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Lincoln National Corp. (LNC)

Q2 2021 Earnings Call

CORPORATE PARTICIPANTS

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

Tracy Benguigui
Analyst, Barclays Capital, Inc.

Erik Bass
Analyst, Autonomous Research

Thomas Gallagher
Analyst, Evercore Group LLC

Elyse Greenspan
Analyst, Wells Fargo Securities LLC

Humphrey Lee
Analyst, Dowling & Partners Securities LLC

John Barnidge
Analyst, Piper Sandler & Co.

MANAGEMENT DISCUSSION SECTION

Operator: Good morning and thank you for joining Lincoln Financial Group's second quarter 2021 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 Vice President of Investor Relations, Al Copersino. Please go ahead, sir.

Albert S. Copersino

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

Thank you, Katherine. 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, 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 2020 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 this call, including adjusted return on equity and adjusted income from operations or adjusted operating income to the most comparable GAAP measures.

Presenting on today's call are Dennis Glass, President and Chief Executive Officer, and Randy Freitag, Chief Financial Officer and Head of Individual Life. After their prepared comments, 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, Al. Good morning everyone. Lincoln had an excellent second quarter with record adjusted operating earnings per share and operating revenues and earnings growth in all four businesses. The impact of pandemic-related claims on earnings continues to decline and was more than offset by another quarter of strong returns from our alternative investment portfolio.

Driving these results is the execution of our reprice, shift and add new product strategy, expense management, an improving customer experience from digital and virtual enhancements and a strong balance sheet, providing room for increased share repurchases.

Touching on each of these. First, our product introductions are adding new consumer value propositions, which open new market segments to us, further broadens our sales opportunities off an already strong base of products, and increases our long-term sales growth potential. Our expanding shelf space and ongoing improvements in distribution productivity are effectively getting these new products into the hands of consumers, and we are achieving attractive new business returns on capital deployed.

Second, we have a successful track record of increasing the expense efficiency of our product manufacturing, back office operations and distribution functions, while enhancing the customer and partner experience. This quarter, we reported lower expense ratios company wide and in most of our businesses. As we've talked about recently, we are about to start on another program that will further improve efficiency and the customer experience, and enable us to achieve meaningful savings. We'll be excited to provide you with more details next quarter.

Third, our high quality investment portfolio, higher statutory capital and RBC ratios along with cash at the holding company and contingent capital, all provide capital deployment flexibility.

Now, turning to the business segments. Starting with Annuities, we have long been a leader in Annuities with a diversified product portfolio that provides a broad range of customer value propositions. Total annuities sales this quarter were again strong as we grew 14% sequentially with growth across all product categories for the second quarter in a row and a good mix of product sales.

Last year, we established ourselves as a leader in indexed variable annuities. This year, we are seeing growth in both indexed variable annuities and traditional VAs without living benefits. We also see ongoing market demand for VAs with guaranteed living benefits at attractive economics to Lincoln, as protected income solutions continue to resonate with customers.

We had projected total annuity sales to begin the year at a similar pace to what we saw in the fourth quarter, then build over the course of the year, benefiting from shelf space we added last year and are adding this year, which is driving indexed variable annuity growth opportunities. We're pleased to see sales year-to-date ahead of our expectations. Looking forward, near-term sales may be impacted by typical summer seasonality, but we're confident that full year sales will remain ahead of our earlier expectations.

Turning to flows. VA net flows were positive, and while we reported negative net fixed annuity flows, this is a direct result of past management actions taken to maintain rigorous return standards and allow us to direct capital to its highest and best use. We expect Annuities earnings to continue to benefit from new sales, growing fees on AUM from the strong stock market and our diversified high quality in force book.

In Retirement Plan Services, we once again reported excellent results and remain well positioned with scale in our target markets of small and mid case 401(k), health care, government and not-for-profit, a broad suite of products, a competitive cost structure and award-winning digital technology. Total deposits were up 21% and included double-digit growth in both first-year sales and recurring deposits.

Sales continue to benefit from the success of YourPath, our target date fund alternative. We have continued to innovate, introducing PathBuilder Income, which includes an income solution as part of a target-date-like investment option. This type of innovation will serve as a catalyst for future growth.

Finally, we once again reported positive net flows. And while flows can be lumpy, we expect this positive momentum to persist. It was another outstanding quarter for the Retirement business. We continue to excel in our target market segments as we benefit from our attractive competitive position, continued investments in the plan sponsor and planned participant experience and our expanding set of solutions aimed at helping people secure their retirement.

