NACCO INDUSTRIES INC
Form 10-Q
April 30, 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

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FORM 10-Q
(Mark One)

þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2014

OR

o 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 1-9172

NACCO INDUSTRIES, INC.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| DELAWARE<br>(State or other jurisdiction of incorporation or organization) | 34-1505819<br>(I.R.S. Employer Identification No.) |
| 5875 LANDERBROOK DRIVE, SUITE 220, CLEVELAND, OHIO<br>(Address of principal executive offices) | 44124-4069<br>(Zip code) |

(440) 229-5151
(Registrant's telephone number, including area code)

N/A
(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 for 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 þ NO o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

YES þ NO o

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

| | | | |
|---|---|---|---|
| Large accelerated filer o | Accelerated filer þ | Non-accelerated filer o<br>(Do not check if a smaller reporting company) | Smaller reporting company o |

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

YES o NO þ

Number of shares of Class A Common Stock outstanding at April 25, 2014: 6,218,289
Number of shares of Class B Common Stock outstanding at April 25, 2014: 1,580,870

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Part I
FINANCIAL INFORMATION
Item 1. Financial Statements

NACCO INDUSTRIES, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

| | MARCH 31 2014 | DECEMBER 31 2013 | MARCH 31 2013 |
|---|---|---|---|
| | (In thousands, except share data) | | |
| ASSETS | | | |
| Cash and cash equivalents | $70,070 | $ 95,390 | $96,870 |
| Accounts receivable, net | 74,788 | 120,789 | 90,240 |
| Accounts receivable from affiliates | 32,247 | 32,636 | 27,642 |
| Inventories, net | 193,913 | 184,445 | 162,234 |
| Deferred income taxes | 10,721 | 14,452 | 10,604 |
| Prepaid expenses and other | 21,498 | 13,578 | 19,272 |
| Total current assets | 403,237 | 461,290 | 406,862 |
| Property, plant and equipment, net | 245,858 | 219,256 | 184,062 |
| Coal supply agreements and other intangibles, net | 58,920 | 59,685 | 68,711 |
| Other non-current assets | 71,985 | 69,725 | 54,093 |
| Total assets | $780,000 | $ 809,956 | $713,728 |
| LIABILITIES AND EQUITY | | | |
| Accounts payable | $103,642 | $ 133,016 | $90,576 |
| Revolving credit agreements of subsidiaries - not guaranteed by the parent company | 47,364 | 23,460 | 42,754 |
| Current maturities of long-term debt of subsidiaries - not guaranteed by the parent company | 7,868 | 7,859 | 6,965 |
| Accrued payroll | 10,351 | 29,030 | 13,590 |
| Other current liabilities | 32,836 | 44,754 | 27,366 |
| Total current liabilities | 202,061 | 238,119 | 181,251 |
| Long-term debt of subsidiaries - not guaranteed by the parent company | 168,069 | 152,431 | 123,839 |
| Mine closing reserves | 29,878 | 29,764 | 29,223 |
| Pension and other postretirement obligations | 7,409 | 7,648 | 15,142 |
| Long-term deferred income taxes | 22,918 | 24,786 | 24,632 |
| Other long-term liabilities | 60,122 | 59,428 | 59,148 |
| Total liabilities | 490,457 | 512,176 | 433,235 |
| Stockholders' equity | | | |
| Common stock: | | | |
| Class A, par value $1 per share, 6,218,289 shares outstanding (December 31, 2013 - 6,290,414 shares outstanding; March 31, 2013 - 6,756,482 shares outstanding) | 6,218 | 6,290 | 6,756 |
| Class B, par value $1 per share, convertible into Class A on a one-for-one basis, 1,580,870 shares outstanding (December 31, 2013 - 1,581,106 shares outstanding; March 31, 2013 - 1,582,155 shares outstanding) | 1,581 | 1,581 | 1,582 |
| Capital in excess of par value | — | 941 | 20,035 |
| Retained earnings | 294,183 | 301,227 | 272,547 |
| Accumulated other comprehensive loss | (12,439 ) | (12,259 ) | (20,427 ) |

| | | | |
|---|---|---|---|
| Total stockholders' equity | 289,543 | 297,780 | 280,493 |
| Total liabilities and equity | $780,000 | $ 809,956 | $713,728 |

See notes to Unaudited Condensed Consolidated Financial Statements.

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NACCO INDUSTRIES, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

| | THREE MONTHS ENDED MARCH 31 | |
|---|---|---|
| | 2014 | 2013 |
| | (In thousands, except per share data) | |
| Revenues | $177,413 | $196,052 |
| Cost of sales | 141,242 | 149,791 |
| Gross profit | 36,171 | 46,261 |
| Earnings of unconsolidated mines | 12,438 | 12,098 |
| Operating expenses | | |
| Selling, general and administrative expenses | 48,429 | 50,296 |
| Amortization of intangible assets | 765 | 1,041 |
| | 49,194 | 51,337 |
| Operating profit (loss) | (585) | 7,022 |
| Other expense (income) | | |
| Interest expense | 1,454 | 1,304 |
| Income from other unconsolidated affiliates | (388) | (391) |
| Closed mine obligations | 316 | 405 |
| Other, net, including interest income | 122 | (133) |
| | 1,504 | 1,185 |
| Income (loss) before income tax provision (benefit) | (2,089) | 5,837 |
| Income tax provision (benefit) | (565) | 1,415 |
| Net income (loss) | $(1,524) | $4,422 |
| | | |
| Basic earnings (loss) per share | $(0.19) | $0.53 |
| Diluted earnings (loss) per share | $(0.19) | $0.53 |
| | | |
| Dividends per share | $0.25 | $0.25 |
| | | |
| Basic weighted average shares outstanding | 7,848 | 8,360 |
| Diluted weighted average shares outstanding | 7,860 | 8,399 |

See notes to Unaudited Condensed Consolidated Financial Statements.

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NACCO INDUSTRIES, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

| | THREE MONTHS ENDED MARCH 31 | |
|---|---|---|
| | 2014 | 2013 |
| | (In thousands) | |
| Net income (loss) | $(1,524) | $4,422 |
| Foreign currency translation adjustment | (174) | 479 |
| Deferred gain on available for sale securities | 63 | 244 |
| Current period cash flow hedging activity, net of $225 tax benefit and $76 tax expense in the three months ended March 31, 2014 and March 31, 2013, respectively. | (407) | 120 |
| Reclassification of hedging activities into earnings, net of $96 and $93 tax benefit in the three months ended March 31, 2014 and March 31, 2013, respectively. | 180 | 149 |
| Reclassification of pension and postretirement adjustments into earnings, net of $83 and $144 tax benefit in the three months ended March 31, 2014 and March 31, 2013, respectively. | 158 | 442 |
| Total other comprehensive income (loss) | $(180) | $1,434 |
| Comprehensive income (loss) | $(1,704) | $5,856 |

See notes to Unaudited Condensed Consolidated Financial Statements.

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NACCO INDUSTRIES, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

| | THREE MONTHS ENDED MARCH 31 | |
|---|---|---|
| | 2014 | 2013 |
| | (In thousands) | |
| Operating activities | | |
| Net income (loss) | $(1,524) | $4,422 |
| Adjustments to reconcile from net income (loss) to net cash used for operating activities: | | |
| Depreciation, depletion and amortization | 5,979 | 5,372 |
| Amortization of deferred financing fees | 184 | 149 |
| Deferred income taxes | 1,796 | 1,810 |
| Other | (3,559) | (16,548) |
| Working capital changes: | | |
| Accounts receivable | 46,307 | 32,584 |
| Inventories | (9,469) | 7,684 |
| Other current assets | (7,949) | (7,735) |
| Accounts payable | (26,899) | (37,862) |
| Other current liabilities | (30,882) | (14,902) |
| Net cash used for operating activities | (26,016) | (25,026) |
| Investing activities | | |
| Expenditures for property, plant and equipment | (31,845) | (7,465) |
| Other | (57) | 837 |
| Net cash used for investing activities | (31,902) | (6,628) |
| Financing activities | | |
| Additions to long-term debt | 1,553 | 2,793 |
| Reductions of long-term debt | (354) | (132) |
| Net additions (reductions) to revolving credit agreements | 38,352 | (6,801) |
| Cash dividends paid | (1,964) | (2,102) |
| Purchase of treasury shares | (4,986) | (5,100) |
| Other | — | 3 |
| Net cash provided by (used for) financing activities | 32,601 | (11,339) |
| Effect of exchange rate changes on cash | (3) | 8 |
| Cash and cash equivalents | | |
| Decrease for the period | (25,320) | (42,985) |
| Balance at the beginning of the period | 95,390 | 139,855 |
| Balance at the end of the period | $70,070 | $96,870 |

See notes to Unaudited Condensed Consolidated Financial Statements.

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NACCO INDUSTRIES, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

| | | | | | Accumulated Other Comprehensive Income (Loss) | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Class A Common Stock | Class B Common Stock | Capital in Excess of Par Value | Retained Earnings | Foreign Currency Translation Adjustment | Deferred Gain (Loss) on Available for Sale Securities | Deferred Gain (Loss) on Cash Flow Hedging | Pension and Postretirement Plan Adjustment | Total Stockholders' Equity |
| | (In thousands, except per share data) | | | | | | | | |
| Balance, January 1, 2013 | $6,771 | $ 1,582 | $24,612 | $270,227 | $ (574 ) | $292 | $(286) | $ (21,293 ) | $281,331 |
| Stock-based compensation | 75 | — | 433 | — | — | — | — | — | 508 |
| Purchase of treasury shares | (90 ) | — | (5,010 ) | — | — | — | — | — | (5,100 ) |
| Net income (loss) | — | — | — | 4,422 | — | — | — | — | 4,422 |
| Cash dividends on Class A and Class B common stock: $0.25 per share | — | — | — | (2,102 ) | — | — | — | — | (2,102 ) |
| Current period other comprehensive income (loss) | — | — | — | — | 479 | 244 | 120 | — | 843 |
| Reclassification adjustment to net income (loss) | — | — | — | — | — | — | 149 | 442 | 591 |
| Balance, March 31, 2013 | $6,756 | $ 1,582 | $20,035 | $272,547 | $ (95 ) | $536 | $(17 ) | $ (20,851 ) | $280,493 |
| | | | | | | | | | |
| Balance, January 1, 2014 | $6,290 | $ 1,581 | $941 | $301,227 | $ (803 ) | $1,021 | $676 | $ (13,153 ) | $297,780 |
| Stock-based compensation | 19 | — | 398 | — | — | — | — | — | 417 |
| Purchase of treasury shares | (91 ) | — | (1,339 ) | (3,556 ) | — | — | — | — | (4,986 ) |
| Net income (loss) | — | — | — | (1,524 ) | — | — | — | — | (1,524 ) |
| Cash dividends on Class A and Class B common stock: $0.25 per share | — | — | — | (1,964 ) | — | — | — | — | (1,964 ) |
| Current period other comprehensive income (loss) | — | — | — | — | (174 ) | 63 | (407 ) | — | (518 ) |
| Reclassification adjustment to net income (loss) | — | — | — | — | — | — | 180 | 158 | 338 |
| | $6,218 | $ 1,581 | $— | $294,183 | $ (977 ) | $1,084 | $449 | $ (12,995 ) | $289,543 |

Balance, March 31,
2014

See notes to Unaudited Condensed Consolidated Financial Statements.

NACCO INDUSTRIES, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2014
(In thousands, except as noted and per share amounts)

NOTE 1—Basis of Presentation

The accompanying Unaudited Condensed Consolidated Financial Statements include the accounts of NACCO Industries, Inc. (the “parent company” or “NACCO”) and its wholly owned subsidiaries (collectively, “NACCO Industries, Inc. and Subsidiaries” or the “Company”). Intercompany accounts and transactions are eliminated in consolidation. The Company's subsidiaries operate in the following principal industries: mining, small appliances and specialty retail. The Company manages its subsidiaries primarily by industry.

The North American Coal Corporation and its affiliated companies (collectively, “NACoal”) mine and market steam and metallurgical coal for use in power generation and steel production and provide selected value-added mining services for other natural resources companies. Hamilton Beach Brands, Inc. (“HBB”) is a leading designer, marketer and distributor of small electric household appliances, as well as commercial products for restaurants, bars and hotels. The Kitchen Collection, LLC (“KC”) is a national specialty retailer of kitchenware and gourmet foods operating under the Kitchen Collection® and Le Gourmet Chef® store names in outlet and traditional malls throughout the United States.

These financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("U.S. GAAP") for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the financial position of the Company at March 31, 2014 and the results of its operations, comprehensive income, cash flows and changes in equity for the three months ended March 31, 2014 and 2013 have been included. These Unaudited Condensed Consolidated Financial Statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

The balance sheet at December 31, 2013 has been derived from the audited financial statements at that date but does not include all of the information or notes required by U.S. GAAP for complete financial statements.

Operating results for the three months ended March 31, 2014 are not necessarily indicative of the results that may be expected for the remainder of the year ending December 31, 2014. The HBB and KC businesses are seasonal and a majority of revenues and operating profit typically occurs in the second half of the calendar year when sales of small electric household appliances to retailers and consumers increase significantly for the fall holiday-selling season. For further information regarding seasonality of these businesses, refer to the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

Certain amounts in the prior periods' Unaudited Condensed Consolidated Financial Statements have been reclassified to conform to the current period's presentation.

NOTE 2—Recently Issued Accounting Standards

Accounting Guidance Adopted in 2014: In April 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-08, which includes amendments that change the requirements for reporting discontinued operations and require additional disclosures about discontinued operations. Under the new guidance, only disposals representing a strategic shift in operations - that is, a major effect on the organization's operations and financial results should be presented as discontinued operations. Examples include a disposal of a major geographic area, a major line of business, or a major equity method investment. Additionally, the ASU requires expanded disclosures about discontinued operations that will provide financial statement users with more information about the assets, liabilities, income, and expenses of discontinued operations. The Company adopted this guidance during the first quarter of 2014. The adoption did not have an effect on the Company’s financial position, results of operations or cash flows.

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NOTE 3—Inventories

Inventories are summarized as follows:

| | MARCH 31 2014 | DECEMBER 31 2013 | MARCH 31 2013 |
|---|---|---|---|
| Coal - NACoal | $29,521 | $24,710 | $14,685 |
| Mining supplies - NACoal | 17,920 | 17,406 | 15,299 |
| Total inventories at weighted average cost | 47,441 | 42,116 | 29,984 |
| Sourced inventories - HBB | 97,322 | 90,713 | 80,007 |
| Retail inventories - KC | 49,150 | 51,616 | 52,243 |
| Total inventories at FIFO | 146,472 | 142,329 | 132,250 |
| | $193,913 | $184,445 | $162,234 |

NOTE 4—Stockholders' Equity

Stock Repurchase Program: On November 8, 2011, the Company announced that its Board of Directors approved the repurchase of up to $50 million of the Company's Class A Common Stock outstanding (the "2011 Stock Repurchase Program"). The original authorization for the 2011 Stock Repurchase Program expired on December 31, 2012; however, in November 2012 the Company's Board of Directors approved an extension of the 2011 Stock Repurchase Program through December 31, 2013. In total, the Company repurchased $35.6 million of Class A Common Stock under the 2011 Stock Repurchase Program.

On November 12, 2013, the Company's Board of Directors terminated the 2011 Stock Repurchase Program and approved a new stock repurchase program (the "2013 Stock Repurchase Program") providing for the purchase of up to $60 million of the Company's Class A Common Stock outstanding through December 31, 2015. The timing and amount of any repurchases under the 2013 Stock Repurchase Program will be determined at the discretion of the Company's management based on a number of factors, including the availability of capital, other capital allocation alternatives and market conditions for the Company's Class A Common Stock. The 2013 Stock Repurchase Program does not require the Company to acquire any specific number of shares. It may be modified, suspended, extended or terminated by the Company at any time without prior notice and may be executed through open market purchases, privately negotiated transactions or otherwise. All or part of the repurchases under the 2013 Stock Repurchase Program may be implemented under a Rule 10b5-1 trading plan, which would allow repurchases under pre-set terms at times when the Company might otherwise be prevented from doing so.

As of March 31, 2014, the Company had repurchased a total of 107,073 shares of Class A Common Stock for an aggregate purchase price of $5.9 million under the 2013 Stock Repurchase Program, including 90,978 shares at an average purchase price of $54.80 per share during the three months ended March 31, 2014.

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Amounts Reclassified out of Accumulated Other Comprehensive Income (Loss): The following table summarizes the amounts reclassified out of Accumulated other comprehensive income (loss) ("AOCI") and recognized in the Unaudited Condensed Consolidated Statements of Operations:

| Details about AOCI Components | Amount Reclassified from AOCI Three Months Ended March 31, 2014 | Three Months Ended March 31, 2013 | Location of (gain) loss reclassified from AOCI into income (loss) |
|---|---|---|---|
| (Gain) loss on cash flow hedging | | | |
| Foreign exchange contracts | $(88) | $10 | Cost of sales |
| Interest rate contracts | 364 | 232 | Interest expense |
| | 276 | 242 | Total before income tax benefit |
| | (96) | (93) | Income tax benefit |
| | $180 | $149 | Net of tax |
| | | | |
| Pension and postretirement plan | | | |
| Actuarial loss | $260 | $631 | (a) |
| Prior-service credit | (19) | (45) | (a) |
| | 241 | 586 | Total before income tax benefit |
| | (83) | (144) | Income tax benefit |
| | $158 | $442 | Net of tax |
| | | | |
| Total reclassifications for the period | $338 | $591 | Net of tax |

(a) These AOCI components are included in the computation of pension and postretirement health care (income) expense. See Note 11 for further discussion.

NOTE 5—Derivative Financial Instruments

The Company uses forward foreign currency exchange contracts to partially reduce risks related to transactions denominated in foreign currencies. The Company offsets fair value amounts related to foreign currency exchange contracts executed with the same counterparty. These contracts hedge firm commitments and forecasted transactions relating to cash flows associated with sales and purchases denominated in currencies other than the Company's subsidiaries' functional currencies. Changes in the fair value of forward foreign currency exchange contracts that are effective as hedges are recorded in AOCI. Deferred gains or losses are reclassified from AOCI to the Unaudited Condensed Consolidated Statements of Operations in the same period as the gains or losses from the underlying transactions are recorded and are generally recognized in cost of sales. The ineffective portion of derivatives that are classified as hedges is immediately recognized in earnings and generally recognized in cost of sales.

The Company uses interest rate swap agreements to partially reduce risks related to floating rate financing agreements that are subject to changes in market rates of interest. Terms of the interest rate swap agreements provide for the Company to receive a variable interest rate and pay a fixed interest rate. The Company's interest rate swap agreements and its variable rate financings are based upon LIBOR. Changes in the fair value of interest rate swap agreements that are effective as hedges are recorded in AOCI. Deferred gains or losses are reclassified from AOCI to the Unaudited Condensed Consolidated Statements of Operations in the same period as the gains or losses from the underlying transactions are recorded and are generally recognized in interest expense. The ineffective portion of derivatives that are classified as hedges is immediately recognized in earnings and included on the line “Other” in the “Other expense (income)” section of the Unaudited Condensed Consolidated Statements of Operations.

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Interest rate swap agreements and forward foreign currency exchange contracts held by the Company have been designated as hedges of forecasted cash flows. The Company does not currently hold any nonderivative instruments designated as hedges or any derivatives designated as fair value hedges.

The Company periodically enters into foreign currency exchange contracts that do not meet the criteria for hedge accounting. These derivatives are used to reduce the Company's exposure to foreign currency risk related to forecasted purchase or sales transactions or forecasted intercompany cash payments or settlements. Gains and losses on these derivatives are included on the line “Cost of sales” or “Other” in the “Other expense (income)” section of the Unaudited Condensed Consolidated Statements of Operations.

Cash flows from hedging activities are reported in the Unaudited Condensed Consolidated Statements of Cash Flows in the same classification as the hedged item, generally as a component of cash flows from operations.

The Company measures its derivatives at fair value on a recurring basis using significant observable inputs, which is Level 2 as defined in the fair value hierarchy. The Company uses a present value technique that incorporates the LIBOR-swap curve, foreign currency spot rates and foreign currency forward rates to value its derivatives, including its interest rate swap agreements and foreign currency exchange contracts, and also incorporates the effect of its subsidiary and counterparty credit risk into the valuation.
Foreign Currency Derivatives: HBB held forward foreign currency exchange contracts denominated primarily in Canadian dollars with total notional amounts of $11.0 million, $5.0 million and $8.6 million at March 31, 2014, December 31, 2013 and March 31, 2013, respectively. The fair value of these contracts approximated a net asset of $0.1 million at March 31, 2014, a net asset of less than $0.1 million at December 31, 2013 and a net asset of $0.2 million at March 31, 2013.

Forward foreign currency exchange contracts that qualify for hedge accounting are used to hedge transactions expected to occur within the next twelve months. The mark-to-market effect of forward foreign currency exchange contracts that are considered effective as hedges have been included in AOCI. Based on market valuations at March 31, 2014, $0.1 million of the amount included in AOCI is expected to be reclassified as income into the Unaudited Condensed Consolidated Statements of Operations over the next twelve months, as the transactions occur.
Interest Rate Derivatives: HBB has interest rate swap agreements that hedge interest payments on its one-month LIBOR borrowings. The following table summarizes the notional amounts, related rates and remaining terms of interest rate swap agreements active at March 31, 2014, delayed at December 31, 2013 and active at March 31, 2013, in millions:

| Notional Amount | | | Average Fixed Rate | | | |
|---|---|---|---|---|---|---|
| MARCH 31 2014 | DECEMBER 31 2013 | MARCH 31 2013 | MARCH 31 2014 | DECEMBER 31 2013 | MARCH 31 2013 | Remaining Term at March 31, 2014 |
| $ 20.0 | $ 20.0 | $ 25.0 | 1.4 % | 1.4 % | 4.0 % | extending to January 2020 |

The fair value of HBB's interest rate swap agreements was a net asset of $0.6 million, a net asset of $0.8 million, and a net liability of $0.2 million at March 31, 2014, December 31, 2013, and March 31, 2013, respectively. The mark-to-market effect of interest rate swap agreements that are considered effective as hedges have been included in AOCI. Based on market valuations at March 31, 2014, $0.1 million of the amount included in AOCI is expected to be reclassified as income into the Unaudited Condensed Consolidated Statements of Operations over the next twelve months, as cash flow payments are made in accordance with the interest rate swap agreements. The interest rate swap agreements held by HBB on March 31, 2014 are expected to continue to be effective as hedges.
NACoal has interest rate swaps that hedge interest payments on its one-month LIBOR borrowings. The following table summarizes the notional amounts, related rates and remaining terms of the interest rate swap agreement active at

March 31, 2014, December 31, 2013 and March 31, 2013 in millions:

| Notional Amount | | | Average Fixed Rate | | | |
|---|---|---|---|---|---|---|
| MARCH 31 2014 | DECEMBER 31 2013 | MARCH 31 2013 | MARCH 31 2014 | DECEMBER 31 2013 | MARCH 31 2013 | Remaining Term at March 31, 2014 |
| $ 100.0 | $ 100.0 | N/A | 1.4 % | 1.4 % | N/A | extending to May 2018 |

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The fair value of NACoal's interest rate swap agreement was a net asset of less than $0.1 million and $0.1 million at March 31, 2014 and December 31, 2013, respectively. NACoal did not hold any derivative financial instruments at March 31, 2013. The mark-to-market effect of the interest rate swap agreement that is considered effective as a hedge has been included in AOCI. Based on market valuations at March 31, 2014, less than $0.1 million of the amount included in AOCI is expected to be reclassified as income into the Unaudited Condensed Consolidated Statements of Operations over the next twelve months, as cash flow payments are made in accordance with the interest rate swap agreement. The interest rate swap agreement held by NACoal on March 31, 2014 is expected to continue to be effective as a hedge.

The following table summarizes the fair value of derivatives designated as hedging instruments reflected on a gross basis at March 31, 2014, December 31, 2013, and March 31, 2013 as recorded in the Unaudited Condensed Consolidated Balance Sheets:

| | Derivative Assets | | | |
|---|---|---|---|---|
| Derivatives designated as hedging instruments | Balance Sheet Location | MARCH 31 2014 | DECEMBER 31 2013 | MARCH 31 2013 |
| Interest rate swap agreements | Prepaid expenses and other | $103 | $128 | $— |
| Interest rate swap agreements | Other non-current assets | 491 | 809 | — |
| Foreign currency exchange contracts | Prepaid expenses and other | 125 | 83 | 205 |
| | | $719 | $1,020 | $205 |

| | Derivative Liabilities | | | |
|---|---|---|---|---|
| Derivatives designated as hedging instruments | Balance Sheet Location | MARCH 31 2014 | DECEMBER 31 2013 | MARCH 31 2013 |
| Interest rate swap agreements | Other current liabilities | $— | $— | $227 |
| Foreign currency exchange contracts | Other current liabilities | — | — | — |
| | | $— | $— | $227 |

The following table summarizes the fair value of derivatives not designated as hedging instruments reflected on a gross basis at March 31, 2014, December 31, 2013, and March 31, 2013 as recorded in the Unaudited Condensed Consolidated Balance Sheets:

| | Derivative Liabilities | | | |
|---|---|---|---|---|
| Derivatives not designated as hedging instruments | Balance Sheet Location | MARCH 31 2014 | DECEMBER 31 2013 | MARCH 31 2013 |
| Foreign currency exchange contracts | Other current liabilities | $46 | $14 | $— |
| | | $46 | $14 | $— |

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The following table summarizes the pre-tax impact of derivative instruments for the three months ended March 31, 2014 and 2013 as recorded in the unaudited condensed consolidated statements of operations:

| | Amount of Gain or (Loss) Recognized in AOCI on Derivatives (Effective Portion) | | Location of Gain or (Loss) Reclassified from AOCI into Income (Effective Portion) | Amount of Gain or (Loss) Reclassified from AOCI into Income (Effective Portion) | |
|---|---|---|---|---|---|
| | THREE MONTHS | | | THREE MONTHS | |
| Derivatives in Cash Flow Hedging Relationships | 2014 | 2013 | | 2014 | 2013 |
| Interest rate swap agreements | $(708) | $(3) | Interest expense | $(364) | $(232) |
| Foreign currency exchange contracts | 76 | 199 | Cost of sales | 88 | (10) |
| Total | $(632) | $196 | | $(276) | $(242) |

| | Location of Gain or (Loss) Recognized in Income on Derivative | Amount of Gain or (Loss) Recognized in Income on Derivatives | |
|---|---|---|---|
| | | THREE MONTHS | |
| Derivatives Not Designated as Hedging Instruments | | 2014 | 2013 |
| Foreign currency exchange contracts | Other | $(46) | $— |
| Total | | $(46) | $— |

See Note 6 for a discussion of the Company's fair value disclosures. There was no gain or loss recognized from ineffectiveness and no amounts were excluded from effectiveness testing.

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NOTE 6—Fair Value Disclosure

Recurring Fair Value Measurements: The following table presents the Company's assets and liabilities accounted for at fair value on a recurring basis:

| | | Fair Value Measurements at Reporting Date Using | | |
|---|---|---|---|---|
| | | Quoted Prices in Active Markets for Identical Assets | Significant Other Observable Inputs | Significant Unobservable Inputs |
| Description | Date | (Level 1) | (Level 2) | (Level 3) |
| | March 31, 2014 | | | |
| Assets: | | | | |
| Available for sale securities | $6,638 | $6,638 | $— | $— |
| Interest rate swap agreements | 594 | — | 594 | — |
| Foreign currency exchange contracts | 125 | — | 125 | — |
| | $7,357 | $6,638 | $719 | $— |
| Liabilities: | | | | |
| Foreign currency exchange contracts | $46 | $— | $46 | $— |
| Contingent consideration | 1,589 | — | — | 1,589 |
| | $1,635 | $— | $46 | $1,589 |
| | December 31, 2013 | | | |
| Assets: | | | | |
| Available for sale securities | $6,540 | $6,540 | $— | $— |
| Interest rate swap agreements | 937 | — | 937 | — |
| Foreign currency exchange contracts | 83 | — | 83 | — |
| | $7,560 | $6,540 | $1,020 | $— |
| Liabilities: | | | | |
| Foreign currency exchange contracts | $14 | $— | $14 | $— |
| Contingent consideration | 1,581 | — | — | 1,581 |
| | $1,595 | $— | $14 | $1,581 |
| | March 31, 2013 | | | |
| Assets: | | | | |
| Available for sale securities | $5,794 | $5,794 | $— | $— |
| Foreign currency exchange contracts | 205 | — | 205 | — |
| | $5,999 | $5,794 | $205 | $— |
| Liabilities: | | | | |
| Interest rate swap agreements | $227 | $— | $227 | $— |
| Contingent consideration | 4,360 | — | — | 4,360 |
| | $4,587 | $— | $227 | $4,360 |

Bellaire Corporation (“Bellaire”) is a non-operating subsidiary of the Company with legacy liabilities relating to closed mining operations, primarily former Eastern U.S. underground coal mining operations. In connection with Bellaire's normal permit renewal with the Pennsylvania Department of Environmental Protection ("DEP"), Bellaire was notified during 2004 that in order to obtain renewal of the permit Bellaire would be required to establish a mine water treatment trust (the "Mine Water Treatment Trust"). On October 1, 2010, Bellaire executed a Post-Mining Treatment

Trust Consent Order and Agreement with the DEP which established the Mine Water Treatment Trust to provide a financial assurance mechanism in order to assure the long-term treatment of post-mining discharges. Bellaire agreed to initially fund the Mine Water Treatment Trust with $5.0 million. Bellaire's Mine Water Treatment Trust invests in available for sale securities that are reported at fair value based upon

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quoted market prices in active markets for identical assets; therefore, they are classified as Level 1 within the fair value hierarchy and in the table above.

The Company uses significant other observable inputs to value derivative instruments used to hedge foreign currency and interest rate risk; therefore, they are classified within Level 2 of the valuation hierarchy. The fair value for these contracts is determined based on exchange rates and interest rates, respectively. See Note 5 for further discussion of the Company's derivative financial instruments. The valuation techniques and Level 3 inputs used to estimate the fair value of contingent consideration payable in connection with the Company's 2012 acquisition of Reed Minerals are described below. There were no transfers into or out of Levels 1, 2 or 3 during the three months ended March 31, 2014 and 2013.

The following table summarizes changes in Level 3 liabilities measured at fair value on a recurring basis:

| | | Contingent Consideration |
|---|---|---|
| Balance at | January 1, 2014 | $1,581 |
| Accretion expense | | 8 |
| Payments | | — |
| Balance at | March 31, 2014 | $1,589 |

The contingent consideration is structured as an earn-out payment to the sellers of Reed Minerals. The earn-out is calculated as a percentage by which the monthly average coal selling price exceeds an established threshold multiplied by the number of tons sold during the month. The earn-out period covers the first 15.0 million tons of coal sold from the Reed Minerals coal reserves. There is no monetary cap on the amount payable under this contingent payment arrangement. The liability for contingent consideration is included in Other long-term liabilities in the Unaudited Condensed Consolidated Balance Sheet. Earn-out payments, if payable, are paid quarterly. No earn-out payments were made during the three months ended March 31, 2014. Earn-out payments of less than $0.1 million were paid during the three months ended March 31, 2013.

The estimated fair value of the contingent consideration was determined based on the income approach with key assumptions that include future projected metallurgical coal prices, forecasted coal deliveries and the estimated discount rate used to determine the present value of the projected contingent consideration payments. Future projected coal prices were estimated using a stochastic modeling methodology based on Geometric Brownian Motion with a risk neutral Monte Carlo simulation. Significant assumptions used in the model include coal price volatility and the risk-free interest rate based on U.S. Treasury yield curves with maturities consistent with the expected life of the contingent consideration. Volatility is considered a significant assumption and is based on historical coal prices. A significant increase or decrease in any of the aforementioned key assumptions related to the fair value measurement of the contingent consideration may result in a significantly higher or lower reported fair value for the contingent consideration liability.

The future anticipated cash flow for the contingent consideration was discounted using an interest rate that appropriately captures a market participant's view of the risk associated with the liability. This fair value measurement is based on significant inputs not observable in the market and thus represents a Level 3 measurement within the fair value hierarchy.

Other Fair Value Measurement Disclosures: The carrying amounts of cash and cash equivalents, accounts receivable and accounts payable approximate fair value due to the short-term maturities of these instruments. The fair values of revolving credit agreements and long-term debt, excluding capital leases, were determined using current rates offered for similar obligations taking into account subsidiary credit risk, which is Level 2 as defined in the fair value hierarchy. At March 31, 2014, both the fair value and the book value of the revolving credit agreements and long-term debt, excluding capital leases, was $210.6 million. At December 31, 2013, both the fair value and the book value of the revolving credit agreements and long-term debt, excluding capital leases, was $170.7 million. At March 31, 2013, the fair value of the revolving credit agreements and long-term debt, excluding capital leases, was $162.8 million compared with the book value of $162.0 million.

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NOTE 7—Unconsolidated Subsidiaries

NACoal has two consolidated mining operations: Mississippi Lignite Mining Company (“MLMC”) and Reed Minerals. NACoal also provides dragline mining services for independently owned limerock quarries in Florida. NACoal has ten wholly owned unconsolidated subsidiaries that each meet the definition of a variable interest entity and are accounted for using the equity method:

The Coteau Properties Company ("Coteau")
The Falkirk Mining Company ("Falkirk")
The Sabine Mining Company ("Sabine")
Demery Resources Company, LLC (“Demery”)
Caddo Creek Resources Company, LLC (“Caddo Creek”)
Coyote Creek Mining Company, LLC (“Coyote Creek”)
Camino Real Fuels, LLC (“Camino Real”)
Liberty Fuels Company, LLC (“Liberty”)
NoDak Energy Services, LLC ("NoDak")
North American Coal Corporation India Private Limited ("NACC India")

Coteau, Falkirk and Sabine were developed between 1974 and 1981 and operate lignite coal mines under long-term contracts with various utility customers. Coteau, Falkirk and Sabine are capitalized primarily with debt financing, which the utility customers have arranged and guaranteed, and are without recourse to NACCO and NACoal. Demery, Caddo Creek, Coyote Creek, Camino Real and Liberty (collectively with Coteau, Falkirk and Sabine, the "Unconsolidated Mines") were formed to develop, construct and operate surface mines under long-term contracts. Demery commenced delivering coal to its customer in 2012 and is expected to reach full production levels in late 2015. Liberty commenced production in 2013 and is expected to increase production levels gradually from 0.5 to 1 million tons in 2014 to full production of approximately 4.7 million tons of coal annually in 2019. Caddo Creek, Coyote Creek and Camino Real are still in development and are not expected to be at full production for several years. NoDak was formed to operate and maintain a coal processing facility. NACC India was formed to provide technical advisory services to the third-party owners of a coal mine in India.

The contracts with the customers of the Unconsolidated Mines provide for reimbursement at a price based on actual costs plus an agreed pre-tax profit per ton of coal sold or actual costs plus a management fee. Although NACoal owns 100% of the equity and manages the daily operations of these entities, the Company has determined that the equity capital provided by NACoal is not sufficient to adequately finance the ongoing activities or absorb any expected losses without additional support from the customers. The customers have a controlling financial interest and have the power to direct the activities that most significantly affect the economic performance of the entities. As a result, NACoal is not the primary beneficiary and therefore does not consolidate these entities' financial position or results of operations. The income taxes resulting from the operations of the Unconsolidated Mines are solely the responsibility of the Company. The pre-tax income from the Unconsolidated Mines is reported on the line “Earnings of unconsolidated mines” in the Unaudited Condensed Consolidated Statements of Operations, with related income taxes included in the provision for income taxes. The Company has included the pre-tax earnings of the Unconsolidated Mines above operating profit because they are an integral component of the Company's business and operating results. The pre-tax income from NoDak is reported on the line "Income from other unconsolidated affiliates" in the "Other expense (income)" section of the Unaudited Condensed Consolidated Statements of Operations, with the related income taxes included in the provision for income taxes. The net income from NACC India is reported on the line "Income from other unconsolidated affiliates" in the "Other expense (income)" section of the Unaudited Condensed Consolidated Statements of Operations.

The investments in the Unconsolidated Mines, NoDak and NACC India and related tax positions totaled $34.1 million, $33.1 million, and $37.2 million at March 31, 2014, December 31, 2013, and March 31, 2013, respectively, and is included on the line “Other Non-current Assets” in the Unaudited Condensed Consolidated Balance Sheets. The Company's maximum risk of loss relating to these entities is limited to its invested capital, which was $5.3 million, $5.4 million, and $5.1 million at March 31, 2014, December 31, 2013, and March 31, 2013 respectively.

Included in "Accounts receivable from affiliates" is $29.6 million, $27.9 million and $25.2 million as of March 31, 2014, December 31, 2013 and March 31, 2013, respectively due from Coyote Creek, primarily for the purchase of a dragline from NACoal.

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Summarized financial information for the Unconsolidated Mines, NoDak and NACC India is as follows:

| | THREE MONTHS ENDED MARCH 31 | |
|---|---|---|
| | 2014 | 2013 |
| Revenues | $138,523 | $139,636 |
| Gross profit | $19,493 | $19,497 |
| Income before income taxes | $13,168 | $12,783 |
| Net income | $10,146 | $9,801 |

NOTE 8—Contingencies

Various legal and regulatory proceedings and claims have been or may be asserted against NACCO and certain subsidiaries relating to the conduct of their businesses, including product liability, patent infringement, asbestos-related claims, environmental and other claims. These proceedings and claims are incidental to the ordinary course of business of the Company. Management believes that it has meritorious defenses and will vigorously defend the Company in these actions. Any costs that management estimates will be paid as a result of these claims are accrued when the liability is considered probable and the amount can be reasonably estimated. Although the ultimate disposition of these proceedings is not presently determinable, management believes, after consultation with its legal counsel, that the likelihood is remote that material costs will be incurred in excess of accruals already recognized.

HBB is investigating or remediating historical environmental contamination at some current and former sites operated by HBB or by businesses it acquired. Based on the current stage of the investigation or remediation at each known site, HBB estimates the total investigation and remediation costs and the period of assessment and remediation activity required for each site. The estimate of future investigation and remediation costs is primarily based on variables associated with site clean-up, including, but not limited to, physical characteristics of the site, the nature and extent of the contamination and applicable regulatory programs and remediation standards. No assessment can fully characterize all subsurface conditions at a site. There is no assurance that additional assessment and remediation efforts will not result in adjustments to estimated remediation costs or the time frame for remediation at these sites.

HBB's estimates of investigation and remediation costs may change if it discovers contamination at additional sites or additional contamination at known sites, if the effectiveness of its current remediation efforts change, if applicable federal or state regulations change or if HBB's estimate of the time required to remediate the sites changes. HBB's revised estimates may differ materially from original estimates.

At March 31, 2014, December 31, 2013, and March 31, 2013, HBB had accrued an undiscounted obligation of $6.8 million, $6.9 million and $5.0 million, respectively, for environmental investigation and remediation activities at these sites. In addition, HBB estimates that it is reasonably possible that it may incur additional expenses in the range of $0 to $4.3 million related to the environmental investigation and remediation at these sites.

NOTE 9—Product Warranties

HBB provides a standard warranty to consumers for all of its products. The specific terms and conditions of those warranties vary depending upon the product brand. In general, if a product is returned under warranty, a refund is provided to the consumer by HBB's customer, the retailer. Generally, the retailer returns those products to HBB for a credit. The Company estimates the costs which may be incurred under its standard warranty programs and records a liability for such costs at the time product revenue is recognized.

The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary. Factors that affect the Company's warranty liability include the number of units sold, historical and anticipated rates of warranty claims and the cost per claim.

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Changes in the Company's current and long-term recorded warranty liability are as follows:

| | 2014 |
|---|---|
| Balance at January 1 | $5,343 |
| Warranties issued | 1,674 |
| Settlements made | (2,466) |
| Balance at March 31 | $4,551 |

NOTE 10—Income Taxes

The income tax provision includes U.S. federal, state and local, and foreign income taxes and is based on the application of a forecasted annual income tax rate applied to the current quarter's year-to-date pre-tax income or loss. In determining the estimated annual effective income tax rate, the Company analyzes various factors, including projections of the Company's annual earnings, taxing jurisdictions in which the earnings will be generated, the impact of state and local income taxes, the Company's ability to use tax credits and net operating loss carryforwards, and available tax planning alternatives. Discrete items, including the effect of changes in tax laws, tax rates and certain circumstances with respect to valuation allowances or other unusual or non-recurring tax adjustments are reflected in the period in which they occur as an addition to, or reduction from, the income tax provision, rather than included in the estimated effective annual income tax rate.

NOTE 11—Retirement Benefit Plans

The Company maintains various defined benefit pension plans that provide benefits based on years of service and average compensation during certain periods. The Company's policy is to make contributions to fund these plans within the range allowed by applicable regulations. Plan assets consist primarily of publicly traded stocks and government and corporate bonds. Pension benefits were frozen for all employees effective as of the close of business on December 31, 2013. All eligible employees of the Company, including employees whose pension benefits are frozen, receive retirement benefits under defined contribution retirement plans.

