Best's Rating Report

# NATIONAL WESTERN LIFE INSURANCE COMPANY®

Denver, Colorado

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## NATIONAL WESTERN LIFE INSURANCE COMPANY

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**AMB#: 006811** **NAIC#: 66850**
**FEIN#: 84-0467208**
**Publicly Traded Corporation: National Western Life Insurance Company**
**NASDAQ: NWLI**

### BEST'S CREDIT RATING

**Best's Financial Strength Rating:** A **Outlook**: Stable
**Best's Financial Size Category:** XII

### RATING RATIONALE

**Rating Rationale:** The rating of National Western Life Insurance Company (NWL) reflects its consistently positive net operating results, increased statutory capital and surplus and consolidated stockholders' equity, strong risk-adjusted capitalization, and conservative investment portfolio with well-defined hedging strategies and effective asset/liability management (ALM). Partially offsetting these positive factors are significant exposure to interest-sensitive liabilities driven by the sales of fixed indexed annuities, and the challenges to grow its domestic ordinary life insurance segment as a result of an intense competition from large life insurers in the U.S. The rating also acknowledges the company's existing exposure to life insurance business to residents in Central and South American countries with lower sovereign creditworthiness. However, this risk is mitigated by the company's unique market position and accepting the premiums only in U.S.-dollar denominated currency.

NWL maintains a diversified business profile categorized into three primary segments: Domestic Life, International Life, and Annuities. Domestic life and annuity products are distributed through independent national marketing organizations and are heavily concentrated in fixed indexed products. International operations focus on foreign nationals in the upper socioeconomic classes in Central and South America, the Caribbean, Eastern Europe, Asia, and the Pacific Rim. NWL accepts applications from independent consultants in these regions, primarily for universal life products. Annuity premiums have declined since 2011 due to management's strategic initiative to limit annuity production in a low interest rate environment and focus on domestic life, which has grown steadily in recent years. In spite of reduced premiums, NWL reported an increase in both GAAP and statutory net operating gains and income, which have trended favorably over the last five years. NWL continues to maintain strong risk-adjusted capitalization supported by profitable operating performance, a conservative investment portfolio, and effective ALM to mitigate significant mismatch or a duration risk. In addition, the company utilizes derivative hedging instruments to mitigate exposure to market risk associated with its fixed indexed products.

Partially offsetting these positive rating factors is NWL's large exposure to interest sensitive liabilities, which resulted primarily from sizable fixed indexed annuity sales over the past five years. While the growth in fixed indexed annuity business has been supported by a fixed income investment portfolio and crediting rates actively managed to maintain adequate interest margin, the spread compression risk in the current low interest rate environment could impact the company's operating results. However, these risks are somewhat mitigated by the large portion of annuities remaining within the surrender charge period, and those with market value adjustments. A.M. Best also notes the company may be challenged to sustain new sales growth given the intense competition from larger life insurance companies with substantial financial resources and marketing depth. Furthermore, the company may be challenged to sustain its historical operating performance given the expected expense strains associated with growing its life business segments.

A.M. Best believes positive rating actions are unlikely in the near term to medium term. NWL's rating may face downward pressure if operating results deteriorate and do not meet A.M. Best's expectations, there is a material increase to interest-sensitive liabilities relative to its capital and surplus position, or risk-adjusted capitalization weakens materially due to adverse performance from investment or insurance risks.

**KEY FINANCIAL INDICATORS ($000)**

| Year | Assets | Total Capital Capital Surplus Funds | Asset Valuation Reserve | Net Premiums Written | Net Invest Income | Net Income |
|---|---|---|---|---|---|---|
| 2009 | 6,726,515 | 817,042 | 53,268 | 986,579 | 382,247 | 72,944 |
| 2010 | 7,782,948 | 878,451 | 62,047 | 1,587,591 | 387,478 | 76,954 |
| 2011 | 8,669,719 | 922,522 | 66,081 | 1,564,046 | 375,477 | 53,901 |
| 2012 | 9,164,763 | 1,004,766 | 70,764 | 1,088,001 | 444,469 | 84,473 |
| 2013 | 9,771,161 | 1,126,232 | 65,146 | 1,105,383 | 641,188 | 106,159 |

(*) Data reflected within all tables of this report has been compiled from the company-filed statutory statement.

