

## SUMMARY CONSOLIDATED FINANCIAL AND OTHER DATA

The following table presents our summary consolidated financial and other data for each of the years in the three-year period ended December 31, 2005 and as of December 31, 2005, 2004 and 2003. The selected consolidated financial and other data have been derived from our consolidated financial statements, which have been prepared in accordance with GAAP.

	For the Year Ended December 31,		
	2005	2004	2003
	(In thousands)		
<b>Income Statement Data</b>			
<b>Revenues:</b>			
Insurance premiums .....	\$ 354,556	\$ 378,093	\$ 411,226
Policy and contract charges.....	137,740	123,115	103,106
Net investment income.....	675,687	682,856	667,057
Net realized investment gains (losses) and change in value of trading equity securities .....	2,301	9,553	(1,095)
Mutual fund commissions, fees and other income .....	123,492	114,176	100,482
<b>Total revenues</b> .....	<b>1,293,776</b>	<b>1,307,793</b>	<b>1,280,776</b>
<b>Benefits and expenses:</b>			
Increase in policy liabilities.....	84,467	63,590	168,105
Policy benefits.....	363,414	416,125	329,674
Policyholders' dividends and dividend obligations .....	116,103	115,008	126,774
Interest credited to policyholder account liabilities .....	230,819	256,892	244,551
Operating expenses .....	177,230	173,914	173,827
Interest expense on debt.....	20,465	17,148	12,134
Sales practice remediation benefit and early retirement of debt and other financing.....	974	987	(1,979)
Policy acquisition expenses and amortization of present value of future profits, net .....	166,774	147,816	142,916
<b>Total benefits and expenses</b> .....	<b>1,160,246</b>	<b>1,191,480</b>	<b>1,196,002</b>
Income tax expense.....	34,834	27,995	6,619
Minority interest in consolidated subsidiaries.....	1,237	944	769
Cumulative effect of accounting changes, net.....	-	1,350	-
<b>Net income</b> .....	<b>\$ 97,459</b>	<b>\$ 86,024</b>	<b>\$ 77,386</b>

A reconciliation of net income to pre-tax operating income is as follows:

	For the Year Ended December 31,		
	2005	2004	2003
	(In thousands)		
<b>Income Statement Data (continued)</b>			
Net income .....	\$ 97,459	\$ 86,024	\$ 77,386
Net realized investment (gains) losses, net of related policy acquisition expense, policyholder dividend obligation and income tax effects .....	(1,786)	(5,053)	1,711
Adjustments to reverse the effect of: Sales practice remediation benefit and early retirement of debt, net of related income taxes.....	974	642	(1,286)
Income tax expense on operations .....	33,991	25,620	6,848
Minority interest in consolidated subsidiaries .....	1,237	944	769
Cumulative effect of accounting change, net of related income taxes .....	-	1,350	-
<b>Pre-tax operating income</b> .....	<b>\$ 131,875</b>	<b>\$ 109,527</b>	<b>\$ 85,428</b>

	As of December 31,		
	2005	2004	2003
	(In thousands)		
<b>Balance Sheet Data</b>			
Total cash and investments .....	\$11,826,799	\$10,837,088	\$10,243,122
Other general account assets .....	1,367,992	1,179,714	1,129,237
Separate account assets .....	840,125	779,591	659,604
Total assets.....	<u>\$14,034,916</u>	<u>\$12,796,393</u>	<u>\$12,031,963</u>
Total liabilities and minority interest in consolidated subsidiaries .....	<u>\$12,776,944</u>	<u>\$11,569,329</u>	<u>\$10,909,821</u>
Common stock, additional paid-in capital and retained earnings .....	\$ 1,228,285	\$ 1,130,826	\$ 1,044,802
Accumulated other comprehensive income .....	29,687	96,238	77,340
Total equity .....	<u>\$ 1,257,972</u>	<u>\$ 1,227,064</u>	<u>\$ 1,122,142</u>

