

LINCOLN NATIONAL CORP  
Form 10-Q  
November 09, 2006

---

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D. C. 20549

---

FORM 10-Q

---

(Mark One)

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended September 30, 2006.

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission File Number 1-6028

---

LINCOLN NATIONAL CORPORATION  
(Exact name of registrant as specified in its charter)

---

Indiana  
(State or other jurisdiction of  
incorporation or organization)

35-1140070  
(I.R.S. Employer  
Identification No.)

1500 Market Street, Suite 3900, Philadelphia,  
Pennsylvania  
(Address of principal executive offices)

19102-2112  
(Zip Code)

(215) 448-1400  
Registrant's telephone number, including area code

Not Applicable  
Former name, former address and former fiscal year, if changed since last report

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

(Check one): Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

As of November 1, 2006, 277,379,975 shares of common stock of the registrant were outstanding.

---

**Item 1. Financial Statements****LINCOLN NATIONAL CORPORATION  
CONSOLIDATED BALANCE SHEETS**

|   | <b>September 30,<br/>2006<br/>(Unaudited)</b> | <b>December 31,<br/>2005</b> |
|---|---|------------------------------|
|   | <b>(in millions)</b>                          |                              |
| <b>ASSETS</b>   |   |                              |
| Investments:  |   |                              |
| Securities available-for-sale, at fair value:               |   |                              |
| Fixed maturity (cost: 2006- \$54,931; 2005-\$32,384)        | \$ 55,824                                     | \$ 33,443                    |
| Equity (cost: 2006- \$647; 2005-\$137)                      | 662   | 145                          |
| Trading securities  | 3,172   | 3,246                        |
| Mortgage loans on real estate                               | 7,581   | 3,663                        |
| Real estate   | 424   | 183                          |
| Policy loans  | 2,725   | 1,862                        |
| Derivative investments                                      | 349   | 175                          |
| Other investments   | 870   | 452                          |
| Total Investments   | 71,607  | 43,169                       |
| Cash and invested cash                                      | 1,108   | 2,312                        |
| Deferred acquisition costs and value of businesses acquired | 8,172   | 5,163                        |
| Premiums and fees receivable                                | 346   | 343                          |
| Accrued investment income                                   | 928   | 526                          |
| Amounts recoverable from reinsurers                         | 8,007   | 6,926                        |
| Goodwill  | 4,498   | 1,194                        |
| Other assets  | 2,703   | 1,480                        |
| Assets held in separate accounts                            | 74,357  | 63,747                       |
| Total Assets  | \$ 171,726                                    | \$ 124,860                   |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>                 |   |                              |
| <b>Liabilities:</b>   |   |                              |
| Insurance and Investment Contract Liabilities:              |   |                              |
| Insurance policy and claim reserves                         | \$ 14,720                                     | \$ 11,703                    |
| Investment contract and policyholder funds                  | 58,517  | 35,592                       |
| Total Insurance and Investment Contract Liabilities         | 73,237  | 47,295                       |
| Short-term debt   | 559   | 120                          |
| Long-term debt  |   |                              |
| Senior notes  | 2,330   | 999                          |
| Junior subordinated debentures issued to affiliated trusts  | 333   | 334                          |
| Capital securities  | 1,072   | -                            |
| Reinsurance related derivative liability                    | 233   | 292                          |
| Funds withheld reinsurance liabilities                      | 2,085   | 2,012                        |
| Deferred gain on indemnity reinsurance                      | 779   | 836                          |
| Other liabilities   | 4,698   | 2,841                        |
| Liabilities related to separate accounts                    | 74,357  | 63,747                       |
| Total Liabilities   | 159,683                                       | 118,476                      |
| <b>Shareholders' Equity:</b>                                |   |                              |
| Series A preferred stock-10,000,000 shares authorized       |   |                              |

Edgar Filing: LINCOLN NATIONAL CORP - Form 10-Q

|  |            |            |
|--|------------|------------|
| (2006 liquidation value-\$1)                         | 1          | 1          |
| Common stock-800,000,000 shares authorized           | 7,448      | 1,775      |
| Retained earnings                                    | 3,986      | 4,081      |
| Accumulated Other Comprehensive Income:              |            |            |
| Net unrealized gain on securities available-for-sale | 478        | 497        |
| Net unrealized gain on derivative instruments        | 56         | 7          |
| Foreign currency translation adjustment              | 137        | 83         |
| Minimum pension liability adjustment                 | (63)       | (60)       |
| Total Accumulated Other Comprehensive Income         | 608        | 527        |
| Total Shareholders' Equity                           | 12,043     | 6,384      |
| Total Liabilities and Shareholders' Equity           | \$ 171,726 | \$ 124,860 |

See accompanying Notes to the Consolidated Financial Statements.

**LINCOLN NATIONAL CORPORATION**  
**CONSOLIDATED STATEMENTS OF INCOME**

|   | Three Months Ended                      |              | September 30, |              | Nine Months Ended |              | September 30, |              |
|---|---|--------------|---------------|--------------|-------------------|--------------|---------------|--------------|
|   | 2006                                    | 2005         | 2006          | 2005         | 2006              | 2005         | 2006          | 2005         |
|   | (Unaudited)                             |              |               |              |                   |              |               |              |
|   | (in millions, except per share amounts) |              |               |              |                   |              |               |              |
| <b>Revenue:</b>   |   |              |               |              |                   |              |               |              |
| Insurance premiums                                      | \$                                      | 426          | \$            | 83           | \$                | 959          | \$            | 226          |
| Insurance fees  |   | 676          |               | 448          |                   | 1,841        |               | 1,294        |
| Investment advisory fees                                |   | 83           |               | 68           |                   | 242          |               | 185          |
| Communications sales                                    |   | 60           |               | -            |                   | 117          |               | -            |
| Net investment income                                   |   | 1,108        |               | 671          |                   | 2,855        |               | 2,034        |
| Realized gain (loss)                                    |   | (10)         |               | 4            |                   | (16)         |               | 7            |
| Amortization of deferred gain on indemnity reinsurance  |   | 19           |               | 19           |                   | 56           |               | 57           |
| Other revenue and fees                                  |   | 125          |               | 102          |                   | 351          |               | 285          |
| <b>Total Revenue</b>                                    |   | <b>2,487</b> |               | <b>1,395</b> |                   | <b>6,405</b> |               | <b>4,088</b> |
| <b>Benefits and Expenses:</b>                           |   |              |               |              |                   |              |               |              |
| Benefits  |   | 1,201        |               | 589          |                   | 2,961        |               | 1,750        |
| Underwriting, acquisition, insurance and other expenses |   | 728          |               | 482          |                   | 1,949        |               | 1,494        |
| Communications expenses                                 |   | 31           |               | -            |                   | 61           |               | -            |
| Interest and debt expense                               |   | 67           |               | 21           |                   | 154          |               | 65           |
| <b>Total Benefits and Expenses</b>                      |   | <b>2,027</b> |               | <b>1,092</b> |                   | <b>5,125</b> |               | <b>3,309</b> |
| Income before Federal income taxes                      |   | 460          |               | 303          |                   | 1,280        |               | 779          |
| Federal income taxes                                    |   | 96           |               | 74           |                   | 346          |               | 173          |
| <b>Net Income</b>                                       | \$                                      | <b>364</b>   | \$            | <b>229</b>   | \$                | <b>934</b>   | \$            | <b>606</b>   |
| <b>Net Income Per Common Share:</b>                     |   |              |               |              |                   |              |               |              |
| Basic   | \$                                      | 1.31         | \$            | 1.33         | \$                | 3.82         | \$            | 3.50         |
| Diluted   | \$                                      | 1.29         | \$            | 1.30         | \$                | 3.76         | \$            | 3.44         |

See accompanying Notes to the Consolidated Financial Statements.

**LINCOLN NATIONAL CORPORATION**  
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY**

|  | Number of Shares                        |             | Amounts     |       |
|--|---|-------------|-------------|-------|
|  | 2006                                    | 2005        | 2006        | 2005  |
|  | (Unaudited)                             |             | (Unaudited) |       |
|  | (in millions, except for share amounts) |             |             |       |
| <b>Series A Preferred Stock:</b>   |   |             |             |       |
| Balance at beginning-of-year   | 15,515                                  | 16,912      | \$ 1        | \$ 1  |
| Conversion into common stock   | (1,602)                                 | (1,017)     | -           | -     |
| Balance at September 30  | 13,913                                  | 15,895      | 1           | 1     |
| <b>Common Stock:</b>   |   |             |             |       |
| Balance at beginning-of-year   | 173,768,078                             | 173,557,730 | 1,775       | 1,655 |
| Issued for acquisition   | 112,301,906                             | -           | 5,632       | -     |
| Conversion of series A preferred stock   | 25,632                                  | 16,272      | -           | -     |
| Stock compensation/issued for benefit plans  | 5,456,670                               | 1,920,236   | 179         | 105   |
| Deferred compensation payable in stock   | 161,715                                 | 53,617      | 9           | 2     |
| Retirement of common stock   | (14,373,938)                            | (2,331,000) | (147)       | (22)  |
| Balance at September 30  | 277,340,063                             | 173,216,855 | 7,448       | 1,740 |
| <b>Retained Earnings:</b>  |   |             |             |       |
| Balance at beginning-of-year   |   |             | 4,081       | 3,590 |
| Comprehensive income   |   |             | 1,015       | 296   |
| Less other comprehensive income (loss) (net of federal income tax):                      |   |             |             |       |
| Net unrealized loss on securities available-for-sale, net of reclassification adjustment |   |             | (19)        | (254) |
| Net unrealized gain (loss) on derivative instruments                                     |   |             | 49          | (5)   |
| Foreign currency translation adjustment  |   |             | 54          | (55)  |
| Minimum pension liability adjustment   |   |             | (3)         | 4     |
| Net Income   |   |             | 934         | 606   |
| Retirement of common stock   |   |             | (709)       | (82)  |
| Dividends declared:  |   |             |             |       |
| Series A preferred (\$1.50 per share)  |   |             | -           | -     |
| Common (2006-\$1.14; 2005-\$1.10)  |   |             | (320)       | (191) |
| Balance at September 30  |   |             | 3,986       | 3,923 |
| <b>Net Unrealized Gain on Securities Available-for-Sale:</b>                             |   |             |             |       |
| Balance at beginning-of-year   |   |             | 497         | 823   |
| Change during the period   |   |             | (19)        | (254) |
| Balance at September 30  |   |             | 478         | 569   |

**Net Unrealized Gain on Derivative****Instruments:**

|                              |    |     |
|------------------------------|----|-----|
| Balance at beginning-of-year | 7  | 14  |
| Change during the period     | 49 | (5) |
| Balance at September 30      | 56 | 9   |

**Foreign Currency Translation****Adjustment:**

|   |     |      |
|---|-----|------|
| Accumulated adjustment at beginning-of-year | 83  | 154  |
| Change during the period                    | 54  | (55) |
| Balance at September 30                     | 137 | 99   |

**Minimum Pension Liability****Adjustment:**

|                              |      |      |
|------------------------------|------|------|
| Balance at beginning-of-year | (60) | (61) |
| Change during the period     | (3)  | 4    |
| Balance at September 30      | (63) | (57) |

|  |    |        |    |       |
|--|----|--------|----|-------|
| Total Shareholders' Equity at September 30 | \$ | 12,043 | \$ | 6,284 |
|--|----|--------|----|-------|

**Common Stock at End of****Quarter:**

|  |             |             |
|--|-------------|-------------|
| Assuming conversion of preferred stock | 277,571,615 | 173,471,175 |
| Diluted basis                          | 281,348,962 | 176,296,287 |

See accompanying Notes to the Consolidated Financial Statements.

**LINCOLN NATIONAL CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

|   | Nine Months Ended<br>September 30, |         |
|---|------------------------------------|---------|
|   | 2006                               | 2005    |
|   | (Unaudited)<br>(in millions)       |         |
| <b>Cash Flows from Operating Activities:</b>                                      |                                    |         |
| Net income  | \$ 934                             | \$ 606  |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                    |         |
| Deferred acquisition costs and value of business acquired                         | (448)                              | (280)   |
| Premiums and fees receivable  | 59                                 | (4)     |
| Accrued investment income   | (47)                               | (40)    |
| Policy liabilities and accruals   | (315)                              | (298)   |
| Contractholder funds  | 992                                | 1,076   |
| Net trading securities purchases, sales and maturities                            | 56                                 | (121)   |
| Gain on reinsurance embedded derivative/trading securities                        | (3)                                | (5)     |
| Increase in funds withheld liability  | 73                                 | 128     |
| Amounts recoverable from reinsurers   | 215                                | (143)   |
| Federal income taxes  | 73                                 | 100     |
| Stock-based compensation expense  | 35                                 | 37      |
| Depreciation  | 44                                 | 60      |
| Gain on sale of subsidiaries/business   | -                                  | (14)    |
| Realized loss on investments and derivative instruments                           | 16                                 | 13      |
| Amortization of deferred gain   | (56)                               | (58)    |
| Other   | 316                                | (189)   |
| Net Adjustments   | 1,010                              | 262     |
| Net Cash Provided by Operating Activities   | 1,944                              | 868     |
| <b>Cash Flows from Investing Activities:</b>                                      |                                    |         |
| Securities-available-for-sale:  |                                    |         |
| Purchases   | (7,165)                            | (4,139) |
| Sales   | 4,557                              | 2,133   |
| Maturities  | 2,250                              | 1,788   |
| Purchase of other investments   | (352)                              | (698)   |
| Sale or maturity of other investments   | 63                                 | 839     |
| Increase in cash collateral on loaned securities                                  | (55)                               | 89      |
| Purchase of Jefferson Pilot Stock, net of cash acquired of \$39                   | (1,826)                            | -       |
| Proceeds from sale of subsidiaries/business                                       | -                                  | 14      |
| Other   | 134                                | 33      |
| Net Cash Provided by (Used in) Investing Activities                               | (2,394)                            | 59      |
| <b>Cash Flows from Financing Activities:</b>                                      |                                    |         |
| Issuance of long-term debt  | 2,045                              | -       |
| Payment of long-term debt   | -                                  | (241)   |
| Net increase (decrease) in short-term debt  | (564)                              | 144     |
| Universal life and investment contract deposits                                   | 5,398                              | 3,649   |
| Universal life and investment contract withdrawals                                | (5,397)                            | (3,270) |



Edgar Filing: LINCOLN NATIONAL CORP - Form 10-Q

|   |          |          |
|---|----------|----------|
| Investment contract transfers                       | (1,257)  | (1,044)  |
| Common stock issued for benefit plans               | 153      | 70       |
| Retirement of common stock                          | (852)    | (104)    |
| Dividends paid to shareholders                      | (280)    | (191)    |
| Net Cash (Used in) Provided by Financing Activities | (754)    | (987)    |
| Net (Decrease) Increase in Cash and Invested Cash   | (1,204)  | (60)     |
| Cash and Invested Cash at Beginning-of-Year         | 2,312    | 1,662    |
| Cash and Invested Cash at September 30              | \$ 1,108 | \$ 1,602 |

See accompanying Notes to the Consolidated Financial Statements.

**LINCOLN NATIONAL CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Unaudited)

**1. Basis of Presentation**

The accompanying Consolidated Financial Statements include Lincoln National Corporation and its majority-owned subsidiaries (“LNC” or the “Company” which also may be referred to as “we” or “us”). As discussed below in Note 2 we completed our merger with Jefferson-Pilot Corporation on April 3, 2006. Through subsidiary companies, we operate multiple insurance and investment management businesses divided into seven business segments (see Note 8). The collective group of companies uses “Lincoln Financial Group” as its marketing identity. We report less than majority-owned entities in which we have at least a 20% interest on the equity basis. These unaudited Consolidated Financial Statements have been prepared in conformity with accounting principles generally accepted in the United States (“GAAP”). In the opinion of management, these statements include all normal recurring adjustments necessary for a fair presentation of the results.

These financial statements should be read in conjunction with the audited Consolidated Financial Statements and the accompanying notes incorporated by reference into our latest annual report on Form 10-K for the year ended December 31, 2005 (“2005 Form 10-K”). On April 3, 2006, LNC filed a Current Report on Form 8-K dated April 3, 2006 that incorporated the audited financial statements and notes for Jefferson-Pilot as of December 31, 2005 and 2004, and for the years ended December 31, 2005, 2004 and 2003 from Jefferson-Pilot’s Annual Report on Form 10-K for the year ended December 31, 2005. The accompanying unaudited Consolidated Financial Statements should also be read in conjunction with those financial statements and notes.

Operating results for the three and nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2006. All material intercompany accounts and transactions have been eliminated in consolidation.

Certain amounts reported in prior periods’ unaudited Consolidated Financial Statements have been reclassified to conform to the 2006 presentation. These reclassifications have no effect on net income or shareholders’ equity of the prior periods. Included in these reclassifications is the change in the definition of cash flows from funds withheld liabilities from financing to operating cash flows in the unaudited Consolidated Statements of Cash Flows. While this had no effect on total cash flow, for the nine months ended September 30, 2005, net cash provided by operating activities and net cash used in financing activities were increased and decreased, respectively, by \$128 million. A similar reclassification in our Consolidated Statements of Cash Flows for the years ended December 31, 2005, 2004 and 2003 would have increased net cash provided by operating activities (with corresponding decreases in net cash provided by (used) in financing activities) by \$117 million, \$77 million, and \$56 million, resulting in net cash provided by operating activities of \$1.1 billion, \$1.1 billion and \$1.0 billion, respectively.

**2. Business Combination**

On April 3, 2006, we completed our merger with Jefferson-Pilot Corporation (“Jefferson-Pilot”) by acquiring 100% of the outstanding shares of Jefferson-Pilot in a transaction accounted for under the purchase method of accounting prescribed by SFAS No.141, “Business Combinations” (“SFAS 141”). Jefferson-Pilot’s results of operations are included in our results of operations beginning April 3, 2006. As a result of the merger, our product portfolio was expanded, and we now offer fixed and variable universal life, fixed annuities, including indexed annuities, variable annuities, mutual funds and institutional accounts, 401(k) and 403(b) offerings, and group life, disability and dental insurance products. We also own and operate television and radio stations in selected markets in the Southeastern and Western United States and produce and distribute sports programming.

SFAS 141 requires that the total purchase price be allocated to the assets acquired and liabilities assumed based on their fair values at the merger date. We are in the process of finalizing our internal studies of the fair value of the net assets acquired including investments, value of business acquired (“VOBA”), intangible assets and certain liabilities. As such, the preliminary fair values in the table below are subject to adjustment as additional information is obtained, which may result in adjustments to goodwill, which we do not expect to be material. During the three months ended September 30, 2006, adjustments were made to the purchase price and estimated fair value of assets acquired, which resulted in a decrease in goodwill of \$5 million. Further adjustments may be required as additional information becomes available, however, we do not expect such adjustments to be material.

Edgar Filing: LINCOLN NATIONAL CORP - Form 10-Q

The aggregate consideration paid for the merger was as follows:

| <b>(in millions, except share data)</b>                     | <b>Share Amounts</b> |          |
|---|----------------------|----------|
| LNC common shares issued                                    | 112,301,906          |          |
| Purchase price per share of LNC common share <sup>(1)</sup> | \$ 48.98             |          |
| Fair value of common shares issued                          |                      | \$ 5,501 |
| Cash paid to Jefferson Pilot shareholders                   |                      | 1,800    |
| Fair value of Jefferson-Pilot stock options <sup>(2)</sup>  |                      | 131      |
| Transaction costs   |                      | 65       |
| Total purchase price  |                      | \$ 7,497 |

(1)The value of the shares of LNC common stock exchanged with Jefferson-Pilot shareholders was based upon the average of the closing prices of LNC common stock for the five day trading period ranging from two days before, to two days after, October 10, 2005, the date the merger was announced.

(2)Includes certain stock options that vested immediately upon the consummation of the merger. Any future income tax deduction related to these vested stock options will be recognized on the option exercise date as an adjustment to the purchase price and recorded to goodwill.

The fair value of Jefferson-Pilot's net assets assumed in the merger was \$4.2 billion. Goodwill of \$3.3 billion resulted from the excess of purchase price over the fair value of Jefferson-Pilot's net assets. We paid a premium over the fair value of Jefferson-Pilot's net assets for a number of potential strategic and financial benefits that are expected to be realized as a result of the merger including, but not limited to, the following:

- Greater size and scale with improved earnings diversification and strong financial flexibility;

- Broader, more balanced product portfolio;

- Larger distribution organization; and

- Value creation opportunities through expense savings and revenue enhancements across business units.

The following table summarizes the preliminary fair values of the net assets acquired as of the acquisition date:

| <b>(in millions)</b>                             | <b>Preliminary Fair Value</b> |
|--|-------------------------------|
| Investments                                      | \$ 27,905                     |
| Due from reinsurers                              | 1,296                         |
| Value of business acquired                       | 2,478                         |
| Goodwill   | 3,302                         |
| Other assets                                     | 1,642                         |
| Assets held in separate accounts                 | 2,574                         |
| Policy liabilities                               | (26,527)                      |
| Long-term debt                                   | (905)                         |
| Income tax liabilities                           | (849)                         |
| Accounts payable, accruals and other liabilities | (845)                         |
| Liabilities related to separate accounts         | (2,574)                       |
| Total purchase price                             | \$ 7,497                      |

The goodwill resulting from the merger was allocated to the following segments:

| <b>(in millions)</b> |          |
|----------------------|----------|
| Individual Markets:  |          |
| Life Insurance       | \$ 1,326 |
| Annuities            | 988      |

|                                    |    |       |
|------------------------------------|----|-------|
| Total Individual Markets           |    | 2,314 |
| Employer Markets: Group Protection |    | 281   |
| Lincoln Financial Media            |    | 707   |
| Total goodwill                     | \$ | 3,302 |

6

---

The following table summarizes the fair value of identifiable intangible assets acquired in the merger and reported in other assets.

| <b>(in millions)</b>                                 |        | <b>Weighted<br/>Average<br/>Amortization<br/>Period</b> |
|--|--------|---|
| Lincoln Financial Media:                             |        |   |
| FCC licenses   | \$ 638 | N/A   |
| Sports production rights                             | 11     | 5 years   |
| Network affiliation agreements                       | 10     | 21 years  |
| Other  | 11     | 16 years  |
| Total Lincoln Financial Media                        | 670    |   |
| Individual Markets - Life Insurance:                 |        |   |
| Sales force  | 100    | 25 years  |
| Total identifiable intangibles                       | \$ 770 |   |
| Identifiable intangibles not subject to amortization | \$ 638 | N/A   |
| Identifiable intangibles subject to amortization     | 132    | 22 years  |
| Total identifiable intangibles                       | \$ 770 |   |

The following unaudited pro forma condensed consolidated results of operations assume that the merger with Jefferson-Pilot was completed as of January 1, 2006 and 2005:

| <b>(in millions, except per share amounts)</b> | <b>Three<br/>Months Ended<br/>September 30,<br/>2005</b> |    | <b>Nine Months Ended<br/>September 30,<br/>2006</b> |    | <b>2005</b> |
|--|--|----|---|----|-------------|
| Revenue  | \$ 2,433   | \$ | 7,476   | \$ | 7,181       |
| Net income                                     | 364  |    | 1,048   |    | 1,046       |
| Net income per common share:                   |  |    |   |    |             |
| Basic  | \$ 1.14  | \$ | 4.29  | \$ | 3.26        |
| Diluted  | \$ 1.12  | \$ | 4.23  | \$ | 3.22        |

We initially financed the cash portion of the merger consideration by borrowing \$1.8 billion under a credit agreement that we entered into with a group of banks in December 2005 (the "bridge facility"). During the second quarter of 2006, we issued the following debt securities:

| <b>Security</b>   | <b>Net<br/>Proceeds<br/>(in millions)</b> | <b>Interest Due</b>                           |
|---|---|---|
| \$500M Floating Rate Senior Notes, due 4/6/2009 <sup>(1)</sup>            | \$ 499                                    | Quarterly in January, April, July and October |
| \$500M 6.15% Senior Notes, due 4/7/2036 <sup>(2)</sup>                    | 492                                       | Semi-annually in April and October            |
| Capital Securities  |   |   |
| \$275M 6.75% Junior Subordinated Debentures, due 4/20/2066 <sup>(3)</sup> | 266                                       | Quarterly in January, April, July and October |

|   |          |                                   |
|---|----------|-----------------------------------|
| \$800M 7% Junior Subordinated<br>Debentures, due 5/17/2066 <sup>(4)</sup> | 788      | Semi-annually in May and November |
| Total proceeds  | \$ 2,045 |                                   |

- (1) Interest at a rate of three-month LIBOR plus 0.11%.
- (2) Redeemable any time subject to a make-whole provision.
- (3) Redeemable in whole or in part on or after April 20, 2011 (and prior to such date in whole or in part under certain circumstances).
- (4) Redeemable in whole or in part on or after May 17, 2016 (and prior to such date in whole or in part under certain circumstances). Beginning May 17, 2016, interest is due quarterly in February, May, August and November.

We used the net proceeds from the offerings, and other cash, to repay the outstanding loan balance under the bridge facility.

At the time of the merger, the following debt securities that were previously issued by Jefferson-Pilot were included within our Consolidated Balance Sheet:

· Junior subordinated debentures issued by Jefferson-Pilot in 1997 consist of \$211 million at an interest rate of 8.14% and \$107 million at an interest rate of 8.285%. Interest is paid semi-annually. These debentures mature in 2046, but are redeemable prior to maturity at our option beginning January 15, 2007, with two-thirds subject to a call premium of 4.07% and the remainder subject to a call premium of 4.14%, each grading to zero as of January 15, 2017. Premiums arose from recording these securities at their respective fair values, which were based on discounted cash flows using our incremental borrowing rate at the date of the merger. The premiums are being amortized to the respective call dates using an approximate effective yield methodology. The unamortized premiums included in the amounts above totaled \$9 million. As we expect to call these securities within the next twelve months, they have been reported in short-term debt on our consolidated balance sheet.

· Ten-year term notes of \$284 million at 4.75% and \$300 million of floating rate EXtensible Liquidity Securities® (“EXL”s) that currently have a maturity of August 2007, subject to periodic extension through 2011. Each quarter, the holders must make an election to extend the maturity of the EXLs for 13 months, otherwise they become due and payable on the next maturity date to which they had previously been extended. The EXLs bear interest at LIBOR plus a spread, which increases annually to a maximum of 10 basis points. The amount reported on our consolidated balance sheet is net of a \$16 million discount that arose from recording the ten-year term notes at their respective fair values based on discounted cash flows using our incremental borrowing rate at the date of merger. The discount is being accreted over the remaining life using an approximate effective yield methodology.

See our current reports on Form 8-K filed with the SEC on April 3, 2006, April 7, 2006, April 20, 2006, May 9, 2006 and May 17, 2006 for additional information.

### **3. Changes in Accounting Principles and Changes in Estimates**

**SFAS No. 123(R) - Share-Based Payment.** In December 2004, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standards (“SFAS”) No. 123 (revised 2004), “Share-Based Payment” (“SFAS 123(R)”), which is a revision of SFAS 123, “Accounting for Stock-based Compensation” (“SFAS 123”). SFAS 123(R) requires us to recognize at fair value all costs resulting from share-based payments to employees, except for equity instruments held by employee share ownership plans. Similar to SFAS 123 under SFAS 123(R), the fair value of share-based payments are recognized as a reduction to earnings over the period an employee is required to provide service in exchange for the award. We had previously adopted the retroactive restatement method under SFAS No. 148, “Accounting for Stock-based Compensation - Transition and Disclosure,” and restated all periods presented to reflect stock-based employee compensation cost under the fair value accounting method for all employee awards granted, modified or settled in fiscal years beginning after December 15, 1994.

Effective January 1, 2006, we adopted SFAS 123(R), using the modified prospective transition method. Under that transition method, compensation cost recognized in 2006 includes: (a) compensation cost for all share-based payments granted prior to but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, and (b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). Results from prior periods have not been restated. The effect of adopting SFAS 123(R) did not have a material effect on our income before Federal income taxes, net income and basic and diluted earnings per share.

SFAS 123(R) eliminates the alternative under SFAS 123 permitting the recognition of forfeitures as they occur. Expected forfeitures, resulting from the failure to satisfy service or performance conditions, must be estimated at the



grant date, thereby recognizing compensation expense only for those awards expected to vest. In accordance with SFAS 123(R), we have included estimated forfeitures in the determination of compensation costs for all share-based payments. Estimates of expected forfeitures must be reevaluated at each balance sheet date, and any change in the estimate recognized retrospectively in net income in the period of the revised estimate.

Prior to the adoption of SFAS 123(R), we presented all tax benefits of deductions resulting from the exercise of stock options as operating cash flows in the Statement of Cash Flows. SFAS 123(R) requires the cash flows from tax benefits resulting from tax deductions in excess of the compensation costs recognized to be classified as financing cash flows. Our

excess tax benefits are classified as financing cash flows, prospectively, in our Statement of Cash Flows for the nine months ended September 30, 2006.

We issue share-based compensation awards under an authorized plan, subject to specific vesting conditions. Generally, compensation expense is recognized ratably over a three-year vesting period, but recognition may be accelerated upon the occurrence of certain events. For awards that specify an employee will vest upon retirement and an employee is eligible to retire before the end of the normal vesting period, we would record compensation expense over the period from the grant date to the date of retirement eligibility. As a result of adopting SFAS 123(R), we have revised the prior method of recording unrecognized compensation expense upon retirement and use the non-substantive vesting period approach for all new share-based awards granted after January 1, 2006. Under the non-substantive vesting period approach, we recognize compensation cost immediately for awards granted to retirement-eligible employees, or ratably over a period from the grant date to the date retirement eligibility is achieved. If we would have applied the non-substantive vesting period approach to all share based compensation awards granted prior to January 1, 2006, it would not have a material effect on our results of operations or financial position.

See Note 11 for more information regarding our stock-based compensation plans.

**FSP 115-1 - The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments.**

In November 2005, the FASB issued FASB Staff Position (“FSP”) FAS 115-1 and FAS 124-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments” (“FSP 115-1”). The guidance in FSP 115-1 nullifies the accounting and measurement provisions of Emerging Issues Task Force No. 03-1 - “The Meaning of Other Than Temporary Impairments and Its Application to Certain Investments” references existing guidance, and supersedes EITF Topic No. D-44 “Recognition of Other-Than-Temporary Impairment upon the Planned Sale of a Security Whose Cost Exceeds Fair Value.” FSP 115-1 was effective for reporting periods beginning after December 15, 2005, on a prospective basis. Our existing policy for recognizing other-than-temporary impairments is consistent with the guidance in FSP 115-1, and includes the recognition of other than temporary impairments of securities resulting from credit related issues as well as declines in fair value related to rising interest rates, where we do not have the intent to hold the securities until either maturity or recovery. We adopted FSP 115-1 effective January 1, 2006. The adoption of FSP 115-1 did not have a material effect on our consolidated financial condition or results of operations.

**Statement of Position 05-1.** In September 2005, the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants (“AICPA”) issued Statement of Position (“SOP”) 05-1, “Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts” (“SOP 05-1”). SOP 05-1 addresses the accounting for Deferred Acquisition Costs (“DAC”) on internal replacements other than those described in SFAS No. 97, “Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments.” An internal replacement is defined by SOP 05-1 as a modification in product benefits, features, rights or coverages that occurs by (a) exchanging the contract for a new contract, (b) amending, endorsing or attaching a rider to the contract, or (c) electing a feature or coverage within a replaced contract. Contract modifications that result in a substantially unchanged contract will be accounted for as a continuation of the replaced contract. Contract modifications that result in a substantially changed contract should be accounted for as an extinguishment of the replaced contract, and any unamortized DAC, unearned revenue and deferred sales charges must be written-off. SOP 05-1 is to be applied prospectively and is effective for internal replacements occurring in fiscal years beginning after December 15, 2006. We expect to adopt SOP 05-1 effective January 1, 2007. We are currently evaluating the potential effects of SOP 05-1 on our consolidated financial condition and results of operations.

**SFAS No. 155 - Accounting for Certain Hybrid Financial Instruments - an amendment of FASB Statements No. 133 and 140.** In February 2006, the FASB issued SFAS No. 155, “Accounting for Certain Hybrid Financial Instruments - an amendment of FASB Statements No. 133 and 140” (“SFAS 155”), which permits fair value

remeasurement for a hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. Under SFAS 155, an entity may make an irrevocable election to measure a hybrid financial instrument at fair value, in its entirety, with changes in fair value recognized in earnings. SFAS 155 also: (a) clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133"); (b) eliminates the interim guidance in SFAS 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets," and establishes a requirement to evaluate beneficial interests in securitized financial assets to identify interests that are either freestanding derivatives or hybrid financial instruments that contain an embedded derivative requiring bifurcation; (c) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives; and (d) eliminates restrictions on a qualifying special-purpose entity's ability to hold passive derivative financial instruments that pertain to beneficial interests that are or contain a derivative financial instrument. We expect to adopt SFAS 155 beginning January 1, 2007, for all financial instruments acquired, issued, or subject to a remeasurement event occurring after that date. Upon adoption of SFAS 155, the fair value election may also be applied to hybrid financial instruments that had previously been bifurcated pursuant to SFAS 133. Prior period restatement is not permitted. SFAS 155 is not expected to have a material impact on our consolidated financial condition and results of

operations at adoption, however, application of the requirements of SFAS 155 may result in the classification of additional derivative transactions with changes in fair value recognized in net income.

**FASB Interpretation No. 48 - Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109.** In July 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 establishes criteria that an individual tax position must meet for any part of the benefit of the tax position to be recognized in the financial statements. These criteria include determining whether it is more-likely-than-not that a tax position will be sustained upon examination by the appropriate taxing authority. If the tax position meets the more-likely-than-not threshold, the position is measured as the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. If a tax position does not meet the more-likely-than-not recognition threshold, the benefit is not recognized in the financial statements. Upon adoption of FIN 48, the guidance will be applied to all tax positions, and only those tax positions meeting the more-likely-than-not threshold will be recognized or continue to be recognized in the financial statements. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. In addition, FIN 48 expands disclosure requirements to include additional information related to unrecognized tax benefits. FIN 48 is effective for fiscal years beginning after December 15, 2006, and the cumulative effect of applying the provisions of FIN 48 will be reported as an adjustment to the opening balance of retained earnings for that fiscal year. We are currently evaluating the potential effects of FIN 48 on our consolidated financial condition and results of operations.

**SFAS No. 157 - Fair Value Measurements.** In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" ("SFAS 157"), which establishes a framework for measuring fair value under current accounting pronouncements that require or permit fair value measurement. SFAS 157 retains the exchange price notion, but clarifies that exchange price is the price in an orderly transaction between market participants to sell the asset or transfer the liability in the most advantageous market for that asset or liability. Fair value measurement is based on assumptions used by market participants in pricing the asset or liability, which may include inherent risk, restrictions on the sale or use of an asset, or nonperformance risk which would include the reporting entity's own credit risk. SFAS 157 establishes a three-level fair value hierarchy, which prioritizes the inputs to valuation techniques used to measure fair value. The highest priority is given to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs in situations where there is little or no market activity for the asset or liability. In addition, SFAS 157 expands the disclosure requirements for annual and interim reporting to focus on the inputs used to measure fair value, including those measurements using significant unobservable inputs, and the effects of the measurements on earnings. SFAS 157 will be applied prospectively and is effective for fiscal years beginning after November 15, 2007. Retrospective application is required for certain financial instruments as a cumulative effect adjustment to the opening balance of retained earnings. We are currently evaluating the effects of SFAS 157 on our consolidated financial condition and results of operations.

**SFAS No. 158 - Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB Statements No. 87, 88, 106, and 132(R).** In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB Statements No. 87, 88, 106, and 132(R)" ("SFAS 158"). The guidance requires us to recognize on the balance sheet the funded status of our defined benefit postretirement plans as either an asset or liability, depending on the plans' funded status, with changes in the funded status recognized through other comprehensive income. The funded status is measured as the difference between the fair value of the plan assets and the projected benefit obligation, for pension plans, or the accumulated postretirement benefit obligation for postretirement benefit plans. Prior service costs or credits and net gains or losses which are not recognized in current net periodic benefit cost, pursuant to SFAS No. 87, "Employers' Account for Pensions" or SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions," must be recognized in other comprehensive income, net of tax, in the period in which they occur. As these items are recognized in net periodic benefit cost, the amounts accumulated in other comprehensive income are adjusted. Disclosure requirements have also been expanded to separately provide information on the prior service costs or credits and net gains and losses recognized in other comprehensive income and their effects on net periodic

benefit costs. SFAS 158 is effective for fiscal years ending after December 15, 2006 and is applied prospectively. We will adopt the provisions of SFAS 158 as of December 31, 2006. Using the measurement of plan assets and benefit obligations at December 31, 2005 as a basis for determining the financial statement impact of SFAS 158, accumulated other comprehensive income would be reduced by approximately \$67 million. The funded status of the plans we maintain as a result of our merger with Jefferson-Pilot was recognized in our Consolidated Balance Sheet as of the merger date.

**4. Federal Income Taxes**

The effective tax rate was 21% and 24% for the third quarter of 2006 and 2005, respectively. The effective tax rate for the nine months ended September 30, 2006 and 2005 was 27% and 22%, respectively. Differences in the effective rates and the U.S. statutory rate of 35% are the result of the separate account dividends-received deduction ("DRD"), foreign tax credits and other tax preference items.

The separate account DRD is estimated for the current year using information from the most recently completed tax return. As knowledge of the underlying factors becomes known, current year estimated DRD is revised and reflected in the effective tax rate of that period. Factors that affect the estimate include known actual mutual fund distributions and fee income from the our variable insurance products, changes in eligible dividends received by the mutual funds, amounts of distributions from these mutual funds, appropriate levels of taxable income as well as the utilization of capital loss carry forwards at the mutual fund level. Our DRD increased \$27 million and \$39 million for the three and nine months ended September 30, 2006 from the same 2005 periods, including a tax benefit of \$20 million for the three and nine months ended September 30, 2006, resulting from true-ups related to prior years' tax returns. There were no material true-up adjustments in 2005.