## BUSINESS PROFILE

National Western Life Insurance Company (NWL) is a thinly-traded public stock life insurance company chartered in the state of Colorado in 1956. Controlling interest in the company is beneficially held by Robert L. Moody, the company's founder and Chairman of the Board, who holds 34% of the company's publicly-traded Class A common stock and 99% of Class B common stock. The balance of shares is distributed among approximately 4,000 stockholders. Class A common stockholders elect one-third of the Board of Directors with the remaining Board of Directors elected by the Class B common stockholders. NWL's ownership structure is considered a strength providing stability that allows management to focus on its long-term business strategies. NWL is licensed to sell life insurance and annuity products in 49 U.S. states (not licensed in New York), the District of Columbia, and four U.S. territories or possessions. NWL is also licensed in Haiti, and although not otherwise licensed, accepts applications from and issues policies to residents of various countries in Central and South America, the Caribbean, the Pacific Rim, Eastern Europe, and Asia.

In addition to its life insurance business, NWL has various non-insurance subsidiaries which have only modest impact on NWL's consolidated financial operations. The Westcap Corporation (Delaware) is a real estate management company managing various commercial real estate investments. NWL Investments, Inc. (Texas) was formed for the purpose of holding real estate investments including joint ventures. NWL Services, Inc. (Nevada) and Regent Care San Marcos Holdings (Texas) each own a nursing home in Reno, Nevada and San Marcos, Texas, respectively. NWL Financial, Inc. (Nevada) owns various non-Texas sourced investments such as preferred stock, common stock and municipal bonds. NWL Investments I, L.P. (Texas) owns various real estate joint venture interests. NWLSM, Inc. (Nevada) holds investments in municipal bonds as well as the life interest in the Libbie Shearn Moody Trust Asset.

NWL manages its life insurance businesses between domestic insurance operations (U.S.) and international insurance operations. NWL's domestic operation focuses on the middle and upper-middle income markets, writing both life and annuity products. NWL had experienced substantial growth in the domestic annuity business in recent years, while growth in its domestic ordinary life segment has just recently begun to emerge. The company remains committed in its efforts to grow the domestic life segment going forward as it works to control the growth of the annuity segment. NWL's domestic life segment markets a full array of traditional life insurance products including universal life insurance, equity indexed life, term life and whole life. Single premium universal life policies are offered as an alternative to its annuity products. In recent years, the company expanded the domestic ordinary life insurance product portfolio and added supplemental policy riders. In 2005, NWL introduced its first domestic equity indexed universal life product (EIUL). The EIUL portfolio has been a steady provider of domestic ordinary life sales over the past several years. To further augment its domestic ordinary life segment, NWL also has implemented strategies to increase its brand awareness.

NWL's domestic annuity products are sold both on a tax qualified and nonqualified basis and include flexible premium (FPDA), single premium deferred annuities (SPDAs), fixed-indexed annuities (FIAs), and single premium immediate annuities (SPIAs). The company's equity-indexed universal life products and its FIAs provide the contract holder the ability to elect an interest crediting mechanism that is linked, in part, to an outside index including the S&P 500 Composite Stock Price Index as well as several international indices. The principal driver of annuity deposits in recent years has been the strong sales of both its FIAs and traditional annuities. This growth has been aided by consumers' gravitation towards annuity products having the safety of guaranteed interest rates and protection of principal, while in the case of the FIAs, allowing for some equity market participation.

A.M. Best notes that NWL's total net premium and deposit growth in recent years has been driven primarily by strong sales of its annuities, especially its FIA products, which have been subject to industry-wide market conduct and suitability challenges. NWL's prudent product design and customer profiles, its diverse business profile and integrated risk model, including hedging programs, and active market conduct and compliance programs somewhat mitigate these concerns. Furthermore, NWL has addressed the recent changes to the NAIC's suitability model regulation for annuities and life insurance by complying with the training component of the regulation and further enhancing its internal processing procedures.

NWL markets and distributes products domestically through independent national marketing organizations (NMOs). These NMOs assist NWL in recruiting, contracting, and managing independent agents, who are compensated on a commission basis. NWL establishes minimum production requirements, and organizations that fail to meet those requirements are not retained. In recent years, NWL has reviewed its distribution, terminating non-productive relationships. NWL has selectively increased recruiting of NMOs. Many of its new marketing relationships are based on increasing life production, including contracting with groups who have expertise in the company's niche markets. The company continues to recruit additional distributors while also exploring alternative distribution channels such as partnerships with banks and broker-dealers. The company continually explores new marketing niches and continues to enhance its technology and customer services.

