06-Aug-2020

Lincoln National Corp. (LNC)

Q2 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

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

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

Thank you, operator. Good morning, and welcome to Lincoln Financial's Second Quarter Earnings Call. Before we begin, I have an important reminder. Any comments made during the call regarding future expectations, trends, and market conditions, including comments about sales and deposits, expenses, income from operations, share repurchases, 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 include those described in the cautionary statement disclosures in our earnings release issued yesterday, as well as those detailed in our 2019 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 full reconciliations of the non-GAAP measures used on the call, included adjusted return on equity and adjusted income from operations or adjusted operating income to the most comparable GAAP measures. A slide presentation containing supplemental second quarter 2020 earnings and investment portfolio information is also posted on our website in the Investor Relations section.

Presenting on today's call are Dennis Glass, President and Chief Executive Officer; and Randal 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, everyone. As we all know, the pandemic's course and economic consequences, including lower interest rates, are both challenging and difficult to predict. However, Lincoln is very effectively dealing with the immediate COVID-19 operating issues, such as working from home and virtual selling. We are also aggressively responding to the overall health, economic, and capital market environment.

Our near-term focus continues to be on maintaining our already strong balance sheet, actively repricing products to achieve appropriate returns and delivering on expense savings targets. Additionally, over the medium- to long-term, our emphasis is on improving the way we operate by capitalizing on the benefits of the accelerated shift in digital and virtual selling to increase wholesaler and employee productivity; adding new, well-priced products to complement our refreshed product portfolio and drive growth; and targeting additional expense saving programs. We expect all these actions will create long-term competitive advantages.

I will cover each of these items later, but first, I will touch on second quarter results. Second quarter adjusted operating income was affected by elevated claims experience from COVID-19 and negative returns within our alternative investment portfolio, both consistent with our expectations. Excluding these items, adjusted operatings per share would have been more consistent with the very strong prior-year quarter. Based on the current level of equity markets, we see a lift in third quarter earnings related to higher fees on assets under management and the recovery in returns on the alternative investment portfolio. We also expect lower COVID-related claims. In aggregate, prior to any impacts from our annual assumption review, we expect adjusted EPS more in line with results from the first quarter of 2020.

As I just mentioned, we are responding aggressively to the current environment. In the Individual Life and Annuity businesses, this includes active product repricing related to lower interest rates, and in some products, higher reserve requirements. Also, as we noted on our first quarter earnings call, we are reducing the amount of capital deployed towards new sales by approximately $400 million this year to help maintain our strong capital position. The overall product strategy is to continue to reprice products when necessary to achieve our targeted returns, shift our selling emphasis to products achieving good returns and providing a powerful consumer value, and add new products. In short, our reprice, shift, and add new product strategy. With this backdrop, I will go into more detail on each business, focusing a little more on product sales and net flows in the individual lines.

Starting with the Life Insurance business. We have one of the broadest portfolios of life products in the industry and the strongest distribution platform. This has enabled us to target several products that do not require significant repricing, including term and indexed universal life where sales are up 7% year-to-date; and Executive Benefits which, while lumpy quarter-to-quarter, have consistently contributed to annual sales. Life products most affected by price increases include universal life, MoneyGuard, and variable UL, where we expect sales to be down materially in 2020. With changes to these products and as new product developments kick in, we are confident we will rebuild sales levels, achieving strong returns on capital and contribute to future earnings growth.

In the Annuities business, we achieved positive net flows driven by lower surrender rates and strong growth in variable annuity sales without guaranteed living benefits, which represented more than half of our total annuity sales. Indexed variable annuities, a great example of a product achieving good returns and providing a powerful consumer value, were up 68% over the prior-year quarter, surpassing $1 billion in sales this quarter. Total annuity sales were down, as we reduced benefits on VAs with living benefits and de-emphasized fixed annuity sales due to lower interest rates. However, we are capturing the asset protection value propositions through our indexed variable annuity, which is more capital-efficient and provides better new business returns.

Though our collective pricing actions are dampening near-term sales, they are protecting the strong returns we have long had in our Annuity business. Beyond our repricing, the shift in add components of our strategy will create additional opportunities as we look to 2021.

Shifting to our employer-focused businesses where repricing isn't as significant, in Retirement Plan Services, strong growth in first year sales generated a double-digit increase in total deposits. Net flows were affected by two large case terminations, however, we expect to have positive net flows in the second half of the year. At the plan sponsor level, recurring deposits are facing some headwinds from employees reducing or eliminating matching contributions and workforce reductions. At the participant level, we have not seen meaningful outflows related to the CARES Act; and our high-tech, high-touch model, coupled with our innovative product help customers better navigate these uncertain times and drive our future growth.