We also receive a credit against our U.S. tax liability for foreign taxes paid by us from our separate account assets. The increased allocation of separate account investments to the international equity markets during 2005 and 2006 has increased the amount of these foreign tax credits ("FTC"). In the three and nine months ended September 30, 2006, we reported a net benefit of \$7 million and \$12 million, respectively, for the separate account FTC, including a \$5 million third quarter adjustment comprised of a \$4 million true-up related to a prior year tax return and \$1 million related to the 2006 year.

We are required to establish a valuation allowance for any gross deferred tax assets that are unlikely to reduce taxes payable in future years' tax returns. At September 30, 2006, we believe that it is more likely than not that all gross deferred tax assets will reduce taxes payable in future years. Our Federal income tax liability at December 31, 2004 included a valuation allowance of \$47 million attributable to the net operating losses of our foreign life reinsurance subsidiary domiciled in Barbados. This valuation allowance was reduced to zero as of December 31, 2005, including reductions of \$13 million and \$43 million in the third quarter and first nine months of 2005, respectively.

We are subject to annual tax examinations from the Internal Revenue Service ("IRS"). During the first quarter of 2006, the IRS completed its examination for the tax years 1999 through 2002 with assessments resulting in a payment that was not material to our consolidated results of operations. In addition to taxes assessed and interest, the payment included a deposit relating to a portion of the assessment, which we continue to challenge. We believe this portion of the assessment is inconsistent with existing law, and are protesting it through the established IRS appeals process. We do not anticipate that any adjustments that might result from such audits would be material to our consolidated results of operations or financial condition. The Jefferson-Pilot subsidiaries acquired in the April 2006 merger are subject to a separate IRS examination cycle. During the second quarter of 2006, the IRS completed its examinations for the tax years 2000-2003 of Jefferson-Pilot Corporation and its subsidiaries, resulting in a refund that was not material to our consolidated results of operations.

## 5. Supplemental Financial Data

A rollforward of DAC and value of business acquired on the Consolidated Balance Sheet is as follows:

| (in millions)  | Nine Months Ended<br>September 30, |       |      |       |
|--|------------------------------------|-------|------|-------|
|  | 2006                               |       | 2005 |       |
| Balance at beginning-of-year   | \$                                 | 5,163 | \$   | 4,590 |
| Business acquired  |                                    | 2,478 |      | -     |
| Deferral   |                                    | 1,061 |      | 675   |
| Amortization   |                                    | (613) |      | (396) |
| Adjustment related to realized gains on securities available-for-sale    |                                    | (39)  |      | (40)  |
| Adjustment related to unrealized losses on securities available-for-sale |                                    | 56    |      | 228   |
| Foreign currency translation adjustment                                  |                                    | 66    |      | (68)  |
| Balance at end-of-period   | \$                                 | 8,172 | \$   | 4,989 |

Realized gains and losses on investments and derivative instruments on the Consolidated Statements of Income for the nine months ended September 30, 2006 and 2005 are net of amounts amortized against DAC of \$39 million and \$40 million, respectively. In addition, realized gains and losses for the nine months ended September 30, 2006 and 2005 are net of adjustments made to policyholder reserves of \$(1) million. We have either a contractual obligation or a consistent historical practice of making allocations of investment gains or losses to certain policyholders and to certain reinsurance arrangements.

A rollforward of deferred sales inducements, included in other assets on the Consolidated Balance Sheet, is as follows:

| (in millions)                | Nine Months Ended<br>September 30, |      |      |      |
|------------------------------|------------------------------------|------|------|------|
|                              | 2006                               |      | 2005 |      |
| Balance at beginning-of-year | \$                                 | 129  | \$   | 86   |
| Capitalized                  |                                    | 58   |      | 44   |
| Amortization                 |                                    | (14) |      | (12) |
| Balance at end-of-period     | \$                                 | 173  | \$   | 118  |

Details underlying underwriting, acquisition, insurance and other expenses on the Consolidated Statements of Income are as follows:

| (in millions)  | Three Months Ended<br>September 30, |        | Nine Months Ended<br>September 30, |        |
|--|-------------------------------------|--------|------------------------------------|--------|
|  | 2006                                | 2005   | 2006                               | 2005   |
| Commissions  | \$ 439                              | \$ 232 | \$ 1,096                           | \$ 649 |
| General and administrative expenses                          | 421                                 | 364    | 1,129                              | 1,012  |
| Deferred acquisition costs net of amortization               | (198)                               | (140)  | (448)                              | (279)  |
| Other intangibles amortization                               | 3                                   | 2      | 11                                 | 6      |
| Taxes, licenses and fees                                     | 50                                  | 21     | 131                                | 78     |
| Restructuring charges - includes merger-integration expenses | 1                                   | 3      | 11                                 | 28     |
| Other merger-integration expenses                            | 12                                  | -      | 19                                 | -      |

|       |    |     |    |     |    |       |    |       |
|-------|----|-----|----|-----|----|-------|----|-------|
| Total | \$ | 728 | \$ | 482 | \$ | 1,949 | \$ | 1,494 |
|-------|----|-----|----|-----|----|-------|----|-------|

As discussed in Note 2, the excess of the purchase price for the Jefferson-Pilot merger over the fair value of net assets acquired totaled \$3.3 billion.

12

---



The carrying amount of goodwill by reportable segment is as follows:

| <b>(in millions)</b>    | <b>Balance at<br/>December 31,<br/>2005</b> |              | <b>Jefferson-Pilot<br/>Merger (Note 2)</b> | <b>Balance at<br/>September 30,<br/>2006</b> |                 |
|-------------------------|---|--------------|--|--|-----------------|
| Individual Markets:     |   |              |  |  |                 |
| Life Insurance          | \$  | 855          | \$   | 1,326  | \$ 2,181        |
| Annuities               |   | 44           |  | 988  | 1,032           |
| Employer Markets:       |   |              |  |  |                 |
| Retirement Products     |   | 20           |  | -  | 20              |
| Group Protection        |   | -            |  | 281  | 281             |
| Investment Management   |   | 261          |  | -  | 261             |
| Lincoln Financial Media |   | -            |  | 707  | 707             |
| Lincoln UK*             |   | 14           |  | -  | 16              |
| <b>Total</b>            | <b>\$</b>                                   | <b>1,194</b> | <b>\$</b>                                  | <b>3,302</b>                                 | <b>\$ 4,498</b> |

\* Changes in the carrying amount of goodwill for the Lincoln UK segment from December 31, 2005 to September 30, 2006, are due to the translation of the balances from British pounds to U.S. dollars based on the prevailing exchange rate as of the respective balance sheet dates.

Details of investment contract and policyholder funds on the Consolidated Balance Sheet are as follows:

| <b>(in millions)</b>                             | <b>September 30,<br/>2006</b> |               | <b>December 31,<br/>2005</b> |               |
|--|-------------------------------|---------------|------------------------------|---------------|
| Premium deposit funds                            | \$                            | 20,709        | \$                           | 21,713        |
| Other policyholder funds                         |                               | 36,783        |                              | 12,972        |
| Deferred front end loads                         |                               | 924           |                              | 796           |
| Undistributed earnings on participating business |                               | 101           |                              | 111           |
| <b>Total</b>                                     | <b>\$</b>                     | <b>58,517</b> | <b>\$</b>                    | <b>35,592</b> |

## 6. Insurance Benefit Reserves

We issue variable contracts through our separate accounts for which investment income and investment gains and losses accrue directly to, and investment risk is borne by, the contractholder (traditional variable annuities). We also issue variable annuity and life contracts through separate accounts that include various types of guaranteed minimum death benefit ("GMDB") features, a guaranteed minimum withdrawal benefit ("GMWB") and guaranteed income benefits ("GIB"). The GMDB features generally include those where we contractually guarantee that the contractholder receives (a) a return of no less than total deposits made to the contract less any partial withdrawals, (b) total deposits made to the contract less any partial withdrawals plus a minimum return, or (c) the highest contract value on any contract anniversary date through age 80 minus any payments or withdrawals following such contract anniversary.

The following table provides information on the GMDB features outstanding at September 30, 2006 and December 31, 2005. (Note that our variable contracts with guarantees may offer more than one type of guarantee in each contract; therefore, the amounts listed are not mutually exclusive.) The net amount at risk ("NAR") is defined as the current guaranteed minimum death benefit in excess of the current account balance at the balance sheet date.

| <b>(dollars in billions)</b> | <b>In Event of Death</b>      |                              |
|------------------------------|-------------------------------|------------------------------|
|                              | <b>September 30,<br/>2006</b> | <b>December 31,<br/>2005</b> |

**Return of net deposit**

|   |    |      |    |      |
|---|----|------|----|------|
| Account value                           | \$ | 35.5 | \$ | 31.9 |
| NAR                                     |    | 0.1  |    | 0.1  |
| Average attained age of contractholders |    | 54   |    | 53   |

**Return of net deposits plus a minimum return**

|   |    |     |    |     |
|---|----|-----|----|-----|
| Account value                           | \$ | 0.4 | \$ | 0.3 |
| NAR                                     |    | -   |    | -   |
| Average attained age of contractholders |    | 66  |    | 66  |
| Guaranteed minimum return               |    | 5%  |    | 5%  |

**Highest specified anniversary account value minus withdrawals post anniversary**

|   |    |      |    |      |
|---|----|------|----|------|
| Account value                           | \$ | 21.0 | \$ | 18.8 |
| NAR                                     |    | 0.3  |    | 0.4  |
| Average attained age of contractholders |    | 63   |    | 63   |

The following summarizes the liabilities for GMDB:

| <b>(in millions)</b>         | <b>September 30,<br/>2006</b> | <b>September 30,<br/>2005</b> |
|------------------------------|-------------------------------|-------------------------------|
| Balance at beginning of year | \$ 15                         | \$ 18                         |
| Changes in reserves          | 11                            | 5                             |
| Benefits paid                | (5)                           | (11)                          |
| Balance at end-of-period     | \$ 21                         | \$ 12                         |

The changes to the benefit reserves amounts above are reflected in benefits in the Consolidated Statements of Income. Also included in benefits are the results of the hedging program, which included losses of \$(1) million and \$(3) million for GMDB for the three and nine months ended September 30, 2006, respectively, and \$(4) million and \$(2) million for the three and nine months ended September 30, 2005, respectively.

Approximately \$12.2 billion and \$8.2 billion of separate account values at September 30, 2006 and December 31, 2005 were attributable to variable annuities with a GMWB feature. This GMWB feature offers the contractholder a guarantee equal to the initial deposit adjusted for any subsequent purchase payments or withdrawals. There are one-year and five-year step-up options, which allow the contractholder to step up the guarantee. GMWB features are considered to be derivatives under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" resulting in the guarantees being recognized at fair value, with changes in fair value being reported in net income.

Approximately \$2.2 billion and \$1.2 billion of separate account values at September 30, 2006 and December 31, 2005, respectively, were attributable to variable annuities with a GIB feature. Similar to GMWB features, the GIB feature is considered a derivative with the resulting guarantees being recognized at fair value and changes in fair value being reported in net income.

Separate account balances attributable to variable annuity contracts with guarantees are as follows:

| <b>(in billions)</b>                                      | <b>September 30,<br/>2006</b> | <b>December 31,<br/>2005</b> |
|---|-------------------------------|------------------------------|
| <b>Asset Type</b>   |                               |                              |
| Domestic equity   | \$ 36.3                       | \$ 32.2                      |
| International equity                                      | 5.2                           | 4.2                          |
| Bonds   | 5.9                           | 5.1                          |
| Total   | 47.4                          | 41.5                         |
| Money market  | 5.1                           | 4.0                          |
| Total   | \$ 52.5                       | \$ 45.5                      |
| Percent of total variable annuity separate account values | 74%                           | 96%                          |

Liabilities of \$132 million related to life insurance policies with no-lapse guarantees (secondary guarantees) are included in investment contract and policyholder funds within the consolidated balance sheet as of September 30, 2006. These liabilities are calculated by multiplying the benefit ratio (present value of total expected secondary guarantee benefits over the life of the contract divided by the present value of total expected assessments over the life of the contract) by the cumulative assessments recorded from contract inception through the balance sheet date less the cumulative secondary guarantee benefit payments plus interest. If experience or assumption changes result in a new benefit ratio, the reserves are unlocked to reflect the changes in a manner similar to deferred policy acquisition costs and value of business acquired.

**7.**

**Restrictions and Contingencies**

**Statutory Restrictions**

Our insurance subsidiaries are subject to certain insurance department regulatory restrictions as to the transfer of funds and payment of dividends to the holding company. Generally, these restrictions pose no short-term liquidity concerns for the holding company. For example, under Indiana laws and regulations, our Indiana insurance subsidiaries, including one of our major insurance subsidiaries, The Lincoln National Life Insurance Company (“LNL”), may pay dividends to LNC only from unassigned surplus, without prior approval of the Indiana Insurance Commissioner (the “Commissioner”), or must receive prior approval of the Commissioner to pay a dividend if such dividend, along with all other dividends paid within the preceding twelve consecutive months, would exceed the statutory limitation. The current statutory limitation is the greater of (i) 10% of the insurer’s policyholders’ surplus, as shown on its last annual statement on file with the Commissioner or (ii) the insurer’s statutory net gain from operations for the previous twelve months, but in no event to exceed statutory unassigned surplus. Indiana law gives the Commissioner broad discretion to disapprove requests for dividends in excess of these limits. Our other major insurance subsidiaries, Jefferson-Pilot Life Insurance Company, Jefferson Pilot Financial Insurance Company, and Jefferson Pilot LifeAmerica Insurance Company are domiciled in North Carolina, Nebraska and New Jersey, respectively, and are subject to similar, but not identical, restrictions.

LNL is recognized as an accredited reinsurer in the state of New York, which effectively enables it to conduct reinsurance business with unrelated insurance companies that are domiciled within the state of New York. As a result, in addition to regulatory restrictions imposed by the state of Indiana, LNL is also subject to the regulatory requirements that the State of New York imposes upon accredited reinsurers. These include reserve requirements, which differ from Indiana’s requirements.

The New York regulations require LNL to report more reserves to the state of New York. As a result, the level of statutory surplus that LNL reports to New York is less than the statutory surplus reported to Indiana and the National Association of Insurance Commissioners. If New York requires LNL to maintain a higher level of capital to remain an accredited reinsurer in New York, LNL’s ability to pay dividends to us could be constrained. However, we do not expect that LNL’s ability to pay dividends during 2006 will be constrained as a result of our status in New York.

Lincoln UK’s operations consist primarily of unit-linked life and pension products, which are similar to U.S. produced variable life and annuity products. Lincoln UK’s insurance subsidiaries are regulated by the U.K. Financial Services Authority (“FSA”) and are subject to capital requirements as defined by the U.K. Capital Resources Requirement (formerly the Required Minimum Solvency Margin). All insurance companies operating in the U.K. also have to complete a risk-based capital (“RBC”) assessment to demonstrate to the FSA that they hold sufficient capital to cover their risks. RBC requirements in the U.K. are different than the NAIC requirements. In addition, the FSA has imposed certain minimum capital requirements for the combined U.K. subsidiaries. Lincoln UK maintains approximately 1.5 to 2 times the required capital as prescribed by the regulatory margin. As is the case with regulated insurance companies in the U.S., changes to regulatory capital requirements can impact the dividend capacity of the UK insurance subsidiaries and cash flow to us.

## Reinsurance

Our amounts recoverable from reinsurers represent receivables from and reserves ceded to reinsurers. We obtain reinsurance from a diverse group of reinsurers and we monitor concentration, as well as financial strength ratings of our principal reinsurers. Swiss Re Life & Health America, Inc. ("Swiss Re") represents our largest reinsurance exposure. In 2001, we sold our reinsurance business to Swiss Re primarily through indemnity reinsurance arrangements. Because we are not relieved of our liability to the ceding companies for this business, the liabilities and obligations associated with the reinsured contracts remain on our Consolidated Balance Sheets with a corresponding reinsurance receivable from the business sold to Swiss Re, which totaled \$4.1 billion at September 30, 2006 and December 31, 2005. Swiss Re has funded a trust with a balance of \$1.7 billion at September 30, 2006 to support this business. In addition to various remedies that we would have in the event of a default by Swiss Re, we continue to hold assets in support of certain of the transferred reserves. These assets consist of those reported as trading securities and certain mortgage loans. Our liabilities for funds withheld and embedded derivatives included \$2.1 billion and \$0.2 billion, respectively, at September 30, 2006 related to the business sold to Swiss Re.

### **United Kingdom Selling Practices**

Various selling practices of the Lincoln UK operations have come under scrutiny by the U.K. regulators. These include the sale and administration of individual pension products and mortgage endowments. Regarding the sale and administration of pension products to individuals, regulatory agencies have raised questions as to what constitutes appropriate advice to individuals who bought pension products as an alternative to participation in an employer-sponsored plan. In cases of alleged inappropriate advice, an extensive investigation has been or is being carried out and the individual put in a position similar to what would have been attained if the individual had remained in an employer-sponsored plan.

At September 30, 2006 and December 31, 2005, the aggregate liability associated with Lincoln UK selling practices was \$6 million and \$13 million, respectively. The liabilities reflect our assessment of the likely outcome of known issues and are based on estimates that are subject to uncertainty. Future changes in complaint levels or changes in the regulatory position on time limits for making a complaint regarding the sale of mortgage endowment contracts could affect Lincoln UK's ultimate exposure to mis-selling issues, although we believe that any future change would not materially affect our consolidated financial position.

In July 2006, we negotiated a memorandum of understanding with certain of our liability carriers, from whom we received a reimbursement during the third quarter of 2006 of \$26 million for certain losses incurred in connection with certain United Kingdom selling practices. The reimbursement was included in net income for the third quarter. We continue to pursue claims with other liability carriers and we cannot reasonably predict either the timing or the amount of any future reimbursements.

### **Marketing and Compliance Issues**

There continues to be a significant amount of federal and state regulatory activity in the industry relating to numerous issues including, but not limited to, market timing and late trading of mutual fund and variable insurance products and broker-dealer access arrangements. Like others in the industry, we have received inquiries including requests for information and/or subpoenas from various authorities including the SEC, National Association of Securities Dealers ("NASD"), and the New York Attorney General, as well as notices of potential proceedings from the SEC and NASD. We are in the process of responding to, and in some cases have settled or are in the process of settling, certain of these inquiries and potential proceedings. We continue to cooperate fully with such authorities.

Regulators also continue to focus on replacement and exchange issues. Under certain circumstances companies have been held responsible for replacing existing policies with policies that were less advantageous to the policyholder. Our management continues to monitor compliance procedures to minimize any potential liability. Due to the uncertainty surrounding all of these matters, it is not possible to provide a meaningful estimate of the range of potential outcomes; however it is management's opinion that future developments will not materially affect our consolidated financial position.

### **Media Commitments**

Lincoln Financial Media has commitments to purchase future sports programming rights, and for employment contracts, leases and syndicated television programming of approximately \$287 million through 2011 and \$16 million thereafter. We have offset the purchase of these programming rights by receiving commitments from other entities to purchase a portion of our sports programming rights of approximately \$203 million through 2011, as well as by entering into advertising contracts with customers for the airing of commercials. These commitments are not reflected as an asset or liability in our Consolidated Balance Sheet because the programs are not currently available for use.

### **Other Contingency Matters**

We and our subsidiaries are involved in various pending or threatened legal proceedings, including purported class actions, arising from the conduct of business. In some instances, these proceedings include claims for unspecified or substantial punitive damages and similar types of relief in addition to amounts for alleged contractual liability or requests for equitable relief. After consultation with legal counsel and a review of available facts, it is management's opinion that these proceedings ultimately will be resolved without materially affecting our consolidated financial position.

State guaranty funds assess insurance companies to cover losses to policyholders of insolvent or rehabilitated companies. Mandatory assessments may be partially recovered through a reduction in future premium taxes in some states. We have accrued for expected assessments net of estimated future premium tax deductions.

### **Guarantees**

We have guarantees with off-balance-sheet risks having contractual values of \$3 million and \$4 million at September 30, 2006 and December 31, 2005, respectively.

Certain of our subsidiaries have sold commercial mortgage loans through grantor trusts, which issued pass-through certificates. These subsidiaries have agreed to repurchase any mortgage loans which remain delinquent for 90 days at a repurchase price substantially equal to the outstanding principal balance plus accrued interest thereon to the date of repurchase. In case of default by the borrowers, we have recourse to the underlying real estate. It is management's opinion that the value of the properties underlying these commitments is sufficient that in the event of default, the impact would not be material to us. These guarantees expire in 2009.

We guarantee the repayment of operating leases on facilities that we have subleased to third parties, which obligate us to pay in the event the third parties fail to perform their payment obligations under the subleasing agreements. We have recourse to the third parties enabling us to recover any amounts paid under our guarantees. The annual rental payments subject to these guarantees are \$15 million and expire in 2009.

### **Derivative Instruments**

We maintain an overall risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate risk, foreign currency risk, equity risk, and credit risk. We assess these risks by continually identifying and monitoring changes in interest rate exposure, foreign currency exposure, equity market exposure, and credit exposure that may adversely impact expected future cash flows and by evaluating hedging opportunities. Derivative instruments that are currently used as part of our interest rate risk management strategy include interest rate swaps, interest rate futures and interest rate caps. Derivative instruments that are used as part of our foreign currency risk management strategy include foreign currency swaps and foreign exchange forwards. Call options on our stock, total return swaps, put options and equity futures are used as part of our equity market risk management strategy. We also use credit default swaps as part of our credit risk management strategy.

As a result of our acquisition of Jefferson-Pilot, we now distribute indexed annuity contracts. These contracts permit the holder to elect an interest rate return or an equity market component, where interest credited to the contracts is linked to the performance of the S&P 500® index. Policyholders may elect to rebalance index options at renewal dates, either annually or biannually. At each renewal date, we have the opportunity to re-price the indexed component by establishing participation rates, subject to minimum guarantees. We purchase S&P 500® index call options that are highly correlated to the portfolio allocation decisions of our policyholders, such that we are economically hedged with respect to equity returns for the current reset period. The mark-to-market of the options held impacts net investment income and generally offsets the change in value of the embedded derivative within the indexed annuity which is recorded as a component of interest credited to policyholders' within insurance benefits. SFAS 133 requires that we calculate fair values of index options we may purchase in the future to hedge policyholder index allocations in future reset periods. These fair values represent an estimate of the cost of the options we will purchase in the future, discounted back to the date of the balance sheet, using current market indicators of volatility and interest rates. Changes in the fair values of these liabilities are included in interest credited. The notional amounts of policyholder fund balances allocated to the equity-index options were \$2.2 billion at September 30, 2006.

By using derivative instruments, we are exposed to credit risk (our counterparty fails to make payment) and market risk (the value of the instrument falls and we are required to make a payment). When the fair value of a derivative contract is positive, this generally indicates that the counterparty owes us and, therefore, creates a credit risk for us equal to the extent of the fair value gain in the derivative. When the fair value of a derivative contract is negative, we owe the counterparty and therefore we have no credit risk, but have been affected by market risk. We minimize the credit risk in derivative instruments by entering into transactions with high quality counterparties with minimum credit ratings that are reviewed regularly by us, by limiting the amount of credit exposure to any one counterparty, and by requiring certain counterparties to post collateral if our credit risk exceeds certain limits. We also maintain a policy of requiring that all derivative contracts be governed by an International Swaps and Derivatives Association ("ISDA") Master Agreement. We do not believe that the credit or market risks associated with derivative instruments are material to any insurance subsidiary or the Company.



We and our insurance subsidiaries are required to maintain minimum ratings as a matter of routine practice in negotiating ISDA agreements. Under some ISDA agreements our insurance subsidiaries have agreed to maintain certain financial strength or claims-paying ratings. A downgrade below these levels could result in termination of the derivatives contract at which time any amounts payable by us would be dependent on the market value of the underlying derivative contract. In certain transactions, we and the counterparty have entered into a collateral support agreement requiring us to post collateral upon significant downgrade. We do not believe the inclusion of termination or collateralization events pose any material threat to the liquidity position of any insurance subsidiary or the Company.

Market risk is the adverse effect that a change in interest rates, currency rates, implied volatility rates, or a change in certain equity indexes or instruments has on the value of a financial instrument. We manage the market risk by establishing and monitoring limits as to the types and degree of risk that may be undertaken.

Our derivative instruments are monitored by our risk management committee as part of that committee's oversight of our derivative activities. Our derivative instruments committee is responsible for implementing various hedging strategies that are developed through our analysis of financial simulation models and other internal and industry sources. The resulting hedging strategies are then incorporated into our overall risk management strategies.

## **8. Segment Information**

In the quarter ended June 30, 2006, we completed our merger with Jefferson-Pilot and changed our management organization. We also realigned our reporting segments to reflect the current manner by which our chief operating decision makers view and manage the business. All segment data for reporting periods have been adjusted to reflect the current segment reporting. As a result of these changes, we provide products and services in five operating businesses: (1) Individual Markets, (2) Employer Markets, (3) Investment Management, (4) Lincoln UK and (5) Lincoln Financial Media, and report results through seven business segments. The following is a brief description of these segments.

*Individual Markets.* The Individual Markets business provides its products through two segments, Individual Annuities and Individual Life Insurance. Through its Individual Annuities segment, Individual Markets provides tax-deferred investment growth and lifetime income opportunities for its clients by offering individual fixed annuities, including indexed annuities, and variable annuities. The Individual Life Insurance segment offers wealth protection and transfer opportunities through both single and survivorship versions of universal life, variable universal life, interest-sensitive whole life, term insurance, as well as a linked-benefit product, which is a universal life insurance policy linked with riders that provide for long-term care costs.

*Employer Markets.* The Employer Markets business provides its products through two segments, Retirement Products and Group Protection, formerly referred to as Benefit Partners. Through its Retirement Products segment, which consists of its Defined Contribution and Executive Benefits businesses, Employer Markets provides employer-sponsored variable and fixed annuities, mutual-fund based programs in the 401(k), 403(b), and 457 marketplaces and corporate/bank owned life insurance. The Group Protection segment offers group non-medical insurance products, principally term life, disability and dental, to the employer marketplace through various forms of contributory and noncontributory plans. Most of our group contracts are sold to employers with fewer than 500 employees.

*Investment Management.* The Investment Management segment, through Delaware Investments, provides a broad range of managed accounts and portfolios, mutual funds, subadvised funds, and other investment products to individual investors and to institutional investors such as private and public pension funds, foundations, and endowment funds. Delaware Investments is the marketing name for Delaware Management Holdings, Inc. and its subsidiaries.

*Lincoln UK.* Lincoln UK is headquartered in Barnwood, Gloucester, England, and is licensed to do business throughout the United Kingdom. Lincoln UK primarily focuses on protecting and enhancing the value of its existing customer base. The segment accepts new deposits from existing relationships and markets a limited range of new products. Lincoln UK's product portfolio principally consists of unit-linked life and pension products, which are similar to U.S. produced variable life and annuity products, where the risk associated with the underlying investments is borne by the policyholders.

*Lincoln Financial Media.* The Lincoln Financial Media segment operates domestic radio and television broadcasting stations and produces syndicated collegiate sports programming. Federal Communications Commission ("FCC") licenses, which are required for operations, are subject to periodic renewal. All of our licenses are current.

We also have "Other Operations," which includes the financial data for operations that are not directly related to the business segments, unallocated items (such as corporate investment income on assets not allocated to our business

units, interest expense on short-term and long-term borrowings, and certain expenses, including restructuring and merger-related expenses) and the historical results of the former reinsurance segment, which was sold to Swiss Re in the fourth quarter of 2001, along with the ongoing amortization of deferred gain on the indemnity reinsurance portion of the transaction with Swiss Re.

Segment operating revenue and income (loss) from operations are internal measures used by our management and Board of Directors to evaluate and assess the results of our segments. Operating revenue is GAAP revenue excluding realized gains and losses on investments and derivative instruments, gains and losses on reinsurance embedded derivative/trading securities, gains and losses on sale of subsidiaries/businesses and the amortization of deferred gain arising from reserve development on business sold through reinsurance. Income (loss) from operations is GAAP net income excluding net realized investment gains and losses, losses on early retirement of debt, reserve development net of related amortization on business sold through reinsurance and cumulative effect of accounting changes. Our management and Board of Directors believe that operating revenue and income (loss) from operations explain the results of our ongoing businesses in a manner

that allows for a better understanding of the underlying trends in our current businesses because net realized investment gains and losses, reserve development net of related amortization on business sold through reinsurance and cumulative effect of accounting changes are unpredictable and not necessarily indicative of current operating fundamentals or future performance of the business segments, and in many instances, decisions regarding these items do not necessarily relate to the operations of the individual segments. Operating revenue and income (loss) from operations do not replace revenues and net income as the GAAP measures of our consolidated results of operations.

The following tables show financial data by segment:

| (in millions)  | Three Months Ended<br>September 30, |                 | Nine Months Ended<br>September 30, |                 |
|--|-------------------------------------|-----------------|------------------------------------|-----------------|
|  | 2006                                | 2005            | 2006                               | 2005            |
| <b>Revenue:</b>  |                                     |                 |                                    |                 |
| Segment Operating Revenue:   |                                     |                 |                                    |                 |
| Individual Markets:  |                                     |                 |                                    |                 |
| Individual Annuities   | \$ 597                              | \$ 363          | \$ 1,524                           | \$ 1,050        |
| Life Insurance   | 895                                 | 459             | 2,297                              | 1,409           |
| Individual Markets Total   | 1,492                               | 822             | 3,821                              | 2,459           |
| Employer Markets:  |                                     |                 |                                    |                 |
| Retirement Products  | 349                                 | 298             | 1,006                              | 872             |
| Group Protection   | 332                                 | -               | 687                                | -               |
| Employer Markets Total   | 681                                 | 298             | 1,693                              | 872             |
| Investment Management <sup>(1)</sup>   | 140                                 | 123             | 415                                | 347             |
| Lincoln UK   | 72                                  | 103             | 223                                | 256             |
| Lincoln Financial Media <sup>(2)</sup>   | 60                                  | -               | 117                                | -               |
| Other Operations   | 86                                  | 68              | 244                                | 227             |
| Consolidating adjustments  | (34)                                | (23)            | (93)                               | (80)            |
| Net realized investment results <sup>(3)</sup>   | (10)                                | 4               | (16)                               | 6               |
| Reserve development net of related<br>amortization<br>on business sold through reinsurance | -                                   | -               | 1                                  | 1               |
| <b>Total</b>   | <b>\$ 2,487</b>                     | <b>\$ 1,395</b> | <b>\$ 6,405</b>                    | <b>\$ 4,088</b> |
| <b>Net Income:</b>   |                                     |                 |                                    |                 |
| Segment Operating Income:  |                                     |                 |                                    |                 |
| Individual Markets:  |                                     |                 |                                    |                 |
| Individual Annuities   | \$ 129                              | \$ 79           | \$ 285                             | \$ 181          |
| Life Insurance   | 123                                 | 65              | 339                                | 186             |
| Individual Markets Total   | 252                                 | 144             | 624                                | 367             |
| Employer Markets:  |                                     |                 |                                    |                 |
| Retirement Products  | 65                                  | 56              | 195                                | 152             |
| Group Protection   | 29                                  | -               | 66                                 | -               |
| Employer Markets Total   | 94                                  | 56              | 261                                | 152             |
| Investment Management <sup>(1)</sup>   | 13                                  | 5               | 41                                 | 8               |
| Lincoln UK   | 8                                   | 10              | 29                                 | 30              |
| Lincoln Financial Media  | 15                                  | -               | 27                                 | -               |
| Other Operations   | (11)                                | 12              | (38)                               | 44              |
| Net realized investment results <sup>(4)</sup>   | (7)                                 | 2               | (11)                               | 4               |
| Reserve development net of related<br>amortization<br>on business sold through reinsurance | -                                   | -               | 1                                  | 1               |
| <b>Net Income</b>  | <b>\$ 364</b>                       | <b>\$ 229</b>   | <b>\$ 934</b>                      | <b>\$ 606</b>   |

(1) Revenues for the Investment Management segment include inter-segment revenues for asset management services provided to our other segments. These inter-segment revenues totaled \$24 million and \$25 million for the three months ended September 30, 2006 and 2005, and \$72 million and \$74 million for the nine months ended September 30, 2006 and 2005, respectively.

(2)

Lincoln Financial Media revenues are net of \$8 million and \$17 million of commissions paid to agencies during the third quarter of 2006 and the six months since the merger.

- (3) Includes realized losses on investments and derivative instruments of \$6 million and \$1 million for the three months ended September 30, 2006 and 2005, respectively; gain (loss) on reinsurance embedded derivative/trading securities of \$ (4) million and \$5 million for the three months ended September 30, 2006 and 2005, respectively. Includes realized losses on investments and derivative instruments of \$20 million and \$13 million for the nine months ended September 30, 2006 and 2005, gain on reinsurance embedded derivative/trading securities of \$4 million and \$5 million for the nine months ended September 30, 2006 and 2005, respectively; and gain on sale of subsidiaries/businesses of \$14 million for the nine months ended September 30, 2005.

- (4) Includes after-tax realized losses on investments and derivative instruments of \$5 million and \$1 million for the three months ended September 30, 2006 and 2005, respectively; gain (loss) on reinsurance embedded derivative/trading securities of \$(2) million and \$3 million for the three months ended September 30, 2006 and 2005, respectively. Includes realized losses on investments and derivative instruments of \$13 million and \$8 million for the nine months ended September 30, 2006 and 2005, respectively; gain on reinsurance embedded derivative/trading securities of \$2 million and \$3 million for the nine months ended September 30, 2006 and 2005, respectively; and gain on sale of subsidiaries/businesses of \$9 million for the nine months ended September 30, 2005.

| (in millions)             | As of<br>September 30,<br>2006 |
|---------------------------|--------------------------------|
| <b>Assets:</b>            |                                |
| Individual Markets        |                                |
| Individual Life Insurance | \$ 41,426                      |
| Individual Annuities      | 67,056                         |
| Employer Markets          |                                |
| Retirement Products       | 35,953                         |
| Group Protection          | 2,306                          |
| Investment Management     | 565                            |
| Lincoln UK                | 10,384                         |
| Lincoln Financial Media   | 1,487                          |
| Other Operations          | 25,201                         |
| Consolidating adjustments | (12,652)                       |
| Total                     | \$ 171,726                     |

## 9. Earnings Per Share

The income used in the calculation of our diluted earnings per share is net income reduced by minority interest adjustments related to outstanding stock options under the Delaware Investments U.S., Inc. ("DIUS") stock option incentive plan of less than \$1 million for all periods presented.

A reconciliation of the denominator in the calculations of basic and diluted net income per share is as follows:

|  | Three Months Ended<br>September 30, |             | Nine Months Ended<br>September 30, |             |
|--|-------------------------------------|-------------|------------------------------------|-------------|
|  | 2006                                | 2005        | 2006                               | 2005        |
| <b>Denominator: [number of shares]</b>   |                                     |             |                                    |             |
| Weighted-average shares as used in basic calculation   | 278,472,606                         | 172,614,421 | 244,436,546                        | 173,018,733 |
| Conversion of preferred stock  | 229,398                             | 258,153     | 236,090                            | 262,342     |
| Non-vested stock   | 1,215,886                           | 1,401,023   | 1,296,788                          | 1,223,935   |
| Average stock options outstanding during the period  | 17,027,119                          | 6,957,917   | 14,198,174                         | 6,246,594   |
| Assumed acquisition of shares with assumed proceeds and benefits from exercising stock options | (14,296,624)                        | (6,086,239) | (12,150,774)                       | (5,467,039) |
| Shares repurchaseable from measured but unrecognized   |                                     |             |                                    |             |

Edgar Filing: LINCOLN NATIONAL CORP - Form 10-Q

|   |             |             |             |             |
|---|-------------|-------------|-------------|-------------|
| stock option expense                                    | (1,532,286) | (650,891)   | (1,303,201) | (552,577)   |
| Average deferred compensation shares                    | 1,301,204   | 1,340,854   | 1,281,868   | 1,278,772   |
| Weighted-average shares, as used in diluted calculation | 282,417,303 | 175,835,238 | 247,995,491 | 176,010,760 |

In the event the average market price of our common stock exceeds the issue price of stock options, such options would be dilutive to our earnings per share and will be shown in the table above. Participants in our deferred compensation plans that select our stock for measuring the investment return attributable to their deferral amounts will be paid out in our stock. These deferred compensation plan obligations are dilutive and are shown in the table above.

