07-May-2020

Lincoln National Corp. (LNC)

Q1 2020 Earnings Call

CORPORATE PARTICIPANTS

Christopher A. Giovanni
Senior Vice President-Investor Relations & Strategic Planning & Corporate Treasurer, Lincoln National Corp.

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

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

OTHER PARTICIPANTS

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

Jimmy S. Bhullar
Analyst, JPMorgan Securities LLC

Thomas Gallagher
Analyst, Evercore Group LLC

Humphrey Hung Fai Lee
Analyst, Dowling & Partners

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and thank you for joining Lincoln Financial Group's First Quarter 2020 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'd like to turn the conference over to the Corporate Treasurer, Chris Giovanni. Please go ahead, sir.

Christopher A. Giovanni

Senior Vice President-Investor Relations & Strategic Planning & Corporate Treasurer, Lincoln National Corp.

Thank you, operator. Good morning, and welcome to Lincoln Financial's first 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, 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 risks and uncertainties that could cause actual results to differ materially from current expectations. These risks and uncertainties are described in the cautionary statement disclosures in our earnings release issued yesterday and our reports on Forms 8-K and 10-Q filed with the SEC. These forward-looking statements are only made 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. A slide presentation, which provides addition information on our investment portfolio, is also included on our website.

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 R. Glass

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

Thank you, Chris. Good morning. The health crisis has been difficult on everyone. We hope you are staying safe and our thoughts are with you. I also want to recognize our Lincoln employees for their extraordinary efforts and unwavering commitment over the past few months.

Lincoln has been navigating the current crisis by focusing on three priorities: first and foremost, doing what we can to help protect the health and safety of our employees; second, is operating the business in the best interest of our customers, partners, policyholders and shareholders; and third, is doing our part to help America overcome the challenges of COVID-19.

Early on, Lincoln began monitoring the emerging pandemic and started taking actions to reduce this health threat, including restricting travel, eliminating non-critical face-to-face meetings and setting social distancing guidelines. In March, we moved to a work-from-home model for 99% of our employees to help limit the spread of the virus within the Lincoln family and our communities.

Because of our business continuity planning and significant digital investments, which we have discussed with you, the connectivity and productivity of our employees working from home has been excellent. We have maintained our commitments to our customers and partners during this difficult time with service at the same high standards we have always delivered.

Finally, we remain committed to honoring our namesake through our actions as a responsible company. Our foundation has made significant financial commitments to help distribute food throughout the communities where we operate and, as a founding sponsor of People + Work Connect, we are bringing companies together to help get people back to work faster.

This morning, we are going to handle our prepared remarks a little differently. I will briefly touch on the first quarter results before detailing the current environment and the potential impacts to Lincoln along with the strategies and actions we have in place to successfully manage through this period of uncertainty. Randy will then cover results in greater detail and speak to our strong financial position.

So, our first quarter results were solid and largely unaffected by the virus. While we are now in a different environment, it is important to highlight that we continue to execute on our long-term strategic plan and this quarter's results. Once again, demonstrate that. Adjusted operating earnings per share were up 5% compared to the prior-year quarter, adjusted operating revenues increased 3%, net flows nearly doubled and we generated a return on equity, excluding AOCI of over 13%.

The annuity business had a strong quarter as both the top and bottom line grew in the mid-single-digits over the prior-year quarter and we produced positive net flows in both variable and fixed annuities. Notably, sales of VAs without guarantees exceeded VAs with guarantees for the first time in recent history as sales of our indexed variable annuity, which is much less sensitive to interest rates, gain further momentum. We expect this shift to continue as we expand shelf space and add new producers.

In Retirement Plan Services, we also grew both the top and bottom line versus the prior-year period. Net flows were once again positive in the quarter with strong growth in recurring deposits and low withdrawal rates being the biggest drivers. Our high-touch, high-tech, focused service model distinguishes us from the competitors and as a differentiator in our target markets. We are leveraging these capabilities, which are more important now in these uncertain times to drive positive outcomes for plan sponsors and participants.

Turning to Life Insurance, operating revenues and operating income each grew in the high-single digits compared to the first quarter of 2019. As expected, sales decreased compared to the prior year as increases in IUL and term, which are strategic focuses and less sensitive to interest rates, are offset by declines in other products, in part driven by pricing actions. We remain focused on leveraging our broad product portfolio to maintain product diversification.

Lastly on Group Protection, operating income decreased year-over-year, driven primarily by higher-than-expected mortality. This offsets strong premium growth and expense efficiencies. Premiums are benefiting from improvement in persistency combined with renewal rate increases over the prior year. Our expense ratio improved 120 basis points as we continue to achieve synergies from the Liberty acquisition.