Within the Life Insurance business, we continue to execute our product strategy that increases consumer value propositions while further diversifying our product risk profile. Our investment in new products further broadens our portfolio and supports shelf space expansion with new distribution partners, including in the P&C space.

Complementing this expansion has been our continued focus on simplifying the client and adviser experience. Nearly all of our business is e-submitted and e-delivered, and our recently expanded online interview capabilities are resulting in higher placement rates at a lower cost per policy. This makes it easier for customers to do business with us and generates cost savings.

Our strategies have taken hold and are driving double-digit sequential sales growth. By product category, individual life sales were up sequentially with growth seen in term life as well as across our expanded index UL, variable UL and MoneyGuard solutions. In addition, our executive benefit sales remained strong through the first half of the year, and we expect momentum to continue into the second half. I'm confident that actions we have taken will result in sequential sales growth accelerating in the second half of the year as our new product offerings continue to garner additional shelf space supported by our industry leading distribution.

Lastly, on Group Protection, where we have been driving toward our target margin range of 5% to 7%, our selective price increases as well as our successful efforts to raise persistency led to a 2% increase in premiums over the prior-year period. Although sales, in what is a seasonally smaller quarter, were down versus the strong prior-year quarter, we continue to have success expanding into higher-margin employee-paid products, which represented 56% of second quarter sales.

Included within our employee-paid products is supplemental health insurance, where we will be adding a hospital indemnity solution, another example of Lincoln expanding our already broad portfolio of high-quality offerings.

As we have communicated, we continue to take action to increase group protections, underlying operating margins. Excluding pandemic-related claims and excess alternative investment income, we are in the middle of our target range and expect further expansion over time as we drive premium growth, continue to invest in our claims organization and diligently manage expenses.

A few words on one of our key competitive advantages, our industry leading distribution. As the industry evolves, the strength of our distribution franchise remains a constant. We are known in the marketplace for our consistent distribution presence, with broad reach across channels, as demonstrated by our recent life insurance shelf expansion with a large P&C insurer.

Nearly 100,000 active producers, wholesalers, group representative consultants and other distribution professionals sell our products. And through strategic investments in technology and training, we have positioned ourselves to influence where and how we engage with our active producers, leading with a virtual first model for the long term.

We already see this as the distribution teams begin meeting with their clients in person again, while still leveraging virtual tools, both to improve the service we deliver and tightly manage our expenses. Our distribution team's productivity metrics are up, and our efforts are being recognized, as we received two industry awards this quarter for innovation in virtual training and digital marketing.

Briefly on investment results, credit quality remains excellent. Our general account portfolio is predominantly comprised of fixed income investments, of which approximately 97% are investment grade. And within that, 59% are rated A, A equivalent or better.

Examples of the underlying asset classes includes corporates, commercial mortgage loans and structured securities. The commercial mortgage loan portfolio is high quality, well diversified and continues to perform well, with nearly 100% of the loans in the two highest CML rating categories. And within that, 85% in the highest rating category and virtually no credit losses or loan modifications. Additionally, the structured securities are predominantly rated AA and higher, with nearly no exposure to below investment grade securities.

During the quarter, we invested new money at an average yield of 2.7%, with approximately 50% in shorter duration assets, reflecting our shorter duration product sales. 60% of our purchases were in investments other than public corporates, providing diversification and good relative value and adding approximately 100 basis points of yield over comparably rated public corporates.

Lastly, our alternatives performance was once again strong, driven by portfolio construction that has emphasized buyout and growth equity strategies, with a 10% return in the quarter, significantly exceeding our long-term targeted quarterly return of 2.5%.

In summary, our product strategy is helping sales momentum build at attractive returns, driven by new product introductions, expanding shelf space and overall distribution strength. Group Protection margins are recovering. Expense savings initiatives will continue to contribute to earnings growth, and our strong balance sheet and free cash flow generation and potential block sale transactions all put Lincoln in an excellent position of fund sale growth, while increasing our capital deployment. In short, we are very confident in our ability to continue to generate good earnings growth for shareholders.

Before I turn the call over to Randy, a brief comment on how interest rate levels affect our business model. As we've mentioned before, low rates affect us in three principal ways. First is product pricing and design and their impact on consumer demand; second is spread compression; third is the impact of cash flow testing on reserve requirements.