21

---



## 10. Employee Benefit Plans

### Pension and Other Post-retirement Plans

As a result of our merger with Jefferson-Pilot, we maintain defined benefit pension plans and post-retirement benefit plans for the former U.S. employees of Jefferson-Pilot and have included these plans in the tables below as of April 3, 2006. The components of net periodic benefit expense for our defined benefit pension plans and post-retirement benefit plans are as follows:

| (in millions)                           | Pension Benefits<br>Three months ended<br>September 30, |      | Other Post-retirement<br>Benefits<br>Three months ended<br>September 30, |      |
|---|---|------|--|------|
|   | 2006  | 2005 | 2006   | 2005 |
| <b>U.S. Plans:</b>                      |   |      |  |      |
| Service cost                            | \$ 9  | \$ 5 | \$ 1   | \$ 1 |
| Interest cost                           | 15  | 8    | 2  | 1    |
| Expected return on plan assets          | (19)  | (11) | -  | -    |
| Recognized net actuarial losses         | 1   | 1    | -  | -    |
| Net periodic benefit expense            | \$ 6  | \$ 3 | \$ 3   | \$ 2 |
| <b>Non-U.S. Plans:</b>                  |   |      |  |      |
| Service cost                            | \$ -  | \$ - |  |      |
| Interest cost                           | 4   | 4    |  |      |
| Expected return on plan assets          | (4)   | (3)  |  |      |
| Recognized net actuarial (gains) losses | 1   | 1    |  |      |
| Net periodic benefit expense            | \$ 1  | \$ 2 |  |      |

| (in millions)                           | Pension Benefits<br>Nine months ended<br>June 30, |       | Other Post-retirement<br>Benefits<br>Nine months ended<br>June 30, |      |
|---|---|-------|--|------|
|   | 2006  | 2005  | 2006   | 2005 |
| <b>U.S. Plans:</b>                      |   |       |  |      |
| Service cost                            | \$ 23   | \$ 14 | \$ 2   | \$ 2 |
| Interest cost                           | 38  | 25    | 6  | 4    |
| Expected return on plan assets          | (48)  | (33)  | (1)  | -    |
| Recognized net actuarial losses         | 2   | 1     | -  | -    |
| Net periodic benefit expense            | \$ 15   | \$ 7  | \$ 7   | \$ 6 |
| <b>Non-U.S. Plans:</b>                  |   |       |  |      |
| Service cost                            | \$ 1  | \$ 1  |  |      |
| Interest cost                           | 12  | 12    |  |      |
| Expected return on plan assets          | (13)  | (10)  |  |      |
| Recognized net actuarial (gains) losses | 3   | 2     |  |      |
| Net periodic benefit expense            | \$ 3  | \$ 5  |  |      |

## 11. Stock-Based Incentive Compensation Plans

See Note 8 to the Consolidated Financial Statements in our 2005 Form 10-K for a detailed discussion of stock and incentive compensation.

We have various incentive plans for our employees, agents and directors and our subsidiaries that provide for the issuance of stock options, stock incentive awards, stock appreciation rights (“SARs”), restricted stock awards, restricted stock

units (“performance shares”), and deferred stock units. DIUS has a separate stock option incentive plan. We have a policy of issuing new shares to satisfy option exercises. Total pre-tax compensation expense (income) for all of our stock-based incentive compensation plans is as follows:

| (in millions)          | Three Months Ended<br>September 30, |       | Nine Months Ended<br>September 30, |       |
|------------------------|-------------------------------------|-------|------------------------------------|-------|
|                        | 2006                                | 2005  | 2006                               | 2005  |
| Stock options          | \$ 6                                | \$ 2  | \$ 11                              | \$ 9  |
| Shares                 | 11                                  | 8     | 21                                 | 20    |
| Cash awards            | 2                                   | 1     | 3                                  | 3     |
| DIUS stock options     | 2                                   | 4     | 7                                  | 12    |
| SARs                   | (1)                                 | -     | (1)                                | 2     |
| Restricted stock       | 1                                   | 1     | 2                                  | 1     |
| Total                  | \$ 21                               | \$ 16 | \$ 43                              | \$ 47 |
| Recognized tax benefit | \$ 7                                | \$ 6  | \$ 15                              | \$ 16 |

Outstanding options to acquire Jefferson-Pilot common stock that existed immediately prior to the date of the merger remain subject to the same terms and conditions that existed, except that each of these stock options is now or will be exercisable for LNC common stock equal to the number of shares of Jefferson-Pilot common stock subject to such option multiplied by 1.0906 (rounded down to the nearest whole share), with the exercise price determined by dividing the exercise price of the Jefferson-Pilot options by 1.0906 (rounded up to the sixth decimal place). Grants of Jefferson-Pilot stock options in February 2006 will generally continue to vest in one-third annual increments. All employee and director stock options outstanding as of December 31, 2005 vested and became exercisable upon closing the merger. Jefferson-Pilot stock options held by its non-employee agents did not become fully vested and exercisable in connection with the merger, but will vest in accordance with the applicable option agreement.

#### *LNC Stock-Based Incentive Plans*

Information with respect to stock option and performance share awards, granted under our long-term incentive plans is provided in the table below.

|                                    | September 30, |           |
|------------------------------------|---------------|-----------|
|                                    | 2006          | 2005      |
| <b>Awards</b>                      |               |           |
| 10-year LNC stock options          | -             | 370,646   |
| Performance share units            | 174,173       | 435,827   |
| <b>Outstanding at September 30</b> |               |           |
| 10-year LNC stock options          | 851,194       | 988,797   |
| Non-employee agent stock options   | 536,262       | -         |
| Performance share units            | 1,011,690     | 1,588,610 |

In the second quarter of 2006, a performance period from 2006 - 2008 was approved by the Compensation Committee. Participants in this performance period received one-half of their award in 10-year LNC stock options, with the remainder of the award in a combination of performance shares and cash. Stock options granted for this performance period vest ratably over the three-year period, based solely on a service condition. Depending on the performance, the actual amount of performance units could range from zero to 200% of the granted amount.

For the three-year performance periods 2004-2006 and 2005-2007, the performance measures for determining the actual amount of 10-year LNC stock options and all performance share units were established at the beginning of each three-year performance period. Depending on the performance, the actual amount of stock options and performance share units awarded could range from zero to 200% of the granted amount, with the amount in excess of 100% resulting in a payout of additional shares. Certain Jefferson-Pilot executives were brought into the 2004-2006 and 2005-2007 plans on a pro-rata basis. Non-employee agent stock options are five-year options with some vesting based on the agents' future performance and others vesting upon grant based on past performance.

The option price assumptions used for our stock option incentive plans were as follows:

|  | <b>Nine Months<br/>Ended September<br/>30, 2006</b> | <b>Nine Months<br/>Ended<br/>September 30,<br/>2005</b> |
|--|---|---|
| Dividend yield                                 | 2.7%  | 3.1%  |
| Expected volatility                            | 23.1%   | 26.5%   |
| Risk-free interest rate                        | 4.9%  | 4.0%  |
| Expected life (in years)                       | 4.5   | 4.1   |
| Weighted-average fair value per option granted | \$ 11.57  | \$ 9.12   |

Expected volatility is measured based on the historical volatility of the LNC stock price for the previous three-year period. The expected term of the options granted represents the weighted-average period of time from the grant date to the exercise date, weighted for the number of shares exercised for an option grant relative to the number of options exercised over the previous three-year period.

As of September 30, 2006, there was \$32 million of unrecognized compensation cost related to non-vested awards under these plans. The cost is expected to be recognized over a weighted-average period of 1.7 years. Information with respect to our incentive plans involving stock options with performance conditions is as follows:

| <b>Options</b>  | <b>Shares</b> | <b>Weighted-<br/>Average<br/>Exercise Price</b> | <b>Weighted-<br/>Average<br/>Remaining<br/>Contractual<br/>Term</b> | <b>Aggregate<br/>Intrinsic<br/>Value<br/>(in millions)</b> |
|---|---------------|---|---|--|
| Outstanding at December 31, 2005                                | 988,787       | \$ 43.01  |   |  |
| Jefferson-Pilot agent options converted to LNC                  | 573,144       | 46.97   |   |  |
| Exercised (includes shares tendered)                            | (162,160)     | 29.48   |   |  |
| Forfeited or expired  | (12,315)      | 46.85   |   |  |
| Outstanding at September 30, 2006                               | 1,387,456     | \$ 46.24  | 5.90  | \$ 22  |
| Vested or expected to vest at September 30, 2006 <sup>(1)</sup> | 1,366,018     | \$ 46.23  | 5.86  | \$ 22  |
| Exercisable at September 30, 2006                               | 399,438       | \$ 42.42  | 3.04  | \$ 8   |

<sup>(1)</sup> Includes estimated forfeitures.

The total fair value of options vested during the nine months ended September 30, 2006 and 2005 was \$4 million and \$3 million, respectively. The total intrinsic value of options exercised during the nine months ended September 30, 2006 was \$5 million. There were no options with performance conditions exercised during the nine months ended September 30, 2005 as no performance period had been completed.

Information with respect to our incentive plans involving stock options with service conditions is as follows:

| <b>Options</b>                   | <b>Shares</b> | <b>Weighted-<br/>Average<br/>Exercise Price</b> | <b>Weighted-<br/>Average<br/>Remaining<br/>Contractual<br/>Term</b> | <b>Aggregate<br/>Intrinsic<br/>Value<br/>(in millions)</b> |
|----------------------------------|---------------|---|---|--|
| Outstanding at December 31, 2005 | 7,928,931     | \$ 44.58  |   |  |

Edgar Filing: LINCOLN NATIONAL CORP - Form 10-Q

|   |             |    |       |      |        |
|---|-------------|----|-------|------|--------|
| Granted-original  | 817,966     |    | 56.36 |      |        |
| Granted-reloads   | 92,062      |    | 57.52 |      |        |
| Jefferson-Pilot options converted to LNC                        | 10,300,392  |    | 41.82 |      |        |
| Exercised (includes shares tendered)                            | (4,785,883) |    | 41.31 |      |        |
| Forfeited or expired  | (148,123)   |    | 50.22 |      |        |
| Outstanding at September 30, 2006                               | 14,205,345  | \$ | 44.39 | 4.74 | \$ 251 |
| Vested or expected to vest at September 30, 2006 <sup>(1)</sup> | 14,133,906  | \$ | 44.33 | 4.72 | \$ 251 |
| Exercisable at September 30, 2006                               | 12,206,185  | \$ | 42.75 | 4.42 | \$ 236 |

(1) Includes estimated forfeitures.

Edgar Filing: LINCOLN NATIONAL CORP - Form 10-Q

The total fair value of options vested during the nine months ended September 30, 2006 and 2005 was \$8 million and \$6 million, respectively. The total intrinsic value of options exercised during the nine months ended September 30, 2006 and 2005 was \$79 million and \$28 million, respectively.

Information with respect to our performance shares at September 30, 2006 is as follows:

|                                 | <b>Shares</b> | <b>Weighted-Average<br/>Grant-Date<br/>Fair Value</b> |
|---------------------------------|---------------|---|
| Nonvested at December 31, 2005  | 1,577,278     | \$ 37.65  |
| Granted                         | 174,173       | 56.04   |
| Vested <sup>(1)</sup>           | (641,736)     | 25.88   |
| Forfeited                       | (98,025)      | 46.53   |
| Nonvested at September 30, 2006 | 1,011,690     | \$ 47.42  |

<sup>(1)</sup> Shares vested at December 31, 2005, but were not issued until the second quarter of 2006.

*Delaware Stock Option Incentive Plan*

The option price assumptions used for the DIUS stock option incentive plans were as follows:

|  | <b>Nine Months<br/>Ended<br/>September 30,<br/>2006</b> | <b>Nine Months<br/>Ended<br/>September 30,<br/>2005</b> |
|--|---|---|
| Dividend yield                                 | 1.3%  | 2.6%  |
| Expected volatility                            | 38.0%   | 45.0%   |
| Risk-free interest rate                        | 4.7%  | 3.9%  |
| Expected life (in years)                       | 4.1   | 4.6   |
| Weighted-average fair value per option granted | \$ 51.35  | \$ 48.84  |

Expected volatility is measured based on several factors including the historical volatility of the DIUS valuation since the inception of the plan in 2001 and comparisons to other public management companies with similar operating structures. The expected term of the options granted represents the weighted-average period of time from the grant date to the exercise date, based on the historical expected life of DIUS options.

At September 30, 2006, DIUS had 10,099,485 shares of common stock outstanding. Information with respect to the DIUS incentive plan involving stock options is as follows:

| <b>Options</b>  | <b>Shares</b> | <b>Weighted-<br/>Average<br/>Exercise Price</b> | <b>Weighted-<br/>Average<br/>Remaining<br/>Contractual<br/>Term</b> |
|---|---------------|---|---|
| Outstanding at December 31, 2005                                | 1,469,194     | \$ 128.74                                       |   |
| Granted - original  | 68,000        | 155.73  |   |
| Exercised   | (99,485)      | 116.81  |   |
| Forfeited or expired  | (187,982)     | 126.67  |   |
| Outstanding at September 30, 2006                               | 1,249,727     | \$ 131.47                                       | 6.8   |
| Vested or expected to vest at September 30, 2006 <sup>(1)</sup> | 1,212,336     | \$ 131.40                                       | 6.8   |
| Exercisable at September 30, 2006                               | 697,503       | \$ 124.39                                       | 6.3   |

(1) Includes estimated forfeitures.

The total fair value of shares that became fully vested during the nine months ended September 30, 2006 and 2005 was \$12 million in both periods. The total intrinsic value of options exercised during the nine months ended September 30, 2006 and 2005 was \$4 million and \$1 million, respectively. Unrecognized compensation expense related to nonvested awards under this plan was \$18 million as of September 30, 2006. The cost is expected to be recognized over a weighted-average period of 2.4 years. The amount of cash received and the tax benefit realized from stock option exercises under this plan

25

---



during the nine months ended September 30, 2006 was \$12 million and \$1 million, respectively, compared to \$6 million and \$1 million for the nine months ended September 30, 2005.

The value of DIUS shares is determined using a market transaction approach based on profit margin, assets under management and revenues. The valuation is performed by a third-party appraiser at least semi-annually and reviewed by the Compensation Committee. The last valuation was performed as of December 31, 2005 with a value of \$155.73 per share. A valuation as of June 30, 2006 was recently completed and is subject to approval of the Compensation Committee of the Board of Directors. The value of outstanding shares exercised under this plan and the intrinsic value of vested and partially vested options totaled \$40 million at September 30, 2006 and is included in other liabilities on the Consolidated Balance Sheet.

#### *Stock Appreciation Rights Incentive Plan*

We recognize compensation expense for SARs based on the fair value method using an option-pricing model. Compensation expense and the related liability are recognized on a straight-line basis over the vesting period of the SARs. The SARs liability is marked-to-market through net income, which causes volatility in net income as a result of changes in the market value of our stock. We hedge this volatility by purchasing call options on LNC stock. Call options hedging vested SARs are also marked-to-market through net income. The mark-to-market gain (loss) recognized through net income on the call options on LNC stock was \$5 million and \$7 million for the three and nine months ended September 30, 2006, respectively, compared to \$3 million and \$1 million for the three and nine months ended September 30, 2005. The SARs liability at September 30, 2006 and December 31, 2005 was \$9 million and \$8 million, respectively. As of September 30, 2006, there was \$8 million of unrecognized compensation cost related to nonvested awards under this plan excluding the effect of call options. The cost is expected to be recognized over a weighted-average period of 3.5 years.

The option pricing assumptions used for our SAR plan were as follows:

|  | <b>Nine Months<br/>Ended<br/>September 30,<br/>2006</b> | <b>Nine Months<br/>Ended<br/>September 30,<br/>2005</b> |
|--|---|---|
| Dividend yield                                 | 2.5%  | 3.0%  |
| Expected volatility                            | 23.1%   | 23.4%   |
| Risk-free interest rate                        | 5.1%  | 4.4%  |
| Expected life (in years)                       | 2.5   | 2.2   |
| Weighted-average fair value per option granted | \$ 20.19  | \$ 11.20  |

Expected volatility is measured based on the historical volatility of the LNC stock price. The expected term of the options granted represents time from the grant date to the exercise date.

Information with respect to our SAR plan is as follows:

| <b>SARs</b>                          | <b>Shares</b> | <b>Weighted-<br/>Average<br/>Exercise Price</b> | <b>Weighted-<br/>Average<br/>Remaining<br/>Contractual<br/>Term</b> | <b>Aggregate<br/>Intrinsic<br/>Value<br/>(in millions)</b> |
|--------------------------------------|---------------|---|---|--|
| Outstanding at December 31, 2005     | 1,098,126     | \$ 44.24  |   |  |
| Granted-original                     | 182,550       | 54.91   |   |  |
| Exercised (includes shares tendered) | (445,131)     | 56.06   |   |  |
| Forfeited or expired                 | (38,855)      | 44.93   |   |  |

Edgar Filing: LINCOLN NATIONAL CORP - Form 10-Q

|   |         |    |       |      |    |    |
|---|---------|----|-------|------|----|----|
| Outstanding at September 30, 2006                               | 796,690 | \$ | 46.79 | 2.56 | \$ | 12 |
| Vested or expected to vest at September 30, 2006 <sup>(1)</sup> | 779,402 | \$ | 46.65 | 2.51 | \$ | 12 |
| Exercisable at September 30, 2006                               | 316,229 | \$ | 45.95 | 1.30 | \$ | 5  |

<sup>(1)</sup> Includes estimated forfeitures.

The payment for SARs exercised during the nine months ended September 30, 2006 and 2005 was \$5 million and \$5 million, respectively.

26

---

In addition to the stock-based incentives discussed above, we have awarded restricted shares of our stock (non-vested stock) under the incentive compensation plan, generally subject to a three-year vesting period. Information with respect to our restricted stock at September 30, 2006 is as follows:

|                                 | Shares   | Weighted-Average<br>Grant-Date<br>Fair Market<br>Value |
|---------------------------------|----------|--|
| Nonvested at December 31, 2005  | 177,598  | \$ 43.01   |
| Granted                         | 209,943  | 57.69  |
| Vested                          | (65,514) | 38.49  |
| Nonvested at September 30, 2006 | 322,027  | \$ 53.50   |

As of September 30, 2006, there was \$13 million of unrecognized compensation cost related to nonvested awards under this plan. The cost is expected to be recognized over a weighted-average period of 2.21 years.

## 12. Restructuring Charges

### *Merger with Jefferson-Pilot*

Upon completion of the merger with Jefferson Pilot, we implemented a restructuring plan relating to the integration of our legacy operations with those of Jefferson Pilot. The realignment will enhance productivity, efficiency and scalability while positioning us for future growth. During the third quarter of 2006, we recorded additional reserves within the Other Operations business segment for restructuring charges of \$1 million (net of a \$1 million reversal related to other plans), which is included in Other Liabilities on our Consolidated Balance Sheet.

The following is the detail of the reserve for restructuring charges:

| (in millions)  | Total               |
|--|---------------------|
| Total expected costs <sup>(1)</sup>                                      | \$ 180              |
| Employee severance and termination benefits in 2006                      | 11                  |
| Cash payments incurred   | (4)                 |
| <b>Restructuring reserve at September 30, 2006</b>                       | <b>\$ 7</b>         |
| Additional amounts expended that do not qualify as restructuring charges | \$ 19               |
| Expected completion date   | 4th Quarter<br>2009 |

<sup>(1)</sup> The total expected costs include the involuntary employee termination benefits that were recorded in goodwill as a part of the Purchase Price Allocation (see Note 2). Merger integration costs relating to employee severance and termination benefits of \$13 million was included in other liabilities in the purchase price allocation. As of September 30, 2006, approximately \$2 million of these costs were incurred.

## 13. Stock Repurchases

On April 3, 2006, we entered into an agreement to purchase a variable number of shares of our common stock from a third party broker-dealer, using an accelerated stock buyback program for an aggregate purchase price of \$500

million. Shortly thereafter, we received approximately 8 million shares of our common stock. The number of shares repurchased under this agreement was based on the volume weighted average share price of our common stock over the program's duration. On July 17, 2006, we received our final delivery of shares under the program, bringing the total aggregate shares retired under the plan to approximately 8.8 million shares. All shares were retired upon receipt.

On August 11, 2006, we entered into an agreement to purchase approximately 5.5 million shares of our common stock from a third party broker-dealer, using an accelerated stock buyback program for an initial aggregate purchase price of \$350 million. We funded the program with internally generated funds, asset sales and commercial paper. The number of shares

repurchased under this agreement was based on the volume weighted average share price of our common stock over the program's duration, less a discount. On October 23, 2006, we received our final delivery of shares under the program, bringing the total aggregate shares retired under the plan to approximately 5.7 million shares. All shares were retired upon receipt.

**14. Subsequent Event**

On October 19, 2006, we called for redemption on November 19, 2006 our outstanding 7.65% Junior Subordinated Deferrable Interest Debentures, Series E due 2050 (the "Junior Subordinated Debentures"), which are held by Lincoln National Capital V. As a result, all of the outstanding 7.65% Trust Preferred Securities, Series E and 7.65% Common Securities of Lincoln National Capital V will be redeemed on November 19, 2006. The redemption price for the Trust Preferred Securities, Series E will be \$25.00 per security, for a total principal amount of \$172.5 million, plus any accrued distributions through the redemption date. As a result of these transactions, we expect to incur a non-cash charge of approximately \$4 million after-tax in the fourth quarter of 2006 related to unamortized issuance costs. We are funding the redemption with internally generated funds and commercial paper.

On November 3, 2006, we entered into an agreement to purchase approximately 2.3 million shares of our common stock from a third party broker-dealer, using an accelerated stock buyback program for an aggregate purchase price of \$150 million. All shares will be retired upon receipt. We may receive from, or be required to pay a price adjustment to the third party broker-dealer based on the volume weighted average share price of our common stock during the term of the program, less a discount. The price adjustment can be settled, at our option, in cash or in shares of our common stock. We expect the program to be completed late in the fourth quarter of 2006.

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following is a discussion of the financial condition of Lincoln National Corporation and its consolidated subsidiaries ("LNC" or the "Company" which also may be referred to as "we" or "us"). On April 3, 2006, LNC completed its merger with Jefferson-Pilot Corporation (Jefferson-Pilot). Beginning on April 3, 2006, the results of operations and financial condition of Jefferson-Pilot, after being adjusted for the effects of purchase accounting, were consolidated with LNC's. Accordingly, all financial information presented herein for the three months ended and as of September 30, 2006 includes the consolidated accounts of LNC and Jefferson-Pilot. The financial information presented herein for the nine months ended September 30, 2006, reflects the accounts of LNC for the three months ended March 31, 2006, and the consolidated accounts of LNC and Jefferson-Pilot for the three and six months ended September 30, 2006. The data presented herein for 2005 periods reflects the accounts of LNC. The balance sheet information presented below is as of September 30, 2006 and December 31, 2005. The statement of operations information is for the three and nine months ended September 30, 2006 and 2005.

For more information regarding the completion of the merger, including the calculation and allocation of the purchase price, see Note 2 to the unaudited Consolidated Financial Statements in this Form 10-Q.

This discussion and analysis should be read in conjunction with our Consolidated Financial Statements and Notes thereto presented in Item 1 ("Consolidated Financial Statements") and Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") in our latest annual report on Form 10-K for the year ended December 31, 2005 ("2005 Form 10-K"). On April 3, 2006, LNC filed a Current Report on Form 8-K dated April 3, 2006 that incorporated the audited financial statements and notes for Jefferson-Pilot as of December 31, 2005 and 2004, and for the years ended December 31, 2005, 2004 and 2003 from Jefferson-Pilot's Annual Report on Form 10-K for the year ended December 31, 2005. The accompanying unaudited Consolidated Financial Statements should also be read in conjunction with those financial statements and notes.

You should also read our discussion below of "Critical Accounting Policies" for an explanation of those accounting estimates that we believe are most important to the portrayal of our financial condition and results of operations and that require our most difficult, subjective and complex judgments. Financial information in the tables that follow is presented in conformity with accounting principles generally accepted in the United States of America ("GAAP"), unless otherwise indicated. Certain reclassifications have been made to prior periods' financial information to conform to the 2006 presentation.

### **Forward-Looking Statements—Cautionary Language**

Certain statements made in this report and in other written or oral statements made by LNC or on LNC's behalf are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995 ("PSLRA"). A forward-looking statement is a statement that is not a historical fact and, without limitation, includes any statement that may predict, forecast, indicate or imply future results, performance or achievements, and may contain words like: "believe", "anticipate", "expect", "estimate", "project", "will", "shall" and other words or phrases with similar meaning in connection with a discussion of future operating or financial performance. In particular, these include statements relating to future actions, prospective services or products, future performance or results of current and anticipated services or products, sales efforts, expenses, the outcome of contingencies such as legal proceedings, operations, trends or financial results. LNC claims the protection afforded by the safe harbor for forward-looking statements provided by the PSLRA.

Forward-looking statements involve risks and uncertainties that may cause actual results to differ materially from the results contained in the forward-looking statements. Risks and uncertainties that may cause actual results to vary materially, some of which are described within the forward-looking statements include, among others:

Problems arising with the ability to successfully integrate our and Jefferson-Pilot's businesses, which may affect our ability to operate as effectively and efficiently as expected or to achieve the expected synergies from the merger or to achieve such synergies within our expected timeframe, and the application of purchase price accounting on results of operations;

- Legislative, regulatory or tax changes, both domestic and foreign, that affect the cost of, or demand for, LNC's products, the required amount of reserves and/or surplus, or otherwise affect our ability to conduct business, including changes to statutory reserves and/or risk-based capital requirements related to secondary guarantees under universal life and variable annuity products such as Actuarial Guideline VACARVM; restrictions on revenue sharing and 12b-1 payments; and the potential for U.S. Federal tax reform;
- The initiation of legal or regulatory proceedings against LNC or its subsidiaries and the outcome of any legal or regulatory proceedings, such as: (a) adverse actions related to present or past business practices common in businesses in which LNC and its subsidiaries compete; (b) adverse decisions in significant actions including, but

## Edgar Filing: LINCOLN NATIONAL CORP - Form 10-Q

not limited to, actions brought by federal and state authorities, and extra-contractual and class action damage cases; (c) new decisions that result in changes in law; and (d) unexpected trial court rulings;

- Changes in interest rates causing a reduction of investment income, the margins of LNC's fixed annuity and life insurance businesses and demand for LNC's products;
- A decline in the equity markets causing a reduction in the sales of LNC's products, a reduction of asset fees that LNC charges on various investment and insurance products, an acceleration of amortization of deferred acquisition costs ("DAC"), the value of business acquired ("VOBA"), deferred sales inducements ("DSI") and deferred front-end loads ("DFEL") and an increase in liabilities related to guaranteed benefit features of LNC's variable annuity products;
- Ineffectiveness of LNC's various hedging strategies used to offset the impact of declines in and volatility of the equity markets;
- A deviation in actual experience regarding future persistency, mortality, morbidity, interest rates or equity market returns from LNC's assumptions used in pricing its products, in establishing related insurance reserves, and in the amortization of intangibles that may result in an increase in reserves and a decrease in net income;
- Changes in accounting principles generally accepted in the United States ("GAAP") that may result in unanticipated changes to LNC's net income;
- Lowering of one or more of LNC's debt ratings issued by nationally recognized statistical rating organizations, and the adverse impact such action may have on LNC's ability to raise capital and on its liquidity and financial condition;
- Lowering of one or more of the insurer financial strength ratings of LNC's insurance subsidiaries, and the adverse impact such action may have on the premium writings, policy retention, and profitability of its insurance subsidiaries;
- Significant credit, accounting, fraud or corporate governance issues that may adversely affect the value of certain investments in the portfolios of LNC's companies requiring that LNC realize losses on such investments;
- The impact of acquisitions and divestitures, restructurings, product withdrawals and other unusual items, including LNC's ability to integrate acquisitions and to obtain the anticipated results and synergies from acquisitions;
- The adequacy and collectibility of reinsurance that LNC has purchased;
- Acts of terrorism or war that may adversely affect LNC's businesses and the cost and availability of reinsurance;
- Competitive conditions, including pricing pressures, new product offerings and the emergence of new competitors, that may affect the level of premiums and fees that LNC can charge for its products;
- The unknown impact on LNC's business resulting from changes in the demographics of LNC's client base, as aging baby-boomers move from the asset-accumulation stage to the asset-distribution stage of life;
- Loss of key management, portfolio managers in the Investment Management segment, financial planners or wholesalers; and
- Changes in general economic or business conditions, both domestic and foreign, that may be less favorable than expected and may affect foreign exchange rates, premium levels, claims experience, the level of pension benefit costs and funding, and investment results.



The risks included here are not exhaustive. Other sections of this report and LNC's annual report on Form 10-K, current reports on Form 8-K and other documents filed with the SEC include additional factors which could impact LNC's business and financial performance. Moreover, LNC operates in a rapidly changing and competitive environment. New risk factors emerge from time to time and it is not possible for management to predict all such risk factors.

Further, it is not possible to assess the impact of all risk factors on LNC's business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements. Given these risks and uncertainties, investors should not place undo reliance on forward-looking statements as a prediction of actual results. In addition, LNC disclaims any obligation to update any forward-looking statements to reflect events or circumstances that occur after the date of this report.

## INTRODUCTION

### *Executive Summary*

We are a holding company that operates multiple insurance and investment management businesses as well as broadcasting and sports programming business through subsidiary companies. Through our business segments, we sell a wide range of wealth protection, accumulation and retirement income products and solutions. These products include institutional and/or retail fixed and indexed annuities, variable annuities, universal life insurance, variable universal life insurance, term life insurance, mutual funds, "529" college savings plans and managed accounts.

Our individual products and services are distributed primarily through brokers, planners, agents and other intermediaries with sales and marketing support provided by Lincoln Financial Distributors ("LFD"), our wholesaling distribution arm. Our group products and services are distributed primarily through financial advisors, employee benefit brokers, third party administrators, and other employee benefit firms with sales support provided by Lincoln's Employer Markets group and retirement sales specialists. Our retail distributor, Lincoln Financial Network, offers LNC and non-proprietary products and advisory services through a national network of approximately 4,100 full-time financial planners and advisors, along with more than 11,000 general agents, all operating under multiple affiliation models and open architecture.

On April 3, 2006, Jefferson-Pilot, a financial services and broadcasting holding company, merged with and into one of our wholly owned subsidiaries. Through its subsidiaries, Jefferson-Pilot provided products and services in four major businesses: (1) life insurance, (2) annuities and investment products, (3) group life, disability and dental insurance and (4) broadcasting and sports programming production and distribution.

As a result of the merger, we provide products and services in five operating businesses: (1) Individual Markets, (2) Employer Markets, (3) Investment Management, (4) Lincoln UK and (5) Lincoln Financial Media, and are reporting results through seven business segments. The following is a brief description of these segments.

*Individual Markets.* The Individual Markets business provides its products through two segments, Individual Annuities and Individual Life Insurance. Through its Individual Annuities segment, Individual Markets provides tax-deferred investment growth and lifetime income opportunities for its clients by offering individual fixed annuities, including indexed annuities, and variable annuities. The Individual Life Insurance segment offers wealth protection and transfer opportunities through both single and survivorship versions of universal life, variable universal life, interest-sensitive whole life, term insurance, as well as a linked-benefit product, which is a universal life insurance policy linked with riders that provide for long-term care costs.

*Employer Markets.* The Employer Markets business provides its products through two segments, Retirement Products and Group Protection, formerly referred to as Benefit Partners. Through its Retirement Products segment, which consists of its Defined Contribution and Executive Benefits businesses, Employer Markets provides employer-sponsored variable and fixed annuities, mutual-fund based programs in the 401(k), 403(b), and 457 marketplaces and corporate owned life insurance. The Group Protection segment offers group non-medical insurance products, principally term life, disability and dental, to the employer marketplace through various forms of contributory and noncontributory plans. Most of our group contracts are sold to employers with fewer than 500 employees.

*Investment Management.* The Investment Management segment, through Delaware Investments, provides a broad range of managed accounts and portfolios, mutual funds, subadvised funds, and other investment products to individual investors and to institutional investors such as private and public pension funds, foundations, and endowment funds. Delaware Investments is the marketing name for Delaware Management Holdings, Inc. and its subsidiaries.

*Lincoln UK.* Lincoln UK is headquartered in Barnwood, Gloucester, England, and is licensed to do business throughout the United Kingdom. Lincoln UK primarily focuses on protecting and enhancing the value of its existing customer base. The segment accepts new deposits from existing relationships and markets a limited range of new products. Lincoln UK's product portfolio principally consists of unit-linked life and pension products, which are similar to U.S. produced variable life and annuity products, where the risk associated with the underlying investments is borne by the policyholders.

*Lincoln Financial Media.* The Lincoln Financial Media segment operates 18 domestic radio and 3 television broadcasting stations and produces and distributes syndicated collegiate sports programming. Profitability for this segment is driven by market growth, audience levels (ratings), which drives demand for advertising inventory and pricing, and operating efficiencies. We focus our efforts at the local level, combining sound business practices with service to the community.

We also have "Other Operations," which includes the financial data for operations that are not directly related to the business segments, unallocated corporate items (such as investment income on investments related to the amount of statutory

surplus in our insurance subsidiaries that is not allocated to our business units and other corporate investments, interest expense on short-term and long-term borrowings, and certain expenses, including restructuring and merger-related expenses) and the historical results of the former reinsurance segment, which was sold to Swiss Re Life & Health America Inc. ("Swiss Re") in the fourth quarter of 2001, along with the ongoing amortization of deferred gain on the indemnity reinsurance portion of the transaction with Swiss Re.

We view our business similar to a columned structure. The base of the structure is our employees. Overlaying the base is financial and risk management, and operating efficiency, which are the cornerstones of our management and business philosophy. Talented employees and strong financial and risk management provide the foundation from which we operate and grow our company. Our April 2006 combination with Jefferson-Pilot, well known within the industry for their operational effectiveness, further strengthens the foundation to deliver on our strategic intent. With that as a foundation, there are three pillars that we focus on—product excellence, power of the brand and distribution reach.

Product excellence is one of the pillars of our business. It is important that we continually develop and provide products to the marketplace that not only meet the needs of our customers and compete effectively, but also satisfy our risk profile and meet our profitability standards.

Our merger with Jefferson-Pilot has increased our distribution breadth through retail distribution channels. In addition, we have expanded the life and annuity products available for our existing channels. During 2006 and into 2007, we are focusing on making a larger, unified product suite available to our distribution force.

The creation of our Employer Markets segment should allow us to better capitalize on the success we have already had in this market place - more than \$35 billion in assets under management and administration - and on trends in employer-sponsored benefit plans. These trends include a decline in defined benefit pension plans and an increase in voluntary defined contribution plans, such as 401(k)s / 403(b)s, and a similar trend towards voluntary group life and disability, giving way to a convergence of distribution strategies. We see opportunities to capitalize on revenue synergies by leveraging our Group Protection group business with Retirement Products' defined contribution platform for a single employer solution. We also believe that the recently passed Pension Protection Act of 2006 will benefit the Employer Markets segment.

Within the Individual Markets' variable annuity arena, our Lincoln Smart Security<sup>SM</sup> Advantage, with its one- and five-year reset feature, continued to experience growth in the first nine months, with elections totaling 52% of deposits for the first nine months of 2006. As a result of our merger with Jefferson-Pilot, we offer an indexed fixed annuity, which offers upside growth from equity markets with fixed return protection. We believe that the baby-boomer generation reaching retirement age will present an emerging opportunity for companies like ours that offer products allowing baby-boomers to better manage their wealth accumulation, retirement income and wealth transfer needs.

In our Individual Markets Life Insurance segment, we continue to face competitive pressures, especially related to life insurance products with secondary guarantees. For products with secondary guarantees, we remain committed to maintaining appropriate risk management and pricing discipline despite the competitive environment. Sales of insurance products with such guarantees comprised 69% of our life insurance sales for the third quarter of 2006. In addition, we are seeking capital market solutions in response to regulations requiring increases in statutory reserves for these products.

Our mutual fund offerings have had strong performance over the one-, three-, and five-year performance periods, resulting in strong deposits and net flows and adding to the assets under management for both the retail and institutional products lines in our Investment Management segment. Growth in deposits and net flows have also benefited from the changes we made during 2005 in the management of certain asset category offerings.

We continue to expect our major challenges for the remainder of 2006 and into 2007 to include:

- The successful integration of the Jefferson-Pilot businesses.

While recent increases in long-term rates has eased pressure on spreads, a continuation of the low interest rate environment creates a challenge for our products that generate investment margin profits, such as fixed annuities and universal life insurance.

- The continued, successful expansion of our wholesale distribution businesses.

§ The continuation of competitive pressures in the life insurance marketplace.

Increased regulatory scrutiny of the life and annuity industry, which may lead to higher product costs and negative perceptions about the industry.

- Continued focus by the government on tax reform, which may impact our products.

### ***Recent Developments***

On August 11, 2006, we entered into an agreement to purchase approximately 5.5 million shares of our common stock from a third party broker-dealer, using an accelerated stock buyback program for an initial aggregate purchase price of \$350 million. We funded the program with internally generated funds, asset sales and commercial paper. The number of shares repurchased under this agreement was based on the volume weighted average share price of our common stock over the program's duration, less a discount. On October 23, 2006, we received our final delivery of shares under the program, bringing the total aggregate shares retired under the plan to approximately 5.7 million shares. All shares were retired upon receipt.

On October 19, 2006, we called for redemption on November 19, 2006 our outstanding 7.65% Junior Subordinated Deferrable Interest Debentures, Series E due 2050 (the "Junior Subordinated Debentures"), which are held by Lincoln National Capital V. As a result, all of the outstanding 7.65% Trust Preferred Securities, Series E and 7.65% Common Securities of Lincoln National Capital V will be redeemed on November 19, 2006. The redemption price for the Trust Preferred Securities, Series E will be \$25.00 per security, for a total principal amount of \$172,500,000 million, plus any accrued distributions through the redemption date. As a result of these transactions, we expect to incur a non-cash charge of approximately \$4 million after-tax in the fourth quarter of 2006 related to unamortized issuance costs. We are funding the redemption with internally generated funds and commercial paper.

On November 3, 2006, we entered into an agreement to purchase approximately 2.3 million shares of our common stock from a third party broker-dealer, using an accelerated stock buyback program for an aggregate purchase price of \$150 million. All shares will be retired upon receipt. We may receive from, or be required to pay a price adjustment to the third party broker-dealer based on the volume weighted average share price of our common stock during the term of the program, less a discount. The price adjustment can be settled, at our option, in cash or in shares of our common stock. We expect the program to be completed late in the fourth quarter of 2006.