	As of December 31,		
	2005	2004	2003
	(In thousands)		
<b>Other Selected Data</b>			
Life insurance in force (before reinsurance ceded) .....	\$52,926,644	\$51,149,410	\$49,244,736
Assets under management:			
Life insurance account values .....	\$ 4,920,026	\$ 4,808,575	\$ 4,711,581
Annuity account values .....	5,748,911	5,144,169	4,464,181
Separate account and other liabilities .....	2,108,007	1,616,585	1,734,059
Total equity.....	1,257,972	1,227,064	1,122,142
Mutual funds and client managed assets .....	4,296,760	4,434,746	4,146,400
Total assets under management .....	<u>\$18,331,676</u>	<u>\$17,231,139</u>	<u>\$16,178,363</u>

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion provides an assessment of the consolidated financial position and results of operations of NLV Financial Corporation (NLVF). This discussion and analysis is based on, should be read in conjunction with, and is qualified in its entirety by reference to, our consolidated financial statements as of December 31, 2005 and 2004 and for each of the years in the three-year period ended December 31, 2005, which have been audited by PricewaterhouseCoopers LLP. Our consolidated financial statements have been prepared in accordance with Generally Accepted Accounting Principles (GAAP).

### Overview

Through our flagship subsidiary, National Life Insurance Company, chartered in 1848, our other principal insurance subsidiary, Life Insurance Company of the Southwest ("Life of the Southwest"), acquired between 1996 and 1999, and Sentinel Asset Management, Inc. ("Sentinel"), we develop, market, issue and service a diversified portfolio of life insurance and annuity products, as well as mutual funds. Our life and annuity portfolios include participating whole life, traditional and equity indexed universal life, term life, variable universal life and survivorship life insurance, flexible and single premium fixed (traditional and equity indexed) and variable deferred annuities. Sentinel provides investment advisory and administrative services to The Sentinel Group Funds, Inc. which include a variety of mutual funds including growth, capital preservation, income, international and fixed income products. We market our diverse product portfolio to individuals, families, small business owners, professionals and other middle to upper income customers. We provide financial solutions in the form of estate, business succession and retirement planning; deferred compensation and other key executive benefit plans; and asset management.

In 1999, National Life reorganized from a mutual to a stock insurance company as part of a reorganization into a mutual insurance holding company structure in order, among other things, to compete more effectively, have a more flexible and cost-effective capital structure and be part of an enterprise which is better positioned to make strategic acquisitions as compared with remaining a mutual insurance company. Concurrent with the reorganization into a mutual insurance holding company structure, National Life created a Closed Block of insurance and annuity policies to provide reasonable assurance to owners of policies in the Closed Block that assets will be available to provide for the continuation of dividend payments following the reorganization. Mutual Holding, a Vermont mutual insurance holding company, owns 100% of the outstanding common stock of NLVF, an intermediate stock insurance holding company incorporated under the laws of Delaware. NLVF owns 100% of the outstanding common stock of National Life, Sentinel, and other subsidiaries.

As of December 31, 2005, we had \$18.3 billion of assets under management and served in excess of 630,000 customers. Of these totals, about \$12 billion was attributable to life insurance and annuity account values under management with more than 485,000 policy and contract holders. Approximately \$4.5 billion was attributable to mutual fund and client managed assets representing more than 230,000 customers. The remainder is attributable to our corporate segment, including fair value adjustments for our investment portfolio, our disability income business, and Company sponsored pension plans.

### Distribution

We market and distribute our products throughout the United States through four principal channels: NL Financial Alliance; Life Event Advantage; Independent Agents – 403(b) and Sentinel Asset Management.

- **NL Financial Alliance:** NL Financial Alliance, our career agency channel, consists of approximately 700 full-time agents who specialize in selling our products to professionals, business owners and other affluent individuals for financial and business planning purposes. This channel also markets personal trust and custody services.
- **Life Event Advantage:** Our Life Event Advantage channel consists of approximately 3,700 independent agents who offer our life insurance, annuity and mutual fund products to middle income customers for purposes of providing for the financial consequences of specific life events, such as death, retirement, college funding, disability and chronic or long term illness.

- **Independent Agents – 403(b):** Our Independent Agent - 403(b) channel consists of approximately 3,500 independent agents who sell life insurance and annuity products, with an emphasis on the 403(b) qualified tax deferred retirement savings market for individuals employed by public schools.
- **Sentinel Asset Management:** Our Sentinel Asset Management channel consists of independent broker/dealers who sell Sentinel mutual funds and variable annuity products along with providing investment management services to institutional and private clients in addition to our life insurance subsidiaries.

