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Lincoln National Corp. (LNC)

Q3 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and thank you for joining Lincoln Financial Group's Third Quarter 2022 Earnings Conference Call. At this time, all lines are in a 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 Vice President of Investor Relations, Al Copersino. Please go ahead, sir.

Albert S. Copersino
Vice President & Head-Investor Relations, Lincoln National Corp.

Thank you. 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, including those regarding deposits, expenses, income from operations, share repurchases and liquidity and capital resources are forward-looking statements under the Private Securities Litigation Reform Act of 1995. These forward-looking statements involve risk 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 press release issued yesterday as well as those detailed in our 2021 annual report on Form 10-K, most recent quarterly reports 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 the full reconciliations of the non-GAAP measures used on the call, including adjusted return on equity and adjusted income from operations or adjusted operating income to the most

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comparable GAAP measures. A slide presentation containing supplemental third quarter 2022 information related to our annual assumption review is also posted on our website in the Investor Relations section.

Presenting on today's call are Ellen Cooper, President and CEO; and Randy Freitag, Chief Financial Officer. 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 Ellen.

Ellen Gail Cooper

President, Chief Executive Officer & Director, Lincoln National Corp.

Thank you, Al, and good morning, everyone. Before we discuss the details of our third quarter performance, I want to step back and speak to the magnitude of the unlocking charge resulting from our annual assumption review. I'll also address the decline in our risk-based capital ratio, the recent performance of our life business, provide a quick review of our other businesses, the multiple levers available to improve our capital position and how we are changing the strategic approach to our business in key areas.

First, I will address the unlocking at a high level, and Randy will provide more details. The $2.1 billion total unlocking includes a $2.3 billion charge in our life business, driven by $1.8 billion related to policyholder lapse behavior within the guaranteed universal life or GUL block. This charge was primarily due to updated lapse assumptions where emerging Lincoln GUL experience was validated this year by new industry perspectives. As a result, we expect a $180 million decline in GAAP annual run rate life operating earnings.

On a statutory basis, the updated lapse assumptions also produced a $550 million charge related to the 8D GUL subtest to be booked in the fourth quarter, which translates to about 22 points of RBC. The unlocking has no impact on run rate statutory earnings. As a reminder, GUL is a type of permanent life policy that guarantees insurance will stay in force if the policyholder continues to pay a certain minimum premium. Because of this guarantee, GUL is subject to long-term assumption risk.

Interest rates have been lower than assumed in pricing and were a significant driver of our decision some years ago to reduce sales dramatically and ultimately exit the GUL market. Additionally, over the years, mortality and reinsurance costs have seen unfavorable adjustments. Lapse is the other key assumption.

Over the last several years, as Lincoln's GUL policy experience has materialized, it has provided deeper insights into anticipated behavior patterns in later policy durations, which were subsequently supplemented with a recent industry experience study. As a result, we have reset our assumptions to reflect lower lapsation going forward. In addition, we separately incurred a $634 million GAAP goodwill impairment charge in our life business, primarily driven by variable universal life or VUL equity market impacts and the use of a higher discount rate.

Before I discuss the other topics, I will briefly touch on the operating highlights of our businesses this quarter. We delivered strong sales growth in all four of our businesses reflecting our continued focus on expanding and diversifying the product portfolio. We saw a sales rebound in annuities, up 21% from the prior-year quarter as growth in index variable annuities and fixed annuities more than offset a decline in traditional variable annuities.

Net flows were positive in the quarter for the first time since mid-2020 driven by sales growth. Total Life Insurance sales were up 3% from the prior year quarter, driven primarily by an increase in indexed universal life sales. And in Retirement Plan Services, or RPS total deposits of $2.8 billion were up 16% from the prior year quarter reflecting a 33% increase in first year sales and a 9% increase in recurring deposits. Year-to-date, positive net flows rose to $2.7 billion.

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In Group Protection, sales were up 83% from the prior-year quarter, reflecting strong results across all products and market segments premiums of $1.2 billion were up 8% compared to the prior-year quarter. And finally, our high-quality investment portfolio continues to perform well and higher interest rates have led to spread expansion following years of spread compression.

Now turning to the RBC ratio. We started the year at approximately 430% risk-based capital and are projected to end the year with our RBC at approximately 360%. The year-end projection includes the expected fourth quarter statutory charge as well as other factors.

Before I elaborate on those factors and importantly, our actions underway to replenish capital back to our target, I want to emphasize the following: while we are not satisfied with our projected RBC ratio, we are taking swift and targeted actions to rebuild to our 400% target. We are confident we have ample capital to effectively operate the business as we get back to our targeted level. We have a clear understanding of the issues and have a plan in place to address them as you'll hear this morning.

Effective execution starts with leadership and our new experienced and talented senior leaders will execute on the strategic objectives I introduced last quarter, which are: first, maximizing distributable earnings and improving capital generation. Second, reducing capital sensitivity to market volatility and improving capital efficiency; and third, further diversifying our earnings mix with durable cash-generative income streams.

Continuing this discussion on capital. Our life business has been the source of three quarters of our RBC ratio decline this year, with the three main contributors as follows: as I mentioned, the assumption review will increase our statutory reserves, which will reduce statutory capital and is included in the projected year-end RBC ratio I referenced above. However, the statutory 8D test utilizes prescribed trailing interest rates. And if rates stay at current levels, we would expect to release a portion of these reserves over time.