See Notes 13 and 14 to the unaudited Consolidated Financial Statements in this Form 10-Q and our current report on Form 8-K filed with the SEC on October 19, 2006 for additional information.

### ***Critical Accounting Estimates***

The MD&A included in our 2005 Form 10-K contains a detailed discussion of our critical accounting estimates. The following information updates the critical accounting policies provided in the 2005 Form 10-K.

#### **Deferred Acquisition Costs, Value of Business Acquired, Deferred Sales Inducements and Deferred Front-end Loads.**

Accounting for intangible assets requires numerous assumptions, such as estimates of expected future profitability for our operations and our ability to retain existing blocks of life and annuity business in force. Our accounting policies for the deferred acquisition costs ("DAC"), value of business acquired ("VOBA"), deferred sales inducements ("DSI") and the liability for deferred front-end loads ("DFEL") impact Individual Annuities, Individual Life Insurance, Employer Markets Retirement Products and Other, Group Protection, and Lincoln UK segments. DAC, VOBA, DSI and DFEL may be referred to hereinafter collectively as DAC, unless otherwise noted.

Acquisition costs for variable annuity contracts, universal and variable universal life insurance policies are amortized over the lives of the contracts in relation to the incidence of estimated gross profits ("EGPs") derived from the contracts. Acquisition costs are those costs that vary with and are primarily related to new or renewal business. These costs include commissions and other expenses that vary with new business volume. The costs that we defer are recorded as an asset on our balance sheet as DAC for products we sold or VOBA for books of business we acquired. In addition, we defer costs associated with DSI and revenues associated with DFEL. DFEL is a balance sheet liability, and when

amortized, increases revenues and income.

During the third quarter of each year, we conduct our annual comprehensive review of the assumptions underlying the amortization of DAC, VOBA and DFEL. We review the various assumptions including investment margins, mortality and retention. These assumptions also impact the reserves for the guarantee features within our variable annuity and life insurance products. Additionally, we harmonized several assumptions and related processes as a result of our merger with Jefferson-Pilot. The combined effect of these changes resulted in a decrease to income from operations of \$8 million after-tax for the three- and nine-month periods ended September 30, 2006, compared with a \$27 million after-tax increase to income from operations for the same 2005 periods. The effects varied by segment and are discussed further in the respective segment discussions below.

The table below presents the balances by business segment as of September 30, 2006.

| September 30, 2006 (in millions) | Individual Markets |                | Employer Markets    |                  |        | Lincoln UK | Other Operations | Total |
|----------------------------------|--------------------|----------------|---------------------|------------------|--------|------------|------------------|-------|
|                                  | Annuities          | Life Insurance | Retirement Products | Group Protection |        |            |                  |       |
| DAC & VOBA                       | \$ 1,974           | \$ 4,525       | \$ 762              | \$ 126           | \$ 783 | \$ 2       | \$ 8,172         |       |
| DSI                              | 173                | -              | -                   | -                | -      | -          | 173              |       |
| Total DAC & VOBA and DSI         | 2,147              | 4,525          | 762                 | 126              | 783    | 2          | 8,345            |       |
| DFEL                             | 95                 | 416            | 20                  | -                | 393    | -          | 924              |       |
| Net DAC & VOBA, DSI and DFEL     | \$ 2,052           | \$ 4,109       | \$ 742              | \$ 126           | \$ 390 | \$ 2       | \$ 7,421         |       |

Note: The above table includes DAC and VOBA amortized in accordance with SFAS No. 60, "Accounting and Reporting by Insurance Enterprises." Under SFAS No. 60, acquisition costs for traditional life insurance and Group Protection's products, which include whole life and term life insurance contracts, and group life, dental and disability contracts, are amortized over periods of 10 to 30 years for life products and up to 15 years for group products, on either a straight-line basis or as a level percent of premium of the related policies depending on the block of business. No DAC is being amortized under SFAS No. 60 for fixed and variable payout annuities.

As more fully discussed in our 2005 Form 10-K, we utilize a "reversion to the mean" ("RTM") process to compute our best estimate long-term gross growth rate assumption to evaluate the carrying value of DAC for our variable annuity, annuity-based 401(k) and unit-linked product blocks of business. Under our enhanced RTM process, on each valuation date, future EGPs are projected using stochastic modeling of a large number of future equity market scenarios in conjunction with best estimates of lapse rates, interest margins and mortality to develop a statistical distribution of the present value of future EGPs for each of the blocks of business. The statistical distribution is designed to identify when deviations in equity market returns from expected returns become significant enough to warrant a change of the future equity return EGP assumption.

The stochastic modeling performed for our variable annuity blocks of business is used to develop a range of reasonably possible future EGPs. We compare the range of the present value of the future EGPs from the stochastic modeling to that used in the DAC amortization model. A set of intervals around the mean of these scenarios is utilized to calculate two separate statistical ranges of reasonably possible EGPs. These intervals are compared to the present value of the EGPs used in the DAC amortization model. If the present value of EGP assumptions utilized in the DAC amortization model were to exceed the margin of the reasonable range of statistically calculated EGPs, a revision of the EGPs used to calculate DAC amortization would occur. If a revision is deemed necessary, future EGPs would be re-projected using the current account values at the end of the period during which the revision occurred along with a revised long-term annual equity market gross return assumption such that the re-projected EGPs would be our best estimate of EGPs.

Given where our best estimate of EGPs for the Individual Markets and Employer Markets annuity products was positioned in the range at September 30, 2006, if we were to assume a 9% long-term gross equity market growth assumption from September 30, 2006 forward in determining the revised EGPs, we estimate that it would result in a cumulative decrease to DAC amortization (positive DAC unlocking) of approximately \$139 million pre-tax (\$90 million after-tax). To further illustrate the position in the range of our best estimate of EGPs for the Individual Markets Annuity segment at September 30, 2006, a one-quarter equity market movement of positive 10% would bring us to the first of the two statistical ranges while a one-quarter equity market movement of positive 35% would bring us to the second of the two ranges for this segment. Subsequent equity market performance that would keep us at or move us beyond the first statistical range would likely result in positive unlocking. Negative equity market performance would have to be significantly greater than the above percentages for us to exceed the lower end of the two statistical ranges.



For a more detailed discussion of the RTM process, refer to the discussion in Critical Accounting Policies - Intangible Assets, included in our 2005 Form 10-K.

### **Guaranteed Minimum Benefits**

The Individual Markets Annuity segment has a hedging strategy designed to mitigate the risk and income statement volatility caused by changes in the equity markets, interest rates, and volatility associated with the Lincoln Smart Security<sup>SM</sup> Advantage guaranteed minimum withdrawal benefit (“GMWB”) feature, and equity market risk for our various guaranteed minimum death benefit (“GMDB”) features available in our variable annuity products. The hedging strategy is designed such that changes in the value of the hedge contracts move in the opposite direction of changes in the value of the embedded derivative of the GMWB or changes in the reserve for GMDB contracts subject to the hedging strategy. Account balances covered in this hedging program combined with account balances for which there is no death benefit represent approximately 94% of total variable annuity account balances, which excludes the Alliance mutual fund business. We have not implemented a hedging strategy for our guaranteed income benefit (“GIB”) feature, as less than 4% of variable annuity

account balances are subject to this feature and substantially all of these outstanding contracts are still in the accumulation phase. During the fourth quarter of 2006, we intend to add the GIB benefit to the hedge program.

The reserves related to the GMDB are based on the application of a benefit ratio to total assessments related to the variable annuity. The level and direction of the change in reserves will vary over time based on the emergence of the benefit ratio (which is based on both historical and projected future level of benefits) and the level of assessments (both historical and projected) associated with the variable annuity. We utilize a delta hedging strategy for variable annuity products with a GMDB feature, which uses futures on U.S.-based equity market indices to hedge against movements in equity markets. Because the GMDB reserves are based upon projected long-term equity market return assumptions, and since the value of the hedging contracts will reflect current capital market conditions, the quarterly changes in values for the GMDB reserves and the hedging contracts may not offset each other on an exact basis. Despite these short-term fluctuations in values, we intend to continue to hedge our long-term GMDB exposure in order to mitigate the risk associated with falling equity markets. Our hedging program covers substantially all exposures for these policies.

We utilize a dynamic hedging strategy for variable annuity products with a GMWB feature, which uses futures on U.S.-based equity indices to hedge against movements in the equity markets, as well as interest rate and equity derivative securities to hedge against changes in reserves associated with changes in interest rates and market implied volatilities. As of September 30, 2006, the notional amounts of the underlying hedge instruments are such that the magnitude of the change in the value of the hedge instruments due to changes in equity markets, interest rates, and implied volatilities is designed to offset the magnitude of the change in the fair value of the GMWB guarantee caused by those same factors. At September 30, 2006, the embedded derivative for GMWB was an asset valued at \$25 million. The embedded derivative is an asset at September 30, 2006 as the estimated present value of expected future contract charges is greater than the estimated present value of expected future claims.

As part of our current hedging program, policyholder behavior and equity, interest rate, and volatility market conditions are monitored on a daily basis. We rebalance our hedge positions based upon changes in these factors as needed. While we actively manage our hedge positions, our hedge positions may not be totally effective to offset changes in assets and liabilities caused by movements in these factors due to, among other things, differences in timing between when a market exposure changes and corresponding changes to the hedge positions, extreme swings in the equity markets and interest rates, market volatility, policyholder behavior, divergence between the performance of the underlying funds and the hedging indices, divergence between the actual and expected performance of the hedge instruments, or our ability to purchase hedging instruments at prices consistent with our desired risk and return trade-off.

We also have in place a hedging program for our indexed annuities we obtained through our merger with Jefferson-Pilot. These contracts permit the holder to elect an interest rate return or an equity market component, where interest credited to the contracts is linked to the performance of the S&P 500® index. Policyholders may elect to rebalance index options at renewal dates, either annually or biannually. At each renewal date, we have the opportunity to re-price the indexed component by establishing participation rates, subject to minimum guarantees. We purchase options that are highly correlated to the portfolio allocation decisions of our policyholders, such that we are economically hedged with respect to equity returns for the current reset period. The mark-to-market of the options held impacts net investment income and generally offsets the change in value of the embedded derivative within the indexed annuity, which is recorded as a component of interest credited to policyholders' within insurance benefits. SFAS 133 requires that we calculate fair values of index options we may purchase in the future to hedge policyholder index allocations in future reset periods. These fair values represent an estimate of the cost of the options we will purchase in the future, discounted back to the date of the balance sheet, using current market indicators of volatility and interest rates. Changes in the fair values of these liabilities are included in benefit expense.

**RESULTS OF CONSOLIDATED OPERATIONS**

| Periods ended September<br>30, (in millions)                         | Three Months |        |            | Nine Months |        |            |
|--|--------------|--------|------------|-------------|--------|------------|
|  | 2006         | 2005   | Increase   | 2006        | 2005   | Increase   |
|  |              |        | (Decrease) |             |        | (Decrease) |
| Insurance premiums   | \$ 426       | \$ 83  | 413%       | \$ 959      | \$ 226 | 324%       |
| Insurance fees   | 676          | 448    | 51%        | 1,841       | 1,294  | 42%        |
| Investment advisory fees   | 83           | 68     | 22%        | 242         | 185    | 31%        |
| Communications sales   | 60           | -      | NM         | 117         | -      | NM         |
| Net investment income  | 1,108        | 671    | 65%        | 2,855       | 2,034  | 40%        |
| Amortization of deferred gain  | 19           | 19     | 0%         | 56          | 57     | -2%        |
| Other revenues and fees  | 125          | 102    | 23%        | 351         | 285    | 23%        |
| Net realized investment losses                                       | (10)         | 4      | NM         | (16)        | (7)    | -129%      |
| Gain on sale of subsidiaries   | -            | -      | NM         | -           | 14     | -100%      |
| Total Revenue  | 2,487        | 1,395  | 78%        | 6,405       | 4,088  | 57%        |
| Insurance benefits   | 1,201        | 589    | 104%       | 2,961       | 1,750  | 69%        |
| Underwriting, acquisition,<br>insurance and<br>other expenses        | 728          | 482    | 51%        | 1,949       | 1,494  | 30%        |
| Communications expenses  | 31           | -      | NM         | 61          | -      | NM         |
| Interest and debt expenses   | 67           | 21     | 219%       | 154         | 65     | 137%       |
| Total Benefits and Expenses  | 2,027        | 1,092  | 86%        | 5,125       | 3,309  | 55%        |
| Income before federal income<br>taxes                                | 460          | 303    | 52%        | 1,280       | 779    | 64%        |
| Federal income taxes   | 96           | 74     | 30%        | 346         | 173    | 100%       |
| Net Income   | \$ 364       | \$ 229 | 59%        | \$ 934      | \$ 606 | 54%        |
| Items Included in Net Income<br>(after-tax):                         |              |        |            |             |        |            |
| Realized loss on investments<br>and<br>derivative instruments        | \$ (5)       | \$ (1) |            | \$ (13)     | \$ (8) |            |
| Net gain on reinsurance<br>embedded<br>derivative/trading securities | (2)          | 4      |            | 2           | 3      |            |
| Gain on sale of subsidiaries   | -            | -      |            | -           | 9      |            |
| Restructuring charges  | (1)          | (2)    |            | (7)         | (18)   |            |

The table below provides a detailed comparison of items included within net realized investment losses.

| Periods ended September 30, (in<br>millions) | Three Months |       |            | Nine Months |       |            |
|--|--------------|-------|------------|-------------|-------|------------|
|  | 2006         | 2005  | Increase   | 2006        | 2005  | Increase   |
|  |              |       | (Decrease) |             |       | (Decrease) |
| Realized gains on investments                | \$ 61        | \$ 30 | 103%       | \$ 122      | \$ 89 | 37%        |

Edgar Filing: LINCOLN NATIONAL CORP - Form 10-Q

|   |         |        |       |         |         |       |
|---|---------|--------|-------|---------|---------|-------|
| Realized losses on investments  | (56)    | (17)   | 229%  | (99)    | (52)    | 90%   |
| Realized gain (loss) on derivative instruments  | (4)     | 1      | -500% | (1)     | (2)     | -50%  |
| Amounts amortized to balance sheet accounts   | (9)     | (13)   | -31%  | (39)    | (40)    | -3%   |
| Gain on reinsurance embedded derivative/trading securities  | (4)     | 5      | -180% | 4       | 5       | -20%  |
| Investment expenses   | 2       | (2)    | -200% | (3)     | (7)     | -57%  |
| Net losses on investments and derivative instruments  | \$ (10) | \$ 4   | -350% | \$ (16) | \$ (7)  | 129%  |
| Write-downs for other-than-temporary impairments included in realized losses on investments above | \$ (39) | \$ (6) | -550% | \$ (43) | \$ (18) | -139% |

36

Following are deposits and net flows by business segment. For additional detail of deposit and net flow information, see the discussion in “Results of Operations by Segment” below:

| Periods ended September 30, (in billions) | Three Months    |                 |                     | Nine Months      |                  |                     |
|---|-----------------|-----------------|---------------------|------------------|------------------|---------------------|
|   | 2006            | 2005            | Increase (Decrease) | 2006             | 2005             | Increase (Decrease) |
| <b>Deposits:</b>                          |                 |                 |                     |                  |                  |                     |
| Individual Markets:                       |                 |                 |                     |                  |                  |                     |
| Annuities                                 | \$ 2.720        | \$ 1.904        | 43%                 | \$ 7.596         | \$ 5.527         | 37%                 |
| Life Insurance                            | 0.753           | 0.497           | 52%                 | 2.264            | 1.434            | 58%                 |
| Employer Markets:                         |                 |                 |                     |                  |                  |                     |
| Defined Contribution                      | 1.086           | 1.011           | 7%                  | 3.486            | 3.324            | 5%                  |
| Executive Benefits                        | 0.058           | 0.057           | 2%                  | 0.182            | 0.158            | 15%                 |
| Investment Management                     | 4.903           | 6.738           | -27%                | 20.013           | 22.941           | -13%                |
| Consolidating Adjustments (1)             | (1.019)         | (0.841)         | 21%                 | (2.896)          | (2.583)          | 12%                 |
| <b>Total Deposits</b>                     | <b>\$ 8.501</b> | <b>\$ 9.366</b> | <b>-9%</b>          | <b>\$ 30.645</b> | <b>\$ 30.801</b> | <b>-1%</b>          |
| <b>Net Flows:</b>                         |                 |                 |                     |                  |                  |                     |
| Individual Markets:                       |                 |                 |                     |                  |                  |                     |
| Annuities                                 | \$ 0.304        | \$ 0.717        | -58%                | \$ 1.773         | \$ 2.109         | -16%                |
| Life Insurance                            | 0.491           | 0.295           | 66%                 | 1.296            | 0.794            | 63%                 |
| Employer Markets:                         |                 |                 |                     |                  |                  |                     |
| Defined Contribution                      | 0.037           | 0.028           | 32%                 | 0.331            | 0.445            | -26%                |
| Executive Benefits                        | (0.011)         | 0.042           | -126%               | 0.064            | 0.112            | -43%                |
| Investment Management                     | 0.745           | 3.545           | -79%                | 6.651            | 12.339           | -46%                |
| Consolidating Adjustments (1)             | 0.151           | (0.103)         | -247%               | 0.139            | (0.039)          | -456%               |
| <b>Total Net Flows</b>                    | <b>\$ 1.717</b> | <b>\$ 4.524</b> | <b>-62%</b>         | <b>\$ 10.254</b> | <b>\$ 15.760</b> | <b>-35%</b>         |

| (in billions)                                 | As of September 30, |          | As of             | Increase over Prior quarter | Increase over Prior year |
|---|---------------------|----------|-------------------|-----------------------------|--------------------------|
|   | 2006                | 2005     | December 31, 2005 |                             |                          |
| <b>Assets Under Management by Advisor (2)</b> |                     |          |                   |                             |                          |
| Investment Management:                        |                     |          |                   |                             |                          |
| External Assets                               | \$ 89.5             | \$ 73.3  | \$ 77.6           | 22%                         | 15%                      |
| Insurance-related Assets                      | 67.4                | 43.1     | 43.1              | 56%                         | 56%                      |
| Lincoln UK                                    | 9.5                 | 8.5      | 8.6               | 12%                         | 10%                      |
| Within Business Units (Policy Loans)          | 2.7                 | 1.8      | 1.9               | 50%                         | 42%                      |
| By Non-LNC Entities                           | 51.2                | 38.2     | 40.6              | 34%                         | 26%                      |
|   | \$ 220.3            | \$ 164.9 | \$ 171.8          | 34%                         | 28%                      |

(1) Consolidating adjustments represent the elimination of deposits and net flows on products affecting more than one segment.

(2) Assets under management by advisor provide a breakdown of assets that we manage or administer either directly or through unaffiliated third parties. These assets represent our investments, assets held in separate accounts and assets that we manage or administer for individuals or other companies. We earn insurance fees, investment advisory fees or investment income on these assets.

NM - Not Meaningful

37

---

## Comparison of Three and Nine months Ended September 30, 2006 to 2005

Net income increased \$135 million, or 59%, and \$328 million, or 54%, for the three months and nine months ended September 30, 2006 compared to the same periods in 2005, respectively. The April 2006 merger with Jefferson-Pilot is the primary driver of the increase. Also included in the increase was the net effect of a favorable insurance recovery related to losses incurred in connection with U.K. sales practices and a favorable income tax adjustment primarily related to the separate accounts dividends-received deduction (“DRD”) partially offset by net unfavorable adjustments from the completion of the annual comprehensive review of assumptions underlying the amortization of DAC/VOBA/DFEL and reserves for annuity and life insurance products with guarantees.

### *Revenues*

The April 2006 merger with Jefferson-Pilot was the primary driver for the increase in insurance premiums and fees for the three and nine month periods ended September 30, 2006, compared with the same 2005 periods. In addition to the merger, the increase in insurance fees and investment advisory fees in the third quarter and first nine months of 2006 reflects growth in deposits and assets under management, and to a lesser extent, the effects of favorable equity market performance. Assets under management increased 34% as a result of the Jefferson-Pilot merger, positive net flows and market value gains throughout 2005 and the first nine months of 2006. The average level of the equity markets was higher in 2006 compared to 2005, resulting in higher fee income. Excluding the impact of dividends, the S&P 500 index was 8.7% higher and the average daily S&P 500 index was 7.1% higher in the first nine months of 2006 than the first nine months of 2005.

The increase in net investment income in the third quarter of 2006 compared to the same period in 2005 primarily reflects the addition of Jefferson-Pilot investment assets, higher portfolio yields and higher invested assets due to the favorable effect of asset growth from net flows and equity markets.

Included in revenues were net realized gains (losses) on investments of \$(10) million and \$4 million for the third quarters of 2006 and 2005, respectively, and \$(16) million and \$(7) million for the first nine months of 2006 and 2005, respectively. See “Consolidated Investments” below for additional information on our investment performance. Revenues from the sale of subsidiaries/businesses in the first nine months of 2005 included a pre-tax gain of \$14 million from an agreement to settle in full the residual contingent payments resulting from the arrangement to outsource Lincoln UK’s back-office operations to Capita Life and Pension Services Limited, a subsidiary of Capita Group Plc (“Capita”) the outsourcing firm for Lincoln UK’s customer and policy administration functions.

### *Benefits and Expenses*

Consolidated benefits and expenses for the third quarter and first nine months of 2006 increased \$935 million, or 86%, and \$1.816 billion, or 55%, compared to the same periods in 2005, primarily due to the merger with Jefferson-Pilot. See “Results of Operations by Segment” below for further discussion by segment. Growth in our business partially offset by the effect of spread management through lower crediting rates on interest-sensitive business and movements from fixed to variable annuity products also contributed to the increase. Expenses for the third quarter and first nine months of 2006 benefited from a \$26 million (\$17 million after-tax) insurance recovery related to losses incurred in connection with U.K. sales practices.

Consolidated expenses for the third quarter and first nine months of 2006 include expenses of \$13 million and \$30 million, respectively, related to the merger with Jefferson-Pilot for related integration costs, including restructuring charges that were the result of actions undertaken by us to eliminate duplicate operations and functions as a result of the Jefferson-Pilot merger. These actions will be ongoing and are expected to be substantially complete by late 2008, with a total estimated cost of \$180 million pre-tax. Expenses for the third quarter and first nine months of 2005 included pre-tax restructuring charges of \$3 million and \$28 million, respectively, and were the result of expense initiatives undertaken by us during 2003 to improve operational efficiencies. For additional information on

restructuring charges, see Note 12 to the unaudited Consolidated Financial Statements of this Form 10-Q.

Consolidated expenses for the three and nine months ended September 30, 2006 also included a net increase of \$12 million pre-tax for the effect of net unfavorable unlocking resulting from the annual comprehensive review of the assumptions underlying the amortization of DAC, VOBA, DSI and DFEL as well as the reserves related to GMDB and the embedded derivative related to GMWB and liabilities for life insurance products sold with secondary guarantees, which compares with a net reduction of \$42 million pre-tax for the 2005 periods. The impact of the adjustments from the prospective assumption review varied by segment. The factors impacting the adjustments are discussed further in the respective segment discussions below. Expenses for the three and nine months ended September 30, 2006, include an increase in net operating and administrative expenses of approximately \$38 million pre-tax (\$25 million, after-tax) caused by an update of our incentive compensation accruals to reflect updated estimates of expected performance.



*Federal Income Taxes*

Federal income tax expense for the third quarter and first nine months of 2006 include a reduction of \$39 million related to a favorable true-up to the 2005 tax return relating primarily to the separate accounts DRD and, to a lesser extent, foreign tax credits and other tax preference items, and revised estimates of these items for 2006. The estimate for 2006 is expected to favorably benefit ongoing quarterly earnings by \$5 million. Federal income tax expense for the third quarter and first nine months of 2005 included reductions of \$13 million and \$43 million, respectively, related to a partial release of a deferred tax valuation allowance in our Barbados insurance company, which was included in Other Operations. For additional information on our effective tax rates, see Note 4 to the unaudited Consolidated Financial Statements of this Form 10-Q.

## **RESULTS OF OPERATIONS BY SEGMENT**

In this MD&A, in addition to providing consolidated revenues and net income (loss), we also provide segment operating revenue and income (loss) from operations because we believe they are meaningful measures of revenues and the profit or loss generated by our operating segments. Operating revenue is GAAP revenue excluding realized gains and losses on investments and derivative instruments, gains and losses on reinsurance embedded derivative/trading securities, gains and losses on sale of subsidiaries/businesses and the amortization of deferred gain arising from reserve development on business sold through reinsurance. Income (loss) from operations is GAAP net income excluding net realized investment gains and losses, losses on early retirement of debt, reserve development net of related amortization on business sold through reinsurance and cumulative effect of accounting changes. Operating revenue and income (loss) from operations are the financial performance measures we use to evaluate and assess the results of our segments. Accordingly, we report operating revenue and income (loss) from operations by segment in Note 8 to our unaudited Consolidated Financial Statements. Our management and Board of Directors believe that operating revenue and income (loss) from operations explain the results of our ongoing businesses in a manner that allows for a better understanding of the underlying trends in our current businesses because net realized investment gains and losses, reserve development net of related amortization on business sold through reinsurance and cumulative effect of accounting changes are unpredictable and not necessarily indicative of current operating fundamentals or future performance of the business segments, and in many instances, decisions regarding these items do not necessarily relate to the operations of the individual segments. Operating revenue and income (loss) from operations do not replace revenues and net income as the GAAP measures of our consolidated results of operations.

Following is a reconciliation of our segment revenue and income from operations to our consolidated revenue and net income:

| (in millions)  | Three Months Ended<br>September 30, |                 | Nine Months Ended<br>September 30, |                 |
|--|-------------------------------------|-----------------|------------------------------------|-----------------|
|  | 2006                                | 2005            | 2006                               | 2005            |
| <b>Revenue:</b>  |                                     |                 |                                    |                 |
| Segment Operating Revenue:   |                                     |                 |                                    |                 |
| Individual Markets:  |                                     |                 |                                    |                 |
| Individual Annuities   | \$ 597                              | \$ 363          | \$ 1,524                           | \$ 1,050        |
| Life Insurance   | 895                                 | 459             | 2,297                              | 1,409           |
| Individual Markets Total   | 1,492                               | 822             | 3,821                              | 2,459           |
| Employer Markets:  |                                     |                 |                                    |                 |
| Retirement Products  | 349                                 | 298             | 1,006                              | 872             |
| Group Protection   | 332                                 | -               | 687                                | -               |
| Employer Markets Total   | 681                                 | 298             | 1,693                              | 872             |
| Investment Management <sup>(1)</sup>   | 140                                 | 123             | 415                                | 347             |
| Lincoln UK   | 72                                  | 103             | 223                                | 256             |
| Lincoln Financial Media <sup>(2)</sup>   | 60                                  | -               | 117                                | -               |
| Other Operations   | 86                                  | 68              | 244                                | 227             |
| Consolidating adjustments  | (34)                                | (23)            | (93)                               | (80)            |
| Net realized investment results <sup>(3)</sup>                                       | (10)                                | 4               | (16)                               | 6               |
| Reserve development net of related amortization on business sold through reinsurance | -                                   | -               | 1                                  | 1               |
| <b>Total</b>   | <b>\$ 2,487</b>                     | <b>\$ 1,395</b> | <b>\$ 6,405</b>                    | <b>\$ 4,088</b> |
| <b>Net Income:</b>   |                                     |                 |                                    |                 |
| Segment Operating Income:  |                                     |                 |                                    |                 |
| Individual Markets:  |                                     |                 |                                    |                 |
| Individual Annuities   | \$ 129                              | \$ 79           | \$ 285                             | \$ 181          |
| Life Insurance   | 123                                 | 65              | 339                                | 186             |
| Individual Markets Total   | 252                                 | 144             | 624                                | 367             |
| Employer Markets:  |                                     |                 |                                    |                 |
| Retirement Products  | 65                                  | 56              | 195                                | 152             |
| Group Protection   | 29                                  | -               | 66                                 | -               |
| Employer Markets Total   | 94                                  | 56              | 261                                | 152             |
| Investment Management <sup>(1)</sup>   | 13                                  | 5               | 41                                 | 8               |
| Lincoln UK   | 8                                   | 10              | 29                                 | 30              |
| Lincoln Financial Media  | 15                                  | -               | 27                                 | -               |
| Other Operations   | (11)                                | 12              | (38)                               | 44              |
| Net realized investment results <sup>(4)</sup>                                       | (7)                                 | 2               | (11)                               | 4               |
| Reserve development net of related amortization on business sold through reinsurance | -                                   | -               | 1                                  | 1               |
| <b>Net Income</b>  | <b>\$ 364</b>                       | <b>\$ 229</b>   | <b>\$ 934</b>                      | <b>\$ 606</b>   |

(1) Revenues for the Investment Management segment include inter-segment revenues for asset management services provided to our other segments. These inter-segment revenues totaled \$24 million and \$25 million for the three months ended September 30, 2006 and 2005, and \$72 million and \$74 million for the nine months ended September 30, 2006 and 2005, respectively.

- (2) Lincoln Financial Media revenues are net of \$8 million and \$17 million of commissions paid to agencies during the third quarter of 2006 and the six months since the merger.
- (3) Includes realized losses on investments and derivative instruments of \$6 million and \$1 million for the three months ended September 30, 2006 and 2005, respectively; gain (loss) on reinsurance embedded derivative/trading securities of \$ (4) million and \$5 million for the three months ended September 30, 2006 and 2005, respectively. Includes realized losses on investments and derivative instruments of \$20 million and \$13 million for the nine months ended September 30, 2006 and 2005, gain on reinsurance embedded derivative/trading securities of \$4 million and \$5 million for the nine months ended September 30, 2006 and 2005, respectively; and gain on sale of subsidiaries/businesses of \$14 million for the nine months ended September 30, 2005.

- (4) Includes after-tax realized losses on investments and derivative instruments of \$5 million and \$1 million for the three months ended September 30, 2006 and 2005, respectively; gain (loss) on reinsurance embedded derivative/trading securities of \$(2) million and \$3 million for the three months ended September 30, 2006 and 2005, respectively. Includes realized losses on investments and derivative instruments of \$13 million and \$8 million for the nine months ended September 30, 2006 and 2005, respectively; gain on reinsurance embedded derivative/trading securities of \$2 million and \$3 million for the nine months ended September 30, 2006 and 2005, respectively; and gain on sale of subsidiaries/businesses of \$9 million for the nine months ended September 30, 2005.

### **Individual Markets**

The Individual Markets business provides its products through two segments - Individual Annuities and Individual Life Insurance. Through its Individual Annuities segment, Individual Markets provides tax-deferred investment growth and lifetime income opportunities for its clients by offering individual fixed annuities, including indexed annuities, and variable annuities. The Individual Life Insurance segment offers wealth protection and transfer opportunities through both single and survivorship versions of universal life, variable universal life, interest-sensitive whole life, term insurance, as well as a linked-benefit product, which is a universal life insurance policy linked with riders that provide for long-term care costs.

### **Individual Markets - Individual Annuities**

|   | Three Months Ended<br>September 30                     |       |                        | Nine Months Ended<br>September 30                     |        |                        |
|---|--|-------|------------------------|---|--------|------------------------|
|   | 2006   | 2005  | Increase<br>(Decrease) | 2006  | 2005   | Increase<br>(Decrease) |
| <b>Operating Summary (in millions)</b>                  |  |       |                        |   |        |                        |
| <b>Operating Revenues:</b>                              |  |       |                        |   |        |                        |
| Insurance premiums                                      | \$ 12  | \$ 11 | 9%                     | \$ 37   | \$ 29  | 28%                    |
| Insurance fees  | 196  | 152   | 29%                    | 562   | 419    | 34%                    |
| Net investment income                                   | 313  | 153   | 105%                   | 724   | 463    | 56%                    |
| Other revenues and fees                                 | 76   | 47    | 62%                    | 201   | 139    | 45%                    |
| Total Operating Revenues                                | 597  | 363   | 64%                    | 1,524   | 1,050  | 45%                    |
| <b>Operating Expenses:</b>                              |  |       |                        |   |        |                        |
| Insurance benefits                                      | 236  | 118   | 100%                   | 565   | 369    | 53%                    |
| Underwriting, acquisition, insurance and other expenses | 228  | 140   | 63%                    | 617   | 450    | 37%                    |
| Total Operating Expenses                                | 464  | 258   | 80%                    | 1,182   | 819    | 44%                    |
| Income from operations before taxes                     | 133  | 105   | 27%                    | 342   | 231    | 48%                    |
| Federal income taxes                                    | 4  | 26    | -85%                   | 57  | 50     | 14%                    |
| Income from Operations                                  | \$ 129   | \$ 79 | 63%                    | \$ 285  | \$ 181 | 57%                    |
|   | <b>Three<br/>Months<br/>Ended<br/>September<br/>30</b> |       |                        | <b>Nine<br/>Months<br/>Ended<br/>September<br/>30</b> |        |                        |

| <b>Net Flows (in billions)</b>                   | <b>2006</b> | <b>2005</b> | <b>Improvement<br/>(Decline)</b> | <b>2006</b> | <b>2005</b> | <b>Improvement<br/>(Decline)</b> |
|--|-------------|-------------|----------------------------------|-------------|-------------|----------------------------------|
| Variable Portion of Variable Annuity Deposits    | \$ 1.658    | \$ 1.410    | 18%                              | \$ 5.191    | \$ 4.026    | 29%                              |
| Variable Portion of Variable Annuity Withdrawals | (1.011)     | (0.848)     | -19%                             | (2.973)     | (2.379)     | -25%                             |
| Variable Portion of Variable Annuity Net Flows   | 0.647       | 0.562       | 15%                              | 2.218       | 1.647       | 35%                              |
| Fixed Portion of Variable Annuity Deposits       | 0.560       | 0.476       | 18%                              | 1.516       | 1.390       | 9%                               |
| Fixed Portion of Variable Annuity Withdrawals    | (0.189)     | (0.188)     | -1%                              | (0.539)     | (0.445)     | -21%                             |
| Fixed Portion of Variable Annuity Net Flows      | 0.371       | 0.288       | 29%                              | 0.977       | 0.945       | 3%                               |
| Total Variable Annuity Deposits                  | 2.218       | 1.886       | 18%                              | 6.707       | 5.416       | 24%                              |
| Total Variable Annuity Withdrawals               | (1.200)     | (1.036)     | -16%                             | (3.512)     | (2.824)     | -24%                             |
| Total Variable Annuity Net Flows                 | 1.018       | 0.850       | 20%                              | 3.195       | 2.592       | 23%                              |
| Indexed Annuity Deposits                         | 0.244       | -           | N/M                              | 0.472       | -           | N/M                              |
| Indexed Annuity Withdrawals                      | (0.068)     | -           | N/M                              | (0.114)     | -           | N/M                              |
| Indexed Annuity Net Flows                        | 0.176       | -           | N/M                              | 0.358       | -           | N/M                              |
| Fixed Annuity Deposits                           | 0.258       | 0.018       | N/M                              | 0.417       | 0.111       | 276%                             |
| Fixed Annuity Withdrawals                        | (1.148)     | (0.151)     | N/M                              | (2.197)     | (0.594)     | N/M                              |
| Fixed Annuity Net Flows                          | (0.890)     | (0.133)     | N/M                              | (1.780)     | (0.483)     | N/M                              |
| Total Annuity Deposits                           | 2.720       | 1.904       | 43%                              | 7.596       | 5.527       | 37%                              |
| Total Annuity Withdrawals                        | (2.416)     | (1.187)     | 104%                             | (5.823)     | (3.418)     | -70%                             |
| Total Annuity Net Flows                          | 0.304       | 0.717       | -58%                             | 1.773       | 2.109       | -16%                             |
| Annuitants Incremental Deposits                  | \$ 2.681    | \$ 1.864    | 44%                              | \$ 7.504    | \$ 5.393    | 39%                              |

| <b>September 30, (in billions)</b>  | <b>2006</b> |       | <b>2005</b> |       | <b>Increase<br/>(Decrease)</b> |
|-------------------------------------|-------------|-------|-------------|-------|--------------------------------|
| <b>Account Values:</b>              |             |       |             |       |                                |
| Variable Annuities                  | \$          | 44.0  | \$          | 35.3  | 25%                            |
| Fixed Annuities                     |             | 18.9  |             | 11.4  | 66%                            |
| Fixed Annuities Ceded to Reinsurers |             | (2.0) |             | (2.3) | -13%                           |
| Total Fixed Annuities               |             | 16.9  |             | 9.1   | 86%                            |
| Total Annuities                     | \$          | 60.9  | \$          | 44.4  | 37%                            |
| Fixed Portion of Variable Annuities |             | 3.7   |             | 4.3   | -14%                           |

| <b>September 30, (in billions)</b>    | <b>Three Months</b> |             |                                | <b>Nine Months</b> |             |                                |
|---------------------------------------|---------------------|-------------|--------------------------------|--------------------|-------------|--------------------------------|
|                                       | <b>2006</b>         | <b>2005</b> | <b>Increase<br/>(Decrease)</b> | <b>2006</b>        | <b>2005</b> | <b>Increase<br/>(Decrease)</b> |
| Average Daily Variable Account Values | \$ 42.1             | \$ 34.4     | 22%                            | \$ 41.1            | \$ 32.3     | 27%                            |

**Interest Margins**

| <b>Periods Ended September 30,</b>  | <b>Three Months</b> |             |   | <b>Nine Months</b> |             |   |
|---|---------------------|-------------|---|--------------------|-------------|---|
|   | <b>2006</b>         | <b>2005</b> | <b>Increase<br/>(Decrease)<br/>(basis<br/>points)</b> | <b>2006</b>        | <b>2005</b> | <b>Increase<br/>(Decrease)<br/>(basis<br/>points)</b> |
| Net investment income yield   | 5.98%               | 5.68%       | 30  | 5.76%              | 5.71%       | 5   |
| Interest rate credited to policyholders   | 3.87%               | 3.93%       | (6)   | 3.86%              | 3.93%       | (7)   |
| Interest rate margin  | 2.11%               | 1.75%       | 36  | 1.90%              | 1.78%       | 12  |
| Effect on yield and interest rate margin from commercial mortgage loan prepayment and bond makewhole premiums | 0.05%               | 0.01%       | 4   | 0.06%              | 0.03%       | 3   |
| Interest rate margin adjusted   | 2.06%               | 1.74%       | 32  | 1.84%              | 1.75%       | 9   |

|  |    |      |    |      |    |      |    |      |
|--|----|------|----|------|----|------|----|------|
| Average fixed annuity account values (in billions) | \$ | 18.7 | \$ | 10.2 | \$ | 14.5 | \$ | 10.4 |
|--|----|------|----|------|----|------|----|------|

|   |    |   |    |   |    |   |    |   |
|---|----|---|----|---|----|---|----|---|
| Effect on income from operations (after-tax, after-DAC) (in millions) |    |   |    |   |    |   |    |   |
| Commercial mortgage loan prepayment and bond makewhole premiums       | \$ | 1 | \$ | - | \$ | 2 | \$ | 1 |

**Individual Annuities - Comparison of Three and Nine months Ended September 30, 2006 to 2005**

Income from operations for this segment increased \$50 million, or 63%, and \$104 million, or 57%, for the three months and nine months ended September 30, 2006 compared to the same periods in 2005, respectively. The increases for the comparable three-month and nine-month periods are due primarily to growth in account values from positive net flows and favorable market conditions, the addition of Jefferson-Pilot and a favorable tax adjustment related to the separate account DRD and foreign tax credits from the filing of the 2005 tax return.