The Company also maintains postretirement health care plans which provide benefits to eligible retired employees. All health care plans of the Company have a cap on the Company's share of the costs. These plans have no assets. Under the Company's current policy, plan benefits are funded at the time they are due to participants.
The components of pension and postretirement health care expense (income) are set forth below:

| | THREE MONTHS ENDED MARCH 31 | |
|---|---|---|
| | 2014 | 2013 |
| U.S. Pension and Postretirement Health Care | | |
| Service cost | $18 | $20 |
| Interest cost | 794 | 780 |
| Expected return on plan assets | (1,267) | (1,216) |
| Amortization of actuarial loss | 244 | 601 |
| Amortization of prior service credit | (19) | (45) |
| Total | $(230) | $140 |
| Non-U.S. Pension | | |
| Service cost | $— | $— |
| Interest cost | 49 | 50 |
| Expected return on plan assets | (74) | (72) |

| | | |
|---|---|---|
| Amortization of actuarial loss | 16 | 30 |
| Total | $(9) | $8 |

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NOTE 12—Business Segments

NACCO is a holding company with the following principal subsidiaries: NACoal, HBB and KC. See Note 1 for a discussion of the Company's industries and product lines. NACCO's non-operating segment, NACCO and Other, includes the accounts of the parent company and Bellaire Corporation ("Bellaire"), a non-operating subsidiary of the Company.

Financial information for each of NACCO's reportable segments is presented in the following table. The line “Eliminations” in the revenues section eliminates revenues from HBB sales to KC. The amounts of these revenues are based on current market prices of similar third-party transactions. No other sales transactions occur among reportable segments.

| | THREE MONTHS ENDED MARCH 31 | |
|---|---|---|
| | 2014 | 2013 |
| Revenues from external customers | | |
| NACoal | $39,872 | $51,147 |
| HBB | 101,325 | 106,151 |
| KC | 36,876 | 39,711 |
| Eliminations | (660) | (957) |
| Total | $177,413 | $196,052 |
| | | |
| Operating profit (loss) | | |
| NACoal | $6,653 | $11,785 |
| HBB | 937 | 2,668 |
| KC | (6,514) | (4,980) |
| NACCO and Other | (1,352) | (2,436) |
| Eliminations | (309) | (15) |
| Total | $(585) | $7,022 |
| Net income (loss) | | |
| NACoal | $5,705 | $9,591 |
| HBB | 350 | 1,501 |
| KC | (4,033) | (3,267) |
| NACCO and Other | (1,197) | (2,003) |
| Eliminations | (2,349) | (1,400) |
| Total | $(1,524) | $4,422 |

NOTE 13—Subsequent Events

During the fourth quarter of 2013, NACoal acquired the equipment of National Coal of Alabama, Inc. ("NCOA") in exchange for the assumption of outstanding debt of $9.7 million associated with the acquired equipment. The outstanding debt was repaid concurrently with the acquisition of equipment utilizing borrowings under NACoal's existing unsecured revolving line of credit. In April 2014, NACoal acquired coal reserves and prepaid royalties and assumed certain reclamation obligations of NCOA. No cash payment was made to NCOA. This acquisition, which will be accounted for as a business combination, provides additional coal reserves in Alabama and equipment that can be used at NACoal's Reed Minerals mine, also located in Alabama.

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Item 2. - Management's Discussion and Analysis of Financial Condition and Results of Operations
(Dollars in thousands, except as noted and per share data)

NACCO Industries, Inc. (the “parent company” or “NACCO”) and its wholly owned subsidiaries (collectively, the “Company”) operate in the following principal industries: mining, small appliances and specialty retail. Results of operations and financial condition are discussed separately by subsidiary, which corresponds with the industry groupings.

The North American Coal Corporation and its affiliated coal companies (collectively, “NACoal”) mine and market steam and metallurgical coal for use in power generation and steel production and provide selected value-added mining services for other natural resources companies. Hamilton Beach Brands, Inc. (“HBB”) is a leading designer, marketer and distributor of small electric household appliances, as well as commercial products for restaurants, bars and hotels. The Kitchen Collection, LLC (“KC”) is a national specialty retailer of kitchenware and gourmet foods operating under the Kitchen Collection® and Le Gourmet Chef® store names in outlet and traditional malls throughout the United States.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES
Please refer to the discussion of the Company's Critical Accounting Policies and Estimates as disclosed on pages 34 through 37 in the Company's Annual Report on Form 10-K for the year ended December 31, 2013. The Company's Critical Accounting Policies and Estimates have not materially changed since December 31, 2013.

THE NORTH AMERICAN COAL CORPORATION

NACoal mines and markets steam and metallurgical coal for use in power generation and steel production and provides selected value-added mining services for other natural resources companies. Coal is surface mined from NACoal's developed mines in North Dakota, Texas, Mississippi, Louisiana and Alabama. Total coal reserves approximate 2.2 billion tons with approximately 1.1 billion tons committed to customers pursuant to long-term contracts.

NACoal has two consolidated mining operations: Mississippi Lignite Mining Company (“MLMC”) and Reed Minerals. NACoal also provides dragline mining services for independently owned limerock quarries in Florida. NACoal has ten wholly owned unconsolidated subsidiaries that each meet the definition of a variable interest entity and are accounted for using the equity method:

The Coteau Properties Company ("Coteau")
The Falkirk Mining Company ("Falkirk")
The Sabine Mining Company ("Sabine")
Demery Resources Company, LLC (“Demery”)
Caddo Creek Resources Company, LLC (“Caddo Creek”)
Coyote Creek Mining Company, LLC (“Coyote Creek”)
Camino Real Fuels, LLC (“Camino Real”)
Liberty Fuels Company, LLC (“Liberty”)
NoDak Energy Services, LLC ("NoDak")
North American Coal Corporation India Private Limited ("NACC India")

Coteau, Falkirk and Sabine were developed between 1974 and 1981 and operate lignite coal mines under long-term contracts with various utility customers. Coteau, Falkirk and Sabine are capitalized primarily with debt financing, which the utility customers have arranged and guaranteed, and are without recourse to NACCO and NACoal. Demery, Caddo Creek, Coyote Creek, Camino Real and Liberty (collectively with Coteau, Falkirk and Sabine, the

"Unconsolidated Mines") were formed to develop, construct and operate surface mines under long-term contracts. Demery commenced delivering coal to its customer in 2012 and is expected to reach full production levels in late 2015. Liberty commenced production in 2013 and is expected to increase production levels gradually from 0.5 to 1 million tons in 2014 to full production of approximately 4.7 million tons of coal annually in 2019. Caddo Creek, Coyote Creek and Camino Real are still in development and are not expected to be at full production for several years. NoDak was formed to operate and maintain a coal processing facility. NACC India was formed to provide technical advisory services to the third-party owners of a coal mine in India.

The contracts with the customers of the Unconsolidated Mines provide for reimbursement at a price based on actual costs plus an agreed pre-tax profit per ton of coal sold or actual costs plus a management fee.

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FINANCIAL REVIEW

Tons of coal sold by NACoal's operating mines were as follows for the three months ended March 31:

| | 2014 | 2013 |
|---|---|---|
| | (In millions) | |
| Coteau | 4.0 | 3.8 |
| Falkirk | 2.0 | 2.0 |
| Sabine | 1.1 | 1.2 |
| Unconsolidated mines | 7.1 | 7.0 |
| MLMC | 0.6 | 0.9 |
| Reed Minerals | 0.2 | 0.2 |
| Consolidated mines | 0.8 | 1.1 |
| Total tons sold | 7.9 | 8.1 |

The limerock dragline mining operations sold 5.0 million and 6.3 million cubic yards of limerock in the three months ended March 31, 2014 and March 31, 2013, respectively.

The results of operations for NACoal were as follows for the three months ended March 31:

| | 2014 | 2013 |
|---|---|---|
| Revenue - consolidated mines | $37,496 | $45,835 |
| Royalty and other | 2,376 | 5,312 |
| Total revenues | 39,872 | 51,147 |
| Cost of sales - consolidated mines | 36,582 | 42,158 |
| Cost of sales - royalty and other | 445 | 260 |
| Total cost of sales | 37,027 | 42,418 |
| Gross profit | 2,845 | 8,729 |
| Earnings of unconsolidated mines (a) | 12,438 | 12,098 |
| Selling, general and administrative expenses | 7,865 | 8,001 |
| Amortization of intangible assets | 765 | 1,041 |
| Operating profit | 6,653 | 11,785 |
| Interest expense | 1,071 | 784 |
| Other income (including income from other unconsolidated affiliates) | (473) | (360) |
| Income before income tax provision | 6,055 | 11,361 |
| Income tax provision | 350 | 1,770 |
| Net income | $5,705 | $9,591 |
| | | |
| Effective income tax rate (b) | 5.8 % | 15.6 % |

(a) See Note 7 to Unaudited Condensed Consolidated Financial Statements for a discussion of the Company's unconsolidated subsidiaries, including summarized financial information.
(b) The NACoal effective tax rate is affected by the benefit of percentage depletion.

See further information regarding the consolidated effective income tax rate in Note 10 to Unaudited Condensed Consolidated Financial Statements.

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First Quarter of 2014 Compared with First Quarter of 2013

The following table identifies the components of change in revenues for the first quarter of 2014 compared with the first quarter of 2013:

| | Revenues |
|---|---|
| 2013 | $51,147 |
| Decrease from: | |
| Consolidated mining operations | (8,339) |
| Royalty and other income | (2,936) |
| 2014 | $39,872 |

Revenues decreased to $39.9 million in the first quarter of 2014 from $51.1 million in the first quarter of 2013 primarily due to a decrease in revenue at the consolidated mining operations as a result of a planned outage at MLMC's customer's power plant resulting in fewer tons sold in the first quarter of 2014 compared with the first quarter of 2013, and lower customer requirements at the limerock dragline mining operations. This decrease was partially offset by a slight increase in revenue at Reed Minerals as an increase in tons sold was largely offset by a lower selling price. A decrease in royalty and other income also contributed to the reduction in revenues.

The following table identifies the components of change in operating profit for the first quarter of 2014 compared with the first quarter of 2013:

| | Operating Profit |
|---|---|
| 2013 | $11,785 |
| Increase (decrease) from: | |
| Royalty and other income | (3,235) |
| Consolidated mining operations | (2,110) |
| Other selling, general and administrative expenses | (450) |
| Earnings of unconsolidated mines | 340 |
| Loss on sale of asset | 323 |
| 2014 | $6,653 |

Operating profit decreased to $6.7 million in the first quarter of 2014 from $11.8 million in the first quarter of 2013 due to a substantial decrease in royalty and other income and lower operating results at the consolidated mining operations. The decrease at the consolidated mining operations was primarily attributable to a decrease in tons sold at MLMC due to a planned, but longer than expected, outage at the customer's power plant resulting in decreased customer requirements. Reed Minerals also generated a slightly higher loss in the first quarter of 2014 compared with the first quarter of 2013 due to an increase in depreciation expense on equipment acquired during 2013 and 2014, as well as from higher repairs and maintenance expense.

Net income decreased to $5.7 million in the first quarter of 2014 from $9.6 million in the first quarter of 2013 primarily due to the factors affecting operating profit, partially offset by lower income tax expense due to a lower effective income tax rate resulting from a shift in the mix of taxable income toward entities with lower estimated effective income tax rates and a higher tax benefit from percentage depletion.

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LIQUIDITY AND CAPITAL RESOURCES

Cash Flows

The following tables detail the changes in cash flow for the three months ended March 31:

| | 2014 | 2013 | Change |
|---|---|---|---|
| Operating activities: | | | |
| Net income | $5,705 | $9,591 | $(3,886) |
| Depreciation, depletion and amortization | 4,778 | 4,030 | 748 |
| Other | (4,237) | (15,577) | 11,340 |
| Working capital changes | 11,770 | 12,335 | (565) |
| Net cash provided by operating activities | 18,016 | 10,379 | 7,637 |
| | | | |
| Investing activities: | | | |
| Expenditures for property, plant and equipment | (30,936) | (6,225) | (24,711) |
| Other | (189) | 798 | (987) |
| Net cash used for investing activities | (31,125) | (5,427) | (25,698) |
| | | | |
| Cash flow before financing activities | $(13,109) | $4,952 | $(18,061) |

The increase in net cash provided by operating activities was primarily the result of the change in other operating activities, partially offset by the decrease in net income during the first three months of 2014 compared with the first three months of 2013. The change in other operating activities was primarily the result of changes in intercompany taxes from unconsolidated mines.

The increase in net cash used for investing activities was primarily attributable to expenditures for property, plant and equipment, mainly for the refurbishment of a dragline and purchase of equipment at Reed Minerals in the first three months of 2014.

| | 2014 | 2013 | Change |
|---|---|---|---|
| Financing activities: | | | |
| Net additions (reductions) to long-term debt and revolving credit agreements | $10,094 | $(7,339) | $17,433 |
| Capital contribution from NACCO | 3,000 | — | 3,000 |
| Net cash provided by (used for) financing activities | $13,094 | $(7,339) | $20,433 |

The change in net cash provided by (used for) financing activities was primarily due to an increase in borrowings and a capital contribution from NACCO during the first three months of 2014 compared with a reduction in borrowings in the first three months of 2013.

Financing Activities

NACoal has an unsecured revolving line of credit of up to $225.0 million (the “NACoal Facility”) that expires in November 2018. Borrowings outstanding under the NACoal Facility were $150.0 million at March 31, 2014. At March 31, 2014, the excess availability under the NACoal Facility was $74.0 million, which reflects a reduction for outstanding letters of credit of $1.0 million.

The NACoal Facility has performance-based pricing, which sets interest rates based upon achieving various levels of debt to EBITDA ratios, as defined in the NACoal Facility. Borrowings bear interest at a floating rate plus a margin based on the level of debt to EBITDA ratio achieved. The applicable margins, effective March 31, 2014, for base rate and LIBOR loans were 1.00% and 2.00%, respectively. The NACoal Facility has a commitment fee which is based upon achieving various levels of debt to EBITDA ratios. The commitment fee was 0.35% on the unused commitment at March 31, 2014. The weighted average interest rate applicable to the NACoal Facility at March 31, 2014 was 2.97% including the floating rate margin and the effect of the interest rate swap agreement.

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To reduce the exposure to changes in the market rate of interest, NACoal has entered into an interest rate swap agreement for a portion of the NACoal Facility. Terms of the interest rate swap agreement require NACoal to receive a variable interest rate and pay a fixed interest rate. NACoal has interest rate swaps with notional values totaling $100.0 million at March 31, 2014 at an average fixed interest rate of 1.4%. See Note 5 to the Unaudited Condensed Consolidated Financial Statements for further discussion of NACoal's interest rate swap agreement.

The NACoal Facility contains restrictive covenants, which require, among other things, NACoal to maintain a maximum debt to EBITDA ratio of 3.50 to 1.00 and an interest coverage ratio of not less than 4.00 to 1.00. The NACoal Facility provides the ability to make loans, dividends and advances to NACCO, with some restrictions based on maintaining a maximum debt to EBITDA ratio of 3.00 to 1.00 in conjunction with maintaining unused availability thresholds of borrowing capacity, as defined in the NACoal Facility, of $15.0 million. At March 31, 2014, NACoal was in compliance with all covenants in the NACoal Facility.

During 2004 and 2005, NACoal issued unsecured notes totaling $45.0 million in a private placement (the “NACoal Notes”), which require annual principal payments of approximately $6.4 million, which began in October 2008, and will mature on October 4, 2014. These unsecured notes bear interest at a weighted-average fixed rate of 6.08%, payable semi-annually on April 4 and October 4. The NACoal Notes are redeemable at any time at the option of NACoal, in whole or in part, at an amount equal to par plus accrued and unpaid interest plus a “make-whole premium,” if applicable. NACoal had $6.4 million of the private placement notes outstanding at March 31, 2014. The NACoal Notes contain certain covenants and restrictions that require, among other things, NACoal to maintain certain net worth, leverage and interest coverage ratios, and limit dividends to NACCO based upon maintaining a maximum debt to EBITDA ratio of 3.25 to 1.00. At March 31, 2014, NACoal was in compliance with the financial covenants in the NACoal Notes.

NACoal has a demand note payable to Coteau which bears interest based on the applicable quarterly federal short-term interest rate as announced from time to time by the Internal Revenue Service. At March 31, 2014, the balance of the note was $4.8 million and the interest rate was 0.25%.

NACoal believes funds available from cash on hand at the Company, the NACoal Facility and operating cash flows will provide sufficient liquidity to meet its operating needs and commitments arising during the next twelve months and until the expiration of the NACoal Facility in November 2018.

Contractual Obligations, Contingent Liabilities and Commitments

Since December 31, 2013, there have been no significant changes in the total amount of NACoal's contractual obligations, contingent liabilities or commercial commitments, or the timing of cash flows in accordance with those obligations as reported on page 46 in the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

Capital Expenditures

Expenditures for property, plant and equipment were $30.9 million during the first three months of 2014. NACoal estimates that its capital expenditures for the remainder of 2014 will be an additional $29.1 million, primarily for dragline refurbishment, mine equipment and development at its mines. These expenditures are expected to be funded from internally generated funds and bank borrowings.

Capital Structure

NACoal's capital structure is presented below:

| | MARCH 31<br>2014 | DECEMBER 31<br>2013 | Change |
|---|---|---|---|
| Cash and cash equivalents | $12 | $ 27 | $(15) |
| Other net tangible assets | 262,036 | 242,486 | 19,550 |
| Coal supply agreements and other intangibles, net | 58,920 | 59,685 | (765) |
| Net assets | 320,968 | 302,198 | 18,770 |
| Total debt | (173,937) | (163,843) | (10,094) |
| Total equity | $147,031 | $ 138,355 | $8,676 |
| Debt to total capitalization | 54% | 54% | —% |

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The increase in other net tangible assets during the first three months of 2014 was primarily due to an increase in property, plant and equipment slightly offset by a decrease in accounts receivable. The increase in property, plant and equipment was mainly attributable to the refurbishment of a dragline and purchase of equipment at Reed Minerals. The decrease in accounts receivable primarily resulted from the reduction in revenue due to the planned outage at MLMC's customer's power plant, as well as the collection of a Reed Minerals receivable in the first three months of 2014. Total debt increased mainly to fund the increase in property, plant and equipment.

OUTLOOK

NACoal continues to expect improved operating performance overall at its coal mining operations in 2014. At the unconsolidated mining operations, steam coal tons delivered in 2014 are expected to increase over 2013 provided customers achieve currently planned power plant operating levels in 2014. Demery commenced delivering coal to its customer in 2012 and full production levels are expected to be reached in late 2015. Liberty commenced production in 2013 for Mississippi Power Company's new Kemper County Energy Facility. Production levels at Liberty are expected to increase gradually from 0.5 million to 1 million tons in 2014 to full production of approximately 4.7 million tons of coal annually in 2019.

Unconsolidated mines currently in development are expected to continue to generate modest income during 2014. The three mines in development are not expected to be at full production for several years. Mining permits needed to commence mining operations were issued in 2013 for the Caddo Creek and the Camino Real projects in Texas. Caddo Creek expects to begin making initial coal deliveries in late 2014. Camino Real expects initial deliveries in the latter half of 2015, and expects to mine approximately 3.6 million tons of coal annually when at full production. Coyote Creek is developing a mine in Mercer County, North Dakota, from which it expects to deliver approximately 2.5 million tons of coal annually beginning in May 2016.

Consolidated coal mining operations are expected to improve significantly. Tons sold at Reed Minerals are expected to continue to increase in 2014 compared with 2013 and productivity improvements and increased mining efficiencies are expected in the second half of 2014. As part of its overall Reed Minerals improvement program, NACoal plans to temporarily idle a higher-cost Reed Minerals mining area during the last three quarters of 2014 while it files a revised mining permit. This permit will allow for a larger contiguous mining area that is expected to improve productivity and reduce costs. While this mining area is temporarily idled, NACoal will continue to supply current customers with coal mined from a nearby operation. In addition during the fourth quarter of 2013 and the first quarter of 2014, NACoal continued to acquire additional reserves and equipment near the Reed Minerals operation as part of its improvement program and the company's plans to expand its Alabama metallurgical coal platform. The improvements at Reed Minerals are expected to be somewhat offset by reduced results at MLMC due to fewer deliveries in 2014 compared with 2013 because of a planned outage at the customer's power plant in the first quarter of 2014, which was longer than expected, and another significant planned outage at the customer's power plant in the fourth quarter of 2014. Deliveries at MLMC are expected to increase over the longer term as a result of continued operational improvements at the customer's power plant. NACoal also has project opportunities for which it expects to continue to incur additional expenses in 2014. In particular, the company continues to move forward to obtain a permit for its Otter Creek reserve in North Dakota in preparation for construction of a new mine.

Limerock deliveries over the remainder of 2014 are expected to continue to be lower than 2013 as a result of reduced customer requirements.

Substantial declines in royalty and other income are also expected in 2014 from the high levels realized in 2013 and as a result, net income is expected to decrease significantly in 2014 compared with 2013.

NACoal expects a significant decline in net income in the second quarter of 2014 compared with the first quarter of 2014 due to increased losses at Reed Minerals and substantially lower royalty and other income. However, in the second half of 2014, NACoal expects net income to increase significantly compared with the second half of 2013. Productivity improvements and increased mining efficiencies are expected to result in a slight profit at Reed Minerals in the second half of 2014 compared with a large loss in the second half of 2013 but are not expected to offset Reed Minerals' operating losses incurred in the first half of the year. This improvement in the second half of 2014 is expected to be partially offset by significantly reduced deliveries at MLMC due to another planned outage at the customer's power plant and lower royalty and other income than in the second half of 2013. Overall, net income for the full year is expected to decline due to expected lower first half results. Cash flow before financing activities in 2014 is expected to be positive as compared with the negative cash flow before financing activities in 2013.

Over the longer term, NACoal's goal is to increase earnings of its unconsolidated mines by approximately 50% by 2017 from 2012 levels through the development and maturation of its new mines and normal escalation of contractual compensation at its existing mines. Also, NACoal has a goal of at least doubling the earnings contribution from its consolidated mining operations

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by 2017 from 2012 levels due to benefits from anticipated continued operational improvements at MLMC's customer's power plant and from the company's execution of its long-term plan at the Reed Minerals operations. The company views its acquisition of Reed Minerals as a metallurgical coal strategic initiative which includes significantly increased volume and profitability for the company over the long term.

NACoal also expects to continue its efforts to develop new mining projects. The company is actively pursuing domestic opportunities for new or expanded coal mining projects, which include prospects for power generation, coal-to-liquids, coal-to-chemicals, coal gasification, coal drying and other clean coal technologies. NACoal also continues to pursue additional non-coal mining opportunities, principally in aggregates, and international value-added mining services projects, particularly in India.

HAMILTON BEACH BRANDS, INC.

HBB is a leading designer, marketer and distributor of small electric household appliances, as well as commercial products for restaurants, bars and hotels. HBB’s products are marketed primarily to retail merchants and wholesale distributors. HBB's business is seasonal, and a majority of its revenues and operating profit typically occurs in the second half of the year when sales of small electric appliances to retailers and consumers increase significantly for the fall holiday-selling season.

FINANCIAL REVIEW

The results of operations for HBB were as follows for the three months ended March 31:

| | 2014 | | 2013 | |
|---|---|---|---|---|
| Revenues | $101,325 | | $106,151 | |
| Operating profit | $937 | | $2,668 | |
| Interest expense | $295 | | $469 | |
| Other expense (income) | $220 | | $(183 | ) |
| Net income | $350 | | $1,501 | |
| Effective income tax rate | 17.1 | % | 37.0 | % |

First Quarter of 2014 Compared with First Quarter of 2013

The following table identifies the components of change in revenues for the first quarter of 2014 compared with the first quarter of 2013:

| | Revenues | |
|---|---|---|
| 2013 | $106,151 | |
| Decrease from: | | |
| Unit volume and product mix | (3,285 | ) |
| Foreign currency | (990 | ) |
| Other | (551 | ) |
| 2014 | $101,325 | |

Revenues for the first quarter of 2014 decreased to $101.3 million from $106.2 million in the first quarter of 2013 primarily as a result of a decrease in sales volumes in the U.S. and International consumer markets, partially offset by improved sales of commercial products. Unfavorable foreign currency movements in the first quarter of 2014 compared with the comparable 2013 period also contributed to the decrease in revenue as both the Canadian dollar and the Mexican peso weakened against the U.S. dollar.

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The following table identifies the components of change in operating profit for the first quarter of 2014 compared with the first quarter of 2013:

| | Operating Profit |
|---|---|
| 2013 | $2,668 |
| Decrease from: | |
| Foreign currency | (672) |
| Selling, general and administrative expenses | (625) |
| Gross profit | (434) |
| 2014 | $937 |

HBB's operating profit decreased to $0.9 million in the first quarter of 2014 from $2.7 million in the first quarter of 2013 primarily due to unfavorable foreign currency movements, increased selling, general and administrative expenses and reduced gross profit. Selling, general and administrative expenses increased mainly due to higher employee-related costs and advertising expenses. The decrease in gross profit primarily resulted from decreased sales volumes partially offset by a shift in sales mix to higher-priced, higher-margin products.

HBB recognized net income of $0.4 million in the first quarter of 2014 compared with $1.5 million in the first quarter of 2013 primarily due to the factors affecting operating profit.

LIQUIDITY AND CAPITAL RESOURCES

Cash Flows

The following tables detail the changes in cash flow for the three months ended March 31:

| | 2014 | 2013 | Change |
|---|---|---|---|
| Operating activities: | | | |
| Net income | $350 | $1,501 | $(1,151) |
| Depreciation and amortization | 634 | 538 | 96 |
| Other | 1,496 | 1,168 | 328 |
| Working capital changes | (18,556) | (150) | (18,406) |
| Net cash (used for) provided by operating activities | (16,076) | 3,057 | (19,133) |
| | | | |
| Investing activities: | | | |
| Expenditures for property, plant and equipment | (495) | (337) | (158) |
| Other | — | 4 | (4) |
| Net cash used for investing activities | (495) | (333) | (162) |
| | | | |
| Cash flow before financing activities | $(16,571) | $2,724 | $(19,295) |

Net cash provided by operating activities decreased $19.1 million in the first three months of 2014 compared with the first three months of 2013 primarily due to the change in working capital and the decrease in net income. The change in working capital was mainly from an increase in inventory in the first quarter of 2014 compared with a decrease in the 2013 comparable period, a larger decrease in accounts payable and a larger decrease in accrued payroll from increased payments, partially offset by a larger decrease in accounts receivable in the first quarter of 2014 compared with the 2013 comparable period. The increase in inventory and decrease in accounts receivable was primarily the result of reduced sales in the first three months of 2014. The decrease in accounts payable was mainly due to the timing of inventory purchases and a shift in payment terms with certain suppliers.

| | 2014 | 2013 | Change |
|---|---|---|---|

| | | | |
|---|---|---|---|
| Financing activities: | | | |
| Net additions (reductions) to revolving credit agreement | $19,189 | $(5,022) | $24,211 |
| Net cash provided by (used for) financing activities | $19,189 | $(5,022) | $24,211 |

The change in net cash provided by (used for) financing activities was the result of an increase in borrowings during the first three months of 2014 compared with a decrease in borrowings in the first three months of 2013.

Financing Activities

HBB has a $115.0 million senior secured floating-rate revolving credit facility (the "HBB Facility") that expires in July 2017. The obligations under the HBB Facility are secured by substantially all of HBB's assets. The approximate book value of HBB's assets held as collateral under the HBB Facility was $198.3 million as of March 31, 2014. At March 31, 2014, the borrowing base under the HBB Facility was $96.0 million and borrowings outstanding under the HBB Facility were $37.6 million. At March 31, 2014, the excess availability under the HBB Facility was $58.4 million.

The maximum availability under the HBB Facility is governed by a borrowing base derived from advance rates against eligible accounts receivable, inventory and trademarks of the borrowers, as defined in the HBB Facility. Adjustments to reserves booked against these assets, including inventory reserves, will change the eligible borrowing base and thereby impact the liquidity provided by the HBB Facility. A portion of the availability is denominated in Canadian dollars to provide funding to HBB's Canadian subsidiary. Borrowings bear interest at a floating rate, which can be a base rate or LIBOR, as defined in the HBB Facility, plus an applicable margin. The applicable margins, effective March 31, 2014, for base rate loans and LIBOR loans denominated in U.S. dollars were 0.00% and 1.50%, respectively. The applicable margins, effective March 31, 2014, for base rate loans and bankers' acceptance loans denominated in Canadian dollars were 0.00% and 1.50%, respectively. The HBB Facility also requires a fee of 0.375% per annum on the unused commitment. The margins and unused commitment fee under the HBB Facility are subject to quarterly adjustment based on average excess availability and average usage, respectively. The weighted average interest rate applicable to the HBB Facility at March 31, 2014 was 3.03% including the floating rate margin and the effect of interest rate swap agreements.

To reduce the exposure to changes in the market rate of interest, HBB has entered into interest rate swap agreements for a portion of the HBB Facility. Terms of the interest rate swap agreements require HBB to receive a variable interest rate and pay a fixed interest rate. HBB has interest rate swaps with notional values totaling $20.0 million at March 31, 2014 at an average fixed interest rate of 1.4%. See Note 5 to Unaudited Condensed Consolidated Financial Statements for further discussion of HBB's interest rate swap agreements.

The HBB Facility includes restrictive covenants, which, among other things, limit the payment of dividends to NACCO, subject to achieving availability thresholds. Dividends are limited to the greater of $20.0 million or excess cash flow from the most recently ended fiscal year in each of the two twelve-month periods following the closing date of the HBB Facility, so long as HBB has excess availability under the HBB Facility of not less than $25.0 million and maintains a minimum fixed charge coverage ratio of 1.0 to 1.0, as defined in the HBB Facility; and in such amounts as determined by HBB subsequent to the second anniversary of the closing date of the HBB Facility, so long as HBB has excess availability under the HBB Facility of not less than $25.0 million. The HBB Facility also requires HBB to achieve a minimum fixed charge coverage ratio in certain circumstances, as defined in the HBB Facility. At March 31, 2014, HBB was in compliance with the financial covenants in the HBB Facility.

HBB believes funds available from cash on hand at the Company, the HBB Facility and operating cash flows will provide sufficient liquidity to meet its operating needs and commitments arising during the next twelve months and until the expiration of the HBB Facility in July 2017.

Contractual Obligations, Contingent Liabilities and Commitments

Since December 31, 2013, there have been no significant changes in the total amount of HBB's contractual obligations, contingent liabilities or commercial commitments, or the timing of cash flows in accordance with those obligations as reported on page 52 in the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

Capital Expenditures

Expenditures for property, plant and equipment were $0.5 million for the first three months of 2014 and are estimated to be an additional $6.2 million for the remainder of 2014. These planned capital expenditures are primarily for tooling for new products and improvements to HBB's information technology infrastructure. These expenditures are expected to be funded from internally generated funds and bank borrowings.

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Capital Structure

Working capital is significantly affected by the seasonality of HBB's business. The following is a discussion of the changes in HBB's capital structure at March 31, 2014 compared with both March 31, 2013 and December 31, 2013.

March 31, 2014 Compared with March 31, 2013

| | MARCH 31 2014 | MARCH 31 2013 | Change |
|---|---|---|---|
| Cash and cash equivalents | $2,626 | $494 | $2,132 |
| Other net tangible assets | 87,400 | 79,640 | 7,760 |
| Net assets | 90,026 | 80,134 | 9,892 |
| Total debt | (37,636) | (34,654) | (2,982) |
| Total equity | $52,390 | $45,480 | $6,910 |
| Debt to total capitalization | 42% | 43% | (1)% |

Other net tangible assets increased $7.8 million from March 31, 2013 primarily due to an increase in inventory and a change in HBB's pension liability partially offset by an increase in accounts payable, a decrease in accounts receivable and a change in deferred income taxes. The increase in inventory and the decrease in accounts receivable were driven by lower sales in the first quarter of 2014 compared with the first quarter of 2013. The increase in accounts payable was due to the timing of inventory purchases.

Total equity increased $6.9 million primarily attributable to both HBB's net income of $23.9 million and the change in Accumulated other comprehensive loss of $3.0 million for the twelve months ended March 31, 2014, partially offset by $20.0 million of dividends paid to NACCO during the twelve months ended March 31, 2014.

March 31, 2014 Compared with December 31, 2013

| | MARCH 31 2014 | DECEMBER 31 2013 | Change |
|---|---|---|---|
| Cash and cash equivalents | $2,626 | $11 | $2,615 |
| Other net tangible assets | 87,400 | 70,700 | 16,700 |
| Net assets | 90,026 | 70,711 | 19,315 |
| Total debt | (37,636) | (18,447) | (19,189) |
| Total equity | $52,390 | $52,264 | $126 |
| Debt to total capitalization | 42% | 26% | 16% |

Other net tangible assets increased $16.7 million from December 31, 2013 primarily due to lower levels of accounts payable, a decrease in other current liabilities from decreased payroll-related accruals as payments were made during the first three months of 2014, increased inventory and a decrease in intercompany taxes payable. The increase in other net tangible assets was partially offset by a decrease in accounts receivable. The changes in accounts payable and accounts receivable were primarily attributable to the seasonality of the business. The increase in inventory was driven by higher sales forecasts in the first quarter of 2014.

Total debt increased $19.2 million as a result of the seasonality of the business and the required funding of operations during the first three months of 2014.

OUTLOOK

HBB's target consumer, the middle-market mass consumer, continues to struggle with financial and economic concerns. As a result, sales volumes in the middle-market portion of the U.S. small kitchen appliance market in which

HBB participates are projected to grow only moderately in 2014. International and commercial product markets in which HBB participates are also anticipated to grow in 2014 compared with 2013.

HBB expects sales volumes to grow more favorably than the market due to improved placements in 2014 compared with 2013. HBB continues to focus on strengthening its North American consumer market position through product innovation, promotions, increased placements and branding programs, together with appropriate levels of advertising for the company's highly successful and innovative product lines. HBB expects the FlexBrew™ coffee maker, launched in late 2012, and the Hamilton Beach® Breakfast Sandwich Maker, launched in early 2013, to continue to gain market position. The company is continuing to introduce innovative products and upgrades to certain products in several small appliance categories. These products, as well as other new product introductions in the pipeline for 2014, are expected to affect both revenues and operating profit positively. As a result of these new products and execution of the company's strategic initiatives, both domestically and internationally, HBB expects an increase in revenues in 2014 compared with 2013 at more than the 2014 market forecast rate of increase.

Overall, HBB expects full-year 2014 net income to be comparable to or moderately lower than 2013. The anticipated increase in sales volumes attributable to the continued implementation and execution of HBB's strategic initiatives is expected to be substantially offset by the costs of implementing those initiatives and by increased advertising and promotional costs and outside services fees. Product and transportation costs, as well as the negative effects of foreign currency fluctuations, are expected to gradually increase throughout 2014 compared with 2013. HBB continues to monitor both currency effects and commodity costs closely and intends to adjust product prices and product placements appropriately in response to such cost increases. HBB expects cash flow before financing activities in 2014 to be substantial but down significantly from 2013.

Longer term, HBB will work to take advantage of the potential to improve return on sales through economies of scale derived from market growth and a focus on its five strategic volume growth initiatives: (1) enhancing its placements in the North America consumer business through consumer-driven innovative products and strong sales and marketing support, (2) enhancing internet sales by providing best-in-class retailer support and increased consumer content and engagement, (3) participating in the "only-the-best" market with a strong brand and broad product line, (4) expanding internationally in the emerging Asian and Latin American markets by increasing product offerings and expanding its distribution channels and sales and marketing capabilities and (5) achieving global Commercial market leadership through a commitment to an enhanced global product line for chains and distributors serving the global food service and hospitality markets. During 2013 and the first quarter of 2014, HBB continued to make strides in the execution of its strategic initiatives and expects to continue to do so in the remainder of 2014.

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THE KITCHEN COLLECTION, LLC

KC is a national specialty retailer of kitchenware and gourmet foods operating under the Kitchen Collection® and Le Gourmet Chef® ("LGC") store names in outlet and traditional malls throughout the United States. KC's business is seasonal, and a majority of its revenues and operating profit typically occurs in the second half of the year when sales of kitchenware to consumers increase significantly for the fall holiday-selling season.

FINANCIAL REVIEW

The results of operations for KC were as follows for the three months ended March 31:

| | 2014 | | 2013 | |
|---|---|---|---|---|
| Revenues | $36,876 | | $39,711 | |
| Operating loss | $(6,514 | ) | $(4,980 | ) |
| Interest expense | $88 | | $51 | |
| Other expense (income) | $18 | | $23 | |
| Net loss | $(4,033 | ) | $(3,267 | ) |
| Effective income tax rate | 39.1 | % | 35.4 | % |

First Quarter of 2014 Compared with First Quarter of 2013

The following table identifies the components of change in revenues for the first quarter of 2014 compared with the first quarter of 2013:

| | Revenues | |
|---|---|---|
| 2013 | $39,711 | |
| Increase (decrease) from: | | |
| Closed stores | (3,085 | ) |
| KC comparable store sales | (1,667 | ) |
| LGC comparable store sales | (246 | ) |
| New store sales | 2,007 | |
| Other | 156 | |
| 2014 | $36,876 | |

Revenues for the first quarter of 2014 decreased to $36.9 million from $39.7 million in the first quarter of 2013. The decrease was primarily the result of the loss of sales from closing unprofitable KC and LGC stores since March 31, 2013 and a decline in both KC and LGC comparable store sales. The decrease in comparable store sales was mainly due to fewer customer visits and a reduction in store transactions at both store formats, partially offset by a modest improvement in the average sales transaction value at KC stores in the first quarter of 2014 compared with the first quarter of 2013. First quarter 2014 revenues were also unfavorably affected by an increase in the number of temporary store closures due to inclement weather. These decreases were partially offset by sales at newly opened KC stores.

At March 31, 2014, KC operated 238 stores compared with 255 stores at March 31, 2013 and 272 stores at December 31, 2013. At March 31, 2014, LGC operated 20 stores compared with 44 stores at March 31, 2013 and 32 stores at December 31, 2013.

The following table identifies the components of change in operating loss for the first quarter of 2014 compared with the first quarter of 2013:

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| | Operating Loss |
|---|---|
| 2013 | $(4,980) |
| (Increase) decrease from: | |
| Comparable stores | (1,678) |
| New stores | (276) |
| Closed stores | (70) |
| Other | (38) |
| Selling, general and administrative expenses | 528 |
| 2014 | $(6,514) |

KC recognized an operating loss of $6.5 million in the first quarter of 2014 compared with an operating loss of $5.0 million in the first quarter of 2013. The increase in the operating loss was primarily due to reduced sales and unfavorable margins from the liquidation of discontinued inventory at comparable stores and seasonal losses at newly opened stores. Unfavorable margins from the liquidation of inventory at closed stores were almost completely offset by reduced closed store expenses. Favorable selling, general and administrative expenses primarily due to lower employee-related costs partially offset the increased operating loss.

KC reported a net loss of $4.0 million in the first quarter of 2014 compared with a net loss of $3.3 million in the first quarter of 2013 primarily due to the factors affecting the operating loss, partially offset by a higher estimated effective income tax rate in the first quarter of 2014 compared with the first quarter of 2013 resulting in a greater tax benefit on the 2014 operating loss.

LIQUIDITY AND CAPITAL RESOURCES

Cash Flows

The following tables detail the changes in cash flow for the three months ended March 31:

| | 2014 | 2013 | Change |
|---|---|---|---|
| Operating activities: | | | |
| Net loss | $(4,033) | $(3,267) | $(766) |
| Depreciation and amortization | 491 | 728 | (237) |
| Other | (26) | (63) | 37 |
| Working capital changes | (6,804) | (15,323) | 8,519 |
| Net cash used for operating activities | (10,372) | (17,925) | 7,553 |
| | | | |
| Investing activities: | | | |
| Expenditures for property, plant and equipment | (341) | (772) | 431 |
| Other | 112 | 15 | 97 |
| Net cash used for investing activities | (229) | (757) | 528 |
| | | | |
| Cash flow before financing activities | $(10,601) | $(18,682) | $8,081 |

Net cash used for operating activities decreased $7.6 million in the first three months of 2014 compared with the first three months of 2013 primarily due to the change in working capital. The change in working capital was mainly the result of a lesser decrease in accounts payable due to lower inventory levels in the first three months of 2014 compared with the first three months of 2013.

Expenditures for property, plant and equipment decreased primarily due to the reduction in number of stores.

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| | 2014 | 2013 | Change |
|---|---|---|---|
| Financing activities: | | | |
| Net additions to revolving credit agreement | $10,268 | $8,221 | $2,047 |
| Other | — | (2 ) | 2 |
| Net cash provided by financing activities | $10,268 | $8,219 | $2,049 |

The change in net cash provided by financing activities was the result of an increase in borrowings to fund operations during the first three months of 2014 compared with the first three months of 2013.