Second, while smaller than the impacts of the prior two years, we continue to experience pandemic claims this year, particularly in the first quarter. We expect these impacts to continue to moderate over time. Third, setting aside the impact of the 8D test and pandemic claims, the life insurance business is a negative contributor to cash flow generation. A portion of this negative contribution is attributable to increased reserves in our VUL portfolio due to this year's equity market decline.

However, there are other factors weighing on the life insurance business' ability to generate distributable earnings, including negative statutory earnings producing negative cash flow from our GUL block which are not affected by the assumption change, an increase in recurring reinsurance costs, the loss of ongoing free cash flow from previous block transactions and the transition to principal-based reserving, which has changed the pattern of distributable earnings and capital intensity for certain products, notably term life.

The remaining 25% of this year's projected RBC decline is attributable to a variety of factors, including higher capital allocation to fixed annuity sales and stable value offerings within our retirement business as well as the impact of group's pandemic claims and lower fees in our annuity business.

Our annuity business has always been and remains highly cash generative and well-risk-managed. However, this year's market movements, specifically the declines in equity markets and the increase in interest rates had negatively impacted both equity and bond fund returns, resulting in lower fees on assets under management and consequently reduced capital generation.

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Additionally, we hedge our variable annuity guaranteed benefits out of LNBAR. The current hedge program has been highly effective and has focused on generating sufficient assets to fund future claims by minimizing GAAP net income volatility. This year's capital market environment has led to market volatility and increased hedge breakage that has resulted in reduced capital within LNBAR.

We intend to organically rebuild the LNBAR capital position over time. And while we have taken an average of about $120 million of dividends per year out of LNBAR, we do not expect to take the dividend for some time. In September, we announced enhancements to our VA hedging program that focus on maximizing distributable earnings and explicitly protecting statutory capital.

The updated VA hedge program aligns with our increased strategic focus on capital generation. Additionally, I note that our two workplace businesses, Group Protection and Retirement Plan Services are well-positioned to deliver strong distributable earnings and contribute to the rebuilding of capital.

I will now discuss the actions that the leadership team and I are taking to enhance the distributable earnings and capital generation of our business where a number of the initiatives underway will support improvements in our life business, rebuild our RBC ratio to our 400% target and strengthen our balance sheet.

First, while we prioritize balance sheet resilience to replenish our capital, we are pausing share repurchases. We remain committed to returning capital to shareholders, will be maintaining the dividend and expect to return to dividend growth and share repurchases over time.

Second, we have capacity in our capital structure beyond today's mix of primarily common equity and senior debt and are evaluating alternatives such as preferred or additional hybrid securities to provide additional margin given the uncertain macroeconomic environment and risk of potential headwinds from that environment beyond what we see today.

And third, we are considering strategic alternatives for our in-force business, including potential block reinsurance transactions with a wider lens that incorporates our new strategic objectives.

As I have mentioned previously, we have a fully dedicated and staffed up team; while there are no commitments if we find the right opportunity at the right price, we will look to execute. In addition to these three actions, we have several initiatives already underway to advance our strategic objectives that will have a favorable impact to our balance sheet longer term. In particular, a number of the measures we are taking are designed to improve the distributable earnings profile of the life business.

The three new leaders I introduced last quarter, Matt Grove, Head of Individual Life, Annuity and Lincoln Financial Network; James Reid, Head of Workplace Solutions; and Chris Neczypor, our Chief Strategy Officer, are charged with implementing our strategic actions. As a team, we are keenly focused on our reprice, shift and add new product strategy.

In the recent years, we have been focused on shifting the product mix to a diversified set of solutions with lower guarantees, more risk sharing with the customer and improved capital efficiency. As we move forward, consistent with our strategy to maximize distributable earnings, we are refocusing our new business capital allocation process. We had previously focused on growing sales while exceeding our return thresholds.

Going forward, we expect to allocate a targeted amount of capital to new business and will focus on maximizing our return on this capital. We expect this approach to allow us to allocate less capital to new business in 2023

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than we did in 2022 while delivering a robust level of sales and more distributable earnings. This focus on the efficiency of our capital allocation is an important part of our go-forward strategy.

Spark. We are ahead of schedule and making substantial progress in the implementation of this enterprise-wide expense initiative to deliver run rate savings of $260 million to $300 million by late 2024. We have achieved approximately 45% of the planned expense savings to date. We are also working on reducing the market sensitivity of our VUL product to mitigate the capital impact of potential further market declines and are exploring multiple avenues to accomplish this, including both hedge and structural solutions.

And as I previously mentioned, our Workplace Solutions businesses comprised of Group Protection and Retirement Plan Services continue to be critically important to our long-term strategy. Both businesses are focused on the customer, driving differentiation in the market and delivering results. We have spoken with you about our goal of reaching and then sustaining the high end of our 5% to 7% target margins for Group Protection, which will have a positive impact on our capital generation.

We continue to execute our Group Protection margin enhancement strategy of pricing and product discipline, improved claims effectiveness, such as by helping our customers return to the workforce and driving expense efficiencies through Spark. And finally, higher interest rates, enabling a shift from spread compression to spread expansion.

In closing, we are laser-focused on advancing our strategic objectives as we increase capital and strengthen our balance sheet, delivering long-term value for our stakeholders. With a talented leadership team in place, a strong franchise and a long-standing track record of disciplined execution, we have a clear strategy that we will be executing on in the months ahead, and I look forward to updating you on our progress.

Randal J. Freitag

Executive Vice President, Chief Financial Officer & Head-Individual Life, Lincoln National Corp.