*Revenues*

Insurance fees increased 28% in the third quarter and 34% in the first nine months of 2006 compared to the same periods in 2005, due to increases in average daily variable annuity account values and an increase in expense assessment rates resulting primarily from increased sales of riders. The increase in account values reflects cumulative positive net flows and improvement in the equity markets between periods. Excluding the impact of dividends, the S&P 500 index was 8.7% higher and the average daily S&P index was 7.1% higher in the first nine months of 2006 than the first nine months of 2005. The increase in fixed annuity product sales from the same periods in the previous year includes \$244 million and \$472 million for the third quarter and first nine months of 2006, respectively, from the indexed annuity business acquired from the Jefferson-Pilot merger.

New deposits are an important component of our effort to grow the annuity business. Although deposits do not significantly impact current period income from operations, they are an important indicator of future profitability. In the past several years, we have concentrated our efforts on both product and distribution breadth. Annuity deposits increased 43% in



the third quarter of 2006 and 37% for the first nine months of 2006, compared to the same 2005 periods, primarily due to growth in the variable annuity business. New deposits for the 2006 periods include amounts from Jefferson-Pilot.

The growth in individual variable annuity deposits was primarily a result of continued strong sales of products with the Lincoln Smart Security<sup>SM</sup> Advantage feature and the expansion of the wholesaling force in LFD. Variable annuity gross deposits in our Lincoln ChoicePlus<sup>SM</sup> and American Legacy products were up 25% and 24% for the third quarter and first nine months of 2006 compared to the same 2005 periods.

The other component of net flows is retention of the business. One of the key assumptions in pricing a product is the account persistency, which we refer to as the lapse rate. The lapse rate compares the amount of withdrawals to the retained account values. One way to measure a company's success in retaining assets is to look at the overall level of withdrawals from period to period. Additionally, by comparing actual lapse rates to the rates assumed in designing the annuity product, it is possible to gauge the impact of persistency on profitability. Overall lapse rates for the third quarter and first nine months of 2006 were 14.0% and 12.3%, compared to 8.4% and 8.8% for the same periods in 2005. See the discussion below for the drivers of the increased lapse rates.

Our Step Five Fixed Annuity products have a sixty day window period following each five-year fixed guarantee period during which there is no surrender charge, and where crediting rates are reset at the beginning of the window period. Crediting rates for these products are either at or near minimum guaranteed crediting rates. As multi-year guarantees expire, policyholders have the opportunity to renew their annuities at rates in effect at that time. Our ability to retain these annuities will be subject to then-current competitive conditions. Account values for these products were \$2.8 billion at December 31, 2005, with approximately \$1.2 billion and \$1.1 billion of account values entering the window period during 2006 and 2007, respectively. Amounts after 2007 are not significant. Through September 30, 2006, approximately \$841 million of account values entered the window period. For both the third quarter and first nine months of 2006, we experienced lapse rates on these accounts of 56%. Our DAC amortization assumption is a lapse rate of 60% for this product. As discussed below in the section on Benefits and Expenses, in connection with our annual comprehensive review of assumptions underlying DAC\VOBA\DFEL amortization, we adjusted our lapse rate assumptions for these products to reflect actual experience to date. The after-DAC, after-tax effect to the earnings of the segment, is mitigated in part by a 50% coinsurance arrangement on 87% of the account values. See "Reinsurance" for additional information on this arrangement.

In addition to the Step Five Fixed Annuity product discussed above, included in the fixed annuity business acquired with the Jefferson-Pilot merger is approximately \$4.1 billion of average fixed annuity policyholder fund balances with crediting rates that are reset on an annual basis and are not subject to surrender charges. We also have fixed annuity products with crediting rates that are reset on an annual basis, and are not subject to surrender charges. The average crediting rates in the third quarter of 2006 for the Jefferson-Pilot business were approximately 32 basis points in excess of average minimum guaranteed rates, including 42% that were already at their minimum guaranteed rates. Approximately \$2.5 billion of fixed annuity policyholder fund balances acquired with the Jefferson-Pilot merger have multi-year guarantees, approximately \$0.9 billion of which have begun to reset in 2006, with \$373 million and \$218 million entering reset periods in 2007 and 2008, respectively. As multi-year guarantees expire, policyholders have the opportunity to renew their annuities at rates in effect at that time. Our ability to retain these annuities will be subject to then-current competitive conditions. The average spread to the minimum underlying guarantee on these products is approximately 167 basis points. In the third quarter 2006, \$541 million of fixed annuity policyholder fund balances reset, of which approximately \$390 million lapsed where the holder did not select another product that we offer. In the fourth quarter of 2006, approximately \$232 million of fixed annuities with multi-year guarantees will reset and we expect that approximately \$150 million will lapse based upon emerging experience.

Net investment income increased 106% for the third quarter and 56% for the first nine months of 2006 compared with the same 2005 periods. The increase in net investment income for the 2006 periods is due to the addition of the Jefferson-Pilot companies. Overall growth in net investment income has been constrained due primarily to lower investment portfolio yields and lower average fixed annuity account values. Net investment income included \$2

million and \$6 million from commercial mortgage loan prepayment and bond makewhole premiums for the three and nine month periods ended September 30, 2006. There was no investment income from these items in the third quarter of 2005 and \$2 million for the first nine months of 2005. Net investment income for the third quarter and first nine months of 2005 includes \$1 million and \$5 million, respectively, of higher income for partnerships. Net investment income for the third quarter and first nine months of 2006 also includes an increase of \$32 million and \$18 million, respectively from the mark-to-market adjustment for S&P index call options supporting the hedge program for the indexed annuity business acquired in the April 2006 merger with Jefferson-Pilot. This adjustment is largely offset by a related adjustment in insurance benefits expense.

When analyzing the impact of net investment income, it is important to understand that a portion of the investment income earned is credited to the policyholders of our fixed annuity products. The interest credited to policyholders is included in the segment's insurance benefits. Annuity product interest rate margins represent the excess of the yield on earning assets over the average crediting rate. The yield on earning assets is calculated as net investment income on fixed product investment portfolios divided by average earning assets. The average crediting rate is calculated using interest credited on annuity products less bonus credits and excess interest on policies with the dollar cost averaging feature, divided by the average fixed account values net of coinsured account values. Fixed account values reinsured under modified coinsurance agreements are included in account values for this calculation. Interest credited to policyholder balances increased for the third quarter and first nine months of 2006 compared to the same 2005 periods as a result of the Jefferson-Pilot merger, partially offset by lower average fixed account values and lower average crediting rates.

The interest rate margin table above summarizes the effect of changes in the portfolio yield, the rate credited to policyholders, as well as the impact of prepayment premiums on results on an after-DAC, after-tax basis. The adjusted interest rate margin was 2.06% and 1.74% for the third quarters of 2006 and 2005, respectively, and 1.84% and 1.75% for the corresponding nine-month periods. The improvements are due to increases in quarter-over-quarter investment income yield, a reduction in crediting rates and a change in default methodology, while declines in investment income yield were offset by declines in crediting rates for the nine-month periods. During the third quarter, we also harmonized our policy for accounting and reporting for investment defaults by discontinuing the historical practice followed by Jefferson-Pilot of business segments reimbursing Other Operations for actual default experience through an inter-company charge referred to as the default charge. This change in default methodology increased spreads and income from operations for this segment by 9 basis points and \$2 million, respectively. This change did not have an effect on consolidated income from operations.

As interest rates increase and the gap between new money rates and portfolio rates narrows, we expect to manage the effect of spreads for near term operating income through a combination of rate actions and portfolio management. Our expectation includes the assumption that there are no significant changes in net flows in or out of our fixed accounts or other changes which may cause interest rate margins to differ from our expectation. For information on interest rate margins and the interest rate risk due to falling interest rates, see "Item 3 - Quantitative and Qualitative Disclosures About Market Risk" of this Form 10-Q.

#### *Benefits and Expenses*

Insurance benefits include interest credited to policyholders of \$208 million and \$472 million in the third quarter and first nine months of 2006, compared to \$97 million and \$296 million for the same periods in 2005. Increases from the acquisition of Jefferson-Pilot were partially offset from past actions taken to lower crediting rates commensurate with the reduction in the overall investment yield over the last several years and lower fixed account values. See the table above for the interest rate credited to policyholders. Interest credited to policyholders for the third quarter and first nine months of 2006 also includes increases of \$30 million and \$17 million from the mark-to-market adjustment for indexed annuity liabilities acquired in the merger with Jefferson-Pilot resulting from changes in equity markets. This adjustment is largely offset in net investment income by a corresponding change in the market value of S&P index call options acquired to hedge the equity market exposure for these liabilities.

Also included in insurance benefits are the costs associated with guaranteed benefits included within variable annuities with the GMDB, GMWB or GIB riders. For the third quarter of 2006, unfavorable market conditions resulted in increased insurance benefits for the GMDB and GMWB riders, which were offset by favorable hedge results compared to the third quarter of 2005. For the first nine months of 2006, due to favorable market conditions, insurance benefits for the GMDB and GMWB riders were favorable compared to the same 2005 period. This favorable effect was offset by unfavorable hedge results in the first nine months of 2006 compared to the first nine months of 2005. The effect of changes in net reserve and benefit payments and results of the hedge program during the third quarter and first nine months of 2006 attributable to these guaranteed benefits was such that the period over period variances on an after-DAC and after-tax basis were not significant.

In the third quarter of 2006, we completed our annual comprehensive review of the assumptions underlying the prospective amortization of DAC, VOBA and DSI, and the calculations of the GMDB reserves and the embedded derivative related to GMWB. This review resulted in a net favorable unlocking adjustment due to unfavorable fixed annuity account value retention discussed above, growth in our GIB riders with higher partial withdrawals, and unfavorable mortality, partially offset by lowering our long-term interest assumption. For the three and nine months ended September 30, 2006, the result of this prospective assumption adjustment was a decrease in expenses of \$6 million pre-tax (\$4 million after-tax). The comprehensive review completed during the third quarter of 2006 is not expected to significantly affect future amortization expense.

In the third quarter of 2005, we completed our annual comprehensive review of the assumptions underlying the prospective amortization of DAC, VOBA and DSI, and the calculations of the GMDB reserves and the embedded derivative related to GMWB. This review resulted in a favorable adjustment due to continued favorable account value retention partially offset by mortality. For the three and nine months ended September 30, 2005, the result of this adjustment was a reduction in benefits and expenses of \$33 million pre-tax (\$21 million after-tax).

At September 30, 2006, the segment's net amount at risk ("NAR") related to contracts with a GMDB feature was \$0.4 billion. The related GAAP and statutory reserves were \$21 million and \$44 million, respectively. The comparable amounts at December 31, 2005, were a NAR of \$0.5 billion, GAAP reserves of \$15 million and statutory reserves of \$43 million. At any point in time, the NAR is the difference between the potential death benefit payable and the total account value, with a floor of zero (when account values exceed the potential death benefit there is no amount at risk). Accordingly, the NAR represents the maximum amount we would have to pay if all policyholders died. In evaluating the GMDB exposures that exist within our variable annuity business relative to industry peers, it is important to distinguish between the various types of GMDB features, and other factors such as average account values, average amounts of NAR, and the age of contractholders. The following table and discussion provides this information for our variable annuity business as of September 30, 2006:

|   | Type of GMDB Feature |                       |         |         |         | Total |
|---|----------------------|-----------------------|---------|---------|---------|-------|
|   | Return of<br>Premium | High<br>Water<br>Mark | Roll-up | No GMDB |         |       |
| Variable Annuity Account Value (billions) | \$ 21.7              | \$ 21.0               | \$ 0.4  | \$ 4.6  | \$ 47.7 |       |
| % of Total Annuity Account Value          | 45.5%                | 44.0%                 | 0.8%    | 9.7%    | 100.0%  |       |
| Average Account Value (thousands)         | \$ 99.3              | \$ 99.9               | \$ 76.6 | \$ 68.6 | \$ 95.3 |       |
| Average NAR (thousands)                   | \$ 5.8               | \$ 8.2                | \$ 12.9 | N/A     | \$ 7.9  |       |
| NAR (billions)                            | \$ 0.1               | \$ 0.3                | -       | N/A     | \$ 0.4  |       |
| Average Age of Contract Holder            | 64                   | 63                    | 66      | 62      | 63      |       |
| % of Contract Holders > 70 Years of Age   | 13.9%                | 30.5%                 | 39.7%   | 30.4%   | 19.4%   |       |

We have variable annuity contracts containing GMDBs that have a dollar for dollar withdrawal feature. Under such a feature, withdrawals reduce both current account value and the GMDB amount on a dollar for dollar basis. For contracts containing this dollar for dollar feature, the account holder could withdraw a substantial portion of their account value resulting in a GMDB that is multiples of the current account value. Our exposure to this dollar for dollar risk is somewhat mitigated by the fact that we do not allow for partial 1035 exchanges on non-qualified contracts. To take advantage of the dollar for dollar feature, the contractholder must take constructive receipt of the withdrawal and pay any applicable surrender charges. We report the appropriate amount of the withdrawal that is taxable to the Internal Revenue Service, as well as indicating whether or not tax penalties apply under the premature distribution tax rules. We closely monitor the dollar for dollar withdrawal GMDB exposure. Beginning in 2003, the GMDB feature offered on new contract sales is a pro-rata GMDB feature whereby each dollar of withdrawal reduces the GMDB benefit in proportion to the current GMDB to account value ratio. As of September 30, 2006, there were 812 contracts for which the death benefit to account value ratio was greater than ten to one. The NAR on these contracts was \$52 million.

Underwriting, acquisition, insurance and other expenses increased \$88 million, or 63%, and \$167 million, or 37%, for the third quarter and first nine months of 2006, respectively, compared to the same 2005 periods. The increases were driven principally by \$41 million and \$92 million, respectively, from the Jefferson-Pilot companies, higher incentive compensation accruals, and account value growth from sales and favorable equity markets, which resulted in higher commission expenses, net of deferrals and higher DAC amortization.

#### *Federal Income Taxes*

Federal income tax expense for the third quarter and first nine months of 2006 include a reduction of \$33 million related to a favorable true-up to the 2005 tax return primarily relating to the separate accounts DRD. The estimate for 2006 is expected to favorably benefit ongoing quarterly earnings by \$5 million. For additional information see Note 4 to the unaudited Consolidated Financial Statements.

## Individual Markets - Life Insurance

| Operating Summary (in millions)                         | Three Months Ended<br>September 30 |       |            | Nine Months Ended<br>September 30 |        |            |
|---|------------------------------------|-------|------------|-----------------------------------|--------|------------|
|   | 2006                               | 2005  | Increase   | 2006                              | 2005   | Increase   |
|   |                                    |       | (Decrease) |                                   |        | (Decrease) |
| <b>Operating Revenues:</b>                              |                                    |       |            |                                   |        |            |
| Insurance premiums                                      | \$ 87                              | \$ 48 | 81%        | \$ 228                            | \$ 141 | 62%        |
| Insurance fees  | 381                                | 170   | 124%       | 964                               | 552    | 75%        |
| Net investment income                                   | 414                                | 230   | 80%        | 1,070                             | 681    | 57%        |
| Other revenues and fees                                 | 13                                 | 11    | 18%        | 35                                | 35     | 0%         |
| Total Operating Revenues                                | 895                                | 459   | 95%        | 2,297                             | 1,409  | 63%        |
| <b>Operating Expenses:</b>                              |                                    |       |            |                                   |        |            |
| Insurance benefits                                      | 508                                | 251   | 102%       | 1,268                             | 760    | 67%        |
| Underwriting, acquisition, insurance and other expenses | 207                                | 111   | 86%        | 523                               | 373    | 40%        |
| Total Operating Expenses                                | 715                                | 362   | 98%        | 1,791                             | 1,133  | 58%        |
| Income from operations before taxes                     | 180                                | 97    | 86%        | 506                               | 276    | 83%        |
| Federal income taxes                                    | 57                                 | 32    | 78%        | 167                               | 90     | 86%        |
| Income from Operations                                  | \$ 123                             | \$ 65 | 89%        | \$ 339                            | \$ 186 | 82%        |

| (in millions)                      | Three Months Ended<br>September 30 |          |            | Nine Months Ended<br>September 30 |          |            |
|------------------------------------|------------------------------------|----------|------------|-----------------------------------|----------|------------|
|                                    | 2006                               | 2005     | Increase   | 2006                              | 2005     | Increase   |
|                                    |                                    |          | (Decrease) |                                   |          | (Decrease) |
| <b>Sales by Product</b>            |                                    |          |            |                                   |          |            |
| Universal Life ("UL")              |                                    |          |            |                                   |          |            |
| Excluding MoneyGuard <sup>SM</sup> | \$ 120                             | \$ 46    | 161%       | \$ 259                            | \$ 132   | 96%        |
| MoneyGuard <sup>SM</sup>           | 8                                  | 9        | -11%       | 23                                | 25       | -8%        |
| Total Universal Life               | 128                                | 55       | 133%       | 282                               | 157      | 80%        |
| Variable Universal Life ("VUL")    | 13                                 | 9        | 44%        | 39                                | 29       | 34%        |
| Whole Life                         | 1                                  | 1        | 0%         | 2                                 | 1        | 100%       |
| Term                               | 10                                 | 8        | 25%        | 30                                | 26       | 15%        |
| Total                              | \$ 152                             | \$ 73    | 108%       | \$ 353                            | \$ 213   | 66%        |
| <b>Net Flows (in billions)</b>     |                                    |          |            |                                   |          |            |
| Deposits                           | \$ 0.753                           | \$ 0.497 | 52%        | \$ 2.264                          | \$ 1.435 | 58%        |
| Withdrawals & Deaths               | (0.262)                            | (0.202)  | 30%        | (0.968)                           | (0.641)  | 51%        |
| Net Flows                          | \$ 0.491                           | \$ 0.295 | 66%        | \$ 1.296                          | \$ 0.794 | 63%        |
| Policyholder Assessments           | \$ 0.526                           | \$ 0.285 | 85%        | \$ 1.391                          | \$ 0.846 | 64%        |

| (in billions)         | As of September 30, |        | Increase   |
|-----------------------|---------------------|--------|------------|
|                       | 2006                | 2005   | (Decrease) |
| <b>Account Values</b> |                     |        |            |
| Universal Life        | \$ 18.8             | \$ 9.2 | 104%       |

Edgar Filing: LINCOLN NATIONAL CORP - Form 10-Q

|  |         |         |      |
|--|---------|---------|------|
| Variable Universal Life                | 4.8     | 2.3     | 109% |
| Interest-Sensitive Whole Life ("ISWL") | 2.2     | 2.2     | 0%   |
| Total Life Insurance Account Values    | \$ 25.8 | \$ 13.7 | 88%  |

**In Force-Face Amount**

|                          |          |          |      |
|--------------------------|----------|----------|------|
| Universal Life and Other | \$ 263.5 | \$ 127.0 | 107% |
| Term Insurance           | 232.2    | 184.3    | 26%  |
| Total In-Force           | \$ 495.7 | \$ 311.3 | 59%  |

**Net Amount at Risk**

|                          |          |          |      |
|--------------------------|----------|----------|------|
| Universal Life and Other | \$ 233.8 | \$ 110.9 | 111% |
| Term Insurance           | 231.1    | 183.5    | 26%  |
| Total Net Amount at Risk | \$ 464.9 | \$ 294.4 | 58%  |

47

---



**Interest Rate Margins**

| Periods Ended September 30,  | Three Months |       | Increase<br>(Decrease)<br>(basis<br>points) | Nine Months |       | Increase<br>(Decrease)<br>(basis<br>points) |
|--|--------------|-------|---|-------------|-------|---|
|  | 2006         | 2005  |   | 2006        | 2005  |   |
| <b>Interest Sensitive Products</b>                                       |              |       |   |             |       |   |
| Net investment income yield  | 6.08%        | 6.35% | (27)  | 6.23%       | 6.35% | (12)  |
| Interest rate credited to policyholders                                  | 4.52%        | 4.70% | (18)  | 4.51%       | 4.69% | (18)  |
| Interest rate margin   | 1.56%        | 1.65% | (9)   | 1.72%       | 1.66% | 6   |
| Effect on Yield and Interest Rate<br>Margin                              |              |       |   |             |       |   |
| Commercial mortgage loan<br>prepayment and bond<br>makewhole premiums    | 0.20%        | 0.04% | 16  | 0.15%       | 0.05% | 10  |
| Interest rate margin, excluding the<br>above items                       | 1.36%        | 1.61% | (25)  | 1.57%       | 1.61% | (4)   |
| Effect on Income from Operations<br>(After-tax, after-DAC) (in millions) |              |       |   |             |       |   |
| Commercial mortgage loan<br>prepayment and bond<br>makewhole premiums    | \$ 4         | \$ -  |   | \$ 7        | \$ 1  |   |
| <b>Traditional Products</b>  |              |       |   |             |       |   |
| Net investment income yield  | 6.61%        | 6.62% | (1)   | 6.63%       | 6.59% | 4   |
| Effect on Yield  |              |       |   |             |       |   |
| Commercial mortgage loan<br>prepayment and bond<br>makewhole premiums    | 0.15%        | 0.20% | (5)   | 0.15%       | 0.14% | 1   |
| Net investment income yield after<br>adjusted for above items            | 6.46%        | 6.42% | 4   | 6.48%       | 6.45% | 3   |
| Effect on Income from Operations<br>(After-tax) (in millions)            |              |       |   |             |       |   |
| Commercial mortgage loan<br>prepayment and bond<br>makewhole premiums    | \$ 1         | \$ -  |   | \$ 2        | \$ 1  |   |

**Life Insurance - Comparison of Three and Nine months Ended September 30, 2006 to 2005**

Income from operations for this segment increased \$58 million, or 89%, and \$153 million, or 82%, for the three months and nine months ended September 30, 2006 compared to the same periods in 2005, respectively. The increase was driven by the Jefferson-Pilot merger. The increased operating results from the merger were partially offset by the unfavorable adjustments from the annual DAC/VOBA/DFEL comprehensive assumption review compared with the results of that review for the same 2005 periods, an increase in reserves for life insurance policies with secondary guarantees, and unfavorable investment results in the third quarter of 2006 due to a loss on an alternative investment.

*Revenues, First Year Premium, In-force and Net Amount at Risk*

Revenues for the third quarter and first nine months of 2006 increased 95% and 63% compared to the same 2005 periods due to inclusion of results from the Jefferson-Pilot companies beginning in April 2006. Revenues from

insurance fees were up 124% and 75% for the third quarter and first nine months of 2006 compared to the 2005 periods. Insurance fees include mortality assessments, expense assessments (net of DFEL deferrals and amortization) and surrender charges. In addition to the effects of the merger, growth in mortality and expense assessments in the third quarter and first nine months of 2006 compared to the same periods in 2005 was primarily related to increased business in force due to new sales, favorable persistency and the impact of DFEL unlocking discussed in the Benefits and Expenses section below. The improved persistency results should positively affect future revenues.

For the third quarter and first nine months of 2006, we experienced growth in life insurance in-force and NAR in both term life and UL and other permanent products, both as a result of and in addition to the Jefferson-Pilot merger. It is important to view the in-force and NAR growth separately for term products versus UL and other permanent products, as term products by design have a lower profitability to face amount relationship than do permanent life insurance products. Insurance premium revenue relates primarily to whole life and term life insurance products. Term and whole life insurance products have insurance fees and COIs generated from the NAR. These are components of the change in policy reserves on these products, and are reflected in insurance benefits. Excluding the impact of the Jefferson-Pilot companies, insurance premiums for term insurance increased 53% and 43% for the third quarter and first nine months of 2006 compared to the same periods in 2005, while insurance premiums for whole life decreased 16% and 10% for the same periods. For term insurance, gross premiums grew 10% for the third quarter and 8% for the first nine months from continued growth in the term insurance book of business. Also contributing to the growth in net term insurance premiums was a 5% and 4% reduction in premiums paid for reinsurance coverage in the third quarter and first nine months of 2006 compared to the same periods in 2005, primarily resulting from restructuring our reinsurance program in September 2005. Under the restructured program, we reduced the percentage of each new term policy reinsured and changed from using coinsurance to using renewable term reinsurance. See "Reinsurance" below for additional information regarding our reinsurance coverage.

Sales in the table above and as discussed below are reported as follows:

- § UL, VUL, MoneyGuard - 100% of annualized expected target premium plus 5% of paid excess premium, including an adjustment for internal replacements at approximately 50% of target.
- § Whole Life and Term - 100% of first year paid premiums.

Previously, we reported sales as first year paid premium, excluding internal replacements, for all products. We changed our basis of reporting in the second quarter of 2006 to one more consistent with the reporting of industry sales.

Sales are not part of revenues (other than for term products) and do not have a significant impact on current quarter income from operations, but are indicative of future profitability. Total sales for the third quarter and first nine months of 2006 increased 108% and 66% compared to the same periods in 2005 as a result of the merger with the Jefferson-Pilot companies. Excluding the effects of the merger, growth in UL sales was constrained due to restructuring in our retail distribution operation that is now complete, maintaining pricing discipline in a highly competitive environment and a more disciplined approach to investor-owned life insurance sales.

Net investment income increased \$184 million or 80%, and \$389 million or 57%, in the three- and nine-month periods ended September 30, 2006, compared to the same 2005 periods, with the increase being driven by the merger with the Jefferson-Pilot companies. Excluding the effects of the merger, growth in investment income was constrained due to a loss in an alternative investment of \$14 million pre-tax (\$8 million after-tax, after-DAC), partially offset by growth in in-force and higher commercial mortgage loan prepayment and bond make whole premiums.

Interest rate margins for interest sensitive products declined 9 basis points for the third quarter and increased 6 basis points in the first nine months of 2006, respectively, compared to the same 2005 periods. Excluding the effects of commercial mortgage loan prepayment and bond make-whole premiums, interest rate margins for interest sensitive products decreased 25 and 4 basis points in the third quarter and first nine months of 2006, respectively, compared to the same 2005 periods. The loss in the third quarter on an alternative investment, as disclosed above, lowered interest rate margins by 22 and 5 basis points for the third quarter and first nine months of 2006, respectively. During the third quarter, we harmonized our policy for accounting and reporting for investment defaults by discontinuing the historical practice followed by Jefferson-Pilot of business segments reimbursing Other Operations for actual default experience through an inter-company charge referred to as the default charge. This change in default methodology increased spreads and income from operations for this segment by 10 basis points and \$4 million, respectively. This change did not have an effect on consolidated income from operations. Interest sensitive products include UL and ISWL and provide for interest to be credited to policyholder accounts. The difference between what we credit to policyholder accounts and interest income we earn on interest sensitive assets is interest rate margin. Traditional products include term and whole life insurance with interest income used to build the policy reserves. At September 30, 2006 and 2005, interest-sensitive products represented approximately 81% and 78%, respectively, of total interest sensitive and traditional products earning assets.

At September 30, 2006, spreads between new money rates and general account yields have narrowed. Going forward, we expect to be able to manage the effects of spreads on near term operating income through a combination of rate actions and portfolio management. This assumes no significant changes in net flows into or out of our fixed accounts or other changes which may cause interest rate margins to differ from our expectations. At September 30, 2006, 50% of the interest sensitive account values have crediting rates at contract guaranteed levels, and 43% have crediting rates within 50 basis points of contractual guarantees. For information on interest rate margins and the interest rate risk due to falling interest rates, see "Item 3. Quantitative and Qualitative Disclosures About Market Risk" in this Form 10-Q.

#### *Benefits and Expenses*

Insurance benefits include interest credited to policyholders of \$247 million and \$631 million in the third quarter and first nine months of 2006, respectively, compared to \$141 million and \$418 million for the same periods in 2005, with the increase primarily attributable to the merger with the Jefferson-Pilot companies. Also contributing to the increase was growth in the book of business partially offset by actions taken by the segment to lower crediting rates commensurate with the reductions in the overall investment yield in 2005. Refer to the table above for the interest rate credited to policyholders.

Insurance benefits for the third quarter and first nine months include a reserve increase of \$15 million pre-tax, (\$10 million after-tax) from our annual comprehensive assumption reviews relating to life insurance products sold with secondary guarantees. The reserve increase resulted from updating long-term assumptions primarily investment interest rates, as part of our annual comprehensive assumption review. The change in assumptions is expected to result in an increase in reserves in the fourth quarter of \$2 million (\$1million after-tax), and similar increases are expected to continue for the foreseeable future.

Also, as part of our annual comprehensive review of the assumptions, during the third quarter of 2006, we reviewed the assumptions underlying the amortization of DAC, VOBA and DFEL. As a result, for the three and nine months ended September 30, 2006, the segment had a DAC/VOBA/DFEL net prospective negative adjustment of \$14 million pre-tax (\$9 million after-tax), comprised of \$(7) million DFEL and \$21 million DAC/VOBA in the first nine months of 2006, primarily due to favorable persistency, mortality, and expenses. The adjustments primarily reflect the impact of the increased reserves related to life insurance products sold with secondary guarantees, partially offset by improved mortality and expense assumptions. The comprehensive review during the third quarter of 2006 has also resulted in an increase in the on-going amortization expense of approximately \$3 million pre-tax (\$2 million after-tax) per quarter beginning in the third quarter of 2006.

As a result of the annual comprehensive review conducted in the third quarter of 2005, for the three and nine months ended September 30, 2005, the segment had DAC/VOBA/DFEL net prospective positive unlocking adjustment of \$4 million pre-tax (\$2 million after-tax), comprised of \$(20) million DFEL and \$24 million DAC/VOBA. The adjustments were the result of improved mortality assumptions, partially offset by less favorable retention and interest rate assumptions.

The segment had favorable retrospective DAC/VOBA/DFEL unlocking of \$4 million pre-tax (\$2 million after-tax) in the third quarter of 2006, primarily due to favorable persistency, partially offset in part by unfavorable investment results. Retrospective DAC/VOBA/DFEL unlocking in the third quarter and first nine months of 2005 was not significant. Retrospective DAC/VOBA/DFEL unlocking in the first nine months of 2005 was not significant.

UL and VUL products with secondary guarantees represented approximately 24% of permanent life insurance in-force at September 30, 2006 and approximately 69% of sales for these products. As more fully discussed in our 2005 Form 10-K, these products are subject to Actuarial Guideline 38 (also known as "AXXX" and "AG 38") statutory reserve requirements. See "Review of Consolidated Financial Condition - Sources of Liquidity and Cash Flow - Financing Activities" for further information on the manner in which we reinsure our AG 38 reserves.

Underwriting, acquisition, insurance and other expenses increased \$96 million and \$150 million, for the third quarter and first nine months of 2006 compared to the same 2005 periods, with the increase being driven by the merger with the Jefferson-Pilot companies, higher incentive compensation accruals and the unfavorable DAC and VOBA unlocking discussed above.

**Employer Markets**

The Employer Markets business provides its products through two segments, Retirement Products and Group Protection, formerly known as Benefit Partners. The Retirement Products segment operates through two lines of business - Defined Contribution, which provides employer-sponsored variable and fixed annuities, mutual-fund based programs in the 401(k), 403(b), and 457 marketplaces; and Executive Benefits, which provides corporate- and bank-owned life insurance. The Group Protection segment of Employer Markets offers group life, disability, and dental insurance to employers.

**Employer Markets - Retirement Products**

|   | Three Months Ended<br>September 30 |       |                        | Nine Months Ended<br>September 30 |        |                        |
|---|------------------------------------|-------|------------------------|-----------------------------------|--------|------------------------|
|   | 2006                               | 2005  | Increase<br>(Decrease) | 2006                              | 2005   | Increase<br>(Decrease) |
| <b>Operating Summary (in millions)</b>                  |                                    |       |                        |                                   |        |                        |
| <b>Operating Revenues:</b>                              |                                    |       |                        |                                   |        |                        |
| Insurance fees  | \$ 68                              | \$ 68 | 0%                     | \$ 203                            | \$ 183 | 11%                    |
| Net investment income                                   | 276                                | 222   | 24%                    | 784                               | 666    | 18%                    |
| Other revenues and fees                                 | 5                                  | 8     | -38%                   | 19                                | 23     | -17%                   |
| Total Operating Revenues                                | 349                                | 298   | 17%                    | 1,006                             | 872    | 15%                    |
| <b>Operating Expenses:</b>                              |                                    |       |                        |                                   |        |                        |
| Insurance benefits                                      | 178                                | 151   | 18%                    | 494                               | 433    | 14%                    |
| Underwriting, acquisition, insurance and other expenses | 87                                 | 68    | 28%                    | 241                               | 229    | 5%                     |
| Total Operating Expenses                                | 265                                | 219   | 21%                    | 735                               | 662    | 11%                    |
| Income from operations before taxes                     | 84                                 | 79    | 6%                     | 271                               | 210    | 29%                    |
| Federal income taxes                                    | 19                                 | 23    | -17%                   | 76                                | 58     | 31%                    |
| Income from Operations                                  | \$ 65                              | \$ 56 | 16%                    | \$ 195                            | \$ 152 | 28%                    |

**Defined Contribution**

|   | Three Months Ended<br>September 30 |       |                        | Nine Months Ended<br>September 30 |        |                        |
|---|------------------------------------|-------|------------------------|-----------------------------------|--------|------------------------|
|   | 2006                               | 2005  | Increase<br>(Decrease) | 2006                              | 2005   | Increase<br>(Decrease) |
| <b>Operating Summary (in millions)</b>                  |                                    |       |                        |                                   |        |                        |
| <b>Operating Revenues:</b>                              |                                    |       |                        |                                   |        |                        |
| Insurance fees  | \$ 56                              | \$ 55 | 2%                     | \$ 170                            | \$ 157 | 8%                     |
| Net investment income                                   | 185                                | 177   | 5%                     | 558                               | 530    | 5%                     |
| Other revenues and fees                                 | 4                                  | 7     | -43%                   | 15                                | 19     | -21%                   |
| Total Operating Revenues                                | 245                                | 239   | 3%                     | 743                               | 706    | 5%                     |
| <b>Operating Expenses:</b>                              |                                    |       |                        |                                   |        |                        |
| Insurance benefits                                      | 103                                | 101   | 2%                     | 306                               | 301    | 2%                     |
| Underwriting, acquisition, insurance and other expenses | 75                                 | 62    | 21%                    | 217                               | 207    | 5%                     |
| Total Operating Expenses                                | 178                                | 163   | 9%                     | 523                               | 508    | 3%                     |
| Income from operations before taxes                     | 67                                 | 76    | -12%                   | 220                               | 198    | 11%                    |

Edgar Filing: LINCOLN NATIONAL CORP - Form 10-Q

|                        |    |    |    |    |      |     |    |     |     |
|------------------------|----|----|----|----|------|-----|----|-----|-----|
| Federal income taxes   |    | 15 |    | 23 | -35% | 61  |    | 56  | 9%  |
| Income from Operations | \$ | 52 | \$ | 53 | -2%  | 159 | \$ | 142 | 12% |

| <b>Account Values (in billions)</b> |    | <b>September 30,</b> |             | <b>Increase</b>   |
|-------------------------------------|----|----------------------|-------------|-------------------|
|                                     |    | <b>2006</b>          | <b>2005</b> | <b>(Decrease)</b> |
| Variable Annuities                  | \$ | 16.5                 | \$ 15.3     | 8%                |
| Fixed Annuities                     |    | 11.1                 | 10.7        | 4%                |
| Total Annuities                     |    | 27.6                 | 26.0        | 6%                |
| Alliance Mutual Funds               |    | 4.6                  | 3.7         | 24%               |
| Total Annuities and Alliance        | \$ | 32.2                 | \$ 29.7     | 8%                |
| Fixed Portion of Variable Annuity   | \$ | 6.3                  | \$ 5.9      | 7%                |

51

---

| Net Flows (in billions)                                | Periods Ended September<br>30,<br>Three Months |          |                          | Periods Ended September<br>30,<br>Nine Months |          |                          |
|--|--|----------|--------------------------|---|----------|--------------------------|
|  | 2006   | 2005     | Improvement<br>(Decline) | 2006  | 2005     | Improvement<br>(Decline) |
| Variable Portion of<br>Variable Annuity Deposits       | \$ 0.583                                       | \$ 0.553 | 5%                       | \$ 1.966                                      | \$ 1.637 | 20%                      |
| Variable Portion of<br>Variable Annuity<br>Withdrawals | (0.565)  | (0.548)  | -3%                      | (1.888)                                       | (1.556)  | -21%                     |
| Variable Portion of<br>Variable Annuity Net<br>Flows   | 0.018  | 0.005    | N/M                      | 0.078   | 0.081    | -4%                      |
| Fixed Portion of Variable<br>Annuity Deposits          | 0.111  | 0.133    | -17%                     | 0.350   | 0.432    | -19%                     |
| Fixed Portion of Variable<br>Annuity Withdrawals       | (0.265)  | (0.155)  | -71%                     | (0.716)                                       | (0.632)  | -13%                     |
| Fixed Portion of Variable<br>Annuity Net Flows         | (0.154)  | (0.022)  | N/M                      | (0.366)                                       | (0.200)  | 83%                      |
| Total Variable Annuity<br>Deposits                     | 0.694  | 0.686    | 1%                       | 2.316   | 2.069    | 12%                      |
| Total Variable Annuity<br>Withdrawals                  | (0.830)  | (0.703)  | -18%                     | (2.604)                                       | (2.188)  | -19%                     |
| Total Variable Annuity Net<br>Flows                    | (0.136)  | (0.017)  | N/M                      | (0.288)                                       | (0.119)  | 142%                     |
| Fixed Annuity Deposits                                 | 0.157  | 0.126    | 25%                      | 0.413   | 0.412    | 0%                       |
| Fixed Annuity Withdrawals                              | (0.162)  | (0.174)  | 7%                       | (0.383)                                       | (0.489)  | 22%                      |
| Fixed Annuity Net Flows                                | (0.005)  | (0.048)  | 90%                      | 0.030   | (0.077)  | 139%                     |
| Total Annuity Deposits                                 | 0.851  | 0.812    | 5%                       | 2.729   | 2.481    | 10%                      |
| Total Annuity Withdrawals                              | (0.992)  | (0.877)  | -13%                     | (2.987)                                       | (2.677)  | -12%                     |
| Total Annuity Net Flows                                | (0.141)  | (0.065)  | 117%                     | (0.258)                                       | (0.196)  | 32%                      |
| Alliance Mutual Fund<br>Deposits                       | 0.235  | 0.200    | 18%                      | 0.757   | 0.843    | -10%                     |
| Alliance Mutual Fund<br>Withdrawals                    | (0.057)  | (0.107)  | -47%                     | (0.168)                                       | (0.202)  | -17%                     |
| Total Alliance Mutual Fund<br>Net Flows                | 0.178  | 0.093    | 91%                      | 0.589   | 0.641    | -8%                      |
| Total Annuity and Alliance<br>Deposits                 | 1.086  | 1.012    | 7%                       | 3.486   | 3.324    | 5%                       |
| Total Annuity and Alliance<br>Withdrawals              | (1.049)  | (0.984)  | -7%                      | (3.155)                                       | (2.879)  | -10%                     |
| Total Annuity and Alliance<br>Net Flows                | \$ 0.037                                       | \$ 0.028 | 32%                      | \$ 0.331                                      | \$ 0.445 | -26%                     |
| Annuities Incremental<br>Deposits                      | \$ 0.829                                       | \$ 0.796 | 4%                       | \$ 2.672                                      | \$ 2.452 | 9%                       |
|  | 0.235  | 0.200    | 18%                      | 0.757   | 0.843    | -10%                     |



|  |    |       |    |       |    |    |       |    |       |    |
|--|----|-------|----|-------|----|----|-------|----|-------|----|
| Alliance Mutual Fund<br>Incremental Deposits<br>Total Annuities and<br>Alliance Incremental<br>Deposits <sup>(1)</sup> | \$ | 1.064 | \$ | 0.996 | 7% | \$ | 3.429 | \$ | 3.295 | 4% |
|--|----|-------|----|-------|----|----|-------|----|-------|----|

---

(1) Incremental Deposits represent gross deposits reduced by transfers from other segment products.