Lastly, on Group Protection, premiums increased mid-single digits as we benefited from improved persistency, renewal rate increases, and soft sales. We believe the pandemic has only increased national awareness of needs for life insurance and disability and lead management products, as evidenced by our premium growth. Though we may see some disruption in new business sales due to the pandemic, we expect the benefits of our well-diversified customer base will continue to result in strong premium growth while our focus on pricing actions and expense efficiency will improve our margins.

Bottom line, across all businesses, we are in a good position of having created the broadest product portfolio in the industry, the best distribution, and a proven ability to combine these differentiators to shift sales to products with strong value propositions for the customer and good returns for Lincoln.

Now, shifting to other strategic areas of focus in the current environment. First, on the balance sheet, where we remain in a very strong position. Our RBC ratio ended the quarter at 444% and positions us well to manage through this period of uncertainty. During the quarter, we also expanded our highly reliable and committed sources of liquidity within our insurance subsidiaries to approximately $9 billion, up from $7 billion in the first quarter. While we certainly do not expect any liquidity issues, these programs can be used to manage any cash flow stress that might develop. At the holding company, we have $774 million of cash, and our next maturity is not due for three years. In addition, we have our $2.25 billion credit facility.

Within the investment portfolio, we continue to manage credit risk more defensively by adjusting our new money allocation to higher-rated investments, as well as proactively de-risking. As we've mentioned in the past, we began de-risking our investment portfolio a number of years ago, leveraging our multi-manager investment model to analyze a variety of adverse scenarios to identify those securities that have the potential for significant credit deterioration in an economic cycle.

We continued with the execution of our program in the quarter, de-risking the portfolio by another $1 billion. We remain focused on high-quality new money purchases, and when combined with our de-risking actions, the overall quality of the portfolio continues to improve with our exposure to BBB- and below securities decreasing 60 basis points on a sequential basis.

Year-to-date, negative RBC impacts from the investment portfolio are running better than our expectations, supported by our de-risking program and the benefits of various government support programs, including the Fed's action on credit markets. While we remain confident with our balance sheet and capital positions, we expect to stay paused on share buybacks for the third quarter, a prudent approach given that economic outcomes remain unpredictable.

Expense management also remains a key focus in the near-term with Liberty synergies of $125 million nearly achieved; digital savings on track for $40 million to $50 million this year, and progressing towards our $90 million to $150 million target; and we have also made significant progress on our third savings initiative, an additional $100 million this year to help offset near-term pressures. We expect to maintain this $100 million going forward by leveraging virtual sales capabilities, sustained increased workforce productivity, and capitalizing on the recent acceleration in digital adoptions by both advisers and customers, all of which enable us to conduct business more efficiently. We have a track record of responding with expense programs to help maintain margins and are optimistic about our ability to deliver on these targets, and we'll provide more details as we progress.

In closing, second quarter results were impacted by the pandemic and equity markets but, as I noted, we expect earnings to recover to more normal levels in the third quarter. Our balance sheet is in a strong position. We are making pricing changes where necessary and still selling a significant amount of new business at good returns and adding new products to drive future growth opportunities, and we're executing on existing and new cost save initiatives to strengthen earnings. All of these position Lincoln for long-term success and deepen our competitive advantages in order to 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 second quarter adjusted operating income of $187 million or $0.97 per share. A difficult quarter, but consistent with our expectations. There were no notable items within the current or prior-year quarter. However, as expected, this quarter was negatively impacted by COVID-19-related claims and performance in the alternative investment portfolio.

First, in COVID. We estimate that COVID-related claims reduced earnings by approximately $125 million to $145 million or $0.65 to $0.75 per share. We provide an estimated range for COVID impacts because there is undoubtedly a level of imprecision in estimating claims due to timing and recording of deaths. This is slightly above the mortality sensitivity we provided previously. Looking forward, we now estimate every 10,000 COVID-19 deaths in the United States to impact our earnings by approximately $10 million, with $8 million still hitting the Life business and $2 million in Group. In addition, we anticipate morbidity headwinds in Group related to the economic environment.

Next, on alternatives. Returns were negative, which reduced earnings by $0.62 per share relative to our targeted annual return of 10%. This represented a negative 7% pre-tax return in the second quarter. We reported a net loss of $94 million. Importantly, the majority of the difference between our adjusted operating income and our net loss was the result of $150 million in items we consider to be non-economic, related to accounting associated with our 2018 sale of Annuity business to Athene, and the variable annuity GLB non-performance risk.