### **Basis of Presentation and Principles of Consolidation**

The accompanying consolidated financial statements of NLVF have been prepared in conformity with GAAP. All significant intercompany transactions and balances have been eliminated in consolidation. Certain reclassifications have been made to conform prior periods to the current year's presentation.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

### **Results of Consolidated Operations**

#### ***Year Ended December 31, 2005 Compared to Year Ended December 31, 2004***

Overall business growth, solid investment results, and favorable mortality resulted in strong income growth in 2005 compared to 2004. Pre-tax operating income increased \$22.3 million, or 20%, to \$131.9 million in 2005 from \$109.5 million in 2004. Net income increased \$11.4 million, or 13%, to \$97.5 million in 2005 from \$86.0 million in 2004. The increase in net income was primarily due to growth in pre-tax operating income.

#### *Insurance Premiums*

Insurance premiums include premiums from whole life insurance, term life insurance, disability income insurance and immediate annuity policies. Total insurance premiums for 2005 decreased \$23.5 million, or 6%, to \$354.6 million from \$378.1 million in 2004. The decrease over the period is due primarily to several large policies reaching paid up status in 2004 and a decline in insurance sales as the company decided not to aggressively compete with no lapse guarantee products or offer stranger or investor-owned life insurance.

#### *Policy and Contract Charges*

Policy and contract charges for universal life, variable universal life and annuity policies consist of costs of insurance, expense loads, surrender charges, and other related fees. Policy and contract charges increased \$14.6 million, or 12%, to \$137.7 million in 2005 from \$123.1 million in 2004. The increase over the period reflects sales and growth of universal life insurance in force generated primarily from our NL Financial Alliance and Life Event Advantage distribution channels.

#### *Net Investment Income*

Net investment income includes revenues from our general account assets and changes in the values of S&P 500 Index option contracts that hedge the liabilities of our equity indexed annuity business. Net investment income decreased \$7.2 million, or 1%, to \$675.7 million in 2005 from \$682.9 million in 2004. The decrease is primarily due to less of an increase in option values related to the hedging of our equity indexed annuity liabilities, mostly offset by growth in assets related to increased customer deposits and account values. Net Investment Income excluding changes in option values was \$672.3 million in 2005, an increase of \$35.6 million, or 5.6%, from \$636.7 million in 2004.

#### *Net Realized Investment Gains (Losses) and Change in Value of Trading Equity Securities*

Net realized investment gains (losses) and change in value of trading equity securities were gains of \$2.3 million in 2005 compared to gains of \$9.6 million in 2004. Net realized investment gains in 2005 and 2004 consisted primarily of gains in our corporate bond, equity and real estate portfolios.

### *Mutual Fund Commissions, Fees and Other Income*

Mutual fund commissions consist of dealer concessions earned by our affiliated broker/dealers, Equity Services, Inc. and Sentinel Financial Services Company. Mutual fund fees consist primarily of asset management fees earned by our affiliated investment advisors, Sentinel Advisors Company and Sentinel Asset Management, Inc., formerly National Life Capital Management, Inc. Other income primarily consists of expense allowances provided under a reinsurance agreement with UNUM Life Insurance Company of America (“UNUM Life of America”) and changes in the market value of assets held in corporate owned life insurance policies in which we have invested.

Revenues from mutual fund commissions, fees and other income increased \$9.3 million, or 8%, to \$123.5 million in 2005 as compared with \$114.2 million in 2004. The increase was primarily the result of an increase in mutual fund commissions and fee income of \$5.1 million, or 5%, to \$100.5 million in 2005 from \$95.4 million in 2004 due to an increase in the sales of non-proprietary mutual fund and other security products. Another contributor to the increase was greater appreciation in the market value of assets held in our corporate owned life insurance policies in 2005 as compared with 2004.

### *Increase in Policy Liabilities*

Policy liabilities consist primarily of reserves for life insurance, disability income insurance and certain annuities. Policy liabilities increased \$84.5 million in 2005 as compared with an increase of \$63.6 million in 2004. The increase in policy liabilities expense was the result of business growth primarily in the participating life insurance business.