In short, the positive results we saw in the first quarter again demonstrated the strength of our long-term strategic initiatives, which will be critical to our success when the health crisis subsides.

Now, shifting to the current environment, it is important to recognize that we came into this crisis in a position of strength in our businesses and balance sheet and is a markedly more favorable situation than we had heading into the global financial crisis.

First on the businesses. We have a diverse mix of businesses that are all at scale. Our predictable in-force blocks combined with the long-term nature of liabilities results in an attractive and highly recurring revenue stream with over 90% of revenues persisting each year. We have also benefited from strategic actions taken over the past several years to reduce our sensitivity to the capital markets and diversify our sales mix. This includes shifting to non-guaranteed products, which now represent over 80% of total sales, no single product in more than 16% of total sales and achieving our target with 30% of earnings coming from mortality and morbidity sources.

On balance sheet strength, let me address four topics. Liquidity in our Life Insurance subsidiaries is very strong, with the vast majority of our investment portfolio in publicly traded investment-grade securities, and we have strict asset liability management requirements. We also have additional flexibility with $7 billion of committed borrowing facilities, which can be used to manage any cash flow stress that might develop.

At the holding company, we have $760 million of cash and have pre-funded our 2021 debt maturity, which makes our next maturity not due for almost two years. Dividends from the life subsidiaries are more than sufficient to meet our current corporate interest expense and maintain the level of our shareholder dividend.

In addition to the $7 billion of committed borrowing facilities I just noted, we also have a $2.25 billion line of credit, which is undrawn, that can be used for general corporate purposes.

Our investment portfolio has been materially de-risked over the past five years, as we have been selling securities that have greater risk of credit deterioration under stress scenarios. This has reduced the potential impacts from both credit losses and rating downgrades.

The actions have improved results of our rigorous stress testing, which factor in low interest rates and equity market shocks. Our stress planning focuses on maintaining our financial strength ratings and business franchise, preserving our shareholder dividend, and not having to issue equity. Based on our most current stress tests, we are confident we can meet these goals.

Despite our comfort and given the wide array of potential outcomes from the virus and its economic consequences, we are taking additional steps to protect and further improve our capital position, including slowing sales to reduce capital consumption, suspending share buybacks for the second quarter and possibly longer, and selectively trimming more positions in the investment portfolio.

There are other areas where we are seeing or expect to see direct impacts from COVID-19. First, claims experience from the virus, including mortality and morbidity impacts. We expect our virus-related claims experience to be an earnings impact for Lincoln and not a balance sheet event. We do not see many COVID-19 mortality claims in the first quarter, but we expect an increase beginning in the second quarter.

In terms of morbidity impacts, we are seeing an increase in short-term disability claims and long-term disability claim recoveries have slowed. As a result, we believe morbidity trends and experience from COVID-19 and the economic fallout will have a larger impact on life mortality claims within our Group business.

The second area is consumer changes due to financial stress, such as missed premium payments or 401(k) hardship withdrawals. We are extending premium payment grace periods on a case-by-case basis for those with COVID-19-related hardships and following state-issued mandates as appropriate.

As part of the CARES Act, we are waiving eligible withdrawal and loan initiation fees for retirement savers. We believe these are the right things to do. And while early, we have not seen meaningful activity in these programs and do not expect them to have a large impact on earnings.

The third area is distribution disruption. We entered this crisis with industry-leading distribution and customer solutions. Our shelf space and distribution breadth led to over 100,000 individual producers selling a Lincoln product over the past 24 months.

We have efficiently moved to a virtual sales environment across all our distribution channels. We have launched training and armed our 1,500 customer-facing sales professionals with digital tools and appropriate insightful marketing materials.

Interaction with our customers remains at a very high level, all virtually. The digital investments we have made are enabling us to conduct business effectively as our ability to receive applications and issue policies digitally is very good. Also, customers are adopting these tools with take-up rates increasing by 50% or more in most cases.

And four, resulting downdraft in economy will result in some incremental credit downgrades and asset impairments, which I have said is anticipated in our stress testing.

Let me turn to sales. As you have seen, our first quarter sales, which reflect our solid product and distribution positions, were good and highlight our potential for long-term sales growth. However, sales in subsequent quarters will likely be at lower levels than what we saw in first quarter for several reasons. We are seeing consumers and companies being more cautious as they try to better understand their own situations and not make immediate purchase decisions. Also, at Lincoln, we have raised prices on several products and, in a few cases, suspended products where the return on capital or customer value proposition could not be supported in this low interest rate environment.