Financing Activities

KC has a $30.0 million secured revolving line of credit that expires in August 2017 (the “KC Facility”). The obligations under the KC Facility are secured by substantially all of the assets of KC. The approximate book value of KC's assets collateralized under the KC Facility was $60.6 million as of March 31, 2014.

The maximum availability under the KC Facility is derived from a borrowing base formula using KC's eligible inventory and eligible credit card accounts receivable, as defined in the KC Facility. Borrowings bear interest at a floating rate plus a margin based on the excess availability under the agreement, as defined in the KC Facility, which can be either a base rate plus a margin of 1.00% or LIBOR plus a margin of 2.00% as of March 31, 2014. The KC Facility also requires a commitment fee of 0.375% per annum on the unused commitment. The floating rate of interest applicable to the KC Facility at March 31, 2014 was 2.15% including the floating rate margin.

At March 31, 2014, the borrowing base under the KC Facility was $27.0 million and borrowings outstanding under the KC Facility were $11.7 million. At March 31, 2014, the excess availability under the KC Facility was $15.3 million.

The KC Facility allows for the payment of dividends to NACCO, subject to certain restrictions based on availability and meeting a fixed charge coverage ratio as described in the KC Facility. Dividends are limited to (i) $6.0 million in any twelve-month period, so long as KC has excess availability, as defined in the KC Facility, of at least $7.5 million after giving effect to such payment and maintaining a minimum fixed charge coverage ratio of 1.1 to 1.0, as defined in the KC Facility; (ii) $2.0 million in any twelve-month period, so long as KC has excess availability, as defined in the KC Facility, of at least $7.5 million after giving effect to such payment and (iii) in such amounts as determined by KC, so long as KC has excess availability under the KC Facility of $15.0 million after giving effect to such payment. At March 31, 2014, KC was in compliance with all covenants in the KC Facility.

KC believes funds available from cash on hand at KC and the Company, the KC Facility and operating cash flows will provide sufficient liquidity to meet its operating needs and commitments arising during the next twelve months and until the KC Facility expires in August 2017.

Contractual Obligations, Contingent Liabilities and Commitments

Since December 31, 2013, there have been no significant changes in the total amount of KC's contractual obligations, contingent liabilities or commercial commitments, or the timing of cash flows in accordance with those obligations as reported on page 58 in the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

Capital Expenditures

Expenditures for property, plant and equipment were $0.3 million for the first three months of 2014 and are estimated to be an additional $1.0 million for the remainder of 2014. These planned capital expenditures are primarily for fixtures and equipment at new or existing stores and improvements to KC's information technology infrastructure. These expenditures are expected to be funded from internally generated funds and bank borrowings.

Capital Structure

Working capital is significantly affected by the seasonality of KC's business. The following is a discussion of the changes in KC's capital structure at March 31, 2014 compared with both March 31, 2013 and December 31, 2013.

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March 31, 2014 Compared with March 31, 2013

| | MARCH 31 2014 | MARCH 31 2013 | Change |
|---|---|---|---|
| Cash and cash equivalents | $449 | $1,059 | $(610) |
| Other net tangible assets | 44,018 | 47,551 | (3,533) |
| Net assets | 44,467 | 48,610 | (4,143) |
| Total debt | (11,728) | (8,221) | (3,507) |
| Total equity | $32,739 | $40,389 | $(7,650) |
| Debt to total capitalization | 26 % | 17 % | 9 % |

The $3.5 million decrease in other net tangible assets at March 31, 2014 compared with March 31, 2013 was mainly due to a reduction in inventory and property, plant and equipment primarily from a decrease in the number of stores open at March 31, 2014 compared with March 31, 2013.

The increase in borrowings during the first three months of 2014 compared with the first three months of 2013 was mainly due to lower sales volumes.

March 31, 2014 Compared with December 31, 2013

| | MARCH 31 2014 | DECEMBER 31 2013 | Change |
|---|---|---|---|
| Cash and cash equivalents | $449 | $ 781 | $(332) |
| Other net tangible assets | 44,018 | 37,451 | 6,567 |
| Net assets | 44,467 | 38,232 | 6,235 |
| Total debt | (11,728) | (1,460) | (10,268) |
| Total equity | $32,739 | $ 36,772 | $(4,033) |
| Debt to total capitalization | 26 % | (a) | (a) |

(a) Debt to total capitalization is not meaningful.

Other net tangible assets increased $6.6 million at March 31, 2014 compared with December 31, 2013 primarily from decreases in accounts payable, sales tax payable and accrued payroll partially offset by a decrease in inventory, all due to the seasonality of the business.

Total debt increased as a result of the seasonality of the business and the required funding of operations during the first three months of 2014. Total equity decreased as a result of KC's net loss during the first three months of 2014.

OUTLOOK

Consumer traffic to all mall locations, and particularly outlet malls, continued to decline in the first quarter of 2014 and prospects for the remainder of 2014 are uncertain. Fewer households were established in 2013, and this trend is expected to continue in 2014 because the middle-market consumer remains under pressure as a result of financial and economic concerns. These concerns are expected to continue to dampen consumer sentiment and limit consumer spending levels for KC's target customer in 2014. In this context, KC closed 48 stores in the first quarter of 2014 and plans to close approximately ten more in the second quarter, as part of a program to close underperforming stores and realign the business around core stores which perform with acceptable profitability. KC plans to maintain a lower number of stores in 2014 and, as a result, expects 2014 revenues to decrease compared with 2013.

The net effect of closing stores early in 2014 and the anticipated opening of a small number of new stores during the second half of 2014 is expected to contribute to significantly improved operating results beginning in the second quarter and gradually improving throughout 2014 with the objective of approaching break-even operating profit for the full year, compared with a significant loss in 2013, and to generate positive cash flow before financing activities. As part of KC's program to realign its business, the company has taken additional steps to reduce expenses through a number of cost reduction programs implemented during the first quarter of 2014 at its headquarters, distribution center and remaining core stores and by terminating its medical benefit plan in late February 2014. This program is expected to be mostly finalized in the second quarter of 2014 and is expected to generate significant improvements during the second half of 2014. In addition, during the first quarter KC executed revisions to its store layouts designed to focus customers on higher-margin products. These changes appear to be working as margins improved late in the first quarter of 2014 and are expected to continue improving during the balance of 2014. Overall, however, KC expects a moderate net loss in 2014.

Longer term, KC plans to focus on comparable store sales growth around a solid core store portfolio. KC expects to accomplish this by enhancing sales volume and profitability through continued refinement of its formats and ongoing review of specific product offerings, merchandise mix, store displays and appearance, while improving inventory efficiency and store inventory controls. A particular focus will be on increasing sales of higher-margin products. The company will also continue to evaluate and, as lease contracts permit, close or restructure leases for underperforming and loss-generating stores. In the near term, KC expects to add stores cautiously and focus its growth on its core Kitchen Collection® stores, with new stores expected to be located in sound positions in strong outlet malls.

NACCO AND OTHER

NACCO and Other includes the parent company operations and Bellaire.

FINANCIAL REVIEW

Operating Results

The results of operations at NACCO and Other were as follows for the three months ended March 31:

| | THREE MONTHS | |
|---|---|---|
| | 2014 | 2013 |
| Revenues | $— | $— |
| Operating loss | $(1,352) | $(2,436) |
| Other expense | $285 | $401 |
| Net loss | $(1,197) | $(2,003) |

First Quarter of 2014 Compared with First Quarter of 2013

NACCO and Other recognized an operating loss of $1.4 million and $2.4 million in the first quarter of 2014 and 2013, respectively. The decrease in the operating loss in the first quarter of 2014 compared with the first quarter of 2013 was primarily due to an increase in management fees charged to the subsidiaries and lower professional fees.

Management Fees
The management fees charged to the operating subsidiaries represent an allocation of corporate overhead of the parent company. Management fees are allocated among all subsidiaries based upon the relative size and complexity of each subsidiary. The Company believes the allocation method is consistently applied and reasonable.

Following are the parent company management fees included in each subsidiary's selling, general and administrative expenses for the three months ended March 31:

| | 2014 | 2013 |
|---|---|---|

| | | |
|---|---|---|
| NACoal | $1,022 | $740 |
| HBB | $887 | $792 |
| KC | $65 | $62 |

Stock Repurchase Program

On November 8, 2011, the Company announced that its Board of Directors approved the repurchase of up to $50 million of the Company's Class A Common Stock outstanding (the "2011 Stock Repurchase Program"). The original authorization for the 2011 Stock Repurchase Program expired on December 31, 2012; however, in November 2012 the Company's Board of Directors approved an extension of the 2011 Stock Repurchase Program through December 31, 2013. In total, the Company repurchased $35.6 million of Class A Common Stock under the 2011 Stock Repurchase Program.

On November 12, 2013, the Company's Board of Directors terminated the 2011 Stock Repurchase Program and approved a new stock repurchase program (the "2013 Stock Repurchase Program") providing for the purchase of up to $60 million of the Company's Class A Common Stock outstanding through December 31, 2015. The timing and amount of any repurchases under the 2013 Stock Repurchase Program are determined at the discretion of the Company's management based on a number of factors, including the availability of capital, other capital allocation alternatives and market conditions for the Company's Class A common stock. The 2013 Stock Repurchase Program does not require the Company to acquire any specific number of shares. It may be modified, suspended, extended or terminated by the Company at any time without prior notice and may be executed through open market purchases, privately negotiated transactions or otherwise. All or part of the repurchases under the 2013 Stock Repurchase Program may be implemented under a Rule 10b5-1 trading plan, which would allow repurchases under pre-set terms at times when the Company might otherwise be prevented from doing so. As of March 31, 2014, the Company had repurchased a total of 107,073 shares of Class A Common Stock for an aggregate purchase price of $5.9 million under the 2013 Stock Repurchase Program, including 90,978 shares at an average purchase price of $54.80 per share during the three months ended March 31, 2014.

LIQUIDITY AND CAPITAL RESOURCES

Although NACCO's subsidiaries have entered into substantial borrowing agreements, NACCO has not guaranteed any borrowings of its subsidiaries. The borrowing agreements at NACoal, HBB and KC allow for the payment to NACCO of dividends and advances under certain circumstances. Dividends (to the extent permitted by its subsidiaries' borrowing agreements), advances and management fees from its subsidiaries are the primary sources of cash for NACCO.

The Company believes funds available from cash on hand, its subsidiaries' credit facilities and anticipated funds generated from operations are sufficient to finance all of the subsidiaries scheduled principal repayments, and its operating needs and commitments arising during the next twelve months and until the expiration of its subsidiaries' credit facilities.

Contractual Obligations, Contingent Liabilities and Commitments

Since December 31, 2013, there have been no significant changes in the total amount of NACCO and Other contractual obligations, contingent liabilities or commercial commitments, or the timing of cash flows in accordance with those obligations as reported on page 62 in the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

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Capital Structure

NACCO's consolidated capital structure is presented below:

| | MARCH 31 2014 | DECEMBER 31 2013 | Change |
|---|---|---|---|
| Cash and cash equivalents | $70,070 | $ 95,390 | $(25,320 ) |
| Other net tangible assets | 398,542 | 341,230 | 57,312 |
| Coal supply agreement and other intangibles, net | 58,920 | 59,685 | (765 ) |
| Net assets | 527,532 | 496,305 | 31,227 |
| Total debt | (223,301 ) | (183,750 ) | (39,551 ) |
| Bellaire closed mine obligations, net of tax | (14,688 ) | (14,775 ) | 87 |
| Total equity | $289,543 | $ 297,780 | $(8,237 ) |
| Debt to total capitalization | 44% | 38% | 6% |

EFFECTS OF FOREIGN CURRENCY

HBB operates internationally and enters into transactions denominated in foreign currencies. As a result, the Company is subject to the variability that arises from exchange rate movements. The effects of foreign currency fluctuations on revenues, operating profit and net income at HBB are addressed in the previous discussions of operating results. See also Item 3, "Quantitative and Qualitative Disclosures About Market Risk," in Part I of this Form 10-Q.

FORWARD-LOOKING STATEMENTS

The statements contained in this Form 10-Q that are not historical facts are "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These forward-looking statements are made subject to certain risks and uncertainties, which could cause actual results to differ materially from those presented. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. The Company undertakes no obligation to publicly revise these forward-looking statements to reflect events or circumstances that arise after the date hereof. Such risks and uncertainties with respect to each subsidiary's operations include, without limitation:

NACoal: (1) the successful integration of the Reed Minerals acquisition, (2) changes in the demand for and market prices of metallurgical coal produced at the Reed Minerals operations, (3) changes in tax laws or regulatory requirements, including changes in mining or power plant emission regulations and health, safety or environmental legislation, (4) changes in costs related to geological conditions, repairs and maintenance, new equipment and replacement parts, fuel or other similar items, (5) regulatory actions, changes in mining permit requirements or delays in obtaining mining permits that could affect deliveries to customers, (6) weather conditions, extended power plant outages or other events that would change the level of customers' coal or limerock requirements, which would have an adverse effect on results of operations, (7) weather or equipment problems that could affect deliveries to customers, (8) changes in the power industry that would affect demand for NACoal's reserves, (9) changes in the costs to reclaim current NACoal mining areas, (10) costs to pursue and develop new mining opportunities, (11) legal challenges related to Mississippi Power's Kemper County Energy Facility in Mississippi, (12) changes or termination of a long-term mining contract, or a customer default under a contract and (13) increased competition, including consolidation within the industry.

HBB: (1) changes in the sales prices, product mix or levels of consumer purchases of small electric appliances, (2) changes in consumer retail and credit markets, (3) bankruptcy of or loss of major retail customers or suppliers, (4) changes in costs, including transportation costs, of sourced products, (5) delays in delivery of sourced products, (6) changes in or unavailability of quality or cost effective suppliers, (7) exchange rate fluctuations, changes in the foreign import tariffs and monetary policies and other changes in the regulatory climate in the foreign countries in which HBB buys, operates and/or sells products, (8) product liability, regulatory actions or other litigation, warranty claims or returns of products, (9) customer acceptance of, changes in costs of, or delays in the development of new products, (10) increased competition, including consolidation within the industry and (11) changes mandated by federal, state and other regulation, including health, safety or environmental legislation.

KC: (1) changes in gasoline prices, weather conditions, the level of consumer confidence and disposable income as a result of economic conditions, unemployment rates or other events or conditions that may adversely affect the number of customers visiting Kitchen Collection® and Le Gourmet Chef® stores, (2) changes in the sales prices, product mix or levels of consumer

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purchases of kitchenware, small electric appliances and gourmet foods, (3) changes in costs, including transportation costs, of inventory, (4) delays in delivery or the unavailability of inventory, (5) customer acceptance of new products, (6) the anticipated impact of the opening of new stores, the ability to renegotiate existing leases and effectively and efficiently close under-performing stores, (7) increased competition and (8) the impact of tax penalties under health care reform legislation beginning in 2015.

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

### INTEREST RATE RISK

The Company's subsidiaries, NACoal, HBB and KC, have entered into certain financing arrangements that require interest payments based on floating interest rates. As such, the Company's financial results are subject to changes in the market rate of interest. There is an inherent rollover risk for borrowings as they mature and are renewed at current market rates. The extent of this risk is not quantifiable or predictable because of the variability of future interest rates and business financing requirements. To reduce the exposure to changes in the market rate of interest, NACoal and HBB have entered into interest rate swap agreements for a portion of its floating rate financing arrangements. The Company does not enter into interest rate swap agreements for trading purposes. Terms of the interest rate swap agreements provide for the subsidiaries to receive a variable interest rate and pay a fixed interest rate. See Note 5 to Unaudited Condensed Consolidated Financial Statements in this Form 10-Q.

The fair value of the Company's interest rate swap agreements was a net asset of $0.6 million at March 31, 2014. A hypothetical 10% decrease in interest rates would not cause a material change in the fair value of the interest rate swap agreements at March 31, 2014.

### FOREIGN CURRENCY EXCHANGE RATE RISK

HBB operates internationally and enters into transactions denominated in foreign currencies, principally the Canadian dollar, the Mexican peso and, to a lesser extent, the Chinese yuan and Brazilian real. As such, its financial results are subject to the variability that arises from exchange rate movements. HBB uses forward foreign currency exchange contracts to partially reduce risks related to transactions denominated in foreign currencies and not for trading purposes. These contracts generally mature within twelve months and require HBB to buy or sell the functional currency in which the applicable subsidiary operates and buy or sell U.S. dollars at rates agreed to at the inception of the contracts. The fair value of these contracts was a net asset of $0.1 million at March 31, 2014. See Note 5 to Unaudited Condensed Consolidated Financial Statements in this Form 10-Q.

For purposes of risk analysis, the Company uses sensitivity analyses to measure the potential loss in fair value of financial instruments sensitive to changes in foreign currency exchange rates. The Company assumes that a loss in fair value is either a decrease to its assets or an increase to its liabilities. Assuming a hypothetical 10% weakening of the U.S. dollar compared with other foreign currencies at March 31, 2014, the fair value of foreign currency-sensitive financial instruments, which primarily represent forward foreign currency exchange contracts, would not cause a material change in the fair value of the contracts at March 31, 2014. It is important to note that the change in fair value indicated in this sensitivity analysis would be somewhat offset by changes in the fair value of the underlying receivables and payables, which would not be material.

### COMMODITY PRICE RISK

The Company uses certain commodities, including steel and diesel fuel, in the normal course of its mining processes. As such, the cost of operations is subject to variability as the market for these commodities changes. The Company monitors this risk and, from time to time, enters into derivative contracts to hedge this risk. The Company does not currently have any such derivative contracts outstanding, nor does the Company have any significant purchase obligations to obtain fixed quantities of commodities in the future.

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## Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures: An evaluation was carried out under the supervision and with the participation of the Company's management, including the principal executive officer and the principal financial officer, of the effectiveness of the Company's disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, these officers have concluded that the Company's disclosure controls and procedures are effective.

Changes in internal control over financial reporting: During the first quarter of 2014, there have been no changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II
OTHER INFORMATION

Item 1 Legal Proceedings
None.

Item 1A Risk Factors
No material changes for HBB, KC, NACoal or General from the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

Item 2 Unregistered Sales of Equity Securities and Use of Proceeds

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

Issuer Purchases of Equity Securities

| Period | (a) Total Number of Shares Purchased | (b) Average Price Paid per Share | (c) Total Number of Shares Purchased as Part of the Publicly Announced Program | (d) Maximum Number of Shares (or Approximate Dollar Value) that May Yet Be Purchased Under the Program (1) |
|---|---|---|---|---|
| Month #1 (January 1 to 31, 2014) | 5,826 | $59.04 | 5,826 | $58,740,974 |
| Month #2 (February 1 to 28, 2014) | 24,784 | $58.30 | 24,784 | $57,296,067 |
| Month #3 (March 1 to 31, 2014) | 60,368 | $52.95 | 60,368 | $54,099,581 |
| Total | 90,978 | $54.80 | 90,978 | $54,099,581 |

(1) On November 12, 2013, the Company's Board of Directors approved a stock repurchase program (the "2013 Stock Repurchase Program") providing for the purchase of up to $60 million of the Company's Class A Common Stock outstanding through December 31, 2015. The timing and amount of any repurchases under the 2013 Stock Repurchase Program are determined at the discretion of the Company's management based on a number of factors, including the availability of capital, other capital allocation alternatives and market conditions for the Company's Class A Common Stock. The 2013 Stock Repurchase Program does not require the Company to acquire any specific number of shares. It may be modified, suspended, extended or terminated by the Company at any time without prior notice and may be executed through open market purchases, privately negotiated transactions or otherwise. All or part of the repurchases under the 2013 Stock Repurchase Program may be implemented under a Rule 10b5-1 trading plan, which would allow repurchases under pre-set terms at times when the Company might otherwise be prevented from doing so. As of March 31, 2014, the Company repurchased $5.9 million of Class A Common Stock under the 2013 Stock Repurchase Program.

Item 3 Defaults Upon Senior Securities
None.

Item 4 Mine Safety Disclosures
Information concerning mine safety violations or other regulatory matters required by Section 1503(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act and Item 104 of Regulation S-K is included in Exhibit

95 filed with this Quarterly Report on Form 10-Q for the period ended March 31, 2014.

Item 5 Other Information

None.

Item 6 Exhibits

Incorporated by reference to the Exhibit Index on page 42 of this Quarterly Report on Form 10-Q for the period ended March 31, 2014.

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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.

| | |
|---|---|
| | NACCO Industries, Inc.<br>(Registrant) |
| Date: April 30, 2014 | /s/ Elizabeth I. Loveman<br>Elizabeth I. Loveman<br>Vice President and Controller<br>(Principal Accounting Officer) |

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Exhibit Index

| Exhibit Number* | Description of Exhibits |
|---|---|
| 31(i)(1) | Certification of Alfred M. Rankin, Jr. pursuant to Rule 13a-14(a)/15d-14(a) of the Exchange Act |
| 31(i)(2) | Certification of J.C. Butler, Jr. pursuant to Rule 13a-14(a)/15d-14(a) of the Exchange Act |
| 32 | Certifications pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, signed and dated by Alfred M. Rankin, Jr. and J.C. Butler, Jr. |
| 95 | Mine Safety Disclosure Exhibit |
| 101.INS | XBRL Instance Document |
| 101.SCH | XBRL Taxonomy Extension Schema Document |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |

* Numbered in accordance with Item 601 of Regulation S-K.

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TEXT-ALIGN: right">- - - - Total fair value hedges 884 307 - 1,675 319 -
Non-Qualifying Hedges

Interest rate contracts (1)
36,714 750 - 30,232 568 -
Foreign currency contracts (1)
138 - - 4 - -
Equity market contracts (1)
19,276 1,780 - 16,401 2,096 -
Credit contracts (1)
47 - 3 48 - -
Credit contracts (2)
188 - 16 148 - 16
Embedded derivatives:
Indexed annuity contracts (3) - - 733 - - 399 Guaranteed living benefits ("GLB") reserves (3) - - 1,411 - - 2,217 Reinsurance related (4) - - 215 - - 168 Total derivative instruments$61,003 $3,072 $2,378 $51,360 $3,151 $2,800

(1) Reported in derivative investments on our Consolidated Balance Sheets.
(2) Reported in other liabilities on our Consolidated Balance Sheets.
(3) Reported in future contract benefits on our Consolidated Balance Sheets.
(4) Reported in reinsurance related embedded derivatives on our Consolidated Balance Sheets.

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The maturity of the notional amounts of derivative instruments (in millions) was as follows:

| | Remaining Life as of September 30, 2012 | | | | | |
|---|---|---|---|---|---|---|
| | Less Than 1 Year | 1 – 5 Years | 6 – 10 Years | 11 – 30 Years | Over 30 Years | Total |
| Interest rate contracts (1) | $ 3,110 | $ 20,203 | $ 6,307 | $ 10,092 | $ 1,213 | $ 40,925 |
| Foreign currency contracts (2) | 138 | 179 | 191 | 50 | - | 558 |
| Equity market contracts | 9,917 | 3,863 | 5,477 | 25 | 3 | 19,285 |
| Credit contracts | 40 | 195 | - | - | - | 235 |
| Total derivative instruments with notional amounts | $ 13,205 | $ 24,440 | $ 11,975 | $ 10,167 | $ 1,216 | $ 61,003 |

(1) As of September 30, 2012, the latest maturity date for which we were hedging our exposure to the variability in future cash flows for these instruments was June 2042.
(2) As of September 30, 2012, the latest maturity date for which we were hedging our exposure to the variability in future cash flows for these instruments was April 2028.

The change in our unrealized gain (loss) on derivative instruments in accumulated OCI (in millions) was as follows:

| | For the Nine Months Ended September 30, | |
|---|---|---|
| | 2012 | 2011 |
| Unrealized Gain (Loss) on Derivative Instruments | | |
| Balance as of beginning-of-year | $ 119 | $ (15) |
| Other comprehensive income (loss): | | |
| Cumulative effect from adoption of new accounting standards | - | 4 |
| Unrealized holding gains (losses) arising during the year: | | |
| Cash flow hedges: | | |
| Interest rate contracts | 67 | 178 |
| Foreign currency contracts | (3) | 7 |
| Fair value hedges: | | |
| Interest rate contracts | 3 | 3 |
| Change in foreign currency exchange rate adjustment | (7) | (1) |
| Change in DAC, VOBA, DSI and DFEL | 9 | (1) |
| Transfers from derivative instruments to bonds through basis adjustment | 13 | - |
| Income tax benefit (expense) | (30) | (65) |
| Less: | | |
| Reclassification adjustment for gains (losses) included in net income (loss): | | |
| Cash flow hedges: | | |
| Interest rate contracts (1) | (17) | (6) |
| Interest rate contracts (2) | - | 3 |
| Foreign currency contracts (1) | 3 | (3) |
| Fair value hedges: | | |
| Interest rate contracts (2) | 3 | 3 |
| Associated amortization of DAC, VOBA, DSI and DFEL | 2 | - |
| Income tax benefit (expense) | 3 | 1 |
| Balance as of end-of-period | $ 177 | $ 112 |

(1) The OCI offset is reported within net investment income on our Consolidated Statements of Comprehensive Income (Loss).
(2) The OCI offset is reported within interest and debt expense on our Consolidated Statements of Comprehensive Income (Loss).

The gains (losses) on derivative instruments (in millions) recorded within income (loss) from continuing operations on our Consolidated Statements of Comprehensive Income (Loss) were as follows:

| | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Qualifying Hedges | | | | |
| Cash flow hedges: | | | | |
| Interest rate contracts (1) | $ (6 ) | $ (2 ) | $ (17 ) | $ (7 ) |
| Foreign currency contracts (1) | 2 | 2 | 4 | 3 |
| Total cash flow hedges | (4 ) | - | (13 ) | (4 ) |
| Fair value hedges: | | | | |
| Interest rate contracts (2) | 5 | 13 | 28 | 38 |
| Non-Qualifying Hedges | | | | |
| Interest rate contracts (1) | (4 ) | (25 ) | (23 ) | (41 ) |
| Interest rate contracts (3) | (2 ) | 982 | 206 | 1,008 |
| Foreign currency contracts (3) | (4 ) | (5 ) | (8 ) | (11 ) |
| Equity market contracts (3) | (343) | 694 | (773) | 560 |
| Equity market contracts (4) | (136) | 154 | (246) | 120 |
| Credit contracts (1) | - | (1 ) | (1 ) | (1 ) |
| Credit contracts (3) | (7 ) | (8 ) | (2 ) | (6 ) |
| Embedded derivatives: | | | | |
| Indexed annuity contracts (3) | (63 ) | 135 | (143) | 81 |
| GLB reserves (3) | 570 | (2,065) | 861 | (1,935) |
| Reinsurance related (3) | (30 ) | (58 ) | (48 ) | (76 ) |
| AFS securities (1) | - | - | - | 1 |
| Total derivative instruments | $ (18 ) | $ (184 ) | $ (162) | $ (266 ) |

(1) Reported in net investment income on our Consolidated Statements of Comprehensive Income (Loss).
(2) Reported in interest and debt expense on our Consolidated Statements of Comprehensive Income (Loss).
(3) Reported in realized gain (loss) on our Consolidated Statements of Comprehensive Income (Loss).
(4) Reported in commissions and other expenses on our Consolidated Statements of Comprehensive Income (Loss).

Gains (losses) (in millions) on derivative instruments designated and qualifying as cash flow hedges were as follows:

| | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Gain (loss) recognized as a component of OCI with the offset to net investment income | $ (5 ) | $ - | $ (15 ) | $ (4 ) |

As of September 30, 2012, $22 million of the deferred net losses on derivative instruments in accumulated OCI were expected to be reclassified to earnings during the next 12 months. This reclassification would be due primarily to the interest rate variances related to the interest rate swap agreements.

For the three and nine months ended September 30, 2012 and 2011, there were no material reclassifications to earnings due to hedged firm commitments no longer deemed probable or due to hedged forecasted transactions that had not occurred by the end of the originally specified time period.

Gains (losses) (in millions) on derivative instruments designated and qualifying as fair value hedges were as follows:

| | For the Three Months Ended September 30, 2012 | 2011 | For the Nine Months Ended September 30, 2012 | 2011 |
|---|---|---|---|---|
| Gain (loss) recognized as a component of OCI with the offset to interest expense | $ 1 | $ 1 | $ 3 | $ 3 |

Information related to our open credit default swap liabilities for which we are the seller (dollars in millions) was as follows:

As of September 30, 2012

| Maturity | Reason for Entering | Nature of Recourse | Credit Rating of Underlying Obligation (1) | Number of Instruments | Fair Value (2) | Maximum Potential Payout |
|---|---|---|---|---|---|---|
| 12/20/2012 (3) | (5) | (6) | BBB+ | 4 | $ - | $ 40 |
| 12/20/2016 (4) | (5) | (6) | BBB- | 3 | (6) | 68 |
| 03/20/2017 (4) | (5) | (6) | BBB- | 4 | (11) | 81 |
| | | | | 11 | $ (17) | $ 189 |

As of December 31, 2011

| Maturity | Reason for Entering | Nature of Recourse | Credit Rating of Underlying Obligation (1) | Number of Instruments | Fair Value (2) | Maximum Potential Payout |
|---|---|---|---|---|---|---|
| 12/20/2012 (3) | (5) | (6) | BBB+ | 4 | $ - | $ 40 |
| 12/20/2016 (4) | (5) | (6) | BBB+ | 3 | (12) | 68 |
| 03/20/2017 (4) | (5) | (6) | BBB | 2 | (4) | 40 |
| | | | | 9 | $ (16) | $ 148 |

(1) Represents average credit ratings based on the midpoint of the applicable ratings among Moody's, S&P and Fitch Ratings, as scaled to the corresponding S&P ratings.
(2) Broker quotes are used to determine the market value of credit default swaps.
(3) These credit default swaps were sold to our contract holders prior to 2007, where we determined there was a spread versus premium mismatch.
(4) These credit default swaps were sold to a counter-party of the consolidated VIEs as discussed in Note 4 in our 2011 Form 10-K.
(5) Credit default swaps were entered into in order to generate income by providing default protection in return for a quarterly payment.
(6)

Sellers do not have the right to demand indemnification or compensation from third parties in case of a loss (payment) on the contract.

Details underlying the associated collateral of our open credit default swaps for which we are the seller, if credit risk related contingent features were triggered (in millions), are as follows:

| | As of September 30, 2012 | As of December 31, 2011 |
|---|---|---|
| Maximum potential payout | $ 189 | $ 148 |
| Less: | | |
| Counterparty thresholds | - | - |
| Maximum collateral potentially required to post | $ 189 | $ 148 |

Certain of our credit default swap agreements contain contractual provisions that allow for the netting of collateral with our counterparties related to all of our collateralized financing transactions that we have outstanding. If these netting agreements were not in place, we would have been required to post approximately $16 million as of September 30, 2012, after considering the fair values of the associated investments counterparties' credit ratings as compared to ours and specified thresholds that once exceeded result in the payment of cash.

Credit Risk

We are exposed to credit loss in the event of nonperformance by our counterparties on various derivative contracts and reflect assumptions regarding the credit or nonperformance risk. The nonperformance risk is based upon assumptions for each counterparty's credit spread over the estimated weighted average life of the counterparty exposure less collateral held. As of September 30, 2012, the nonperformance risk adjustment was $4 million. The credit risk associated with such agreements is minimized by purchasing such agreements from financial institutions with long-standing, superior performance records. Additionally, we maintain a policy of requiring all derivative contracts to be governed by an International Swaps and Derivatives Association ("ISDA") Master Agreement. We 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 derivative contracts, at which time any amounts payable by us would be dependent on the market value of the underlying derivative contracts. In certain transactions, we and the counterparty have entered into a collateral support agreement requiring either party to post collateral when net exposures exceed pre-determined thresholds. These thresholds vary by counterparty and credit rating. The amount of such exposure is essentially the net replacement cost or market value less collateral held for such agreements with each counterparty if the net market value is in our favor. As of September 30, 2012, our exposure was $50 million.

The amounts recognized (in millions) by S&P credit rating of counterparty, for which we had the right to reclaim cash collateral or were obligated to return cash collateral, were as follows:

| | As of September 30, 2012 | | As of December 31, 2011 | |
|---|---|---|---|---|
| S&P Credit Rating of Counterparty | Collateral Posted by Counter-Party (Held by LNC) | Collateral Posted by LNC (Held by Counter-Party) | Collateral Posted by Counter-Party (Held by LNC) | Collateral Posted by LNC (Held by Counter-Party) |
| AA | $ 46 | $ - | $ 35 | $ - |

| | | | | |
|---|---|---|---|---|
| AA- | 76 | - | 219 | - |
| A+ | 668 | - | 848 | - |
| A | 879 | (83 ) | 1,681 | (120 ) |
| A- | 1,415 | - | 387 | - |
| BBB | 2 | - | - | - |
| | $ 3,086 | $ (83 ) | $ 3,170 | $ (120 ) |

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7. Federal Income Taxes

A reconciliation of the effective tax rate differences (in millions) was as follows:

| | For the Three Months Ended September 30, 2012 | For the Three Months Ended September 30, 2011 | For the Nine Months Ended September 30, 2012 | For the Nine Months Ended September 30, 2011 |
|---|---|---|---|---|
| Tax rate times pre-tax income | $ 146 | $ 54 | $ 409 | $ 347 |
| Effect of: | | | | |
| Tax-preferred investment income | (32 ) | (47 ) | (101) | (107) |
| Tax credits | (17 ) | (14 ) | (38 ) | (35 ) |
| Change in uncertain tax positions | (83 ) | - | (83 ) | - |
| Other items | 31 | 1 | 37 | 9 |
| Federal income tax expense (benefit) | $ 45 | $ (6 ) | $ 224 | $ 214 |
| Effective tax rate | 11 % | -4 % | 19 % | 22 % |

The effective tax rate is the ratio of tax expense over pre-tax income (loss). The tax-preferred investment income relates primarily to separate account dividends-received deductions. The change in uncertain tax positions relates primarily to the lapse of statute of limitations for prior year tax returns and excludes amounts included in other items. Additional amounts related to uncertain tax positions are included in discontinued operations. See Note 3 for information on amounts reflected in discontinued operations. Other items include corrections of immaterial errors in prior period financial statements.

As of September 30, 2012 and 2011, $94 million and $231 million, respectively, of our unrecognized tax benefits presented below, if recognized, would have affected our income tax expense and effective tax rate. A reconciliation of the unrecognized tax benefits (in millions) was as follows:

| | For the Nine Months Ended September 30, 2012 | For the Nine Months Ended September 30, 2011 |
|---|---|---|
| Balance as of beginning-of-year | $ 316 | $ 318 |
| Decreases for prior year tax positions | (200) | (12 ) |
| Increases for current year tax positions | 27 | 2 |
| Decreases for lapse of statute of limitations | (74 ) | - |
| Balance as of end-of-period | $ 69 | $ 308 |

8. Guaranteed Benefit Features

Information on the guaranteed death benefit ("GDB") features outstanding (dollars in millions) was as follows (our variable contracts with guarantees may offer more than one type of guarantee in each contract; therefore, the amounts listed are not mutually exclusive):

| | As of September 30, 2012 | As of December 31, 2011 |
|---|---|---|
| Return of Net Deposits | | |
| Total account value | $ 61,418 | $ 54,004 |
| Net amount at risk (1) | 460 | 1,379 |
| Average attained age of contract holders | 60 years | 59 years |
| Minimum Return | | |
| Total account value | $ 152 | $ 155 |
| Net amount at risk (1) | 37 | 48 |
| Average attained age of contract holders | 72 years | 72 years |
| Guaranteed minimum return | 5% | 5% |
| Anniversary Contract Value | | |
| Total account value | $ 22,968 | $ 21,648 |
| Net amount at risk (1) | 1,305 | 2,939 |
| Average attained age of contract holders | 67 years | 67 years |

(1) Represents the amount of death benefit in excess of the account balance. The decrease in net amount at risk when comparing September 30, 2012, to December 31, 2011, was attributable primarily to the increase in the equity markets during the first nine months of 2012.

The determination of GDB liabilities is based on models that involve a range of scenarios and assumptions, including those regarding expected market rates of return and volatility, contract surrender rates and mortality experience. The following summarizes the balances of and changes in the liabilities for GDB (in millions), which were recorded in future contract benefits on our Consolidated Balance Sheets:

| | For the Nine Months Ended September 30, 2012 | 2011 |
|---|---|---|
| Balance as of beginning-of-year | $ 84 | $ 44 |
| Changes in reserves | 54 | 108 |
| Benefits paid | (36 ) | (34 ) |
| Balance as of end-of-period | $ 102 | $ 118 |

Account balances of variable annuity contracts with guarantees (in millions) were invested in separate account investment options as follows:

| | As of | As of |
|---|---|---|

| Asset Type | September 30, 2012 | December 31, 2011 |
|---|---|---|
| Domestic equity | $ 37,679 | $ 34,286 |
| International equity | 14,466 | 13,095 |
| Bonds | 20,347 | 17,735 |
| Money market | 7,225 | 5,892 |
| Total | $ 79,717 | $ 71,008 |
| | | |
| Percent of total variable annuity separate account values | 98 % | 98 % |

Future contract benefits also includes reserves for our products with secondary guarantees for our products sold through our Life Insurance segment. These UL and VUL products with secondary guarantees represented 38% of permanent life insurance in force as of September 30, 2012, and 26% and 31% of total sales for these products for the three and nine months ended September 30, 2012, respectively.

9. Contingencies and Commitments

Regulatory bodies, such as state insurance departments, the SEC, Financial Industry Regulatory Authority and other regulatory bodies, regularly make inquiries and conduct examinations or investigations concerning our compliance with, among other things, insurance laws, securities laws, laws governing the activities of broker-dealers, registered investment advisors and unclaimed property laws.

LNC and its subsidiaries are involved in various pending or threatened legal or regulatory proceedings, including purported class actions, arising from the conduct of business both in the ordinary course and otherwise. In some of the matters, very large and/or indeterminate amounts, including punitive and treble damages, are sought. Modern pleading practice in the U.S. permits considerable variation in the assertion of monetary damages or other relief. Jurisdictions may permit claimants not to specify the monetary damages sought or may permit claimants to state only that the amount sought is sufficient to invoke the jurisdiction of the trial court. In addition, jurisdictions may permit plaintiffs to allege monetary damages in amounts well exceeding reasonably possible verdicts in the jurisdiction for similar matters. This variability in pleadings, together with the actual experiences of LNC in litigating or resolving through settlement numerous claims over an extended period of time, demonstrates to management that the monetary relief which may be specified in a lawsuit or claim bears little relevance to its merits or disposition value.

Due to the unpredictable nature of litigation, the outcome of a litigation matter and the amount or range of potential loss at particular points in time is normally difficult to ascertain. Uncertainties can include how fact finders will evaluate documentary evidence and the credibility and effectiveness of witness testimony, and how trial and appellate courts will apply the law in the context of the pleadings or evidence presented, whether by motion practice, or at trial or on appeal. Disposition valuations are also subject to the uncertainty of how opposing parties and their counsel will themselves view the relevant evidence and applicable law.

We establish liabilities for litigation and regulatory loss contingencies when information related to the loss contingencies shows both that it is probable that a loss has been incurred and the amount of the loss can be reasonably estimated. It is possible that some matters could require us to pay damages or make other expenditures or establish accruals in amounts that could not be estimated as of September 30, 2012. While the potential future charges could be material in the particular quarterly or annual periods in which they are recorded, based on information currently known by management, management does not believe any such charges are likely to have a material adverse effect on LNC's financial position.

For some matters, the Company is able to estimate a reasonably possible range of loss. For such matters in which a loss is probable, an accrual has been made. For such matters where a loss is believed to be reasonably possible, but not probable, no accrual has been made. Accordingly, the estimate contained in this paragraph reflects two types of matters. For some matters included within this estimate, an accrual has been made, but there is a reasonable possibility that an exposure exists in excess of the amount accrued. In these cases, the estimate reflects the reasonably possible range of loss in excess of the accrued amount. For other matters included within this estimation, no accrual has been made because a loss, while potentially estimable, is believed to be reasonably possible but not probable. In these cases, the estimate reflects the reasonably possible loss or range of loss. As of September 30, 2012, we estimate the aggregate range of reasonably possible losses, including amounts in excess of amounts accrued for these matters as of such date, to be up to approximately $200 million.

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On June 13, 2009, a single named plaintiff filed a putative national class action in the Circuit Court of Allen County, Indiana, captioned Peter S. Bezich v. LNL, No. 02C01-0906-PL73, asserting he was charged a cost-of-insurance fee that exceeded the applicable mortality charge, and that this fee breached the terms of the insurance contract. The parties are conducting fact discovery, and no class certification motion has yet been filed. We dispute the allegations and are vigorously defending this matter.

