# Lincoln National Corporation's (LNC) CEO Dennis Glass on Q3 2019 Results - Earnings Call Transcript

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Q3: 10-30-19 Earnings Summary

*Press Release* *10-Q* *Slides*

EPS of $-0.25 misses by $-2.66 | Revenue of $4.7B (7.75% Y/Y) beats by $234.23M

## Earning Call Audio

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Lincoln National Corporation (NYSE:LNC) Q3 2019 Results Earnings Conference Call
October 31, 2019 10:00 AM ET

**Company Participants**

Chris Giovanni - Corporate Treasurer

Dennis Glass - President & Chief Executive Officer

Randy Freitag - EVP, Chief Financial Officer & Head of Individual Life

**Conference Call Participants**

Ryan Krueger - KBW

Alex Scott - Goldman Sachs

Thomas Gallagher - Evercore ISI

Erik Bass - Autonomous Research

Suneet Kamath - Citi

John Barnidge - Sandler O'Neill

Elyse Greenspan - Wells Fargo

John Nadel - UBS

Joshua Shanker - Deutsche Bank

**Operator**

Good morning and thank you for joining Lincoln Financial Group's Third Quarter 2019 Earnings Conference Call. At this time, all lines are in listen-only mode. Later, we will announce the opportunity for questions and instructions will be given at that time. [Operator Instructions]

Now, I would like to turn the conference over to the Corporate Treasurer, Chris Giovanni. Please go ahead sir.

**Chris Giovanni**

Thank you, Kathryn. Good morning and welcome to Lincoln Financial's third quarter earnings call. Before we begin, I have an important reminder. Any comments made during the call regarding future expectations, trends and market conditions, including comments about sales and deposits, expenses, income from operations, share repurchases, liquidity, and capital resources are forward-looking statements under the Private Securities Litigation Reform Act of 1995.

These forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from current expectations. These risks and uncertainties include those described in the cautionary statement disclosures in our earnings release issued yesterday, as well as those detailed in our 2018 Annual Report on Form 10-K, most recently most recent quarterly report on Form 10-Q, and from time-to-time in our other filings with the SEC. These forward-looking statements are made only as of today and we undertake no obligation to update or revise any of them to reflect events or circumstances that occur after this date.

We appreciate your participation today and invite you to visit Lincoln's website www.lincolnfinancial.com, where you can find our press release and statistical supplement which include a full reconciliation to the non-GAAP measures used in the call, including adjusted return on equity and adjusted income from operations or adjusted operating income to their most comparable GAAP measures.

Presenting on today's call are Dennis Glass, President and Chief Executive Officer; and Randy Freitag, Chief Financial Officer and Head of Individual Life. After their prepared remarks, we will move to the question-and-answer portion of the call.

I would now like to turn the call over to Dennis.

**Dennis Glass**

Thank you, Chris. Good morning everyone. Third quarter earnings were disappointing, but I am confident that our strategies and management actions are driving and are going to continue to drive earnings growth. I also want to emphasize that our franchise and business model have the strength to deal with low interest rates, a headwind, facing us and the industry.

First, on the quarter's negative operating earnings results there were three primary impacts. Number one, our annual review included a significant charge with a component related to interest rates. While our interest rate assumptions were already more conservative than most competitors, we still followed a rigorous process and made appropriate changes.

Number two, alternatives meaningfully underperformed as we wrote down a large private equity holding. This is an investment we've owned for many years. The third impact was quarterly fluctuations we see from time to time. Randy will cover each of these in more detail shortly.

Turning to the ongoing strength of the franchise, we continue to benefit from actions taken by management to accelerate growth, diversify sales, achieve appropriate returns, and tactically tilt our sales mix towards shorter duration products which are less sensitive to interest rates. These actions helped drive double-digit sales growth in annuities, life insurance, in group protection and along with the Liberty acquisition resulted in 84% of our total sales coming from products without long-term guarantees up 20 percentage points compared to five years ago.

We are also successfully executing on our digital program and diligently managing expenses which were down 3% compared to the prior year quarter. Net savings from our digital program should begin to ramp up next year and along with further Liberty integration savings provide a tailwind to earnings in the medium term.

Lastly, our diversified and attractive business mix enables us to consistently generate a significant amount of cash flow which we are both investing in growth and returning to shareholders. Our active share buyback program led to an 8% decrease in shares outstanding compared to the prior year and last night we announced an 8% increase in the quarterly common stock dividend.

Now turning to the business segments starting with Annuities. Our decision to broaden the product portfolio and participate in more segments of the market enabled us to meet different customer needs, sustain our growth and maintain a diversified sales mix even while we are adjusting pricing and product features in response to lower interest rates.