Thank you, Ellen, and good morning to everyone on the call. Before I discuss our earnings results today, I'm going to provide commentary around three topics: the results of this year's assumption review; where we expect to end the year from an RBC standpoint and the drivers behind that outcome; and lastly, the writing off of the remainder of the goodwill associated with our life business.

Starting with the results of this year's assumption review, which in total reduced our earnings by $2.1 billion with $2 billion of that impact in adjusted operating income with the balance below the line.

Looking at the adjusted operating income impact of this year's assumption review by business unit. At positive $6 million and $1 million, respectively, the impacts in retirement and group were negligible, while the annuity business experienced a favorable impact of $217 million, driven by the impact of higher interest rates on projected profitability.

Turning to the Life business, which had a negative impact of $2.2 billion, driven by four primary factors. First, rate increase settlements with two reinsurance partners in 2022 drove an unfavorable impact of $81 million. Second, an unfavorable impact of $106 million associated with updates to our underlying morbidity assumptions. Third, an unfavorable impact of $223 million from updating our mortality assumptions. I'd attribute about two-thirds of this adjustment to updates we made to expected mortality improvement as we aligned this assumption to overall industry expectations, and about one-third to adjustments to underlying older age mortality assumptions. Lastly, an unfavorable impact of $1.8 billion from updated policyholder behavior assumptions in our guaranteed universal life book.

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Digging into that impact. About 70% of the $1.8 billion impact was driven by changes in our long-term expectations around lapsation. As a reminder, a lapse occurs when a policyholder runs out of account value and decides to not pay additional premium to keep their policy in force. Coming into 2022, we have limited policyholder behavior experience. Combining our own data with a significant amount of experience contained in the industry study that I referenced on last quarter's call gave us the credible data needed to update our assumptions. With the result being that we now are assuming significantly greater persistency than we had been previously.

As to the other 30%, I noted on last quarter's call that we saw a drop in lapse and surrender rates with the onset of the pandemic. In the case of GUL, we do not expect these to recover to pre-pandemic levels.

A little more color on our GUL book. It is made up of 128,000 policies. Including the impact of the assumption review, we have net GAAP reserves of $20.7 billion compared to $23.1 billion of net statutory reserves, which includes the $550 million statutory reserve charge we expect to take next quarter. I would note that if interest rates remain near current levels, we would expect to recover roughly one-half of that statutory capital impact at year-end 2023.

In addition to the one-time impact I described above, we expect a $180 million reduction in run rate after-tax life GAAP operating earnings, but no impact on run rate statutory results.

Turning to our risk-based capital ratio. We began 2022 at 427%, and as noted by Ellen, expect to end the year at approximately 360%. This year's expected 67-point drop is driven by a number of items, of which 75% came from life insurance, including the expected fourth quarter statutory charge, smaller but continuing pandemic claims and negative cash flow generations.

Rebuilding RBC is our number one goal, and we are targeting an RBC ratio of 400%. Additionally, our leverage ratio has been negatively impacted by this quarter's unlocking of goodwill charges and is above our longer term target of 25%. We expect to manage [indiscernible] (00:25:16) time through organic equity growth, which will be enhanced by the pausing of the buyback program.

In LNBAR, as we communicated previously, we will not take a dividend from this entity as we replenish capital following this year's elevated hedge breakage. As we communicated on our LDTI call, we are changing the focus of our hedge program to specifically focus on the protection of capital.

Turning to the $634 million write-off of our remaining life goodwill balance. This result was driven by a number of factors, but two items that I would spike out are an increase in the discount rate used to value the business driven by increases in the broader interest rate environment and the impact of the decline in equity markets on our VUL business.

Now, let me turn to our results for the quarter. Last night, we reported a third quarter adjusted operating loss of $1.7 billion or $10.23 per share, which includes $11.62 per share from this year's assumption review. Not including the impact of the assumption review, adjusted operating earnings would have been $237 million or $1.39 per share for the quarter. Pandemic-related claims reduced operating earnings by $48 million or $0.28 per share and alternative investment returns were below long-term expectations by $93 million or $0.55 per share.

Turning to the balance sheet. Book value per share, excluding AOCI, came in at $64.09, while cash at the holding company stands at $756 million. The VA hedge program was 99% effective for the quarter, resulting in breakage

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of $82 million, improved versus recent periods. Not including the impact of the prior-year quarter's $94 million legal expense notable item, G&A expenses net of amounts capitalized were up 11% as we experienced a number of one-time expenses that added roughly $30 million to G&A in the quarter. I'd also add that strong sales were a contributor to the growth in G&A.

Now, turning to segment results, starting with Annuities. Operating income, not including the impact of the annual assumption review was $232 million compared to $343 million in the prior-year quarter. Adjusting for notable items in both periods, operating income declined 32% from the prior-year quarter due to a 19% decrease in average separate account values and alternative investment results that were $18 million less favorable than the prior-year period. The decline in equity markets during the quarter increased our net amount at risk for living benefits and death benefits to 9% and 6% of account values, respectively. I note that as we have continued to work on diversifying our annuity business, VAs with living benefit guarantees have come down to 46% of total annuity account values.

Turning to Annuities' return metrics. Excluding the annual review, return on assets and return on equity were 63 basis points and 15%, respectively. Looking ahead, we expect our diverse product portfolio, revised VA hedge program and the benefit of higher interest rates to drive future earnings and cash flow generation.

Retirement Plan Services reported operating income of $52 million, which includes a $6 million favorable impact from DAC unlocking. Excluding notable items, operating earnings were $46 million compared to $60 million in the prior-year quarter. The decline in operating earnings was driven by a $10 million drop in alternative investment income results and a 9% decline in average account values as positive net flows were not able to overcome the lower equity markets. These headwinds were partially offset by a 14-basis-point increase in base spreads. Continued organic growth, solid performance during a turbulent year in the capital markets and spread expansion show the resilience and competitive strength of RPS.