### *Policy Benefits*

Policy benefits include death benefits for life insurance policies, policy surrenders for whole life policies and disability income benefits. In addition, policy benefits include a small amount of miscellaneous benefits such as payments on life-contingent immediate annuities and premium waiver benefits due to disability. Policy benefits decreased \$52.7 million, or 13%, to \$363.4 million in 2005 as compared with \$416.1 million in 2004. The decrease in policy benefits for 2005 compared to 2004 was primarily due to less surrender benefits paid, as 2004 was impacted by the payout of a few longer-term policies with significant surrender values. Death benefits rose modestly in absolute terms in 2005, but declined as a percentage of inforce.

### *Policyholders' Dividends and Dividend Obligations*

Policyholders' dividends consist of the pro rata amount of dividends earned that will be paid or credited at the next policy anniversary and Policyholder Dividend Obligations (PDOs) arising from the Closed Block. Dividends are based on a scale that seeks to reflect the relative contribution of each group of policies to our overall operating results. The dividend scale is approved annually by National Life's Board of Directors. The total policyholder dividend expense increased \$1.1 million, or 1%, to \$116.1 million in 2005 compared to \$115.0 million in 2004. These amounts include both dividends accrued and paid to policyholders of \$116.5 million in 2005 and \$120.8 million in 2004. The decrease in policyholders' dividends paid for 2005 compared to 2004 resulted mainly from a reduction in the dividend scale, partially offset by increases in the account values of in force policies upon which dividends are primarily paid. Actual experience of the Closed Block was slightly worse than projected in 2005, giving rise to a decrease of \$0.4 million in PDO during 2005. This decrease was due to lower investment returns partially offset by favorable mortality as compared to 2004.

### *Interest Credited to Policyholder Account Liabilities*

Interest credited to policyholder account liabilities consists of interest for universal life insurance, fixed deferred annuities and equity indexed annuities. Interest credited decreased \$26.1 million, or 10%, to \$230.8 million in 2005 from \$256.9 million in 2004. The decrease was primarily due to less growth in the S&P 500 Index resulting in lower credits to equity indexed annuity policyholder account values, partially offset by growth in policyholder account values. While credited interest rates have declined steadily over the last few years in line with market interest rates and investment yields, our sales of universal life, fixed (traditional and equity indexed) annuities have resulted in increased account values upon which interest is credited.

### *Operating Expenses*

Operating expenses consist primarily of administrative and maintenance expenses related to servicing the business and overhead needs of our operations. Expenses directly related to the acquisition of new business, including commissions paid on new insurance and annuity policies, are included in policy acquisition expenses and are deferred and amortized in relation to estimated gross profits of the business. Operating expenses increased \$3.3 million, or 2%, to \$177.2 million in 2005 from \$173.9 million in 2004. The increase in operating expenses is primarily attributable to expansion of our mutual fund distribution and agency restructurings, mostly offset by improved operational efficiency, diligent expense management, and enhanced information technology performance resulting from the information technology arrangement commenced in January 2004 with Keane, Inc., an independent technology company with worldwide operations.

### *Interest Expense on Debt*

Interest expense on debt consists of interest paid on NLVF's \$20 million of Trust Preferred Securities and \$275 million of Senior Notes due 2033 (\$200 million) and 2035 (\$75 million). Interest expense on debt totaled \$20.5 million in 2005 compared to \$17.1 million in 2004. The increase was primarily due to the issuance in March 2005 of an additional \$75 million of Senior Notes due 2035.

### *Sales Practice Remediation Benefit and Early Retirement of Debt*

The sales remediation benefit and debt retirement charge are non-recurring items that are not an ongoing part of our business. The sales remediation benefit and debt retirement charge resulted in an aggregate charge of \$(1.0) million in 2005 essentially equal to 2004. In 2005, the charge was due to redeeming preferred stock in connection with the Company's legal entity restructuring to align with its strategy while increasing financial flexibility and reducing costs. Included in this amount for 2004 was a change in sales practice remediation provision, which was a benefit of \$2.4 million in 2004. The change was the result of continuing progress related to National Life's settlement of class action lawsuits brought against it in 1997 related to the sale of certain life insurance policies during the 1980s and 1990s. This item also includes a charge of \$3.4 million in 2004 for original issue costs and discount expensed in connection with the early retirement of our surplus notes in March 2004 (\$62.8 million).