Total sales increased 12% compared to the prior year quarter and net flows were positive for the fourth consecutive quarter. Consistent with our strategy, we have shifted our sales mix as five years ago over 70% of our sales are variable annuities with living benefit guarantees compared to this quarter where sales were evenly balanced among VAs with living benefit guarantees, VAs with outliving benefit guarantees and fixed annuities.

Expanding shelf space and adding new producers resulted in significant momentum in indexed variable annuity sales. This led to a 54% increase in sales of BAs without living benefit guarantees which improves our long-term risk profile. We are also expanding shelf space and increasing wholesalers in fixed annuities which resulted in 15% sales growth including significant gains in independent marketing organizations where we launched customized products for two large distribution partners last year.

So another quarter of strong momentum for the Annuities business as growing metrics are clearly benefiting from our broad set of consumer solutions and our multichannel distribution model, where both client facing headcount and total producers are up 12% over the prior year quarter. When combined with disciplined pricing, appropriate assumptions, and an industry-leading hedge program, we are well positioned to deliver strong results even if consumer preferences and capital markets shift.

In Retirement Plan Services, our high touch, high-tech digitally focused model plays a competitive advantage in our target markets. This differentiated service model continues to improve the experience of both plan sponsors and employees driving higher participation and contribution rates and benefiting retention. As a result, recurring deposits increased 12% over the prior year quarter with double-digit growth in both the small and mid to large markets and net flows remain positive.

Total deposits decreased as the prior quarter benefited from a previously disclosed sale of $1 billion healthcare plan. The sales pipeline is strong as we enter the fourth quarter with YourPath, our proprietary alternative to target the funds and another great example of product innovation at Lincoln, which is a true differentiator in the marketplace.

Additionally, we've seen opportunity to expand YourPath adoption across our in-force block proving incremental growth. Overall, it was a solid quarter for retirement business highlighted by another quarter of [indiscernible] inflows and healthy bottom line growth.

Turning to Life Insurance, strategically we have and are repositioning the light portfolio towards products with both meet consumer needs drive profitable growth. In the quarter individual life sales increased 26% demonstrating the life business franchise strength by shifting and growing at the same time. Total sales grew 40% because we had a large executive benefits case in the quarter.

Our sales are benefiting from further penetrating the IUL market which is a large and fast-growing industry segment where we are taking market share. Term sales are growing as we make significant process improvements and adjust prices more agilely. We are also maintaining our leadership position in the VUL and hybrid markets.

The ability to grown and do product sales is in part accomplished through our industry leading distribution platform. Our client facing headcount is nearly 300 employees and up 8% over the prior year quarter. We are in every major life distribution channel and over the past two years over 66,000 independent producers have sold a Lincoln life insurance product.

This vast network of distribution partners has helped us position our sales mix. We are now two-thirds of our sales are not meaningfully effective by the level of interest rates. Our manufacturing capabilities have created diverse byproduct portfolio where no product represents more than 30% of total life sales and this broad based strength has enabled us to maintain aggregate returns above targets.

Nonetheless we are making additional pricing changes where needed to reflect low interest rates. While Life insurance earnings were most affected by our annual assumption review, the business remains well position moving forward with a proven record of disciplined growth and financial management which has enabled us to overcome headwinds facing the industry.

Turning to Group Protection, benefits from the Liberty acquisition and successful integration, will once again demonstrate at this quarter as sales were robust, premiums grew and after tax margins remained strong. Our national competitive environment has enabled us to effectively execute strategic objectives and maximize the competitive advantages created by the acquisition.

This includes leveraging our larger book of business and expanding capabilities to cross-sell additional lines of coverage and further penetrate the employee paid markets. These strategies contribute to 53% growth in sales compared to the prior quarter with employee paid sales increasing at a faster rate than employer paid.

The 5000+ market historical strength of Liberty is seeing growth reemerge as distribution partners gained confidence and our post integration service and execution, while the 1000 to 5000 mid-market segment is benefiting from the best of both companies. The group business had another strong quarter and we are optimistic that we will continue to achieve attractive margins.

Shifting to investment results, we invested new money into the pretax yield of 3.7%, 190 basis points over the average 10-year treasury. Additionally, as the credit cycle extends we have continued to focus on managing credit risk, more intensively, by derisking in sectors and securities that have greater risk of credit deterioration under a stress scenario and further diversifying the portfolio.

We have decreased our overall exposure to corporate credit, particularly in the energy and consumer cyclical sectors, while increasing our exposure to infrastructure, consumer non-cyclical and high quality loan-to-value commercial mortgage loans. The portfolio of credit quality is in great shape with below investment grade assets representing less than 4% of total assets and BBB minus rated securities decreasing by more than 100 basis points from prior year quarter.

As I noted up front we had a write-down of a large private equity holding. Our commitment to this single investment was $11 million and over the following five years the value increased $138 million, before being marked down this quarter to $24 million. Over this period the alternatives portfolio achieved a 9% pretax return including this write down.