Looking forward, first, as I've described this morning, our reprice shift and add new product strategy will provide us with sales growth opportunities in a variety of interest rate scenarios. Second, our focus on expenses, including the meaningful cost saving program I mentioned earlier, is expected to replace all earnings lost to spread compression over the next few years. Third and finally, we have no significant cash flow testing reserve implications. In sum, low rates have already been with us for some time and going forward, we expect to continue to meet or surpass our 8% to 10% long-term EPS growth target.

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 $608 million or $3.17 per share, both record highs for Lincoln. There were no notable items in the current or prior-year quarter. Additionally, this quarter's result was impacted by pandemic-related claims, which reduced earnings by $43 million or $0.22 per share, while results benefited from strong performance in the alternatives investment portfolio, boosting earnings by $113 million or $0.59 per share above target. It was an extremely strong quarter that highlights our underlying earnings power.

Net income totaled $642 million or $3.34 per share, boosted by gains in the investment portfolio and excellent performance from the variable annuity hedge program. This quarter's record bottom line result was driven by strong top line performance with adjusted operating revenue up 16% from the prior year, which included growth in each of the four businesses, and solid expense management as our expense ratio came down 130 basis points.

Consistent with the record earnings, key financial metrics were excellent as adjusted operating return on equity came in at 17.3% and book value per share, excluding AOCI, grew 9% and stands at $75.45, an all-time high.

Now turning to segment results, starting with Annuities. Operating income for the quarter was $323 million, compared to $237 million in the prior-year quarter. The quarter's earnings were driven by record average account values of $166 billion, up 24% over the past year and $12 million of favorable alternative investment income.

Base spreads, excluding variable investment income, decreased 7 basis points sequentially. Looking forward, we'd expect spreads to be in this range, trending up modestly over time.

Expense ratio improved 110 basis points compared to the prior-year period as our focus on expenses continues to benefit the bottom line. Return metrics remain solid with return on assets coming in at 78 basis points and return on equity at 25%.

Risk metrics on the VA book once again demonstrate the quality of our in-force, with a net amount at risk at 47 basis points of account values for living benefits and at 33 basis points for death benefits. Growing account values, a high quality and high return book of business and ongoing expense discipline are all indicators of strong future performance from the Annuities business.

Retirement Plan Services reported operating income of $62 million compared to $30 million in the prior-year quarter. This quarter's results were driven by higher fees on account values and included $7 million of favorable alternative investment results.

Total deposits of $2.8 billion helped drive $0.5 billion of net flows in the quarter. Over the trailing 12 months, net flows of $1.6 billion combined with favorable equity markets, drove average account values up 28% to $94 billion. The expense ratio improved 240 basis points over the prior-year quarter as strong revenue growth combined with diligent expense management led to an increase in profitability.

Base spreads, excluding variable investment income, compressed 8 basis points versus the prior-year quarter, better than our stated 10 to 15 basis point range as crediting rate actions continued to take hold. Strong net book flow performance and great expense management, position our Retirement business nicely moving forward.

Turning to Life Insurance, we reported operating income of $255 million versus a loss of $37 million in the prior-year quarter. This quarter's earnings included $83 million of favorable alternative investment experience and a return to pre-pandemic levels of mortality as pandemic-related claims of $15 million were largely offset by favorable underlying mortality.

Earnings drivers continued to grow with average account values up 12% and average Life Insurance in force up 7% over the prior year. Base spreads, excluding variable investment income, declined 7 basis points compared to the prior-year quarter, in line with our 5 to 10 basis point expectation.

Expense ratio improved 90 basis points over the prior-year quarter as our efficiency efforts continue to benefit margins. The combination of accelerating sales, expense discipline and a declining impact from pandemic mortality positions us well for a strong second half of the year.

Group Protection reported operating income of $46 million, compared to $39 million in the prior-year quarter. This quarter's earnings included $8 million of favorable alternative investment results. Compared to the first quarter, operating income rose from a loss of $26 million, driven primarily by improved pandemic related claims of $28 million, down from $90 million sequentially.

As Dennis noted, excluding pandemic claims and favorable alternative investment income, the Group margin of 6.1% was in the middle of our 5% to 7% targeted range, an improvement from the first quarter.

The loss ratio was 79.3% in the quarter, a 750 basis point sequential improvement. Excluding pandemic related claims from both periods, loss ratio improved 50 basis points or 76.1% due to better mortality results.