Specific to the Athene transaction, as we have noted in the past, changes in fair value for many of the assets run through the balance sheet, while the offsetting change runs through the income statement. This non-economic impact will fluctuate but, over time, will subside and reverse. Additionally, this year's new accounting standard for expected credit losses, or CECL, reduce net income by $79 million. Lastly, the variable annuities hedge program performed very well with 99% hedge effectiveness in another volatile quarter for the capital markets.

Now, turning to segment results, starting with Annuities. Reported operating income of $237 million compared to $266 million in the prior year, with the decrease primarily driven by negative returns within our alternative investment portfolio. Average account values decreased 3% on a sequential basis, but the end-of-period account values increased 10% over the same period. Given the increase in end-of-period account values, net amount at risk decreased to less than 2% of account values for living benefit and less than 1% for death benefits. This compares favorably to nearly 4% for both as of the end of the first quarter.

Base spreads, excluding variable investment income, increased 1 basis point on a sequential basis. G&A expenses net of amounts capitalized decreased 12% year-over-year, as the entire organization focuses on helping offset pressures from the economic environment. Hurt by negative investment results, ROA came in at 71 basis points and ROE at 19%. Looking ahead, we expect tailwinds from the equity markets and the variable investment income to drive a recovery in earnings and returns to more normal levels in the third quarter, excluding any impact from our annual assumption review.

Retirement Plan Services reported operating income of $30 million compared to $42 million in the prior year, with the decrease driven largely by alternative investment performance. Deposits totaled $2.3 billion and included growth in both first year sales and recurring deposits. Average account values decreased 3% compared to the first quarter, though end-of-period values increased 10%. Base spreads, excluding variable investment income, compressed 24 basis points versus the prior year, which was above normal, primarily due to lower yield on floating rate securities where the crediting rate on the matched liability adjusts less quickly, combined with the impact of significant deposits towards quarter-end. G&A expenses net of amounts capitalized decreased 11% year-over-year, which led to a 110 basis point improvement in the expense ratio. Similar to the Annuities business, we expect tailwinds from equity markets and variable investment income to drive earnings higher in the third quarter.

Turning to our Life Insurance segment. We reported an operating loss of $37 million compared to operating income of $168 million in the prior year, with the decrease driven by mortality related to COVID-19 and alternative investment performance. COVID-19-related mortality was consistent with our previously stated expectations within the Life business. Underlying earnings drivers continued to show growth with average account values up 2% and average Life Insurance in-force up 10%. G&A expenses net of amounts capitalized decreased 11% year-over-year, which led to a 20 basis point improvement in the expense ratio. Base spreads were consistent with the first quarter. As a reminder, the year-over-year decline is above our 5 basis point to 10 basis point expectation due to a non-economic change to our crediting rate methodology. Looking forward, based on what we know today, we expect the third quarter to see less of an impact on mortality from COVID-19 and a strong recovery in variable investment income.

Group Protection reported operating income of $39 million compared to $68 million in the prior-year quarter, with the decrease primarily driven by COVID-related mortality. The loss ratio was 77.8%, a 70 basis point improvement on a sequential basis, but up 4 percentage points compared to the prior-year period. Group life loss experience was impacted by COVID-19, with the majority of the increase attributable to the pandemic. Our disability loss ratio is consistent with recent quarters but elevated compared to the prior-year quarter. While we saw some improvement in LTV incidence rates on a sequential basis, claims resolutions were lower which we attribute in part to indirect impacts of COVID-19, including the resulting economic conditions. Offsetting disability was favorable dental experience, which we largely attribute to COVID-19. We expect to see this normalize in the third quarter as access to dental care resumes.

Results were negatively impacted by alternatives performance, with that negative being offset by G&A expenses net of amounts capitalized that declined 8% over the prior-year quarter, driving a 170 basis point improvement in the expense ratio. While disappointed by this quarter's elevated loss ratios, our results were affected by several direct and indirect impacts of the pandemic. However, we are encouraged by our premium growth and expense management.

Before shifting to capital, let me make a few comments on third quarter expectations. As Dennis noted, based on what we know today, we expect earnings to recover to more normal levels in the third quarter, excluding potential impacts from our annual assumption review. This is driven by some of my earlier comments about tailwinds from equity markets, strong expected returns from the alternatives portfolio, and lower expected mortality-related impacts from COVID-19 compared to the second quarter.