NWL has been committed to its international insurance operations for almost 50 years. This ongoing commitment to the international business, without interruption, is viewed as a strong competitive advantage. A.M. Best recognizes NWL's international life operation as a key contributor to both steady premium growth and earnings. Moreover, geographic spread of the international business offers diversification that helps to minimize large fluctuations arising from various economic, political, and competitive pressures that may occur from one country to another. NWL's international life operations focus on foreign nationals in upper socioeconomic classes that have substantial financial resources in Central and South America, the Caribbean, the Pacific Rim, Eastern Europe, and Asia. NWL does not have subsidiary operations outside the U.S., but accepts applications in its Austin, Texas home office for its life insurance and investment products issued. The company further minimizes risk exposure by requiring payment of premiums and benefits in U.S. dollars.

Specifically designed products offered to NWL's international clients consist of fixed indexed universal life, universal life, whole life, interest sensitive whole life, and term life. The fixed indexed universal life products have been the principal driver of new business in recent years. NWL maintains strict underwriting controls and procedures on the international business it accepts. A.M. Best notes historical claims experience, due to natural causes, has been similar to that in the U.S., principally due to the relative wealth and subsequent access to quality medical care of individuals insured. A.M. Best also notes that historical claims experience, due to unnatural causes (accident and homicide), has been somewhat higher than U.S. claims experience and the international products are priced for the extra mortality.

International applications are accepted and submitted by approximately 3,500 independent contractors, consultants, and broker-agents. Broker-agents are recruited, trained and prepared to sell life insurance through Executive General Brokers (EGBs) many of whom are second generation or have been submitting applications for life insurance to NWL for more than ten years. These EGBs have more intimate knowledge of their local market and prospective brokers. Going forward, NWL will continue to enhance its customer service to its international business through the further integration of technology and its multi-lingual home office staff. Service to its business is critical and is made more difficult due to distance and cultural differences. To better serve its international customers, NWL's website is available in English, Spanish, Russian, Portuguese and Chinese. The website provides real time policy issue status, commission information, downloading of company forms, uploading of applications and underwriting information directly into NWL's processing queues and real time access for policyholder review of their product status, values and payment history.

In 2009, NWL began a comprehensive upgrade of its information technology and administrative systems. This multi-year undertaking is estimated to cost more than $30 million. Under the banner of "NWL CONNEX" this project is comprised of five separate initiatives aimed at increasing sales growth opportunities via electronic applications, improve new business placement rates, improve the speed to market of new products, provide the ability to expand distribution systems, strengthen the relationships with producers, improve customer service, enhance financial controls and compliance capabilities, and improve productivity.

**Territory:** The company is licensed in the District of Columbia, American Samoa, Guam, Northern Mariana Islands, Puerto Rico, U.S. Virgin Islands, AL, AK, AZ, AR, CA, CO, CT, DE, FL, GA, HI, ID, IL, IN, IA, KS, KY, LA, ME, MD, MA, MI, MN, MS, MO, MT, NE, NV, NH, NJ, NM, NC, ND, OH, OK, OR, PA, RI, SC, SD, TN, TX, UT, VT, VA, WA, WV, WI and WY. The company is also licensed in the Republic of Haiti.

## OPERATING PERFORMANCE

**Operating Results:** NWL's US GAAP and Statutory net operating results have remained positive over the past several years as a result of favorable earnings trends in its international and annuity segments. Additionally, NWL has consistently recognized sizable operating gains on its excess surplus. Earnings have been negatively impacted by the company's domestic life segment due to expense strains associated with new business growth and expenses relating to continued legal proceedings. In light of the current economic environment and the risk associated with NWL's considerable amount of annuities with minimum guarantees, management has strategically taken steps to control the inflow of annuity premium. While these actions resulted in a significant decrease in annual premiums,

A.M. Best looks favorably on this decision as it mitigates some of the risks a continued low interest rate environment could have on earnings. Furthermore, the realized gains and losses from its derivative options create statutory income volatility due to mark-to-market accounting process. A.M. Best notes that the changes in option values are mostly offset by corresponding increases or decreases in the amount paid to policyholders of indexed products, although not by a corresponding amount.

## BALANCE SHEET STRENGTH

**Capitalization:** NWL has experienced significant growth in interest-sensitive liabilities over the last several years, due to growth in fixed indexed annuity deposits, which generally require significant capital to support policyholder obligations. Nevertheless, NWL maintains a strong risk-adjusted capital position given its current business and investment risks, as measured by Best's Capital Adequacy Ratio (BCAR). The company's capital base is supported by its overall profitable statutory net operating performance, a high quality fixed-income investment portfolio, strong cash flow analytics and an effective Asset-Liability Management process.