On July 23, 2012, The Lincoln National Life Insurance Company ("LNL") was added as a noteholder defendant to a putative class action adversary proceeding ("Adversary Proceeding") captioned Lehman Brothers Special Financing, Inc. v. Bank of America, N.A. et al., Adv. Pro. No. 10-03547 (JMP) and instituted under In re Lehman Brothers Holdings Inc. in the United States Bankruptcy Court in the Southern District of New York. Plaintiff Lehman Brothers Special Financing Inc. ("LBSF") seeks to (i) overturn the application of certain priority of payment provisions in 47 collateralized debt obligation transactions on the basis such provisions are unenforceable under the Bankruptcy Code; and (ii) recover funds paid out to Noteholders in accordance with the Note agreements. The Adversary proceeding is stayed through January 20, 2013, and LNL's response is currently due to be filed on March 5, 2013.

Our life insurance subsidiaries are currently being audited on behalf of multiple states' treasury and controllers' offices for compliance with laws and regulations concerning the identification, reporting and escheatment of unclaimed contract benefits or abandoned funds. The audits focus on insurance company processes and procedures for identifying unreported death claims, and their use of the Social Security Master Death File to identify deceased policy and contract holders. In addition, our life insurance subsidiaries are the subject of multiple regulatory inquiries and examinations with a similar focus on the handling of unreported claims and abandoned property. The audits and related examination activity may result in payments to beneficiaries, escheatment of funds deemed abandoned under state laws, administrative penalties and changes in our procedures for the identification of unreported claims and handling of escheatable property.

See Note 13 to the consolidated financial statements in our 2011 Form 10-K for additional discussion of commitments and contingencies, which information is incorporated herein by reference.

10. Shares and Stockholders' Equity

Common and Preferred Shares

The changes in our preferred and common stock (number of shares) were as follows:

| | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Series A Preferred Stock | | | | |
| Balance as of beginning-of-period | 9,632 | 10,854 | 10,072 | 10,914 |
| Conversion of convertible preferred stock (1) | (100) | - | (540) | (60) |
| Balance as of end-of-period | 9,532 | 10,854 | 9,532 | 10,854 |
| Common Stock | | | | |
| Balance as of beginning-of-period | 279,168,971 | 308,339,163 | 291,319,222 | 315,718,554 |
| Conversion of convertible preferred stock (1) | 1,600 | - | 8,640 | 960 |
| Stock compensation/issued for benefit plans | 60,238 | 32,712 | 394,633 | 215,618 |
| Retirement/cancellation of shares | (4,157,191) | (6,712,700) | (16,648,877) | (14,275,957) |
| Balance as of end-of-period | 275,073,618 | 301,659,175 | 275,073,618 | 301,659,175 |
| Common Stock as of End-of-Period | | | | |
| Assuming conversion of preferred stock | 275,226,130 | 301,832,839 | 275,226,130 | 301,832,839 |
| Diluted basis | 282,361,186 | 306,899,902 | 282,361,186 | 306,899,902 |

(1) Represents the conversion of Series A preferred stock into common stock.

Our common and Series A preferred stocks are without par value.

Average Shares

A reconciliation of the denominator (number of shares) in the calculations of basic and diluted EPS was as follows:

| | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Weighted-average shares, as used in basic calculation | 277,883,878 | 304,779,641 | 282,989,766 | 310,357,508 |
| Shares to cover exercise of outstanding warrants | 10,150,192 | 10,150,292 | 10,150,218 | 10,150,292 |
| Shares to cover conversion of preferred stock | 153,886 | 173,664 | 154,165 | 174,293 |
| Shares to cover non-vested stock | 1,141,821 | 815,594 | 1,087,724 | 801,261 |
| Average stock options outstanding during the period | 513,722 | 500,578 | 540,976 | 698,054 |
| Assumed acquisition of shares with assumed proceeds from exercising outstanding warrants | (4,840,576) | (5,153,660) | (4,787,407) | (4,223,290) |
| Assumed acquisition of shares with assumed proceeds and benefits from exercising stock options (at average market price for the period) | (352,501) | (342,848) | (371,115) | (459,168) |
| | (210) | (31,025) | (5,553) | (80,317) |

| | | | | |
|---|---|---|---|---|
| Shares repurchaseable from measured but unrecognized stock option expense | | | | |
| Average deferred compensation shares | - | 1,105,447 | - | 1,070,549 |
| Weighted-average shares, as used in diluted calculation | 284,650,212 | 311,997,683 | 289,758,774 | 318,489,182 |

In the event the average market price of LNC common stock exceeds the issue price of stock options and the options have a dilutive effect to our EPS, such options will be shown in the table above.

The income used in the calculation of our diluted EPS is our net income (loss), reduced by preferred stock dividends and accretion of discount.  These amounts are presented on our Consolidated Statements of Comprehensive Income (Loss).

Accumulated OCI

The following summarizes the components and changes in accumulated OCI (in millions):

| | For the Nine Months Ended September 30, | |
|---|---|---|
| | 2012 | 2011 |
| Unrealized Gain (Loss) on AFS Securities | | |
| Balance as of beginning-of-year | $ 2,947 | $ 1,072 |
| Cumulative effect from adoption of new accounting standards | - | 105 |
| Unrealized holding gains (losses) arising during the period | 2,804 | 3,232 |
| Change in foreign currency exchange rate adjustment | 9 | 2 |
| Change in DAC, VOBA, DSI and other contract holder funds | (724) | (791) |
| Income tax benefit (expense) | (779) | (837) |
| Less: | | |
| Reclassification adjustment for gains (losses) included in net income (loss) | (148) | (83) |
| Associated amortization of DAC, VOBA, DSI and DFEL | 1 | (10) |
| Income tax benefit (expense) | 51 | 33 |
| Balance as of end-of-period | $ 4,353 | $ 2,843 |
| Unrealized OTTI on AFS Securities | | |
| Balance as of beginning-of-year | $ (110) | $ (129) |
| (Increases) attributable to: | | |
| Cumulative effect from adoption of new accounting standards | - | (5) |
| Gross OTTI recognized in OCI during the period | (96) | (48) |
| Change in DAC, VOBA, DSI and DFEL | 14 | 11 |
| Income tax benefit (expense) | 31 | 13 |
| Decreases attributable to: | | |
| Sales, maturities or other settlements of AFS securities | 112 | 91 |
| Change in DAC, VOBA, DSI and DFEL | (14) | (18) |
| Income tax benefit (expense) | (35) | (25) |
| Balance as of end-of-period | $ (98) | $ (110) |
| Unrealized Gain (Loss) on Derivative Instruments | | |
| Balance as of beginning-of-year | $ 119 | $ (15) |
| Cumulative effect from adoption of new accounting standards | - | 4 |
| Unrealized holding gains (losses) arising during the period | 67 | 188 |
| Change in foreign currency exchange rate adjustment | (7) | (1) |
| Change in DAC, VOBA, DSI and DFEL | 9 | (1) |
| Transfers from derivative instruments to bonds through basis adjustment | 13 | - |
| Income tax benefit (expense) | (30) | (65) |
| Less: | | |
| Reclassification adjustment for gains (losses) included in net income (loss) | (11) | (3) |
| Associated amortization of DAC, VOBA, DSI and DFEL | 2 | - |
| Income tax benefit (expense) | 3 | 1 |
| Balance as of end-of-period | $ 177 | $ 112 |
| Foreign Currency Translation Adjustment | | |
| Balance as of beginning-of-year | $ 1 | $ 1 |

| | | |
|---|---|---|
| Foreign currency translation adjustment arising during the period | (6) | 3 |
| Income tax benefit (expense) | 2 | (1) |
| Balance as of end-of-period | $ (3) | $ 3 |
| Funded Status of Employee Benefit Plans | | |
| Balance as of beginning-of-year | $ (278) | $ (181) |
| Adjustment arising during the period | (2) | (3) |
| Income tax benefit (expense) | 1 | 1 |
| Balance as of end-of-period | $ (279) | $ (183) |

11. Realized Gain (Loss)

Details underlying realized gain (loss) (in millions) reported on our Consolidated Statements of Comprehensive Income (Loss) were as follows:

| | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Total realized gain (loss) related to certain investments (1) | $ (54 ) | $ (45 ) | $ (153) | $ (92 ) |
| Realized gain (loss) on the mark-to-market on certain instruments (2) | 59 | (105) | 99 | (95 ) |
| Indexed annuity net derivative results: (3) | | | | |
| Gross gain (loss) | (5 ) | (4 ) | 14 | 3 |
| Associated amortization of DAC, VOBA, DSI and DFEL | - | 1 | (6 ) | (2 ) |
| Variable annuity net derivatives results: (4) | | | | |
| Gross gain (loss) | 92 | (12 ) | 107 | 33 |
| Associated amortization of DAC, VOBA, DSI and DFEL | (22 ) | 2 | (33 ) | (17 ) |
| Total realized gain (loss) | $ 70 | $ (163) | $ 28 | $ (170) |

(1) See “Realized Gain (Loss) Related to Certain Investments” section in Note 5.
(2) Represents changes in the fair values of certain derivative investments (including those associated with our consolidated VIEs), total return swaps (embedded derivatives that are theoretically included in our various modified coinsurance and coinsurance with funds withheld reinsurance arrangements that have contractual returns related to various assets and liabilities associated with these arrangements) and trading securities.
(3) Represents the net difference between the change in the fair value of the S&P 500 call options that we hold and the change in the fair value of the embedded derivative liabilities of our indexed annuity products along with changes in the fair value of embedded derivative liabilities related to index call options we may purchase in the future to hedge contract holder index allocations applicable to future reset periods for our indexed annuity products.
(4) Includes the net difference in the change in embedded derivative reserves of our GLB products and the change in the fair value of the derivative instruments we own to hedge GDB and GLB products, including the cost of purchasing the hedging instruments.

12. Stock-Based Incentive Compensation Plans

We sponsor various incentive plans for our employees and directors and for the employees and agents of our subsidiaries that provide for the issuance of stock options, performance shares (performance-vested shares as opposed to time-vested shares), stock appreciation rights ("SARs") and restricted stock units. We have a policy of issuing new shares to satisfy option exercises.

LNC stock-based awards granted were as follows:

| | For the Three Months Ended September 30, 2012 | For the Nine Months Ended September 30, 2012 |
|---|---|---|
| Awards | | |
| 10-year LNC stock options | 33,292 | 903,502 |
| Performance shares | 11,698 | 306,456 |
| SARs | - | 80,225 |
| Restricted stock units | 44,191 | 730,421 |
| Non-employee: | | |
| Agent stock options | - | 99,113 |
| Director stock options | - | 51,140 |
| Director restricted stock units | 11,037 | 33,383 |

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13. Fair Value of Financial Instruments

The carrying values and estimated fair values of our financial instruments (in millions) were as follows:

| | As of September 30, 2012 | | As of December 31, 2011 | |
|---|---|---|---|---|
| | Carrying Value | Fair Value | Carrying Value | Fair Value |
| Assets | | | | |
| AFS securities: | | | | |
| Fixed maturity securities | $ 81,179 | $ 81,179 | $ 75,433 | $ 75,433 |
| VIEs' fixed maturity securities | 706 | 706 | 700 | 700 |
| Equity securities | 156 | 156 | 139 | 139 |
| Trading securities | 2,650 | 2,650 | 2,675 | 2,675 |
| Mortgage loans on real estate | 6,690 | 7,338 | 6,942 | 7,608 |
| Derivative investments | 3,072 | 3,072 | 3,151 | 3,151 |
| Other investments | 1,123 | 1,123 | 1,069 | 1,069 |
| Cash and invested cash | 4,373 | 4,373 | 4,510 | 4,510 |
| Separate account assets | 93,326 | 93,326 | 83,477 | 83,477 |
| | | | | |
| Liabilities | | | | |
| Future contract benefits: | | | | |
| Indexed annuity contracts embedded derivatives | (733) | (733) | (399) | (399) |
| GLB reserves embedded derivatives | (1,411) | (1,411) | (2,217) | (2,217) |
| Other contract holder funds: | | | | |
| Remaining guaranteed interest and similar contracts | (914) | (914) | (1,114) | (1,114) |
| Account values of certain investment contracts | (28,161) | (32,344) | (27,468) | (30,812) |
| Short-term debt (1) | (200) | (201) | (300) | (309) |
| Long-term debt | (5,494) | (6,266) | (5,391) | (5,345) |
| Reinsurance related embedded derivatives | (215) | (215) | (168) | (168) |
| VIEs' liabilities - derivative instruments | (174) | (174) | (291) | (291) |
| Other liabilities: | | | | |
| Deferred compensation plans | (378) | (378) | (354) | (354) |
| Credit default swaps | (16) | (16) | (16) | (16) |

(1) The difference between the carrying value and fair value of short-term debt as of September 30, 2012, and December 31, 2011, related to current maturities of long-term debt.

Valuation Methodologies and Associated Inputs for Financial Instruments Not Carried at Fair Value

The following discussion outlines the methodologies and assumptions used to determine the fair value of our financial instruments not carried at fair value on our Consolidated Balance Sheets. Considerable judgment is required to develop these assumptions used to measure fair value. Accordingly, the estimates shown are not necessarily indicative of the amounts that would be realized in a one-time, current market exchange of all of our financial instruments.

Mortgage Loans on Real Estate

The fair value of mortgage loans on real estate is established using a discounted cash flow method based on credit rating, maturity and future income. The ratings for mortgages in good standing are based on property type, location, market conditions, occupancy, debt-service coverage, loan-to-value, quality of tenancy, borrower and payment record. The fair value for impaired mortgage loans is based on the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's market price or the fair value of the collateral if the loan is collateral dependent. The inputs used to measure the fair value of our mortgage loans on real estate are classified as Level 2 within the fair value hierarchy.

Other Investments

The carrying value of our assets classified as other investments approximates fair value. Other investments include LPs and other privately held investments that are accounted for using the equity method of accounting and the carrying value is based on our proportional share of the net assets of the LPs. The inputs used to measure the fair value of our other investments are classified as Level 3 within the fair value hierarchy.

Other Contract Holder Funds

Other contract holder funds include remaining guaranteed interest and similar contracts and account values of certain investment contracts. The fair value for the remaining guaranteed interest and similar contracts is estimated using discounted cash flow calculations as of the balance sheet date. These calculations are based on interest rates currently offered on similar contracts with maturities that are consistent with those remaining for the contracts being valued. As of September 30, 2012, and December 31, 2011, the remaining guaranteed interest and similar contracts carrying value approximated fair value. The fair value of the account values of certain investment contracts is based on their approximate surrender value as of the balance sheet date. The inputs used to measure the fair value of our other contract holder funds are classified as Level 3 within the fair value hierarchy.

Short-Term and Long-Term Debt

The fair value of long-term debt is based on quoted market prices. For short-term debt, excluding current maturities of long-term debt, the carrying value approximates fair value. The inputs used to measure the fair value of our short-term and long-term debt are classified as Level 2 within the fair value hierarchy.

Financial Instruments Carried at Fair Value

We did not have any assets or liabilities measured at fair value on a nonrecurring basis as of September 30, 2012, or December 31, 2011, and we noted no changes in our valuation methodologies between these periods.

The following summarizes our financial instruments carried at fair value (in millions) on a recurring basis by the fair value hierarchy levels described in "Summary of Significant Accounting Policies" in Note 1 of our 2011 Form 10-K:

| | As of September 30, 2012 | | | |
|---|---|---|---|---|
| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total Fair Value |
| Assets | | | | |
| Investments: | | | | |
| Fixed maturity AFS securities: | | | | |
| Corporate bonds | $ 65 | $ 64,556 | $ 1,855 | $ 66,476 |
| U.S. government bonds | 476 | 31 | 1 | 508 |
| Foreign government bonds | - | 585 | 76 | 661 |
| RMBS | - | 6,734 | 3 | 6,737 |
| CMBS | - | 1,083 | 43 | 1,126 |
| CDOs | - | - | 147 | 147 |
| State and municipal bonds | - | 4,305 | 33 | 4,338 |
| Hybrid and redeemable preferred securities | 20 | 1,053 | 113 | 1,186 |
| VIEs' fixed maturity securities | 111 | 595 | - | 706 |
| Equity AFS securities | 44 | 26 | 86 | 156 |
| Trading securities | 2 | 2,588 | 60 | 2,650 |
| Derivative investments | - | 839 | 2,233 | 3,072 |
| Cash and invested cash | - | 4,373 | - | 4,373 |
| Separate account assets | - | 93,326 | - | 93,326 |
| Total assets | $ 718 | $ 180,094 | $ 4,650 | $ 185,462 |
| Liabilities | | | | |
| Future contract benefits: | | | | |
| Indexed annuity contracts embedded derivatives | $ - | $ - | $ (733) | $ (733) |
| GLB reserves embedded derivatives | - | - | (1,411) | (1,411) |
| Long-term debt | - | (1,203) | - | (1,203) |
| Reinsurance related embedded derivatives | - | (215) | - | (215) |
| VIEs' liabilities - derivative instruments | - | - | (174) | (174) |
| Other liabilities: | | | | |
| Deferred compensation plans | - | - | (378) | (378) |
| Credit default swaps | - | - | (16) | (16) |
| Total liabilities | $ - | $ (1,418) | $ (2,712) | $ (4,130) |

| | As of December 31, 2011 | | | |
|---|---|---|---|---|
| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total Fair Value |
| Assets | | | | |
| Investments: | | | | |
| Fixed maturity AFS securities: | | | | |
| Corporate bonds | $ 63 | $ 57,310 | $ 1,888 | $ 59,261 |
| U.S. government bonds | 475 | 18 | 1 | 494 |
| Foreign government bonds | - | 636 | 97 | 733 |
| RMBS | - | 7,881 | 158 | 8,039 |
| CMBS | - | 1,566 | 34 | 1,600 |
| CDOs | - | - | 102 | 102 |
| State and municipal bonds | - | 4,047 | - | 4,047 |
| Hybrid and redeemable preferred securities | 15 | 1,042 | 100 | 1,157 |
| VIEs' fixed maturity securities | 108 | 592 | - | 700 |
| Equity AFS securities | 37 | 46 | 56 | 139 |
| Trading securities | 2 | 2,605 | 68 | 2,675 |
| Derivative investments | - | 681 | 2,470 | 3,151 |
| Cash and invested cash | - | 4,510 | - | 4,510 |
| Separate account assets | - | 83,477 | - | 83,477 |
| Total assets | $ 700 | $ 164,411 | $ 4,974 | $ 170,085 |
| Liabilities | | | | |
| Future contract benefits: | | | | |
| Indexed annuity contracts embedded derivatives | $ - | $ - | $ (399) | $ (399) |
| GLB reserves embedded derivatives | - | - | (2,217) | (2,217) |
| Long-term debt | - | (1,688) | - | (1,688) |
| Reinsurance related embedded derivatives | - | (168) | - | (168) |
| VIEs' liabilities - derivative instruments | - | - | (291) | (291) |
| Other liabilities: | | | | |
| Deferred compensation plans | - | - | (354) | (354) |
| Credit default swaps | - | - | (16) | (16) |
| Total liabilities | $ - | $ (1,856) | $ (3,277) | $ (5,133) |

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The following summarizes changes to our financial instruments carried at fair value (in millions) and classified within Level 3 of the fair value hierarchy. This summary excludes any effect of amortization of DAC, VOBA, DSI and DFEL. The gains and losses below may include changes in fair value due in part to observable inputs that are a component of the valuation methodology.

| | For the Three Months Ended September 30, 2012 | | | | | |
|---|---|---|---|---|---|---|
| | Beginning Fair Value | Items Included in Net Income | Gains (Losses) in OCI and Other (1) | Issuances, Sales, Maturities, Settlements, Calls, Net | Transfers In or Out of Level 3, Net (2) | Ending Fair Value |
| Investments: (3) | | | | | | |
| Fixed maturity AFS securities: | | | | | | |
| Corporate bonds | $ 1,678 | $ 1 | $ 24 | $ 225 | $ (73 ) | $ 1,855 |
| U.S. government bonds | 1 | - | - | - | - | 1 |
| Foreign government bonds | 102 | - | - | (2 ) | (24 ) | 76 |
| RMBS | 184 | - | - | - | (181 ) | 3 |
| CMBS | 39 | (2 ) | 4 | (2 ) | 4 | 43 |
| CDOs | 120 | (2 ) | 2 | 27 | - | 147 |
| State and municipal bonds | 32 | - | 1 | - | - | 33 |
| Hybrid and redeemable preferred securities | 129 | - | 13 | - | (29 ) | 113 |
| Equity AFS securities | 85 | - | 1 | - | - | 86 |
| Trading securities | 72 | - | 4 | (2 ) | (14 ) | 60 |
| Derivative investments | 2,517 | (268 ) | 47 | (63 ) | - | 2,233 |
| Future contract benefits: (4) | | | | | | |
| Indexed annuity contracts embedded derivatives | (431 ) | (63 ) | - | (239 ) | - | (733 ) |
| GLB reserves embedded derivatives | (1,926 ) | 570 | - | - | - | (1,356 ) |
| VIEs' liabilities - derivative instruments (5) | (231 ) | 57 | - | - | - | (174 ) |
| Other liabilities: | | | | | | |
| Deferred compensation plans (6) | (358 ) | (18 ) | - | (2 ) | - | (378 ) |
| Credit default swaps (7) | (11 ) | (5 ) | - | - | - | (16 ) |
| Total, net | $ 2,002 | $ 270 | $ 96 | $ (58 ) | $ (317 ) | $ 1,993 |

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| | For the Three Months Ended September 30, 2011 | | | | | |
|---|---|---|---|---|---|---|
| | Beginning Fair Value | Items Included in Net Income | Gains (Losses) in OCI and Other (1) | Issuances, Sales Maturities, Settlements, Calls, Net | Transfers In or Out of Level 3, Net (2) | Ending Fair Value |
| Investments: (3) | | | | | | |
| Fixed maturity AFS securities: | | | | | | |
| Corporate bonds | $ 1,573 | $ (18 ) | $ (33 ) | $ (11 ) | $ (11 ) | $ 1,500 |
| U.S. government bonds | 2 | - | - | (1 ) | - | 1 |
| Foreign government bonds | 96 | 1 | 9 | (1 ) | - | 105 |
| RMBS | 161 | (1 ) | 2 | 24 | (47 ) | 139 |
| CMBS | 53 | (7 ) | 3 | (12 ) | - | 37 |
| CDOs | 126 | 5 | (8 ) | (12 ) | - | 111 |
| Hybrid and redeemable preferred securities | 106 | - | (12 ) | (18 ) | 16 | 92 |
| Equity AFS securities | 96 | - | (14 ) | 10 | - | 92 |
| Trading securities | 71 | 1 | 1 | (5 ) | 1 | 69 |
| Derivative investments | 1,492 | 684 | 340 | 10 | - | 2,526 |
| Future contract benefits: (4) | | | | | | |
| Indexed annuity contracts embedded derivatives | (506 ) | 135 | - | 29 | - | (342 ) |
| GLB reserves embedded derivatives | (278 ) | (2,065) | - | - | - | (2,343) |
| VIEs' liabilities - derivative instruments (5) | (198 ) | (109 ) | - | - | - | (307 ) |
| Other liabilities: | | | | | | |
| Deferred compensation plans (6) | (360 ) | 22 | - | 13 | - | (325 ) |
| Credit default swaps (7) | (7 ) | (8 ) | - | - | - | (15 ) |
| Total, net | $ 2,427 | $ (1,360) | $ 288 | $ 26 | $ (41 ) | $ 1,340 |

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| | For the Nine Months Ended September 30, 2012 | | | | | |
|---|---|---|---|---|---|---|
| | Beginning Fair Value | Items Included in Net Income | Gains (Losses) in OCI and Other (1) | Issuances, Sales, Maturities, Settlements, Calls, Net | Transfers In or Out of Level 3, Net (2) | Ending Fair Value |
| Investments: (3) | | | | | | |
| Fixed maturity AFS securities: | | | | | | |
| Corporate bonds | $ 1,888 | $ (16 ) | $ 14 | $ 327 | $ (358 ) | $ 1,855 |
| U.S. government bonds | 1 | - | - | - | - | 1 |
| Foreign government bonds | 97 | - | - | (4 ) | (17 ) | 76 |
| RMBS | 158 | (3 ) | 3 | (8 ) | (147 ) | 3 |
| CMBS | 34 | (9 ) | 15 | (10 ) | 13 | 43 |
| CDOs | 102 | (2 ) | 7 | 34 | 6 | 147 |
| State and municipal bonds | - | - | 1 | 32 | - | 33 |
| Hybrid and redeemable preferred securities | 100 | (1 ) | 19 | - | (5 ) | 113 |
| Equity AFS securities | 56 | - | 5 | 25 | - | 86 |
| Trading securities | 68 | 2 | 3 | (2 ) | (11 ) | 60 |
| Derivative investments | 2,470 | (557 ) | 114 | 206 | - | 2,233 |
| Future contract benefits: (4) | | | | | | |
| Indexed annuity contracts embedded derivatives | (399 ) | (143 ) | - | (191 ) | - | (733 ) |
| GLB reserves embedded derivatives | (2,217) | 861 | - | - | - | (1,356) |
| VIEs' liabilities - derivative instruments (5) | (291 ) | 117 | - | - | - | (174 ) |
| Other liabilities: | | | | | | |
| Deferred compensation plans (6) | (354 ) | (37 ) | - | 13 | - | (378 ) |
| Credit default swaps (7) | (16 ) | - | - | - | - | (16 ) |
| Total, net | $ 1,697 | $ 212 | $ 181 | $ 422 | $ (519 ) | $ 1,993 |

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| | For the Nine Months Ended September 30, 2011 | | | | | |
|---|---|---|---|---|---|---|
| | Beginning Fair Value | Items Included in Net Income | Gains (Losses) in OCI and Other (1) | Issuances, Sales, Maturities, Settlements, Calls, Net | Transfers In or Out of Level 3, Net (2) | Ending Fair Value |
| Investments: (3) | | | | | | |
| Fixed maturity AFS securities: | | | | | | |
| Corporate bonds | $ 1,816 | $ 5 | $ 10 | $ (247 ) | $ (84 ) | $ 1,500 |
| U.S. government bonds | 2 | - | - | (1 ) | - | 1 |
| Foreign government bonds | 113 | - | 12 | (3 ) | (17 ) | 105 |
| RMBS | 119 | (3 ) | 7 | 16 | - | 139 |
| CMBS | 109 | (53 ) | 57 | (75 ) | (1 ) | 37 |
| CDOs | 172 | 19 | (17 ) | (63 ) | - | 111 |
| Hybrid and redeemable preferred securities | 119 | - | (5 ) | (18 ) | (4 ) | 92 |
| Equity AFS securities | 92 | 8 | (13 ) | 3 | 2 | 92 |
| Trading securities | 76 | - | 4 | (8 ) | (3 ) | 69 |
| Derivative investments | 1,495 | 600 | 335 | 96 | - | 2,526 |
| Future contract benefits: (4) | | | | | | |
| Indexed annuity contracts embedded derivatives | (497 ) | 80 | - | 75 | - | (342 ) |
| GLB reserves embedded derivatives | (408 ) | (1,935) | - | - | - | (2,343) |
| VIEs' liabilities - derivative instruments (5) | (209 ) | (98 ) | - | - | - | (307 ) |
| Other liabilities: | | | | | | |
| Deferred compensation plans (6) | (363 ) | 10 | - | 28 | - | (325 ) |
| Credit default swaps (7) | (16 ) | (5 ) | - | 6 | - | (15 ) |
| Total, net | $ 2,620 | $ (1,372) | $ 390 | $ (191 ) | $ (107 ) | $ 1,340 |

(1) The changes in fair value of the interest rate swaps are offset by an adjustment to derivative investments (see Note 5).
(2) Transfers in or out of Level 3 for AFS and trading securities are displayed at amortized cost as of the beginning-of-period. For AFS and trading securities, the difference between beginning-of-period amortized cost and beginning-of-period fair value was included in OCI and earnings, respectively, in prior periods.
(3) Amortization and accretion of premiums and discounts are included in net investment income on our Consolidated Statements of Comprehensive Income (Loss). Gains (losses) from sales, maturities, settlements and calls and OTTI are included in realized gain (loss) on our Consolidated Statements of Comprehensive Income (Loss).
(4) Gains (losses) from sales, maturities, settlements and calls are included in realized gain (loss) on our Consolidated Statements of Comprehensive Income (Loss).
(5) The changes in fair value of the credit default swaps and contingency forwards are included in realized gain (loss) on our Consolidated Statements of Comprehensive Income (Loss).
(6) Deferrals and subsequent changes in fair value for the participants' investment options are reported in commissions and other expenses on our Consolidated Statements of Comprehensive Income (Loss).
(7) Gains (losses) from sales, maturities, settlements and calls are included in net investment income on our Consolidated Statements of Comprehensive Income (Loss).

The following provides the components of the items included in issuances, sales, maturities, settlements, calls, net, excluding any effect of amortization of DAC, VOBA, DSI and DFEL and changes in future contract benefits, (in millions) as reported above:

| | For the Three Months Ended September 30, 2012 | | | | | |
|---|---|---|---|---|---|---|
| | Issuances | Sales | Maturities | Settlements | Calls | Total |
| Investments: | | | | | | |
| Fixed maturity AFS securities: | | | | | | |
| Corporate bonds | $ 247 | $ - | $ (7 ) | $ (14 ) | $ (1 ) | $ 225 |
| Foreign government bonds | - | - | - | (2 ) | - | (2 ) |
| CMBS | - | - | - | (2 ) | - | (2 ) |
| CDOs | 30 | - | - | (3 ) | - | 27 |
| Trading securities | - | (1 ) | - | (1 ) | - | (2 ) |
| Derivative investments | 55 | (43 ) | (75 ) | - | - | (63 ) |
| Future contract benefits: | | | | | | |
| Indexed annuity contracts embedded derivatives | (31 ) | - | - | (208 ) | - | (239) |
| Other liabilities: | | | | | | |
| Deferred compensation plans | - | - | - | (2 ) | - | (2 ) |
| Total, net | $ 301 | $ (44 ) | $ (82 ) | $ (232 ) | $ (1 ) | $ (58 ) |

| | For the Three Months Ended September 30, 2011 | | | | | |
|---|---|---|---|---|---|---|
| | Issuances | Sales | Maturities | Settlements | Calls | Total |
| Investments: | | | | | | |
| Fixed maturity AFS securities: | | | | | | |
| Corporate bonds | $ 22 | $ (14 ) | $ (10 ) | $ (9 ) | $ - | $ (11 ) |
| U.S. government bonds | - | - | - | (1 ) | - | (1 ) |
| Foreign government bonds | - | - | - | - | (1 ) | (1 ) |
| RMBS | 28 | (1 ) | - | (3 ) | - | 24 |
| CMBS | - | - | - | (12 ) | - | (12 ) |
| CDOs | - | - | - | (12 ) | - | (12 ) |
| Hybrid and redeemable preferred securities | - | (18 ) | - | - | - | (18 ) |
| Equity AFS securities | 10 | - | - | - | - | 10 |
| Trading securities | - | (2 ) | - | (3 ) | - | (5 ) |
| Derivative investments | 87 | 6 | (83 ) | - | - | 10 |
| Future contract benefits: | | | | | | |
| Indexed annuity contracts embedded derivatives | (11 ) | - | - | 40 | - | 29 |
| Other liabilities: | | | | | | |
| Deferred compensation plans | - | - | - | 13 | - | 13 |
| Total, net | $ 136 | $ (29 ) | $ (93 ) | $ 13 | $ (1 ) | $ 26 |

| | For the Nine Months Ended September 30, 2012 | | | | | |
|---|---|---|---|---|---|---|
| | Issuances | Sales | Maturities | Settlements | Calls | Total |
| Investments: | | | | | | |
| Fixed maturity AFS securities: | | | | | | |
| Corporate bonds | $ 404 | $ (27 ) | $ (5 ) | $ (41 ) | $ (4 ) | $ 327 |
| Foreign government bonds | - | - | - | (4 ) | - | (4 ) |
| RMBS | - | - | (7 ) | (1 ) | - | (8 ) |
| CMBS | - | - | - | (10 ) | - | (10 ) |
| CDOs | 47 | - | - | (13 ) | - | 34 |
| State and municipal bonds | 32 | - | - | - | - | 32 |
| Equity AFS securities | 25 | - | - | - | - | 25 |
| Trading securities | - | - | - | (2 ) | - | (2 ) |
| Derivative investments | 428 | (40 ) | (182 ) | - | - | 206 |
| Future contract benefits: | | | | | | |
| Indexed annuity contracts embedded derivatives | (66 ) | - | - | (125 ) | - | (191) |
| Other liabilities: | | | | | | |
| Deferred compensation plans | - | - | - | 13 | - | 13 |
| Total, net | $ 870 | $ (67 ) | $ (194 ) | $ (183 ) | $ (4 ) | $ 422 |

| | For the Nine Months Ended September 30, 2011 | | | | | |
|---|---|---|---|---|---|---|
| | Issuances | Sales | Maturities | Settlements | Calls | Total |
| Investments: | | | | | | |
| Fixed maturity AFS securities: | | | | | | |
| Corporate bonds | $ 45 | $ (146) | $ (11 ) | $ (46 ) | $ (89 ) | $ (247) |
| U.S. government bonds | - | - | - | (1 ) | - | (1 ) |
| Foreign government bonds | - | (2 ) | - | - | (1 ) | (3 ) |
| RMBS | 28 | (1 ) | - | (11 ) | - | 16 |
| CMBS | - | (53 ) | - | (22 ) | - | (75 ) |
| CDOs | - | (34 ) | - | (29 ) | - | (63 ) |
| Hybrid and redeemable preferred securities | - | (18 ) | - | - | - | (18 ) |
| Equity AFS securities | 18 | (15 ) | - | - | - | 3 |
| Trading securities | - | (3 ) | - | (5 ) | - | (8 ) |
| Derivative investments | 362 | (27 ) | (239 ) | - | - | 96 |
| Future contract benefits: | | | | | | |
| Indexed annuity contracts embedded derivatives | (49 ) | - | - | 124 | - | 75 |
| Other liabilities: | | | | | | |
| Deferred compensation plans | - | - | - | 28 | - | 28 |
| Credit default swaps | - | 6 | - | - | - | 6 |
| Total, net | $ 404 | $ (293) | $ (250 ) | $ 38 | $ (90 ) | $ (191) |

The following summarizes changes in unrealized gains (losses) included in net income, excluding any effect of amortization of DAC, VOBA, DSI and DFEL and changes in future contract benefits, related to financial instruments carried at fair value classified within Level 3 that we still held (in millions):

| | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Investments: (1) | | | | |
| Derivative investments | $ (279) | $ 696 | $ (618) | $ 574 |
| Future contract benefits: (1) | | | | |
| Indexed annuity contracts embedded derivatives | 4 | (4) | 22 | - |
| GLB reserves embedded derivatives | 556 | (2,011) | 924 | (1,781) |
| VIEs' liabilities - derivative instruments (1) | 57 | (108) | 117 | (98) |
| Other liabilities: | | | | |
| Deferred compensation plans (2) | (18) | 22 | (37) | 10 |
| Credit default swaps (3) | (5) | (8) | - | (7) |
| Total, net | $ 315 | $ (1,413) | $ 408 | $ (1,302) |

(1) Included in realized gain (loss) on our Consolidated Statements of Comprehensive Income (Loss).
(2) Included in commissions and other expenses on our Consolidated Statements of Comprehensive Income (Loss).
(3) Included in net investment income on our Consolidated Statements of Comprehensive Income (Loss).

The following provides the components of the transfers in and out of Level 3 (in millions) as reported above:

| | For the Three Months Ended September 30, 2012 | | | For the Three Months Ended September 30, 2011 | | |
|---|---|---|---|---|---|---|
| | Transfers In to Level 3 | Transfers Out of Level 3 | Total | Transfers In to Level 3 | Transfers Out of Level 3 | Total |
| Investments: | | | | | | |
| Fixed maturity AFS securities: | | | | | | |
| Corporate bonds | $ 241 | $ (314) | $ (73) | $ 4 | $ (15) | $ (11) |
| Foreign government bonds | 27 | (51) | (24) | - | - | - |
| RMBS | - | (181) | (181) | - | (47) | (47) |
| CMBS | 4 | - | 4 | - | - | - |
| Hybrid and redeemable preferred securities | - | (29) | (29) | 16 | - | 16 |
| Trading securities | 3 | (17) | (14) | 1 | - | 1 |
| Total, net | $ 275 | $ (592) | $ (317) | $ 21 | $ (62) | $ (41) |

| | For the Nine Months Ended September 30, 2012 | | | For the Nine Months Ended September 30, 2011 | | |
|---|---|---|---|---|---|---|
| | Transfers In to Level 3 | Transfers Out of Level 3 | Total | Transfers In to Level 3 | Transfers Out of Level 3 | Total |
| Investments: | | | | | | |
| Fixed maturity AFS securities: | | | | | | |
| Corporate bonds | $ 163 | $ (521 ) | $ (358) | $ 33 | $ (117 ) | $ (84 ) |
| Foreign government bonds | 29 | (46 ) | (17 ) | - | (17 ) | (17 ) |
| RMBS | - | (147 ) | (147) | - | - | - |
| CMBS | 13 | - | 13 | - | (1 ) | (1 ) |
| CDOs | 6 | - | 6 | - | - | - |
| Hybrid and redeemable preferred securities | 35 | (40 ) | (5 ) | 18 | (22 ) | (4 ) |
| Equity AFS securities | - | - | - | 2 | - | 2 |
| Trading securities | 5 | (16 ) | (11 ) | 1 | (4 ) | (3 ) |
| Total, net | $ 251 | $ (770 ) | $ (519) | $ 54 | $ (161 ) | $ (107) |

Transfers in and out of Level 3 are generally the result of observable market information on a security no longer being available or becoming available to our pricing vendors.  For the three and nine months ended September 30, 2012 and 2011, our corporate bonds transfers in and out were attributable primarily to the securities' observable market information no longer being available or becoming available, respectively.  Transfers in and out of Levels 1 and 2 are generally the result of a change in the type of input used to measure the fair value of an asset or liability at the end of the reporting period.  When quoted prices in active markets become available or when these prices become unavailable, but we are able to employ a valuation methodology using significant observable inputs, transfers between Levels 1 and 2 will result.  For the three and nine months ended September 30, 2012 and 2011, the transfers between Levels 1 and 2 of the fair value hierarchy were less than $1 million for our financial instruments carried at fair value.

The following summarizes the fair value (in millions), valuation techniques and significant unobservable inputs of the Level 3 fair value measurements that were developed as of September 30, 2012:

| | Fair Value | Valuation Technique | Significant Unobservable Inputs | Range |
|---|---|---|---|---|
| Assets | | | | |
| Investments: | | | | |
| Fixed maturity AFS and trading securities | | | | |
| Corporate bonds | $ 1,065 | Discounted cash flow | Liquidity/duration adjustment (1) | 1.8% - 13.2% |
| Foreign government bonds | 77 | Discounted cash flow | Liquidity/duration adjustment (1) | 1.8% - 6.1% |
| Hybrid and redeemable preferred stock | 21 | Discounted cash flow | Liquidity/duration adjustment (1) | 2.7% - 2.8% |
| Equity AFS and trading securities | 12 | Discounted cash flow | Liquidity/duration adjustment (1) | 4.3% - 4.5% |
| Liabilities | | | | |
| Future contract benefits: | | | | |
| Indexed annuity contracts embedded derivatives | (733) | Discounted cash flow | Lapse rate (2) | 1.0% - 15.0% |
| | | | Mortality rate (3) | (7) |
| GLB reserves embedded derivatives | (1,411) | Monte Carlo simulation | Long-term lapse rate (2) | 1.0% - 27.0% |
| | | | Utilization of guaranteed withdrawal (5) | 90.0% - 100.0% |
| | | | Non-performance risk ("NPR") (6) | 0.04% - 0.47% |
| | | | Mortality rate (3) | (7) |
| | | | Volatility (4) | 1.0% - 35.0% |

(1) The liquidity/duration adjustment input represents an estimated market participant composite of adjustments attributable to liquidity premiums, expected durations, structures and credit quality that would be applied to the market observable information of an investment.

(2)

The lapse rate input represents the estimated probability of a contract surrendering during a year, and thereby forgoing any future benefits. The range represents the lapse rates during the surrender charge period for indexed annuity contracts.

(3) The mortality rate input represents the estimated probability of when an individual belonging to a particular group, categorized according to age or some other factor such as occupation, will die.

(4) The volatility input represents overall volatilities assumed for the underlying variable annuity funds, which include a mixture of equity and fixed income assets. Fair value of the variable annuity GLB embedded derivatives would increase if higher volatilities were used for valuation.

(5) The utilization of guaranteed withdrawals input represents the estimated percentage of contract holders that utilize the guaranteed withdrawal feature.

(6) The NPR input represents the estimated additional credit spread that market participants would apply to the market observable discount rate when pricing a contract.

(7) Based on the "Annuity 2000 Mortality Table" developed by the Society of Actuaries Committee on Life Insurance Research that was adopted by the National Association of Insurance Commissioners in 1996 for our mortality input.