I would note this particular investment was a uniquely concentrated position within an otherwise highly diversified private equipment portfolio, which includes 255 limited partnerships with an average size of less than $7 million and no other single investment with a carrying value greater than $36 million. Overall we continue to like construction and diversification of the alternatives portfolio and believe our long-term annual return target of 10% remains achievable.

Before closing, let me briefly comment on the current interest rate environment. As we have noted in the past, there are three areas of potential impacts from low rates. One, new business returns. Two, spread compression and three the balance sheet. First on new business returns. We have benefited from the actions mentioned earlier by selling more products without long-term guarantees and that are less impacted by low interest rates.

Nevertheless, we have been taking a proactive approach by reviewing all our product features and pricing to make sure we maintain a disciplined balance between customer value, growth, risk and returns. We are comfortable selling where we are today given our product mix combined with pricing actions we have taken or expect to take. We will continue to reprice when necessary to achieve appropriate returns on the capital we invest in growth.

Next on spread compression, previously we anticipated 2% to 3% headwind to EPS growth from interest rates and to see that debate over time. Given the current interest rate environment we expect to be at the upper end of that range as spread compression is persisting longer than we had originally anticipated. However, it is important to recognize that this level of spread compression is consistent with recent years and the benefit from our diverse business model has enabled us to grow EPS and generate a steady percentage of earnings from capital market sensitive businesses.

Third, on the balance sheet while the impact from unlocking was larger than usual this year, I would note that book value per share excluding AOCI still increased 5% compared to the prior year quarter and the charge was non-cash. We continue to expect minimal impacts on statutory capital from asset adequacy testing unless the 10-year treasury rate is persistently in the 1% range and even then we expect manageable impacts.

So while this quarter's results included significant negative impacts, we continue to successfully execute on key strategic initiatives that position Lincoln to sustain our track record of excellent financial performance and create long-term value for shareholders.

I will now turn the call over to Randy.

**Randy Freitag**

Thank you, Dennis. Last night we reported a third quarter adjusted operating loss of $46 million or $0.25 per share. As we noted in the earnings release, this year's annual review of DAC and reserve assumptions resulted in a charge of $403 million or $2 per share. Included in this was $291 million from interest rates of which $139 million came from the impact of the significant drop in rates on the starting point.

Additionally, we lowered our long-term ultimate interest rate assumption to 3.5% and extended our gradient period to seven years, which resulted in a $152 million negative impact. Based on our review of industry surveys, we remain on the conservative side with respect to interest rate assumptions and continue to follow our normal process of prudently responding to changes in the capital markets and appropriately reflecting our experience across our assumptions.

Outside of interest rates there was a $112 million net unfavorable impact with mortality updates and higher reassurance cost coming in negative, partially offset by several adjustments, including modifications to policyholder behavior assumptions and other items. As part of this year's review we did not unlock to the coming quarter which still provides an approximate $135 million after-tax cushion against declines in the equity markets.

In addition to the significant impacts from the annual assumption review, there were a few other items that resulted in some large variability this quarter including negative returns in the alternatives portfolio primarily from the write-down Dennis mentioned, reduced adjusted operating earnings by $94 million or $0.47 per share relative to expectations. And quarterly fluctuations in individual life mortality relative to our annual expectations along with a higher group loss ratio reduced adjusted operating earnings by $42 million or $0.21 per share.

We are normalizing for unlocking alternatives and quarterly fluctuations and implies an EPS of approximately $2.40 and gives you a much better indication of our earnings power.

Moving to the performance of key financial metrics, we're normalizing for notable items and alternatives underperformance, strong sales, net flows and equity market strength resulted in all four businesses showing operating revenue growth over the prior year quarter. G&A expenses net of months capitalized decrease 3% year-over-year and when combined with revenue growth, the expense ratio improved 60 basis points.

Moving to the balance sheet, capital ratios are solid. We have significant cash at the holding company and strong capital generation is enabling us to both invest in growth and return capital to shareholders.

Before shifting to segment results, our net loss in the quarter was $161 million. This included a $33 million charge from an early tender for debt and acquisition and integration costs of $31 million. The hedge program performed well during a period of heightened market volatility, with $22 million of net losses and the general account performed well as credit losses were negligible.

Now turning to the second results starting with annuities, reported operating income for the quarter was $169 million which included a $93 million unfavorable impact from our annual review primarily related to interest rates. Adjusting for notable items in both periods, this quarter's alternatives underperformance of $10 million and our Marco [ph] reinsurance transaction earnings decreased slightly.

Return metrics excluding notable items and alternatives, underperformance remained strong with ROA at 81 basis points and a ROE of 22% average account values of $134 million increased 2% excluding the reentrance transaction driven by positive net flows and equity market gains. Risk metrics remained solid as net amount of risk sits just about 1% of a comp value for living benefits and 0.5% for debt benefits.