Group's expense ratio rose 30 basis points year over year as we make ongoing investments in our claims organization to address elevated claim volume due to the pandemic. We expect the expense ratio to improve when the pandemic subsides and we execute our ongoing expense saving initiatives.

Growing operating revenues coupled with improving underlying margin performance have put the Group business on much firmer footing looking forward.

Turning to capital and capital management, we ended the quarter with $11.2 billion of statutory surplus, and estimate our RBC ratio at 483%. As a reminder, our RBC ratio includes 26 percentage points from non-economic goodwill associated with the Liberty acquisition that we expect will go away by year end.

We estimate C1 factor changes being implemented by the NAIC will negatively impact our year-end RBC ratio by approximately 15 percentage points. We are supportive of these factor changes and would note that they have no impact on our view of credit, nor do we expect them to change our capital deployment strategy.

Cash at the holding company stands at $762 million, above our $450 million target, as we have prefunded our $300 million 2022 debt maturity. We deployed $150 million towards buybacks in the second quarter, in line with our goal communicated last quarter to return to pre-pandemic quarterly buyback levels.

Supported by the strength of our balance sheet, we intend to repurchase up to $200 million of stock in the third quarter. This will position us to have full-year buybacks in line with pre-pandemic levels.

To conclude, we delivered excellent results with record earnings, book value, excluding AOCI and adjusted operating ROE. For all the reasons we discussed today, we feel great about continuing our excellent performance looking forward.

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

Albert S. Copersino
Vice President & Head-Investor Relations, 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 one follow-up and then re-queue if you have additional questions.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question comes from Tracy Benguigui with Barclays. Your line is open.

Tracy Benguigui
Analyst, Barclays Capital, Inc.

Q

Thank you. Good morning. Just quickly looking at interest rates, I mean, it's not at the spot where most folks were thinking about, probably as you began to start speaking about entering into some type of block sale. And I'm just wondering, as you're still exploring that avenue, where we are with interest rates. Does that deter the progress at all in getting a deal done?

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

A

Tracy, thanks for the question. Yeah. I think interest rates are obviously down a little bit over the last quarter or two, but yeah, I don't see interest rates as being a material driver of any change in value that we may have seen over that time. I'd remind you that on the other side of that, equity markets are up nicely. So there are other factors at play. And I'd also remind you, Tracy, we do have a very diverse book of life insurance. So the type of business we can put into the marketplace can be influenced by a number of different factors.

So still feel very good about the whole block sale process. I think, as I've said before, I think there's a lot of demand, especially on the Life Insurance side. And so we continue to work very, very fully on potentially getting something done that we believe would be additive to shareholder value. Yeah, no promises there, but I think the environment still seems to be very attractive, especially in the life block sale side.

Tracy Benguigui
Analyst, Barclays Capital, Inc.

Q

So is it fair we should still hang on tight to hear more or anything you could give some hints on where you are in that process?

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

A

The reality of these situations, Tracy, is that until you announce something, it seems like you're doing nothing, right? And so, that's what I can tell you. I can tell you we're working hard. We think there's a lot of demand out there and we have a lot of quality business here at Lincoln that we can put into that demand. So, yeah, you're going to have to hold tight, but I think that, as I said, I think the environment is still attractive for those sorts of transactions.

Tracy Benguigui
Analyst, Barclays Capital, Inc.

Q

Okay. And I recognize that you've introduced a bunch of new products, and I'm wondering, and you made some traction on sales, but when you think you'll reach an inflection point to return to production level pre-pandemic?

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

A

Tracy, it's Dennis. As we have been saying for some quarters now, and then you just pointed out, we've got a broad suite of products. We've got great distribution, and we expect to continue to see progress on sales growth. And it's difficult to predict in a business line what exactly that's going to be. But all the trends are positive, and we're comfortable with our comments about continuing to escalate sales in the intermediate and long term.

Tracy Benguigui
Analyst, Barclays Capital, Inc.

Q

Yeah. Just – sorry, lastly on that, something that caught my attention. You mentioned that the market demand for your VAs with GLBs are at attractive economics for Lincoln. Could we expect that these protective income solution, could that ever extend to your variable index annuities? I mean, at least we saw Prudential introduce this type of rider for their structured annuity product.