From the table above, we have excluded Level 3 fair value measurements obtained from independent, third-party pricing sources. We do not develop the significant inputs used to measure the fair value of these assets and liabilities, and the information regarding the significant inputs is not readily available to us. Independent broker-quoted fair values are non-binding quotes developed by market makers or broker-dealers obtained from third-party sources recognized as market participants. The fair value of a broker-quoted asset or liability is based solely on the receipt of an updated quote from a single market maker or a broker-dealer recognized as a market participant as we do not adjust broker quotes when used as the fair value measurement for an asset or liability. Significant increases or decreases in any of the quotes received from a third-party broker-dealer may result in a significantly higher or lower fair value measurement.

Changes in any of the significant inputs presented in the table above may result in a significant change in the fair value measurement of the asset or liability as follows:

- Investments – An increase in the liquidity/duration adjustment input would result in a decrease in the fair value measurement.
- Indexed annuity contracts embedded derivatives – An increase in the lapse rate or mortality rate inputs would result in a decrease in the fair value measurement.
- GLB reserves embedded derivatives – An increase in our lapse rate, wait period, NPR or mortality rate inputs would result in a decrease in the fair value measurement. An increase in the percent of maximum withdrawal amount input would result in an increase in the fair value measurement.

For each category discussed above, the unobservable inputs are not inter-related; therefore, a directional change in one input will not affect the other inputs.

As part of our on-going valuation process, we assess the reasonableness of our valuation techniques or models and make adjustments as necessary. For more information, see "Summary of Significant Accounting Policies" in Note 1 of our 2011 Form 10-K.

14. Segment Information

We provide products and services and report results through our Annuities, Retirement Plan Services, Life Insurance and Group Protection segments. We also have Other Operations, which includes the financial data for operations that are not directly related to the business segments. Our reporting segments reflect the manner by which our chief operating decision makers view and manage the business. See Note 22 of our 2011 Form 10-K for a brief description of these segments and Other Operations.

Segment operating revenues 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. Income (loss) from operations is GAAP net income excluding the after-tax effects of the following items, as applicable:

- Realized gains and losses associated with the following ("excluded realized gain (loss)"):
  - § Sales or disposals of securities;
  - § Impairments of securities;
  - § Changes in the fair value of derivatives, embedded derivatives within certain reinsurance arrangements and trading securities;
  - § Changes in the fair value of the derivatives we own to hedge our GDB riders within our variable annuities;
  - § Changes in the fair value of the embedded derivatives of our GLB riders accounted for at fair value, net of the change in the fair value of the derivatives we own to hedge them; and
  - § Changes in the fair value of the embedded derivative liabilities related to index call options we may purchase in the future to hedge contract holder index allocations applicable to future reset periods for our indexed annuity products accounted for at fair value;
- Changes in reserves resulting from benefit ratio unlocking on our GDB and GLB riders;
- Income (loss) from reserve changes, net of related amortization, on business sold through reinsurance;
- Gains (losses) on early extinguishment of debt;
- Losses from the impairment of intangible assets;
- Income (loss) from discontinued operations; and
- Income (loss) from the initial adoption of new accounting standards.

Operating revenues represent GAAP revenues excluding the pre-tax effects of the following items, as applicable:

- Excluded realized gain (loss);
- Revenue adjustments from the initial adoption of new accounting standards;
- Amortization of DFEL arising from changes in GDB and GLB benefit ratio unlocking; and
- Amortization of deferred gains arising from the reserve changes on business sold through reinsurance.

We use our prevailing corporate federal income tax rate of 35% while taking into account any permanent differences for events recognized differently in our financial statements and federal income tax returns when reconciling our non-GAAP measures to the most comparable GAAP measure. Operating revenues and income (loss) from operations do not replace revenues and net income as the GAAP measures of our consolidated results of operations.

Segment information (in millions) was as follows:

| | For the Three Months Ended September 30, 2012 | 2011 | For the Nine Months Ended September 30, 2012 | 2011 |
|---|---|---|---|---|
| Revenues | | | | |
| Operating revenues: | | | | |
| Annuities | $ 745 | $ 711 | $ 2,210 | $ 2,179 |
| Retirement Plan Services | 255 | 247 | 765 | 771 |
| Life Insurance | 1,296 | 1,176 | 3,765 | 3,552 |
| Group Protection | 517 | 479 | 1,560 | 1,458 |
| Other Operations | 101 | 122 | 321 | 352 |
| Excluded realized gain (loss), pre-tax | 39 | (186 ) | (55 ) | (239 ) |
| Amortization of deferred gain arising from reserve changes on business sold through reinsurance, pre-tax | 1 | 1 | 2 | 2 |
| Amortization of DFEL associated with benefit ratio unlocking, pre-tax | - | (3 ) | - | (2 ) |
| Total revenues | $ 2,954 | $ 2,547 | $ 8,568 | $ 8,073 |

| | For the Three Months Ended September 30, 2012 | 2011 | For the Nine Months Ended September 30, 2012 | 2011 |
|---|---|---|---|---|
| Net Income (Loss) | | | | |
| Income (loss) from operations: | | | | |
| Annuities | $ 139 | $ 153 | $ 433 | $ 442 |
| Retirement Plan Services | 29 | 39 | 101 | 129 |
| Life Insurance | 154 | 154 | 434 | 433 |
| Group Protection | 16 | 27 | 59 | 77 |
| Other Operations | (3 ) | (44 ) | (75 ) | (104) |
| Excluded realized gain (loss), after-tax | 25 | (121) | (35 ) | (156) |
| Gain (loss) on early extinguishment of debt, after-tax | - | (5 ) | - | (5 ) |
| Income (expense) from reserve changes (net of related amortization) on business sold through reinsurance, after-tax | 1 | - | 1 | 1 |
| Impairment of intangibles, after-tax | 2 | - | 2 | - |
| Benefit ratio unlocking, after-tax | 10 | (42 ) | 24 | (39 ) |
| Income (loss) from continuing operations, after-tax | 373 | 161 | 944 | 778 |
| Income (loss) from discontinued operations, after-tax | 29 | (8 ) | 27 | (8 ) |
| Net income (loss) | $ 402 | $ 153 | $ 971 | $ 770 |

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

The following Management's Discussion and Analysis ("MD&A") is intended to help the reader understand the financial condition as of September 30, 2012, compared with December 31, 2011, and the results of operations for the three and nine months ended September 30, 2012, compared with the corresponding periods in 2011 of Lincoln National Corporation and its consolidated subsidiaries. Unless otherwise stated or the context otherwise requires, "LNC," "Lincoln," "Company," "we," "our" or "us" refers to Lincoln National Corporation and its consolidated subsidiaries. The MD&A is provided as a supplement to, and should be read in conjunction with our consolidated financial statements and the accompanying notes to the consolidated financial statements ("Notes") presented in "Part I – Item 1. Financial Statements"; our Form 10-K for the year ended December 31, 2011 ("2011 Form 10-K"), including the sections entitled "Part I – Item 1A. Risk Factors," as updated in "Part II – Item 1A. Risk Factors" below, "Part II – Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Part II – Item 8. Financial Statements and Supplementary Data"; our quarterly reports on Form 10-Q filed in 2012; and our current reports on Form 8-K filed in 2012.

In this report, in addition to providing consolidated revenues and net income (loss), we also provide segment operating revenues and income (loss) from operations because we believe they are meaningful measures of revenues and the profitability of our operating segments. Financial information that follows is presented in conformity with accounting principles generally accepted in the United States of America ("GAAP"), unless otherwise indicated. See Note 1 in our 2011 Form 10-K for a discussion of GAAP.

Operating revenues and income (loss) from operations are the financial performance measures we use to evaluate and assess the results of our segments. Accordingly, we define and report operating revenues and income (loss) from operations by segment in Note 14. Our management believes that operating revenues 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 the excluded items 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. In addition, we believe that our definitions of operating revenues and income (loss) from operations will provide investors with a more valuable measure of our performance because it better reveals trends in our business.

Certain reclassifications have been made to prior periods' financial information.

## FORWARD-LOOKING STATEMENTS – CAUTIONARY LANGUAGE

Certain statements made in this report and in other written or oral statements made by us or on our 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, trends in our businesses, prospective services or products, future performance or financial results and the outcome of contingencies, such as legal proceedings. We claim 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:

- Deterioration in general economic and business conditions that may affect account values, investment results, guaranteed benefit liabilities, premium levels, claims experience and the level of pension benefit costs, funding and investment results;
- Adverse global capital and credit market conditions could affect our ability to raise capital, if necessary, and may cause us to realize impairments on investments and certain intangible assets, including goodwill and the valuation allowance against deferred tax assets, which may reduce future earnings and/or affect our financial condition and ability to raise additional capital or refinance existing debt as it matures;
- Because of our holding company structure, the inability of our subsidiaries to pay dividends to the holding company in sufficient amounts could harm the holding company's ability to meet its obligations;
- Legislative, regulatory or tax changes, both domestic and foreign, that affect the cost of, or demand for, our subsidiaries' products, the required amount of reserves and/or surplus, or otherwise affect our ability to conduct business, including changes to statutory reserve requirements related to secondary guarantee universal life and annuities; regulations regarding captive reinsurance arrangements; restrictions on revenue sharing and 12b-1 payments; and the potential for U.S. federal tax reform;
- Declines in or sustained low interest rates causing a reduction in investment income, the interest margins of our businesses, estimated gross profits ("EGPs") and demand for our products;

- Uncertainty about the effect of rules and regulations to be promulgated under the Dodd-Frank Wall Street Reform and Consumer Protection Act on us and the economy and the financial services sector in particular;
- The initiation of legal or regulatory proceedings against us, and the outcome of any legal or regulatory proceedings, such as: adverse actions related to present or past business practices common in businesses in which we compete; adverse decisions in significant actions including, but not limited to, actions brought by federal and state authorities and class action cases; new decisions that result in changes in law; and unexpected trial court rulings;
- A decline in the equity markets causing a reduction in the sales of our subsidiaries' products, a reduction of asset-based fees that our subsidiaries charge on various investment and insurance products, an acceleration of the net amortization of deferred acquisition costs ("DAC"), 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 our subsidiaries' variable annuity products;
- Ineffectiveness of our risk management policies and procedures, including various hedging strategies used to offset the effect of changes in the value of liabilities due to changes in the level and volatility of the equity markets and interest rates;
- A deviation in actual experience regarding future persistency, mortality, morbidity, interest rates or equity market returns from the assumptions used in pricing our subsidiaries' products, in establishing related insurance reserves and in the net amortization of DAC, VOBA, DSI and DFEL, which may reduce future earnings;
- Changes in GAAP, including the potential incorporation of International Financial Reporting Standards ("IFRS") into the U.S. financial reporting system, that may result in unanticipated changes to our net income;
- Lowering of one or more of our debt ratings issued by nationally recognized statistical rating organizations and the adverse effect such action may have on our ability to raise capital and on our liquidity and financial condition;
- Lowering of one or more of the insurer financial strength ratings of our insurance subsidiaries and the adverse effect such action may have on the premium writings, policy retention, profitability of our insurance subsidiaries and liquidity;
- Significant credit, accounting, fraud, corporate governance or other issues that may adversely affect the value of certain investments in our portfolios, as well as counterparties to which we are exposed to credit risk, requiring that we realize losses on investments;
- Inability to protect our intellectual property rights or claims of infringement of the intellectual property rights of others;
- Interruption in telecommunication, information technology or other operational systems or failure to safeguard the confidentiality or privacy of sensitive data on such systems;
- The effect of acquisitions and divestitures, restructurings, product withdrawals and other unusual items;
- The adequacy and collectibility of reinsurance that we have purchased;
- Acts of terrorism, a pandemic, war or other man-made and natural catastrophes that may adversely affect our 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 our subsidiaries can charge for their products;
- The unknown effect on our subsidiaries' businesses resulting from changes in the demographics of their client base, as aging baby-boomers move from the asset-accumulation stage to the asset-distribution stage of life; and
- Loss of key management, financial planners or wholesalers.

The risks included here are not exhaustive. Our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and other documents filed with the Securities and Exchange Commission ("SEC") include additional factors that could affect our businesses and financial performance. Moreover, we operate 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 effect of all risk factors on our businesses 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 undue reliance on forward-looking statements as a prediction of actual results. In addition, we disclaim 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 retirement businesses 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 fixed and indexed annuities, variable annuities, universal life insurance ("UL"), variable universal life insurance ("VUL"), indexed UL, linked-benefit UL, term life insurance, employer-sponsored defined contribution retirement plans, mutual funds and group life, disability and dental.

We provide products and services and report results through our Annuities, Retirement Plan Services, Life Insurance and Group Protection segments. We also have Other Operations. These segments and Other Operations are described in "Part I – Item 1. Business" of our 2011 Form 10-K.

For information on how we derive our revenues, see the discussion in results of operations by segment below.

Our current market conditions, significant operational matters, industry trends, issues and outlook are described in "Introduction – Executive Summary" of our 2011 Form 10-K.

For factors that could cause actual results to differ materially from those set forth in this section, see "Forward-Looking Statements – Cautionary Language" above and "Part I – Item 1A. Risk Factors" in our 2011 Form 10-K, as updated in "Part II – Item 1A. Risk Factors" below.

## Critical Accounting Policies and Estimates

The MD&A included in our 2011 Form 10-K contains a detailed discussion of our critical accounting policies and estimates. The following information updates the "Critical Accounting Policies and Estimates" provided in our 2011 Form 10-K and, accordingly, should be read in conjunction with the "Critical Accounting Policies and Estimates" discussed in our 2011 Form 10-K.

### DAC, VOBA, DSI and DFEL

#### New DAC Methodology

In October 2010, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update No. 2010-26, "Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts" (referred to herein as the "new DAC methodology"), which clarifies the types of costs incurred by an insurance entity that can be capitalized in the acquisition of insurance contracts. Only those costs incurred that result directly from and are essential to the successful acquisition of new or renewal insurance contracts may be capitalized as deferrable acquisition costs. This determination of deferability must be made on a contract-level basis. This new DAC methodology contrasts to the prior guidance we followed that defined deferrable acquisition costs as costs that vary with and are related primarily to new or renewal business, regardless of whether the acquisition efforts were successful or unsuccessful.

Some examples of acquisition costs that remain subject to deferral as part of the new DAC methodology include the following:

- Employee, agent or broker commissions for successful contract acquisitions;
- Wholesaler production bonuses for successful contract acquisitions;
- Renewal commissions and bonuses to agents or brokers;
- Medical and inspection fees for successful contract acquisitions;
- Premium-related taxes and assessments; and
- A portion of the salaries and benefits of certain employees involved in the underwriting, contract issuance and processing, medical and inspection and sales force contract selling functions related to the successful issuance or renewal of an insurance contract.

All other acquisition-related costs, including costs incurred by the insurer for soliciting potential customers, market research, training, administration, management of distribution and underwriting functions, unsuccessful acquisition or renewal efforts and product development, are considered non-deferrable acquisition costs and must be expensed in the period incurred.

In addition, the following indirect costs are considered non-deferrable acquisition costs as part of the new DAC methodology and must be charged to expense in the period incurred:

- Administrative costs;
- Rent;
- Depreciation;
- Occupancy costs;
- Equipment costs (including data processing equipment dedicated to acquiring insurance contracts); and
- Other general overhead.

We adopted the new DAC methodology as of January 1, 2012, and elected to apply the guidance retrospectively.  The retrospective adoption resulted in the restatement of all periods presented with a cumulative effect adjustment to the opening balance of retained earnings and accumulated other comprehensive income (loss) ("AOCI") for the earliest period presented.  Further, our adoption of the new DAC methodology resulted in an overall reduction in deferrable acquisition costs, partially offset by lower DAC amortization, in each of our business segments. See Note 2 for more discussion of the effect of adoption.

Unlocking

As discussed in our 2011 Form 10-K, we conduct an annual comprehensive review of the assumptions and the projection models used for our estimates of future gross profits underlying the amortization of DAC, VOBA, DSI and DFEL and the calculations of the embedded derivatives and reserves for life insurance and annuity products with living benefit and death benefit guarantees in the third quarter of each year. As a result of this review, we may record prospective unlocking on an annual basis that result in increases or decreases to the carrying values of these items. Prospective unlocking is driven by changes in assumptions or projection models related to our expectations of future EGPs.

Details underlying the increase (decrease) to income (loss) from continuing operations from our prospective unlocking as a result of our annual comprehensive review (in millions) were as follows:

| | For the Three Months Ended September 30, | | |
|---|---|---|---|
| | 2012 | 2011 | Change |
| Income (loss) from operations: | | | |
| Annuities | $ (5 ) | $ (18 ) | 72 % |
| Retirement Plan Services | (3 ) | (2 ) | -50 % |
| Life Insurance | 36 | 51 | -29 % |
| Excluded realized gain (loss) (1) | 76 | (78 ) | 197 % |
| Income (loss) from continuing operations | $ 104 | $ (47 ) | NM |

(1) Includes unlocking related to the non-performance risk ("NPR") component of our guaranteed living benefit ("GLB") embedded derivative reserves (see "Realized Gain (Loss) and Benefit Ratio Unlocking – Variable Annuity Net Derivative Results" below for more information).

Our prospective unlocking – assumption changes were attributable primarily to the following:

2012

During the third quarter of 2012, we lowered our new money investment yield assumption to reflect the current new money rates and to approximate the forward curve for interest rates. This reduction in the interest rate assumption resulted in resetting the current new money investment rate followed by a gradual annual recovery over seven years to a rate 50 basis points below our previous ultimate long-term assumption. As a result of this assumption revision, we recorded unfavorable prospective unlocking of $110 million, after-tax, for Life Insurance, $4 million, after-tax, for Annuities, and $6 million, after-tax, for Retirement Plan Services.

- For Annuities and Retirement Plan Services, we modified our policyholder behavior assumptions and lowered our new money investment yield assumption as discussed above;
- For Life Insurance, we modified our policyholder behavior assumptions, partially offset by lowering our new money investment yield assumption as discussed above; and
  - For excluded realized gain (loss), we modified our policyholder behavior assumptions for GLB riders.

2011

- For Annuities, we lowered our long-term equity market growth rate and interest margin assumptions, partially offset by lowering our lapse assumptions;
- For Life Insurance, we updated our crediting rate assumptions to reflect actions implemented to reduce interest crediting rates; and
- For excluded realized gain (loss), we lowered our assumptions for long-term volatility, partially offset by lowering our lapse assumptions.

Reversion to the Mean ("RTM")

As equity markets do not move in a systematic manner, we reset the baseline of account values from which EGPs are projected, which we refer to as our RTM process, as discussed in our 2011 Form 10-K.

Our long-term variable fund growth rate assumption, which is used in the determination of DAC, VOBA, DSI and DFEL amortization for our variable annuity and VUL products, is an immediate drop of approximately 11% followed by growth going forward of 8% to 9% depending on the block of business and reflecting differences in contract holder fund allocations between fixed income and equity-type investments. If we were to have unlocked our RTM assumption in the corridor as of September 30, 2012, we would have recorded a favorable prospective unlocking of approximately $215 million, pre-tax, for Annuities, approximately $20 million, pre-tax, for Retirement Plan Services, and approximately $20 million, pre-tax, for Life Insurance.

Investments

Investment Valuation

The following summarizes our available-for-sale ("AFS") and trading securities and derivative investments carried at fair value by pricing source and fair value hierarchy level (in millions):

| | As of September 30, 2012 | | | |
|---|---|---|---|---|
| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total Fair Value |
| Priced by third party pricing services | $ 719 | $ 71,629 | $ - | $ 72,348 |
| Priced by independent broker quotations | - | - | 3,475 | 3,475 |
| Priced by matrices | - | 10,766 | - | 10,766 |
| Priced by other methods (1) | - | - | 1,175 | 1,175 |
| Total | $ 719 | $ 82,395 | $ 4,650 | $ 87,764 |
| Percent of total | 1% | 94% | 5% | 100% |

(1) Represents primarily securities for which pricing models were used to compute fair value.

For more information about the valuation of our financial instruments carried at fair value, see "Part II – Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – Introduction – Critical Accounting Policies and Estimates – Investments – Investment Valuation" in our 2011 Form 10-K and Note 13.

As of September 30, 2012, we evaluated the markets that our securities trade in and concluded that none were inactive. We will continue to re-evaluate this conclusion, as needed, based on market conditions. We use unobservable inputs to measure the fair value of securities trading in less liquid or illiquid markets with limited or no pricing information. We obtain broker quotes for securities such as synthetic convertibles, index-linked certificates of deposit and collateralized debt obligations ("CDOs") when sufficient security structure or other market information is not available to produce an evaluation. For broker-quoted only securities, non-binding quotes from market makers or broker-dealers are obtained from sources recognized as market participants. Broker-quoted securities are based solely on receipt of updated quotes from a single market maker or a broker-dealer recognized as a market participant. Our broker-quoted only securities are generally classified as Level 3 of the fair value hierarchy. As of September 30, 2012, we used broker quotes for 74 securities as our final price source, representing 1% of total securities owned.

Derivatives

Our accounting policies for derivatives and the potential effect on interest spreads in a falling rate environment are discussed in Note 6 of this report and "Part II – Item 7A. Quantitative and Qualitative Disclosures About Market Risk" in our 2011 Form 10-K.

Guaranteed Living Benefits

Within our individual annuity business, approximately 50% of our variable annuity account values contained a guaranteed withdrawal benefit ("GWB") rider as of September 30, 2012. Declines in the equity markets increase our exposure to potential benefits under the GWB contracts, leading to an increase in our existing liability for those benefits. For example, a GWB contract is "in the money" if the contract holder's account balance falls below the guaranteed amount. As of September 30, 2012 and 2011,

44% and 91%, respectively, of all GWB in-force contracts were "in the money," and our exposure to the guaranteed amounts, after reinsurance, as of September 30, 2012 and 2011, was $1.1 billion and $3.8 billion, respectively. Our exposure before reinsurance for these same periods was $1.2 billion and $4.1 billion, respectively. However, the only way the GWB contract holder can monetize the excess of the guaranteed amount over the account value of the contract is upon death or through a series of withdrawals that do not exceed a specific percentage per year of the guaranteed amount. If, after the series of withdrawals, the account value is exhausted, the contract holder will receive a series of annuity payments equal to the remaining guaranteed amount, and, for our lifetime GWB products, the annuity payments can continue beyond the guaranteed amount. The account value can also fluctuate with equity market returns on a daily basis resulting in increases or decreases in the excess of the guaranteed amount over account value.

For information on our variable annuity hedge program performance, see our discussion in "Realized Gain (Loss) and Benefit Ratio Unlocking – Variable Annuity Net Derivatives Results" below.

## Acquisitions and Dispositions

For information about acquisitions and divestitures, see "Part II – Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – Acquisitions and Dispositions" and Note 3.

## RESULTS OF CONSOLIDATED OPERATIONS

Details underlying the consolidated results, deposits, net flows and account values (in millions) were as follows:

| | For the Three Months Ended September 30, | | | For the Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| | 2012 | 2011 | Change | 2012 | 2011 | Change |
| Net Income (Loss) | | | | | | |
| Income (loss) from operations: | | | | | | |
| Annuities | $ 139 | $ 153 | -9 % | $ 433 | $ 442 | -2 % |
| Retirement Plan Services | 29 | 39 | -26 % | 101 | 129 | -22 % |
| Life Insurance | 154 | 154 | 0 % | 434 | 433 | 0 % |
| Group Protection | 16 | 27 | -41 % | 59 | 77 | -23 % |
| Other Operations | (3 ) | (44 ) | 93 % | (75 ) | (104) | 28 % |
| Excluded realized gain (loss), after-tax | 25 | (121) | 121 % | (35 ) | (156) | 78 % |
| Gain (loss) on early extinguishment of debt, after-tax | - | (5 ) | 100 % | - | (5 ) | 100 % |
| Income (expense) from reserve changes (net of related amortization) on business sold through reinsurance, after-tax | 1 | - | NM | 1 | 1 | 0 % |
| Impairment of intangibles, after-tax | 2 | - | NM | 2 | - | NM |
| Benefit ratio unlocking, after-tax | 10 | (42 ) | 124 % | 24 | (39 ) | 162 % |
| | 373 | 161 | 132 % | 944 | 778 | 21 % |

| | | | | | | |
|---|---|---|---|---|---|---|
| Income (loss) from continuing operations, after-tax | | | | | | |
| Income (loss) from discontinued operations, after-tax | 29 | (8 ) | NM | 27 | (8 ) | NM |
| Net income (loss) | $ 402 | $ 153 | 163 % | $ 971 | $ 770 | 26 % |

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| | For the Three Months Ended September 30, | | | For the Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| | 2012 | 2011 | Change | 2012 | 2011 | Change |
| Deposits | | | | | | |
| Annuities | $ 2,677 | $ 2,709 | -1 % | $ 8,025 | $ 8,274 | -3 % |
| Retirement Plan Services | 1,717 | 1,456 | 18 % | 4,519 | 3,996 | 13 % |
| Life Insurance | 1,106 | 1,343 | -18 % | 3,403 | 3,887 | -12 % |
| Total deposits | $ 5,500 | $ 5,508 | 0 % | $ 15,947 | $ 16,157 | -1 % |
| Net Flows | | | | | | |
| Annuities | $ 396 | $ 663 | -40 % | $ 1,391 | $ 1,845 | -25 % |
| Retirement Plan Services | 232 | 329 | -29 % | 638 | 285 | 124 % |
| Life Insurance | 695 | 963 | -28 % | 2,169 | 2,652 | -18 % |
| Total net flows | $ 1,323 | $ 1,955 | -32 % | $ 4,198 | $ 4,782 | -12 % |

| | As of September 30, | | |
|---|---|---|---|
| | 2012 | 2011 | Change |
| Account Values | | | |
| Annuities | $ 94,158 | $ 81,229 | 16 % |
| Retirement Plan Services | 43,103 | 37,020 | 16 % |
| Life Insurance | 36,589 | 34,419 | 6 % |
| Total account values | $ 173,850 | $ 152,668 | 14 % |

Comparison of the Three and Nine Months Ended September 30, 2012 to 2011

Net income increased due primarily to the following:

- The effect of favorable prospective unlocking;
- Favorable tax adjustments during 2012 due primarily to the release of reserves associated with prior tax years that were closed in the third quarter;
- Realized gains on the mark-to-market on certain instruments during 2012 as compared to realized losses during 2011 attributable to spreads narrowing on corporate credit default swaps; and
- Growth in account values, insurance in force and group earned premiums.

The increase in net income was partially offset by the following:

- Higher gross realized gains during 2011 originating from asset sales to reposition the investment portfolio;
- Spread compression due to new money rates averaging below our portfolio yields, partially offset by actions implemented to reduce interest crediting rates; and
- Strategic investments in technology platforms and distribution processes, partially offset by aggressively managing expenses.

RESULTS OF ANNUITIES

Income (Loss) from Operations

Details underlying the results for Annuities (in millions) were as follows:

| | For the Three Months Ended September 30, 2012 | 2011 | Change | For the Nine Months Ended September 30, 2012 | 2011 | Change |
|---|---|---|---|---|---|---|
| Operating Revenues | | | | | | |
| Insurance premiums (1) | $ 29 | $ 15 | 93 % | $ 64 | $ 60 | 7 % |
| Insurance fees | 332 | 317 | 5 % | 980 | 948 | 3 % |
| Net investment income | 268 | 271 | -1 % | 819 | 837 | -2 % |
| Operating realized gain (loss) | 30 | 23 | 30 % | 82 | 69 | 19 % |
| Other revenues and fees (2) | 86 | 85 | 1 % | 265 | 265 | 0 % |
| Total operating revenues | 745 | 711 | 5 % | 2,210 | 2,179 | 1 % |
| Operating Expenses | | | | | | |
| Interest credited | 146 | 177 | -18 % | 480 | 530 | -9 % |
| Benefits | 131 | 87 | 51 % | 226 | 165 | 37 % |
| Commissions and other expenses | 295 | 287 | 3 % | 974 | 961 | 1 % |
| Total operating expenses | 572 | 551 | 4 % | 1,680 | 1,656 | 1 % |
| Income (loss) from operations before taxes | 173 | 160 | 8 % | 530 | 523 | 1 % |
| Federal income tax expense (benefit) | 34 | 7 | NM | 97 | 81 | 20 % |
| Income (loss) from operations | $ 139 | $ 153 | -9 % | $ 433 | $ 442 | -2 % |

(1) Includes primarily our single-premium immediate annuities ("SPIA"), which have a corresponding offset in benefits for changes in reserves.

(2) Consists primarily of fees attributable to broker-dealer services that are subject to market volatility.

Comparison of the Three Months Ended September 30, 2012 to 2011

Income from operations for this segment decreased due primarily to the following:

- More favorable tax return true-ups recorded in 2011 than in 2012 driven by the separate account dividends-received deduction ("DRD") and other items;
- Higher benefits attributable to the effect of prospective unlocking (see "Critical Accounting Policies and Estimates – DAC, VOBA, DSI and DFEL – Unlocking" for more information); and
- Higher commissions and other expenses driven by higher account values driving higher trail commissions and strategic investments in technology platforms and distribution processes.

The decrease in income from operations was partially offset by the following:

- Higher net investment income, net of interest credited, driven by:
  - § The effect of prospective unlocking (see "Critical Accounting Policies and Estimates – DAC, VOBA, DSI and DFEL – Unlocking" for more information);
  - § Higher average fixed account values since the third quarter of 2011 (see the "Other Information" table within "Net Investment Income and Interest Credited" below for drivers of changes in our account values); and

§ More favorable investment income on alternative investments within our surplus portfolio (see “Consolidated Investments – Alternative Investments” below for more information);

partially offset by:

§ Spread compression due to new money rates averaging below our portfolio yields, partially offset by actions implemented to reduce interest crediting rates; and

§ Lower prepayment and bond makewhole premiums (see “Consolidated Investments – Commercial Mortgage Loan Prepayment and Bond Makewhole Premiums” below for more information); and

- Higher insurance fees driven by higher average daily variable account values since the third quarter of 2011 (see the "Account Value Information" table within "Insurance Fees" below for drivers of changes in our account values).

Comparison of the Nine Months Ended September 30, 2012 to 2011

Income from operations for this segment decreased due primarily to the following:

- Higher benefits attributable to the following:
  - § The effect of prospective unlocking (see "Critical Accounting Policies and Estimates – DAC, VOBA, DSI and DFEL – Unlocking" for more information);
  - § Unfavorable mortality experience on SPIA during 2012 as compared to favorable experience during 2011; and
  - § An increase in the growth in benefit reserves from higher than expected GLB payments;
- More favorable tax return true-ups recorded in 2011 than in 2012 driven by the separate account DRD and other items; and
- Higher commissions and other expenses driven by higher account values driving higher trail commissions and strategic investments in technology platforms and distribution processes.

The decrease in income from operations was partially offset by the following:

- Higher insurance fees driven by higher average daily variable account values since the third quarter of 2011 (see the "Account Value Information" table within "Insurance Fees" below for drivers of changes in our account values); and
- Higher net investment income, net of interest credited, driven by:
  - § The effect of prospective unlocking (see "Critical Accounting Policies and Estimates – DAC, VOBA, DSI and DFEL – Unlocking" for more information);
  - § Higher average fixed account values since the third quarter of 2011 (see the "Other Information" table within "Net Investment Income and Interest Credited" below for drivers of changes in our account values); and
  - § More favorable investment income on alternative investments within our surplus portfolio (see "Consolidated Investments – Alternative Investments" below for more information);

  partially offset by:
  - § Spread compression due to new money rates averaging below our portfolio yields, partially offset by actions implemented to reduce interest crediting rates; and
  - § Lower prepayment and bond makewhole premiums (see "Consolidated Investments – Commercial Mortgage Loan Prepayment and Bond Makewhole Premiums" below for more information).

Additional Information

New deposits are an important component of net flows and key to our efforts to grow our business. Although deposits do not significantly affect current period income from operations, they are an important indicator of future profitability.

The other component of net flows relates to the retention of the business. An important measure of retention is the lapse rate, which compares the amount of withdrawals to the average account values. The overall lapse rate for our annuity products was 8% for the three and nine months ended September 30, 2012 and 2011.

Our fixed annuity business includes products with discretionary crediting rates that are reset on an annual basis and are not subject to surrender charges. Our ability to retain annual reset annuities will be subject to current competitive conditions at the time interest rates for these products reset. We expect to manage the effects of spreads on near-term income from operations through portfolio management and, to a lesser extent, crediting rate actions, which assumes no significant changes in net flows into or out of our fixed accounts or other changes that may cause interest rate spreads to differ from our expectations. As mentioned in "Critical Accounting Policies and Estimates – DAC, VOBA, DSI and DFEL – Unlocking" above, during the third quarter of 2012, we lowered our new money investment yield assumption to reflect the current new money rates and to approximate the forward curve for interest rates.

For information on interest rate spreads, see "Part I – Item 3. Quantitative and Qualitative Disclosures About Market Risk – Interest Rate Risk – Interest Rate Risk on Fixed Insurance Businesses – Falling Rates" herein. For information on the interest rate risk due to falling interest rates, see "Part II – Item 7A. Quantitative and Qualitative Disclosures About Market Risk – Interest Rate Risk – Interest Rate Risk on Fixed Insurance Businesses – Falling Rates" and "Part I – Item 1A. Risk Factors – Market Conditions – Changes in interest rates and sustained low interest rates may cause interest rate spreads to decrease and changes in interest rates may also result in increased contract withdrawals" in our 2011 Form 10-K.

We provide information about this segment's operating revenue and operating expense line items, the period in which amounts are recognized, key drivers of changes and historical details underlying the line items and their associated drivers below. For detail on the operating realized gain (loss), see "Realized Gain (Loss) and Benefit Ratio Unlocking" below.

For factors that could cause actual results to differ materially from those set forth in this section, see "Forward-Looking Statements – Cautionary Language" above and "Part I – Item 1A. Risk Factors" in our 2011 Form 10-K, as updated in "Part II – Item 1A. Risk Factors" below.

Insurance Fees

Details underlying insurance fees, account values and net flows (in millions) were as follows:

| | For the Three Months Ended September 30, | | | For the Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| | 2012 | 2011 | Change | 2012 | 2011 | Change |
| Insurance Fees | | | | | | |
| Mortality, expense and other assessments | $ 337 | $ 316 | 7 % | $ 979 | $ 950 | 3 % |
| Surrender charges | 2 | 8 | -75 % | 12 | 29 | -59 % |
| DFEL: | | | | | | |
| Deferrals | (5 ) | (16 ) | 69 % | (18 ) | (51 ) | 65 % |
| Amortization, net of interest: | | | | | | |
| Prospective unlocking | (6 ) | 6 | NM | (6 ) | 6 | NM |
| Amortization, net of interest, excluding unlocking | 4 | 3 | 33 % | 13 | 14 | -7 % |
| Total insurance fees | $ 332 | $ 317 | 5 % | $ 980 | $ 948 | 3 % |

| | As of or For the Three Months Ended September 30, | | | As of or For the Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| | 2012 | 2011 | Change | 2012 | 2011 | Change |
| Account Value Information | | | | | | |
| Variable annuity deposits (1) | $ 1,518 | $ 1,415 | 7 % | $ 4,621 | $ 4,558 | 1 % |
| Increases (decreases) in variable annuity account values: | | | | | | |
| Net flows (1) | (97 ) | (41 ) | NM | (251 ) | (243 ) | -3 % |
| Change in market value (1) | 3,186 | (8,345 ) | 138 % | 6,576 | (5,981 ) | 210 % |
| Transfers to the variable portion of variable annuity products from the fixed portion of variable annuity products | 696 | 609 | 14 % | 2,064 | 2,140 | -4 % |
| Variable annuity account values (1) | 73,400 | 60,774 | 21 % | 73,400 | 60,774 | 21 % |
| Average daily variable annuity account values (1) | 71,535 | 65,169 | 10 % | 69,926 | 66,625 | 5 % |
| Average daily S&P 500 | 1,402.14 | 1,227.42 | 14 % | 1,366.26 | 1,282.45 | 7 % |

(1) Excludes the fixed portion of variable.

We charge contract holders mortality and expense assessments on variable annuity accounts to cover insurance and administrative expenses. These assessments are a function of the rates priced into the product and the average daily variable account values. Average daily account values are driven by net flows and the equity markets. In addition, for our fixed annuity contracts and for some variable contracts, we collect surrender charges when contract holders surrender their contracts during their surrender charge periods to protect us from premature withdrawals. Insurance fees include charges on both our variable and fixed annuity products, but exclude the attributed fees on our GLB products; see “Part II – Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations – Realized Gain (Loss) and Benefit Ratio Unlocking – Operating Realized Gain (Loss)” in our 2011 Form 10-K for discussion of these attributed fees.

Net Investment Income and Interest Credited

Details underlying net investment income, interest credited (in millions) and our interest rate spread were as follows:

| | For the Three Months Ended September 30, 2012 | 2011 | Change | For the Nine Months Ended September 30, 2012 | 2011 | Change |
|---|---|---|---|---|---|---|
| Net Investment Income | | | | | | |
| Fixed maturity securities, mortgage loans on real estate and other, net of investment expenses | $ 236 | $ 243 | -3 % | $ 711 | $ 735 | -3 % |
| Commercial mortgage loan prepayment and bond makewhole premiums (1) | 2 | 6 | -67 % | 8 | 23 | -65 % |
| Alternative investments (2) | - | - | NM | 1 | - | NM |
| Surplus investments (3) | 30 | 22 | 36 % | 99 | 79 | 25 % |
| Total net investment income | $ 268 | $ 271 | -1 % | $ 819 | $ 837 | -2 % |
| Interest Credited | | | | | | |
| Amount provided to contract holders | $ 160 | $ 176 | -9 % | $ 491 | $ 525 | -6 % |
| DSI deferrals | (11 ) | (10 ) | -10 % | (30 ) | (29 ) | -3 % |
| Interest credited before DSI amortization | 149 | 166 | -10 % | 461 | 496 | -7 % |
| DSI amortization: | | | | | | |
| Prospective unlocking | (14 ) | 2 | NM | (14 ) | 2 | NM |
| Amortization, excluding unlocking | 11 | 9 | 22 % | 33 | 32 | 3 % |
| Total interest credited | $ 146 | $ 177 | -18 % | $ 480 | $ 530 | -9 % |

(1) See “Consolidated Investments – Commercial Mortgage Loan Prepayment and Bond Makewhole Premiums” below for additional information.
(2) See “Consolidated Investments – Alternative Investments” below for additional information.
(3) Represents net investment income on the required statutory surplus for this segment and includes the effect of investment income on alternative investments for such assets that are held in the portfolios supporting statutory surplus versus the portfolios supporting product liabilities.

| | For the Three Months Ended September 30, 2012 | 2011 | Basis Point Change | For the Nine Months Ended September 30, 2012 | 2011 | Basis Point Change |
|---|---|---|---|---|---|---|
| Interest Rate Spread | | | | | | |
| Fixed maturity securities, mortgage loans on real estate and other, net of investment expenses | 4.83 % | 5.08 % | (25 ) | 4.88 % | 5.18 % | (30 ) |
| Commercial mortgage loan prepayment and bond makewhole premiums | 0.04 % | 0.12 % | (8 ) | 0.05 % | 0.16 % | (11 ) |
| Net investment income yield on reserves | 4.87 % | 5.20 % | (33 ) | 4.93 % | 5.34 % | (41 ) |
| Interest rate credited to contract holders | 2.94 % | 3.33 % | (39 ) | 3.04 % | 3.34 % | (30 ) |
| Interest rate spread | 1.93 % | 1.87 % | 6 | 1.89 % | 2.00 % | (11 ) |

| | As of or For the Three Months Ended September 30, | | | As of or For the Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| | 2012 | 2011 | Change | 2012 | 2011 | Change |
| Other Information | | | | | | |
| Fixed annuity deposits (1) | $ 1,159 | $ 1,294 | -10 % | $ 3,403 | $ 3,717 | -8 % |
| Increases (decreases) in fixed annuity account values: | | | | | | |
| Net flows (1) | 493 | 704 | -30 % | 1,641 | 2,089 | -21 % |
| Transfers from the fixed portion of variable annuity products to the variable portion of variable annuity products | (696 ) | (609 ) | -14 % | (2,064 ) | (2,140 ) | 4 % |
| Reinvested interest credited (1) | 201 | 45 | NM | 609 | 445 | 37 % |
| Fixed annuity account values (1) | 20,757 | 20,455 | 1 % | 20,757 | 20,455 | 1 % |
| Average fixed account values (1) | 20,788 | 20,415 | 2 % | 20,678 | 20,190 | 2 % |
| Average invested assets on reserves | 19,493 | 19,160 | 2 % | 19,523 | 18,947 | 3 % |

(1) Includes the fixed portion of variable.