So annuities results were a bit noiser than usual this quarter, but underlying trends were solid as net flows remained positive and year-over-year earnings growth should reemerge following the year of a theme related impacts.

In Retirement Plan Services, we reported operating income of $44 million up from $40 million in the prior year quarter driven by great expense management. Net flows totaled $272 million in the quarter which when combined with favorable equity markets and further organic growth drove average account values to $74 billion up 4%. A 3% decrease in G&A net of a month's capitalized combined with revenue growth resulted in a 100 basis point year-over-year improvement in the expense ratio.

Base spreads excluding veritable investment income compressed six basis points versus the prior year quarter and ROA came in at 24 basis points. The retirement business had a strong quarter with organic growth and expense discipline remaining key drivers going forward.

Turning to life insurance, the annual assumption review and this year's – and this quarter's alternatives underperformance have the greatest impact on the life business as we reported an operating loss of $245 million. In total, the net assumption changes reduced operating earnings by $320 million including $225 million from interest rates. As noted earlier, there were several other unlocking adjustments that had a net unfavorable impact of $95 million in the life segment.

Additionally, $69 million of alternative investment underperformance impacted the life business. Adjusting for notable items and this quarter's alternatives underperformance our operating earnings were $144 million compared to $196 million in the prior year quarter. The decline was related to $29 million in unfavorable mortality relative to our annual expectations in the current quarter compared to $22 million of favorable mortality in the prior year quarter.

Underlying drivers were solid with average life insurance in-force up 8% over the prior year quarter and average account values increasing 4%, both of which helped drive a 3% increase in operating revenues excluding the impacts from unlocking and the underperformance and alternatives.

Base spreads, excluding variable investment income compressed six basis points when adjusting for an unfavorable impact in the prior year quarter. So a challenging earnings quarter for the life business, however key growth drivers remain solid, positioning us nicely moving forward.

Group Protection reported operating income of $61 million compared to $63 million in the prior-year quarter, with this quarter's alternatives underperformance reducing earnings by $7 million. The loss ratio in the quarter was 74.1%, up 50 basis points year-over-year and sequentially as a higher underlying loss ratio was partially offset by favorable reserve review impacts.

G&A expenses decreased 7% as we continue to benefit from integration synergies, which resulted in a 120 basis point improvement in the expense ratio compared to the prior-year quarter. Overall, business trends remained positive, which resulted in an after-tax margin of 6%. Favorable impacts from expense savings and pricing discipline should enable us to sustain attractive margins.

Turning to capital and capital management. Statutory surplus stands at $9.4 billion and our RBC ratio ended the quarter at approximately 425%. Holding company cash came in at $765 million, ahead of our $450 million target as we pre-funded a $300 million debt maturity due in February 2020 to take advantage of attractive rates. During the quarter, we returned $224 million of capital to shareholders, included $150 million of share buybacks.

To conclude, third quarter earnings were definitely noisier than usual with significant impacts from our annual assumption review, underperformance of alternatives and other quarterly fluctuations. Looking through those items, we continue to see strong underlying earnings.

While the impact from this year's annual review was larger than previous years, driven by a prudent change to our long-term interest rate assumption, this is a non-cash charge, does not impact our RBC ratio and leaves our balance sheet well positioned for low interest rates.

I would also note that over the past five years, we have grown book value per share excluding AOCI by nearly 40%, including a 5% increase this year to $69.33. Importantly, this quarter's results had several positives, including double-digit sales growth in three of our four businesses, revenue growth in all four businesses when adjusting for unlocking and the underperformance of alternatives, continued discipline around managing costs, SG&A expenses declined compared to the prior year and all of our businesses continued to demonstrate strong core earnings power after adjusting for the items previously mentioned.

With that, let me turn the call back over to Chris.

**Chris Giovanni**

Thank you, Dennis and Randy.

We will now begin the question-and-answer portion of the call. As a reminder, we ask that you please limit yourself to one question and only one follow-up and then re-queue for additional questions. And with that, let me turn it back over to the operator.

## Question-and-Answer Session

**Operator**

Thank you. [Operator Instructions] And our first question comes from Ryan Krueger with KBW. Your line is open.

**Ryan Krueger**

Hi, thanks, good morning. Randy, do you expect much ongoing impact from the actuarial assumption review to future earnings?

**Randy Freitag**

Hey Ryan. As I've said in prior unlockings, I'd expect a bit of a headwind from these changes. But when I sit down, I take a look at analyst expectations for the next quarter. I don't see much of an overall impact. I think there are a couple of items that I'd point out as we move into 2020, outside of that impact. First, as we mentioned, the decline in rates has moved spread compression up a little bit. So we have been traveling in the 2% range and I think we're up towards 3%.