As you know, we will also complete our annual assumption review in the third quarter. As a reminder, last year's review included a charge related to interest rates, reflecting an impact of the drop-in rate on the starting point, a lower long-term ultimate interest rate assumption, and extending our grading period. Interest rates are much lower today than they were last year, which could impact the interest rate component of our assumptions again this year. That said, I do not want to front-run the process as there are a lot of people working on the review, and it's ultimately about what all the impacts add up to.

Turning to capital. We ended the quarter in a strong capital position, with statutory capital of $9.7 billion and an RBC ratio of 444%, up 5 percentage points since our 2019 annual filing. At the holding company, we have $774 million of cash; and during the second quarter, we further improved our liquidity position by paying off our 2021 debt and pre-funding our $300 million debt maturity due in 2022, the result being our next maturity is not due until September 2023.

So, to conclude, as expected, earnings results were impacted by COVID-19-related claims and performance of the alternative investment portfolio. Excluding the impact of these items, operating ROE would have been approximately 13%. Expense management was excellent as all four businesses reduced G&A expenses, resulting in a 7% decrease in consolidated G&A. Lastly, our capital and liquidity positions are strong and have, in fact, grown stronger during this current period of uncertainty as a result of management actions.

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

Christopher A. Giovanni

Senior Vice President-Investor Relations & 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 you have additional questions.

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

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] And our first question comes from Erik Bass with Autonomous Research. Your line is open.

Erik Bass
Analyst, Autonomous Research LLP

Q

Good morning. Thank you. Just, first, can you just help us think about the sensitivity to any changes, if you were to make any to your long-term interest rate assumption or the grading period? And should we look at what happened last year and expect that the impact would be similar?

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

A

Hey, Erik. It's Randy. Thanks for the question. So, as I said in my script, if you go back to last year, the interest rate component was a negative in the overall unlocking. It was, in total, $291 million, and was impacted by three different areas. First, the starting point and changes to the ultimate rate in the grading period. The starting point component of that was $139 million of negative last year.

And when you think about our assumption, think about the starting point as a mark-to-market, right? So, our starting point, where are we investing money today, what is the market? And then, you have the ultimate rate, which is more of a subjective view of where could rates go to over time. And then, what connects them is the grading period. Last year, that $139 million impact from that objective view of where rates were was driven by the fact that rates were lower. And, again, this year, rates are lower. So, you wouldn't be surprised if that one component was negative again this year.

In terms of the more subjective view of where rates could go over time, I think that's part of the process of reaching out to all our managers, collectively coming up with a reasonable view of what that future could be. And that'll be part of what we're doing right now and what we'll do over the remainder of the quarter.

So, I think that – and, hopefully, that gives you some insights. I also said in my script, and I just want to remind everybody, at the end of the day, interest rates are one piece of what is a broad set of assumptions. And so, we'll review all of those assumptions. And while the interest rate piece of that may have a negative bent to it right now, at the end of the day, it's going to be about what all the assumption impacts add up to.

Erik Bass
Analyst, Autonomous Research LLP

Q

Got it. Thank you. That's helpful. And then, a bigger picture question for the Life business. Does the pandemic experience change your view at all on risk retention limits and the amount of reinsurance you may look to utilize, especially since you don't have any material exposure to longevity businesses that act as an offset to mortality?

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

A

Erik, no. I don't think so. The pandemic itself – I think the use of reinsurance and the amount of reinsurance you're using is more aligned with things like, is the cost of reinsurance at that moment in time attractive? What is our risk appetite as a company? And as we talked about, mortality and morbidity-based earnings are something we are very comfortable with. We are very comfortable with our ability to underwrite life insurance.

And so, our current retention program – and just as a reminder, we keep up to the first $2.5 million. After that, we reinsure the majority of the risk. We keep a small percentage of it. So, we're very comfortable with that and I don't think the pandemic changes our view of appropriate risk retention.

Erik Bass
Analyst, Autonomous Research LLP
Q

Got it. Thank you.

Operator: Thank you. Our next question comes from Ryan Krueger with KBW. Your line is open.

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

Hi. Thanks, good morning. On the capital position in the $400 million of expected free cash flow benefits this year from lower sales activity, I guess, has that come through in the first half of the year at around half of that base? I guess, the reason I'm asking is the RBC ratio is kind of just steady in the quarter. I thought it may have increased more, given the lower sales activity. So, if you could maybe review some of the moving parts of the RBC ratio in the quarter, and if you'd expect a build in the second half of the year.