**Interest Rate Margins**

| Periods Ended September 30,   | Three Months |         |                                    | Nine Months |         |                                    |
|---|--------------|---------|------------------------------------|-------------|---------|------------------------------------|
|   | 2006         | 2005    | Increase (Decrease) (basis points) | 2006        | 2005    | Increase (Decrease) (basis points) |
| Net investment income yield   | 6.36%        | 6.25%   | 11                                 | 6.34%       | 6.26%   | 8                                  |
| Interest rate credited to policyholders   | 3.74%        | 3.67%   | 7                                  | 3.71%       | 3.68%   | 3                                  |
| Interest rate margin  | 2.62%        | 2.58%   | 4                                  | 2.63%       | 2.58%   | 5                                  |
| Effect on yield and interest rate margin from commercial mortgage loan prepayment and bond makewhole premiums | 0.14%        | 0.07%   | 7                                  | 0.14%       | 0.11%   | 3                                  |
| Interest rate margin adjusted   | 2.48%        | 2.51%   | (3)                                | 2.49%       | 2.47%   | 2                                  |
| Average fixed annuity account values (in billions)  | \$ 11.0      | \$ 11.0 |                                    | \$ 11.0     | \$ 10.9 |                                    |
| Effect on income from operations (after-tax, after-DAC) (in millions)   |              |         |                                    |             |         |                                    |
| Commercial mortgage loan prepayment and bond makewhole premiums   | \$ 1         | \$ 1    |                                    | \$ 4        | \$ 3    |                                    |

**Defined Contribution - Comparison of Three and Nine months Ended September 30, 2006 to 2005**

Income from operations for this segment's Defined Contribution business declined \$1 million, or 2%, and increased \$17 million, or 12%, for the three and nine months ended September 30, 2006 compared to the same periods in 2005, respectively. Third quarter results for 2006 and 2005 include favorable after-tax adjustments of \$2 million and \$12 million from the completion of our annual comprehensive review of assumptions underlying the amortization of DAC and VOBA. The third quarter of 2006 also includes a favorable tax adjustment primarily related to the separate account DRD. Excluding these items, income from operations for the three and nine month periods ended September 30, 2006 compared to the same 2005 periods benefited from increases in account values from cumulative positive net flows and improvement in the equity markets between periods.

*Revenues*

Insurance fees increased 2% in the third quarter and 8% in the first nine months of 2006 compared to the same periods in 2005 as a result of increases in average daily variable annuity account values. The increase in account values reflects cumulative positive net flows and improvement in the equity markets between periods. Excluding the impact of dividends, the S&P 500 index was 8.7% higher and the average daily S&P index was 7.1% higher in the first nine months of 2006 than the first nine months of 2005. Product sales, as measured by deposits, increased 7% in the third quarter of 2006, compared to the third quarter of 2005, across all product lines. Deposits for the first nine months of 2006 increased 5% over the same 2005 period as higher variable annuity sales more than offset lower Alliance mutual

fund deposits.

New deposits are an important component of our effort to grow the Defined Contribution business. Although deposits do not significantly impact current period income from operations, they are an important indicator of future profitability. Annuity deposits increased 5% in the third quarter of 2006 and 10% for the first nine months of 2006 compared to the same 2005 periods, primarily due to growth in the annuity-based 401(k) Director business.

Alliance program deposits were \$345 million and \$1.1 billion (including Alliance program fixed annuity deposits) in the third quarter and first nine months of 2006, an increase of 18% and a decline of 8%, respectively from the same 2005 periods. The Alliance program bundles our fixed annuity products with mutual funds, along with recordkeeping and employee education components. We earn fees for the services that we provide to mutual fund accounts and investment margins on fixed annuities of Alliance program accounts. The amounts associated with the Alliance mutual fund program are not included in the separate accounts reported in our Consolidated Balance Sheets. During the first nine months of 2006, we restructured the Alliance program sales organization and now have a dedicated team in place to focus on deposit growth going forward.

In October 2006, we terminated the relationship with the third-party wholesaler of our 401(k) Director product, after having provided a 90-day notice of termination in July. Although the effect of the termination on sale of the 401(k) Director product is still unknown, we do not expect the termination to have a material adverse effect on our results of operations.

The other component of net flows is lapse rates. Overall lapse rates were 13.1% and 13.2% for the three and first nine months ended September 30, 2006, compared to 12.0% and 12.4% for the third quarter and first nine months of 2005. In both periods, overall lapse rates have been more favorable than the level of persistency assumed in product pricing. We

believe that over time, the persistency of the employer-sponsored business tends to be higher than in the individual annuity marketplace as employer-sponsored products involve systematic deposits, are part of an overall employee benefit plan, and are generally not subject to the level of exchange activity typically experienced in the individual marketplace.

Net investment income increased 5% in the three and nine month periods ended September 30, 2006, compared with the same 2005 periods. The increases were due to growth in fixed annuity account values. The increase also includes \$4 million and \$11 million from commercial mortgage loan prepayment and bond makewhole premiums for the third quarter and first nine months of 2006 compared to \$2 million and \$9 million for the same 2005 periods.

A portion of the investment income in this segment is credited to our fixed annuity policyholders. The interest credited to policyholders is included in the segment's expenses. As stated above, annuity product interest rate margins represent the excess of the yield on earning assets over the average crediting rate. The yield on earning assets is calculated as net investment income on fixed product investment portfolios divided by average earning assets. The average crediting rate is calculated using interest credited on annuity products divided by the average fixed account values. Interest credited to policyholder balances increased for the third quarter and first nine months of 2006 compared to the same 2005 periods as a result of higher average fixed account values and higher average crediting rates.

The interest rate margin table above summarizes the effect of changes in the portfolio yield, the rate credited to policyholders, as well as the impact of prepayment premiums on results on an after-DAC, after-tax basis. The interest rate margin increased to 2.62% for the third quarter of 2006 from 2.58% for the same 2005 period. This was driven by an increase in quarter-over-quarter investment income yield, partially offset by an increase in crediting rates. After removing the effects of prepayment premiums, the interest rate margin was 2.48% for the third quarter of 2006 compared to 2.51% for the third quarter of 2005. In response to the competitive environment, we increased crediting rates in April 2006 by 10 basis points for a series of our fixed annuity products with approximately \$6 billion of account values. Effective October 1, 2006, we increased the crediting rates for these products by an additional 10 basis points. We are currently evaluating further crediting rate actions, with the expectation of maintaining stable spreads over the near term, excluding the effects of prepayment premiums. For information on interest rate margins and the interest rate risk due to falling interest rates, see "Item 3 - Quantitative and Qualitative Disclosures About Market Risk" of this Form 10-Q.

#### *Benefits and Expenses*

Interest credited to policyholders is included in insurance benefits and increased 2% in the third quarter and first nine months of 2006, compared to the same periods in 2005. The increase is a result of the increase in crediting rates discussed above. See the table above for the interest rate credited to policyholders.

Underwriting, acquisition, insurance and other expenses increased 21% and 5% for the third quarter and first nine months of 2006, respectively, compared to the same 2005 periods. These increases were primarily the result of less favorable DAC/VOBA adjustments as discussed below, higher incentive compensation accruals and a change in expense allocation methodology put into effect in the second quarter of 2006 as a result of the Jefferson-Pilot merger, which shifted expenses to other business segments. The change in methodology was not material to the other segments and did not affect consolidated expenses.

During the third quarter of 2006, we conducted our annual comprehensive review of the assumptions underlying the amortization of DAC, VOBA and DFEL. As a result of this comprehensive review, for the three and nine months ended September 30, 2006, the segment had DAC/VOBA/DFEL net prospective positive unlocking adjustment of \$7 million pre-tax (\$5 million after-tax). The adjustments primarily reflect a lower long-term interest rate assumption and favorable margins, partially offset by lower persistency assumptions. The comprehensive review during the third quarter of 2006 is not expected to significantly affect on-going amortization expense.

As a result of the annual comprehensive review conducted in the third quarter of 2005, for the three and nine months ended September 30, 2005, the segment had DAC/VOBA/DFEL net prospective positive unlocking adjustment of \$22 million pre-tax (\$14 million after-tax). The adjustments were the result of improved retention assumptions.

A portion of the variable annuity contracts in the segment contain GMDB's in the form of a Return of Premium ("ROP") GMDB feature, which guarantees a return of premiums adjusted for any withdrawals. At September 30, 2006, approximately \$13.8 billion, or 60%, of variable annuity contract account values contained an ROP death benefit feature and the net amount at risk related to these contracts was \$23 million. The remaining variable annuity contract account values, including all the 401(k) Director product, contain no GMDB feature.

*Federal Income Taxes*

Federal income tax expense for the third quarter and first nine months of 2006 include a reduction of \$3 million related to a favorable true-up to the 2005 tax return primarily relating to the separate accounts DRD. The estimate for 2006 is not expected to significantly affect ongoing quarterly earnings. For additional information, see Note 4 to the unaudited Consolidated Financial Statements.

*Executive Benefits***Executive Benefits**

|   | Three Months Ended<br>September 30 |       |                        | Nine Months Ended<br>September 30 |       |                        |
|---|------------------------------------|-------|------------------------|-----------------------------------|-------|------------------------|
|   | 2006                               | 2005  | Increase<br>(Decrease) | 2006                              | 2005  | Increase<br>(Decrease) |
| <b>Operating Summary (in millions)</b>                  |                                    |       |                        |                                   |       |                        |
| <b>Operating Revenues:</b>                              |                                    |       |                        |                                   |       |                        |
| Insurance fees  | \$ 12                              | \$ 13 | -8%                    | \$ 33                             | \$ 26 | 27%                    |
| Net investment income                                   | 91                                 | 45    | 102%                   | 226                               | 136   | 66%                    |
| Other revenues and fees                                 | 1                                  | 1     | 0%                     | 4                                 | 4     | 0%                     |
| Total Operating Revenues                                | 104                                | 59    | 76%                    | 263                               | 166   | 58%                    |
| <b>Operating Expenses:</b>                              |                                    |       |                        |                                   |       |                        |
| Insurance benefits                                      | 75                                 | 50    | 50%                    | 188                               | 132   | 42%                    |
| Underwriting, acquisition, insurance and other expenses | 12                                 | 6     | 100%                   | 24                                | 22    | 9%                     |
| Total Operating Expenses                                | 87                                 | 56    | 55%                    | 212                               | 154   | 38%                    |
| Income from operations before taxes                     | 17                                 | 3     | NM                     | 51                                | 12    | NM                     |
| Federal income taxes                                    | 4                                  | -     | NM                     | 15                                | 2     | NM                     |
| Income from Operations                                  | \$ 13                              | \$ 3  | 333%                   | \$ 36                             | \$ 10 | 260%                   |

**Net Flows and Account Values**

| (in billions)                                | Three Months Ended<br>September 30, |          |                        | Nine Months Ended<br>September 30, |          |                        |
|--|-------------------------------------|----------|------------------------|------------------------------------|----------|------------------------|
|  | 2006                                | 2005     | Increase<br>(Decrease) | 2006                               | 2005     | Increase<br>(Decrease) |
| <b>COLI/BOLI- Balance</b>                    |                                     |          |                        |                                    |          |                        |
| <b>Beginning-of-Period</b>                   | \$ 4.228                            | \$ 1.194 | 254%                   | \$ 1.318                           | \$ 1.122 | 17%                    |
| Business acquired                            | -                                   | -        | NM                     | 2.795                              | -        | NM                     |
| Deposits                                     | 0.058                               | 0.057    | 2%                     | 0.182                              | 0.158    | 15%                    |
| Withdrawals & deaths                         | (0.069)                             | (0.015)  | NM                     | (0.118)                            | (0.046)  | 157%                   |
| Net flows                                    | (0.011)                             | 0.042    | NM                     | 0.064                              | 0.112    | -43%                   |
| Policyholder assessments                     | (0.016)                             | (0.008)  | 92%                    | (0.042)                            | (0.024)  | 75%                    |
| Interest credited and change in market value | 0.051                               | 0.028    | 82%                    | 0.117                              | 0.046    | 267%                   |
| <b>COLI/BOLI-Balance</b>                     |                                     |          |                        |                                    |          |                        |
| <b>End-of-Period</b>                         | \$ 4.252                            | \$ 1.256 | 239%                   | \$ 4.252                           | \$ 1.256 | 238%                   |

September 30,

|  |    | <b>2006</b> |    | <b>2005</b> |      |
|--|----|-------------|----|-------------|------|
| COLI/BOLI - In-Force                       | \$ | 15.342      | \$ | 7.506       | 104% |
| Institutional Pensions -<br>Account Values | \$ | 2.711       | \$ | 2.877       | -6%  |

### **Executive Benefits - Comparison of Three and Nine months Ended September 30, 2006 to 2005**

Income from operations for Executive Benefits business increased \$10 million and \$26 million for the three months and nine months ended September 30, 2006 compared to the same periods in 2005, respectively, due primarily to the April 2006 merger with Jefferson-Pilot. Excluding the effects of the merger, growth in our COLI/BOLI in-force also contributed to the increases. Mortality in the Institutional Pension business was unfavorable for the third quarter of 2006 compared to the third quarter of 2005, but remained favorable for the first nine months of 2006 compared to the same 2005 period.

#### *Revenues*

Insurance fees for this business declined 8% and increased 27% for the third quarter and first nine months of 2006, respectively, primarily as a result of the Jefferson-Pilot BOLI business.

Included in the COLI/BOLI acquired with the Jefferson-Pilot companies are life insurance products sold to community banks, which accounted for \$2 billion in policyholder fund balances. At September 30, 2006, VOBA balances, net of unearned revenue reserves, related to these blocks was approximately \$123 million. These policies, which are generally not subject to surrender charges, are owned by several thousand policyholders. These policies were primarily

originated through, and continue to be serviced by, two marketing organizations. The surrender rate for this product may increase beyond current experience due to the absence of surrender charges and rising interest rates that may result in returns available to policyholders on competitors' products being more attractive than on our policies in force. The following factors may influence policyholders to continue these coverages: 1) our ability to adjust crediting rates; 2) relatively high minimum rate guarantees; 3) the difficulty of re-underwriting existing and additional covered lives; and 4) unfavorable tax attributes of certain surrenders. Our assumptions for amortizing VOBA and unearned revenue for these policies reflect a higher long-term expected lapse rate than other blocks of business due to the factors noted above. Lapse experience for this block in a particular period could vary significantly from our long-term lapse assumptions.

Net investment income increased 102% and 66% in the three- and nine-month periods ended September 30, 2006, respectively, compared with the same 2005 periods. The increases were driven principally by the Jefferson-Pilot merger.

#### *Benefits and Expenses*

Insurance benefits, which includes interest credited to policyholders, increased \$25 million, or 50%, in the third quarter and \$56 million, or 42%, in the first nine months of 2006, compared to the same periods in 2005. The increase is primarily due to interest credited to Jefferson-Pilot policyholders. On July 1, 2006 we implemented a 25 basis point increase in crediting rates on our Jefferson-Pilot ESP/BOLI business. Excluding the increase from Jefferson-Pilot companies, insurance benefits for 2006 were essentially level with the same 2005 periods, as increased interest credited on the COLI/BOLI business from growth in account values and rate increases was offset by favorable mortality in the institutional pension business.

Underwriting, acquisition, insurance and other expenses increased \$6 million, or 100%, and \$2 million, or 9%, for the third quarter and first nine months of 2006, respectively, compared to the same 2005 periods. These increases were primarily the result of inclusion of the Jefferson-Pilot ESP/BOLI business and higher incentive compensation accruals, partially offset by a change in expense allocation methodology put into effect in the third quarter of 2006 as a result of the April 2006 Jefferson-Pilot merger. The change in methodology did not affect consolidated expenses.

During the third quarters of 2006 and 2005, we conducted our annual comprehensive reviews of the assumptions underlying the amortization of DAC, VOBA and DFEL. Adjustments to expenses resulting from these reviews were not significant for this business. Also included in acquisition expenses is retrospective unlocking of DAC/VOBA/DFEL, which was not significant for the 2006 periods and the third quarter of 2005. Retrospective unlocking for the first nine months of 2005 resulted in an unfavorable adjustment of \$2 million pre-tax (\$1 million after-tax) due to less favorable persistency.



**Employer Markets - Group Protection**

The Group Protection segment, formerly referred to as Benefit Partners, offers group life, disability, and dental insurance to employers. The segment's products are marketed primarily through a national distribution system of regional group offices. These offices develop business through employee benefit brokers, third-party administrators and other employee benefit firms. The Group Protection segment was added as a result of our merger with Jefferson-Pilot. Therefore, its results are included in our consolidated results effective with the second quarter 2006.

|   | <b>Three Months<br/>Ended<br/>September 30,<br/>2006</b> | <b>Nine Months<br/>Ended<br/>September 30,<br/>2006<sup>(1)</sup></b> |
|---|--|---|
| <b>Operating Summary (in millions)</b>                  |  |   |
| <b>Operating Revenues:</b>                              |  |   |
| Insurance premiums                                      | \$ 304   | \$ 633  |
| Net investment income                                   | 27   | 52  |
| Other revenues and fees                                 | 1  | 2   |
| Total Operating Revenues                                | 332  | 687   |
| <b>Operating Expenses:</b>                              |  |   |
| Insurance benefits                                      | 213  | 439   |
| Underwriting, acquisition, insurance and other expenses | 75   | 147   |
| Total Operating Expenses                                | 288  | 586   |
| Income from operations before taxes                     | 44   | 101   |
| Federal income taxes                                    | 15   | 35  |
| Income from Operations                                  | \$ 29  | \$ 66   |

<sup>(1)</sup> Reflects results from the closing of the Jefferson-Pilot merger on April 3, 2006

| <b>Product Line Data</b> | <b>Three Months Ended September 30,<br/>2006</b> |                            |                        | <b>Nine Months Ended September 30,<br/>2006</b> |                            |                        |
|--------------------------|--|----------------------------|------------------------|---|----------------------------|------------------------|
|                          | <b>Income<br/>from<br/>Operations</b>            | <b>Earned<br/>Premiums</b> | <b>Loss<br/>Ratios</b> | <b>Income<br/>from<br/>Operations</b>           | <b>Earned<br/>Premiums</b> | <b>Loss<br/>Ratios</b> |
| <b>(in millions)</b>     |  |                            |                        |   |                            |                        |
| Life                     | \$ 10  | \$ 110                     | 72.3%                  | \$ 23   | \$ 222                     | 70.1%                  |
| Disability               | 16   | 135                        | 64.5%                  | 37  | 268                        | 61.9%                  |
| Dental                   | 2  | 31                         | 71.7%                  | 4   | 63                         | 73.9%                  |
| Total Non-medical        | 28   | 276                        | 68.4%                  | 64  | 553                        | 66.6%                  |
| Other                    | 1  | 28                         |                        | 2   | 80                         |                        |
| Total                    | \$ 29  | \$ 304                     |                        | \$ 66   | \$ 633                     |                        |

**Expense Ratios**

General and Administrative  
Expenses  
to Earned Premiums

11.7%

10.6%

Total Expenses to Earned  
Premiums

24.5%

23.2%

Sales - Annualized Premium  
 Life, Disability and Dental  
 Combined

\$ 50

\$ 96

Income from operations for this segment was \$29 million and \$66 million for the third quarter and first nine months of 2006, respectively, and benefited from favorable claim experience on all products, particularly long-term disability. We recognize premiums for this segment as revenues and claims are incurred. Because group underwriting risks may change over time, management focuses on trends in loss ratios to compare actual experience with pricing expectations. The level of expenses is also an important driver of profitability for this segment, as group insurance contracts are offered within an environment that competes on the basis of price and service. Reported sales relate to long-duration contracts sold to new policyholders and new programs sold to existing policyholders. The trend in sales is an important indicator of development of business in force over time.

*Revenues*

57

---

The Employer Markets Group Protection segment did not experience any substantial change as a result of the merger. Insurance premiums for the third quarter and first nine months of 2006 increased modestly compared to similar periods in 2005 reported by Jefferson-Pilot prior to the merger. Sequentially, premiums declined from last quarter, largely due to lower premiums from its non-core Exec-U-Care® business. Premiums on this product are seasonal based on underlying claim reporting patterns, with the second quarter of the year reflecting higher premiums than other quarters. The Exec-U-Care® business provides an insured medical expense reimbursement vehicle to executives for non-covered health plan costs, produces significant revenues and benefits expenses for this segment but only a limited amount of segment income from operations. Discontinuance of this product would significantly impact segment revenues. Core non-medical premiums showed growth over comparable periods reported by Jefferson-Pilot in 2005, but sequentially were essentially flat due to lower sales. Sales have declined in part due to the adverse impact of premium rate increases implemented in prior quarters and weaker industry sales in general.

#### *Benefits and Expenses*

Policy benefits reflect a total non-medical loss ratio of 68.4% and 66.6% for the third quarter and first nine months of 2006, respectively, and were driven primarily by better than expected long-term disability results that we do not believe are sustainable. We experienced favorable long-term disability claims incidence and favorable claims terminations that significantly decreased our loss ratios and reduced policy benefits by \$8 million and \$20 million pre-tax, respectively, for the 2006 periods. Effective claims management contributed to the favorable claim termination experience. We believe that loss ratios in the low-to-mid 70s are more representative of longer-term expectations on this line of business. The discount rate used to calculate long-term disability and life waiver reserves is 5.27%.

Underwriting, acquisition, insurance and other expenses for the third quarter and first nine months of 2006 were at unit expense levels comparable to prior periods reported as Jefferson-Pilot. Excluding the effects of DAC and VOBA amortization, these expenses increased as a percentage of earned premiums due to increased incentive compensation accruals in the third quarter of 2006. During the third quarter of 2006, as a result of a review of assumptions for DAC amortization, we changed the DAC amortization period to 15 years, consistent with the period for VOBA, for all products except Dental, which remains at 7 years. This change was implemented retroactive to the merger date and did not have a significant effect on results.

**Investment Management**

| Operating Summary (in millions)                    | Three Months Ended<br>September 30 |       |                        | Nine Months Ended<br>September 30 |        |                        |
|--|------------------------------------|-------|------------------------|-----------------------------------|--------|------------------------|
|  | 2006                               | 2005  | Increase<br>(Decrease) | 2006                              | 2005   | Increase<br>(Decrease) |
| <b>Operating Revenues:</b>                         |                                    |       |                        |                                   |        |                        |
| Investment advisory fees                           | \$ 82                              | \$ 68 | 21%                    | \$ 242                            | \$ 185 | 31%                    |
| Investment advisory fees - insurance-related       | 24                                 | 25    | (4%)                   | 72                                | 74     | (3%)                   |
| Other revenues and fees                            | 34                                 | 30    | 13%                    | 101                               | 88     | 15%                    |
| Total Operating Revenues                           | 140                                | 123   | 14%                    | 415                               | 347    | 20%                    |
| <b>Operating Expenses:</b>                         |                                    |       |                        |                                   |        |                        |
| Operating and administrative expenses              | 120                                | 115   | 4%                     | 353                               | 334    | 6%                     |
| Total Operating Expenses                           | 120                                | 115   | 4%                     | 353                               | 334    | 6%                     |
| Income from operations before Federal income taxes | 20                                 | 8     | 150%                   | 62                                | 13     | 377%                   |
| Federal income taxes                               | 7                                  | 3     | 133%                   | 21                                | 5      | 320%                   |
| Income from Operations                             | \$ 13                              | \$ 5  | 160%                   | \$ 41                             | \$ 8   | 413%                   |

**Assets Under Management**

| September 30, (in billions)                                | 2006       | 2005       | Increase |
|--|------------|------------|----------|
| Retail-Equity  | \$ 36.954  | \$ 30.988  | 19%      |
| Retail-Fixed   | 10.521     | 9.371      | 12%      |
| Total Retail   | 47.475     | 40.359     | 18%      |
| Institutional-Equity                                       | 22.649     | 18.951     | 20%      |
| Institutional-Fixed  | 19.387     | 13.964     | 39%      |
| Total Institutional  | 42.036     | 32.915     | 28%      |
| Insurance-related Assets                                   | 67.410     | 43.095     | 56%      |
| Total Assets Under Management                              | \$ 156.921 | \$ 116.369 | 35%      |
| <b>Total Sub-advised Assets, included in above amounts</b> |            |            |          |
| Retail   | \$ 16.421  | \$ 14.319  | 15%      |
| Institutional  | 4.561      | 4.986      | (9%)     |
| Total Sub-advised Assets at the End of the Period          | \$ 20.982  | \$ 19.305  | 9%       |

**Net Flows**

| Periods Ended September<br>30, (in billions)   | Three Months |          |                        | Nine Months |           |                        |
|--|--------------|----------|------------------------|-------------|-----------|------------------------|
|  | 2006         | 2005     | Increase<br>(Decrease) | 2006        | 2005      | Increase<br>(Decrease) |
| <b>Retail:</b>                                 |              |          |                        |             |           |                        |
| Equity:  |              |          |                        |             |           |                        |
| Fund deposits                                  | \$ 1.516     | \$ 2.630 | -42%                   | \$ 6.834    | \$ 8.719  | -22%                   |
| Redemptions and transfers                      | (1.999)      | (1.211)  | 65%                    | (6.019)     | (4.178)   | 44%                    |
| Net flows-Equity                               | (0.483)      | 1.419    | NM                     | 0.815       | 4.541     | -82%                   |
| Fixed Income:                                  |              |          |                        |             |           |                        |
| Fund deposits                                  | 0.981        | 0.942    | 4%                     | 2.965       | 2.753     | 8%                     |
| Redemptions and transfers                      | (0.798)      | (0.641)  | 24%                    | (2.453)     | (2.000)   | 23%                    |
| Net flows-Fixed Income                         | 0.183        | 0.301    | -39%                   | 0.512       | 0.753     | -32%                   |
| Total Retail:                                  |              |          |                        |             |           |                        |
| Fund deposits                                  | 2.497        | 3.572    | -30%                   | 9.799       | 11.472    | -15%                   |
| Redemptions and transfers                      | (2.797)      | (1.852)  | 51%                    | (8.472)     | (6.178)   | 37%                    |
| Net flows-Total Retail                         | (0.300)      | 1.720    | NM                     | 1.327       | 5.294     | -75%                   |
| <b>Institutional:</b>                          |              |          |                        |             |           |                        |
| Equity:  |              |          |                        |             |           |                        |
| Inflows/deposits                               | 1.274        | 2.131    | -40%                   | 4.367       | 7.431     | -41%                   |
| Withdrawals and transfers                      | (0.843)      | (0.948)  | -11%                   | (3.186)     | (2.693)   | 18%                    |
| Net flows-Equity                               | 0.431        | 1.183    | -64%                   | 1.181       | 4.738     | -75%                   |
| Fixed Income:                                  |              |          |                        |             |           |                        |
| Inflows/deposits                               | 1.133        | 1.036    | 9%                     | 5.847       | 4.038     | 45%                    |
| Withdrawals and transfers                      | (0.518)      | (0.393)  | 32%                    | (1.704)     | (1.731)   | -2%                    |
| Net flows-Fixed Income                         | 0.615        | 0.643    | -4%                    | 4.143       | 2.307     | 80%                    |
| Total Institutional:                           |              |          |                        |             |           |                        |
| Inflows/deposits                               | 2.407        | 3.167    | -24%                   | 10.214      | 11.469    | -11%                   |
| Withdrawals and transfers                      | (1.361)      | (1.341)  | 1%                     | (4.890)     | (4.424)   | 11%                    |
| Net flows-Total Institutional                  | 1.046        | 1.826    | -43%                   | 5.324       | 7.045     | -24%                   |
| <b>Combined Retail and Institutional:</b>      |              |          |                        |             |           |                        |
| Deposits/inflows                               | 4.904        | 6.739    | -27%                   | 20.013      | 22.941    | -13%                   |
| Redemptions, withdrawals<br>and transfers      | (4.158)      | (3.193)  | 30%                    | (13.362)    | (10.602)  | 26%                    |
| Net flows-Combined Retail<br>and Institutional | \$ 0.746     | \$ 3.546 | -79%                   | \$ 6.651    | \$ 12.339 | -46%                   |

Note: The term deposits, in the above table and in the following discussion, represents purchases of mutual funds and managed accounts, deposits in variable annuity funds, and inflows in advisory accounts.

### **Investment Management - Comparison of Three and Nine months Ended September 30, 2006 to 2005**

Income from operations for the third quarter and first nine months of 2006 was \$13 million and \$41 million, respectively, compared to \$5 million and \$8 million for the same 2005 periods. These improvements were driven by growth in assets under management. In addition, the 2005 periods include expenses associated with investment talent acquisitions.

#### *Revenues, Deposits and Net Flows*

Investment advisory fees increased 21% and 31% for the third quarter and first nine months of 2006 compared to the same periods in 2005, due to a higher average level of assets under management resulting from positive net flows and changes in product mix, and improved returns in the equity markets. We believe that changes in the management of certain asset category offerings and the recognition in the marketplace of improving investment performance are the primary drivers of the increase in the asset base and continued growth in net flows. The level of net flows may vary considerably from period to period and net flows in one quarter may not be indicative of net flows in subsequent quarters.

Investment advisory fees include amounts that are ultimately paid to sub-advisors for managing the sub-advised assets. The amounts paid to sub-advisors are included in the segment's expenses. In addition, included in the investment advisory fees—external are fees earned from managing funds included within our variable annuity and life insurance products.

Investment advisory fees - insurance-related is made up of fees for asset management services this segment provides for our general account assets supporting our fixed products and surplus, including those of the Individual and Employer Markets businesses. In the second quarter of 2006, we lowered the fees being charged for this service to 9 basis points on

assets managed from 16 basis points. The effect on revenue was generally offset by an increase in general account assets from the Jefferson-Pilot merger.

The increase in assets under management from September 30, 2005 to 2006 is primarily the result of positive net flows, market value gains and the increase in general account assets from the Jefferson-Pilot merger. Net flows for the twelve months ended September 30, 2006, were \$2.5 billion in retail and \$7.1 billion in institutional. Market value gains were \$4.6 billion in retail and \$2.1 billion in institutional for the same period.

The International ADR managed accounts product currently sub-advised by Mondrian Investment Partners was closed to new investors in the second quarter of 2006. This closure was primarily driven by investment considerations surrounding capacity limitations and the need to protect the interests of our existing customers. Compared to the same 2005 periods, our flow of funds from new managed accounts declined as a result of this product closing for the three- and nine-month periods ended September 30, 2006. Our International Value team offers an alternative to the closed International product. Although impacting the growth of deposits and the level of investment advisory fees, the closing of the International ADR managed accounts has not had an adverse material effect on our results of operations.

In May 2006, we closed several Large Cap Growth products to new accounts. These products remain open to contributions from existing accounts. This product had experienced significant growth in the last several quarters prior to closing. Similar to the International ADR product, this closure was primarily driven by investment considerations surrounding capacity limitations and the need to protect the interests of our existing customers. Although impacting the growth of deposits and the level of investment advisory fees, the closing of this product has not had an adverse material effect on our results of operations.

#### *Expenses*

Operating and administrative expenses increased 4% in the third quarter and 6% for the first nine months of 2006 compared to the same periods in 2005, primarily from expenses that vary with revenues and levels of assets under management. Unlike the capitalization of acquisition costs with insurance products, the capitalization of acquisition costs of new business in the asset management business is limited to the back-end sales charges for certain classes of shares. Operating and administrative expenses first nine months of 2005 include the second quarter 2005 additions of a large cap equity growth team and an international equity team.

**Lincoln UK**

|   | Three Months Ended<br>September 30 |       |                        | Nine Months Ended<br>September 30 |       |                        |
|---|------------------------------------|-------|------------------------|-----------------------------------|-------|------------------------|
|   | 2006                               | 2005  | Increase<br>(Decrease) | 2006                              | 2005  | Increase<br>(Decrease) |
| <b>Operating Summary (in millions)</b>                  |                                    |       |                        |                                   |       |                        |
| <b>Operating Revenues:</b>                              |                                    |       |                        |                                   |       |                        |
| Insurance premiums                                      | \$ 21                              | \$ 17 | 24%                    | \$ 58                             | \$ 48 | 21%                    |
| Insurance fees  | 33                                 | 65    | -49%                   | 112                               | 147   | -24%                   |
| Net investment income                                   | 18                                 | 21    | -14%                   | 53                                | 61    | -13%                   |
| Total Operating Revenues                                | 72                                 | 103   | -30%                   | 223                               | 256   | -13%                   |
| <b>Operating Expenses:</b>                              |                                    |       |                        |                                   |       |                        |
| Insurance benefits                                      | 25                                 | 35    | -29%                   | 78                                | 89    | -12%                   |
| Underwriting, acquisition, insurance and other expenses | 34                                 | 53    | -36%                   | 101                               | 121   | -17%                   |
| Total Operating Expenses                                | 59                                 | 88    | -33%                   | 179                               | 210   | -15%                   |
| Income before taxes                                     | 13                                 | 15    | -13%                   | 44                                | 46    | -4%                    |
| Federal income taxes                                    | 5                                  | 5     | 0%                     | 15                                | 16    | -6%                    |
| Income from Operations                                  | \$ 8                               | \$ 10 | -20%                   | \$ 29                             | \$ 30 | -3%                    |

| September 30, (in billions)                          | 2006   | 2005   | Increase<br>(Decrease) |
|--|--------|--------|------------------------|
| Unit-Linked Assets                                   | \$ 8.1 | \$ 7.2 | 13%                    |
| Individual Life Insurance In-Force                   | 18.5   | 18.2   | 2%                     |
| Exchange Rate Ratio-U.S. Dollars to Pounds Sterling: |        |        |                        |
| Average for the Period                               | 1.878  | 1.779  | 6%                     |
| End of Period  | 1.872  | 1.764  | 6%                     |

**Lincoln UK - Comparison of Three and Nine months Ended September 30, 2006 to 2005***Revenues*

The average exchange rate for the U.S. dollar relative to the British pound sterling increased 6% for the third quarter of 2006 and declined 1% for the first nine months of 2006 compared to the same periods in 2005. Excluding the effect of the exchange rate, insurance premiums increased 18% and 22%, respectively, for the third quarter of 2006 and first nine months of 2006 compared to the same periods in 2005. The increase in insurance premiums reflects an increase in the annuitization of vesting pension policies. The receipt of these premiums results in a corresponding increase in benefits. Our annualized policy lapse rate, as measured by the number of policies in-force, improved slightly to 6.7% for the nine months ended September 30, 2006, compared to 7.0% for the comparable 2005 period. Excluding the effects of exchange rates, insurance fees declined 52% and 23%, respectively, for the third quarter and first nine months of 2006 compared to the same periods in 2005, which were driven by adjustments from the completion of our third quarter comprehensive assumption reviews for 2006 and 2005, as discussed below.