So if you do the math, that's approximately $20 million. And the other thing I'd point out is that resolutions that we've had with some major reinsurance partners this year, I think would imply a headwind of a similar magnitude, but I also point out that we've been having these exact sorts of impacts over the past five years or six years and we are going to work hard to overcome them with things like the digital program. So, I don't see much other than the items I mentioned, Ryan.

**Ryan Krueger**

Got it, thanks. And then just higher level, clearly had a number of things go against you this quarter. It sounded like I think in your prepared remarks, you sounded like you were pointing to $2.40 is still a pretty good run rate going forward. Just wanted to confirm if that's kind of your intention to suggest that's a better run rate going forward past this quarter?

**Randy Freitag**

Ryan, absolutely. So I said approximately $2.40 in my script. We've noted that the earnings themselves reported were $0.25 negative, but the three specific items we mentioned, which were the unlocking, which was $2 per share, which was the alternatives underperformance primarily in that one security was $0.47. So if you add those two items to what we reported, you would get to $2.22.

The other items we mentioned were the individual life mortality. That was $29 million. Then also mentioned that the group business itself had a bit of a tick up, a little bit of a tick up in their loss ratios and that was in the range of $13 million or so. I also noted that, that was offset by a favorable reserve review impact, but so if you take the $29 million and $13 million, that would be another $0.20 or $0.21 or so.

So, if you add those items together, you'd get up to the approximate $2.40 that I mentioned and exactly consistent with sort of what we expect coming out of the quarter.

**Ryan Krueger**

Great. Thanks, Randy.

**Randy Freitag**

You bet.

**Operator**

Thank you. And our next question comes from Alex Scott with Goldman Sachs. Your line is open.

**Alex Scott**

Hi, good morning. I guess my first question is just on corporate expenses. I mean, it looks like it's running at a higher level and I know part of that is just pre-funding maturity next year, but I'd just be interested to hear where you expect that to run, I mean how much will that benefit from some of the things you're doing on the efficiency side as we think about next year?

**Randy Freitag**

Hey, Alex. Thanks for the question. Let me just speak to corporate or other operations in total. I'd say that this quarter had a few negatives that primarily were on the benefits line. I think if you look in there, we've seen some seasonality in benefits in other operations segment typically in the third quarter.

So I think there were some negatives, maybe in the mid-single digit range, but I'd point out that if you looked at across for instance in retirement, I think they had some small positives that probably from a total standpoint sort of offset each other. So Other Operations segment did have a little bit of a negative tinge this quarter, but I think that was offset by some other items across other businesses.

**Alex Scott**

Got it. And them a follow up I had was just with the stock trading where it is. Is there anything strategically you guys can do to take advantage of the situation, the valuation, the environment or is the macro where it is and rates as low as they are, I mean, does that kind of prevent you from acting?

**Dennis Glass**

Alex, it's Dennis. Our intention is to continue to review all options that would result an increase in the growth rate of earnings per share. I think the lower interest rates make that a little bit more difficult today, but there is a flow of ideas that are coming through, nothing that is imminent. So the answer is interest rates make it tougher, but we continue to review all opportunities, both from a normal growth perspective and the occasional unique item to grow EPS,

**Randy Freitag**

Alex, I'd also point out that it's just if you look at this year, we've been able to fund substantial growth in sales, in life and annuities while at the same time continuing to return capital to shareholders. I think year-to-date, we're at about $765 million of capital return, $540 million of that in buyback. So not only have we been able to fund the strong sales growth we've seen, but we've been able to continue to return capital to shareholders and obviously, that's our goal, to continue to fund organic growth while at the same time in a disciplined manner returning capital to shareholders.

**Alex Scott**

Thank you.

**Operator**

Thank you. And our next question comes from Tom Gallagher with Evercore ISI. Your line is open.

**Thomas Gallagher**

Good morning. Can you discuss, Randy, can you talk a little bit about what the underlying drivers were on the mortality and reinsurance pricing side? The reason I ask is, I'm just wondering have you reflected the rate that's been pushed through by the reinsurers currently, or are you assuming further rate increases or put through just - and I'm saying that just because you've obviously had adverse mortality in three of the last four quarters now.

So I just want to know whether, I don't know there is some, there is some level of assumed, we'll call it, adversity that's embedded in this review, whether it's reinsurance cost to your own mortality or whether you're assuming that, that normalizes or reverts back to like normal trend?

**Randy Freitag**

Tom, I think there are a couple of questions inside there. So let me hopefully tackle all of them. On the other impacts, and as we mentioned, the other impacts outside of interest rates totaled $112 million and $95 million of that was in the Life business. I will make a few comments on some of the components.