These factors will decrease the amount of capital we invest in growth, but meaningfully increase our free cash flow, a prudent shift in the current economic environment. Let me expand on this by touching on our strategic approach to proactively respond to lower interest rates and increased economic uncertainty.

Since the beginning of last year, we have been actively repricing products where returns are more affected by interest rates. This has been primarily concentrated in our Life and annuity businesses as new business returns and RPS and Group are less affected by low rates. Products that have been particularly affected include fixed annuities, variable annuities with guarantees, universal life, and MoneyGuard.

We're also shifting to emphasize existing products that meet or exceed return requirements. As I noted earlier, our indexed variable annuity continues to gain momentum, enabling sales of VAs without guarantees to overtake sales of VAs with guarantees, which is a great risk capital and return tradeoff.

Bottom line, we're going to continue to sell products that solve consumer needs, while maintaining our focus on achieving appropriate returns on capital. We are in a fortunate position of having the broadest product portfolio in the industry, a proven ability to shift sales, and a demonstrated capability to add new well-priced products, all of which should support long-term growth initiatives as the economy stabilizes.

Lastly, on the investment portfolio, I noted earlier we had been managing credit risk more defensively by adjusting our new money allocation to higher rated investments as well as proactively de-risking in preparation for a potential credit cycle.

For example, within our commercial mortgage loan portfolio, more than 99% are rated the equivalent of investment grade with an average loan-to-value of 48% and debt service coverage ratio of 2.4 times.

Within a structured portfolio, 97% of CLOs are rated AA and above. We have also shifted our investment portfolio through de-risking actions, selling more than $5 billion since 2015 with 70% in securities rated BBB minus or below. These measures have contributed to below investment grade assets representing just 4% of rated assets and our energy allocation declining approximately 50%, and importantly, shifting the mixed sub sectors generally less impacted by the price of oil.

As I mentioned upfront, our rigorous stress testing of the investment portfolio involves a wide array of scenarios to assess significant credit deterioration and this has informed many of the actions I just discussed. The power of our multi-manager investment model also becomes more evident in the current environment.

We have leveraged our entire suite of managers since the onset of COVID-19 to analyze a variety of extremely adverse scenarios on a name-by-name basis across all asset classes in the portfolio. While we do expect to see an increase in ratings migration and credit losses, we currently believe the impact will be significantly below our financial plan stress test results and be manageable.

So, in closing, the impact from COVID-19 and the economic fallout remains unknown.

However, throughout Lincoln's 115-year existence, we have overcome similar economic challenges and our management team has a history of leading through difficult environments, including the financial crisis.

Importantly, we learned valuable lessons and, as I have noted, taken several actions since 2008 to prepare us well for this crisis. While we expect sales and earnings to decline, our liquidity and capital positions are strong, our financial planning and stress testing are robust, and I am confident that strategies we have in place combined with actions we are taking will drive long-term shareholder value.

I will now turn the call over to Randy.

Randal J. Freitag

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

Thank you, Dennis. Last night, we reported first quarter adjusted operating income of $465 million or $2.24 per share, a strong start to the year, and up 5% over the prior-year period. There were no notable items within the current or prior-year quarter. However, there were a few items driving some variability both up and down and I will detail them in the business segments.

Touching on the performance of key financial metrics compared to the prior year. Adjusted operating ROE increased 90 basis points to 13.5%. Book value per share excluding AOCI increased 2% to $70.24 with the current quarter negatively impacted by $1.40 per share related to the new accounting standard for expected credit losses or CECL. On an after-tax basis, our CECL reserve increased $51 million and stands at $270 million. Adjusted operating revenue increased 3% to $4.5 billion and expense management was excellent as G&A net of amounts capitalized decreased nearly 3% after adjusting for a $30 million non-economic decline associated with accounting for Lincoln equity and employees and directors deferred comp accounts. Net income per share for the quarter was $0.15 with the primary driver being unprecedented volatility in the capital markets, which resulted in a $349 million loss on variable annuity net derivative results with approximately one-third driven by some basis risk, which we expect to reverse over time.

Overall, the hedging program was highly effective, covering well over 95% of the changes in the hedge target during what was the most volatile quarter we have ever seen. Let me provide a couple measures to size the volatility. First, the hedge target increased $5.2 billion. However, the total distance traveled was $20 million, more than two times any preceding quarter. Next, the amount of trading that occurred during a volatile four-week period was equivalent to a typical nine-month period.