Comprehensive reviews of the assumptions underlying the amortization of DAC/VOBA/DFEL were completed in the third quarters of 2006 and 2005 which resulted in impacts to income from operations of \$(4) million pre-tax (\$(3) million after-tax) and \$3 million pre-tax (\$2 million after-tax), respectively. The effect of these reviews on DFEL



resulted in a negative unlocking adjustment of \$11 million in the third quarter of 2006, compared with a positive unlocking adjustment of \$22 million in the third quarter of 2005. The adjustment for 2006 results from less favorable retention of pension assets, while a modeling change drove the 2005 adjustment. The impact of the unlocking of DAC and VOBA is included in expenses discussed below.

*Expenses*

Operating expenses were 33% lower in the third quarter of 2006 and 15% lower in the first nine months of 2006 compared to the same periods in 2005. Excluding the effect of the exchange rate, operating expenses were 36% and 14% lower in the first quarter and first nine months of 2006 than the same periods in 2005. The decrease in operating expenses was driven by adjustments from our annual comprehensive review of assumptions for the amortization of DAC/VOBA/DFEL conducted in the third quarters of 2006 and 2005. The 2006 comprehensive assumption review resulted in a net positive prospective unlocking adjustment of \$3 million for DAC and VOBA amortization, primarily due to favorable lapse rates. The comprehensive review of the assumptions underlying the amortization of DAC and VOBA

completed in the third quarter of 2005, resulted in a net negative prospective unlocking adjustment to DAC and VOBA amortization of \$18 million.

The services provided to the segment under the Capita agreement are currently deemed to be exempt from value added tax ("VAT"). In 2005, the European Court of Justice indicated that VAT should be applied to such an arrangement. The European Commission has announced that they are to conduct a review of the treatment of VAT within financial services. It is uncertain when this review will be completed and what the outcome will be. Future changes in the application of VAT to Lincoln UK's outsourcing arrangement with Capita could impact the segment's results, although we believe that any future change would not materially effect our consolidated financial position.

### **Lincoln Financial Media**

The Lincoln Financial Media segment consists of 18 radio and 3 television broadcasting stations located in selected markets in the Southeastern and Western United States and also produces and distributes syndicated collegiate basketball and football sports programming. Operations of this segment were acquired in the April 2006 merger with Jefferson-Pilot.

| <b>Operating Summary (in millions)</b>             | <b>Three Months<br/>Ended<br/>September 30,<br/>2006</b> | <b>Nine Months<br/>Ended<br/>September 30,<br/>2006<sup>(2)</sup></b> |
|--|--|---|
| <b>Operating Revenue</b>                           |  |   |
| Communications revenues (net) <sup>(1)</sup>       | \$ 60  | \$ 117  |
| <b>Operating Expenses</b>                          |  |   |
| Operating expenses                                 | 37   | 75  |
| Income from operations before Federal income taxes | 23   | 42  |
| Federal income taxes                               | 8  | 15  |
| <b>Income from Operations</b>                      | <b>\$ 15</b>   | <b>\$ 27</b>  |

<sup>(1)</sup> Communications revenues are net of commissions of \$8 million and \$17 million paid to agencies

<sup>(2)</sup> Reflects results from the closing of the Jefferson-Pilot merger on April 3, 2006

Communications revenues increased 1% in the third quarter of 2006 and the six month period since the merger, compared to the corresponding periods of the prior year. Earnings increased 5% in the third quarter of 2006, compared to the third quarter of 2005. In the six months since the merger, earnings decreased 8% from the comparable period of 2005, due mainly to the amortization expense discussed below.

Operating expenses and income from operations include amortization expenses for the third quarter and first nine months of 2006 of \$1 million pre-tax and \$4 million pre-tax, respectively, for intangibles arising from the application of purchase accounting related to the merger. The primary driver of the amortization in these periods is related to an intangible for advertising contracts that was fully amortized in the second quarter. The remaining intangible assets with a determinant useful life are valued at \$27 million at September 30, 2006 and are amortized over periods of 5 to 21 years. See Note 2 to the unaudited Consolidated Financial Statements for additional details.

Profitability for Lincoln Financial Media is seasonal and is principally influenced by such factors as retail events, special and sporting events and political advertising. Although, generally results are most favorable in the fourth

quarter, we expect full year results for 2006 to be in the low \$40 million range.

63

---

Because our broadcasting businesses rely on advertising revenues, they are sensitive to cyclical changes in both the general economy and in the economic strength of local markets. Advertising revenues from the automotive industry for our stations totaled 25% and 23% of their broadcasting revenues in the third quarter of 2006 and the six month period since the merger, respectively. If automotive advertising is curtailed, it could have a significant negative impact on broadcasting revenues. In both the third quarter and six months since the merger, 7% of television revenues came from a network agreement with our CBS-affiliated stations that expires in 2011. The trend in the industry is away from networks compensating affiliates for carrying their programming and there is a possibility those revenues will be eliminated when the contract is renewed. Many different businesses compete for available advertising sales in our markets, including newspapers, magazines, billboards and other radio and television broadcasters. Technological media changes, such as satellite radio and the internet, and consolidation in the broadcast and advertising industries, may increase competition for audiences and advertisers.

**Other Operations**

Other Operations includes investments related to amount of statutory surplus in our insurance subsidiaries that is not allocated to our business units, other corporate investments, benefit plan net assets, and the unamortized deferred gain on the indemnity reinsurance portion of the sales transaction for our former reinsurance segment, which was sold to Swiss Re Life & Health America Inc. ("Swiss Re") in 2001. Income from operations for Other Operations includes earnings on the investments, financial results for operations that are not directly related to the business segments, unallocated corporate items (such as corporate investment income and interest expense on short-term and long-term borrowings, and certain expenses, including restructuring and merger-related expenses) and the amortization of the deferred gain on the indemnity reinsurance portion of the transaction with Swiss Re.

| Operating Summary (in millions)                        | Three Months Ended<br>September 30 |       |                        | Nine Months Ended<br>September 30 |       |                        |
|--|------------------------------------|-------|------------------------|-----------------------------------|-------|------------------------|
|  | 2006                               | 2005  | Increase<br>(Decrease) | 2006                              | 2005  | Increase<br>(Decrease) |
| <b>Income (Loss) from Operations by Source:</b>        |                                    |       |                        |                                   |       |                        |
| Earnings on investments & other income                 | \$ 33                              | \$ 27 | 22%                    | \$ 94                             | \$ 89 | 6%                     |
| Amortization of deferred gain on indemnity reinsurance | 19                                 | 19    | 0%                     | 56                                | 57    | -2%                    |
| Interest on debt                                       | (67)                               | (21)  | 219%                   | (152)                             | (65)  | 134%                   |
| Operating expenses                                     | (12)                               | (29)  | -59%                   | (71)                              | (86)  | -17%                   |
| Income (loss) from operations before taxes             | (27)                               | (4)   | NM                     | (73)                              | (5)   | NM                     |
| Federal income tax benefit                             | (16)                               | (16)  | 0%                     | (35)                              | (49)  | 29%                    |
| Income (Loss) from Operations                          | \$ (11)                            | \$ 12 | NM                     | \$ (38)                           | \$ 44 | NM                     |

**Other Operations - Comparison of Three and Nine months Ended September 30, 2006 to 2005**

Earnings on investments and other income increased 22% for the three month period ended September 30, 2006, and 6% for the first nine months of 2006, respectively, compared to the same 2005 periods. The increases for the third quarter and nine months ended September 30, 2006 compared to the same 2005 periods resulted from investment income from the Jefferson-Pilot companies for the period. Earnings on investments and other income for the third quarter of 2005 includes higher investment income on investment partnerships, and for the first nine months of 2005 \$26 million pre-tax of fees from standby real estate equity commitments received in the second quarter of 2005. We utilize an internal formula to determine the amount of capital that is allocated to our business segments. Investment income on capital in excess of the calculated amounts is reported in Other Operations. During the third quarter, we also harmonized our policy for accounting and reporting for investment defaults by discontinuing the historical practice followed by Jefferson-Pilot of business segments reimbursing Other Operations for actual default experience through an inter-company charge referred to as the default charge. This change in default methodology decreased income from operations for Other Operations by \$8 million after-tax, with an offsetting increase in our other segments. Accordingly, this change did not have an effect on consolidated income from operations.

Interest on debt for the third quarter and first nine months of 2006 increased 219% and 134%, respectively, compared to the same 2005 periods. Corporate borrowings increased \$2.8 billion in the nine months ended September 30, 2006,

including approximately \$2.1 billion used to finance the \$1.8 billion cash portion of the Jefferson-Pilot merger consideration and the \$500 million stock repurchase. The increase also includes \$0.9 billion for the fair value of Jefferson-Pilot corporate debt.

Operating expenses decreased 59% and 16% for the third quarter and first nine months of 2006, respectively, compared to the same periods in 2005. Included in operating expenses for the 2006 periods is \$26 million of recoveries from insurers related to U.K. mis-selling losses. Operating expenses in the three and nine month periods ended September 30, 2006 include expenses of \$13 million and \$30 million, respectively, related to the merger with Jefferson-Pilot for related integration costs, including restructuring charges. In 2005, we had restructuring charges of \$3 million and \$28 million for the three and nine month periods ended September 30, 2005, which related to our 2005 restructuring activities in our retail distribution unit and the 2003 restructuring plan related to the realignment of our business units. See Note 12 to the unaudited Consolidated Financial Statements for additional information.

Included in income from operations for the three and nine month periods ended September 30, 2005 are reductions in Federal income tax expense of \$13 million and \$43 million, respectively, related to partial releases of a deferred tax allowance in our Barbados insurance company.

**CONSOLIDATED INVESTMENTS**

The following table presents consolidated invested assets, net investment income and investment yield.

| <b>(in billions)</b>   | <b>September 30,</b>      |       | <b>December 31,</b>      |       | <b>September 30,</b> |       |
|--|---------------------------|-------|--------------------------|-------|----------------------|-------|
|  | <b>2006</b>               |       | <b>2005</b>              |       | <b>2005</b>          |       |
| Total Consolidated Investments (at Fair Value)                               | \$                        | 71.6  | \$                       | 43.2  | \$                   | 44.1  |
| Average Invested Assets (at Amortized Cost) <sup>(1)</sup>                   |                           | 62.0  |                          | 43.9  |                      | 43.9  |
|  | <b>Three Months Ended</b> |       | <b>Nine Months Ended</b> |       |                      |       |
|  | <b>September 30,</b>      |       | <b>September 30,</b>     |       |                      |       |
| <b>(\$ in millions)</b>  | <b>2006</b>               |       | <b>2005</b>              |       | <b>2006</b>          |       |
| Net Investment Income  | \$                        | 1,108 | \$                       | 671   | \$                   | 2,855 |
| Investment Yield (ratio of net investment income to average invested assets) |                           | 6.27% |                          | 6.09% |                      | 6.14% |
|  |                           |       |                          |       |                      | 6.18% |
| <b>Items Included in Net Investment Income:</b>                              |                           |       |                          |       |                      |       |
| Limited partnership investment income  | \$                        | (9)   | \$                       | 14    | \$                   | 18    |
| Prepayment and makewhole premiums  |                           | 26    |                          | 5     |                      | 51    |
| Standby real estate equity commitments <sup>(2)</sup>                        |                           | -     |                          | -     |                      | 26    |

<sup>(1)</sup> Based on the average of invested asset balances at the beginning and ending of each quarter within the period.

<sup>(2)</sup> Represents income earned during the second quarter of 2005 that was in excess of ordinary income amounts.

The increase in our investment portfolio for the first nine months of 2006 is primarily the result of the Jefferson-Pilot merger, which added \$27.9 billion of investment assets after purchase accounting adjustments, and by purchases of investments as a result of cash flow generated by our business segments. The increase was partially offset by a decline in the fair value of securities available-for-sale.

Diversification across asset classes is fundamental to our investment policy. Our investment portfolio, excluding cash and invested cash, is composed of fixed maturity securities, mortgage loans on real estate, real estate either wholly owned or in joint ventures and other long-term investments. We purchase investments for our segmented portfolios that have yield, duration and other characteristics that take into account the liabilities of the products being supported. The dominant investments held are fixed maturity securities available-for-sale, which represent approximately 78.0% of the investment portfolio. Trading securities, which are primarily fixed maturity securities, represent approximately 4.4% of the investment portfolio.

We have the ability to maintain our investment holdings throughout credit cycles because of our capital position, the long-term nature of our liabilities and the matching of our portfolios of investment assets with the liabilities of our various products.

The quality of our available-for-sale fixed maturity securities portfolio, as measured at fair value and by the percentage of fixed maturity securities invested in various ratings categories, relative to the entire available-for-sale fixed maturity security portfolio, as of September 30, 2006 was as follows:

| <b>NAIC Designation</b> | <b>Rating Agency<br/>Equivalent Designation</b> | <b>Amortized<br/>Cost<br/>(in millions)</b> | <b>Estimated<br/>Fair Value</b> | <b>% of<br/>Total</b> |
|-------------------------|---|---|---------------------------------|-----------------------|
| 1                       | AAA / AA / A                                    | \$ 32,511                                   | \$ 33,081                       | 59.3%                 |
| 2                       | BBB   | 18,788                                      | 19,058                          | 34.1%                 |
| 3                       | BB  | 2,297                                       | 2,343                           | 4.2%                  |
| 4                       | B   | 1,173                                       | 1,170                           | 2.1%                  |
| 5                       | CCC and lower                                   | 141   | 147                             | 0.3%                  |
| 6                       | In or near default                              | 21  | 25                              | 0.0%                  |
|                         |   | \$ 54,931                                   | \$ 55,824                       | 100.0%                |



The National Association of Insurance Commissioners (“NAIC”) assigns securities quality ratings and uniform valuations called “NAIC Designations” which are used by insurers when preparing their annual statements. The NAIC assigns designations to publicly traded as well as privately placed securities. The designations assigned by the NAIC range from class 1 to class 6, with designations in classes 1 and 2 generally considered investment grade.

Fixed maturity securities available-for-sale invested in below investment grade securities (NAIC designations 3 thru 6) were \$3.7 billion, or 6.6%, and \$2.5 billion, or 7.5%, of all fixed maturity securities available-for-sale, as of September 30, 2006 and December 31, 2005, respectively. This represents 5.1% of the total investment portfolio at September 30, 2006 compared to 5.8% at December 31, 2005. On an amortized cost basis, below investment grade securities represented 6.6% of available-for-sale fixed maturity securities at September 30, 2006 compared to 7.6% at December 31, 2005.

**Fixed Maturity and Equity Securities Portfolios:** Fixed maturity securities and equity securities consist of portfolios classified as available-for-sale and trading. Mortgage-backed and private securities are included in both available-for-sale and trading portfolios.

*Available-for-Sale:* Securities that are classified as “available-for-sale” make up 95% of our fixed maturity and equity securities portfolio. These securities are carried at fair value on our Consolidated Balance Sheets. Changes in fair value, net of related DAC, amounts required to satisfy policyholder commitments and taxes, are charged or credited directly to shareholders’ equity. Changes in fair value that are other than temporary are recorded as realized losses in the Consolidated Statements of Income. This includes the recognition of other than temporary impairments of securities resulting from credit related issues, as well as declines in fair value related to rising interest rates, where we do not have the intent to hold the securities until either maturity or recovery.

*Trading Securities:* Trading securities, which support certain funds withheld and modco reinsurance arrangements, are carried at fair value and changes in fair value are recorded in net income as they occur. Investment results for these portfolios, including gains and losses from sales, are passed directly to the reinsurers through the contractual terms of the reinsurance arrangements. Offsetting these amounts are corresponding changes in the fair value of the embedded derivative liability associated with the underlying reinsurance arrangement.

*Mortgage-Backed Securities:* Our fixed maturity securities include mortgage-backed securities. These securities are subject to risks associated with variable prepayments, which may result in these securities having a different actual cash flow and maturity than expected at the time of purchase. We limit the extent of our risk on mortgage-backed securities by prudently limiting exposure to the asset class, by generally avoiding the purchase of securities with a cost that significantly exceeds par, by purchasing securities backed by stable collateral and by concentrating on securities with enhanced priority in their trust structure. Such securities with reduced risk typically have a lower yield (but higher liquidity) than higher-risk mortgage-backed securities. At selected times, higher-risk securities may be purchased if they do not compromise the safety of the general portfolio.

**Mortgage Loans on Real Estate and Real Estate:**

The following summarizes key information on mortgage loans:

| <b>(dollars in millions)</b>                                    | <b>September 30,<br/>2006</b> | <b>December 31,<br/>2005</b> |
|---|-------------------------------|------------------------------|
| Total Portfolio (net of reserves)                               | \$ 7,581                      | \$ 3,663                     |
| Percentage of total investment portfolio                        | 10.6%                         | 8.5%                         |
| Percentage of investment by property type                       |                               |                              |
| Commercial office buildings                                     | 33.1%                         | 40.9%                        |
| Retail stores   | 25.5%                         | 19.2%                        |
| Industrial buildings  | 21.4%                         | 18.9%                        |
| Apartments  | 11.5%                         | 11.5%                        |
| Hotels/motels   | 6.4%                          | 6.4%                         |
| Other   | 2.1%                          | 3.1%                         |
| <br>  |                               |                              |
| Impaired mortgage loans   | \$ 31                         | \$ 66                        |
| Impaired mortgage loans as a percentage of total mortgage loans | 0.4%                          | 1.8%                         |
| Restructured loans in good standing                             | \$ 56                         | \$ 45                        |
| Reserve for mortgage loans                                      | \$ 3                          | \$ 9                         |

In addition to the dispersion by property type, the mortgage loan portfolio is geographically diversified throughout the United States.

All mortgage loans that are impaired have an established allowance for credit loss. Changing economic conditions impact our valuation of mortgage loans. Changing vacancies and rents are incorporated into the discounted cash flow analysis that we perform for monitored loans and may contribute to the establishment of (or an increase or decrease in) an allowance for credit losses. In addition, we continue to monitor the entire commercial mortgage loan portfolio to identify risk. Areas of current emphasis are the hotel, retail, office and industrial properties that have deteriorating credits or have experienced debt coverage reduction. Where warranted, we have established or increased loss reserves based upon this analysis. Impaired mortgage loans were 0.4% and 1.8% of total mortgage loans at September 30, 2006 and December 31, 2005, respectively. As of September 30, 2006, and December 31, 2005, all commercial mortgage loans were current as to principal and interest payments.

**Limited Partnership Investments:** As of September 30, 2006 and December 31, 2005, our consolidated investments included limited partnership investments of \$472 million and \$312 million, respectively. These include investments in approximately 68 different partnerships that allow us to gain exposure to a broadly diversified portfolio of asset classes such as venture capital, hedge funds, and oil and gas. The partnerships do not represent off-balance sheet financing and generally involve several third-party partners. Select partnerships contain “capital calls” which require us to contribute capital upon notification by the general partner. These capital calls are contemplated during the initial investment decision and are planned for well in advance of the call date. The capital calls are not material in size and pose no threat to our liquidity. Limited partnership investments are accounted for using the equity method of accounting and the majority of these investments are included in other investments in the Consolidated Balance Sheets.

**Net Investment Income:** Net investment income increased 65% and 40% in the third quarter and first nine months of 2006, respectively, compared to the same 2005 periods. Excluding commercial mortgage loan prepayment and bond makewhole premiums, the increase in net investment income in the third quarter and first nine months of 2006 compared to the same periods in 2005 primarily reflects higher portfolio yields and higher invested assets due to the April 2006 Jefferson-Pilot merger, which added \$27.9 billion in invested assets, and the favorable effect of asset

growth from net flows.

As of September 30, 2006 and December 31, 2005, the carrying amount of fixed maturity securities, mortgage loans on real estate and real estate that were non-income producing was \$41 million and \$67 million, respectively.

The following discussion addresses our invested assets excluding trading account securities. As discussed above, investment results attributable to the trading securities are passed directly to the reinsurers under the terms of the reinsurance arrangements. See the discussion in our 2005 Form 10-K under "Consolidated Investments" for additional information regarding our investments.

**Realized Gains and Losses on Investments and Derivative Instruments:** We had net pre-tax realized losses on investments and derivatives of \$6 million and \$1 million for the three months ended September 30, 2006 and 2005, respectively, and \$20 million and \$12 million for the first nine months ended September 30, 2006 and 2005, respectively. Prior to the amortization of DAC, provision for policyholder commitments and investment expenses, pre-tax net realized gains were \$0.2 million and \$14 million for the three months ended September 30, 2006 and 2005, respectively and \$22 million and \$35 million for the first nine months ended September 30, 2006 and 2005, respectively.

68

---

Included within net realized losses are write-downs for other-than-temporary impairments on fixed maturities and equity securities of \$39 million and \$43 million for the three and nine months ended September 30, 2006, respectively, compared to \$6 million and \$18 million for the same periods in 2005. Included in the write-downs for the 2006 periods was \$39 million related to securities whose decline in fair value is related to changes in interest rates and for which we do not have the intent to hold the securities to recovery or maturity.

For additional information regarding our process for determining whether declines in fair value of securities available-for-sale are other than temporary, see “Critical Accounting Policies - Write-Downs for Other-Than Temporary Impairments and Allowance for Losses” in our 2005 Form 10-K.

**Unrealized Gains and Losses—Available-for-Sale Securities:** When considering unrealized gain and loss information, it is important to realize that the information relates to the status of securities at a particular point in time and may not be indicative of the status of our investment portfolios subsequent to the balance sheet date. Further, since the timing of the recognition of realized investment gains and losses through the selection of which securities are sold is largely at management’s discretion, it is important to consider the information provided below within the context of the overall unrealized gain or loss position of our investment portfolios. These are important considerations that should be included in any evaluation of the potential impact of unrealized loss securities on our future earnings.

At September 30, 2006 and December 31, 2005, gross unrealized gains on securities available-for-sale were \$1,317 million and \$1,380 million, respectively, and gross unrealized losses on securities available-for-sale were \$408 million and \$313 million, respectively. At September 30, 2006, gross unrealized gains and losses on fixed maturity securities available-for-sale were \$1,299 million and \$405 million, respectively, and gross unrealized gains and losses on equity securities available-for-sale were \$18 million and \$3 million, respectively. At December 31, 2005, gross unrealized gains and losses on fixed maturity securities available-for-sale were \$1,371 million and \$312 million, respectively, and gross unrealized gains and losses on equity securities available-for-sale were \$9 million and \$1 million, respectively. Changes in unrealized gains and losses can be attributed to changes in interest rates and credit spreads, which have created temporary price fluctuations. Interest rates rose during the first nine months of 2006 as indicated by a change in the 10-year treasury yield from 4.36% at December 31, 2005 to 4.64% at September 30, 2006.

For total publicly traded and private securities that we held at September 30, 2006 that were in an unrealized loss position, the fair value, amortized cost, unrealized loss and total time period that the security has been in an unrealized loss position are presented in the table below:

| (in millions)              | Fair Value | % Fair Value | Amortized Cost | % Amortized Cost | Unrealized Loss | % Unrealized Loss |
|----------------------------|------------|--------------|----------------|------------------|-----------------|-------------------|
| <= 90 days                 | \$ 1,409   | 7.9%         | \$ 1,429       | 7.8%             | (20)            | 4.9%              |
| > 90 days but <= 180 days  | 3,200      | 17.9%        | 3,243          | 17.7%            | (43)            | 10.5%             |
| > 180 days but <= 270 days | 4,992      | 27.9%        | 5,057          | 27.7%            | (65)            | 15.9%             |
| > 270 days but <= 1 year   | 5,262      | 29.4%        | 5,394          | 29.5%            | (132)           | 32.4%             |
| > 1 year                   | 3,026      | 16.9%        | 3,174          | 17.3%            | (148)           | 36.3%             |
| Total                      | \$ 17,889  | 100.0%       | \$ 18,297      | 100.0%           | (408)           | 100.0%            |

Edgar Filing: LINCOLN NATIONAL CORP - Form 10-Q

The composition by industry categories of securities that we held at September 30, 2006 in an unrealized loss position is presented in the table below:

| (in millions)                         | Fair Value | % Fair Value | Amortized Cost | % Amortized Cost | Unrealized Loss | % Unrealized Loss |
|---------------------------------------|------------|--------------|----------------|------------------|-----------------|-------------------|
| Collateralized Mortgage Obligations   | \$ 2,751   | 15.4%        | \$ 2,795       | 15.3%            | (44)            | 10.8%             |
| Banking                               | 1,849      | 10.3%        | 1,890          | 10.3%            | (41)            | 10.0%             |
| Automotive                            | 293        | 1.6%         | 333            | 1.8%             | (40)            | 9.8%              |
| Electric                              | 1,325      | 7.4%         | 1,351          | 7.4%             | (26)            | 6.4%              |
| Commercial Mortgage Backed Securities | 1,174      | 6.6%         | 1,196          | 6.5%             | (22)            | 5.4%              |
| Asset Backed Securities               | 892        | 5.0%         | 907            | 5.0%             | (15)            | 3.7%              |
| Food and Beverage                     | 585        | 3.3%         | 597            | 3.3%             | (12)            | 2.9%              |
| Sovereign                             | 302        | 1.7%         | 312            | 1.7%             | (10)            | 2.5%              |
| Media - Noncable                      | 380        | 2.1%         | 390            | 2.1%             | (10)            | 2.5%              |
| Chemicals                             | 176        | 1.0%         | 186            | 1.0%             | (10)            | 2.5%              |
| Paper                                 | 309        | 1.7%         | 319            | 1.7%             | (10)            | 2.5%              |
| Pipelines                             | 413        | 2.3%         | 423            | 2.3%             | (10)            | 2.5%              |
| Property & Casualty                   | 580        | 3.2%         | 589            | 3.2%             | (9)             | 2.2%              |
| Technology                            | 185        | 1.0%         | 194            | 1.1%             | (9)             | 2.2%              |
| Retailers                             | 227        | 1.3%         | 236            | 1.3%             | (9)             | 2.2%              |
| Entertainment                         | 291        | 1.6%         | 299            | 1.6%             | (8)             | 1.9%              |
| Government Sponsored Distributors     | 453        | 2.5%         | 460            | 2.5%             | (7)             | 1.7%              |
| Metals and Mining                     | 185        | 1.0%         | 192            | 1.0%             | (7)             | 1.7%              |
| Wirelines                             | 361        | 2.0%         | 368            | 2.0%             | (7)             | 1.7%              |
| Real Estate Investment Trusts         | 206        | 1.2%         | 213            | 1.2%             | (7)             | 1.7%              |
| Transportation Services               | 328        | 1.8%         | 334            | 1.8%             | (6)             | 1.5%              |
| Industrial - Other                    | 245        | 1.4%         | 250            | 1.4%             | (5)             | 1.2%              |
| Financial - Other                     | 240        | 1.3%         | 245            | 1.3%             | (5)             | 1.2%              |
| Consumer Products                     | 170        | 1.0%         | 175            | 1.0%             | (5)             | 1.2%              |
| Integrated                            | 191        | 1.1%         | 196            | 1.1%             | (5)             | 1.2%              |
| Home Construction                     | 150        | 0.8%         | 154            | 0.8%             | (4)             | 1.0%              |
| Brokerage                             | 164        | 0.9%         | 168            | 0.9%             | (4)             | 1.0%              |
| Independent                           | 175        | 1.0%         | 179            | 1.0%             | (4)             | 1.0%              |
| Building Materials                    | 253        | 1.4%         | 257            | 1.4%             | (4)             | 1.0%              |
| Conventional 30 Year                  | 259        | 1.4%         | 262            | 1.4%             | (3)             | 0.7%              |
| Oil Field Services                    | 153        | 0.9%         | 156            | 0.9%             | (3)             | 0.7%              |
| Gaming                                | 230        | 1.3%         | 233            | 1.3%             | (3)             | 0.7%              |
| Packaging                             | 82         | 0.5%         | 85             | 0.5%             | (3)             | 0.7%              |
| Wireless                              | 104        | 0.6%         | 107            | 0.6%             | (3)             | 0.7%              |
| Non-Agency                            | 118        | 0.7%         | 121            | 0.7%             | (3)             | 0.7%              |
| Diversified                           | 77         | 0.4%         | 79             | 0.4%             | (2)             | 0.5%              |
| Manufacturing                         | 214        | 1.2%         | 216            | 1.2%             | (2)             | 0.5%              |
| Municipal                             | 130        | 0.7%         | 132            | 0.7%             | (2)             | 0.5%              |
| Local Authorities                     | 62         | 0.3%         | 64             | 0.3%             | (2)             | 0.5%              |
| Lodging                               | 99         | 0.6%         | 101            | 0.6%             | (2)             | 0.5%              |

Edgar Filing: LINCOLN NATIONAL CORP - Form 10-Q

|                         |           |        |           |        |       |        |
|-------------------------|-----------|--------|-----------|--------|-------|--------|
| Non-Captive Diversified | 113       | 0.6%   | 115       | 0.6%   | (2)   | 0.5%   |
| Non Captive Consumer    | 169       | 0.9%   | 171       | 0.9%   | (2)   | 0.5%   |
| Airlines                | 65        | 0.4%   | 67        | 0.4%   | (2)   | 0.5%   |
| Pharmaceuticals         | 106       | 0.6%   | 108       | 0.6%   | (2)   | 0.5%   |
| Textile                 | 48        | 0.3%   | 50        | 0.3%   | (2)   | 0.5%   |
| Railroads               | 100       | 0.6%   | 102       | 0.6%   | (2)   | 0.5%   |
| Healthcare              | 153       | 0.9%   | 155       | 0.8%   | (2)   | 0.5%   |
| Consumer Cyclical       |           |        |           |        |       |        |
| Services                | 57        | 0.3%   | 58        | 0.3%   | (1)   | 0.2%   |
| Industries with         |           |        |           |        |       |        |
| Unrealized Losses <     |           |        |           |        |       |        |
| \$1MM                   | 697       | 3.9%   | 707       | 3.9%   | (10)  | 2.5%   |
| Total                   | \$ 17,889 | 100.0% | \$ 18,297 | 100.0% | (408) | 100.0% |

Unrealized losses on available-for-sale securities subject to enhanced credit analysis were \$3 million at September 30, 2006, compared with \$5 million at December 31, 2005.

**Unrealized Loss on All Below-Investment-Grade Available-for-Sale Fixed Maturity Securities:** Gross unrealized losses on all available-for-sale below-investment-grade securities were \$69 million at September 30, 2006, representing 17.0% of total gross unrealized losses on all available-for-sale securities. Generally, below-investment-grade fixed maturity securities are more likely than investment-grade securities to develop credit concerns. The remaining \$339 million or 83.0% of the gross unrealized losses relate to investment grade available-for-sale securities. The ratios of fair value to amortized cost reflected in the table below are not necessarily indicative of the fair value to amortized cost relationships for the securities throughout the entire time that the securities have been in an unrealized loss position nor are they necessarily indicative of these ratios subsequent to September 30, 2006.

Edgar Filing: LINCOLN NATIONAL CORP - Form 10-Q

For fixed maturity securities that we held at September 30, 2006 that are below-investment-grade and in an unrealized loss position, the fair value, amortized cost, unrealized loss and the ratios of market value to amortized cost are presented in the table below.

| Aging Category (in millions) | Ratio of                           | Fair Value | Amortized | Unrealized |
|------------------------------|------------------------------------|------------|-----------|------------|
|                              | Amortized<br>Cost to Fair<br>Value |            | Cost      | Loss       |
| <=90 days                    | 70% to                             |            |           |            |
|                              | 100%                               | \$ 325     | \$ 331    | \$ (6)     |
|                              | 40% to                             |            |           |            |
|                              | 70%                                | -          | -         | -          |
| Below 40%                    | Below                              |            |           |            |
|                              | 40%                                | -          | -         | -          |
|                              |                                    | 325        | 331       | (6)        |
|                              |                                    |            |           |            |
| >90 days but <=180 days      | 70% to                             |            |           |            |
|                              | 100%                               | 336        | 345       | (9)        |
|                              | 40% to                             |            |           |            |
|                              | 70%                                | 4          | 6         | (2)        |
| Below 40%                    | Below                              |            |           |            |
|                              | 40%                                | -          | -         | -          |
|                              |                                    | 340        | 351       | (11)       |
|                              |                                    |            |           |            |
| >180 days but <=270 days     | 70% to                             |            |           |            |
|                              | 100%                               | 188        | 192       | (4)        |
|                              | 40% to                             |            |           |            |
|                              | 70%                                | -          | -         | -          |
| Below 40%                    | Below                              |            |           |            |
|                              | 40%                                | -          | -         | -          |
|                              |                                    | 188        | 192       | (4)        |
|                              |                                    |            |           |            |
| >270 days but <=1 year       | 70% to                             |            |           |            |
|                              | 100%                               | 51         | 58        | (7)        |
|                              | 40% to                             |            |           |            |
|                              | 70%                                | -          | -         | -          |
| Below 40%                    | Below                              |            |           |            |
|                              | 40%                                | -          | -         | -          |
|                              |                                    | 51         | 58        | (7)        |
|                              |                                    | 904        | 932       | (28)       |
| <= 1 year Total              |                                    |            |           |            |
| >1 year                      | 70% to                             |            |           |            |
|                              | 100%                               | 276        | 302       | (26)       |
|                              | 40% to                             |            |           |            |
|                              | 70%                                | 14         | 29        | (15)       |
| Below 40%                    | Below                              |            |           |            |
|                              | 40%                                | -          | -         | -          |
|                              |                                    | 290        | 331       | (41)       |
|                              |                                    | 1,194      | 1,263     | (69)       |
| Total Below-Investment-Grade |                                    | \$         | \$        | \$         |

At September 30, 2006, the range of maturity dates for publicly traded and private securities held that were subject to enhanced analysis and monitoring for potential changes in unrealized loss status varies, with 33.5% of these securities maturing in greater than 10 years, 65.3% maturing between 1 and 5 years, and the remaining securities maturing in one year or less. At December 31, 2005, the range of maturity dates for these securities varies, with 36.9% maturing between 5 and 10 years, 47.7% maturing after 10 years and the remaining securities maturing in less than 5 years. At September 30, 2006, none of these securities were rated as investment grade compared to less than 0.5% at December 31, 2005.

**Unrealized Loss on Fixed Maturity Securities Available-for-Sale in Excess of \$10 million:** At September 30, 2006, we had no investment grade available-for-sale fixed maturity securities with unrealized losses in excess of \$10 million. At September 30, 2006, fixed maturity securities available-for-sale with gross unrealized losses greater than \$10 million are presented in the table below.

| (in millions)               | Fair Value | Amortized<br>Cost | Unrealized<br>Loss | Length of time<br>in Loss<br>Position |
|-----------------------------|------------|-------------------|--------------------|---------------------------------------|
| <b>Non-Investment Grade</b> |            |                   |                    |                                       |
| Ford Motor Co. & affiliates | \$ 32      | \$ 48             | \$ (16)            | > 1 year                              |
| Total Non-Investment-Grade  | \$ 32      | \$ 48             | \$ (16)            |                                       |

At September 30, 2006, our total available-for-sale holdings in Ford Motor and its affiliates and securities it guarantees had a fair value of \$79 million and an amortized cost of \$93 million. In addition, at September 30, 2006, we held fixed maturity securities available-for-sale of General Motors Corp. and affiliates with fair value of \$97 million and amortized cost of \$90 million and DaimlerChrysler and affiliates with fair value of \$114 million and amortized cost of \$120 million. Our total gross unrealized loss on available-for-sale securities for these three companies was \$27 million. Our investments also include a mortgage loan on real estate of \$9 million secured by a property that is leased to General Motors.



The information presented above is subject to rapidly changing conditions. As such, we expect that the level of securities with overall unrealized losses will fluctuate, as will the level of unrealized loss securities that are subject to enhanced analysis and monitoring.

## REINSURANCE

Our insurance companies cede insurance to other companies. The portion of risks exceeding each company's retention limit is reinsured with other insurers. We seek reinsurance coverage within the businesses that sell life insurance to limit our exposure to mortality losses and enhance our capital management.

As a result of the Jefferson-Pilot merger, we currently have two reinsurance programs - one for LNL and its insurance subsidiaries, Lincoln Life & Annuity Company of New York and First Penn-Pacific Life Insurance Company (the "LNL program"), and one for the Jefferson-Pilot insurance companies (the "JP program"). Under the LNL program, we reinsure approximately 85% to 90% of the mortality risk on newly issued non-term life insurance contracts. Collectively, for all issue years, LNL has ceded approximately 35% to 40% of total mortality risk including mortality risk for term insurance contracts as of September 30, 2006. Our policy for this program is to retain no more than \$5 million on a single insured life issued on fixed and variable universal life insurance contracts. Additionally, the retention per single insured life for term life insurance and for Corporate Owned Life Insurance (COLI) is \$1 million and \$2 million, respectively.

Beginning in September 2005, we changed the LNL program for our primary term products from coinsurance to renewable term and from 90% to 80% on a first dollar quota share basis. In January 2006, we changed this program from 80% first dollar quota share to an excess of retention program.