NWL's GAAP stockholders consolidated equity has been generally increasing in recent years resulting primarily from favorable investment performance and strong earnings generated primarily in its annuity and international segments. A.M. Best notes that the company has paid minimal cash dividends in recent years, as general policy is to reinvest earnings to support the financing of its new business growth initiatives.

**Liquidity:** National Western maintains a highly liquid investment portfolio, comprised primarily of publicly traded investment grade bonds. The company has no outstanding debt on the balance sheet and retains access to $40 million through a bank line of credit. NWL's liquidity is supported by the high level of annuity contracts currently inside a surrender charge period; however, a significant increase in interest rates may cause disintermediation requiring the company to quickly liquidate some investments.

**Investments:** NWL's invested assets have been increasing over the past several years impacted primarily by its domestic annuity production. The company's investment philosophy emphasizes the prudent handling of policyowners' and stockholders' funds to obtain maximum possible yield while maintaining security of principal and adequate liquidity in a measure consistent with current and long-term requirements of the company.

NWL's invested assets consist primarily of high quality, long-term fixed income securities. The company's remaining invested assets consist of common stock, direct mortgage loans, contract loans, cash balances and short-term securities, other invested assets (Schedule BA), and index options. NWL utilizes derivative call options to hedge the equity return component of the company's fixed indexed products.

**Investments - Bond Portfolio:** NWL's long-term bond portfolio is comprised almost entirely of investment grade bonds with slightly more than fifteen percent in private placements. NWL's prevailing strategy has been to purchase bonds and hold them to maturity, as it is unlikely that a security would need to be sold to cover payments of liabilities given the company's strong positive cash flow and product features discouraging withdrawal of funds. The long-term bond holdings are well-diversified among government agency issues, corporate obligations, public utility securities and U.S. Government debt. In addition to diversification, the company manages the credit quality of its investments in debt securities. Thorough credit analysis is performed on potential corporate investments including examination of a company's credit and industry outlook, financial ratios and trends, and event risks. The company does not purchase below investment grade (BIGs) securities, and the modest current exposure is a result of subsequent downgrades.

NWL's holds approximately twenty percent of its long-term bond portfolio in residential mortgage-backed structured securities (MBSs) with the majority in agency-backed structured securities. These MBSs, coupled with its large and expanding block of interest-sensitive liabilities, exposes the company to prepayment and extension risks as well as a potential asset/liability mismatch. A.M. Best believes these risks are somewhat mitigated as the majority of the mortgage-backed structured securities are in tranches that have more predictable cash flow patterns and are less sensitive to interest rate fluctuations. NWL further mitigates these risks by closely monitoring its mortgage-backed structured securities by actively managing asset/liability duration. Additionally, the interest rate risk is further mitigated by the surrender charge protection and market value adjustment (MVA) features included in new annuity contracts. The company has minimal direct exposure to the sub-prime and Alt-A residential mortgage markets in its structured securities with almost all in the higher-rated tranches and earlier vintages. The company has some exposure to European debt instruments, however these securities are not related to sovereign debt or financial institutions domiciled in the region.

**Investments - Mortgage Loans and Real Estate:** The direct mortgage loan segment consists almost entirely of commercial properties and developments, with the majority of mortgage loans concentrated with the West South Central (AR, LA, OK, TX) region of the United States. 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, hotels, and health care 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 lessee. Present performance of the portfolio is regarded as favorable with modest levels of foreclosures recorded in recent years.

## MANAGEMENT

**Officers:** Chairman of the Board and Chief Executive Officer, Robert L. Moody; President and Chief Operating Officer, Ross R. Moody; Senior Vice President and Chief Investment Officer, Patricia L. Scheuer; Senior Vice Presidents and Chief Marketing Officers, S. Christopher Johnson (Domestic Marketing), Carlos A. Martinez (International Marketing); Senior Vice President and Chief Administrative Officer, Robert Sweeney; Senior Vice President and Secretary, James P. Payne; Senior Vice President, Treasurer and Chief Financial Officer, Brian M. Pribyl; Senior Vice President and Chief Actuary, Kitty Kennedy Nelson; Senior Vice President, Charles D. Milos (Mortgage Loans and Real Estate); Vice Presidents, Fabiola A. Best (Life Underwriting), James D. Egan (Human Resources), Gary L. Fischer (Marketing), Luis V. Freire (International Marketing), Paul T. Garofoli (Marketing), Mark D. Gulas (Actuarial Services), Doris Kruse (Policy Benefits), Paul J. Martinsen (Information Technologies), R. Rega Paulson (Legal), Reynaldo Perez (Legal), Donna R. Richardson (Client Services), Larry G. Scott (Actuarial Services), Anthony J. Zagar (Marketing); Medical Director, Carlos Gray, M.D.