Now, turning to segment results starting with Annuities. Operating income of $261 million increased 4% from the prior year. Increase in earnings was primarily driven by higher average account values, which have benefited from nearly $1.9 billion in positive net flows over the past 12 months, including $520 million in the first quarter.

Base spread excluding variable investment income increased 5 basis points on a sequential basis. However, fixed annuity earnings declined over the same period due to lower variable investment income. Return metrics remained solid with ROA at 76 basis points and a 21% ROE and the period account values decreased 3% compared to the prior year and totaled $126 million. As a result, net amount at risk increased to 3.6% of account value for both living and death benefits. We expect this percentage will remain at the very low end of peers, highlighting the lower risk nature of our in-force business.

Looking ahead, we expect some headwinds from first quarter's end-of-period account values be 9% below average comp values. Though, we are well-positioned to continue delivering strong financial performance.

In Retirement Plan Services, operating income of $40 million was up 3% from the prior year with the increase in earnings primarily driven by strong expense management. Deposits totaled $2.8 billion and included growth in both first year sales and recurring deposits. Net flows totaled $671 million and $1.7 billion over the trailing 12 months.

Average account values increased 8%, so end-of-period values were 8% below the quarterly average. Base spreads excluding variable investment income compressed 18 basis points versus the prior year, elevated somewhat by a higher-than-normal cash position. We continue to expect a 10 to 15 basis point decline for the full year.

G&A expenses net of amounts capitalized decreased 4% year-over-year. When combined with an increase in operating revenues, the expense ratio improved 110 basis points compared to the prior year. Retirement business had a strong quarter, highlighted by growth in deposits, net flows, operating revenues and earnings. However, we do expect some headwinds for lower count values in the near term.

Turning to our Life Insurance segment, operating income of $171 million increased 9% from the prior year driven by new business growth. As you know, within our annual mortality expectation, we typically see elevated experience in the first quarter. However, results came in $19 million better than expected, similar to last year's first quarter.

Underlying earnings drivers were solid with average account values up 5% over the prior year and average Life Insurance in-force up 11%. Operating revenues increased 7%, while G&A expenses were flat, which resulted in a 40-basis point improvement in the expense ratio.

Spreads increased 6 basis points year-over-year as variable investment income returned to more normal levels. It's more than offset the impact from a non-economic change to our crediting rate methodology, which caused base spreads to decline 19 basis points, consistent with what we expect for the full year. So, a solid start to the year for the Life business with operating revenues and operating income each growing high-single digits. As Dennis noted, we are keeping a close eye on COVID-19-related mortality claims. We expect this to negatively impact near-term earnings results. So, the business remains well-positioned.

Group Protection reported operating income of $40 million compared to $55 million in the prior year with the decrease primarily driven by higher-than-expected mortality. Premiums increased 7%, benefiting from improvement in persistency and renewal rate increases. The loss ratio in the first quarter was 78.5%, up nearly 5 percentage points compared to the favorable loss ratio we reported in the prior-year period.

In the Life business, we saw elevated large claim experience in some larger accounts, which added a couple points to the total loss ratio. We would expect these larger cases based on credible experience to ultimately return to historical levels. Disability experience was slightly elevated primarily by higher incidence. This impacted the total loss ratio by roughly 1 point.

G&A expenses declined over the prior year as we continue to achieve synergies from the Liberty acquisition, are also benefiting from favorable expense variances. Each resulted in a 120-basis point improvement in the expense ratio.

While disappointed by this quarter's elevated loss ratios, we are encouraged by premium trends and expense management. Additionally, we do expect some negative near-term impacts from COVID-19 and the slowdown in the economy on a mortality and morbidity claims.

Before shifting to capital, let me make a few comments on second quarter expectations. While we do not provide guidance, there are three items we expect to impact results. One, the impact from lower end of period account values I noted in Annuities and RPS. I would remind you that every 1% change in equity markets impacts earnings by approximately $10 million.

Second, as you know, we report private equity returns on a one-quarter lag. Given the significant decline in equity markets in the first quarter, we expect a negative return on the alternative portfolio.

Third, we expect mortality and morbidity claims related to COVID-19 will increase. We currently estimate every 10,000 deaths in the United States will impact our earnings by approximately $9 million, with $8 million hitting the Life business, $1 million in Group and minimal impacts the Annuities and RPS businesses. Additionally, and as noted before, we would expect elevated loss ratios in group disability.

Turning to capital. We ended the quarter in a very strong position with our RBC ratio increasing 7 points to 446%. Additionally, we further improved our liquidity position as we paid off our only debt maturity due this year in February and increased our holding company cash to $760 million by pre-funding our June 2021 debt maturity of $296 million.