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

Thanks. Ryan, thanks for the question. Yeah, I think a little more than half came through in the first quarter, and it's really driven by – in that first year, what our expectations are around fixed annuity sales. The fixed annuity sales have a pretty big first year drag on their own. And for a lot of valid reasons, we have trimmed back our sales of pure fixed annuities.

In terms of what you saw in the second quarter, why didn't the RBC ratio grow? I'd just remind you that the two big items we talked about in GAAP, COVID-19 claims and alternative performance, those also occur in statutory. So – and actually, they're a little bigger in statutory because you don't have a DAC offset. So, when you think about those two items providing roughly $300 million of headwinds to the statutory results in the quarter, when you think about some other items – we had some other small negatives that we put up, so you're talking about $350 million to $400 million of headwinds that we saw on a statutory basis.

So, I'm very happy, actually, that, overall, capital stayed level for the quarter. It's just means that underlying all that, there were some good, strong statutory earnings. So, very happy with the results in the quarter and have actually seen a fair amount of the benefit driven by lower fixed annuity sales on the denominator.

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

Thanks. And then, on buybacks, I know it's still paused for the third quarter, but as you've seen credit experience something quite a bit better so far, I guess, is it – would it – can you potentially contemplate it to bring the buyback back before the end of the year at this point?

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

A

Ryan, it's Dennis. And I think we'll just stay with the – a couple of comments. One, it's very unpredictable these days. I mean, as we all know, there's so many drivers of what might happen over the next several quarters which could affect earnings, which could affect our investments. So, I think, right now, the focus is on maintaining our high-quality strength in the balance sheet. And at this point, we'll just comment that the – we're pausing for the third quarter.

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

Q

Got it. Understood. Thank you.

Operator: Thank you. Our next question comes from Elyse Greenstaff (sic) [Elyse Greenspan] with Wells Fargo. Your line is open.

Elyse Greenspan
Analyst, Wells Fargo Securities LLC

Q

Hi. Thanks. Good morning. I guess, my question follows up on the capital question to a certain degree. You guys obviously, a little while ago, did that block reinsurance deal with Athene that was helpful to free up capital for buyback. Obviously, given where interest rates are, from what we're hearing, right, there is a greater bid/ask spread on some deals in the market right now. But do you guys have a view on whether you'd be more or less willing to transact in other deals? And then, would you consider transactions similar to that to free up capital and potentially return to buying back your shares sooner than you might otherwise?

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

A

Elyse, it's Dennis. I think your first point, which is that low interest rates have an effect on what you can get for selling blocks of business, and so I think, right now, it's probably – there may be some deals done, but it's hard to clear the table for buyer and seller on blocks of business. We've seen some very strategic activity in the marketplace which go beyond sort of just pure return from the sale of a block. But absent the strategic deals, I think it's been pretty quiet.

We continue to be in the flow of opportunities, and we'll continue to see what makes sense. And so, we're open-minded, focused, and if something comes along that makes sense for both buyer and seller, we would do it. But again, I think it's – we'd be – I'm sort of like, I'm going to be coming back to the unpredictable circumstances that we're in. I think that chills that marketplace a little bit.

Elyse Greenspan
Analyst, Wells Fargo Securities LLC

Q

Okay. That's helpful. And then, you guys provided an updated sensitivity on COVID, but it's a little bit higher within Group than you guys expected before. I guess, when thinking about mortality impacting the third quarter, is it just as simple as we should just kind of, I guess, pay attention to the death rate, number of lives, and kind of use the sensitivity there? Or what would – given the mix in – of your book in the third quarter, what could cause that to vary within Group where things could potentially trend in a little bit better than expected?

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

A

Hey, Elyse. It's Randy. And thanks for the question. When you think about COVID-19, we spent a fair amount of time last quarter coming up with our estimates. We included our doctors, we included our data experts in terms of analyzing the different studies that were out there. We included our actuaries in terms of understanding our own mix of business. So, we spent a lot of time, and I think that shows in the overall fact that our estimate came very close to our actual experience. I've actually been a little surprised by some of the companies that I've seen out there who missed by upwards of 75%. I'm not really sure why we've seen those sorts of gaps. But we spent a lot of time, and so we're very – nobody's happy with claims, but we think we did a really good job of estimating the potential impact.

