

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, 2006 and as of December 31, 2006, 2005 and 2004. 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,		
	2006	2005	2004
	(In thousands)		
Income Statement Data			
Revenues:			
Insurance premiums	\$ 336,007	\$ 347,547	\$ 375,546
Policy and contract charges	156,950	145,845	131,189
Net investment income	791,015	675,893	682,871
Net realized investment gains and change in value of trading equity securities	2,660	2,301	9,553
Mutual fund commissions, fees and other income	124,482	120,696	106,190
Total revenues	1,411,114	1,292,282	1,305,349
Benefits and expenses:			
Increase in policy liabilities	81,783	84,465	63,588
Policy benefits	351,767	354,498	407,670
Policyholders' dividends and dividend obligations	122,308	116,103	115,008
Interest credited to policyholder account liabilities	334,600	232,731	262,801
Operating expenses	168,351	153,050	150,228
Interest expense on debt	21,975	20,465	17,148
Sales practice remediation benefit and early retirement of debt and other financing	–	974	987
Policy acquisition expenses and amortization of present value of future profits, net	179,549	195,649	171,896
Total benefits and expenses	1,260,333	1,157,935	1,189,326
Income tax expense	40,237	35,651	27,705
Minority interest in consolidated subsidiaries	(103)	1,237	944
Cumulative effect of accounting changes, net	–	–	1,350
Net income	\$ 110,647	\$ 97,459	\$ 86,024

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

	For the Year Ended December 31,		
	2006	2005	2004
	(In thousands)		
Income Statement Data (continued)			
Net income	\$ 110,647	\$ 97,459	\$ 86,024
Net realized investment gains, net of related policy acquisition expense, policyholder dividend obligation and income tax effects	(4,590)	(1,785)	(5,053)
Adjustments to reverse the effect of:			
Sales practice remediation benefit and early retirement of debt, net of related income taxes.....	–	974	642
Income tax expense on operations	37,767	34,808	25,910
Minority interest in consolidated subsidiaries	(103)	1,237	944
Cumulative effect of accounting change, net of related income taxes	–	–	1,350
Pre-tax operating income.....	\$ 143,721	\$ 132,693	\$ 109,817

	As of December 31,		
	2006	2005	2004
	(In thousands)		
Balance Sheet Data			
Total cash and investments	\$12,605,518	\$11,832,403	\$10,837,088
Other general account assets	1,427,359	1,346,781	1,179,714
Separate account assets	941,376	840,125	779,591
Total assets.....	<u>\$14,974,253</u>	<u>\$14,019,309</u>	<u>\$12,796,393</u>
Total liabilities and minority interest in consolidated subsidiaries	<u>\$13,611,205</u>	<u>\$12,761,337</u>	<u>\$11,569,329</u>
Common stock, additional paid-in capital and retained earnings	\$ 1,338,932	\$ 1,228,285	\$ 1,130,826
Accumulated other comprehensive income	24,116	29,687	96,238
Total equity	<u>\$ 1,363,048</u>	<u>\$ 1,257,972</u>	<u>\$ 1,227,064</u>

	As of December 31,		
	2006	2005	2004
	(In thousands)		
Other Selected Data			
Life insurance in force (before reinsurance ceded)	\$54,858,299	\$52,926,644	\$51,149,410
Assets under management:			
NL Financial Alliance	\$ 2,892,700	\$ 3,099,400	\$ 2,960,900
Independent Producers Alliance.....	5,402,000	4,724,100	4,082,000
Independent Financial Alliance.....	254,400	198,900	167,900
Sentinel Asset Management	4,252,200	4,150,000	4,289,200
Corporate and Other	6,498,600	6,158,500	5,731,200
Total assets under management	<u>\$19,299,900</u>	<u>\$18,330,900</u>	<u>\$17,231,200</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, 2006 and 2005 and for each of the years in the three-year period ended December 31, 2006, which have been audited by PricewaterhouseCoopers LLP. Our consolidated financial statements have been prepared in accordance with Generally Accepted Accounting Principles (GAAP) in the United States of America.