So as we do every year, we obviously analyzed mortality, that's one of the big components. And what we found was there is a small slice of business where mortality rates are at the older stages. We're a little out of wax, we brought them in line with the rest rates are at the older stages. We're a little out of wax, we brought them in line with the rest of the book and that drove one of the negative impacts I referenced.

On the reinsurance side, really look at this as the completion of what has been a six-year process, which saw us back in 2014, put estimates in our models that reinsurance rates would go up. In 2019, we completed negotiations with most of our major reinsurance partners and really have good clarity on the few remaining pieces.

So I believe that this puts that issue largely behind us. On the favorable side, modifications to policyholder, behavior assumptions, investment allocations and some of the other items, I think this is just the nature of assumptions, things emerge, you see more experience, it's going to lead to some pluses. It's going to lead to some minuses, and hopefully over time they equal out. This year, unfortunately they were on the negative side.

But once again over time and we've actually seen this, they have tended to even out. I think I looked at this recently over the last decade and looked at de-unlockings by with all the pieces. And outside of interest rates, what you see is that over the last decade, all of the other items I really summed to a very small positive number actually, which speaks to our goal. We know when we price a product, we're not going to get every single assumption right.

We try to make sure that we do a prudent job of coming up with some best estimates and then hope over time that the totality of those assumptions will equal at least from a financial standpoint, the impacts, the numbers you have been, you are pricing, and that's what we've seen over a longer period of time. Not to diminish the $112 million negative impact that we have this quarter.

I think you also inside your question had a comment or a question about, you know, the last few quarters and it's a fact that in three of the last four quarters, we've had a negative or unfavorable mortality, but I think inside of there, Tom, I think that's a bit of cherry picking because it's also a fact that if you look at the last eight quarters that I can say that five of the last eight quarters have had favorable mortality and that's what we expect, all right. So we retain more insurance these days over the last five years or six years, we have done some more captures.

So we expect that we're going to have more quarterly volatility, but once again, over time we expect that mortality will come in line with our expectations. That's what we've seen over the last couple of years, that's what we've seen over the last decade and that's what we would expect going forward.

**Thomas Gallagher**

That was helpful, Randy. And from what Dennis mentioned on impacts and I think you reiterated that point, it sounds like there is not much of a statutory impact expected based on low rates, but what about a consequence of this charge? Is there any, should we think about any reduction in stat earnings because I think at least the comments I heard, it seemed more be directed at the balance sheet, I'm just curious whether you would expect there to be any impact to statutory earnings or cash flow?

**Randy Freitag**

Not going forward, Tom. I mean I think for this quarter obviously the alternatives that flows through statutory earnings and this quarter's unfavorable mortality would flow to this quarter's earnings but not going forward, I don't see an impact.

And as a reminder, on our statutory asset adequacy and testing, Dennis mentioned this, we really don't see negative impacts until that 10-year treasury using that as a proxy, gets down to the 1% range where we see roughly $350 million of asset adequacy reserves required, 50 basis points on the tenure goes to about $700 million. Those aren't small numbers, but those are manageable numbers in the context of a company with $9.4 billion of statutory surplus.

**Thomas Gallagher**

Got it. All right, thank you.

**Randy Freitag**

You bet.

**Operator**

Thank you. And our next question comes from Erik Bass with Autonomous Research. Your line is open.

**Erik Bass**

Hi, thank you. Starting with the group business, you mentioned a little bit of softness in terms of the claims experienced this quarter. I was just hoping you can give a little bit more color there on what drove that?

**Randy Freitag**

Yes. So inside the group, which had $61 million of reported earnings, you had a favorable impact from the reserve review this year of about $10 million and then offsetting that you had slightly elevated loss ratios in the quarter and that was pretty much evenly split between life and disability, and in both cases, it was driven by severity. So life claims came in a little higher than our average expectation and the average reserve we put up on new LTD claims came in a little higher than our expectations.

**Erik Bass**

Got it. Thank you. And then on the interest rate assumption change, I realized you moved more than just the kind of long-term rate assumption, but you kind of put in context the change this quarter versus the guidance you had given, I think at Investor Day of $160 million impact for a 50 basis points change.

**Randy Freitag**

Yes, Erik, I'll take that. So the guidance we've given, which has really been focused on a change in that ultimate rate assumption has been $160 million per 50 basis points. This quarter, we reduced that assumption by 25 basis points and we saw pretty much exactly half of that $160 million. I think it came in at actually at $74 million.

Additionally, you have heard us reference in the past, maybe it was a couple of years ago, referenced the fact that at least from a financial impact standpoint, we saw that five years of grade was roughly the equivalent of 50 basis points cut and that, once again, that's what we saw, we extended our grade from five to seven and we saw roughly that impact came in at $78 million.