As we mentioned, in the Life business, we had $8 million when the final number came in right in line with that, so that number sticks. But in the Group business, we did see a little pickup from $1 million, which was the estimate we provided last quarter, to now – we're now updating to $2 million. I don't think there's anything that's really impactful in there. I think it just reflects a growing understanding of exactly how the pandemic is going to hit different areas of the economy. So, we felt good about the $9 million because it came in pretty close. We'll update it to $10 million, and we feel that provides a good estimate as we move into the third quarter.

Elyse Greenspan
Analyst, Wells Fargo Securities LLC

Q

Okay. Thank you for the color.

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

A

You bet.

Operator: Thank you. [Operator Instructions] Our next question comes from John Barnidge with Piper Sandler. Your line is open.

John Barnidge
Analyst, Piper Sandler & Co.

Q

Thank you. As we look forward in the Group Protection segment, can you talk about how you square a favorable claim trend – trends in dental, in the likelihood that it's a segment of the population that's just not going to use their benefits this year? And square that with renewal pricing and the prospect of catch-up claims or emergence of more severe claims in 2021?

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

A

John, thank you for the question. So, yeah, I think it's a very broad question about Group results. Dental itself is a relatively small component of our Group business. We had, what, a little – almost a little short of $1.1 billion of premiums in the quarter, and Group premiums represent only about 6% to 7% of that, about $65 million. So – and on a relative basis, we're less impacted by what's going on in the dental world than some of our peer companies.

Now, in terms of what we expect as we move into the third quarter, we are expecting and we started to experience that people are going back to the dentist. So, we're expecting that the Group loss ratio will move back more in line with its longer-term trend, which is right around 70%. We had roughly 40% this quarter.

In terms of the other businesses, disability and life – starting with life. We saw our loss ratio on a year-over-year basis tick up about 11 points. We think the majority of that or the primary driver of that was COVID. If you unwound that 11% increase in loss ratio, it translates into about $35 million of after-tax claims. The reality is, we have about two-thirds of those actually reported on the death cert as COVID.

But there are a couple of factors. One, we don't have all of the death certifications yet. So, that number will probably go up more. And then, we believe, based upon our analysis, that there's a fair amount of under-reporting especially in April in terms of cause of death associated with COVID. So, we believe that COVID was the primary driver in the quarter. And as we move into the third quarter, while we have increased our sensitivity from $1 million to $2 million, we do believe that, overall, the impact of COVID-related claims will fall because we believe that the number of deaths will come in below the 125,000 the US experienced in the second quarter.

In terms of disability, it's a little more difficult to predict exactly how disability is going to be impacted by COVID and the overall impacts that are – that it's having on the economy. As I mentioned in my script, incidence for the quarter, while improving a little bit from the first quarter, is still up a little bit year-over-year. Now, that incidence really is associated with stuff that is going on in the fourth quarter. So, we're happy that the incidence started to trend down, but it is still up a little bit year-over-year.

And then, in terms of termination experience, as I mentioned, we did see a little tick down in our termination experience. And we think that's most likely an indirect impact of the pandemic as it's more difficult to get people in to see their doctors, et cetera, et cetera. So, it's a little more difficult to predict exactly how disability experience will move forward. But as I said in my script, we wouldn't be surprised if there's a little bit of headwind in the disability business associated with the pandemic and the resulting impact on the economy. Hope that's helpful.

John Barnidge Q
Analyst, Piper Sandler & Co.

Thank you very much.

Operator: Our next question comes from Thomas Gallagher with Evercore. Your line is open.

Thomas Gallagher Q
Analyst, Evercore ISI

Good morning. As you guys look to pivot to a de-risking approach into 2021, I think it makes sense that it's going to free up more capital and improve cash flow. But it will likely put more pressure on GAAP earnings growth, I'm assuming, whether that's on the yield side as you think about risk or the weaker sales this year translating into lower revenue growth next year. Is that a fair way to think about it, Randy? And if so, how much – how many points of GAAP EPS pressure do you think that strategy will have assuming that that lasts for the next several quarters?

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

Tom, let me take a quick – let me take the first response for that. We're not pivoting to a de-risk approach in 2021 so much as we're watching the developments, and right now we're being a little bit more cautious about deploying capital. If things improve, which I hope they do for America, for all the right reasons, that could change our view on how we deploy capital. So, that's one point.

The second point is, and we've been emphasizing this a lot, is the expense management activities that are underway can improve earnings and, to some extent, offset the, to your point, the growth in earnings in 2021 that's lost a little bit to the lower level of sales that we're seeing in 2020.