### *Policy Acquisition Expenses and Amortization of Present Value of Future Profits, Net*

Policy acquisition expenses include commissions and other costs of acquiring business that vary with and are primarily attributable to the production of new business. Policy acquisition expenses are net of amounts deferred and include the amortization of amounts previously deferred. Policy acquisition expenses increased \$19.0 million, or 13%, to \$166.8 million in 2005 as compared with \$147.8 million in 2004 primarily due to the amortization of \$11 million for the remaining deferred acquisition cost asset related to our discontinued disability income block of business.

### *Income Tax Expense*

Federal income tax expense of \$34.8 million and \$28.0 million for 2005 and 2004, respectively, was recorded with an effective tax rate of 26.1% for 2005 as compared to an effective rate of 24% for 2004. The effective tax rate for 2005 was higher than that for 2004 primarily due to higher pretax income in 2005. For both periods, our effective tax rate is less than our nominal income tax rate of 35% due to credits generated from our investment in qualified affordable housing projects and other permanent differences.

### *Minority Interest in Consolidated Subsidiaries*

Minority interest in consolidated subsidiaries represents the portion of net income or loss of our consolidated partnerships allocated to minority shareholders. The minority interest in consolidated subsidiaries was \$1.2 million in 2005, substantially unchanged from \$0.9 million in 2004. On December 30, 2005, the company acquired the sole minority interest (4%) in the Sentinel partnerships from the Penn Mutual Life Insurance Company.

### *Cumulative Effect of Accounting Change, Net*

There were no accounting changes in 2005 creating a cumulative effect. In July 2004, the Accounting Standards Executive Committee issued SoP 03-01, "Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts". SoP 03-01 provides guidance on accounting and reporting by

insurance enterprises for certain nontraditional long-duration contracts and for separate accounts. It also provides guidance on accounting for guaranteed minimum death benefits and for determining the classification of reinsurance contracts as either primarily investment or insurance at inception. Pursuant to the adoption of SoP 03-01, the company recorded in 2004 an after-tax cumulative effect of \$(1.4) million, which consisted of sales inducement assets of \$1.9 million, offset by \$4.0 million of sales inducement liabilities on various annuity products and income tax effects of \$0.7 million.

### ***Recent Developments***

The company announced on December 12, 2005, the preliminary agreement to acquire substantially all of the assets of Bramwell Capital Management, Inc. The purchase is subject to board and regulatory approvals and is expected to close by the end of March 2006.

### ***Year Ended December 31, 2004 Compared to Year Ended December 31, 2003***

Overall revenue growth, solid investment results and diligent expense management resulted in strong income growth in 2004 compared to 2003. Pre-tax operating income increased \$24.1 million, or 28%, to \$109.5 million in 2004 from \$85.4 million in 2003. Net income increased \$8.6 million, or 11%, to \$86.0 million in 2004 from \$77.4 million in 2003. The increase in net income was primarily due to growth in pre-tax operating income and realized investment gains. The \$9.6 million net realized investment gain and change in value of trading equity securities in 2004 was \$10.7 million more favorable than the \$1.1 million net realized investment loss and change in value of trading equity securities in 2003.

### ***Insurance Premiums***

Insurance premiums include premiums from whole life insurance, term life insurance, disability income insurance and immediate annuity policies. Total insurance premiums for 2004 decreased \$33.1 million, or 8%, to \$378.1 million from \$411.2 million in 2003. The decrease over the period is due primarily to a decline in single premium life insurance sales as the company withdrew a product due to the low interest rate environment.

### ***Policy and Contract Charges***

Policy and contract charges for universal life, variable universal life and annuity policies consist of costs of insurance, expense loads, surrender charges, and other related fees. Policy and contract charges increased \$20.0 million, or 19%, to \$123.1 million in 2004 from \$103.1 million in 2003. The increase over the period reflects increased sales and growth of universal life insurance in force generated primarily from our NL Financial Alliance and Life Event Advantage distribution channels.

