of marketable debt securities that could be readily converted to cash for liquidity needs. The Company may also borrow up to \$40 million on its bank line of credit for short-term cash needs. This line of credit was renewed through July 2009.

A primary liquidity concern for life insurers is the risk of an extraordinary level of early policyholder withdrawals. The Company includes provisions within its annuity and universal life insurance policies, such as surrender charges, that help limit and discourage early withdrawals.

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The actual amounts paid by product line in connection with surrenders and withdrawals for the three and nine months ended September 30 are noted in the table below.

|                  | Three Months Ended September<br>30, |        | Nine Months Ended September 30, |         |
|------------------|-------------------------------------|--------|---------------------------------|---------|
|                  | 2006                                | 2005   | 2006                            | 2005    |
|                  | (In thousands)                      |        |                                 |         |
| Product Line:    |                                     |        |                                 |         |
| Traditional Life | \$ 1,359                            | 1,489  | 3,416                           | 4,138   |
| Universal Life   | 7,564                               | 8,715  | 23,073                          | 23,410  |
| Annuities        | 89,585                              | 74,315 | 271,172                         | 230,421 |
| Total            | \$ 98,508                           | 84,519 | 297,661                         | 257,969 |

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

In the past, cash flows from the Company's insurance operations have been sufficient to meet current needs. Cash flows from operating activities were \$169.8 million and \$141.2 million for the nine months ended September 30, 2006 and 2005, respectively. The Company also has significant cash flows from both scheduled and unscheduled investment security maturities, redemptions, and prepayments. These cash flows totaled \$286.4 million and \$379.1 million for the nine months ended September 30, 2006 and 2005, respectively. These cash flow items could be reduced if interest rates rise and increase cash outflows. Net cash inflows from the Company's universal life and investment annuity deposit product operations totaled \$25.9 million and \$132.9 million during the nine months ended September 30, 2006 and 2005, respectively.

#### Capital Resources

The Company relies on stockholders' equity for its capital resources as there is no long-term debt outstanding and the Company does not anticipate the need for any long-term debt in the near future. As of September 30, 2006, the Company had commitments of approximately \$8.0 million which were approved by the Company's Board of Directors for the construction of a nursing home facility in Central Texas. The construction of the new facility is expected to begin in 2006.

#### OFF-BALANCE SHEET ARRANGEMENTS AND CONTRACTUAL OBLIGATIONS

It is not Company practice to enter into off-balance sheet arrangements nor is it Company policy to issue guarantees to third parties, other than in the normal course of issuing insurance contracts. Commitments related to insurance products sold are reflected as liabilities for future policy benefits. Insurance contracts guarantee certain performances by the Company.

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Insurance reserves are the means by which life insurance companies determine the liabilities that must be established to assure that future policy benefits are provided for and can be paid. These reserves are required by law and based upon standard actuarial methodologies to ensure fulfillment of commitments guaranteed to policyholders and their beneficiaries, even though the obligations may not be due for many years. Refer to Note (1) in the Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005 for a discussion of reserving methods.

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

|   |           | Payment Due by Period |                     |                |                |                      |
|---|-----------|-----------------------|---------------------|----------------|----------------|----------------------|
|   |           | Total                 | Less Than<br>1 Year | 1 - 3<br>Years | 3 - 5<br>Years | More Than<br>5 Years |
|   |           | (In thousands)        |                     |                |                |                      |
| Operating lease obligations   | \$        | 3,142                 | 817                 | 1,458          | 867            | -                    |
| Purchase obligations  |           | 14,625                | 14,625              | -              | -              | -                    |
| Life claims payable (1)   |           | 49,260                | 49,260              | -              | -              | -                    |
| Other long-term reserve liabilities reflected on the balance sheet under GAAP (2) |           | 357,901               | 68,882              | 101,258        | 54,079         | 133,682              |
| <b>Total</b>  | <b>\$</b> | <b>424,928</b>        | <b>133,584</b>      | <b>102,716</b> | <b>54,946</b>  | <b>133,682</b>       |

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

(2) Other long-term reserve liabilities includes obligations that are reported within the Company's reserve liabilities that reflect determinable payout patterns related to immediate annuities. The above amounts are undiscounted whereas the amounts included in future policy benefit liabilities are discounted in accordance with GAAP. Liabilities for future policy benefits and other policyholder liabilities of approximately \$5.2 billion as of September 30, 2006 have been excluded from the contractual obligations table. These excluded liabilities include future policy benefits relating to life insurance products, deferred annuities, and universal life products. Amounts excluded from the table are comprised of policies or contracts where (a) the Company is not currently making payments and will not make payments in the future until the occurrence of a payment triggering event, such as death or (b) the occurrence of a payment triggering event, such as a surrender of a policy or contract, which is outside of the control of the Company. The timing of these payments is not reasonably fixed and determinable. These uncertainties are considered in the Company's asset/liability management program as previously noted.

#### CHANGES IN ACCOUNTING PRINCIPLES AND CRITICAL ACCOUNTING POLICIES

##### Changes in Accounting Principles

Refer to Note 2 of the Notes to Condensed Consolidated Financial Statements.

## REGULATORY AND OTHER ISSUES

### Statutory Accounting Practices

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

### Risk-Based Capital Requirements

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

## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

## ITEM 4. CONTROLS AND PROCEDURES

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

There have been no changes in the Company's internal controls over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended September 30, 2006 that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

By letter dated May 16, 2006 addressed to the Audit Committee of National Western Life Insurance Company, the Company's independent auditors, KPMG LLP ("KPMG"), provided notice that as part of their review of the Company's condensed consolidated interim financial statements as of March 31, 2006 and for the three months ended, they noted a control deficiency they considered to be a material weakness. The control deficiency noted by KPMG

involved the Company's application of SFAS No. 123(R), *Share-Based Payments*, specifically the Company's level of technical expertise in this area, with respect to the Company's stock option plan and its recent implementation of a limited stock buy-back program.

The Company subsequently addressed KPMG's material weakness notice by obtaining additional clarification from an independent third party regarding the guidance of SFAS No. 123(R) and its application to the Company's stock option plan and limited stock buy-back program. Additional remediation procedures were implemented enhancing the Company's existing controls including oversight by the Company's Disclosure Controls and Procedures Committee corresponding to Company planned efforts relative to the implementation and application of new accounting standards.

## PART II. OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

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

### ITEM 1A. RISK FACTORS

There have been no changes relative to the risk factors disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

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

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

For the months ended August and September, 2006, the Company purchased 1,020 shares and 750 shares from option holders at an average price of \$225.50 and \$231.33, respectively. These purchased shares are reported in the Company's condensed consolidated financial statements as authorized and unissued.

### ITEM 6. EXHIBITS

#### (a) Exhibits

Exhibit 11 - Computation of Earnings Per Share (filed on page \_\_ of this report).



- Exhibit 31(a) - Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- Exhibit 31(b) - Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- Exhibit 32(a) - Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURES

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

NATIONAL WESTERN LIFE INSURANCE COMPANY  
(Registrant)

Date: November 7,  
2006  
\_\_\_\_\_

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

Date: November 7,  
2006  
\_\_\_\_\_

/S/ Brian M. Pribyl  
\_\_\_\_\_

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

/S/ Kay E. Osbourn

Date: November 7,  
2006

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Kay E. Osbourn  
Vice President,  
Controller and Assistant  
Treasurer  
(Principal Accounting Officer)