So, we're continuing to pull all the levers to focus on earnings growth, at the same time, that we're watching on protecting our capital base. Because, again, repeated this – said this a couple of times, it's very – we're in very unpredictable times. And so, I think being cautious on capital deployment is the right answer, but not stopping there, and taking other actions such as expense management to offset some of the GAAP earnings issues associated with that.

Thomas Gallagher
Analyst, Evercore ISI

Q

Got you. And would you guys be able to offer up any way you could think about the impact if we isolate – put the expense initiatives on the side, is this maybe a couple of points of growth being sacrificed or is it potentially more meaningful than that?

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

A

Tom, it's kind of difficult to answer that question. I mean, if you look at some of the components of our 8% to 10% growth targets over time, I think you get about 4% from new business. That'll come down a little bit, I don't know how much. If we get 1% from expense efficiencies, that'll come up a little bit. Whether or not they completely offset each other would be hard to predict right now. Then, you've got the impact of capital markets and spread compression, then you have share buybacks. So, all of those things contribute to the long-term outcome, and a little bit unpredictable in the short-term.

Thomas Gallagher
Analyst, Evercore ISI

Q

Got you. And then, my follow-up is, the 55% free cash flow conversion ratio that you've given out, how should we be thinking about that now? I presume it may actually get better, just given the level of capital that gets freed up from lower sales. Is that a fair way to think about it? And can you shed any light into how you're thinking about the 55% ratio? I guess, my question is, is there enough potential adverse impacts from credit and low rates that it's still not going to trend above 55%, or do you think it might actually move above that?

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

A

Hey, Tom. It's Randy. Thanks for the question. I think you highlighted most of the relevant points. So, I'll add one to what you mentioned. On its own, lower sales is supportive of statutory earnings. So, that's a positive in that regard. What's the other side of statutory earnings is what is your required GAAP, all right, so what at the end of the day are your distributable earnings? That's statutory earnings less your change in required capital. And that's driven by a lot of factors, including level of sales; and as sales come down, that's supportive.

But on addition to that is really the big driver of the change in required capital will be what goes on in the credit markets, and that's really where a lot of the uncertainty in the current environment lies. And, as Dennis mentioned, if we look into the third quarter, we still think it's uncertain enough where the best action is to not do buybacks. We'll reassess that in the fourth quarter. And as we get around to planning for next year and looking at the results, we'll make our best estimates what we think as we look into 2021 and beyond.

But ultimately, what happens to free cash flow, I think, is going to be determined by what we believe will be the impact on the credit markets of everything that's going on, whether that's the pandemic or the resulting impact on the overall economy.

Thomas Gallagher
Analyst, Evercore ISI

Q

Makes sense. Thanks, Randy.

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

A

Yes.

Operator: Thank you. Our next question comes from Humphrey Lee with Dowling & Partners. Your line is open.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Q

Good morning and thank you for taking my questions. Just a couple of clarification questions. So, you mentioned that for alternative returns, you expect better results in the third quarter. Do you anticipate the return to be better than kind of your normal run rate, so providing a decent tailwind in the third quarter?

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

A

Humphrey, it's Dennis. Again, I don't think we're going to predict exactly what's going to happen in the alternative portfolio in the third quarter. Let me just say this. As we've seen the effects of capital markets and energy prices on our returns in the second quarter, both of those are trending up. And so, we, therefore, think that our alternative returns will be trending up.

For the last six or seven years, we have about a 10% return on our alts portfolio. Our alts portfolio today consists of about 88% private equity and the balance in hedge funds. The private equity returns generally have a higher long-term outcome and return. So, we're comfortable in the long-term with our 10% and our experience supports that.

And again, quarter-to-quarter, it's sort of difficult to predict. But I will say that what we saw in the second quarter had to do with equity markets in large part, and little bit in energy prices. And again, those indicators have trended up in the third quarter – or in second quarter, affecting the third quarter alts business returns.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Q

That's helpful. And then, Dennis, in your prepared remarks, you talked about sales outlook for different channels. And for Life Insurance, you expect to be down substantially for 2020. But what about for Annuities? Do you expect some of the pressure to continue in the balance of the year? And, if so, do you still anticipate the segments to see net inflows for the full year basis?

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

A

Yeah. We'll have to see how net flows develop, Humphrey. Though I would come back to the aggregate sales, as we look forward, are shifting more toward our indexed variable annuities and are – which is getting a good return. We continue to get additional shelf space. We continue to provide additional sort of value propositions within that product, so we see that continuing to grow.