These changes have the effect of reducing premiums paid to reinsurers while increasing our exposure to mortality losses, and could result in more volatility in results for our Individual Markets Life Insurance segment. With respect to annuities, we had previously reinsured a portion of our fixed annuity business, but beginning in 2004, we have retained the full risk on newly issued contracts.

The insurance subsidiaries participating in the JP program are Jefferson Pilot Financial Insurance Company, Jefferson Pilot LifeAmerica Insurance Company and Jefferson-Pilot Life Insurance Company. For the JP program, our policy is to reinsure risks in excess of retention, which ranges from \$0.4 million to \$2.1 million, depending on the retention limit set for various individual life and annuity products, on a single insured life. We also attempt to reduce exposure to losses that may result from unfavorable events or circumstances by reinsuring certain levels and types of accident and health insurance risks underwritten.

With the integration of the Lincoln and Jefferson-Pilot companies and their products, an effort is underway to evaluate corporate-wide retention levels for existing and new products concerning any one individual life and in the aggregate. This evaluation, to maximize profitability while minimizing mortality risk, will include the impact of changes in mortality retention balanced with the impact of premiums paid to reinsurers. This evaluation is expected to be completed prior to the end of 2006.

Portions of our deferred annuity business have been reinsured on a modified coinsurance basis with other companies to limit our exposure to interest rate risks. At September 30, 2006, the reserves associated with these reinsurance arrangements totaled \$1.9 billion. To cover products other than life insurance, we acquire other insurance coverages with retentions and limits that management believes are appropriate for the circumstances. The accompanying financial statements reflect premiums, benefits and DAC, net of insurance ceded. See "Part I—Item 1—Risk Factors" and "Forward-looking Statements—Cautionary Language" and Note 5 to the Consolidated Financial Statements in our 2005 Form 10-K for further information. Our insurance companies remain liable if their reinsurers are unable to meet contractual obligations under applicable reinsurance agreements.

In a coinsurance program, the reinsurer shares proportionately in all financial terms of the reinsured policies, i.e. premiums, expenses, claims, etc. based on their respective quota share of the risk. In a renewable term program, the reinsurer is paid a renewable term premium to cover the proportionate share of mortality risk assumed by the reinsurer. In a first dollar quota share program, the reinsurer receives a proportionate share of all risks issued based on their respective quota share of the risk. In an excess of retention program, the reinsurer assumes a proportionate share of risks that exceed our per life retention.

Our amounts recoverable from reinsurers represent receivables from and reserves ceded to reinsurers. At September 30, 2006 the amounts recoverable from reinsurers was \$8.0 billion, compared to \$6.9 billion at December 31, 2005. We obtain reinsurance from a diverse group of reinsurers and we monitor concentration, as well as financial strength ratings of our principal reinsurers. Swiss Re represents our largest exposure. In 2001, we sold our reinsurance business to Swiss Re

primarily through indemnity reinsurance arrangements. Because we are not relieved of our liability to the ceding companies for this business, the liabilities and obligations associated with the reinsured contracts remain on our Consolidated Balance Sheets with a corresponding reinsurance receivable from the business sold to Swiss Re, which totaled \$4.1 billion at September 30, 2006 and December 31, 2005. Swiss Re has funded a trust with a balance of \$1.7 billion at September 30, 2006 to support this business. In addition to various remedies that we would have in the event of a default by Swiss Re, we continue to hold assets in support of certain of the transferred reserves. These assets consist of those reported as trading securities and certain mortgage loans. Our liabilities for funds withheld and embedded derivatives included \$2.1 billion and \$0.2 billion, respectively, at September 30, 2006 related to the business sold to Swiss Re.

During the third quarter one of our reinsurers, Scottish Re Group Ltd (“Scottish Re”), received rating downgrades from various rating agencies. Of the \$1.4 billion of fixed annuity business that we reinsure with Scottish Re, approximately 79% is reinsured through the use of modified coinsurance treaties, in which we possess the investments that support the reserves ceded to Scottish Re. For our annuity business ceded on a coinsurance basis, Scottish Re had previously established an irrevocable investment trust for the benefit of LNC that supports the reserves. In addition to fixed annuities, we have approximately \$79 million of policy liabilities on the life insurance business we have reinsured with Scottish Re. Scottish Re continues to perform under its contractual responsibilities to us. We are still evaluating the impact of these ratings downgrades with respect to our existing exposures to Scottish Re as well as with respect to reinsuring any new business with Scottish Re. Based on current information, we do not believe that Scottish Re’s ratings downgrades will have a material adverse effect on our results of operations, liquidity or financial condition.

## **REVIEW OF CONSOLIDATED FINANCIAL CONDITION**

### **Liquidity and Capital Resources**

Liquidity refers to the ability of an enterprise to generate adequate amounts of cash from its normal operations to meet cash requirements with a prudent margin of safety. Our principal sources of cash flow from operating activities are insurance premiums and fees, investment advisory fees and investment income, while sources of cash flows from investing activities result from maturities and sales of invested assets. We use cash to pay policy claims and benefits, operating expenses, commissions and taxes, to purchase new investments, to pay dividends to our shareholders and to repurchase our stock and debt securities. Our operating activities provided cash of \$1.9 billion and \$0.9 billion in the first nine months of 2006 and 2005, respectively. When considering our liquidity and cash flow, it is important to distinguish between the needs of our insurance subsidiaries and the needs of the holding company, LNC. As a holding company with no operations of its own, LNC derives its cash primarily from its operating subsidiaries.

The liquidity resources of the holding company are principally comprised of dividends and interest payments from subsidiaries augmented by holding company short-term investments, bank lines of credit, a commercial paper program, and the ongoing availability of long-term financing under an SEC shelf registration. These sources of liquidity and cash flow support the general corporate needs of the holding company, including its common stock dividends, interest and debt service, funding of callable securities, securities repurchases, and acquisitions.

### ***Sources of Liquidity and Cash Flow***

The following table summarizes the primary sources of holding company cash flow. The table focuses on significant and recurring cash flow items and excludes the effects of certain financing activities, namely the periodic issuance and retirement of debt and cash flows related to our intercompany cash management account. Taxes have been eliminated from the analysis due to a tax sharing agreement among our primary subsidiaries resulting in a modest impact on net cash flows at the holding company. Also excluded from this analysis is the modest amount of investment income on short-term investments of the holding company.



| (in millions)                                    | Three Months Ended |        | Nine Months Ended |        | Year Ended |
|--|--------------------|--------|-------------------|--------|------------|
|  | September 30,      |        | September 30,     |        | December   |
|  | 2006               | 2005   | 2006              | 2005   | 31,        |
|  |                    |        |                   |        | 2005       |
| Dividends from Subsidiaries                      |                    |        |                   |        |            |
| LNL  | \$ 100             | \$ 50  | \$ 250            | \$ 150 | \$ 200     |
| Jefferson-Pilot Life Insurance Company           | -                  | -      | 2                 | -      | -          |
| Jefferson Pilot Financial Insurance Company      | 75                 | -      | 148               | -      | -          |
| Non-regulated companies <sup>(1)</sup>           | -                  | -      | 235               | -      | -          |
| Lincoln Financial Media                          | 10                 | -      | 23                | -      | -          |
| Delaware Investments                             | 12                 | 11     | 36                | 32     | 42         |
| Lincoln UK                                       | 21                 | 23     | 60                | 23     | 44         |
| Other  | -                  | 1      | -                 | 1      | 1          |
| Subsidiary Loan Repayments & Interest            |                    |        |                   |        |            |
| LNL Interest on Surplus Notes <sup>(2)</sup>     | -                  | 19     | 59                | 58     | 78         |
|  | \$ 218             | \$ 104 | \$ 813            | \$ 264 | \$ 365     |
| Other Cash Flow and Liquidity Items              |                    |        |                   |        |            |
| Return of seed capital                           | \$ 11              | \$ 3   | \$ 16             | \$ 19  | \$ 19      |
| Net capital received from stock option exercises | 83                 | 30     | 161               | 60     | 83         |
|  | \$ 94              | \$ 33  | \$ 177            | \$ 79  | \$ 102     |

(1) Represents dividend of proceeds from sale of equity securities used to repay borrowings under the bridge facility.

(2) Represents interest on the holding company's \$1.25 billion in surplus note investments in LNL. Interest of \$20 million for the third quarter of 2006 was received on October 1, 2006.

### Subsidiaries

Our insurance subsidiaries are subject to certain insurance department regulatory restrictions as to the transfer of funds and payment of dividends to the holding company. Generally, these restrictions pose no short-term liquidity concerns for the holding company. For example, under Indiana laws and regulations, our Indiana insurance subsidiaries, including one of our major insurance subsidiaries, The Lincoln National Life Insurance Company ("LNL"), may pay dividends to LNC only from unassigned surplus, without prior approval of the Indiana Insurance Commissioner (the "Commissioner"), or must receive prior approval of the Commissioner to pay a dividend if such dividend, along with all other dividends paid within the preceding twelve consecutive months, would exceed the statutory limitation. The current statutory limitation is the greater of (i) 10% of the insurer's policyholders' surplus, as shown on its last annual statement on file with the Commissioner or (ii) the insurer's statutory net gain from operations for the previous twelve months, but in no event to exceed statutory unassigned surplus. Indiana law gives the Commissioner broad discretion to disapprove requests for dividends in excess of these limits. Our other major insurance subsidiaries, Jefferson-Pilot Life Insurance Company, Jefferson Pilot Financial Insurance Company, and Jefferson Pilot LifeAmerica Insurance Company are domiciled in North Carolina, Nebraska and New Jersey, respectively, and are subject to similar, but not identical, restrictions.

Our domestic insurance subsidiaries paid dividends of \$175 million and \$400 million for the third quarter and first nine months of 2006 compared to \$50 and \$150 million for the third quarter and first nine months of 2005,

respectively. Based upon anticipated ongoing positive statutory earnings and favorable credit markets, we expect our domestic insurance subsidiaries could pay dividends of approximately \$850 million in 2006 without prior approval from the respective insurance commissioners. The actual amount of surplus that our insurance subsidiaries could pay as dividends is constrained by the amount of surplus we hold to maintain our ratings, to provide an additional layer of margin for risk protection, and for future investment in our businesses. Our non-regulated subsidiaries could pay dividends of approximately \$200 million at September 30, 2006.

Lincoln UK's operations consist primarily of unit-linked life and pension products, which are similar to U.S. produced variable life and annuity products. Lincoln UK's insurance subsidiaries are regulated by the United Kingdom Financial Services Authority ("FSA") and are subject to capital requirements as defined by the U.K. Capital Resources Requirement (formerly the Required Minimum Solvency Margin). All insurance companies operating in the U.K. also have to complete a risk-based capital ("RBC") assessment to demonstrate to the FSA that they hold sufficient capital to cover their risks. RBC requirements in the U.K. are different than the NAIC requirements. In addition, the FSA has imposed certain minimum capital requirements for the combined U.K. subsidiaries. Lincoln UK maintains approximately 1.5 to 2 times the required capital as prescribed by the regulatory margin. As is the case with regulated insurance companies in the U.S., changes to regulatory capital requirements can impact the dividend capacity of the UK insurance subsidiaries and cash flow to the holding company.

Through the April 2006 merger with Jefferson-Pilot, we acquired certain non-insurance companies that held equity and fixed income securities with a fair value at September 30, 2006 of \$450 million, which are available to meet the liquidity needs of the holding company.

### *Financing Activities*

Although our subsidiaries generate adequate cash flow to meet the needs of our normal operations, periodically we may issue debt or equity securities to fund internal growth, acquisitions, and the retirement of our debt and equity securities. As discussed in more detail below, we issued approximately \$2.1 billion of debt securities to finance the cash portion of our April 2006 merger with Jefferson-Pilot and third quarter 2006 stock repurchase activity.

Our Board of Directors has authorized us to issue up to \$4 billion of securities, including debt securities, preferred stock, common stock, warrants, stock purchase contracts and stock purchase units of LNC and trust preferred securities of four subsidiary trusts. In March 2006, we filed a new shelf registration with the SEC. In April 2006, we issued \$1.3 billion of securities, and in May 2006 we issued \$0.8 billion of securities, which leaves us with \$1.9 billion of remaining authorization.

During the second quarter of 2006 we issued \$2.1 billion of debt securities and acquired debt securities with a fair value of \$905 million previously issued by Jefferson-Pilot, as described in Note 2 to the unaudited Consolidated Financial Statements in this Form 10-Q.

On October 19, 2006, we called for redemption on November 19, 2006 our outstanding 7.65% Junior Subordinated Deferrable Interest Debentures, Series E ("TRuPs") due 2050 (the "Junior Subordinated Debentures"), which are held by Lincoln National Capital V. As a result, all of the outstanding 7.65% Trust Preferred Securities, Series E and 7.65% Common Securities of Lincoln National Capital V will be redeemed on November 19, 2006. The redemption price for the Trust Preferred Securities, Series E will be \$25.00 per security, for a total principal amount of \$172.5 million, plus any accrued distributions through the redemption date. As a result of these transactions, we expect to incur a non-cash charge of approximately \$4 million after-tax in the fourth quarter of 2006 related to unamortized issuance costs. We are funding the redemption with internally generated funds and commercial paper. We are using our share repurchase authorization to effect the repurchase.

The Junior subordinated debentures issued by Jefferson-Pilot in 1997 which consist of \$211 million at an interest rate of 8.14% and \$107 million at an interest rate of 8.285% are redeemable prior to maturity at our option beginning January 15, 2007, with two-thirds subject to a call premium of 4.07% and the remainder subject to a call premium of 4.14%, each grading to zero as of January 15, 2017. We expect to call these securities within the next twelve months and therefore have reported them as short-term debt on our consolidated balance sheet.

At September 30, 2006, we maintained three credit facilities with a group of domestic and foreign banks:

- a \$1.6 billion five-year credit facility entered into in March 2006 and maturing in March 2011, allowing for borrowing or issuances of letters of credit ("LOC"),
- a \$1.0 billion five-year credit facility entered into in February 2006 and maturing in February 2011, allowing for borrowing or issuances of LOCs, and
- a U.K. facility for use by our U.K. subsidiary, which was renewed in January 2006 for 10 million pounds sterling (\$19 million at September 30, 2006), maturing in November 2006.

At September 30, 2006, there were approximately \$848 million in outstanding LOCs under the various credit agreements. These LOCs support intercompany reinsurance transactions and specific treaties associated with our former Reinsurance segment. LOCs are primarily used to satisfy the U.S. regulatory requirements of domestic clients of the former Reinsurance segment who have contracted with the reinsurance subsidiaries not domiciled in the United States and for the reserve credit provided by our affiliated offshore reinsurance company to our domestic insurance companies for ceded business.

Under the credit agreements, we must maintain a minimum consolidated net worth level. In addition, the agreements contain covenants restricting our ability to incur liens, merge or consolidate with another entity where we are not the surviving entity and dispose of all or substantially all of our assets. At September 30, 2006, we were in compliance with all such covenants. All of our credit agreements are unsecured.

If current debt ratings and claims paying ratings were downgraded in the future, certain covenants of various contractual obligations may be triggered which could negatively impact overall liquidity. In addition, contractual selling agreements with intermediaries could be negatively impacted which could have an adverse impact on overall sales of annuities, life insurance and investment products. At September 30, 2006, we maintained adequate current financial strength and senior debt ratings and do not anticipate any ratings-based impact to future liquidity.



Our insurance subsidiaries are employing strategies to lessen the burden of increased AXXX and XXX statutory reserves associated with certain universal life products and other products with secondary guarantees subject to these statutory reserving requirements. Currently, a portion of universal life business with secondary guarantees is reinsured with a wholly owned non-U.S. domiciled subsidiary of LNC. Included in the amounts outstanding at September 30, 2006 discussed above was approximately \$545 million of outstanding LOCs supporting the reinsurance obligations of our non-U.S. domiciled subsidiary to LNL on this universal life business with secondary guarantees. Recognizing that LOCs are generally one to five years in duration, it is likely that our insurance companies will apply a mix of LOCs, reinsurance and capital market strategies in addressing long-term AXXX and XXX needs. LOCs and related capital market alternatives lower the RBC impact of the universal life business with secondary guarantee products. An inability to obtain the necessary LOC capacity or other capital market alternatives could impact our returns on universal life business with secondary guarantee products.

During 2005, we established a wholly-owned domestic reinsurance subsidiary to reinsure a portion of the XXX statutory reserves associated with our term products in anticipation of employing a capital markets solution to mitigate the impact of our term products to statutory capital and surplus in 2007. No reserves were ceded to this new subsidiary as of September 30, 2006.

#### *Alternative Sources of Liquidity*

In order to maximize the use of available cash, the holding company maintains an intercompany cash management account where subsidiaries can borrow from the holding company to meet their short-term needs and can invest their short-term funds with the holding company. Depending on the overall cash availability or need, the holding company invests excess cash in short-term investments or borrows funds in the financial markets. Our insurance subsidiaries, by virtue of their general account fixed income investment holdings, can access liquidity through securities lending programs and repurchase agreements. At September 30, 2006, our insurance subsidiaries had \$0.9 billion carrying value of securities out on loan under the securities lending program, and \$0.5 billion carrying value subject to reverse-repurchase agreements.

One of the life insurance subsidiaries we acquired with the Jefferson-Pilot merger had previously established a program for an unaffiliated trust to sell up to \$1 billion of medium-term notes under Rule 144A of the Securities Act of 1933. Proceeds from the sale of the medium-term notes were used to purchase funding agreements issued by the life insurance subsidiary. At September 30, 2006, we had \$300 million of funding agreements outstanding under this program. The funding agreements were issued at a variable rate and provide for quarterly interest payments, indexed to the 3-month LIBOR plus 7 basis points, with principal due at maturity on June 2, 2008. Concurrent with this issuance, the subsidiary executed an interest rate swap for a notional amount equal to the proceeds of the funding agreements. The swap qualifies for cash flow hedge accounting treatment and converts the variable rate of the funding agreements to a fixed rate of 4.28%.

#### *Uses of Capital*

##### *Return of Capital to Shareholders*

One of the holding company's principal uses of cash is to provide a return to our shareholders. Through dividends and stock repurchases, we have an established record of providing significant cash returns to our shareholders. We have increased our dividend in each of the last 22 years. In determining our dividend payout, we balance the desire to increase the dividend against capital needs, rating agency considerations and requirements for financial flexibility. The following table summarizes this activity for 2006 and 2005.

| <b>Three Months Ended<br/>September 30,</b> | <b>Nine Months Ended<br/>September 30,</b> | <b>Year Ended</b> |
|---|--|-------------------|
|---|--|-------------------|

| <b>(in millions)</b>                        | <b>2006</b> |       | <b>2005</b> |    | <b>December 31, 2005</b> |        |    |       |    |       |
|---|-------------|-------|-------------|----|--------------------------|--------|----|-------|----|-------|
| Dividends to shareholders                   | \$          | 105   | \$          | 64 | \$                       | 191    | \$ | 257   |    |       |
| Repurchase of common stock                  |             | 350   |             | -  |                          | 856    |    | 104   |    |       |
| Total Cash Returned to Shareholders         | \$          | 455   | \$          | 64 | \$                       | 1,176  | \$ | 295   | \$ | 361   |
| Number of shares repurchased (in thousands) |             | 6,315 |             | -  |                          | 14,374 |    | 2,331 |    | 2,331 |
| Average price per share <sup>(1)</sup>      | \$          | 55.43 | \$          | -  | \$                       | 59.31  | \$ | 44.44 | \$ | 44.44 |

<sup>(1)</sup> Adjusted to include 181,257 shares delivered in October to complete the accelerated stock buyback program described below.

On April 3, 2006, we entered into an agreement to purchase a variable number of shares of our common stock from a third party broker-dealer, using an accelerated stock buyback program for an aggregate purchase price of \$500 million. On April 10, 2006, we funded the agreement by borrowing \$500 million under the bridge facility and received approximately 8 million shares of our common stock. We also made a payment of approximately \$2.5 million to provide for dividends on

shares that may not have been acquired by the third party broker-dealer prior to the close of the program. The program was completed in July of 2006, with a total of 8.8 million shares repurchased under the program, all of which were retired.

On August 11, 2006, we entered into an agreement to purchase approximately 5.5 million shares of our common stock from a third party broker-dealer, using an accelerated stock buyback program for an initial aggregate purchase price of \$350 million. We funded the program with internally generated funds, asset sales and commercial paper. We received a price adjustment from the third party broker-dealer based on the volume weighted average share price ("VWAP") of our common stock during the term of the program. The price adjustment was settled in shares of our common stock, and we took delivery of an additional 257,000 shares, resulting in total shares purchased under this program of 5.7 million shares. Our Board of Directors had previously authorized total share repurchases of \$1.8 billion.

On November 3, 2006, we entered into an agreement to purchase approximately 2.3 million shares of our common stock from a third party broker-dealer, using an accelerated stock buyback program for an aggregate purchase price of \$150 million. All shares will be retired upon receipt. We may receive from, or be required to pay a price adjustment to the third party broker-dealer based on the volume weighted average share price of our common stock during the term of the program, less a discount. The price adjustment can be settled, at our option, in cash or in shares of our common stock. We expect the program to be completed late in the fourth quarter of 2006. After the purchases under these programs and the redemption of the 7.65% TRuPs discussed above, the remaining amount of authorized share repurchases will be approximately \$649 million.

The following table summarizes the primary uses of holding company cash flow. The table focuses on significant and recurring cash flow items and excludes the effects of certain financing activities, namely the periodic retirement of debt and cash flows related to our intercompany cash management account. Taxes have been eliminated from the analysis due to a tax sharing agreement among our primary subsidiaries resulting in a modest impact on net cash flows at the holding company.

| (in millions)                    | Three Months Ended |       | Nine Months Ended |        | Year              |
|----------------------------------|--------------------|-------|-------------------|--------|-------------------|
|                                  | September 30,      |       | September 30,     |        | Ended             |
|                                  | 2006               | 2005  | 2006              | 2005   | December 31, 2005 |
| Debt service (interest paid)     | \$ 52              | \$ 22 | \$ 114            | \$ 68  | \$ 90             |
| Capital contribution to Delaware |                    |       |                   |        |                   |
| Investments                      | -                  | -     | -                 | 14     | 14                |
| Common dividends                 | 107                | 64    | 280               | 191    | 255               |
| Common stock repurchase          | 353                | -     | 852               | 104    | 104               |
| Total                            | \$ 512             | \$ 86 | \$ 1,246          | \$ 377 | \$ 463            |

#### *Contingencies and Off-Balance Sheet Arrangements*

We have guarantees with off-balance sheet risks having contractual values of \$3 million and \$4 million at September 30, 2006 and December 31, 2005, respectively. Certain of our subsidiaries have sold commercial mortgage loans through grantor trusts, which issued pass-through certificates. These subsidiaries have agreed to repurchase any mortgage loans which remain delinquent for 90 days at a repurchase price substantially equal to the outstanding principal balance plus accrued interest thereon to the date of repurchase. In case of default by the borrowers, we have recourse to the underlying real estate. It is management's opinion that the value of the properties underlying these commitments is sufficient that in the event of default, the impact would not be material to us. These guarantees expire in 2009.

We guarantee the repayment of operating leases on facilities, which we have subleased to third parties, which obligate us to pay in the event the third parties fail to perform their payment obligations under the subleasing agreements. We have recourse to the third parties enabling us to recover any amounts paid under our guarantees. The annual rental payments subject to these guarantees are \$15 million and expire in 2009.

Lincoln Financial Media has commitments to purchase future sports programming rights, and for employment contracts, leases and syndicated television programming of approximately \$287 million through 2011 and \$16 million thereafter. We have offset the purchase of these programming rights by receiving commitments from other entities to purchase a portion of our sports programming rights of approximately \$203 million through 2011, as well as by entering into advertising contracts with customers for the airing of commercials. These commitments are not reflected as an asset or liability in our Consolidated Balance Sheet because the programs are not currently available for use.

### **Shareholders' Equity**

Total shareholders' equity increased \$5.7 billion during the nine months ended September 30, 2006, primarily due to \$5.6 billion of common stock issued to acquire the outstanding shares of Jefferson-Pilot in April 2006 and, to a lesser extent, net income, partially offset by unrealized losses of securities available-for-sale included in accumulated other comprehensive income resulting from higher interest rates and share repurchase activity.

77

---

## **OTHER MATTERS**

### **Other Factors Affecting Our Business**

In general, our businesses are subject to a changing social, economic, legal, legislative and regulatory environment. Some of the changes include initiatives to require more reserves to be carried by our insurance subsidiaries, to make permanent recent reductions in individual tax rates, to permanently repeal the estate tax and to increase regulation of our annuity and investment management businesses. Although the eventual effect on us of the changing environment in which we operate remains uncertain, these factors and others could have a material effect on our results of operations, liquidity and capital resources.

### **Recent Accounting Pronouncements**

For a discussion of accounting pronouncements that have been implemented during the periods presented or that have been issued and are to be implemented in the future, see Note 3 to the unaudited Consolidated Financial Statements.

### **Restructuring Activities**

See Note 12 to the unaudited Consolidated Financial Statements for the detail of our restructuring activities.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

We provided a discussion of our market risk in Item 7A of our 2005 Form 10-K. During the first nine months of 2006, there was no substantive change in our market risk except for the items noted below:

**Interest Rate Risk—Falling Rates.** As discussed in the Quantitative and Qualitative Disclosures About Market Risk section of our 2005 Form 10-K, spreads on our fixed annuity and interest-sensitive whole life, universal life and fixed portion of variable universal life insurance policies, are at risk if interest rates decline and remain low for a period of time. The following table provides detail on the difference between interest crediting rates and minimum guaranteed rates as of September 30, 2006. For example, at September 30, 2006, there are \$5.1 billion of combined Individual Markets - Annuities and Individual Markets - Life Insurance account values where the excess of the crediting rate over contract minimums is between 0.21% and 0.30%. The analysis presented below ignores any non-guaranteed elements within the life insurance products such as cost of insurance or expense loads, which for many products may be redetermined in the event that interest margins deteriorate below the level that would cause the credited rate to equal the minimum guaranteed rate.

| Excess of Crediting Rates<br>over Contract Minimums<br>As of September 30, 2006 | Account Values        |                       |                                   | Total     | Percent<br>of Total<br>Account<br>Values |
|---|-----------------------|-----------------------|-----------------------------------|-----------|--|
|   | Emp Mkts<br>Annuities | Ind Mkts<br>Annuities | Ind Mkts<br>Life<br>(in millions) |           |  |
| CD and On-Benefit type<br>annuities   | \$ 917                | \$ 10,307             | \$ -                              | \$ 11,224 | 21.90%                                   |
| Discretionary rate setting<br>products*   |                       |                       |                                   |           |  |
| No difference   | 2,726                 | 5,092                 | 10,570                            | 18,388    | 35.88%                                   |
| up to .1%   | 613                   | 1,890                 | 1,107                             | 3,610     | 7.04%                                    |
| 0.11% to .20%   | 4,770                 | 361                   | 21                                | 5,152     | 10.05%                                   |
| 0.21% to .30%   | 1                     | 216                   | 4,836                             | 5,053     | 9.86%                                    |
| 0.31% to .40%   | 1                     | 103                   | 2,307                             | 2,411     | 4.70%                                    |
| 0.41% to .50%   | 100                   | 59                    | 648                               | 807       | 1.57%                                    |
| 0.51% to .60%   | 399                   | 52                    | 30                                | 481       | 0.94%                                    |
| 0.61% to .70%   | 1,004                 | 387                   | 110                               | 1,501     | 2.93%                                    |
| 0.71% to .80%   | 105                   | 3                     | 835                               | 943       | 1.84%                                    |
| 0.81% to .90%   | 0                     | 2                     | 40                                | 42        | 0.08%                                    |
| 0.91% to 1.0%   | 164                   | 9                     | 18                                | 191       | 0.37%                                    |
| 1.01% to 1.50%  | 27                    | 73                    | 384                               | 484       | 0.94%                                    |
| 1.51% to 2.00%  | 37                    | 337                   | 36                                | 410       | 0.80%                                    |
| 2.01% to 2.50%  | 0                     | 341                   | 27                                | 368       | 0.72%                                    |
| 2.51% to 3.00%  | 1                     | 0                     | 0                                 | 1         | 0.00%                                    |
| 3.01% and above   | 180                   | 3                     | 0                                 | 183       | 0.38%                                    |
| Total Discretionary rate setting<br>products                                    | 10,128                | 8,928                 | 20,969                            | 40,025    | 78.10%                                   |
| Grand Total-Account Values  | \$ 11,045             | \$ 19,235             | \$ 20,969                         | \$ 51,249 | 100.00%                                  |

\* For purposes of this table, contracts currently within new money rate bands are grouped according to the corresponding portfolio rate band in which they will fall upon their first anniversary.

We expect to manage interest spreads through the interest rate credit management process for the Employer Markets - Annuities, Individual Markets - Annuities and Individual Markets - Life Insurance segments during the remainder of 2006. Refer to Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations - Results of Operations by Segment for the effects of such expected changes in interest rate environments.

**Derivatives.** As indicated in Note 8 of our 2005 Form 10-K, we have entered into derivative transactions to reduce our exposure to rapid rises in interest rates, the risk of changes in liabilities indexed to equity markets, credit risk, foreign exchange risk and to increase our exposure to certain investments in exchange for a premium. In addition, we are subject to risks associated with changes in the value of our derivatives; however, such changes in value are generally offset by changes in the value of the items being hedged by such contracts. Modifications to our derivative strategy are initiated periodically upon review of our overall risk assessment. During the first nine months of 2006, the more significant changes in our derivative positions are as follows:

1. Entered into \$0.7 billion notional of interest rate cap agreements that are used to hedge our annuity business against the negative impact of a significant and sustained rise in interest rates. A total of \$0.3 billion interest rate caps expired, resulting in no gain or loss. A total of \$5.9 billion notional is outstanding.
2. Entered into \$162 million notional of interest rate swap agreements hedging floating rate bond coupon payments. A total of \$46 million notional matured or was terminated, resulting in a remaining notional of \$1.2 billion. A gain of \$0.2 million was recognized on the termination. These interest rate swap agreements convert floating rate bond coupon payments into a fixed rate of return. The total remaining notional includes \$564 million notional related to the acquisition of Jefferson-Pilot.
3. Entered into \$1.1 billion notional of forward-starting interest rate swap agreements. These swaps partially hedged the future cash flows of a forecasted debt issuance by us to finance the acquisition of Jefferson-Pilot. The entire \$1.1 billion notional was terminated after the acquisition was finalized resulting in a \$41 million gain recorded in Other Comprehensive Income. The gain will be recognized into income over the life of the debt.
4. Terminated \$200 million notional of treasury lock agreements. These treasury lock agreements partially hedged the future cash flows of a forecasted debt issuance by us to finance the acquisition of Jefferson-Pilot. The termination resulted in an \$11 million gain recorded in Other Comprehensive Income. The gain will be recognized into income over the life of the debt.
5. Terminated 0.4 million call options on LNC stock, resulting in a remaining total of 0.9 million call options on an equal number of shares of LNC stock. These call options are hedging the increase in liabilities arising from stock appreciation rights granted on LNC stock.
6. We had financial futures net purchase/termination activity in the amount of \$0.7 billion notional resulting in a remaining notional of \$2.5 billion. These futures are hedging a portion of the liability exposure on certain options in variable annuity products. No gain or loss was recognized as a result of the expirations or terminations.
7. Entered into \$10 million notional of credit default swap agreements. A total of \$10 million notional matured, resulting in a remaining notional of \$20 million. We offer credit protection to investors through selling credit default swaps. These swap agreements allow the credit exposure of a particular obligor to be passed onto us in exchange for a quarterly premium.
8. Entered into \$0.7 billion notional of put option agreements. A total of \$0.2 billion notional was terminated, resulting a remaining notional of \$1.9 billion notional. These put options are hedging a portion of the liability exposure on certain options in variable annuity products. We will receive a payment from the counterparty if the strike rate in the agreement is higher than the specified index rate at maturity.
9. Entered into foreign exchange forward contracts in the amount of \$60 million notional that are hedging dividends received from our Lincoln UK subsidiary. The full amount expired resulting in no remaining notional. A loss of \$0.1 million was recognized in net income as a result of the expirations.
10. Entered into \$30 million notional of foreign currency swaps. A total of \$2 million notional expired, resulting in a remaining notional of \$86 million. These foreign currency swap agreements are part of a hedging strategy. We own various foreign issue securities. Interest payments from these securities are received in a foreign currency and then swapped into U.S. dollars.
11. Entered into \$1.0 billion notional of S&P 500 call options. A total of \$0.7 billion notional expired, resulting in a remaining notional of \$2.2 billion. These call options are hedging the impact of the equity-index interest credited to our indexed annuity products. The total remaining notional includes \$1.2 billion notional related to the



acquisition of Jefferson-Pilot.

12. Entered into \$6 million notional of total return swap agreements resulting in a total of \$106 million notional. These swap agreements are hedging a portion of the liability related to our deferred compensation plans. We receive the total return on a portfolio of indexes and pay a floating rate of interest.

We are exposed to credit loss in the event of non-performance by counterparties on various derivative contracts. However, we do not anticipate non-performance by any of the counterparties. The credit risk associated with such agreements is minimized by purchasing such agreements from financial institutions with long-standing superior performance records.

#### ***Item 4. Controls and Procedures***

##### **(a) Conclusions Regarding Disclosure Controls and Procedures**

We maintain disclosure controls and procedures, which are designed to ensure that information required to be disclosed in the reports we file or submit under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules

80

---

and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. As of the end of the period covered by this report, we, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the Exchange Act). Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are effective in timely alerting them to material information relating to us and our consolidated subsidiaries required to be disclosed in our periodic reports under the Exchange Act.

**(b) Changes in Internal Control Over Financial Reporting**

There was no change in the Company's internal control over financial reporting (as that term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the quarter ended September 30, 2006 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

A control system, no matter how well designed and operated, can provide only reasonable assurance that the control system's objectives will be met. Further, because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud, if any, within the company have been detected. Projections of any evaluation of controls' effectiveness to future periods are subject to risks. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures.

**PART II - OTHER INFORMATION****Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

(c) The following table summarizes purchases of equity securities by the issuer during the quarter ended September 30, 2006:

| <b>Period</b>    | <b>(a) Total Number of Shares (or Units) Purchased <sup>(1)(2)</sup></b> | <b>(b) Average Price Paid per Share (or Unit) <sup>(2)</sup></b> | <b>(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs <sup>(3)</sup></b> | <b>(d) Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs (in millions) <sup>(4)</sup></b> |
|------------------|--|--|---|--|
| 7/1/06 - 7/31/06 | 780,452  | \$ 56.85   | 778,965   | \$ 1,322   |
| 8/1/06 - 8/31/06 | 5,544,693  | 61.21  | 5,536,485   | 972  |
| 9/1/06 - 9/30/06 | 7,797  | 61.20  | -   | 972  |

- (1) Of the total number of shares purchased, 15,483 shares were received in connection with the exercise of stock options and related taxes and 2,009 shares were withheld for taxes on the vesting of restricted stock.
- (2) Price paid per share of \$61.21 for 5.5 million shares purchased under our publicly announced accelerated stock repurchase is based on the final delivery of shares totaling 5.7 million on October 23, 2006. See Note 13 to the unaudited Consolidated Financial Statements for additional information.
- (3) In January 2006, our Board of Directors approved a \$1.6 billion increase in the share repurchase authorization. There is no termination date in connection with this authorization. The amount and timing of share repurchase depends on key capital ratios, rating agency expectations, the generation of free cash flow and an evaluation of the costs and benefits associated with alternative uses of capital.
- (4) As of the last day of the applicable month. As discussed in Liquidity and Capital Resources section, our share repurchase authorization as of November 9, 2006, is \$649 million.
- (5) A domestic Rabbi trust holds shares for the directors' fee deferrals for the former Jefferson-Pilot directors. The fund was frozen but buys shares for dividends earned on shares held in the trust. In addition, during the third quarter of 2006, the Rabbi trust purchased shares with the cash portion of the merger consideration. Trust purchases during the third quarter of 2006 totaled 14,404 shares with an average price of \$55.79, all purchased during July. These are not included in the table above because such shares held by the trust are still outstanding.

**Item 6. Exhibits**

The Exhibits included in this report are listed in the Exhibit Index beginning on page E-1, which is incorporated herein by reference.

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**LINCOLN NATIONAL CORPORATION**

By: **/S/ FREDERICK J. CRAWFORD**  
**Frederick J. Crawford**  
**Senior Vice President and Chief Financial Officer**

By: **/S/ DOUGLAS N. MILLER**  
**Douglas N. Miller**  
**Vice President and Chief Accounting Officer**

Date: November 9, 2006

**LINCOLN NATIONAL CORPORATION**  
**Exhibit Index for the Report on Form 10-Q**  
**For the Quarter Ended September 30, 2006**

|      |  |
|------|--|
| 10.1 | <u>Master Confirmation Agreement and related Supplemental Confirmation, dated August 11, 2006, relating to LNC's accelerated stock repurchase program with Lehman Brothers Finance S.A.*</u> |
| 10.2 | Lincoln National Corporation Non-Employee Director Compensation is incorporated by reference from Exhibit 10.1 of LNC's Form 8-K (File No. 1-6028) filed with the SEC on September 15, 2006. |
| 12   | <u>Historical Ratio of Earnings to Fixed Charges.</u>  |
| 31.1 | <u>Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>   |
| 31.2 | <u>Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>   |
| 32.1 | <u>Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u>                                |
| 32.2 | <u>Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u>                                |

\* Portions of the exhibit have been redacted and are subject to a confidential treatment request filed with the Secretary of the Securities and Exchange Commission ("SEC") pursuant to Rule 24b-2 under the Securities Exchange Act of 1934, as amended.

---