Overview

We offer a broad range of financial products and services, including life insurance, annuities, mutual funds, and investment advisory and administrative services. Life insurance and annuity products are offered through National Life Insurance Company (National Life), our flagship company chartered in 1848, and Life Insurance Company of the Southwest. Our life and annuity portfolios include participating whole life, traditional and indexed universal life, term life, variable universal life and survivorship life insurance, flexible and single premium fixed annuities (traditional and indexed) and variable deferred annuities. Sentinel Asset Management, Inc. (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. 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. National Life Holding Company, 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.

During 2006, we sold our subsidiary, American Guaranty and Trust Company (AG&T), to an unrelated party. We also sold our interest in a consolidated real estate partnership to an entity controlled by the minority partner of the partnership.

As of December 31, 2006, we had \$19.3 billion of assets under management and served in excess of 700,000 customers. Of these totals, about \$9 billion was attributable to life insurance and annuity account values under management with more than 500,000 policy and contract holders. Approximately \$4 billion was attributable to mutual fund and client managed assets representing more than 225,000 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; Independent Financial Alliance; Independent Producers Alliance, 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.

- ***Independent Producers Alliance:*** Our Independent Producers Alliance 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.
- ***Independent Financial Alliance:*** Our Independent Financial Alliance 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.
- ***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, 2006 Compared to Year Ended December 31, 2005

Overall business growth and solid investment results resulted in strong income growth in 2006 compared to 2005. Pre-tax operating income increased \$11.0 million, or 8%, to \$143.7 million in 2006 from \$132.7 million in 2005. Net income increased \$13.1 million, or 13%, to \$110.6 million in 2006 from \$97.5 million in 2005. The increase in net income was primarily due to growth in pre-tax operating income and a favorable settlement of the tax audit for years 2002 and 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 2006 decreased \$11.5 million, or 3%, to \$336.0 million from \$347.5 million in 2005. The decrease over the period is due primarily to several large policies surrendering during the year from the company's Closed Block, partially offset by growth in sales.

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 \$11.2 million, or 8%, to \$157.0 million in 2006 from \$145.8 million in 2005. The increase over the period reflects sales and growth of universal life insurance in force generated primarily from our NL Financial Alliance and Independent Financial Alliance 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 indexed annuity business. Net investment income increased \$115.1 million, or 17%, to \$791.0 million in 2006 from \$675.9 million in 2005. The increase is primarily due to an increase in option values and income received related to the hedging of our indexed annuity liabilities, coupled with growth in assets related to increased customer deposits and account values. Net Investment Income excluding the change in option values was \$713.7 million in 2006, an increase of \$41.2 million, or 6%, from \$672.5 million in 2005.

Net Realized Investment Gains and Change in Value of Trading Equity Securities

Net realized investment gains and change in value of trading equity securities were \$2.7 million in 2006 compared to \$2.3 million in 2005. Net realized investment gains in 2006 and 2005 consisted primarily of gains in our equity and real estate portfolios and our gain on the sale of AG&T partially offset by losses on our 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 Sentinel Asset 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 \$3.8 million, or 3%, to \$124.5 million in 2006 as compared with \$120.7 million in 2005. The increase was primarily the result of an increase in mutual fund commissions and fee income of \$2.8 million, or 3%, to \$105.9 million in 2006 from \$103.1 million in 2005 due to an increase in the sales of non-proprietary mutual fund and other security products. The other primary contributor to the increase was receipt of proceeds from one death from our corporate owned life insurance policies in 2006.