Turning to life insurance. We reported an operating loss for the quarter of $2.2 billion or operating income of $37 million, excluding the net unfavorable impact of our annual assumption review. In the prior-year quarter, we reported operating income of $93 million, which included a $26 million net unfavorable impact from last year's annual assumption review and $19 million from a legal expense. This quarter's result also included alternative investment results that were $131 million less favorable than the prior-year period and $22 million of pandemic-related claims. This represented a $38 million improvement in pandemic-related claims.

Beginning in the fourth quarter, an unfavorable $45 million quarterly run rate impact from the annual review will begin to be reflected in life operating earnings. Average in-force rose 11% compared to the prior-year period, while average account values, net of reinsurance decreased 20%, due to equity market declines, and impacts from the resolution transaction. While this was a difficult quarter, we are confident the combination of the reset of our GUL assumptions, higher interest rates, a product portfolio that has been revamped over the last several years and milder pandemic claims put the life business in position to grow with a particular focus on improving the cash flow profile of the business.

Group Protection reported operating income of $37 million, compared to an operating loss of $32 million in the prior-year quarter, which included a $16 million net favorable impact from last year's annual assumption review. The current quarter included pandemic-related claims of $26 million and alternative investment income that was $5 million below our target return levels. Pandemic-related claims improved $94 million from the year-ago period. Adjusting for pandemic claims and unfavorable alternative investment income, the group margin was 5.5%, within our 5% to 7% target range.

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Excluding pandemic-related claims and the impact of last year's assumption review, the loss ratio improved 20 basis points year-over-year, driven by lower new group disability claims offset by slightly higher group life mortality. We are pleased with the direction of the Group Protection business. Through continued execution of our margin enhancement strategy, we are optimistic about achieving and then sustainably reporting margins at the high end of our targeted range over time.

Moving to investment results, where we continue to report excellent credit results and increasing new money yields. First, regarding the strength of the investment portfolio. Credit migration was net positive for the fifth consecutive quarter. And below-investment grade fixed income assets remain at a historical low of 3%. We recognize the risk of a recession has been increasing and remain diligent in managing credit risk.

As part of our normal process, we recently leveraged our entire multi-manager platform to perform scenario analysis on a name-by-name basis across all asset classes in the portfolio and continue to believe we are well-positioned for a potential recession. The third quarter new money yield rose 80 basis points sequentially to 5%, 90 basis points above the current 4.1% yield on the fixed income portfolio. Higher rates have helped transition from many years of spread compression to spread expansion, which is supportive of earnings and cash flow generation. In addition, higher rates ultimately are beneficial to reserve levels.

Finally, our alternatives return was negative 2.1% this quarter, below our targeted 2.5% quarterly return, a good result compared to the double-digit negative returns of major equity indices in the second quarter.

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

Albert S. Copersino

Vice President & Head-Investor Relations, Lincoln National Corp.

[audio gap] (00:35:47-00:35:52) question-and-answer portion of the call. [Operator Instructions] We expect that we will go a bit past our scheduled ending time off 11:00 AM in order to address more of your questions. Before moving to Q&A, I'd like to turn the call back to Ellen for additional comments.

Ellen Gail Cooper

President, Chief Executive Officer & Director, Lincoln National Corp.

Thank you, Al. Before opening it up to Q&A, as you may have seen, S&P has revised our rating from AA- with a negative outlook to A+ with a stable outlook. In addition, Moody's has affirmed our A1 rating and has revised our outlook from stable to negative. We are confident that we can effectively operate the business with these ratings. We have opened and ongoing conversations with our rating agencies and we'll continue to update them on our progress.

With that, let me turn the call back over to the operator to begin the Q&A.

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QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Your first question today comes from the line of Ryan Krueger with KBW. Your line is now open.

Ryan Krueger
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Thank you, good morning. My first question is, can you give some perspective on how long you think it may take to rebuild the RBC ratio back to the 400% target?

Ellen Gail Cooper
President, Chief Executive Officer & Director, Lincoln National Corp.

A

Yeah, so Ryan, thank you for the question. We know that it's going to take us some time. And what I can say is that we are confident in the plan that we have to rebuild. And so part of – so while we can't give you a definitive amount of time because there are so many factors, so many of the actions that we elaborated in the script are already underway.

So in particular, when you think about all the levers that we can pull around our organic capital generation and you all know that we have had strong capital generation in the past and so the actions underway in particular, around the new business capital allocation, which is so critical, which will clearly support us immediately as well as some of the other solutions that we are looking at, for example, around our VUL portfolio and also what we're implementing as it relates to overall VA.

So we are actively focused there. We are also, as I mentioned in the script, focused on ways that potentially we can even further continue to make progress as it relates to some of the external potential capital generation options. And we will just continue to keep you updated on where we are and on the progress that we are making.

Ryan Krueger
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Thanks. And follow-up is, can you help – can you give us, I guess, either can you quantify where you took your ultimate lapse rate on GUL? And how realistic now that you've made that move, to what extent do you think there is an opportunity to do third-party reinsurance?

Ellen Gail Cooper
President, Chief Executive Officer & Director, Lincoln National Corp.

A

Yeah, Ryan, I'm going to hand that question over to Randy to take.

Randal J. Freitag
Executive Vice President, Chief Financial Officer & Head-Individual Life, Lincoln National Corp.