A portion of our investment income earned is credited to the contract holders of our fixed annuity products, including the fixed portion of variable annuity contracts. We expect to earn a spread between what we earn on the underlying general account investments supporting the fixed annuity product line, including the fixed portion of variable annuity contracts, and what we credit to our fixed annuity contract holders' accounts, including the fixed portion of variable annuity contracts. Changes in commercial mortgage loan prepayments and bond makewhole premiums, investment income on alternative investments and surplus investment income can vary significantly from period to period due to a number of factors and, therefore, may contribute to investment income results that are not indicative of the underlying trends.

Benefits

Details underlying benefits (in millions) were as follows:

| | For the Three Months Ended September 30, | | | For the Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| | 2012 | 2011 | Change | 2012 | 2011 | Change |
| Benefits | | | | | | |
| Prospective unlocking | $ 73 | $ 43 | 70 % | $ 73 | $ 43 | 70 % |
| Net death and other benefits, excluding unlocking | 58 | 44 | 32 % | 153 | 122 | 25 % |
| Total benefits | $ 131 | $ 87 | 51 % | $ 226 | $ 165 | 37 % |

Benefits for this segment include changes in reserves of immediate annuity account values driven by premiums, changes in benefit reserves and our expected costs associated with purchases of derivatives used to hedge our benefit ratio unlocking.

Commissions and Other Expenses

Details underlying commissions and other expenses (in millions) were as follows:

| | For the Three Months Ended September 30, | | | For the Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| | 2012 | 2011 | Change | 2012 | 2011 | Change |
| Commissions and Other Expenses | | | | | | |
| Commissions: | | | | | | |
| Deferrable | $ 124 | $ 121 | 2 % | $ 367 | $ 357 | 3 % |
| Non-deferrable | 79 | 61 | 30 % | 221 | 195 | 13 % |
| General and administrative expenses | 97 | 85 | 14 % | 292 | 265 | 10 % |
| Inter-segment reimbursement associated with reserve financing and LOC expenses (1) | - | (1 ) | 100 % | - | (1 ) | 100 % |
| Taxes, licenses and fees | 9 | 5 | 80 % | 23 | 20 | 15 % |
| Total expenses incurred, excluding broker-dealer | 309 | 271 | 14 % | 903 | 836 | 8 % |
| DAC deferrals | (138) | (137) | -1 % | (411) | (405) | -1 % |
| Total pre-broker-dealer expenses incurred, excluding amortization, net of interest | 171 | 134 | 28 % | 492 | 431 | 14 % |
| DAC and VOBA amortization, net of interest: | | | | | | |
| Prospective unlocking | (57 ) | (11 ) | NM | (57 ) | (11 ) | NM |
| Amortization, net of interest, excluding unlocking | 96 | 78 | 23 % | 280 | 272 | 3 % |
| Broker-dealer expenses incurred | 85 | 86 | -1 % | 259 | 269 | -4 % |
| Total commissions and other expenses | $ 295 | $ 287 | 3 % | $ 974 | $ 961 | 1 % |
| | | | | | | |
| DAC Deferrals | | | | | | |
| As a percentage of sales/deposits | 5.2 % | 5.1 % | | 5.1 % | 4.9 % | |

(1) Represents reimbursements to Annuities from the Life Insurance segment for reserve financing, net of expenses incurred by Annuities for its use of letters of credit ("LOCs"). The inter-segment amounts are not reported on our Consolidated Statements of Income (Loss).

Commissions and other costs that result directly from and are essential to the successful acquisition of new or renewal business are deferred to the extent recoverable and are amortized over the lives of the contracts in relation to EGPs. Certain of our commissions, such as trail commissions that are based on account values, are expensed as incurred rather than deferred and amortized.

Broker-dealer expenses that vary with and are related to sales are expensed as incurred and not deferred and amortized. Fluctuations in these expenses correspond with fluctuations in other revenues and fees.

## RESULTS OF RETIREMENT PLAN SERVICES

Income (Loss) from Operations

Details underlying the results for Retirement Plan Services (in millions) were as follows:

| | For the Three Months Ended September 30, | | | For the Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| | 2012 | 2011 | Change | 2012 | 2011 | Change |
| Operating Revenues | | | | | | |
| Insurance fees | $ 53 | $ 51 | 4 % | $ 158 | $ 161 | -2 % |
| Net investment income | 199 | 193 | 3 % | 598 | 598 | 0 % |
| Other revenues and fees (1) | 3 | 3 | 0 % | 9 | 12 | -25 % |
| Total operating revenues | 255 | 247 | 3 % | 765 | 771 | -1 % |
| Operating Expenses | | | | | | |
| Interest credited | 114 | 109 | 5 % | 337 | 326 | 3 % |
| Benefits | - | 2 | -100 % | - | 2 | -100 % |
| Commissions and other expenses | 102 | 83 | 23 % | 293 | 262 | 12 % |
| Total operating expenses | 216 | 194 | 11 % | 630 | 590 | 7 % |
| Income (loss) from operations before taxes | 39 | 53 | -26 % | 135 | 181 | -25 % |
| Federal income tax expense (benefit) | 10 | 14 | -29 % | 34 | 52 | -35 % |
| Income (loss) from operations | $ 29 | $ 39 | -26 % | $ 101 | $ 129 | -22 % |

(1) Consists primarily of mutual fund account program fees for mid to large employers.

Comparison of the Three Months Ended September 30, 2012 to 2011

Income from operations for this segment decreased due primarily to higher commissions and other expenses driven by the following:

- Strategic investments in technology platforms and distribution expansion efforts; and
- The effect of prospective unlocking (see “Critical Accounting Policies and Estimates – DAC, VOBA, DSI and DFEL – Unlocking” for more information).

Comparison of the Nine Months Ended September 30, 2012 to 2011

Income from operations for this segment decreased due primarily to the following:

- Higher commissions and other expenses driven by strategic investments in technology platforms and distribution expansion efforts;
- Lower net investment income, net of interest credited, driven by:

§ Lower prepayment and bond makewhole premiums (see “Consolidated Investments – Commercial Mortgage Loan Prepayment and Bond Makewhole Premiums” below for more information); and

§ Spread compression due to new money rates averaging below our portfolio yields, partially offset by actions implemented to reduce interest crediting rates;

partially offset by:

§ Higher average fixed account values since the third quarter of 2011 (see the “Other Information” table within “Net Investment Income and Interest Credited” below for drivers of changes in our account values); and

§ More favorable investment income on alternative investments within our surplus portfolio (see “Consolidated Investments – Alternative Investments” below for more information); and

- Lower insurance fees driven by lower average daily variable account values since the third quarter of 2011 (see the “Account Value Information” table within “Insurance Fees” below for drivers of changes in our account values).

Additional Information

Net flows in this business fluctuate based on the timing of larger plans implementing on our platform and terminating over the course of the year, and we expect this trend will continue for the remainder of 2012.

New deposits are an important component of net flows and key to our efforts to grow our business. Although deposits do not significantly affect current period income from operations, they are an important indicator of future profitability. The other component of net flows relates to the retention of the business. An important measure of retention is the lapse rate, which compares the amount of withdrawals to the average account values. The overall lapse rate for our annuity and mutual fund products was 14% and 12% for the three and nine months ended September 30, 2012, respectively, compared to 12% for the corresponding periods in 2011.

Our lapse rate is negatively affected by the continued net outflows from our oldest blocks of annuities business (as presented on our Account Value Roll Forward table below as “Total Multi-Fund® and Other Variable Annuities”), which are also our higher margin product lines in this segment, due to the fact that they are mature blocks with much of the account values out of their surrender charge period. The proportion of these products to our total account values was 37% and 41% as of September 30, 2012, and 2011, respectively. Due to this expected overall shift in business mix toward products with lower returns, a significant increase in new deposit production will be necessary to maintain earnings at current levels.

Our fixed annuity business includes products with discretionary and index-based crediting rates that are reset on a quarterly basis. Our ability to retain quarterly reset annuities will be subject to current competitive conditions at the time interest rates for these products reset. We expect to manage the effects of spreads on near-term income from operations through portfolio management and, to a lesser extent, crediting rate actions, which assumes no significant changes in net flows into or out of our fixed accounts or other changes that may cause interest rate spreads to differ from our expectations. As mentioned in “Critical Accounting Policies and Estimates – DAC, VOBA, DSI and DFEL – Unlocking” above, during the third quarter of 2012, we lowered our new money investment yield assumption to reflect the current new money rates and to approximate the forward curve for interest rates.

For information on interest rate spreads, see “Part I – Item 3. Quantitative and Qualitative Disclosures About Market Risk – Interest Rate Risk – Interest Rate Risk on Fixed Insurance Businesses – Falling Rates” herein. For information on the interest rate risk due to falling interest rates, see “Part II – Item 7A. Quantitative and Qualitative Disclosures About Market Risk – Interest Rate Risk – Interest Rate Risk on Fixed Insurance Businesses – Falling Rates” and “Part I – Item 1A. Risk Factors – Market Conditions – Changes in interest rates and sustained low interest rates may cause interest rate spreads to decrease and changes in interest rates may also result in increased contract withdrawals” in our 2011 Form 10-K.

We provide information about this segment’s operating revenue and operating expense line items, the period in which amounts are recognized, key drivers of changes and historical details underlying the line items and their associated drivers below.

For factors that could cause actual results to differ materially from those set forth in this section, see “Forward-Looking Statements – Cautionary Language” above and “Part I – Item 1A. Risk Factors” in our 2011 Form 10-K, as updated in “Part II – Item 1A. Risk Factors” below.

Insurance Fees

Details underlying insurance fees, account values and net flows (in millions) were as follows:

| | For the Three Months Ended September 30, 2012 | For the Three Months Ended September 30, 2011 | Change | For the Nine Months Ended September 30, 2012 | For the Nine Months Ended September 30, 2011 | Change |
|---|---|---|---|---|---|---|
| Insurance Fees | | | | | | |
| Annuity expense assessments | $ 45 | $ 43 | 5 % | $ 133 | $ 136 | -2 % |
| Mutual fund fees | 8 | 7 | 14 % | 24 | 23 | 4 % |
| Total expense assessments | 53 | 50 | 6 % | 157 | 159 | -1 % |
| Surrender charges | - | 1 | -100 % | 1 | 2 | -50 % |
| Total insurance fees | $ 53 | $ 51 | 4 % | $ 158 | $ 161 | -2 % |

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| | For the Three Months Ended September 30, 2012 | 2011 | Change | For the Nine Months Ended September 30, 2012 | 2011 | Change |
|---|---|---|---|---|---|---|
| Account Value Roll Forward – By Product | | | | | | |
| Total Micro – Small Segment: | | | | | | |
| Balance as of beginning-of-period | $ 6,470 | $ 6,566 | -1 % | $ 6,168 | $ 6,396 | -4 % |
| Gross deposits | 362 | 312 | 16 % | 1,152 | 953 | 21 % |
| Withdrawals and deaths | (330) | (336) | 2 % | (1,110) | (1,045) | -6 % |
| Net flows | 32 | (24) | 233 % | 42 | (92) | 146 % |
| Transfers between fixed and variable accounts | (5) | - | NM | (16) | (6) | NM |
| Investment increase and change in market value | 269 | (686) | 139 % | 572 | (442) | 229 % |
| Balance as of end-of-period | $ 6,766 | $ 5,856 | 16 % | $ 6,766 | $ 5,856 | 16 % |
| | | | | | | |
| Total Mid – Large Segment: | | | | | | |
| Balance as of beginning-of-period | $ 19,139 | $ 17,333 | 10 % | $ 17,434 | $ 16,207 | 8 % |
| Gross deposits | 1,186 | 969 | 22 % | 2,852 | 2,504 | 14 % |
| Withdrawals and deaths | (798) | (408) | -96 % | (1,697) | (1,463) | -16 % |
| Net flows | 388 | 561 | -31 % | 1,155 | 1,041 | 11 % |
| Transfers between fixed and variable accounts | (17) | (19) | 11 % | (24) | (57) | 58 % |
| Investment increase and change in market value | 783 | (1,769) | 144 % | 1,728 | (1,085) | 259 % |
| Balance as of end-of-period | $ 20,293 | $ 16,106 | 26 % | $ 20,293 | $ 16,106 | 26 % |
| | | | | | | |
| Total Multi-Fund® and Other Variable Annuities: | | | | | | |
| Balance as of beginning-of-period | $ 15,788 | $ 16,388 | -4 % | $ 15,531 | $ 16,221 | -4 % |
| Gross deposits | 169 | 175 | -3 % | 515 | 539 | -4 % |
| Withdrawals and deaths | (357) | (383) | 7 % | (1,074) | (1,203) | 11 % |
| Net flows | (188) | (208) | 10 % | (559) | (664) | 16 % |
| Investment increase and change in market value | 444 | (1,122) | 140 % | 1,072 | (499) | NM |
| Balance as of end-of-period | $ 16,044 | $ 15,058 | 7 % | $ 16,044 | $ 15,058 | 7 % |
| | | | | | | |
| Total Annuities and Mutual Funds: | | | | | | |
| Balance as of beginning-of-period | $ 41,397 | $ 40,287 | 3 % | $ 39,133 | $ 38,824 | 1 % |
| Gross deposits | 1,717 | 1,456 | 18 % | 4,519 | 3,996 | 13 % |
| Withdrawals and deaths | (1,485) | (1,127) | -32 % | (3,881) | (3,711) | -5 % |
| Net flows | 232 | 329 | -29 % | 638 | 285 | 124 % |
| Transfers between fixed and variable accounts | (22) | (19) | -16 % | (40) | (63) | 37 % |
| Investment increase and change in market value | 1,496 | (3,577) | 142 % | 3,372 | (2,026) | 266 % |
| Balance as of end-of-period (1) | $ 43,103 | $ 37,020 | 16 % | $ 43,103 | $ 37,020 | 16 % |

(1) Includes mutual fund account values and other third-party trustee-held assets. These items are not included in the separate accounts reported on our Consolidated Balance Sheets as we do not have any ownership interest in them.

| | As of or For the Three Months Ended September 30, | | | As of or For the Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| | 2012 | 2011 | Change | 2012 | 2011 | Change |
| Account Value Information | | | | | | |
| Variable annuity deposits (1) | $ 343 | $ 391 | -12 % | $ 1,219 | $ 1,199 | 2 % |
| Increases (decreases) in variable annuity account values: | | | | | | |
| Net flows (1) | (103 ) | (120 ) | 14 % | (291 ) | (415 ) | 30 % |
| Change in market value (1) | 632 | (1,888 ) | 133 % | 1,405 | (1,176 ) | 219 % |
| Transfers from the variable portion of variable annuity products to the fixed portion of variable annuity products | (79 ) | (124 ) | 36 % | (193 ) | (214 ) | 10 % |
| Variable annuity account values (1) | 13,788 | 12,122 | 14 % | 13,788 | 12,122 | 14 % |
| Average daily variable annuity account values (1) | 13,558 | 13,217 | 3 % | 13,507 | 13,889 | -3 % |
| Average daily S&P 500 | 1,402.14 | 1,227.42 | 14 % | 1,366.26 | 1,282.45 | 7 % |

(1) Excludes the fixed portion of variable.

We charge expense assessments to cover insurance and administrative expenses. Expense assessments are generally equal to a percentage of the daily variable account values. Average daily account values are driven by net flows and the equity markets. Our expense assessments include fees we earn for the services that we provide to our mutual fund programs. In addition, for both our fixed and variable annuity contracts, we collect surrender charges when contract holders surrender their contracts during the surrender charge periods to protect us from premature withdrawals.

Net Investment Income and Interest Credited

Details underlying net investment income, interest credited (in millions) and our interest rate spread were as follows:

| | For the Three Months Ended September 30, | | | For the Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| | 2012 | 2011 | Change | 2012 | 2011 | Change |
| Net Investment Income | | | | | | |
| Fixed maturity securities, mortgage loans on real estate and other, net of investment expenses | $ 184 | $ 180 | 2 % | $ 547 | $ 536 | 2 % |
| Commercial mortgage loan prepayment and bond makewhole premiums (1) | - | 1 | -100 % | 3 | 20 | -85 % |
| Alternative investments (2) | - | - | NM | 1 | 1 | 0 % |
| Surplus investments (3) | 15 | 12 | 25 % | 47 | 41 | 15 % |
| Total net investment income | $ 199 | $ 193 | 3 % | $ 598 | $ 598 | 0 % |
| | | | | | | |
| Interest Credited | $ 114 | $ 109 | 5 % | $ 337 | $ 326 | 3 % |

(1) See “Consolidated Investments – Commercial Mortgage Loan Prepayment and Bond Makewhole Premiums” below for additional information.

(2) See “Consolidated Investments – Alternative Investments” below for additional information.

(3)

Represents net investment income on the required statutory surplus for this segment and includes the effect of investment income on alternative investments for such assets that are held in the portfolios supporting statutory surplus versus the portfolios supporting product liabilities.

| | For the Three Months Ended September 30, 2012 | 2011 | Basis Point Change | For the Nine Months Ended September 30, 2012 | 2011 | Basis Point Change |
|---|---|---|---|---|---|---|
| Interest Rate Spread | | | | | | |
| Fixed maturity securities, mortgage loans on real estate and other, net of investment expenses | 5.23 % | 5.53 % | (30 ) | 5.28 % | 5.57 % | (29 ) |
| Commercial mortgage loan prepayment and bond makewhole premiums | 0.01 % | 0.04 % | (3 ) | 0.02 % | 0.20 % | (18 ) |
| Alternative investments | 0.00 % | 0.00 % | - | 0.01 % | 0.01 % | - |
| Net investment income yield on reserves | 5.24 % | 5.57 % | (33 ) | 5.31 % | 5.78 % | (47 ) |
| Interest rate credited to contract holders | 3.22 % | 3.31 % | (9 ) | 3.22 % | 3.34 % | (12 ) |
| Interest rate spread | 2.02 % | 2.26 % | (24 ) | 2.09 % | 2.44 % | (35 ) |

| | As of or For the Three Months Ended September 30, 2012 | 2011 | Change | As of or For the Nine Months Ended September 30, 2012 | 2011 | Change |
|---|---|---|---|---|---|---|
| Other Information | | | | | | |
| Fixed annuity deposits (1) | $ 489 | $ 378 | 29 % | $ 1,206 | $ 1,042 | 16 % |
| Increases (decreases) in fixed annuity account values: | | | | | | |
| Net flows (1) | 44 | 22 | 100 % | (13 ) | (87 ) | 85 % |
| Transfers to the fixed portion of variable annuity products from the variable portion of variable annuity products | 79 | 124 | -36 % | 193 | 214 | -10 % |
| Reinvested interest credited (1) | 114 | 111 | 3 % | 336 | 327 | 3 % |
| Fixed annuity account values (1) | 14,242 | 13,395 | 6 % | 14,242 | 13,395 | 6 % |
| Average fixed account values (1) | 14,126 | 13,244 | 7 % | 13,918 | 13,048 | 7 % |
| Average invested assets on reserves | 14,095 | 13,068 | 8 % | 13,829 | 12,848 | 8 % |

(1) Includes the fixed portion of variable.

A portion of our investment income earned is credited to the contract holders of our fixed annuity products, including the fixed portion of variable annuity contracts. We expect to earn a spread between what we earn on the underlying general account investments supporting the fixed annuity product line, including the fixed portion of variable annuity contracts, and what we credit to our fixed annuity contract holders' accounts, including the fixed portion of variable annuity contracts. Commercial mortgage loan prepayments and bond makewhole premiums, investment income on alternative investments and surplus investment income can vary significantly from period to period due to a number of factors and, therefore, may contribute to investment income results that are not indicative of the underlying trends.

Benefits

Benefits for this segment include changes in benefit reserves and our expected costs associated with purchases of derivatives used to hedge our benefit ratio unlocking.

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Commissions and Other Expenses

Details underlying commissions and other expenses (in millions) were as follows:

| | For the Three Months Ended September 30, 2012 | For the Three Months Ended September 30, 2011 | Change | For the Nine Months Ended September 30, 2012 | For the Nine Months Ended September 30, 2011 | Change |
|---|---|---|---|---|---|---|
| Commissions and Other Expenses | | | | | | |
| Commissions: | | | | | | |
| Deferrable | $ 4 | $ 5 | -20 % | $ 14 | $ 15 | -7 % |
| Non-deferrable | 13 | 11 | 18 % | 38 | 35 | 9 % |
| General and administrative expenses | 77 | 65 | 18 % | 224 | 200 | 12 % |
| Taxes, licenses and fees | 4 | 3 | 33 % | 12 | 12 | 0 % |
| Total expenses incurred | 98 | 84 | 17 % | 288 | 262 | 10 % |
| DAC deferrals | (9 ) | (8 ) | -13 % | (28 ) | (26 ) | -8 % |
| Total expenses recognized before amortization | 89 | 76 | 17 % | 260 | 236 | 10 % |
| DAC and VOBA amortization, net of interest: | | | | | | |
| Prospective unlocking | 4 | 2 | 100 % | 4 | 2 | 100 % |
| Amortization, net of interest, excluding unlocking | 9 | 5 | 80 % | 29 | 24 | 21 % |
| Total commissions and other expenses | $ 102 | $ 83 | 23 % | $ 293 | $ 262 | 12 % |
| | | | | | | |
| DAC Deferrals | | | | | | |
| As a percentage of annuity sales/deposits | 1.1 % | 1.0 % | | 1.2 % | 1.2 % | |

Commissions and other costs that result directly from and are essential to the successful acquisition of new or renewal business are deferred to the extent recoverable and are amortized over the lives of the contracts in relation to EGPs. Certain of our commissions, such as trail commissions that are based on account values, are expensed as incurred rather than deferred and amortized. We do not pay commissions on sales of our mutual fund products, and distribution expenses associated with the sale of these mutual fund products are expensed as incurred.

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RESULTS OF LIFE INSURANCE

Income (Loss) from Operations

Details underlying the results for Life Insurance (in millions) were as follows:

| | For the Three Months Ended September 30, 2012 | 2011 | Change | For the Nine Months Ended September 30, 2012 | 2011 | Change |
|---|---|---|---|---|---|---|
| Operating Revenues | | | | | | |
| Insurance premiums | $ 103 | $ 104 | -1 % | $ 326 | $ 324 | 1 % |
| Insurance fees | 605 | 498 | 21 % | 1,645 | 1,473 | 12 % |
| Net investment income | 578 | 569 | 2 % | 1,773 | 1,736 | 2 % |
| Operating realized gain | 1 | - | NM | 1 | - | NM |
| Other revenues and fees | 9 | 5 | 80 % | 20 | 19 | 5 % |
| Total operating revenues | 1,296 | 1,176 | 10 % | 3,765 | 3,552 | 6 % |
| Operating Expenses | | | | | | |
| Interest credited | 319 | 312 | 2 % | 941 | 921 | 2 % |
| Benefits | 296 | 152 | 95 % | 1,248 | 1,209 | 3 % |
| Commissions and other expenses | 465 | 493 | -6 % | 951 | 791 | 20 % |
| Total operating expenses | 1,080 | 957 | 13 % | 3,140 | 2,921 | 7 % |
| Income (loss) from operations before taxes | 216 | 219 | -1 % | 625 | 631 | -1 % |
| Federal income tax expense (benefit) | 62 | 65 | -5 % | 191 | 198 | -4 % |
| Income (loss) from operations | $ 154 | $ 154 | 0 % | $ 434 | $ 433 | 0 % |

Comparison of the Three Months Ended September 30, 2012 to 2011

Income from operations for this segment remained flat due primarily to the following:

- Higher insurance fees due to the effect of prospective unlocking and growth in business in force; and
- Lower commissions and other expenses due to the effect of prospective unlocking, partially offset by a higher amortization rate as a result of higher gross profits than our model projections assumed and other reserve changes;

entirely offset by:

- Higher benefits due to:

§ The effect of prospective unlocking; and

§ Continued growth in our secondary guarantee life insurance business;

partially offset by:

§ Lower death claims.

Comparison of the Nine Months Ended September 30, 2012 to 2011

Income from operations for this segment increased due primarily to the following:

- Higher insurance fees due to the effect of prospective unlocking and growth in business in force; and
- Higher net investment income, net of interest credited, driven by:

§ Growth in business in force;

partially offset by:

§

Less favorable investment income on alternative investments and lower prepayment and bond makewhole premiums (see "Consolidated Investments – Alternative Investments" and "Consolidated Investments – Commercial Mortgage Loan Prepayment and Bond Makewhole Premiums" below for more information); and

§ Spread compression due to new money rates averaging below our portfolio yields, partially offset by lower interest crediting rates.

The increase in income from operations was partially offset by the following:

- Higher commissions and other expenses attributable to the effect of prospective unlocking and other reserve changes; and
- Higher benefits due to:
  - § Higher death claims; and
  - § Continued growth in our secondary guarantee life insurance business;

partially offset by:
  - § The effect of prospective unlocking.

See "Critical Accounting Policies and Estimates – DAC, VOBA, DSI and DFEL – Unlocking" for more information about our third quarter prospective unlocking.

Strategies to Address Statutory Reserve Strain

Term products and UL products containing secondary guarantees require reserves calculated pursuant to the Valuation of Life Insurance Policies Model Regulation ("XXX") and Actuarial Guideline 38 ("AG38"), respectively. The calculated reserve levels exceed the expected economic levels of benefits that will arise under these products; therefore, our surplus is reduced to hold these higher reserve levels. Our insurance subsidiaries are employing strategies to reduce the surplus strain of holding the higher statutory reserves associated with term products and UL products containing secondary guarantees. As noted below, we have been successful in executing reinsurance solutions to release surplus to Other Operations. We will continue to manage our present reinsurance solutions and enter into new solutions to minimize the strain on our surplus.

Included in the LOCs issued as of September 30, 2012, was approximately $2.3 billion of long-dated LOCs issued to support inter-company reinsurance arrangements, of which approximately $65 million and $1.4 billion was issued for UL products containing secondary guarantees that will expire in 2015 and 2031, respectively, and approximately $855 million was issued for term business that will expire in 2023. We have also used the proceeds from senior note issuances of approximately $875 million to execute long-term structured solutions supporting UL products containing secondary guarantees. LOCs and related capital market alternatives lower the capital effect of term and UL products containing secondary guarantees. An inability to obtain the necessary LOC capacity or other capital market alternatives could affect our returns on our in-force UL products containing secondary guarantees. However, we believe that our insurance subsidiaries have sufficient capital to support the increase in statutory reserves, based on our current reserve projections, if such structures are not available. See "Part II – Item 1A. Risk Factors – Legislative, Regulatory and Tax – Changes to the calculation of reserves and attempts to mitigate the impact of Regulation XXX and Actuarial Guideline 38 may fail in whole or in part resulting in an adverse effect on our financial condition and results of operations" below for further information on XXX and AG38 reserves. See the table in "Commissions and Other Expenses" below for the presentation of our expenses associated with reserve financing.

Additional Information

We expect to manage the effects of spreads on near-term income from operations through portfolio management, which assumes no significant changes in net flows into or out of our fixed accounts or other changes that may cause interest rate spreads to differ from our expectations. As mentioned in "Critical Accounting Policies and Estimates – DAC, VOBA, DSI and DFEL – Unlocking" above, during the third quarter of 2012, we lowered our new money investment yield assumption to reflect the current new money rates and to approximate the forward curve for interest rates.

For information on interest rate spreads, see "Part I – Item 3. Quantitative and Qualitative Disclosures About Market

Risk – Interest Rate Risk – Interest Rate Risk on Fixed Insurance Businesses – Falling Rates" herein. For information on the interest rate risk due to falling interest rates, see "Part II – Item 7A. Quantitative and Qualitative Disclosures About Market Risk – Interest Rate Risk – Interest Rate Risk on Fixed Insurance Businesses – Falling Rates" and "Part I – Item 1A. Risk Factors – Market Conditions – Changes in interest rates and sustained low interest rates may cause interest rate spreads to decrease and changes in interest rates may also result in increased contract withdrawals" in our 2011 Form 10-K.

Sales are not recorded as a component of revenues (other than for traditional products) and do not have a significant effect on current quarter income from operations but are indicators of future profitability. Generally, we have higher sales during the second half of the year with the fourth quarter being our strongest. However, we face conditions in the marketplace as discussed in "Part II – Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – Introduction – Executive Summary – Current Market Conditions" in our 2011 Form 10-K that may challenge our sales volume for the remainder of 2012. For example, we are implementing pricing changes to our products that reflect the current low interest rate environment that we believe will lower our sales volumes and could potentially reduce our market share until competitive conditions change.

We provide information about this segment's operating revenue and operating expense line items, the period in which amounts are recognized, key drivers of changes and historical details underlying the line items and their associated drivers below. For detail on the operating realized gain (loss), see "Realized Gain (Loss) and Benefit Ratio Unlocking" below.

For factors that could cause actual results to differ materially from those set forth in this section, see "Forward-Looking Statements – Cautionary Language" above and "Part I – Item 1A. Risk Factors" in our 2011 Form 10-K, as updated in "Part II – Item 1A. Risk Factors" below.

Insurance Premiums

Insurance premiums relate to traditional products and are a function of the rates priced into the product and the level of insurance in force. Insurance in force, in turn, is driven by sales, persistency and mortality experience.

Insurance Fees

Details underlying insurance fees, sales, net flows, account values and in-force face amount (in millions) were as follows:

| | For the Three Months Ended September 30, 2012 | For the Three Months Ended September 30, 2011 | Change | For the Nine Months Ended September 30, 2012 | For the Nine Months Ended September 30, 2011 | Change |
|---|---|---|---|---|---|---|
| Insurance Fees | | | | | | |
| Mortality assessments | $ 324 | $ 335 | -3 % | $ 991 | $ 986 | 1 % |
| Expense assessments | 197 | 230 | -14 % | 608 | 694 | -12 % |
| Surrender charges | 25 | 21 | 19 % | 68 | 73 | -7 % |
| DFEL: | | | | | | |
| Deferrals | (73 ) | (119) | 39 % | (238 ) | (360 ) | 34 % |
| Amortization, net of interest: | | | | | | |
| Prospective unlocking | 81 | (13 ) | NM | 75 | (28 ) | NM |
| Amortization, net of interest, excluding unlocking | 51 | 44 | 16 % | 141 | 108 | 31 % |
| Total insurance fees | $ 605 | $ 498 | 21 % | $ 1,645 | $ 1,473 | 12 % |

| | For the Three Months Ended September 30, 2012 | For the Three Months Ended September 30, 2011 | Change | For the Nine Months Ended September 30, 2012 | For the Nine Months Ended September 30, 2011 | Change |
|---|---|---|---|---|---|---|
| Sales by Product | | | | | | |
| UL: | | | | | | |
| Excluding MoneyGuard® | $ 38 | $ 74 | -49 % | $ 136 | $ 242 | -44 % |
| MoneyGuard® | 40 | 48 | -17 % | 121 | 121 | 0 % |
| Total UL | 78 | 122 | -36 % | 257 | 363 | -29 % |
| VUL | 9 | 13 | -31 % | 31 | 34 | -9 % |
| COLI and BOLI | 9 | 8 | 13 % | 31 | 35 | -11 % |
| Term | 16 | 12 | 33 % | 42 | 39 | 8 % |
| Total sales | $ 112 | $ 155 | -28 % | $ 361 | $ 471 | -23 % |
| | | | | | | |
| Net Flows | | | | | | |
| Deposits | $ 1,106 | $ 1,343 | -18 % | $ 3,403 | $ 3,887 | -12 % |
| Withdrawals and deaths | (411 ) | (380 ) | -8 % | (1,234) | (1,235) | 0 % |
| Net flows | $ 695 | $ 963 | -28 % | $ 2,169 | $ 2,652 | -18 % |
| | | | | | | |
| Contract holder assessments | $ 816 | $ 819 | 0 % | $ 2,421 | $ 2,441 | -1 % |

| | As of September 30, 2012 | 2011 | Change |
|---|---|---|---|
| Account Values | | | |
| UL | $ 28,883 | $ 27,485 | 5 % |
| VUL | 5,450 | 4,658 | 17 % |
| Interest-sensitive whole life | 2,256 | 2,276 | -1 % |
| Total account values | $ 36,589 | $ 34,419 | 6 % |
| | | | |
| In-Force Face Amount | | | |
| UL and other | $ 308,470 | $ 304,475 | 1 % |
| Term insurance | 275,992 | 269,969 | 2 % |
| Total in-force face amount | $ 584,462 | $ 574,444 | 2 % |

Insurance fees relate only to interest-sensitive products and include mortality assessments, expense assessments (net of deferrals and amortization related to DFEL) and surrender charges. Mortality and expense assessments are deducted from our contract holders' account values. These amounts are a function of the rates priced into the product and premiums received, face amount in force and account values. Insurance in force, in turn, is driven by sales, persistency and mortality experience. In-force growth should be considered independently with respect to term products versus UL and other products, as term products have a lower profitability relative to face amount compared to interest-sensitive and other products.

Sales in the table above and as discussed above were reported as follows:

- MoneyGuard® (our linked-benefit product) – 15% of single premium deposits;
- MoneyGuard® (flexible premium option), UL (excluding linked-benefit products) and VUL (including corporate-owned UL and VUL ("COLI") and bank-owned UL and VUL ("BOLI")) – first year commissionable premiums plus 5% of excess premiums received, including an adjustment for internal replacements of approximately 50% of commissionable premiums; and
- Term – 100% of first year paid premiums.

The following table summarizes key information pertaining to our UL and VUL products with secondary guarantees:

| | As of or For the Three Months Ended September 30, | | As of or For the Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| As a percentage of interest sensitive life insurance in force | 38 % | 38 % | 38 % | 38 % |
| As a percentage of sales | 26 % | 46 % | 31 % | 49 % |

Changes in the marketplace and continuing efforts to increase sales of higher return products are resulting in a shift in our business mix away from UL products with secondary guarantees to products like Indexed UL, VUL and term. Actuarial Guideline 37, or Variable Life Reserves for Guaranteed Minimum Death Benefits, and AG38 impose additional statutory reserve requirements for these products.

Net Investment Income and Interest Credited

Details underlying net investment income, interest credited (in millions) and our interest rate spread were as follows:

| | For the Three Months Ended September 30, | | | For the Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| | 2012 | 2011 | Change | 2012 | 2011 | Change |
| Net Investment Income | | | | | | |
| Fixed maturity securities, mortgage loans on real estate and other, net of investment expenses | $ 541 | $ 524 | 3 % | $ 1,630 | $ 1,563 | 4 % |
| Commercial mortgage loan prepayment and bond makewhole premiums (1) | 2 | 5 | -60 % | 10 | 21 | -52 % |
| Alternative investments (2) | 3 | 13 | -77 % | 30 | 61 | -51 % |
| Surplus investments (3) | 32 | 27 | 19 % | 103 | 91 | 13 % |
| Total net investment income | $ 578 | $ 569 | 2 % | $ 1,773 | $ 1,736 | 2 % |
| | | | | | | |
| Interest Credited | $ 319 | $ 312 | 2 % | $ 941 | $ 921 | 2 % |

(1) See "Consolidated Investments – Commercial Mortgage Loan Prepayment and Bond Makewhole Premiums" below for additional information.
(2) See "Consolidated Investments – Alternative Investments" below for additional information.
(3) Represents net investment income on the required statutory surplus for this segment and includes the effect of investment income on alternative investments for such assets that are held in the portfolios supporting statutory surplus versus the portfolios supporting product liabilities.

| | For the Three Months Ended September 30, | | Basis Point Change | For the Nine Months Ended September 30, | | Basis Point Change |
|---|---|---|---|---|---|---|
| | 2012 | 2011 | | 2012 | 2011 | |
| Interest Rate Yields and Spread | | | | | | |
| Attributable to interest-sensitive products: | | | | | | |
| Fixed maturity securities, mortgage loans on real estate and other, net of investment expenses | 5.60 % | 5.74 % | (14 ) | 5.70 % | 5.82 % | (12 ) |
| Commercial mortgage loan prepayment and bond makewhole premiums | 0.02 % | 0.06 % | (4 ) | 0.04 % | 0.08 % | (4 ) |
| Alternative investments | 0.03 % | 0.16 % | (13 ) | 0.12 % | 0.26 % | (14 ) |
| Net investment income yield on reserves | 5.65 % | 5.96 % | (31 ) | 5.86 % | 6.16 % | (30 ) |
| Interest rate credited to contract holders | 3.92 % | 4.10 % | (18 ) | 3.93 % | 4.09 % | (16 ) |
| Interest rate spread | 1.73 % | 1.86 % | (13 ) | 1.93 % | 2.07 % | (14 ) |
| | | | | | | |
| Attributable to traditional products: | | | | | | |
| Fixed maturity securities, mortgage loans on real estate and other, net of investment expenses | 5.67 % | 5.90 % | (23 ) | 5.73 % | 5.93 % | (20 ) |
| Commercial mortgage loan prepayment and bond makewhole premiums | 0.00 % | 0.03 % | (3 ) | 0.01 % | 0.04 % | (3 ) |
| Alternative investments | 0.00 % | 0.00 % | - | 0.01 % | 0.01 % | - |
| Net investment income yield on reserves | 5.67 % | 5.93 % | (26 ) | 5.75 % | 5.98 % | (23 ) |

| | For the Three Months Ended September 30, 2012 | 2011 | Change | For the Nine Months Ended September 30, 2012 | 2011 | Change |
|---|---|---|---|---|---|---|
| Averages | | | | | | |
| Attributable to interest-sensitive products: | | | | | | |
| Invested assets on reserves | $ 34,321 | $ 32,080 | 7 % | $ 33,801 | $ 31,454 | 7 % |
| Account values - universal and whole life | 31,666 | 30,237 | 5 % | 31,442 | 29,832 | 5 % |
| Attributable to traditional products: | | | | | | |
| Invested assets on reserves | 4,374 | 4,311 | 1 % | 4,310 | 4,290 | 0 % |

A portion of the investment income earned for this segment is credited to contract holder accounts. Invested assets will typically grow at a faster rate than account values because of the AG38 reserve requirements, which cause statutory reserves to grow at a faster rate than account values. Invested assets are based upon the statutory reserve liabilities and are, therefore, affected by various reserve adjustments, including capital transactions providing relief from AG38 reserve requirements, which leads to a transfer of invested assets from this segment to Other Operations for use in other corporate purposes. We expect to earn a spread between what we earn on the underlying general account investments and what we credit to our contract holders' accounts. We use our investment income to offset the earnings effect of the associated build of our policy reserves for traditional products. Commercial mortgage loan prepayments and bond makewhole premiums and investment income on alternative investments can vary significantly from period to period due to a number of factors, and, therefore, may contribute to investment income results that are not indicative of the underlying trends.

Benefits

Details underlying benefits (dollars in millions) were as follows:

| | For the Three Months Ended September 30, 2012 | 2011 | Change | For the Nine Months Ended September 30, 2012 | 2011 | Change |
|---|---|---|---|---|---|---|
| Benefits | | | | | | |
| Death claims direct and assumed | $ 703 | $ 759 | -7 % | $ 2,283 | $ 2,179 | 5 % |
| Death claims ceded | (317) | (377) | 16 % | (1,102) | (1,047) | -5 % |
| Reserves released on death | (132) | (108) | -22 % | (375) | (345) | -9 % |
| Net death benefits | 254 | 274 | -7 % | 806 | 787 | 2 % |
| Change in secondary guarantee life insurance product reserves: | | | | | | |
| Prospective unlocking | (154) | (355) | 57 % | (145) | (162) | 10 % |
| Change in reserves, excluding unlocking | 111 | 128 | -13 % | 356 | 362 | -2 % |
| Other benefits: | | | | | | |
| Prospective unlocking | - | 33 | -100 % | - | 33 | -100 % |
| Other benefits, excluding unlocking (1) | 85 | 72 | 18 % | 231 | 189 | 22 % |
| Total benefits | $ 296 | $ 152 | 95 % | $ 1,248 | $ 1,209 | 3 % |
| Death claims per $1,000 of in-force | 1.74 | 1.91 | -9 % | 1.85 | 1.85 | 0 % |

(1) Includes primarily traditional product changes in reserves and dividends.

Benefits for this segment includes claims incurred during the period in excess of the associated reserves for its interest-sensitive and traditional products. In addition, benefits includes the change in secondary guarantee life insurance product reserves. The reserve for secondary guarantees is affected by changes in expected future trends of expense assessments causing prospective unlocking adjustments to this liability similar to DAC, VOBA and DFEL. See “Future Contract Benefits and Other Contract Holder Funds” in Note 1 of our 2011 Form 10-K for additional information.