Now, let me discuss how Lincoln thinks about financial strength and how we expect to manage through the current environment. Absolutely none of us enjoy being in a stressed financial world. In many respects, what we have been doing for over a decade is preparing and practicing for a scenario like this.

We started by building a strong balance sheet. When comparing the end of the first quarter to the end of 2008, you would know cash at the holding company net of pre-funded debt maturities is up over $1 billion. Since we pre-funded our 2021 debt maturity, our next maturity is nearly two years away, a very different picture than 2008.

Statutory capital stands at $9.7 billion, nearly double the level in 2008 and our RBC ratio of 446% is up approximately 50 percentage points, which equates to $1.1 billion of capital. Not only is our balance sheet strong, but we have been stress testing at nonstop over the past decade. It is worth repeating that we have three goals in the stress test: maintain our financial strength ratings and business franchise; preserve our shareholder dividend; and not have to issue equity.

Our stress testing has both driven strategic actions and informed our confidence in the financial strength of Lincoln. Let me provide some color on what we think about when we stress test. We assume that equity markets will experience a significant drop in excess of 40% and not snap back over the three years that we model. We drop interest rates to very low levels. Coming into this year, we took the 10-year treasury down to 50 basis points compared to 1% in prior years. And given year-to-date declines, we have subsequently looked at impacts of rates going to zero. We also apply a very deep in the tail credit shock. Officially, we think of it as a CTE-99 credit stress. As you might expect, that level of stress drives significant credit losses and downgrades. That's a real stress, and it drives a long list of negative impacts to earnings and capital. But the stress test does not just identify the negatives. That is just the beginning. It also informs actions that we have taken or will take to offset those negative impacts.

For example, the investment portfolio de-risking that Dennis noted earlier. On the business mix front, products with long-term guarantees that have fallen to approximately 20% of total sales. And we've also successfully managed expenses to offset headwinds, with the most recent example being our employees delivering a plan a few weeks back to reduce expenses by $100 million in 2020. As part of our stress testing, we have also had our eye on possible impacts to statutory capital from reserve strengthening, primarily related to SGUL subtest if interest rates stay low.

Over the years, we have talked about the potential to see an approximate $350 million impact if rates stayed at 1% or $700 million at 50 basis points. Based on an updated analysis, we see a significant reduction. For example, at 50 basis points, we now expect the potential impact to peak in 2021 and be in the range of $100 million to $200 million. This significant improvement is driven by positive experience relative to the conservatism in statutory reserves and an increase in base reserves over the years as the block ages. The low end of the range reflects the wider spreads we're seeing today, while the upper end assumes spreads return to more normal levels.

Next, let me discuss our two primary uses of capital, new business and capital returned to shareholders. We recognize that many of you define capital returned to shareholders as free cash flow, but this fails to capture all the capital we generate in a given year. For instance, in 2019, we returned $938 million of capital to shareholders, including $640 million in buybacks. However, we allocated an additional $1.7 billion of capital to the production of new business. As Dennis noted, we expect sales to decrease as we re-price business for the current environment combined with disruption from COVID-19 and the weaker economy. As a result, I expect the amount of capital that we allocate to new business will be lower by approximately $400 million in 2020.

Turning to our expectations for buybacks. We have made the decision to temporarily halt buybacks considering the events of the past few months. Now that is not an announcement about anything beyond the second quarter. We will assess and reassess as time goes on and resume buybacks when it is prudent to do so. In the meantime, we are focused on achieving the three primary goals we defined in our stress test. And for all the reasons I have described, based on what we know today, I am very confident in our ability to achieve those goals.

So, to conclude, we had a solid first quarter with mid-single-digit revenue and EPS growth and a 13.5% ROE. The impacts are COVID-19 are primarily a near-term earnings headwind. And with a strong RBC ratio, significantly lower expectations for reserve strengthening in a low rate environment and the actions we have taken and will take, the balance sheet is in a good position to manage the stressful environment we are currently in.

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

Christopher A. Giovanni

Senior Vice President-Investor Relations & Strategic Planning & Corporate Treasurer, Lincoln National Corp.

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 if additional questions are necessary.

With that, let me turn the call back to the operator.

QUESTION AND ANSWER SECTION

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

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

Q

Hey, thanks. Good morning. I guess the – starting with the SGUL potential stat reserve impact. That's a pretty sizable difference, the $100 million to $200 million from $750 million. I guess, can you go into some more granular detail on why that improved so much at this point?