**Directors:** Stephen E. Glasgow, E. Douglas McLeod, Charles D. Milos, Robert L. Moody, Ross R. Moody, Russell S. Moody, Ann M. Moody, Frances A. Moody-Dahlberg, Louis E. Pauls, Jr., E. J. Pederson.

# Best's Rating Report

## Balance Sheet
### Assets ($000)

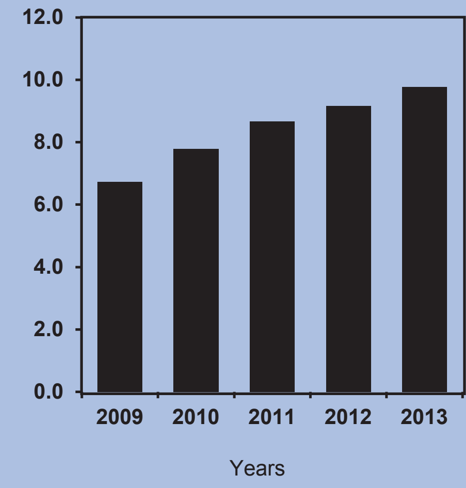
| | 12/31/2013 |
|---|---|
| Total bonds | $8,887,371 |
| Total common stocks | 278,960 |
| Mortgage loans | 98,167 |
| Real estate | 1,520 |
| Contract loans | 65,826 |
| Cash & short-term inv | 103,452 |
| Prems and consids due | 4,241 |
| Accrued invest income | 89,692 |
| Other assets | 241,932 |
| Assets | $9,771,161 |

### Liabilities ($000)

| | |
|---|---|
| Net policy reserves | $8,278,085 |
| Policy claims | 52,865 |
| Deposit type contracts | 137,195 |
| Interest maint reserve | 8,313 |
| Comm taxes expenses | 38,889 |
| Asset val reserve | 65,146 |
| Other liabilities | 64,437 |
| Total Liabilities | $8,644,929 |
| Common stock | 3,635 |
| Paid in & contrib surpl | 40,078 |
| Unassigned surplus | 1,082,519 |
| Total | $9,771,161 |

## NATIONAL WESTERN LIFE INSURANCE COMPANY

**Total Admitted Assets**




in billions
of dollars

**FINANCIAL SUMMARY ($000) as of 12/31/2013**

| | | |
|---|---|---|
| Capital & Surplus | $ | 1,126,232 |
| Net Premiums Written | $ | 1,105,383 |
| Assets | $ | 9,771,161 |
| Total Life Insurance Issued | $ | 2,802,859 |
| Total Life Insurance In Force | $ | 22,372,798 |

# Best's Rating Report

## Why is this *Best's®* *Rating Report* important to you?

A Best's Rating Report from the A.M. Best Company showcases the **opinion** from the leading provider of insurer ratings of a company's financial strength and ability to meet its obligations to policyholders, as well as its relative credit risk.

The A.M. Best Company is the oldest, most experienced rating agency in the world and has been reporting on the financial condition of the insurance companies since 1899.

A Best's Financial Strength Rating is an **independent opinion** of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations.

The Financial Strength Rating opinion addresses the relative ability of an insurer to meet its ongoing insurance policy and contract obligations. The rating is not assigned to specific insurance policies or contracts and does not address any other risk, including, but not limited to, an insurer's claims-payment policies or procedures; the ability of the insurer to dispute or deny claims payment on grounds of misrepresentation or fraud; or any specific liability contractually borne by the policy or contract holder. The rating is **not a recommendation** to purchase, hold or terminate any insurance policy, contract or any other financial obligation issued by an insurer, nor does it address the suitability of any particular policy or contract for a specific purpose or purchaser.

In arriving at a rating decision, A.M. Best relies on third-party audited financial data and/or other information provided to it. While this information is believed to be reliable, A.M. Best does not independently verify the accuracy or reliability of the information.

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