### ***Net Investment Income***

Net investment income includes revenues from our general account assets and changes in the values of S&P 500 Index option contracts that hedge the liabilities of our equity indexed annuity business. Net investment income increased \$15.8 million, or 2%, to \$682.9 million in 2004 from \$667.1 million in 2003. The increase is primarily due to growth in assets related to increased customer deposits and account values, partially offset by lower new money yields in our investment portfolio due to the decline in interest rates over the period and less of an increase in option values related to the hedging of our equity indexed annuity liabilities.

### ***Net Realized Investment Gains (Losses) and Change in Value of Trading Equity Securities***

Net realized investment gains (losses) and change in value of trading equity securities were gains of \$9.6 million in 2004 compared to losses of \$1.1 million in 2003. Net realized investment gains in 2004 consisted primarily of gains in our corporate bond, equity and real estate portfolios. Net realized investment losses in 2003 resulted primarily from credit-related losses in the corporate bond portfolio.

### ***Mutual Fund Commissions, Fees and Other Income***

Mutual fund commissions consist of dealer concessions earned by our affiliated broker/dealers, Equity Services, Inc. and Sentinel Financial Services Company. Mutual fund fees consist primarily of asset management fees earned by our affiliated investment advisors, Sentinel Advisors Company and National Life Capital Management Company (NLCM). Other income primarily consists of expense allowances provided under a reinsurance agreement with UNUM

Life of America and changes in the market value of assets held in corporate owned life insurance policies in which we have invested.

Revenues from mutual fund commissions, fees and other income increased \$13.7 million, or 14%, to \$114.2 million in 2004 as compared with \$100.5 million in 2003. The increase was primarily the result of an increase in mutual fund commissions and fee income of \$23.5 million, or 33%, to \$95.4 million in 2004 from \$71.9 million in 2003 due to strong net mutual fund sales and an increase in the market value of mutual fund assets. The increase was partially offset by less appreciation in the market value of assets held in our corporate owned life insurance policies in 2004 as compared with 2003.

#### *Increase in Policy Liabilities*

Policy liabilities consist primarily of reserves for life insurance, disability income insurance and certain annuities. Policy liabilities increased \$63.6 million in 2004 as compared with an increase of \$168.1 million in 2003. The increase in policy liabilities expense was the result of business growth primarily in the participating life insurance business. The difference in the policy liability increase year-over-year was primarily due to surrenders of a few longer-term policies with significant cash surrender values.

#### *Policy Benefits*

Policy benefits include death benefits for life insurance policies, policy surrenders for whole life policies and disability income benefits. In addition, policy benefits include a small amount of miscellaneous benefits such as payments on life-contingent immediate annuities and premium waiver benefits due to disability. Policy benefits increased \$86.4 million, or 26%, to \$416.1 million in 2004 as compared with \$329.7 million in 2003. The increase in policy benefits for 2004 compared to 2003 was primarily due to higher surrender benefits paid, including the payout of a few longer-term policies with significant surrender values.

#### *Policyholders' Dividends and Dividend Obligations*

Policyholders' dividends consist of the pro rata amount of dividends earned that will be paid or credited at the next policy anniversary and PDOs arising from the Closed Block. Dividends are based on a scale that seeks to reflect the relative contribution of each group of policies to our overall operating results. The dividend scale is approved annually by National Life's Board of Directors. The total policyholder dividend expense decreased \$11.8 million, or 9%, to \$115.0 million in 2004 compared to \$126.8 million in 2003. These amounts include both dividends accrued and paid to policyholders of \$120.8 million in 2004 and \$120.6 million in 2003, partially offset by a reduction in dividends accrued relating to the Closed Block in connection with the PDO totaling \$5.8 million in 2004, as compared to an increase in the dividend accrual of \$6.2 million in 2003. The increase in policyholders' dividends paid for 2004 compared to 2003 resulted mainly from increases in the account values of in force policies upon which dividends are primarily paid. Actual experience of the Closed Block was slightly worse than projected in 2004, giving rise to the decrease in PDO during 2004. This decrease was due to lower investment returns partially offset by favorable mortality as compared to 2003.