As Randy and I both pointed out, fixed annuities are just simply not an emphasis of ours today date and our business model. We would be investing at sort of in the new money range of 2%. There's just not enough juice in a 2% investment return to provide both a good value proposition for the consumer and a good return on capital for Lincoln. So, in aggregate, we would expect total annuity sales to be down, driven mostly by a pretty significant decline in fixed annuities.

Humphrey Hung Fai Lee
Analyst, Dowling & Partners Securities LLC

Q

That's helpful. Thank you.

Operator: Thank you. [Operator Instructions] Our next question comes from Suneet Kamath with Citi. Your line is open.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Q

Thanks. A quick – just another question on capital. One of the things we've been talking about on second quarter calls has been the NAIC's review of the reversion to the mean assumption for interest rates in VA capital. A couple companies have come out and said, if the NAIC were to change that that wouldn't have a big impact on their positions; and I think one company even came out and said they're very much in support of it. Just wondering how – what your view of that is, if there was a change, would it have a significant impact on either your hedging strategy or your VA capital position?

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

A

Hey, Suneet. It's Randy. Yeah, we're very supportive of the NAIC's efforts. I think, if you think about the NAIC and the work they did on what's since referred to as the Oliver Wyman work, they were very prudent in hiring an outside expert. They were very prudent in working with industry. And I think they ended up at a very good spot, a spot that's good for the regulators, that's good for industry. And I think it'll be the same with this.

So we're supporting the effort. We will support it. I don't think it'll likely come into effect until probably 2022, but we do not see it having a big, big impact. I mean, just as a reminder, our hedge program is very focused on the economics and, essentially, they're talking about making the interest rate generator a little more reflective of the economics, and I don't think that's a bad thing.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Q

Got it. And then, my follow-up is just on the Life sales again. So, MoneyGuard has historically been a really big differentiator for you guys. And I know that you've talked about repricing your Life products. But in this interest rate environment with credit spreads as tight as they are, can you make that product work in terms of repricing or is it just sort of a difficult one for you guys to sell to achieve your returns but also provide value to the customer?

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

A

Suneet, it's Randy. You can just look at the results, right, sales were down 36% over the prior year. I think they'll fall even further as we look into the back half of the year. I mean, the short answer to your question is, MoneyGuard – or really any general account type product – is a tough sell. It's tough to create a compelling value proposition for the consumer and a return for the company when you're investing money in the low 2s. So, I think that we would expect that, in the current environment, that MoneyGuard sales will continue to fall.

I think there is a significant opportunity, because MoneyGuard is an example of a product that speaks directly to a huge need for the American consume. And I think there is an opportunity to create a compelling value proposition in MoneyGuard, something we're working on right now. You know we created – that's Lincoln's innovation, MoneyGuard. And we're actively working on creating what we believe is the next version of MoneyGuard, which thematically is going to be very similar to things we've talked about, for instance, with IVA, right, lower guarantees, a different way to generate investment returns, shifting risk to the consumers, probably moving to more of a variable-type chassis.

So, I think there's a huge opportunity for a product like MoneyGuard. But yeah, when you're investing at rates we're investing at today, the existing version of that product is a tough sell. And I'd expect sales to be down over the remainder of the year.

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

Q

And Suneet, if I could jump in. In a period where we're preserving capital, our focus is, on any capital that we're deploying, to be absolutely certain we're getting appropriate returns. So, yes, in aggregate, sales will be down in the last half of the year, we think from the first half of the year in the individual lines, but those products by line of business are getting, in aggregate, appropriate returns. So, even though we're husbanding capital a little bit, the capital that we're deploying is getting good returns on it.

And then, as I've mentioned and Randy just discussed, lots of activity in product development, so that we can begin to rebuild sales and continue to grow earnings from new business over time. And I'd also come back to most of the pressure from interest rates and the repricing activity is going on in the individual lines, and we're seeing good returns and higher levels of sales in both RPS and Group.

Suneet Kamath
Analyst, Citigroup Global Markets, Inc.

Q

Okay. Thanks.

Operator: Thank you. And I'm showing no other questions in the queue. I'd like to turn the call back to Mr. Chris Giovanni for any closing remarks.

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

Katherine, I don't think – he's off mute?

Operator: Mr. Giovanni, your line is open.

Christopher A. Giovanni

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

Thank you. And thank you all for joining us this morning. As always, we are happy to take your questions on the Investor Relations line or you can email us at investorrelations@lfg.com. Thank you, and have a good day.

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