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

A

Ryan, yeah, thanks for the question. It's Randy. We came up with that guidance a number of years ago. And at the time, we talked about the fact that it was going to peak and then it would go down over time. That peak, when we first came out with this guidance was about 2018, so the actual number's been coming down for a little bit. I'll take the hit for not getting the updated guidance out there a little earlier.

But also when you factor in that 2020 is pretty much locked in because of what the index that really drives the thing has been – has done over the past 9, 10 months. Really now, three full years out of the end of 2021 past the peak on this. And as I mentioned in my script, you also have the natural unwinding, some of the conservatism that's embedded in statutory reserves. It's really those two big items, which really drive this big decrease in the – in our expectation for what we'd see in a very low rate environment. I hope that helps.

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

Q

Got it. And then when you run the stress test scenarios that you provided, can you give us, I guess, a sense of what type of RBC ratio you think you would maintain in that scenario? And I guess what RBC are you protecting to in an actual tail event?

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

A

So, I guess you're asking what is our downside when we run our full stress test run.

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

Q

That's right. And what do you need to kind of maintain for capital target in that downside?

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

A

As we mentioned, both Dennis and I mentioned, our stress testing has three goals. One of which is to preserve our financial strength ratings and our business franchise. The other two, which are maintain the dividend, not have to issue equity.

But we gear that whole stress testing run. And I ran through the different stresses that we use. Has a – one of its main goals is maintaining our ratings. So, with the stresses we run offset by the actions that we talked about, we believe that the capital we start at and where we started today as I mentioned is 446%, that the number we will ultimately go down to is consistent with the AA ratings we operate at today. Historically, that number's been in the range of 325% to 350%.

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

Q

Got it. Thank you.

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

A

You bet.

Operator: Thank you. And our next question comes from Jimmy Bhullar with JPMorgan. Your line is open.

Jimmy S. Bhullar
Analyst, JPMorgan Securities LLC

Q

Hi. Good morning. So, first, just a question on the hedge loss that you had. Can you discuss what sort of drove that and whether you're sort of making any changes to the hedge program as a result of that? But just a little bit more detail on the drivers of the loss.

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

A

Sure, Jimmy. This is Randy. First, no changes. It's a great program. No need to make any changes. First, let me make a comparative comment. I think, Jimmy, that we're the only company whose hedging target equals the number that we – that appears on our balance sheet. And I think that's really a best-in-class approach with an economic review of the risks that we are both hedging to. And that appears as the liability in our financial statement.

That liability itself, that hedge target was $5.5 billion at the end of the quarter and that compares to a net amount at risk on our living benefits of $2.5 billion, net amount at risk on our death benefits of about $4 billion. So, with that as a predicate, some comments on VA net derivative results are what I'm going to call breakage in general.

First, it's real number. It's real number that it represents the amount that our derivative assets increased relative to the $5.2 billion increase, which you saw in our liability. But there are a few other things that we know about breakage. One it's lumpy and it will run at very low levels for extended periods of time. That's what we see in for a number of years now.

And over an extended period of time, it's going to average out to a relatively small number. And this is an important one. It's also a number that we price for. So, we have breakage. There's a couple of things that we analyze very closely with the team. The first is capital because breakage ultimately comes out of capital, comes out of capital and we work on. And this I think is a really good example of one of a very positive financial and risk changes that we made coming out of the financial crisis.

Now that we switched from a straight CTE-98 approach to capitalization, an approach that takes a greater of CTE-98 and a percent of account value. What that does is during the good times when markets are rising, it doesn't allow you to pull capital out of the VA business, which is really what a straight CTE-98 approach does.

And that's what we've seen, that percent of account value floor has been controlling for a while. And it's forced us to hold an extra $400 million to $500 million in the business. So, I – well, it gets temporarily used up by this lumpy breakage. We're still left with a very strong capitalization, so great policy change that we made that's worked just like we would have wanted.

The second thing we think about is really the economics of the Annuities business itself, specifically does the breakage change our view of the economics of the business. The answer is no. Let me dig into that a little bit.

The economics really start with our approach to reporting the VA results, which, as I mentioned earlier, I think of as is best in industry. There are two big components, Jimmy, to cost of running a hedge program.

The first is the day-to-day cost of buying hedges. So for every policy we issue, we calculate the cost of the hedging. That cost represents a significant portion of what we actually charge the customer. That cost, which will be about $500 million or so this year, gets pulled straight out of operating revenue, straight out of income. And so, what we're left with is an operating income and operating return on equity that's averaged about 21% over the years. Averaged in a very level that's actually what we reported during the first quarter.