#### *Interest Credited to Policyholder Account Liabilities*

Interest credited to policyholder account liabilities consists of interest for universal life insurance, fixed deferred annuities and equity indexed annuities. Interest credited increased \$12.3 million, or 5%, to \$256.9 million in 2004 from \$244.6 million in 2003. The increase was primarily due to growth in policyholder account values and growth in the S&P 500 Index resulting in credits to equity indexed annuity policyholder account values. While credited interest rates have declined steadily over the last few years in line with market interest rates and investment yields, our strong sales of universal life, fixed deferred and equity indexed annuities have resulted in increased account values upon which interest is credited.

#### *Operating Expenses*

Operating expenses consist primarily of administrative and maintenance expenses related to servicing the business and overhead needs of our operations. Expenses directly related to the acquisition of new business, including commissions paid on new insurance and annuity policies, are included in policy acquisition expenses and are deferred and amortized in relation to estimated gross profits of the business. Operating expenses increased \$0.1 million to \$173.9 million in 2004 from \$173.8 million in 2003.

### *Interest Expense on Debt*

Interest expense on debt consists of interest paid on NLVF's \$20 million of Trust Preferred Securities and \$200 million of Senior Notes due 2033. Interest expense on debt totaled \$17.1 million in 2004 compared to \$12.1 million in 2003. The increase was due to the issuance of the Trust Preferred Securities in May 2003 and Senior Notes due 2033 in August 2003. Partially offsetting the increase was less interest expense due to the March 2004 repurchase of our \$62.8 million remaining outstanding Surplus Notes (the company repurchased \$7.0 million of the Surplus Notes in September 2003).

### *Sales Practice Remediation Benefit and Early Retirement of Debt*

The sales remediation benefit and Surplus Notes retirement charge are non-recurring items that are not an ongoing part of our business. The sales remediation benefit and surplus note retirement charge resulted in an aggregate charge of \$(1.0) million in 2004 compared to an aggregate benefit of \$2.4 million in 2003. Included in this amount was a change in sales practice remediation provision, which was a benefit of \$2.8 million in each of 2004 and 2003. The change was the result of continuing progress related to National Life's settlement of class action lawsuits brought against it in 1997 related to the sale of certain life insurance policies during the 1980s and 1990s. This item also includes a charge of \$3.4 million in 2004 and \$0.4 million in 2003 for original issue costs and discount expensed in connection with the early retirement of our surplus notes in September 2003 (\$7 million) and March 2004 (\$62.8 million).

### *Policy Acquisition Expenses and Amortization of Present Value of Future Profits, Net*

Policy acquisition expenses include commissions and other costs of acquiring business that vary with and are primarily attributable to the production of new business. Policy acquisition expenses are net of amounts deferred and include the amortization of amounts previously deferred. During 2003, we began deferring certain acquisition expenses that previously were not material, but have grown in significance due to overall business growth. Policy acquisition expenses increased \$4.9 million, or 10%, to \$147.8 million in 2004 as compared with \$142.9 million in 2003 primarily due to overall business growth and continued profit growth in the equity indexed annuity line of business, which resulted in accelerated amortization of policy acquisition expenses during 2004.

### *Income Tax Expense*

Federal income tax expense of \$28.0 million and \$6.6 million for 2004 and 2003, respectively, was recorded with an effective tax rate of 24% for 2004 as compared to an effective rate of 8% for 2003. The effective tax rate for 2004 was higher than that for 2003 primarily due to higher pretax income in 2004 and the net effect of favorable settlements with the U.S. Internal Revenue Service ("IRS") that transpired in 2003. For both periods, our effective tax rate is less than our nominal income tax rate of 35% due to credits generated from our investment in qualified affordable housing projects and other permanent differences.

### *Minority Interest in Consolidated Subsidiaries*

Minority interest in consolidated subsidiaries represents the portion of net income or loss of our consolidated partnerships allocated to minority shareholders. The minority interest in consolidated subsidiaries was \$0.9 million in 2004, substantially unchanged from \$0.8 million in 2003.

### *Cumulative Effect of Accounting Changes*

As disclosed in the notes to the consolidated financial statements, the company adopted certain new accounting pronouncements in 2004 and 2005. The effect of these pronouncements are included in the company's results of operations and financial position as appropriate.