A

Ryan, good morning and thank you for the question. When you think about the substantial change we made this year to both our lapse and surrender rate, I think about it this way. So the process we go through, Ryan, a deep dive into our experience and we talked about the fact that our experience had come down with the pandemic, and we now expect that behavior to remain in place, a significant amount of data that we're able to achieve, not only as our own experience grows, but with access to the industry study, which included nine participants and gave us

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the amount of data to understand how policyholders should be expected to behave in the future when they come to this point of do they have to pay additional premium.

You think about all those things, and let me give you insights into what that meant. So when you think about Lincoln today, our own experience for the last couple of years. The total that we have seen in our book, and I mentioned that that was down from before the pandemic, it was rough – a total lapse and surrender rate of roughly 1.2%, right? About 40% of that came from surrenders. And a surrender is somebody who has account value. They decide they want to have that account value back and surrender their policy. So about 40% or roughly 50 basis points.

The other 60 basis points or 60% or roughly 70 basis points comes from lapsation. And lapsations are these people who they run out of account value, they haven't been paying their premiums sufficient to keep their policy in force, and they make the decision not to pay more premiums and so they lapse. So 1.2 in total, roughly 50 basis points from surrenders, 70 basis points from lapses.

It's that experience which we then projected for the future. If you think about those two items, I'd comment on surrenders. So the very design of these policies is that the account value gets used up over time through charges. And so the surrender rate over roughly the next 20 years to 25 years goes from that 0.5% level to zero eventually. And then the lapse is projected forward using all of this behavioral data, which is meant to tie to our current experience and then reflect all of the people in the future who will face this funding decision.

So we feel very, very good about the assumption in the future. Now, let's be clear, right? It's not zero. So there's always some risk, but we feel good that it reflects not only a substantial reduction, but a really solid understanding of how people will behave.

Another way of thinking about it, Ryan, is this. When you look at the model this year compared to last year, over the next decade, we are keeping approximately 8% more of those policies in force. And if you go back to my script, I mentioned that we have about 128,000 policies, 8% of 128,000 means we're keeping about an additional 10,000 policies in force relative to last year. And if you think about this impact, right, this $1.8 billion impact associated with the lapse, changes in the lapse and surrender assumptions and you think about that ongoing impact of $180 million, essentially, what we're doing is we're setting up reserves to fund the claims for all of those additional people that we now expect to stay in force. So I hope that helps, Ryan. Once again, it's not zero. So, of course, there's some residual risk, but we do feel really good about what we've done.

Ellen Gail Cooper
President, Chief Executive Officer & Director, Lincoln National Corp.

A

And Ryan, just to come back to the last part of your question, to sum up what Randy said. We do view, based on best estimate assumptions that we have completely reset our GUL assumptions with full confidence here.

You mentioned also in terms of reinsurance of SGUL, so I want to address that as well. We talked about – I mentioned in my script that we are evaluating all alternatives. And so we talked about the fact that we are evaluating transactions.

We're looking at everything. And we would only look at a potential transaction if there was an opportunity that was at an appropriate price at the right time that really was there to enhance value. And ideally, if we were to go ahead and transact it would meet the objectives that we outlined.

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So increasing capital generation and distributable earnings, reducing the capital volatility. So clearly, if there was an opportunity that involved some reinsurance of SGUL that would meet all of those factors, that certainly would be something that we would want to execute on.

And the other thing that I'll add there is that, we're certainly encouraged by the fact that when we look at the potential buyer universe out there, that we've seen an expansion of buyers that really have shifted from where I would say that they were interested in more straightforward liabilities, and they've shifted into appetite for more complex liabilities.

So, again, everything is on the table. If there's an opportunity, right price, right time, we've got a full team, fully dedicated on taking a look at these opportunities, and we'll be back with further updates as we continue to explore.

Ryan Krueger
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Thank you very much. Appreciate it.

Operator: Your next question comes from the line of Suneet Kamath with Jefferies. Your line is now open.

Suneet Kamath
Analyst, Jefferies LLC

Q

Yeah. Thanks. Good morning. So, first question, just on the common stock dividend. I think that's running around $300 million a year or so. Can you just talk about, given all the changes, kind of how you feel confident in being able to fund that on a ongoing basis as you build back RBC?

Ellen Gail Cooper
President, Chief Executive Officer & Director, Lincoln National Corp.

A

Yeah. So Suneet, we feel very confident, first of all, in continuing to maintain the shareholder dividend. And as you know, we have a significant amount of capital generation. We've got an in-force that throws off distributable earnings. We have a significant amount every year of sales that – where we also allocate new business to those sales, and we have many different levers that we can pull.

And so, we need to start with what are our overall priorities and one of those priorities, again, is to maintain the dividend. And while we do that, we're going to manage all these other levers, as I had mentioned earlier. So we're really looking for ways to overall improve the quality of the distributable earnings.

We're looking at ways that we can improve how we think about really optimizing the capital that's allocated to new business. And then the other piece, which is so critical, and we really have experienced it this year, and that is, we've seen very significant impact to our capital position as a result of the capital markets.

And so, we believe that we can execute on some potential hedge and structural solutions to try to alleviate some of that and mitigate that in the near term on some of the in-force and that's an area that we'll really be focused on, again, to really execute as quickly as possible.

So you put all those pieces together and what we are planning to do is really raise the overall quality of the core earnings, reoptimize the new business capital allocation and at the same time, maintain the shareholder dividend.