Increase in Policy Liabilities

Policy liabilities consist primarily of reserves for life insurance, disability income insurance and certain annuities. Policy liabilities increased \$81.8 million in 2006 as compared with an increase of \$84.5 million in 2005. 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 \$2.7 million, or 1%, to \$351.8 million in 2006 as compared with \$354.5 million in 2005. The decrease in policy benefits for 2006 compared to 2005 was primarily due to less surrender benefits paid, as 2005 was impacted by the payout of a few longer-term policies with significant surrender values. Death benefits rose modestly in absolute terms in 2006, 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 scales are approved annually by National Life’s Board of Directors. The total policyholder dividend expense increased \$6.2 million, or 5%, to \$122.3 million in 2006 compared to \$116.1 million in 2005. These amounts include both dividends accrued and paid to policyholders of \$111.5 million in 2006 and \$116.5 million in 2005. The decrease in policyholders’ dividends paid for 2006 compared to 2005 resulted mainly from a reduction in the Closed Block 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 better than projected in 2006, giving rise to an increase of \$10.8 million in PDO during 2006. This increase was due to favorable mortality partially offset by lower investment returns as compared to 2005.

Interest Credited to Policyholder Account Liabilities

Interest credited to policyholder account liabilities consists of interest for universal life insurance, fixed deferred annuities and indexed annuities. Interest credited increased \$101.9 million, or 44%, to \$334.6 million in 2006 from \$232.7 million in 2005. The increase was primarily due to growth in the S&P 500 Index resulting in higher credits to indexed annuity policyholder account values, coupled with 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, and fixed annuities (traditional and indexed) 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 \$15.3 million, or 10%, to \$168.4 million in 2006 from \$153.1 million in 2005. The increase in operating expenses is primarily attributable to expansion of our distribution, agency restructurings, increased regulatory related expenses, and funding our charitable foundation, which also reduced our effective tax rate, partially offset by improved operational efficiency.

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 \$22.0 million in 2006 compared to \$20.5 million in 2005. The increase was due to the rise in the three-month Libor rate the Trust Preferred interest expense is tied to. In the fourth quarter of 2006, the floating rate obligation was swapped to a fixed rate.

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 no charge in 2006 compared to a charge of \$1.0 million in 2005. 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.

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 decreased \$16.1 million, or 8%, to \$179.5 million in 2006 as compared with \$195.6 million in 2005 primarily due to 2005 including the amortization of \$11 million for the remaining deferred acquisition cost asset related to our discontinued disability income block of business. Also, the deferral policy was reviewed and standardized in 2006 to provide consistency throughout the company resulting in an additional \$3.8 million of underwriting and issuance cost deferrals in 2006.

Income Tax Expense

Federal income tax expense of \$40.2 million and \$35.7 million for 2006 and 2005, respectively, was recorded with an effective tax rate of 26.7% for 2006 as compared to an effective rate of 26.5% for 2005. The effective tax rate for 2006 was higher than that for 2005 primarily due to higher pretax income in 2006. 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 a credit of (\$0.1) million in 2006, compared to a charge of \$1.2 million in 2005. During 2006, the company sold its two remaining entities which had minority interests. On December 30, 2005, the company acquired the sole minority interest (4%) in the Sentinel partnerships from the Penn Mutual Life Insurance Company.

Recent Developments

The company announced on December 14, 2006, the preliminary agreement with Synovus regarding the reorganization of the Synovus Funds involving \$475 million in assets under management. The reorganization is subject to shareholder approval and other contingencies. The reorganization is expected to occur by the end of March 2007.

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 \$22.9 million, or 21%, to \$132.7 million in 2005 from \$109.8 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 \$28.0 million, or 7%, to \$347.5 million from \$375.5 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 11%, to \$145.8 million in 2005 from \$131.2 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 \$7.0 million, or 1%, to \$675.9 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 \$672.5 million in 2005, an increase of \$35.6 million, or 5.6%, from \$636.9 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 \$14.5 million, or 14%, to \$120.7 million in 2005 as compared with \$106.2 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 \$53.2 million, or 13%, to \$354.5 million in 2005 as compared with \$407.7 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 \$30.1 million, or 11%, to \$232.7 million in 2005 from \$262.8 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 \$2.9 million, or 2%, to \$153.1 million in 2005 from \$150.2 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 \$23.7 million, or 14%, to \$195.6 million in 2005 as compared with \$171.9 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 \$35.7 million and \$27.7 million for 2005 and 2004, respectively, was recorded with an effective tax rate of 26.5% 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.