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

A

That's a possibility, and we'll continue to look at what is a consumer really interested in, in a particular product. For the most part, the IVAs are a as protection, consumer value proposition. And that's where our focus is right now, continuing to make improvements in the overall IVA offering. And to the extent that consumers demand some type of a guaranteed income, we'll look at that.

Tracy Benguigui
Analyst, Barclays Capital, Inc.

Q

Okay. Thank you for taking my questions.

Operator: Thank you. Our next question comes from Erik Bass with Autonomous Research. Your line is open.

Erik Bass
Analyst, Autonomous Research

Q

Hi. Thank you. Maybe building on that last question, can you talk about competitive dynamics in the buffered annuity market? And as companies innovate more on features and crediting rate mechanisms, is this shifting the risk profile of the product at all?

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

A

There's certainly more people entering the market because there's so much, Erik, consumer demand for it. The competition on ourselves, we continue to change some of the rider – not the riders, but some of the characteristics of the product. It is not, to answer your question, changing the risk profile to Lincoln, these product changes. And again, I'd say that on the IVA product designs, that sort of at the margin, not fundamental. So it's a good product, the consumer market, and it's a solid product from a risk perspective from a Lincoln standpoint.

Erik Bass
Analyst, Autonomous Research

Q

Got it. Thank you. And then how are you thinking about the use of flow reinsurance as a way to help fund growth, and particularly in more asset-intensive lines like fixed annuities? And is this a way to accommodate your distribution without tying up capital?

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

A

In the – in our history, as you know, Erik, we've done flow deals from time to time. And we continue to look at that as a way to improve the overall sales stream, capital efficiency and so forth. So we'll look at it. And if it makes sense, we'll do it.

Erik Bass
Analyst, Autonomous Research

Q

Got it. And I think, historically, you've done it with fixed annuities. I mean, is there an opportunity to potentially to expand that to other products?

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

A

We've done it with fixed annuities and we've had reinsurance transactions on guaranteed lifetime income products as well. And so I think – but fixed annuities and VAs are where you can see the opportunity for those kind of opportunities or transactions.

Erik Bass
Analyst, Autonomous Research

Q

Got it. Thank you.

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

Thomas Gallagher
Analyst, Evercore Group LLC
Q

Thanks. First question, Randy, the decision to ramp up buybacks to, I think you said $200 million in Q3, can you expand on how we should view this? Is this part ongoing cash flows, part excess capital drawdown, or is this more based on visibility for dividends and cash flow? And maybe talk a little bit about what you're seeing between LNL LNBAR in terms of dividend flows there. Thanks.

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

Tom, thanks for the question. I think, when you think about the strength of the earnings that we talked about, that flows through the statutory also. And so we've seen a significant growth in our overall capital. I think our capital has grown roughly $1 billion year-to-date and the RBC ratio itself has grown by roughly 30 points since the beginning of the year. And I think the main driver of that is the underlying strength of the earnings that we just talked about.

I think you do also see a little bit of benefit – just we do benefit when the markets move, especially in our favor. So I think there's a lot of positive things under there and those positive elements are really what led us to announce getting back to really full-year pre-pandemic levels by the end of the third quarter, which means we'll do a couple hundred million here in the third quarter.

And I think that's really an indication of, for us, how we feel about the strength of our balance sheet, how we feel about the strength of our capital generation capabilities, looking forward that we're back to those levels. I think in terms of what we think for the fourth quarter for next year, I think we'll cross those bridges when we get there. But at this moment in time, we're in an extremely strong position, which will allow us to go out and buy at a little bit of an elevated rate in the third quarter here.

Thomas Gallagher
Analyst, Evercore Group LLC
Q

Got you. And Randy, and any clarity for how dividend flows are looking at for both Lincoln National as well as LNBAR at this point. I know for some time you didn't – you stopped taking dividends out of LNBAR. Are you back to taking some cash out of there?

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

We took some out in the first quarter. We're always looking at the different entities and where they are at any moment in time. As I just talked about, the life companies happen to be in an extremely strong capital position. So that's where we took most of our dividends from in the second quarter. It's just sort of quarter-by-quarter, what do we intend to do, and we look at the various resources which includes LNBAR it includes the life companies, both of which are in a very strong capital position right now. So we didn't happen to take any in the second quarter, but that was more about the strength that we saw in the life company capital than anything else. So I see both of them as a resource looking forward.