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Suneet Kamath
Analyst, Jefferies LLC

Q

Got it. Okay. And then I guess if I take a step back and think about Lincoln over time, one of the hallmarks of your company has been the strength of your distribution relationships and always being present in the market, always providing product for them to sell. And just based on what you're saying, it sounds like there's such a significant amount of change going on at Lincoln around risk management, around product, around capital, I guess how do you balance preserving the strength of those distribution relationships and always being in the market with all of the changes that you're making, just to make sure that you're not disrupting that distribution franchise that has been so important to the company in the past.

Ellen Gail Cooper
President, Chief Executive Officer & Director, Lincoln National Corp.

A

Yeah, Suneet, this is a great question. And I think from our perspective, I think this really goes to a couple of things. The power of our distribution organization and our relationships, coupled with all the work that we've done around reprice, shift and add new as it relates to product strategy. So when we look across the four businesses right now, part of what we are seeing is we have a broad diversified set of product solutions that are really meeting a variety of different customer preferences and really strong, deep distribution relationships. And so you put those things together and when we were talking about things like now really shifting and further emphasizing as it relates to new business capital allocation, the idea of having a set amount of capital and then really optimizing the overall new business relative to that, I want to be clear that that's within the current product suite.

So we really believe that the reprice, shift and add new and all of those actions have given us the broad product portfolio that we need to be able to deliver on our commitment to all of you. But what we're going to be doing is being further laser-focused on how we take the overall products that we're offering and utilize them to really be able to optimize the overall distributable earnings profile at the same time.

And so this is work that's well underway already in partnership inside of the organization, with the business, with the product manufacturing teams and with distribution. And we really are confident that we can really step into this shift without disruption.

Suneet Kamath
Analyst, Jefferies LLC

Q

Okay. Thank you.

Operator: Your next question comes from the line of Alex Scott with Goldman Sachs. Your line is now open.

Alex Scott
Analyst, Goldman Sachs & Co. LLC

Q

Hi. First question I had as a follow-up on the cash flow impact from the life insurance review. Could you talk about your reinsurance of SGUL to the Barbados legal entity? And I would think whatever adjustments you're making on GAAP would have some translation to the way you account for this business in LNBAR, which I think is under GAAP accounting, currently switching to stat, and so I'm just trying to understand, I mean is $550 million really the right number for me to think about in the stat entity, and we can see the RBC moving in the US operating company. But just based on your comments around cash flow from LNBAR probably being shut off for a while, I mean, is there an impact in there that we need to be thinking about? I mean can you disclose anything about the

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capitalization of LNBAR and help us think about the adequacy of capital there, just in light of the ceded of – between UL and variable annuities, there's a lot of your tail risk being ceded there.

Ellen Gail Cooper

President, Chief Executive Officer & Director, Lincoln National Corp.

A

Yeah. So Alex, as it relates to LNBAR, I'll start, and then I'll hand it over to Randy to talk specifically about SGUL. So as it relates to overall LNBAR, we have absolutely seen an impact to our overall capital position year-to-date, driven by what we've seen around market declines, market volatility leading to hedge breakage. And so we are confident that we can organically rebuild the overall capital position as it relates to LNBAR, and at the same time, we announced in September that we are shifting to a hedge strategy, and that hedge strategy will have an explicit stat capital hedge on it.

And so part of the goal there is that the next time that we have an equity market downturn that the hedge will be appropriate from a risk management perspective to really mitigate that. And so while we are in the process right now of organically replenishing and for us, the implication of that is not taking a dividend for some time out of LNBAR as we are focused on that, the other important piece of that is that we really believe as we look forward the next time we see equity market volatility that we won't find ourselves in this situation. So – and I'm going to hand it over to Randy specifically to talk about the SGUL impact as it relates to LNBAR.

Randal J. Freitag

Executive Vice President, Chief Financial Officer & Head-Individual Life, Lincoln National Corp.

A

Alex, thank you for the question. So in terms of other business outside of variable annuity inside of LNBAR in this case, your question specifically on SGUL, what you have in there is some of the financing arrangements with external parties are housed in LNBAR. And so it's not the total contract. You have all the base reserves over in LNL. It's just that financed piece, Alex, that sits over in LNBAR.

In terms of those financed reserves over in LNBAR, those are long-term financing arrangements that are in place. I think the first one that comes up for renewal is sort of in the middle of the 2030s, so it's a little over a decade from now. I think when we think about those financing relationships, one of the ways I've been thinking about it when we plug the new assumptions, you got to remember, when you do financing, the assumptions have provisions for adverse deviations, so you get some support there. But we plug these new assumptions, when these things start rolling over a decade from now, there will be a little bit of pressure on the amount of financing.

One of the ways I'm thinking about it is we talked about with the rates where they are we'll release roughly half – we would expect to release roughly half of the 8D reserve we're putting up at this year. I think that remaining half essentially can be there to support those financing relationships. So I think LNBAR, in terms of its capitalization outside of the VA business is in good shape and very well managed and capitalized consistent with how we capitalized LNL and our overall life companies.

Alex Scott

Analyst, Goldman Sachs & Co. LLC

Q

Got it. And I think you might have touched on it a little bit there, but I wanted to also ask about the subtest and the impact of interest rates. I know this is sort of one of those weird backward-looking discount rate calculation that goes into it. And I think there's a little commentary provided in the opening comments, but could you give us a sensitivity around for every however many basis points of movement in interest rates, how much that would benefit the [ph] SubD test (00:55:15) reserves?