Commissions and Other Expenses

Details underlying commissions and other expenses (in millions) were as follows:

| | For the Three Months Ended September 30, 2012 | 2011 | Change | For the Nine Months Ended September 30, 2012 | 2011 | Change |
|---|---|---|---|---|---|---|
| Commissions and Other Expenses | | | | | | |
| Commissions | $ 115 | $ 161 | -29 % | $ 371 | $ 500 | -26 % |
| General and administrative expenses | 118 | 116 | 2 % | 357 | 343 | 4 % |
| Expenses associated with reserve financing | 17 | 14 | 21 % | 49 | 42 | 17 % |
| Taxes, licenses and fees | 33 | 40 | -18 % | 102 | 110 | -7 % |
| Total expenses incurred | 283 | 331 | -15 % | 879 | 995 | -12 % |
| DAC and VOBA deferrals | (131 ) | (183 ) | 28 % | (420 ) | (569 ) | 26 % |
| Total expenses recognized before amortization | 152 | 148 | 3 % | 459 | 426 | 8 % |
| DAC and VOBA amortization, net of interest: | | | | | | |
| Prospective unlocking | 180 | 231 | -22 % | 147 | 17 | NM |
| Amortization, net of interest, excluding unlocking | 132 | 113 | 17 % | 342 | 345 | -1 % |
| Other intangible amortization | 1 | 1 | 0 % | 3 | 3 | 0 % |
| Total commissions and other expenses | $ 465 | $ 493 | -6 % | $ 951 | $ 791 | 20 % |
| | | | | | | |
| DAC and VOBA Deferrals | | | | | | |
| As a percentage of sales | 117.0% | 118.1% | | 116.3% | 120.8% | |

Commissions and costs that result directly from and are essential to successful acquisition of new or renewal business are deferred to the extent recoverable and for our interest-sensitive products are generally amortized over the lives of the contracts in relation to EGPs. For our traditional products, DAC and VOBA are amortized on either a straight-line basis or as a level percent of premium of the related contracts, depending on the block of business.

RESULTS OF GROUP PROTECTION

Income (Loss) from Operations

Details underlying the results for Group Protection (in millions) were as follows:

| | For the Three Months Ended September 30, 2012 | 2011 | Change | For the Nine Months Ended September 30, 2012 | 2011 | Change |
|---|---|---|---|---|---|---|
| Operating Revenues | | | | | | |
| Insurance premiums | $ 473 | $ 440 | 8 % | $ 1,431 | $ 1,337 | 7 % |
| Net investment income | 41 | 37 | 11 % | 121 | 115 | 5 % |
| Other revenues and fees | 3 | 2 | 50 % | 8 | 6 | 33 % |
| Total operating revenues | 517 | 479 | 8 % | 1,560 | 1,458 | 7 % |
| Operating Expenses | | | | | | |
| Interest credited | 1 | 1 | 0 % | 3 | 2 | 50 % |
| Benefits | 360 | 319 | 13 % | 1,078 | 991 | 9 % |
| Commissions and other expenses | 132 | 118 | 12 % | 389 | 347 | 12 % |
| Total operating expenses | 493 | 438 | 13 % | 1,470 | 1,340 | 10 % |
| Income (loss) from operations before taxes | 24 | 41 | -41 % | 90 | 118 | -24 % |
| Federal income tax expense (benefit) | 8 | 14 | -43 % | 31 | 41 | -24 % |
| Income (loss) from operations | $ 16 | $ 27 | -41 % | $ 59 | $ 77 | -23 % |

| | For the Three Months Ended September 30, 2012 | 2011 | Change | For the Nine Months Ended September 30, 2012 | 2011 | Change |
|---|---|---|---|---|---|---|
| Income (Loss) from Operations by Product Line | | | | | | |
| Life | $ 6 | $ 11 | -45 % | $ 18 | $ 28 | -36 % |
| Disability | 7 | 15 | -53 % | 37 | 48 | -23 % |
| Dental | 2 | - | NM | - | (3 ) | 100 % |
| Total non-medical | 15 | 26 | -42 % | 55 | 73 | -25 % |
| Medical | 1 | 1 | 0 % | 4 | 4 | 0 % |
| Income (loss) from operations | $ 16 | $ 27 | -41 % | $ 59 | $ 77 | -23 % |

Comparison of the Three and Nine Months Ended September 30, 2012 to 2011

Income from operations for this segment decreased due primarily to the following:

- Unfavorable total non-medical loss ratio experience; and
- Higher commissions and other expenses attributable to strategic investments in sales and distribution processes and technology platforms as well as an increase in business.

The decrease in income from operations was partially offset by growth in insurance premiums driven by normal, organic business growth in our non-medical products.

Additional Information

Management compares trends in actual loss ratios to pricing expectations because group-underwriting risks change over time.  We expect normal fluctuations in our composite non-medical loss ratios of this segment, as claims experience is inherently uncertain.  During the third quarter of 2012, our total non-medical loss ratio of 75.7% was above our long-term expectation of 71% to 74%

due primarily to unfavorable long-term disability claims severity and, to a lesser extent, adverse mortality experience. Non-medical loss ratios in general are likely to remain at the high end of our long-term expectation of 71% to 74% during the fourth quarter of 2012. For every one percent increase in the loss ratio above our expectation, we would expect an approximate annual $10 million to $12 million decrease to income from operations.

We are evaluating the potential effects that health care reform may have on the value and profitability of this segment's products and income from operations, including, but not limited to, potential changes to traditional sources of income for our brokers who may seek additional portfolio options and/or modification to compensation structures.

For information on the effects of current interest rates on our long-term disability claim reserves, see "Part II – Item 7A. Quantitative and Qualitative Disclosures About Market Risk – Interest Rate Risk – Interest Rate Risk on Fixed Insurance Businesses – Falling Rates" in our 2011 Form 10-K.

Sales relate to long-duration contracts sold to new contract holders and new programs sold to existing contract holders. We believe that the trend in sales is an important indicator of development of business in force over time.

We provide information about this segment's operating revenue and operating expense line items, the period in which amounts are recognized, key drivers of changes and historical details underlying the line items and their associated drivers below.

For factors that could cause actual results to differ materially from those set forth in this section, see "Forward-Looking Statements – Cautionary Language" above and "Part I – Item 1A. Risk Factors" in our 2011 Form 10-K, as updated in "Part II – Item 1A. Risk Factors" below.

Insurance Premiums

Details underlying insurance premiums (in millions) were as follows:

| | For the Three Months Ended September 30, | | | | For the Nine Months Ended September 30, | | | |
|---|---|---|---|---|---|---|---|---|
| | 2012 | 2011 | Change | | 2012 | 2011 | Change | |
| Insurance Premiums by Product Line | | | | | | | | |
| Life | $ 194 | $ 174 | 11 | % | $ 570 | $ 517 | 10 | % |
| Disability | 207 | 190 | 9 | % | 610 | 568 | 7 | % |
| Dental | 49 | 46 | 7 | % | 142 | 137 | 4 | % |
| Total non-medical | 450 | 410 | 10 | % | 1,322 | 1,222 | 8 | % |
| Medical | 23 | 30 | -23 | % | 109 | 115 | -5 | % |
| Total insurance premiums | $ 473 | $ 440 | 8 | % | $ 1,431 | $ 1,337 | 7 | % |
| | | | | | | | | |
| Sales | $ 97 | $ 75 | 29 | % | $ 252 | $ 187 | 35 | % |

Our cost of insurance and policy administration charges are embedded in the premiums charged to our customers. The premiums are a function of the rates priced into the product and our business in force. Business in force, in turn, is driven by sales and persistency experience. Sales in the table above are the combined annualized premiums for our life, disability and dental products.

Net Investment Income

We use our investment income to offset the earnings effect of the associated build of our policy reserves, which are a function of our insurance premiums and the yields on our invested assets.

Benefits and Interest Credited

Details underlying benefits and interest credited (in millions) and loss ratios by product line were as follows:

| | For the Three Months Ended September 30, 2012 | 2011 | Change | For the Nine Months Ended September 30, 2012 | 2011 | Change |
|---|---|---|---|---|---|---|
| Benefits and Interest Credited by Product Line | | | | | | |
| Life | $ 149 | $ 125 | 19 % | $ 437 | $ 386 | 13 % |
| Disability | 158 | 134 | 18 % | 440 | 396 | 11 % |
| Dental | 34 | 35 | -3 % | 107 | 110 | -3 % |
| Total non-medical | 341 | 294 | 16 % | 984 | 892 | 10 % |
| Medical | 20 | 26 | -23 % | 97 | 101 | -4 % |
| Total benefits and interest credited | $ 361 | $ 320 | 13 % | $ 1,081 | $ 993 | 9 % |
| Loss Ratios by Product Line | | | | | | |
| Life | 76.8 % | 72.1 % | | 76.7 % | 74.7 % | |
| Disability | 76.3 % | 70.4 % | | 72.0 % | 70.0 % | |
| Dental | 69.0 % | 76.2 % | | 75.7 % | 80.0 % | |
| Total non-medical | 75.7 % | 71.8 % | | 74.4 % | 73.1 % | |
| Medical | 85.4 % | 86.9 % | | 88.1 % | 87.8 % | |

Commissions and Other Expenses

Details underlying commissions and other expenses (in millions) were as follows:

| | For the Three Months Ended September 30, 2012 | 2011 | Change | For the Nine Months Ended September 30, 2012 | 2011 | Change |
|---|---|---|---|---|---|---|
| Commissions and Other Expenses | | | | | | |
| Commissions | $ 55 | $ 50 | 10 % | $ 162 | $ 150 | 8 % |
| General and administrative expenses | 70 | 60 | 17 % | 200 | 169 | 18 % |
| Taxes, licenses and fees | 12 | 12 | 0 % | 37 | 32 | 16 % |
| Total expenses incurred | 137 | 122 | 12 % | 399 | 351 | 14 % |
| DAC deferrals | (15 ) | (13 ) | -15 % | (43 ) | (32 ) | -34 % |
| Total expenses recognized before amortization | 122 | 109 | 12 % | 356 | 319 | 12 % |
| DAC and VOBA amortization, net of interest | 10 | 9 | 11 % | 33 | 28 | 18 % |
| Total commissions and other expenses | $ 132 | $ 118 | 12 % | $ 389 | $ 347 | 12 % |
| DAC Deferrals | | | | | | |
| As a percentage of insurance premiums | 3.2 % | 3.0 % | | 3.0 % | 2.4 % | |

Commissions and other costs that result directly from and are essential to the successful acquisition of new or renewal business are deferred to the extent recoverable and are amortized on either a straight-line basis or as a level percent of premium of the related contracts depending on the block of business. Certain broker commissions that vary with and are related to paid premiums are expensed as incurred. The level of expenses is 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.

RESULTS OF OTHER OPERATIONS

Income (Loss) from Operations

Details underlying the results for Other Operations (in millions) were as follows:

| | For the Three Months Ended September 30, 2012 | 2011 | Change | For the Nine Months Ended September 30, 2012 | 2011 | Change |
|---|---|---|---|---|---|---|
| Operating Revenues | | | | | | |
| Insurance premiums | $ - | $ 1 | -100 % | $ 4 | $ 1 | 300 % |
| Net investment income | 61 | 80 | -24 % | 198 | 237 | -16 % |
| Amortization of deferred gain on business sold through reinsurance | 18 | 18 | 0 % | 54 | 54 | 0 % |
| Media revenues (net) | 21 | 20 | 5 % | 60 | 56 | 7 % |
| Other revenues and fees | 1 | 3 | -67 % | 5 | 4 | 25 % |
| Total operating revenues | 101 | 122 | -17 % | 321 | 352 | -9 % |
| Operating Expenses | | | | | | |
| Interest credited | 30 | 27 | 11 % | 91 | 85 | 7 % |
| Benefits | 43 | 34 | 26 % | 105 | 95 | 11 % |
| Media expenses | 16 | 17 | -6 % | 49 | 51 | -4 % |
| Other expenses | 33 | 34 | -3 % | 69 | 62 | 11 % |
| Interest and debt expense | 68 | 71 | -4 % | 203 | 215 | -6 % |
| Total operating expenses | 190 | 183 | 4 % | 517 | 508 | 2 % |
| Income (loss) from operations before taxes | (89 ) | (61 ) | -46 % | (196) | (156) | -26 % |
| Federal income tax expense (benefit) | (86 ) | (17 ) | NM | (121) | (52 ) | NM |
| Income (loss) from operations | $ (3 ) | $ (44 ) | 93 % | $ (75 ) | $ (104) | 28 % |

Comparison of the Three and Nine Months Ended September 30, 2012 to 2011

Loss from operations for Other Operations decreased due primarily to favorable tax adjustments during 2012 related to the release of reserves associated with prior tax years that were closed in the third quarter.

The increase in income from operations was partially offset by lower net investment income, net of interest credited, attributable to the following:

- New money rates averaging below our portfolio yields; and
- Repurchases of common stock, net cash used in operating activities due to interest payments and transfers to other segments for other-than-temporary impairment (“OTTI”) resulting in lower average invested assets.

Additional Information

Other Operations experienced elevated levels of expense during both 2012 and 2011 related primarily to restructuring charges and a state guaranty funds assessment associated with Executive Life Insurance Company of New York, respectively.

We provide information about Other Operations’ operating revenue and operating expense line items, the period in which amounts are recognized, key drivers of changes and historical details underlying the line items and their associated drivers below.

For factors that could cause actual results to differ materially from those set forth in this section, see “Forward-Looking Statements – Cautionary Language” above and “Part I – Item 1A. Risk Factors” in our 2011 Form 10-K, as updated in “Part II – Item 1A. Risk Factors” below.

Net Investment Income and Interest Credited

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. If regulations require increases in our insurance segments' statutory reserves and surplus, the amount of capital retained by Other Operations would decrease and net investment income would be negatively affected.

Write-downs for OTTI decrease the recorded value of our invested assets owned by our business segments. These write-downs are not included in the income from operations of our operating segments. When impairment occurs, assets are transferred to the business segments' portfolios and will reduce the future net investment income for Other Operations, but should not have an effect on a consolidated basis unless the impairments are related to defaulted securities. Statutory reserve adjustments for our business segments can also cause allocations of invested assets between the affected segments and Other Operations.

The majority of our interest credited relates to our reinsurance operations sold to Swiss Re in 2001. A substantial amount of the business was sold through indemnity reinsurance transactions, which is still recorded in our consolidated financial statements. The interest credited corresponds to investment income earnings on the assets we continue to hold for this business. There is no effect to income or loss in Other Operations or on a consolidated basis for these amounts because interest earned on the blocks that continue to be reinsured is passed through to Swiss Re in the form of interest credited.

Benefits

Benefits are recognized when incurred for Institutional Pension products and disability income business.

Other Expenses

Details underlying other expenses (in millions) were as follows:

| | For the Three Months Ended September 30, | | | For the Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| | 2012 | 2011 | Change | 2012 | 2011 | Change |
| Other Expenses | | | | | | |
| General and administrative expenses: | | | | | | |
| Legal | $ - | $ - | NM | $ 1 | $ 2 | -50 % |
| Branding | 4 | 9 | -56 % | 21 | 19 | 11 % |
| Other (1) | 7 | 13 | -46 % | 34 | 37 | -8 % |
| Total general and administrative expenses | 11 | 22 | -50 % | 56 | 58 | -3 % |
| Restructuring charges | 14 | - | NM | 14 | - | NM |
| Taxes, licenses and fees | 11 | 14 | -21 % | 7 | 11 | -36 % |
| Inter-segment reimbursement associated with reserve financing and LOC expenses (2) | (3 ) | (2 ) | -50 % | (8 ) | (7 ) | -14 % |
| Total other expenses | $ 33 | $ 34 | -3 % | $ 69 | $ 62 | 11 % |

(1) Includes expenses that are corporate in nature including charitable contributions, amortization of media intangible assets with a definite life, other expenses not allocated to our business segments and inter-segment expense eliminations.

(2)

Consists of reimbursements to Other Operations from the Life Insurance segment for the use of proceeds from certain issuances of senior notes that were used as long-term structured solutions, net of expenses incurred by Other Operations for its use of LOCs.

Interest and Debt Expense

Our current level of interest expense may not be indicative of the future due to, among other things, the timing of the use of cash, the availability of funds from our inter-company cash management program and the future cost of capital. For additional information on our financing activities, see “Review of Consolidated Financial Condition – Liquidity and Capital Resources – Sources of Liquidity and Cash Flow – Financing Activities” below.

REALIZED GAIN (LOSS) AND BENEFIT RATIO UNLOCKING

Details underlying realized gain (loss), after-DAC (1) and benefit ratio unlocking (in millions) were as follows:

| | For the Three Months Ended September 30, 2012 | 2011 | Change | For the Nine Months Ended September 30, 2012 | 2011 | Change |
|---|---|---|---|---|---|---|
| Components of Realized Gain (Loss), Pre-Tax | | | | | | |
| Total operating realized gain (loss) | $ 31 | $ 23 | 35 % | $ 83 | $ 69 | 20 % |
| Total excluded realized gain (loss) | 39 | (186) | 121 % | (55) | (239) | 77 % |
| Total realized gain (loss), pre-tax | $ 70 | $ (163) | 143 % | $ 28 | $ (170) | 116 % |
| Reconciliation of Excluded Realized Gain (Loss), Net of Benefit Ratio Unlocking, After-Tax | | | | | | |
| Total excluded realized gain (loss) | $ 25 | $ (121) | 121 % | $ (35) | $ (156) | 78 % |
| Benefit ratio unlocking | 10 | (42) | 124 % | 24 | (39) | 162 % |
| Excluded realized gain (loss) net of benefit ratio unlocking, after-tax | $ 35 | $ (163) | 121 % | $ (11) | $ (195) | 94 % |
| Components of Excluded Realized Gain (Loss) Net of Benefit Ratio Unlocking, After-Tax | | | | | | |
| Realized gain (loss) related to certain investments | $ (35) | $ (29) | 155 % | $ (99) | $ (60) | 202 % |
| Gain (loss) on the mark-to-market on certain instruments | 38 | (69) | NM | 64 | (63) | NM |
| Variable annuity net derivatives results: | | | | | | |
| Hedge program performance | 15 | (91) | 208 % | (3) | (121) | 98 % |
| Unlocking for GLB reserves hedged | 84 | (78) | NM | 84 | (78) | 208 % |
| GLB NPR component | (61) | 106 | 160 % | (60) | 127 | NM |
| Total variable annuity net derivatives results | 38 | (63) | 160 % | 21 | (72) | 129 % |
| Indexed annuity forward-starting option (2) | (6) | (2) | NM | 3 | - | NM |
| Excluded realized gain (loss) net of benefit ratio unlocking, after-tax | $35 | $(163) | 121 % | $(11) | $(195) | 94 % |

(1) DAC refers to the associated amortization of DAC, VOBA, DSI and DFEL and changes in other contract holder funds and funds withheld reinsurance liabilities.
(2) Includes unfavorable prospective unlocking – model refinements of $8 million, after-tax, for the three and nine months ended September 30, 2012.

For factors that could cause actual results to differ materially from those set forth in this section, see “Forward-Looking Statements – Cautionary Language” above and “Part I – Item 1A. Risk Factors” in our 2011 Form 10-K, as updated in “Part II – Item 1A. Risk Factors” below.

For information on our counterparty exposure, see “Part I – Item 3. Quantitative and Qualitative Disclosures About Market Risk.”

Comparison of the Three and Nine Months Ended September 30, 2012 to 2011

Realized gain (loss) is driven primarily by the following components of excluded realized gain (loss), which we have described net of benefit ratio unlocking.

We had realized gains during 2012 as compared to losses during 2011 due primarily to the following:

- Realized gains on the mark-to-market on certain instruments during 2012 as compared to realized losses during 2011 attributable to spreads narrowing on corporate credit default swaps; and
- Gains on variable annuity net derivatives results during 2012 as compared to losses during 2011 attributable to:

§ The effect of prospective unlocking (see “Critical Accounting Policies and Estimates – DAC, VOBA, DSI and DFEL – Unlocking” for more information); and

§ Less volatile capital markets during 2012 resulting in more favorable hedge program performance;

partially offset by:

§ Narrowing of our credit spreads during 2012 resulting in an unfavorable GLB NPR component.

The realized gains during 2012 were partially offset by higher gross realized gains related to certain investments during 2011 originating from asset sales to reposition the investment portfolio (see “Consolidated Investments – Realized Gain (Loss) Related to Certain Investments” below for more information).

Operating Realized Gain (Loss)

See “Realized Gain (Loss) and Benefit Ratio Unlocking – Operating Realized Gain (Loss)” in our 2011 Form 10-K for a discussion of our operating realized gain (loss).

Realized Gain (Loss) Related to Certain Investments

See “Consolidated Investments – Realized Gain (Loss) Related to Certain Investments” below.

Gain (Loss) on the Mark-to-Market on Certain Instruments

See “Realized Gain (Loss) and Benefit Ratio Unlocking – Gain (Loss) on the Mark-to-Market on Certain Instruments” in our 2011 Form 10-K for a discussion on the mark-to-market on certain instruments and Note 4 for information about consolidated variable interest entities.

Variable Annuity Net Derivatives Results

See “Realized Gain (Loss) and Benefit Ratio Unlocking – Variable Annuity Net Derivatives Results” in our 2011 Form 10-K for a discussion of our variable annuity net derivatives results. In addition, for information on the unlocking for GLB reserves hedged, see “Critical Accounting Policies and Estimates – DAC, VOBA, DSI and DFEL – Unlocking.”

The variable annuity hedge program ended the third quarter of 2012 with assets of $2.3 billion, which were in excess of the estimated liability of $1.6 billion as of September 30, 2012.

As of September 30, 2012, the net effect of the NPR resulted in a $76 million decrease in the liability for our GLB embedded derivative reserves.

Details underlying the NPR component and associated effect to our GLB embedded derivative reserves (dollars in millions) were as follows:

| | As of September 30, 2012 | As of June 30, 2012 | As of March 31, 2012 | As of December 31, 2011 | As of September 30, 2011 |
|---|---|---|---|---|---|
| 10-year CDS spread | 2.40% | 3.48% | 2.40% | 3.65% | 4.42% |
| NPR factor related to 10-year CDS spread | 0.29% | 0.45% | 0.25% | 0.43% | 0.51% |
| Unadjusted embedded derivative liability | $ 1,432 | $ 2,116 | $ 1,083 | $ 2,418 | $ 2,642 |

Estimating what the absolute amount of the NPR effect will be period to period is difficult due to the utilization of all cash flows and the shape of the spread curve. Currently, we estimate that if the NPR factors as of September 30, 2012, were to have been zero along all points on the spread curve, then the NPR offset to the unadjusted liability would have resulted in an unfavorable effect to net income of approximately $225 million, pre-DAC and pre-tax. Under this scenario, the effect of the NPR would result in an increase rather than a decrease to the unadjusted embedded derivative liability. Alternatively, if the NPR factors were 20 basis points higher along all points on the spread curve as of September 30, 2012, then there would have been a favorable effect to net income of approximately $105 million, pre-DAC and pre-tax. In the preceding two sentences, "DAC" refers to the associated amortization of DAC, VOBA, DSI and DFEL. Changing market conditions could cause this relationship to deviate significantly in future periods. Sensitivity within this range is primarily a result of volatility in our credit default swap ("CDS") spreads and the slope of the CDS spread term structure.

For additional information on our guaranteed benefits, see "Critical Accounting Policies and Estimates – Derivatives – Guaranteed Living Benefits" above.

Indexed Annuity Forward-Starting Option

See "Realized Gain (Loss) and Benefit Ratio Unlocking – Indexed Annuity Forward-Starting Option" in our 2011 Form 10-K for a discussion of our indexed annuity forward-starting option.

CONSOLIDATED INVESTMENTS

Details underlying our consolidated investment balances (in millions) were as follows:

| | | | | | Percentage of Total Investments | | | |
|---|---|---|---|---|---|---|---|---|
| | | As of September 30, 2012 | | As of December 31, 2011 | As of September 30, 2012 | | As of December 31, 2011 | |
| Investments | | | | | | | | |
| AFS securities: | | | | | | | | |
| Fixed maturity | $ | 81,179 | $ | 75,433 | 82.4 | % | 81.0 | % |
| VIEs' fixed maturity | | 706 | | 700 | 0.7 | % | 0.8 | % |
| Total fixed maturity | | 81,885 | | 76,133 | 83.1 | % | 81.8 | % |
| Equity | | 156 | | 139 | 0.2 | % | 0.1 | % |
| Trading securities | | 2,650 | | 2,675 | 2.7 | % | 2.9 | % |
| Mortgage loans on real estate | | 6,690 | | 6,942 | 6.8 | % | 7.4 | % |
| Real estate | | 112 | | 137 | 0.1 | % | 0.1 | % |
| Policy loans | | 2,780 | | 2,884 | 2.8 | % | 3.1 | % |
| Derivative investments | | 3,072 | | 3,151 | 3.1 | % | 3.4 | % |
| Alternative investments | | 873 | | 807 | 0.9 | % | 0.9 | % |
| Other investments | | 250 | | 262 | 0.3 | % | 0.3 | % |
| Total investments | $ | 98,468 | $ | 93,130 | 100.0 | % | 100.0 | % |

Investment Objective

Invested assets are an integral part of our operations. We follow a balanced approach to investing for both current income and prudent risk management, with an emphasis on generating sufficient current income, net of income tax, to meet our obligations to customers, as well as other general liabilities. This balanced approach requires the evaluation of expected return and risk of each asset class utilized, while still meeting our income objectives. This approach is important to our asset-liability management because decisions can be made based upon both the economic and current investment income considerations affecting assets and liabilities. For a discussion on our risk management process, see “Part II – Item 7A. Quantitative and Qualitative Disclosures About Market Risk” in our 2011 Form 10-K.

Investment Portfolio Composition and Diversification

Fundamental to our investment policy is diversification across asset classes. 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.

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.

Fixed Maturity and Equity Securities Portfolios

Fixed maturity securities and equity securities consist of portfolios classified as AFS and trading. Mortgage-backed and private securities are included in both of the AFS and trading portfolios.

Details underlying our fixed maturity and equity securities portfolios by industry classification (in millions) are presented in the tables below. These tables agree in total with the presentation of AFS securities in Note 5; however, the categories below represent a more detailed breakout of the AFS portfolio. Therefore, the investment classifications listed below do not agree to the investment categories provided in Note 5.

| | As of September 30, 2012 | | | | |
|---|---|---|---|---|---|
| | | Gross Unrealized | | | % |
| | Amortized Cost | Gains | Losses and OTTI | Fair Value | Fair Value |
| Fixed Maturity AFS Securities | | | | | |
| Industry corporate bonds: | | | | | |
| Financial services | $ 9,129 | $ 1,075 | $ 87 | $ 10,117 | 12.4 % |
| Basic industry | 3,836 | 428 | 18 | 4,246 | 5.2 % |
| Capital goods | 4,383 | 602 | 19 | 4,966 | 6.1 % |
| Communications | 3,611 | 554 | 21 | 4,144 | 5.1 % |
| Consumer cyclical | 3,641 | 486 | 24 | 4,103 | 5.0 % |
| Consumer non-cyclical | 9,101 | 1,519 | 3 | 10,617 | 13.0 % |
| Energy | 5,489 | 897 | 2 | 6,384 | 7.8 % |
| Technology | 1,974 | 255 | 1 | 2,228 | 2.7 % |
| Transportation | 1,543 | 193 | 1 | 1,735 | 2.1 % |
| Industrial other | 991 | 98 | 1 | 1,088 | 1.3 % |
| Utilities | 11,495 | 1,816 | 16 | 13,295 | 16.2 % |
| Collateralized mortgage and other obligations ("CMOs"): | | | | | |
| Agency backed | 2,613 | 304 | - | 2,917 | 3.6 % |
| Non-agency backed | 1,267 | 39 | 71 | 1,235 | 1.5 % |
| Mortgage pass through securities ("MPTS"): | | | | | |
| Agency backed | 2,397 | 187 | - | 2,584 | 3.2 % |
| Non-agency backed | 1 | - | - | 1 | 0.0 % |
| Commercial mortgage-backed securities ("CMBS"): | | | | | |
| Non-agency backed | 1,104 | 75 | 53 | 1,126 | 1.4 % |
| Corporate asset-backed securities ("ABS"): | | | | | |
| CDOs | 131 | - | 2 | 129 | 0.2 % |
| Commercial real estate ("CRE") CDOs | 28 | - | 10 | 18 | 0.0 % |
| Credit card | 666 | 48 | - | 714 | 0.9 % |
| Home equity | 821 | 5 | 196 | 630 | 0.8 % |
| Manufactured housing | 73 | 5 | - | 78 | 0.1 % |
| Auto loan | 14 | - | - | 14 | 0.0 % |
| Other | 313 | 35 | - | 348 | 0.4 % |
| Municipals: | | | | | |
| Taxable | 3,483 | 822 | 7 | 4,298 | 5.2 % |
| Tax-exempt | 36 | 4 | - | 40 | 0.0 % |
| Government and government agencies: | | | | | |
| United States | 1,479 | 253 | - | 1,732 | 2.1 % |
| Foreign | 1,659 | 254 | 1 | 1,912 | 2.3 % |
| Hybrid and redeemable preferred securities | 1,176 | 95 | 85 | 1,186 | 1.4 % |
| Total fixed maturity AFS securities | 72,454 | 10,049 | 618 | 81,885 | 100.0% |
| Equity AFS Securities | 143 | 21 | 8 | 156 | |
| Total AFS securities | 72,597 | 10,070 | 626 | 82,041 | |

| | | | | |
|---|---|---|---|---|
| Trading Securities (1) | 2,211 | 456 | 17 | 2,650 |
| Total AFS and trading securities | $ 74,808 | $ 10,526 | $ 643 | $ 84,691 |

| | As of December 31, 2011 | | | | |
|---|---|---|---|---|---|
| | | Gross Unrealized | | | % |
| | Amortized | | Losses and | Fair | Fair |
| | Cost | Gains | OTTI | Value | Value |
| Fixed Maturity AFS Securities | | | | | |
| Industry corporate bonds: | | | | | |
| Financial services | $ 8,926 | $ 607 | $ 158 | $ 9,375 | 12.3% |
| Basic industry | 3,394 | 323 | 27 | 3,690 | 4.8% |
| Capital goods | 3,933 | 455 | 9 | 4,379 | 5.8% |
| Communications | 3,247 | 364 | 37 | 3,574 | 4.7% |
| Consumer cyclical | 3,226 | 345 | 36 | 3,535 | 4.6% |
| Consumer non-cyclical | 7,956 | 1,190 | 1 | 9,145 | 12.0% |
| Energy | 5,026 | 690 | 6 | 5,710 | 7.5% |
| Technology | 1,682 | 192 | 3 | 1,871 | 2.5% |
| Transportation | 1,360 | 166 | 1 | 1,525 | 2.0% |
| Industrial other | 755 | 74 | 3 | 826 | 1.1% |
| Utilities | 10,644 | 1,457 | 27 | 12,074 | 15.8% |
| CMOs: | | | | | |
| Agency backed | 3,226 | 357 | - | 3,583 | 4.7% |
| Non-agency backed | 1,481 | 12 | 199 | 1,294 | 1.7% |
| MPTS: | | | | | |
| Agency backed | 2,982 | 179 | - | 3,161 | 4.2% |
| Non-agency backed | 1 | - | - | 1 | 0.0% |
| CMBS: | | | | | |
| Non-agency backed | 1,642 | 73 | 115 | 1,600 | 2.1% |
| ABS: | | | | | |
| CDOs | 88 | - | 6 | 82 | 0.1% |
| CRE CDOs | 33 | - | 13 | 20 | 0.0% |
| Credit card | 790 | 47 | - | 837 | 1.1% |
| Home equity | 905 | 3 | 271 | 637 | 0.8% |
| Manufactured housing | 85 | 5 | 1 | 89 | 0.1% |
| Auto loan | 52 | 1 | - | 53 | 0.1% |
| Other | 246 | 29 | 1 | 274 | 0.4% |
| Municipals: | | | | | |
| Taxable | 3,452 | 565 | 9 | 4,008 | 5.3% |
| Tax-exempt | 38 | 1 | - | 39 | 0.1% |
| Government and government agencies: | | | | | |
| United States | 1,468 | 232 | - | 1,700 | 2.2% |
| Foreign | 1,746 | 152 | 4 | 1,894 | 2.5% |
| Hybrid and redeemable preferred securities | 1,277 | 50 | 170 | 1,157 | 1.5% |
| Total fixed maturity AFS securities | 69,661 | 7,569 | 1,097 | 76,133 | 100.0% |
| Equity AFS Securities | 135 | 16 | 12 | 139 | |
| Total AFS securities | 69,796 | 7,585 | 1,109 | 76,272 | |
| Trading Securities (1) | 2,301 | 408 | 34 | 2,675 | |
| Total AFS and trading securities | $ 72,097 | $ 7,993 | $ 1,143 | $ 78,947 | |

(1)

Certain of our trading securities support our modified coinsurance arrangements (“Modco”), and the investment results are passed directly to the reinsurers. Refer to “Part II – Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations – Consolidated Investments – Fixed Maturity and Equity Securities Portfolios – Trading Securities” in our 2011 Form 10-K for further details.

AFS Securities

In accordance with the AFS accounting guidance, we reflect stockholders' equity as if unrealized gains and losses were actually recognized and consider all related accounting adjustments that would occur upon such a hypothetical recognition of unrealized gains and losses. Such related balance sheet effects include adjustments to the balances of DAC, VOBA, DFEL, other contract holder funds and deferred income taxes. Adjustments to each of these balances are charged or credited to AOCI. For instance, DAC is adjusted upon the recognition of unrealized gains or losses because the amortization of DAC is based upon an assumed emergence of gross profits on certain insurance business. Deferred income tax balances are also adjusted because unrealized gains or losses do not affect actual taxes currently paid.

The quality of our AFS fixed maturity securities portfolio, as measured at estimated fair value and by the percentage of fixed maturity securities invested in various ratings categories, relative to the entire fixed maturity AFS security portfolio (in millions) was as follows:

| NAIC Designation (1) | Rating Agency Equivalent Designation (1) | As of September 30, 2012 Amortized Cost | Fair Value | % of Total | As of December 31, 2011 Amortized Cost | Fair Value | % of Total |
|---|---|---|---|---|---|---|---|
| Investment Grade Securities | | | | | | | |
| 1 | Aaa / Aa / A | $ 41,422 | $ 48,010 | 58.6% | $ 42,436 | $ 47,490 | 62.4% |
| 2 | Baa | 27,286 | 30,315 | 37.0% | 23,323 | 25,237 | 33.1% |
| Total investment grade securities | | 68,708 | 78,325 | 95.6% | 65,759 | 72,727 | 95.5% |
| Below Investment Grade Securities | | | | | | | |
| 3 | Ba | 2,474 | 2,497 | 3.0% | 2,466 | 2,350 | 3.1% |
| 4 | B | 875 | 768 | 0.9% | 960 | 750 | 1.0% |
| 5 | Caa and lower | 298 | 218 | 0.3% | 318 | 218 | 0.3% |
| 6 | In or near default | 99 | 77 | 0.2% | 158 | 88 | 0.1% |
| Total below investment grade securities | | 3,746 | 3,560 | 4.4% | 3,902 | 3,406 | 4.5% |
| Total fixed maturity AFS securities | | $ 72,454 | $ 81,885 | 100.0% | $ 69,661 | $ 76,133 | 100.0% |
| Total securities below investment grade as a percentage of total fixed maturity AFS securities | | 5.2 % | 4.3 % | | 5.6 % | 4.5 % | |

(1) Based upon the rating designations determined and provided by the National Association of Insurance Commissioners ("NAIC") or the major credit rating agencies (Fitch Ratings ("Fitch"), Moody's Investors Service ("Moody's") and Standard & Poor's ("S&P")). For securities where the ratings assigned by the major credit agencies are not equivalent, the second highest rating assigned is used. For those securities where ratings by the major credit rating agencies are not available, which does not represent a significant amount of our total fixed maturity AFS securities, we base the ratings disclosed upon internal ratings.

Comparisons between the NAIC ratings and rating agency designations are published by the NAIC. The NAIC assigns securities quality ratings and uniform valuations, which are used by insurers when preparing their annual statements. The NAIC ratings are similar to the rating agency designations of the Nationally Recognized Statistical Rating Organizations for marketable bonds. NAIC ratings 1 and 2 include bonds generally considered investment grade (rated Baa3 or higher by Moody's, or rated BBB- or higher by S&P and Fitch), by such ratings organizations. However, securities rated NAIC 1 and NAIC 2 could be deemed below investment grade by the rating agencies as a result of the current RBC rules for residential mortgage-backed securities ("RMBS") and CMBS for statutory reporting. NAIC ratings 3 through 6 include bonds generally considered below investment grade (rated Ba1 or lower by Moody's, or rated BB+ or lower by S&P and Fitch).

We have identified exposure to select countries in Europe that are currently experiencing stress in the credit markets, notably Greece, Ireland, Italy, Portugal, Spain, Hungary, Cyprus and Slovenia. These countries were identified due to high credit spreads and political and economic uncertainty in these countries. The exposure was determined by country of domicile, provided that a meaningful portion of revenues is generated from the country of domicile. As of September 30, 2012, we had direct sovereign exposure only to Italy with an amortized cost and fair value of $3 million. We had no exposure to any issuers, sovereign or non-sovereign, located in Greece, Hungary, Cyprus or Slovenia. Our exposure to banks in Greece, Ireland, Italy, Portugal, Spain, Hungary, Cyprus and Slovenia is limited to two large Spanish banks where our investments are in subsidiaries located outside of Spain with an amortized cost and fair value of $59 million.

Our total non-banking and non-sovereign AFS securities exposure to Ireland, Italy, Portugal, Greece and Spain had an amortized cost of $733 million and a fair value of $763 million as of September 30, 2012, of which 53% was related to large multinational companies domiciled in those countries. The detailed breakout by country (in millions) as of September 30, 2012, was as follows:

| | Amortized Cost | Fair Value |
|---|---|---|
| Spain | $ 342 | $ 362 |
| Ireland | 212 | 210 |
| Italy | 139 | 154 |
| Portugal | 40 | 37 |
| Greece | - | - |
| Total | $ 733 | $ 763 |

We hold a European subordinated investment grade financial index hedge in the amount of €35 million with a maturity of June 20, 2017, to provide some protection on possible defaults on our European investments.

We manage European and other investment risks through our internal investment department and outside asset managers. The risk management is focused on monitoring spreads, pricing and monitoring of global economic developments. We have incorporated these risks into our stress testing.

As of September 30, 2012, and December 31, 2011, 63.5% and 67.4%, respectively, of the total publicly traded and private securities in an unrealized loss status were rated as investment grade. See Note 5 for maturity date information for our fixed maturity investment portfolio. Our gross unrealized losses on AFS securities as of September 30, 2012, decreased $483 million. As more fully described in Note 1 in our 2011 Form 10-K, we regularly review our investment holdings for OTTI. We believe the unrealized loss position as of September 30, 2012, does not represent OTTI as we do not intend to sell these debt securities, it is not more likely than not that we will be required to sell the debt securities before recovery of their amortized cost basis, the estimated future cash flows are equal to or greater than the amortized cost basis of the debt securities, or we have the ability and intent to hold the equity securities for a period of time sufficient for recovery. For further information on our unrealized losses on AFS securities, see "Composition by Industry Categories of our Unrealized Losses on AFS Securities" below.

Selected information for certain AFS securities in a gross unrealized loss position (dollars in millions) as of September 30, 2012, was as follows:

| | As of September 30, 2012 | | | | | |
|---|---|---|---|---|---|---|
| | Fair Value | Gross Unrealized Losses and OTTI | Estimated Years until Call or Maturity | Estimated Average Years Until Recovery | Subordination Level Current | Subordination Level Origination |
| CMBS | $ 201 | $ 53 | 1 to 41 | 27 | 26.0 % | 13.0 % |
| Hybrid and redeemable preferred securities | 417 | 85 | 1 to 54 | 29 | N/A | N/A |

As provided in the table above, many of the securities in these categories are long-dated with some of the preferred securities being perpetual. This is purposeful as it matches the long-term nature of our liabilities associated with our life insurance and annuity products. See "Part II – Item 7A. Quantitative and Qualitative Disclosures About Market

Risk” in our 2011 Form 10-K where we present information related to maturities of securities and the expected cash flows for rate sensitive liabilities and maturities of our holding company debt, which also demonstrates the long-term nature of the cash flows associated with these items. Because of this relationship, we do not believe it will be necessary to sell these securities before they recover or mature. For these securities, the estimated range and average period until recovery is the call or maturity period. It is difficult to predict or project when the securities will recover as it is dependent upon a number of factors including the overall economic climate. We do not believe it is necessary to impair these securities as long as the expected future cash flows are projected to be sufficient to recover the amortized cost of these securities.

The actual range and period until recovery could vary significantly depending on a variety of factors, many of which are out of our control. There are several items that could affect the length of the period until recovery, such as the pace of economic recovery, level of delinquencies, performance of the underlying collateral, changes in market interest rates, exposures to various industry or geographic conditions, market behavior and other market conditions.

We concluded that it is not more likely than not that we will be required to sell the fixed maturity AFS securities before recovery of their amortized cost basis, that the estimated future cash flows are equal to or greater than the amortized cost basis of the debt securities, and that we have the ability to hold the equity AFS securities for a period of time sufficient for recovery. This conclusion is consistent with our asset-liability management process. Management considers the following as part of the evaluation:

- The current economic environment and market conditions;
- Our business strategy and current business plans;
- The nature and type of security, including expected maturities and exposure to general credit, liquidity, market and interest rate risk;
- Our analysis of data from financial models and other internal and industry sources to evaluate the current effectiveness of our hedging and overall risk management strategies;
- The current and expected timing of contractual maturities of our assets and liabilities, expectations of prepayments on investments and expectations for surrenders and withdrawals of life insurance policies and annuity contracts;
- The capital risk limits approved by management; and
- Our current financial condition and liquidity demands.