Thomas Gallagher
Analyst, Evercore Group LLC
Q

Got you. And then one just final one for me. The very favorable underwriting experience in individual life ex-COVID, you've now had that for two quarters in a row. Any sort of sense for what you think is driving that? Is it possible we did see a pull forward of mortality over the last year, and so maybe we'll see some continuation of the favorability? Any color on what you expect and what you're seeing there.

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

A

It's hard to know for sure with just one or two quarters of data. But as we analyze, as we look inside, where did the pandemic claims that we had this quarter occur, once again, it was in the older ages. But when you look in total at the older ages, they were sort of – that's where a lot of the benefit was. So I think when we look at that, there's probably an element of pull-forward or a benefiting from people who unfortunately passed last year.

So I think it's a combination this quarter of some pullback, some pull forward and some just underlying good experience, which was driven primarily by severity. So severity was pretty favorable this quarter. So I think it's both elements. But to be fair, just a couple quarters of data from a mortality standpoint is not enough to know any answer with 100% certainty.

Thomas Gallagher
Analyst, Evercore Group LLC

Q

Okay. Thank you.

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

Elyse Greenspan
Analyst, Wells Fargo Securities LLC

Q

Hi, thanks. Good morning. My first question, within Group, if I adjust for the basal VII and COVID, you guys had a 6% margin in the quarter, kind of the midpoint of your target range. So I was just hoping to get some more granularity on the core trends within the quarter and anything you're calling out that was favorable or unfavorable. And then I know you guys had pointed to getting to the top end of that range over the longer term, I believe. Is that still the target for the Group business?

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

A

Elyse, thank you for the question. So we made $46 million in the quarter. Of two items we spiked out were the pandemic of $28 million, and then going the other way, it was favorable also about $8 million. So if you make those two adjustments, you're at $66 million. And that's what drives the 6.1% underlying margin. I didn't spike anything out in my script because I find the quarter relatively unremarkable in that all the key drivers were inside of a normal confidence interval. So looking at disability, three big drivers: incidents, severity and resolutions.

Incidents was right in line with our expectations. Severity went a little bit high, but resolutions were a little better than we expect. So I think the overall quarter itself, that $66 million underlying earnings par number is just very solid. And I think really reflects really good performance.

In terms of what takes it from 6.1% to the upper end of the range, I think it's only one point. And I think it's probably the reality is that the combination of continued expense improvements; Dennis referenced another expense savings initiative, and a little bit from underlying improvement in loss ratio. So feel great about the quarter, and I think we feel great about our ability to continue – see continued improvement going forward over time.

Elyse Greenspan
Analyst, Wells Fargo Securities LLC

Q

And then going back to the potential for a risk transfer transaction, you guys have kind of teed up as being Life Insurance the area where you're focused on for the time being. You've also spoken about maybe doing a VA deal in the past. So is it safe to assume that recognizing these deals take a lot of time and effort, that the focus will be on the Life Insurance side? And then once we perhaps get a deal there, then potentially shift to the VA side? Or you're looking into transactions simultaneously within both books of business?

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

A

I think what we've said in that regard, Elyse, and it continues to be our view, we just believe there's more demand on the life side, and that just makes something on that side more likely than otherwise. I think this is, at the end of the day, ruled by supply/demand. And just happen to believe there's more demand on the life side, so something is more likely there. And that hasn't changed.

Elyse Greenspan
Analyst, Wells Fargo Securities LLC

Q

Okay. And then one last one, sorry if I missed it. The corporate costs were a little bit higher in the quarter. I know sometimes they vary. Was there anything impacting that number?

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

A

Two things I would point out, Elyse. One, there is a little bit of seasonality with some of our brand spend that spikes a little bit in the second quarter. That's a little bit of it. But the other thing, Dennis referenced the next expense saving initiative. And we did – consistent with some of the analysis we've been doing, we did book about $9 million after tax of expenses associated with some of that pre-work on that program into other operations.

Elyse Greenspan
Analyst, Wells Fargo Securities LLC

Q

Okay. That's helpful. Thanks for the color.

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

A

You bet.

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

Humphrey Lee
Analyst, Dowling & Partners Securities LLC

Q

Good morning and thank you for taking my questions. Randy, just if we were to take a step back and just look at the underlying results for the second quarter, adjusting for the COVID claims and the favorable VII, the $280 million seems very strong for your earnings power. Obviously, there are gives and takes in any given quarter, and you highlighted some of that in your earlier remarks. But from your perspective, any reason why it won't grow from this level going forward?