But the other thing we know is that it's not possible to fund the hedge program that's perfect, which leads to the second big cost of running a hedge program, and that's what we're talking about. That's called breakage. And we actually price for that. So, when we price these products, we assume the program will be 80% effective. That means we price in 20% breakage. So, coming into this quarter, that breakage had represented about an additional 2% cost against operating ROE. And when you combine in this quarter's breakage, that cost goes to about 3%.

So, that 21% or so operating ROE gets reduced to about an 18% economic ROE, which compares very favorably to the 16% target that we've priced for all the years. So, from my standpoint, the economics of that business are still very strong and stand strong even after a quarter like this. I hope that helps, Jimmy. A long answer, but I think it's an important topic.

Jimmy S. Bhullar
Analyst, JPMorgan Securities LLC

Q

Sure. And then just another one on your share buybacks. What are the things that you're going to be looking at to sort of decide when to get back into the market?

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

A

I think, Jimmy, ultimately, it's a decision about whether or not you're in a stress scenario. We're going to operate in the second quarter like we're in a stress scenario and we've got a playbook for that situation. We'll get to the next quarter and we'll look at the environment. We'll ultimately make the determination. Are we still on a stress scenario, is that how we should be operating. I guess that's how I think about it, Jimmy.

Jimmy S. Bhullar
Analyst, JPMorgan Securities LLC

Q

Thank you.

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

Thomas Gallagher
Analyst, Evercore Group LLC

Q

Good morning. Randy, just a follow-up on the commentary about LNBAR and about the way you're managing capital. The – should I think about where you're at now or at least at the end of March, would that – would you be holding to CTE-98 now or is it the 4%? That's the greater of at this point. And when you think about that business and you think about what might be required if you had another sort of repeat of 1Q performance, what are your – how much of a buffer I guess do you have when you think about managing capital there? It doesn't sound like you're – there's any risk of near-term additions to that entity. But can you talk a little bit about how it's capitalized now and then thinking about further stresses and positioning?

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

A

Thanks, Tom. I guess I would think about it as – so the CTE-98 calculation, when the markets go down, jumps up. But we've had this account value floor that's been holding us above that. So, we've got that buffer. So, I think about where we are today sort of consistent with that CTE-98 approach. The other thing I had mentioned to you is that the difference between CTE-98 and CTE-95, which is sort of another level you hear people talk about in the industry. In our case, for our book of business, it is somewhere between $1 billion and $1.5 billion.

So, LNBAR, the entity, remains very well-capitalized, will continue to grow capital over there. We haven't taken dividends out of the LNBAR for a long time. We just sort of let the earnings accrue over there. Last year, we really took our first dividend out of there in an extended period of time. So we can easily go back to letting that entity accrue the earnings it naturally makes in any given year, but we feel very good about where we are today, Tom.

Thomas Gallagher
Analyst, Evercore Group LLC

Q

Okay. Thanks. And then, let's see, the other one I just had was on, Dennis, you had mentioned you're seeing increased short-term and long-term disability claims. Can you provide a little bit of color on what you think is going on here? Is it just the historic correlation of unemployment where you see kind of a surge in borderline claims? Or what do you think is going on sort of behind the scenes with disability?

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

Yeah, Tom. So far, there's not been much COVID-19-related claim experience. When we think about the effect on morbidity, particularly in the Group business, we lumped together a couple of the concepts that you just asked about. One is the direct COVID effect on claims and we expect that to increase.

And the second one sort of relates to your question about the experience that all providers have that in a recessionary period of long-term claim incidents increases. So, when we look forward, it's some combination of those two things, direct claims and potential, so again, historical increase in LTD experience associated with recession. So, we'll be watching those things closely as we go through the quarters.

Thomas Gallagher
Analyst, Evercore Group LLC

Q

Thanks, Dennis. And just one last if I could sneak it in. Just – do you have an estimate for stress credit losses that you would expect annually here and how would that compare, Randy, to the $400 million that you said should be freed up at least in 2020 from the lower sales levels?

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

A

Tom, we don't want to talk specifically about the number and the amount of stress credit losses. I mentioned that the CTE-99 scenario drives a significant amount of credit losses as you can imagine. A comment I'd make is that the environment we see today, I'll call the COVID environment, if you will, we don't see this as being as stressful as the stress we run every single year. So, it's hasn't risen to that level yet, and it's really primarily as we see right now as we – as Ellen and her team work very closely with our asset managers, it still appears to be primarily a downgrade event probably supported somewhat by what the fed and the government is doing, but it still appears to be primarily a downgrade event. In the first quarter, we actually had $655 million of downgrades. That hurt our RBC by about 5 points. Despite that, we were still able to grow overall RBC by 7 points. So, that's what we've seen so far as downgrades and that's kind of our expectation for what we're going to see unless the environment changes significantly from what it has been for the last few months.