So you sum those up, $152 million, I think of what we did this year has been pretty much economically or financially equivalent to a 50 basis point reduction in the ultimate rate. So when they some up to 25 basis point reduction and the extension of the grade I think about it has been pretty much equivalent from financial standpoint to a 50 basis point reduction.

**Erik Bass**

Got it. And then the remainder is just truing up for actual versus expected rates over the past year?

**Randy Freitag**

Yes, and this isn't a number, which has been in our results every year, just at a much lower level, but we've never seen year-over-year, the kind of underperformance we had this year to help you understand this quarter. Third quarter we invested due money at $370 million. But there was deceleration as you were moving throughout the quarter.

And so the rate we embedded at the starting point was actually lower than the $370 million that came in overall the books of business on average at about $350 million. As a reminder, last year in the third quarter, we were investing money at $430 million at that time. And of course that number in our model would have been grading up over time.

So that can give you a sense of the magnitude of the drop in the starting point that drove that $139 million impact.

**Erik Bass**

Got it. Thank you. That's helpful.

**Operator**

Thank you. And our next question comes from Suneet Kamath with Citi. Your line is open.

**Suneet Kamath**

Thanks, good morning. I wanted to start with RPS, earlier this week, there was some chatter in the media about some reviews of the 403(b) business, in particular, the K-12 business. So just curious, how big of business is that for you guys within the RPS segment?

**Dennis Glass**

Yeah, this is Dennis. It's about10% of assets, 4% of annual deposits. So it's not very big for us.

**Suneet Kamath**

Got it. And then I guess maybe high level for Dennis. As you think about the current interest rate environment and assuming that we don't really see any material changes from here, how are you balancing this trade-off between kind of growth at the product level and then using some of the freed capital for, if you don't grow for share repurchases?

**Dennis Glass**

That's a big question and a good question - a big question and a good question. As I've said in my script, we have to balance maintaining the strength of the franchise, getting the appropriate returns on capital, repricing where necessary and using capital both to grow the business, protect the franchise and then use what's left over to buy back shares, increase the dividend.

So it's always a balancing act. I can tell you without question that if we aren't getting the returns on products that are appropriate for our model, we will slow those product sales down and use the freed up capital to buy our shares back, and we've been doing that on and off over the years successfully. So very much a daily decision about where we can get the best return on capital, not a daily decision, but an ongoing decision.

**Suneet Kamath**

Okay, thanks Dennis.

**Operator**

Thank you. And our next question comes from John Barnidge with Sandler O'Neill. Your line is open.

**John Barnidge**

Thanks. Can you talk about the strong growth in Group sales and maybe how much of this was new distribution partners versus maybe brokers taking you out of the penalty box and your expectations going forward?

**Dennis Glass**

Sort of all of the above. We saw a good growth in our life business, good growth in disability, but a little bit less growth or actually negative at dental. And so it's across the spectrum. As I mentioned in my remarks, we're seeing a little success in large case market which is getting us out of the penalty box. As I mentioned, the employee paid market were up quite a bit, 45%, that's cross selling more into the Liberty block where they had not as much emphasis on employee paid sales.

Within the book, we're seeing a lot of upselling with existing customers, I think that was up pretty significantly. The upselling with significant customers is if a client has just used us for LTD and they ship over to, say, adding the lifeline. So there's all of these specific issues, but it's the overall strength of the portfolio and bringing - the overall strength of the two companies and using that to increase in sales.

**John Barnidge**

Great, thanks for the answer. My follow-up, I will yield.

**Operator**

Thank you. And our next question comes from Elyse Greenspan with Wells Fargo. Your line is open.

**Elyse Greenspan**

Hi thanks, good morning. My first question is on the Group business. So the loss ratio was a little bit higher this quarter, which you guys pointed to in the prepared remarks. In terms of seasonality, how should we think about, just thinking about the loss ratio for the fourth quarter, any trends that you kind of want to highlight to us?

**Randy Freitag**

Elyse, I'd make a general comment. That historically and that doesn't obviously guarantee it's going to happen, but historically we've tended to see a little bit of a tick up in our loss ratio in the fourth quarter. Can't tell you exactly what drives that seasonality, but if you look back at our results, I think you saw a little bit last year in the fourth quarter, for instance.

So now that 74.1% we reported, which as I mentioned, had two offsetting items inside of it. I think is right in line, maybe even a little better than our long-term expectations, but to your direct question, historically, we would expect to see a little bit of a tick up in the fourth quarter, we have seen historically a little bit of a tick up in the fourth quarter.

**Elyse Greenspan**

Okay, thanks. And then my second question, so with your annual review, you guys ticked up the grading period associated with your rates to seven years from five years, you said. Just as you were doing the review, I guess, can you just provide us why you kind of you guys settled on seven years as opposed to something else, just kind of background there that you can, any additional color?