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

A

Humphrey, thanks for the question. Yeah, you did the math on the second quarter. So, reported $317 million, and when you adjust for those two items, which were both in my script, you'd end up at $280 million. Humphrey, I'd point out that if you went back to the first quarter and you adjusted for the exact same things that I mentioned in my script, you got to $266 million. So $266 million last quarter, $280 million this quarter. And what do we know happened in the second quarter? I think one of the big things is that the average equity markets were up a little over 8%.

Humphrey, we've talked a number of times about the impact of movements in the equity markets on our earnings. So if you do the math there, the rules of thumb we've given you over the years, you would get about a dime. And then we also know that we bought back a little over 1% of our shares. So $266 million, voilà, would end up right up at the $280 million of underlying earnings power we had this quarter.

So for me, this quarter is right in line with our expectations, and we expect to continue to grow off that level, right? I mean, in any given quarter, you can always have things bounce around inside these businesses. I've mentioned a few this quarter, so good underlying mortality at life. But on the other side, you had some expenses we've booked across the organization, among a number of other things. I just think in total, all those pluses and minuses sort of added up to pretty close to zero. So, I think the $280 million number is just a good reflection of the underlying earnings power of Lincoln.

Humphrey Lee
Analyst, Dowling & Partners Securities LLC

Q

Got it. Thank you for that. Shifting gear to RPS, flows were very good. And as you pointed out earlier, you have very strong first year sales and recurring deposits. Just thinking about on the first year sales perspective, some of your peers have talk about lack of activities last year causing a little bit of dampering kind of sales in 2021. But that doesn't seem to be the case for Lincoln. Can you just talk about like what you've done differently or where you're getting traction compared to some of your peers?

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

A

Yeah, Humphrey, it's Dennis. Let me take that, and thank you for the question. I would say it this way. It's just excellent execution on a very strong model. And when I talk about strong model, I talk about we have a good product portfolio. I mentioned a couple of the strong products within that portfolio.

I've mentioned that we focus on the fastest-growing markets, and we have a top 10 position in each one of those markets. We're leveraging some of the strength of the overall organization to add distribution strength, LFD, in particular. We also have good reach in our consultancy channels. So, just overall, it's just execution on a model, which we think has demonstrated good growth and good sales over several years in a row now.

Turning to total deposits, we are seeing strength in recurring deposits and that's related to more participants and employers increasing their contributions to their employees' plans. So, I would just say there's nothing unusual about the quarter. It's just great execution on a good model that's been in place for some time.

Humphrey Lee
Analyst, Dowling & Partners Securities LLC

Q

Thank you for that.

Operator: Thank you. And we have a question from John Barnidge with Piper Sandler. Your line is open.

John Barnidge
Analyst, Piper Sandler & Co.

Q

Thank you. G&A expenses were up sequentially in pretty much all segments. How should we be thinking about this prospectively in a backdrop of probably more activity happening?

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

A

John, thanks for the question. I think you can always get some period-to-period noise. I think I'd point you to the fact that, as I mentioned in my script, if you look over the last year, expenses have grown at a significantly lower rate than revenues.

And so you're seeing significant earnings leverage across the organization. A couple points I would make as you sort of move quarter-to-quarter, as you might imagine, with a quarter this strong, you start to see some of your variable expenses like incentive compensation and that sort of stuff start to elevate a little bit. So, there's a little bit of that in there.

The other thing I'd mention in total, as I mentioned to an earlier question, is we did book $9 million after-tax of expenses associated with our expense initiatives. I talked a little bit about some of the period noise you can get in the branding spend. So, we feel great about expense management. And when you adjust for those things, just, I think, demonstrate that at Lincoln, we have a strong focus on expenses. We've always had a strong focus on expenses, and it comes through in the results.

John Barnidge
Analyst, Piper Sandler & Co.

Q

Thanks for your answer. My other questions have been answered as well. Thanks.

Operator: Thank you. And I'm showing no further questions at this time. I'd like to turn the call back to Al Copersino for closing remarks.

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

Well thank you all for joining us this morning. As always, we're happy to take any follow-up questions that you have. You can e-mail us at investorrelations@lfg.com. Thank you all, and have a great day.

Operator: This concludes today's conference call. Thank you for participating. You may now disconnect. Speakers stand by.