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Ellen Gail Cooper
President, Chief Executive Officer & Director, Lincoln National Corp.
A

So Alex, the comments that we made, which are that the 8D subtest uses 12 months of trailing interest rates for the test, and so I believe it goes from July 1 to July 1. So if you think about where we were a year ago as it relates to rates through July 1 of this year and when we look forward, if we look at rates at this level, we see pretty significant impact reducing that overall 8D statutory impact as we move into 2023.

And Randy, do you have any additional color?

Randal J. Freitag
Executive Vice President, Chief Financial Officer & Head-Individual Life, Lincoln National Corp.
A

Yeah, Alex, let me give you – so very specifically, the index rate that we used at the end of 2021 was 2.96%. The index rate that we'll use at the end of 2022 is 3.5%. And the average of that index that we will use at the end of the 2023, which is being calculated as we speak, right, it started being calculated on July 1 of this year and the calculation will end in the middle of next year, June 30 of next year. It currently sits at about 5% from an average standpoint, and the actual index itself at this red hot moment, or I guess on November 1 is the last time I checked, it was roughly at about 5.70%.

So if you think about that average so far, 5% versus the 3.5% we're using this year, that's 150 basis points. And we mentioned that we would expect with that impact to release roughly half. Right, so 150 basis points, $275 million, I think that gives you a pretty good way to think about it.

Alex Scott
Analyst, Goldman Sachs & Co. LLC
Q

Got it. Thank you.

Randal J. Freitag
Executive Vice President, Chief Financial Officer & Head-Individual Life, Lincoln National Corp.
A

Yes.

Operator: Your next question comes from the line of Tom Gallagher with Evercore. Your line is now open.

Thomas Gallagher
Analyst, Evercore ISI
Q

Good morning. First question, just your plan to issue hybrids, should we assume the proceeds will be immediately injected into LNL to bolster the RBC? Or would you expect to keep that at the holding company?

Ellen Gail Cooper
President, Chief Executive Officer & Director, Lincoln National Corp.
A

So Tom, we would – if we were to issue hybrid, we would likely take a couple hundred million of it and keep it at holdco. We've got a debt maturity coming in 2023. So we would put a little bit aside for that. And the rest of it would – the remainder of it would go into the life companies.

Thomas Gallagher
Analyst, Evercore ISI
Q

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Okay.

Randal J. Freitag
Executive Vice President, Chief Financial Officer & Head-Individual Life, Lincoln National Corp.

A

Yeah, as a reminder, Tom, we have – I think I mentioned in my script, we have a little over $750 million of cash at the holding company. About $300 million of that has already been earmarked, was proceeds from the block deal we did last year, it was earmarked for that upcoming debt maturity, but actual debt maturity is roughly $500 million. So – any – I think as Ellen mentioned, first $200 million will probably be there and the balance we'd downstream.

Thomas Gallagher
Analyst, Evercore ISI

Q

Okay. Thanks. And then in terms of the strategic options, what's most likely in your view from a risk transfer perspective? Or are we looking – I'm assuming life insurance is probably not the most likely given what's happened here. But between maybe VA and fixed annuity or maybe life insurance is still on the table as well. And will that – is that likely to be and I'm not asking for exact timing, but are we talking about something that's closer to a year-plus away or something that could happen sooner than that. And then will the slowing of sales or the pivoting of sales have a meaningful impact on capital generation or is that going to be more modest?

Ellen Gail Cooper
President, Chief Executive Officer & Director, Lincoln National Corp.

A

So, on the first question, I wish I could give you an exact. What I will tell you is that we're looking at all options. And there are – there's such a large universe of buyers. There have never been more buyers out there to potentially look at all options as it relates to various different transactions. So, everything is on the table.

And I come back to the fact that really, ideally, if there is a way with right price, right time that is also meeting the objectives that we've talked about around really improving the cash generation for us, that would be the ideal, but it's got to be at the right price. So – and we are working diligently to really take a look at this. So, we'll be back with more. We'll be back to update you as we can.

On the second piece, we do expect – I want to be clear that we expect a robust level of sales with how we're thinking about new business capital allocation. I fully expect that we will see sales somewhat lower than where they were in 2022, but really on the margin.

And this really gets to the fact that we've got such a broad product portfolio across every single one of our businesses that when we looked at this, this is a matter of really optimizing the capital and really optimizing to maximize distributable earnings and the distribution organization is strong, the product suite is strong.

So, we can position without, as I had mentioned, to Suneet, without much disruption there. So – and yes, we think that it will have a meaningful impact in capital and something that you will see immediately as we move into 2023.

Thomas Gallagher
Analyst, Evercore ISI

Q

Got you. And if I could sneak in one more, when you add all that up, Ellen or Randy and you think about coming up out the other side of this, should we expect the amount of free cash flow still could be meaningfully lower when I consider what will likely be high cost – high-coupon hybrids that you're probably going to be issuing, plus you're

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going to be shrinking the in-force earnings potentially from an in-force deal, trading earnings or cash flow for capital?

Or do you think – and maybe you're not far along in the process to really opine on that. But I just want to – any kind of sense you can get from start to finish here after you solve the capital issue whether there could be meaningful diminution of the free cash flow levels?

Ellen Gail Cooper

President, Chief Executive Officer & Director, Lincoln National Corp.

A

Yes, this is another one where we're going to keep you very updated over time. So, as we move into this year and really when you think about the fact that we just talked about our RBC ratio being down effectively, we're projecting it to be down 67 points this year, that's really going to – at the end of the day, this particular year with markets doing what they're doing, lower cash generation, lower capital generation than we've had previously and that we would like. And so everything that we're talking about in terms of our actions are really to improve that.