**Randy Freitag**

You know, Elyse, I don't think there's anything specifically we can speak to other than it just felt like we are in an environment where getting to the final answer, if you will, or getting to that ultimate rate just felt like it was going to take longer than it did coming in. We came into this year at five years, we felt good about that, but as we looked around and thought about all the things that can and are impacting interest rates, it just felt appropriate to us to think about a little longer period of time before all those various items unwound.

**Dennis Glass**

And there's a lot of forward-looking and backward-looking analysis that we do. But on the specific issue, one of the examples of what we would be thinking about is a historical look back at how quickly in other historical periods that interest rates moved up from one level to the other one. So that would be an example of what we looked at along with other issues to form a judgment about seven years versus five years.

**Elyse Greenspan**

Okay, thank you very much.

**Operator**

Thank you. Our next question comes from John Nadel with UBS. Your line is open.

**John Nadel**

Hey, good morning. I realize that this is a challenging environment and I also realize that the question I'm going to ask may seem a little bit extreme, but it sounds like you've probably given us the path to do this math in any case. If, Randy, if someone said to the entire life insurance industry, Lincoln included, no more of this assumption of rising rates over time, and your balance sheet needs to reflect the current rate environment as it is today. Period.

So let's just put it in round numbers and say instead of a 3.5% 10-year in seven years, let's just assume it sticks at 175 basis points or 2% for the foreseeable future. How big of an impact would that be on whether it's book value per share or just common equity? And similarly, would there be any related impact on a statutory basis from that kind of an extreme?

**Randy Freitag**

So let me take a crack at your question, and I doubt that I am going to be able to answer it exactly, but we have an assumption of the 10-year treasury reverting to 3.5% which seems quite reasonable given all the expectations for growth and everything, but today the 10-year treasury is about 175 basis points lower than that. So, we have an estimate that each 50 basis points reduction is approximately $160 million. We haven't tested and we don't have guidance out there at 175 basis points, but typically we've seen that, that size adjustment has been fairly static for each 50 basis points.

So you can --

**John Nadel**

Okay, that's ratable.

**Randy Freitag**

And I also talked about rates at this level in the statutory balance sheet. Once again, we don't see at this level of interest rates any need for additional, any material need for additional asset adequacy reserves. So really not much impact on the statutory balance sheet. The other thing I'd point out to you is that we carry in our overall book value $32 per share of unrealized gain.

So if you were to mark your liabilities to market, you would logically think about that rather healthy unrealized gain, which from a dollar standpoint is over $6 billion after tax, I believe, going against any sort of impact like that.

**John Nadel**

Yes. No, that's what I'm trying to get at. I mean, I know the stock is down like it is today and on the surface, this is a pretty significant charge relative to the impact of the last several years, but even still if we went to that extreme it feels to me like it's somewhere in the $3 per share to $4 per share impact non-cash. And I guess that's what I was trying to get at. So, thank you.

**Randy Freitag**

You bet.

**Operator**

Thank you. And our next question comes from Joshua Shanker with Deutsche Bank. Your line is open.

**Joshua Shanker**

Yes, thanks for picking up at the end of the call. I mean, Suneet now has kind of asked my questions, but I was wondering if we could dig a little deeper. In this SEC investigation into the K-12, can you explain on what they're looking for? And in the past, has these kind of regulatory issues kept you from growing organically or inorganically in that segment of the market?

**Randy Freitag**

Yes, I'm not giving - we can't get into depth on that. In that market, we have salaried employees, and so I think our practices are pretty good, but I really don't know what is driving those inquiries.

**Joshua Shanker**

Okay. And then if you go back to last year, I'm just wondering about the timing of the process. What was sort of the gap in time between your recognition that there was something wrong between the stock price in the fundamental value of your business and you signing a deal with a theme to bring some earnings into the future to accelerate shareholder return, I guess? If that's true today, I'm wondering how long the process in between wanting to do something and being able to do something has there been?

**Randy Freitag**

Well, that's a pretty tough question because we're always talking to people and we've been talking for a long time, but not in sort of a negotiation, it will have a quick - it will have a quicker and vice versa. So it's very hard to pinpoint any kind of a non-organic transaction in terms of what's the likelihood. So I'll just say that each one is different and we continue to look at opportunities.

**Joshua Shanker**

Okay, thanks for the answers.

**Operator**

Thank you. And that's all the time we have for questions right now. We will be able to follow up with those in the queue later this afternoon. I'd like to turn the call back over to Chris Giovanni.

**Chris Giovanni**

Thank you all for joining us this morning. We'll follow up with those that are still in the queue and as always, we will take your questions on the Investor Relations line at (800) 237-2920 or via email at investorrelations@lfg.com. Thank you all. Have a great day and a great Halloween.

**Operator**

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect. Have a great day.