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

Tom, I might add to what Randy – I'd add to what Randy said and just repeat what both he and I did say in our scripts, is that we're coming into this stress period with a substantially stronger investment portfolio because all the actions that we've taken since 2008. So that's a really good starting point, in addition to what Randy has talked about.

Thomas Gallagher
Analyst, Evercore Group LLC

Q

Thanks.

Operator: Thank you. Our next question comes from Humphrey Lee with Dowling & Partners. Your line is open. Humphrey, please check your mute button.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners

Q

Good morning and thank you for taking my questions. Thank you for providing the color in terms of what you're thinking in terms of mortality and morbidity impacts from COVID-19. But when you think about from – I guess from the top line perspective and especially given some of the unemployment and furloughed employees, what are you seeing in terms of in RPS and in Group Protection relative to your premium base and account value?

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

A

Thanks, Humphrey. When you think about those two businesses, specifically, we haven't seen much in the way of impact so far either from a top line or from a bottom line or at least through the first quarter. I think if you think forward in the Group business, there are really three things that can impact the top line or that we would think might impact the top line. The first is that in this environment disruption that's going on, we'd expect some slowdown in sales. Dennis mentioned that. Offsetting that, there's an expectation that you'll have better-than-expected persistency. I think both those two items sort of offsetting each other, which leaves you with the third impact, which is what you see in a Group business in every recession which you have higher unemployment, lower covered lives, and that provides a bit of a drag on top line growth. So, we grew 7% in the first quarter. Wouldn't be surprised at all if that comes down as you move over the course of the year because really – because of that third item.

In the Retirement business, we haven't really seen much again in terms of people taking additional hardship draws. We saw a very modest amount, $30 million over the past few weeks, 0.03% of account value. So could that pick up and have a modest impact? It could, but that hasn't been our experience so far.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners

Q

Got it. And then looking at your kind of financials this quarter, it looks like you've done a small Life Insurance reinsurance transaction. I was wondering if you can provide some color in terms of the particular transaction and how much capital freed up.

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

A

Yeah, Humphrey. We did sort of I think about an ordinary course transaction with one of our existing partners. It was on a very old book of term insurance, term insurance that was actually past its guarantee period. It generated about, in my recollection here, $50 million to $60 million of capital for a very modest development in earnings. So, it was a good transaction with a partner we've got a long history working with.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners

Q

Got it. Thank you.

Operator: Thank you. And we have a question from Suneet Kamath with Citi. Your line is open.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Q

Thanks. Good morning. So appreciate the update on the SGUL subtest. In the past, you've also provided reserve redundancy guidance for the non-SGUL book. I guess the question is, should we assume that those numbers similar to the SGUL subtests have also increased pretty dramatically since that last guidance?

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

A

Yes, Suneet. I think historically sort have been the base case cash flow testing. They have been growing roughly $1 billion a year and there hasn't really been a change and that we've continued over the past three, four years to – so a lot of profitable businesses. And that's been more than enough to overcome the natural runoff that occurs in the business. So, yeah, I think there hasn't been really any change in the pattern we see over the years.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Q

So then relatedly, we spend a lot of time on this on the last call, so I figured I'd just ask again in this call in terms of in-force transactions. Obviously, the rate environments changed, but spreads have widened. Is doing something with the in-force block part of that playbook that you talked about in terms of managing for capital flexibility and is doing a transaction in this environment possible?

Dennis R. Glass
President, Chief Executive Officer & Director, Lincoln National Corp.

A

Suneet, I think the current environment is really chilling the overall M&A landscape. People are trying to understand their own situations, much less take on somebody else's situation. So big picture M&A I think is chilled for the moment. Both transactions sort of falls into that same general category. And it's possible that something like that could develop. As we've had said in the past and you pointed out that we – all of us have discussed this. It's a balance between what are the return requirements and interest rate return levels and can you get the right – can you clear the table where both the buyer and the seller have an advantage. And we'll just stay in the flow of transactions. But I think there's sort of a chill right now because of the uncertainty.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Q

Got it. Okay. Thanks.

Operator: Thank you. And that's all the time we have for questions. I'm going to turn the call back over to Chris Giovanni for any closing remarks.

Christopher A. Giovanni
Senior Vice President-Investor Relations & Strategic Planning & Corporate Treasurer, Lincoln National Corp.

Thank you all for joining us this morning. As always, we are happy to take your follow-up questions. Please e-mail us at investorrelations@lfg.com. Thank you, and have a great day.

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