The other thing that I want to mention as it relates to hybrid is that while it's true that, of course, that there is a cost, to the earlier question around that, a significant portion of that will then flow into the life companies. And we'll turn around and we'll invest that so that the ultimate cost will be net of the new money yields, which are pretty nice right now. So the cost will be certainly – somewhat – the cost of financing will be somewhat mitigated by the fact that we can invest the majority of the proceeds.

Randal J. Freitag

Executive Vice President, Chief Financial Officer & Head-Individual Life, Lincoln National Corp.

A

And the last thing I'd mention just broader, not specifically on this question, but there are some levers that we are retaining, and there is an uncertain – look, for instance, I mentioned that we still have, even after the $300 million was allocated to the debt maturity, $450 million of cash holding company, we're planning on maintaining that. We also, Tom, retain access to a $500 million contingent capital facility, which we're not drawing down. So we've got a significant plan, a lot of internal and external levers, but there are some that we are retaining for the uncertain world that exists today.

Ellen Gail Cooper

President, Chief Executive Officer & Director, Lincoln National Corp.

A

Tom, one other point to your question about block deal also impacting cash generation, ideally, if we could have our pick in terms of what kinds of transactions would we want, the transactions would improve cash generation as opposed to actually further reducing, so that's the holy grail. It has to be at the right price, of course. We're not going to do something that doesn't make sense. But ideally, that's what we would be focused on.

Thomas Gallagher

Analyst, Evercore ISI

Q

Thanks a lot for the answers.

Operator: Your next question comes from the line of John Barnidge with Piper Sandler. Your line is now open.

John Barnidge

Analyst, Piper Sandler & Co.

Q

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Thank you very much. Appreciate the opportunity. If I heard you correct in the prepared remarks, you had mentioned if rates are at current levels, you'll recover about half of the statutory hit by year-end 2023; appreciate that rate comment, but can you maybe talk about how we should be thinking about the assumptions embedded in that on equity and VII between now and that period?

Randal J. Freitag
Executive Vice President, Chief Financial Officer & Head-Individual Life, Lincoln National Corp.

A

John, the 8D test itself is a test with a fair amount of prescription. So for instance, I'll use like – we made some tweaks to our mortality assumption that had about a $223 million impact; that doesn't really have an impact on the 8D subtest because the mortality assumption is already prescribed with provisions for adverse deviation. So I think the big impact on the 8D test was the change we made to lapse and surrenders. That is pretty much that entire $1.8 billion impact, transports over to the 8D subtest. In terms of the other assumptions, once again, I think with the level of prescription, I don't think of – the sort of risks that you might be implied by your question [indiscernible] (01:05:59).

John Barnidge
Analyst, Piper Sandler & Co.

Q

I was, to clarify, more suggesting you had mentioned about half of that statutory hit with the rates being higher that over the next year, it would build back. I think you had previously talked about capital this year has faced some headwinds from market volatility. So there's a link between rates and equity markets and VII and so if you're thinking rates are a tailwind to the next year to statutory, what are you thinking equity in VII is within that? I'm not necessarily talking related to the actuary review specifically.

Ellen Gail Cooper
President, Chief Executive Officer & Director, Lincoln National Corp.

A

Right. So clearly, equity and VII in terms of how we think about moving into next year, are factors, they are unknown factors. We recognize the fact that we're in an uncertain macroeconomic environment right now, and exactly to some of the points that we made in our remarks, one of the areas that we are laser-focused on right now are ways that we can be reducing, in particular, the capital volatility that we have experienced this year to capital markets. And so we talked about the fact that we're shifting the VA hedge program. That's one thing.

The second thing is to really expedite being able to look at options as it relates to VUL, that has been an area that has really impacted us this year in terms of needing to put up additional reserves as the equity markets have declined. And then we have clearly seen some impact, as you mentioned, from fees on assets under management, and Randy mentioned that in his remarks and alternatives. But really, these other pieces are areas – those are levers that we believe that we can control and that we can put in place that will help to really mitigate some of the impacts of the potential for declining equity markets as we move forward.

Randal J. Freitag
Executive Vice President, Chief Financial Officer & Head-Individual Life, Lincoln National Corp.

A

And John, very specifically this year, right, the items you mentioned, Ellen referenced roughly a 67-point drop this year. So using some of the items you mentioned inside of that, we'd estimate that the VII, the downdraft we've seen in VI would be roughly about 5 points or 6 points over the course of this year as part of that 67 basis points, some of the reserves we've talked about on VUL, which have been driven by the impact of lower equity markets and higher interest rates on the separate account values, that's probably been about 8 points to 10 points.

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And then also, we had talked last quarter sort of limitations on DTA, which is linked to what we've seen in the capital markets. It's probably been about another 8 points. So in terms of the items you mentioned, I would spike those out as specific items that are driven by what we've seen in the capital markets this year.

John Barnidge
Analyst, Piper Sandler & Co.

Q

That's very helpful. Thank you very much.

Randal J. Freitag
Executive Vice President, Chief Financial Officer & Head-Individual Life, Lincoln National Corp.

A

You bet.

Operator: This concludes today's Q&A. If we were unable to get to your question this morning, the team will follow up with you this afternoon. I now would like to turn the call back to Al Copersino for closing remarks.

Albert S. Copersino
Vice President & Head-Investor Relations, Lincoln National Corp.

Thank you for joining us this morning. We're happy to take any follow-up questions that you have; you can e-mail us at investorrelations@lfg.com. Thank you, and have a good day.

Operator: This concludes today's conference call. Thank you for attending. You may now disconnect.

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