To determine the recoverability of a debt security, we consider the facts and circumstances surrounding the underlying issuer including, but not limited to, the following:

- Historical and implied volatility of the security;
- Length of time and extent to which the fair value has been less than amortized cost;
- Adverse conditions specifically related to the security or to specific conditions in an industry or geographic area;
- Failure, if any, of the issuer of the security to make scheduled payments; and
- Recoveries or additional declines in fair value subsequent to the balance sheet date.

As reported on our Consolidated Balance Sheets, we had $102.8 billion of investments and cash, which exceeded the liabilities for our future obligations under insurance policies and contracts, net of amounts recoverable from reinsurers, which totaled $83.5 billion as of September 30, 2012. If it were necessary to liquidate securities prior to maturity or call to meet cash flow needs, we would first look to those securities that are in an unrealized gain position, which had a fair value of $77.5 billion, excluding consolidated variable interest entities ("VIEs") in the amount of $706 million, as of September 30, 2012, rather than selling securities in an unrealized loss position. The amount of cash that we have on hand at any point of time takes into account our liquidity needs in the future, other sources of cash, such as the maturities of investments, interest and dividends we earn on our investments and the on-going cash flows from new and existing business.

See "AFS Securities – Evaluation for Recovery of Amortized Cost" in Note 1 in our 2011 Form 10-K and Note 5 for additional discussion.

As of September 30, 2012, and December 31, 2011, the estimated fair value for all private securities was $11.3 billion and $9.3 billion, respectively, representing 11% and 10%, respectively, of total invested assets.

For information regarding our VIEs' fixed maturity securities, see Note 4 in this report and Note 4 in our 2011 Form 10-K.

Mortgage-Backed Securities ("MBS") (Included in AFS and Trading Securities)

See "Consolidated Investments – Mortgage-Backed Securities" in our 2011 Form 10-K for a discussion of our MBS.

Our RMBS had a market value of $6.9 billion and an unrealized gain of $477 million, or 7%, as of September 30, 2012.

The market value of AFS and trading securities backed by subprime loans was $431 million and represented less than 1% of our total investment portfolio as of September 30, 2012. AFS securities represented $418 million, or 97%, and trading securities represented $13 million, or 3%, of the subprime exposure as of September 30, 2012. AFS and trading securities rated A or above represented 37% of the subprime investments and $225 million in market value of our subprime investments was backed by loans originating in 2005 and forward as of September 30, 2012. The table below summarizes our investments in AFS securities backed by pools of residential mortgages (in millions) as of September 30, 2012:

| | Prime Agency | | Prime/ Non-Agency | | Alt-A | | Subprime | | Total | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Fair Value | Amortized Cost | Fair Value | Amortized Cost | Fair Value | Amortized Cost | Fair Value | Amortized Cost | Fair Value | Amortized Cost |
| Type | | | | | | | | | | |
| RMBS | $ 5,500 | $ 5,010 | $ 778 | $ 760 | $ 459 | $ 508 | $ - | $ - | $ 6,737 | $ 6,278 |
| ABS home equity | 4 | 4 | - | - | 209 | 254 | 417 | 563 | 630 | 821 |
| Total by type (1)(2) | $ 5,504 | $ 5,014 | $ 778 | $ 760 | $ 668 | $ 762 | $ 417 | $ 563 | $ 7,367 | $ 7,099 |
| | | | | | | | | | | |
| Rating | | | | | | | | | | |
| AAA | $ 5,442 | $ 4,958 | $ 30 | $ 28 | $ 4 | $ 4 | $ 29 | $ 29 | $ 5,505 | $ 5,019 |
| AA | 48 | 44 | 42 | 40 | 10 | 10 | 62 | 66 | 162 | 160 |
| A | 14 | 12 | 39 | 38 | 46 | 45 | 59 | 59 | 158 | 154 |
| BBB | - | - | 52 | 51 | 47 | 48 | 37 | 40 | 136 | 139 |
| BB and below | - | - | 615 | 603 | 561 | 655 | 230 | 369 | 1,406 | 1,627 |
| Total by rating (1)(2)(3) | $ 5,504 | $ 5,014 | $ 778 | $ 760 | $ 668 | $ 762 | $ 417 | $ 563 | $ 7,367 | $ 7,099 |
| | | | | | | | | | | |
| Origination Year | | | | | | | | | | |
| 2004 and prior | $ 1,054 | $ 959 | $ 173 | $ 169 | $ 209 | $ 230 | $ 196 | $ 234 | $ 1,632 | $ 1,592 |
| 2005 | 726 | 644 | 109 | 113 | 248 | 274 | 162 | 218 | 1,245 | 1,249 |
| 2006 | 210 | 187 | 156 | 148 | 170 | 210 | 58 | 109 | 594 | 654 |
| 2007 | 998 | 891 | 340 | 330 | 41 | 48 | - | - | 1,379 | 1,269 |
| 2008 | 184 | 167 | - | - | - | - | - | - | 184 | 167 |
| 2009 | 929 | 856 | - | - | - | - | 1 | 2 | 930 | 858 |
| 2010 | 858 | 796 | - | - | - | - | - | - | 858 | 796 |
| 2011 | 416 | 389 | - | - | - | - | - | - | 416 | 389 |
| 2012 | 129 | 125 | - | - | - | - | - | - | 129 | 125 |
| Total by origination year (1)(2) | $ 5,504 | $ 5,014 | $ 778 | $ 760 | $ 668 | $ 762 | $ 417 | $ 563 | $ 7,367 | $ 7,099 |
| | | | | | | | | | | |
| Total AFS RMBS as a percentage of total AFS securities | | | | | | | | | 9.0 % | 9.8 % |
| | | | | | | | | | | |
| Total prime/non-agency, Alt-A and subprime as a percentage of total AFS securities | | | | | | | | | 2.3 % | 2.9 % |

(1) Does not include the fair value of trading securities totaling $228 million, which support our Modco reinsurance agreements because investment results for these agreements are passed directly to the reinsurers. The $228 million in trading securities consisted of $204 million prime, $10 million Alt-A and $14 million subprime.

(2)

Does not include the amortized cost of trading securities totaling $213 million, which support our Modco reinsurance agreements because investment results for these agreements are passed directly to the reinsurers. The $213 million in trading securities consisted of $186 million prime, $11 million Alt-A and $15 million subprime.

(3) Based upon the rating designations determined and provided by the major credit rating agencies (Fitch, Moody's and S&P). For securities where the ratings assigned by the major credit agencies are not equivalent, the second highest rating assigned is used. For those securities where ratings by the major credit rating agencies are not available, which does not represent a significant amount of our total fixed maturity AFS securities, we base the ratings disclosed upon internal ratings.

None of these investments included any direct investments in subprime lenders or mortgages. We are not aware of material exposure to subprime loans in our alternative asset portfolio.

The following summarizes our investments in AFS securities backed by pools of commercial mortgages (in millions) as of September 30, 2012:

| | Multiple Property | | Single Property | | CRE CDOs | | Total | |
|---|---|---|---|---|---|---|---|---|
| | Fair Value | Amortized Cost | Fair Value | Amortized Cost | Fair Value | Amortized Cost | Fair Value | Amortized Cost |
| Type | | | | | | | | |
| CMBS | $ 1,082 | $ 1,039 | $ 44 | $ 65 | $ - | $ - | $ 1,126 | $ 1,104 |
| CRE CDOs | - | - | - | - | 18 | 28 | 18 | 28 |
| Total by type (1)(2) | $ 1,082 | $ 1,039 | $ 44 | $ 65 | $ 18 | $ 28 | $ 1,144 | $ 1,132 |
| Rating | | | | | | | | |
| AAA | $ 661 | $ 604 | $ 13 | $ 13 | $ - | $ - | $ 674 | $ 617 |
| AA | 109 | 106 | 10 | 10 | - | - | 119 | 116 |
| A | 137 | 130 | 6 | 6 | - | - | 143 | 136 |
| BBB | 92 | 92 | 6 | 6 | 6 | 7 | 104 | 105 |
| BB and below | 83 | 107 | 9 | 30 | 12 | 21 | 104 | 158 |
| Total by rating (1)(2)(3) | $ 1,082 | $ 1,039 | $ 44 | $ 65 | $ 18 | $ 28 | $ 1,144 | $ 1,132 |
| Origination Year | | | | | | | | |
| 2004 and prior | $ 444 | $ 436 | $ 22 | $ 22 | $ 2 | $ 3 | $ 468 | $ 461 |
| 2005 | 309 | 289 | 21 | 42 | 6 | 7 | 336 | 338 |
| 2006 | 138 | 133 | 1 | 1 | 10 | 18 | 149 | 152 |
| 2007 | 131 | 127 | - | - | - | - | 131 | 127 |
| 2008 | | | | | | | - | - |
| 2009 | | | | | | | - | - |
| 2010 | 60 | 54 | - | - | - | - | 60 | 54 |
| Total by origination year (1)(2) | $ 1,082 | $ 1,039 | $ 44 | $ 65 | $ 18 | $ 28 | $ 1,144 | $ 1,132 |
| Total AFS securities backed by pools of commercial mortgages as a percentage of total AFS securities | | | | | | | 1.4 % | 1.6 % |

(1) Does not include the fair value of trading securities totaling $22 million, which support our Modco reinsurance agreements because investment results for these agreements are passed directly to the reinsurers. The $22 million in trading securities consisted of $19 million CMBS and $3 million CRE CDOs.
(2) Does not include the amortized cost of trading securities totaling $23 million, which support our Modco reinsurance agreements because investment results for these agreements are passed directly to the reinsurers. The $23 million in trading securities consisted of $20 million CMBS and $3 million CRE CDOs.
(3) Based upon the rating designations determined and provided by the major credit rating agencies (Fitch, Moody's and S&P). For securities where the ratings assigned by the major credit agencies are not equivalent, the second highest rating assigned is used. For those securities where ratings by the major credit rating agencies are not available, which does not represent a significant amount of our total fixed maturity AFS securities, we base the ratings disclosed upon internal ratings.

As of September 30, 2012, the amortized cost and fair value of our AFS exposure to Monoline insurers was $550 million and $521 million, respectively.

Composition by Industry Categories of our Unrealized Losses on AFS Securities

When considering unrealized gain and loss information, it is important to recognize 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, because 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 effect of unrealized loss securities on our future earnings.

The composition by industry categories of all securities in unrealized loss status (in millions) as of September 30, 2012, was as follows:

| | Fair Value | % Fair Value | Amortized Cost | % Amortized Cost | Gross Unrealized Losses and OTTI | % Gross Unrealized Losses and OTTI |
|---|---|---|---|---|---|---|
| ABS | $ 643 | 16.8% | $ 851 | 19.0% | $ 208 | 33.2% |
| Banking | 499 | 13.0% | 643 | 14.4% | 144 | 23.0% |
| CMOs | 466 | 12.1% | 536 | 12.0% | 71 | 11.3% |
| CMBS | 203 | 5.3% | 256 | 5.7% | 53 | 8.5% |
| Media - non-cable | 117 | 3.0% | 140 | 3.1% | 23 | 3.7% |
| Property and casualty insurers | 51 | 1.3% | 71 | 1.6% | 20 | 3.2% |
| Retailers | 81 | 2.1% | 98 | 2.2% | 17 | 2.7% |
| Diversified manufacturing | 124 | 3.2% | 139 | 3.1% | 15 | 2.4% |
| Paper | 97 | 2.5% | 108 | 2.4% | 11 | 1.8% |
| Industries with unrealized losses less than $10 million | 1,565 | 40.7% | 1,630 | 36.5% | 64 | 10.2% |
| Total by industry | $ 3,846 | 100.0% | $ 4,472 | 100.0% | $ 626 | 100.0% |
| | | | | | | |
| Total by industry as a percentage of total AFS securities | 4.7 % | | 6.2 % | | 100.0 % | |

As of September 30, 2012, the amortized cost and fair value of securities subject to enhanced analysis and monitoring for potential changes in unrealized loss status was $666 million and $442 million, respectively.

Mortgage Loans on Real Estate

The following tables summarize key information on mortgage loans on real estate (in millions):

| | As of September 30, 2012 | | As of December 31, 2011 | |
|---|---|---|---|---|
| | Carrying Value | % | Carrying Value | % |
| Credit Quality Indicator | | | | |
| Current | $ 6,646 | 99.3 % | $ 6,854 | 98.7 % |
| Delinquent and in foreclosure (1) | 44 | 0.7 % | 88 | 1.3 % |
| Total mortgage loans on real estate | $ 6,690 | 100.0% | $ 6,942 | 100.0% |

(1) As of September 30, 2012, and December 31, 2011, there were 10 and 16 mortgage loans on real estate, respectively, that were delinquent and in foreclosure.

| | As of September 30, 2012 | As of December 31, 2011 |
|---|---|---|

| | | |
|---|---|---|
| By Segment | | |
| Annuities | $ 1,298 | $ 1,341 |
| Retirement Plan Services | 1,095 | 1,080 |
| Life Insurance | 3,601 | 3,731 |
| Group Protection | 267 | 278 |
| Other Operations | 429 | 512 |
| Total mortgage loans on real estate | $ 6,690 | $ 6,942 |

| | As of September 30, 2012 |
|---|---|
| Allowance for Losses | |
| Balance as of beginning-of-year | $ 31 |
| Additions | 10 |
| Charge-offs, net of recoveries | (12) |
| Recoveries | (8) |
| Balance as of end-of-period | $ 21 |

| | As of September 30, 2012 Carrying Value | % |
|---|---|---|
| Property Type | | |
| Office building | $ 2,066 | 31.0% |
| Industrial | 1,705 | 25.5% |
| Retail | 1,541 | 23.0% |
| Apartment | 1,017 | 15.2% |
| Mixed use | 149 | 2.2% |
| Hotel/Motel | 110 | 1.6% |
| Other commercial | 102 | 1.5% |
| Total | $ 6,690 | 100.0% |
| | | |
| Geographic Region | | |
| Pacific | $ 1,813 | 27.1% |
| South Atlantic | 1,674 | 25.1% |
| West South Central | 656 | 9.8% |
| East North Central | 648 | 9.7% |
| Mountain | 535 | 8.0% |
| Middle Atlantic | 458 | 6.8% |
| East South Central | 436 | 6.5% |
| West North Central | 333 | 5.0% |
| New England | 137 | 2.0% |
| Total | $ 6,690 | 100.0% |

| | As of September 30, 2012 Carrying Value | % |
|---|---|---|
| State Exposure | | |
| CA | $ 1,464 | 22.0% |
| TX | 637 | 9.5% |
| MD | 462 | 6.9% |
| VA | 341 | 5.1% |
| TN | 273 | 4.1% |
| NC | 272 | 4.1% |
| FL | 254 | 3.8% |
| WA | 228 | 3.4% |
| AZ | 220 | 3.3% |
| GA | 214 | 3.2% |
| NY | 210 | 3.1% |
| IN | 204 | 3.0% |
| IL | 177 | 2.6% |
| NV | 171 | 2.6% |
| OH | 168 | 2.5% |
| PA | 155 | 2.3% |
| MN | 141 | 2.1% |
| Other states under 2% | 1,099 | 16.4% |
| Total | $ 6,690 | 100.0% |

| | As of September 30, 2012 Principal Amount | % |
|---|---|---|
| Origination Year | | |
| 2004 and prior | $ 2,120 | 31.6% |
| 2005 | 707 | 10.6% |
| 2006 | 622 | 9.3% |
| 2007 | 846 | 12.6% |
| 2008 | 780 | 11.6% |
| 2009 | 146 | 2.2% |

| | As of September 30, 2012 Principal Amount | % |
|---|---|---|
| Future Principal Payments | | |
| 2012 | $ 65 | 1.0% |
| 2013 | 351 | 5.2% |
| 2014 | 381 | 5.7% |
| 2015 | 558 | 8.3% |
| 2016 | 503 | 7.5% |
| 2017 and thereafter | 4,843 | 72.3% |

| | | | | | |
|---|---|---|---|---|---|
| 2010 | 274 | 4.1% | Total | $ 6,701 | 100.0% |
| 2011 | 896 | 13.4% | | | |
| 2012 | 310 | 4.6% | | | |
| Total | $ 6,701 | 100.0% | | | |

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The global financial markets and credit market conditions experienced a period of extreme volatility and disruption that began in the second half of 2007 and continued and substantially increased throughout 2008 that led to a decrease in the overall liquidity and availability of capital in the mortgage loan market, and in particular a decrease in activity by securitization lenders. These conditions and the overall economic downturn put pressure on the fundamentals of mortgage loans through rising vacancies, falling rents and falling property values.

See Note 5 for information regarding our loan-to-value and debt-service coverage ratios.

There were 9 and 12 impaired mortgage loans on real estate, or less than 1% of the total dollar amount of mortgage loans on real estate as of September 30, 2012 and December 31, 2011. The carrying value on the mortgage loans on real estate that were two or more payments delinquent as of September 30, 2012, was $44 million, or less than 1% of total mortgage loans on real estate. The total principal and interest past due on the mortgage loans on real estate that were two or more payments delinquent as of September 30, 2012, was $25 million. The carrying value on the mortgage loans on real estate that were two or more payments delinquent as of December 31, 2011, was $76 million, or 1% of total mortgage loans on real estate. The total principal and interest past due on the mortgage loans on real estate that were two or more payments delinquent as of December 31, 2011, was $41 million. See Note 1 in our 2011 Form 10-K for more information regarding our accounting policy relating to the impairment of mortgage loans on real estate.

Alternative Investments

Investment income (loss) on alternative investments by business segment (in millions) was as follows:

| | For the Three Months Ended September 30, | | | For the Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| | 2012 | 2011 | Change | 2012 | 2011 | Change |
| Annuities | $ 4 | $ 1 | 300 % | $ 23 | $ 11 | 109 % |
| Retirement Plan Services | 2 | 1 | 100 % | 11 | 6 | 83 % |
| Life Insurance | 7 | 15 | -53 % | 52 | 72 | -28 % |
| Group Protection | 1 | - | NM | 7 | 3 | 133 % |
| Other Operations | - | - | NM | 2 | - | NM |
| Total (1) | $ 14 | $ 17 | -18 % | $ 95 | $ 92 | 3 % |

(1) Includes net investment income on the alternative investments supporting the required statutory surplus of our insurance businesses.

As of September 30, 2012, and December 31, 2011, alternative investments included investments in 99 and 96 different partnerships, respectively, and the portfolio represented approximately 1% of our overall invested assets. The partnerships do not represent off-balance sheet financing and generally involve several third-party partners. Some of our 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 are not material to our liquidity. Alternative investments are accounted for using the equity method of accounting and are included in other investments on our Consolidated Balance Sheets.

As discussed in “Critical Accounting Policies and Estimates – Investments – Valuation of Alternative Investments” in our 2011 Form 10-K, we update the carrying value of our alternative investment portfolio whenever audited financial statements of the investees for the preceding year become available. Net investment income (loss) derived from our consolidated alternative investments by segment (in millions) related to the effect of preceding year audit adjustments recorded during the indicated year at the investee was as follows:

| | For the Three Months Ended September 30, | | | For the Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| | 2012 | 2011 | Change | 2012 | 2011 | Change |
| Annuities | $ - | $ - | NM | $ 5 | $ 4 | 25 % |
| Retirement Plan Services | - | - | NM | 2 | 2 | 0 % |
| Life Insurance | - | (1 ) | 100 % | 23 | 29 | -21 % |
| Group Protection | - | - | NM | 2 | 2 | 0 % |
| Total | $ - | $ (1 ) | 100 % | $ 32 | $ 37 | -14 % |

Non-Income Producing Investments

As of September 30, 2012, and December 31, 2011, the carrying amount of fixed maturity securities, mortgage loans on real estate and real estate that were non-income producing was $11 million and $14 million, respectively.

Net Investment Income

Details underlying net investment income (in millions) and our investment yield were as follows:

| | For the Three Months Ended September 30, | | | For the Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| | 2012 | 2011 | Change | 2012 | 2011 | Change |
| Net Investment Income | | | | | | |
| Fixed maturity AFS securities | $ 981 | $ 964 | 2 % | $ 2,929 | $ 2,878 | 2 % |
| Equity AFS securities | 2 | 1 | 100 % | 4 | 4 | 0 % |
| Trading securities | 36 | 38 | -5 % | 111 | 116 | -4 % |
| Mortgage loans on real estate | 97 | 102 | -5 % | 299 | 306 | -2 % |
| Real estate | 4 | 5 | -20 % | 13 | 17 | -24 % |
| Standby real estate equity commitments | - | - | NM | - | 1 | -100% |
| Policy loans | 37 | 42 | -12 % | 124 | 125 | -1 % |
| Invested cash | 1 | 1 | 0 % | 3 | 3 | 0 % |
| Commercial mortgage loan prepayment and bond makewhole premiums (1) | 5 | 14 | -64 % | 22 | 73 | -70 % |
| Alternative investments (2) | 14 | 17 | -18 % | 95 | 92 | 3 % |
| Consent fees | 1 | - | NM | 3 | 2 | 50 % |
| Other investments | (5 ) | (3 ) | -67 % | (15 ) | (9 ) | -67 % |
| Investment income | 1,173 | 1,181 | -1 % | 3,588 | 3,608 | -1 % |
| Investment expense | (27 ) | (30 ) | 10 % | (79 ) | (86 ) | 8 % |
| Net investment income | $ 1,146 | $ 1,151 | 0 % | $ 3,509 | $ 3,522 | 0 % |

(1) See “Commercial Mortgage Loan Prepayment and Bond Makewhole Premiums” below for additional information.
(2) See “Alternative Investments” above for additional information.

| | For the Three Months Ended September 30, | | Basis Point | For the Nine Months Ended September 30, | | Basis Point |
|---|---|---|---|---|---|---|
| | 2012 | 2011 | Change | 2012 | 2011 | Change |
| Interest Rate Yield | | | | | | |
| Fixed maturity securities, mortgage loans on real estate and other, net of investment expenses | 5.25 % | 5.45 % | (20 ) | 5.33 % | 5.52 % | (19 ) |
| Commercial mortgage loan prepayment and bond makewhole premiums | 0.02 % | 0.07 % | (5 ) | 0.03 % | 0.12 % | (9 ) |
| Alternative investments | 0.07 % | 0.08 % | (1 ) | 0.15 % | 0.15 % | - |
| Consent fees | 0.00 % | 0.00 % | - | 0.00 % | 0.00 % | - |
| Net investment income yield on invested assets | 5.34 % | 5.60 % | (26 ) | 5.51 % | 5.79 % | (28 ) |

| | For the Three Months Ended September 30, | | | For the Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| | 2012 | 2011 | Change | 2012 | 2011 | Change |
| Average invested assets at amortized cost | $ 85,802 | $ 82,254 | 4 % | $ 84,881 | $ 81,117 | 5 % |

We earn investment income on our general account assets supporting fixed annuity, term life, whole life, UL, interest-sensitive whole life and fixed portion of retirement plan and VUL products. The profitability of our fixed annuity and life insurance products is affected by our ability to achieve target spreads, or margins, between the interest income earned on the general account assets and the interest credited to the contract holder on our average fixed account values, including the fixed portion of variable. Net investment income and the interest rate yield table each include commercial mortgage loan prepayments and bond makewhole premiums, alternative investments and contingent interest and standby real estate equity commitments. These items can vary significantly from period to period due to a number of factors and, therefore, can provide results that are not indicative of the underlying trends.

Commercial Mortgage Loan Prepayment and Bond Makewhole Premiums

Prepayment and makewhole premiums are collected when borrowers elect to call or prepay their debt prior to the stated maturity. A prepayment or makewhole premium allows investors to attain the same yield as if the borrower made all scheduled interest payments until maturity. These premiums are designed to make investors indifferent to prepayment.

The decrease in prepayment and makewhole premiums when comparing 2012 to 2011 was attributable primarily to abnormally high prepayments and makewhole premiums during 2011 due to a rapid decline in interest rates leading to increased refinancing activity.

Realized Gain (Loss) Related to Certain Investments

The detail of the realized gain (loss) related to certain investments (in millions) was as follows:

| | For the Three Months Ended September 30, | | | For the Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| | 2012 | 2011 | Change | 2012 | 2011 | Change |
| Fixed maturity AFS securities: | | | | | | |
| Gross gains | $ 4 | $ 17 | -76 % | $ 12 | $ 84 | -86 % |
| Gross losses | (49 ) | (63 ) | 22 % | (161) | (177) | 9 % |
| Equity AFS securities: | | | | | | |
| Gross gains | - | - | NM | 1 | 10 | -90 % |
| Gain (loss) on other investments | (10 ) | (3 ) | NM | (8 ) | 1 | NM |
| Associated amortization of DAC, VOBA, DSI, and DFEL and changes in other contract holder funds | 1 | 4 | -75 % | 3 | (10 ) | 130 % |
| Total realized gain (loss) related to certain investments, pre-tax | $ (54 ) | $ (45 ) | -20 % | $ (153) | $ (92 ) | -66 % |

Amortization of DAC, VOBA, DSI and DFEL and changes in other contract holder funds reflect an assumption for an expected level of credit-related investment losses. When actual credit-related investment losses are realized, we recognize a true-up to our DAC, VOBA, DSI and DFEL amortization and changes in other contract holder funds within realized loss reflecting the incremental effect of actual versus expected credit-related investment losses. These actual to expected amortization adjustments could create volatility in net realized gains and losses. The write-down for impairments includes both credit-related and interest-rate related impairments.

Realized gains and losses generally originate from asset sales to reposition the portfolio or to respond to product experience. During the first nine months of 2012 and 2011, we sold securities for gains and losses. In the process of evaluating whether a security with an unrealized loss reflects declines that are other-than-temporary, we consider our ability and intent to sell the security prior to a recovery of value. However, subsequent decisions on securities sales are made within the context of overall risk monitoring, assessing value relative to other comparable securities and overall portfolio maintenance. Although our portfolio managers may, at a given point in time, believe that the preferred course of action is to hold securities with unrealized losses that are considered temporary until such losses are recovered, the dynamic nature of portfolio management may result in a subsequent decision to sell. These subsequent decisions are consistent with the classification of our investment portfolio as AFS. We expect to continue to manage all non-trading invested assets within our portfolios in a manner that is consistent with the AFS classification.

We consider economic factors and circumstances within countries and industries where recent write-downs have occurred in our assessment of the status of securities we own of similarly situated issuers. While it is possible for realized or unrealized losses on a particular investment to affect other investments, our risk management has been designed to identify correlation risks and other risks inherent in managing an investment portfolio. Once identified, strategies and procedures are developed to effectively monitor and manage these risks. The areas of risk correlation that we pay particular attention to are risks that may be correlated within specific financial and business markets, risks within specific industries and risks associated with related parties.

When the detailed analysis by our credit analysts and investment portfolio managers leads us to the conclusion that a security’s decline in fair value is other-than-temporary, the security is written down to estimated recovery value. In instances where declines are considered temporary, the security will continue to be carefully monitored. See “Critical

Accounting Policies and Estimates” in our 2011 Form 10-K for additional information on our portfolio management strategy.

Details underlying write-downs taken as a result of OTTI (in millions) were as follows:

| | For the Three Months Ended September 30, 2012 | 2011 | Change | For the Nine Months Ended September 30, 2012 | 2011 | Change |
|---|---|---|---|---|---|---|
| OTTI Recognized in Net Income (Loss) | | | | | | |
| Corporate bonds | $ (5 ) | $ (3 ) | -67 % | $ (34 ) | $ (9 ) | NM |
| RMBS | (16 ) | (22 ) | 27 % | (48 ) | (65 ) | 26 % |
| CMBS | (14 ) | (8 ) | -75 % | (50 ) | (47 ) | -6 % |
| CDOs | (2 ) | - | NM | (2 ) | (1 ) | -100 % |
| Hybrid and redeemable preferred securities | - | - | NM | - | (2 ) | 100 % |
| Gross OTTI recognized in net income (loss) | (37 ) | (33 ) | -12 % | (134) | (124) | -8 % |
| Associated amortization of DAC, VOBA, DSI and DFEL | 5 | 7 | -29 % | 22 | 26 | -15 % |
| Net OTTI recognized in net income (loss), pre-tax | $ (32 ) | $ (26 ) | -23 % | $ (112) | $ (98 ) | -14 % |
| | | | | | | |
| Portion of OTTI Recognized in Other Comprehensive Income ("OCI") | | | | | | |
| Gross OTTI recognized in OCI | $ (17 ) | $ (21 ) | 19 % | $ (96 ) | $ (48 ) | -100 % |
| Change in DAC, VOBA, DSI and DFEL | 2 | 3 | -33 % | 14 | 11 | 27 % |
| Net portion of OTTI recognized in OCI, pre-tax | $ (15 ) | $ (18 ) | 17 % | $ (82 ) | $ (37 ) | NM |

The increase in write-downs for OTTI when comparing 2012 to 2011 was primarily due to structured interest only corporate bonds with floating rate coupons where the projected cash flows were less than expected based on current and expected future Libor rates. The $230 million of impairments taken during 2012 were split between $134 million of credit-related impairments and $96 million of noncredit-related impairments. The credit-related impairments were largely attributable to our RMBS and CMBS holdings primarily as a result of continued weakness within the commercial and residential real estate market that affected select RMBS and CMBS holdings. The noncredit-related impairments were incurred due to declines in values of securities for which we do not have an intent to sell or it is not more likely than not that we will be required to sell the securities before recovery.

## REVIEW OF CONSOLIDATED FINANCIAL CONDITION

### Liquidity and Capital Resources

Sources of Liquidity and Cash Flow

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 and investment income, while sources of cash flows from investing activities result from maturities and sales of invested assets. Our operating activities provided cash of $666 million and $934 million for the first nine months of 2012 and 2011, 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 sources of liquidity 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 and the ongoing availability of long-term public financing under an SEC-filed shelf registration statement. These sources of liquidity and cash flow support the general corporate needs of the holding company, including its common and preferred stock dividends, interest and debt service, funding of callable securities, securities repurchases, acquisitions and investment in core businesses. Our cash flows associated with collateral received from and posted with counterparties change as the market value of the underlying derivative contract changes. As the value of a derivative asset declines (or increases), the collateral required to be posted by our counterparties would also decline (or increase).

Likewise, when the value of a derivative liability declines (or increases), the collateral we are required to post for our counterparties' benefit would also decline (or increase). During the first nine months of 2012, our payables for collateral on derivative investments decreased by $27 million as steadily rising equity markets and less volatility lowered the fair values of the associated derivative investments. For additional information, see "Credit Risk" in Note 6.

Details underlying the primary sources of our holding company cash flows (in millions) were as follows:

| | For the Three Months Ended September 30, | | | For the Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| | 2012 | 2011 | Change | 2012 | 2011 | Change |
| Dividends from Subsidiaries | | | | | | |
| The Lincoln National Life Insurance Company | $ 200 | $ 250 | -20 % | $ 550 | $ 550 | 0 % |
| Other | - | 7 | -100 % | - | 19 | -100 % |
| Loan Repayments and Interest from Subsidiaries | | | | | | |
| Interest on inter-company notes | 33 | 32 | 3 % | 97 | 95 | 2 % |
| | $ 233 | $ 289 | -19 % | $ 647 | $ 664 | -3 % |
| Other Cash Flow and Liquidity Items | | | | | | |
| Increase (decrease) in commercial paper, net | $ - | $ - | NM | $ - | $ (100) | 100 % |
| Net capital received from (paid for taxes on) stock option exercises and restricted stock | - | - | NM | (3) | (1) | NM |
| | $ - | $ - | NM | $ (3) | $ (101) | 97 % |

The table above 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 inter-company cash management program (discussed below). Taxes have been eliminated from the analysis due to a tax sharing agreement among our primary subsidiaries resulting in a modest effect 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.

Subsidiaries' Statutory Reserving and Surplus

For discussion of our strategies to lessen the burden of increased AG38 and XXX statutory reserves associated with certain UL products and other products with secondary guarantees on our insurance subsidiaries, see "Results of Life Insurance – Income (Loss) from Operations – Strategies to Address Statutory Reserve Strain."

Financing Activities

Although our subsidiaries currently generate adequate cash flow to meet the needs of our normal operations, periodically we may issue debt or equity securities to maintain ratings and increase liquidity, as well as to fund internal growth, acquisitions and the retirement of our debt and equity securities.

We currently have an effective shelf registration statement, which allows us to issue, in unlimited amounts, securities, including debt securities, preferred stock, common stock, warrants, stock purchase contracts, stock purchase units, depository shares and trust preferred securities of our affiliated trusts.

Details underlying debt and financing activities (in millions) were as follows:

| | For the Nine Months Ended September 30, 2012 | | | | | |
|---|---|---|---|---|---|---|
| | Beginning Balance | Issuance | Maturities and Repayments | Change in Fair Value Hedges | Other Changes (1) | Ending Balance |
| Short-Term Debt | | | | | | |
| Current maturities of long-term debt (2) | $ 300 | $ - | $ (300 ) | $ - | $ 200 | $ 200 |
| Total short-term debt | $ 300 | $ - | $ (300 ) | $ - | $ 200 | $ 200 |
| Long-Term Debt | | | | | | |
| Senior notes | $ 3,730 | $ 300 | $ - | $ (12 ) | $ (185 ) | $ 3,833 |
| Bank borrowing | 200 | - | - | - | - | 200 |
| Federal Home Loan Bank of Indianapolis ("FHLBI") advance | 250 | - | - | - | - | 250 |
| Capital securities | 1,211 | - | - | - | - | 1,211 |
| Total long-term debt | $ 5,391 | $ 300 | $ - | $ (12 ) | $ (185 ) | $ 5,494 |

(1) Includes the net increase (decrease) in commercial paper, non-cash reclassification of long-term debt to current maturities of long-term debt, accretion of discounts and (amortization) of premiums, as applicable.
(2) Consists of a $200 million floating rate senior note maturing on July 18, 2013.

On March 29, 2012, we completed the issuance and sale of $300 million aggregate principal amount of our 4.20% senior notes due 2022. We repaid a $300 million 5.65% fixed rate senior note that matured on August 27, 2012, with these proceeds. In addition to the maturing note discussed above, within the next two years, we have a $300 million 4.75% senior note maturing on January 30, 2014; and a $200 million 4.75% senior note maturing on February 14, 2014. The specific resources or combination of resources that we will use to meet these maturities will depend upon, among other things, the financial market conditions present at the time of maturity. As of September 30, 2012, the holding company had approximately $700 million in cash and cash equivalents and $25 million invested in fixed maturity corporate bonds; however, as discussed below, it had a $51 million payable under the inter-company cash management program.

For information about our short-term and long-term debt and our credit facilities and LOCs, see Note 12 in our 2011 Form 10-K.

We have not accounted for repurchase agreements, securities lending transactions, or other transactions involving the transfer of financial assets with an obligation to repurchase the transferred assets as sales and do not have any other transactions involving the transfer of financial assets with an obligation to repurchase the transferred assets. For information about our collateralized financing transactions on our investments, see “Payables for Collateral on Investments” in Note 5.

If current credit ratings and claims-paying ratings were downgraded in the future, terms in our derivative agreements may be triggered, which could negatively affect overall liquidity. For the majority of our counterparties, there is a termination event should the long-term senior debt ratings of LNC drop below BBB-/Baa3 (S&P/Moody’s). Our long-term senior debt held a rating of A-/Baa2 (S&P/Moody’s) as of September 30, 2012. In addition, contractual selling agreements with intermediaries could be negatively affected, which could have an adverse effect on overall sales of annuities, life insurance and investment products. See “Part I – Item 1A. Risk Factors – Liquidity and Capital

Position – A decrease in the capital and surplus of our insurance subsidiaries may result in a downgrade to our credit and insurer financial strength ratings" and "Part I – Item 1A. Risk Factors – Covenants and Ratings – A downgrade in our financial strength or credit ratings could limit our ability to market products, increase the number or value of policies being surrendered and/or hurt our relationships with creditors" in our 2011 Form 10-K for more information. See "Part I – Item 1. Business – Financial Strength Ratings" in our 2011 Form 10-K for additional information on our current financial strength ratings.

See "Part II – Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – Review of Consolidated Financial Condition – Liquidity and Capital Resources – Financing Activities" in our 2011 Form 10-K for information on our credit ratings.

Alternative Sources of Liquidity

In order to manage our capital more efficiently, we have an inter-company cash management program where certain subsidiaries can lend to or borrow from the holding company to meet short-term borrowing needs. The cash management program is essentially a series of demand loans, which are permitted under applicable insurance laws, among LNC and its affiliates that reduces overall borrowing costs by allowing LNC and its subsidiaries to access internal resources instead of incurring third-party transaction costs. For our Indiana-domiciled insurance subsidiaries, the borrowing and lending limit is currently the lesser of 3% of the insurance company's admitted assets and 25% of its surplus, in both cases, as of its most recent year end. The holding company had a maximum and minimum amount of financing that was used from the cash management program during the third quarter of 2012 of $1 million and $0, respectively. There was no balance as of September 30, 2012. In addition, it had an outstanding payable of $51 million to certain subsidiaries resulting from amounts placed by the subsidiaries in the inter-company cash management account in excess of funds borrowed by those subsidiaries as of September 30, 2012. Any increase (decrease) in either of these holding company cash management program payable balances results in an immediate and equal increase (decrease) to holding company cash and cash equivalents.

Our insurance subsidiaries, by virtue of their investment holdings, can access liquidity through investments pledged programs and repurchase agreements. As of September 30, 2012, our insurance subsidiaries had investments with a carrying value of $1.6 billion out on loan or subject to reverse-repurchase agreements. The cash received in our investments pledged programs and repurchase agreements is typically invested in cash equivalents, short-term investments or fixed maturity securities. For additional details, see "Payables for Collateral on Investments" in Note 5.

For factors that could cause actual results to differ materially from those set forth in this section, see "Forward-Looking Statements – Cautionary Language" above and "Part I – Item 1A. Risk Factors" in our 2011 Form 10-K, as updated in "Part II – Item 1A. Risk Factors" below.

Divestitures

For a discussion of our divestitures, see Note 3 herein and Note 3 in our 2011 Form 10-K.

Uses of Capital

Our principal uses of cash are to pay policy claims and benefits, operating expenses, commissions and taxes, to purchase new investments, to purchase reinsurance, to fund policy surrenders and withdrawals, to pay dividends to our stockholders and to repurchase our stock and debt securities.

Return of Capital to Common Stockholders

One of the Company's primary goals is to provide a return to our common stockholders through share price accretion, dividends and stock repurchases. In determining dividends, the Board takes into consideration items such as current and expected earnings, capital needs, rating agency considerations and requirements for financial flexibility. 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. Free cash flow for the holding company generally represents the amount of dividends and interest received from subsidiaries less interest paid on debt.

Details underlying this activity (in millions, except per share data), were as follows:

| | For the Three Months Ended September 30, | | | For the Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| | 2012 | 2011 | Change | 2012 | 2011 | Change |
| Common dividends to stockholders | $ 22 | $ 15 | 47 % | $ 67 | $ 48 | 40 % |

| | | | | | | |
|---|---|---|---|---|---|---|
| Repurchase of common stock | 100 | 150 | -33 % | 400 | 375 | 7 % |
| Total cash returned to stockholders | $ 122 | $ 165 | -26 % | $ 467 | $ 423 | 10 % |
| | | | | | | |
| Number of shares repurchased | 4.157 | 6.713 | -38 % | 16.649 | 14.276 | 17 % |
| Average price per share | $ 24.07 | $ 22.36 | 8 % | $ 24.05 | $ 26.29 | -9 % |

On November 10, 2011, our Board of Directors approved an increase of the quarterly dividend on our common stock from $0.05 to $0.08 per share. Additionally, we expect to repurchase additional shares of common stock during the remainder of 2012 depending on market conditions and alternative uses of capital. For more information regarding share repurchases, see "Part II – Item 2(c)" below.

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Other Uses of Capital

In addition to the amounts in the table above in "Return of Capital to Common Stockholders," other uses of holding company cash flow (in millions) were as follows:

| | For the Three Months Ended September 30, | | | For the Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| | 2012 | 2011 | Change | 2012 | 2011 | Change |
| Debt service (interest paid) | $ 64 | $ 62 | 3 % | $ 195 | $ 204 | -4 % |
| Capital contribution to subsidiaries | - | - | NM | - | 16 | -100% |
| Total | $ 64 | $ 62 | 3 % | $ 195 | $ 220 | -11 % |

The above 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 inter-company cash management account. Taxes have been eliminated from the analysis due to a tax sharing agreement among our primary subsidiaries resulting in a modest effect on net cash flows at the holding company.

Significant Trends in Sources and Uses of Cash Flow

As stated above, LNC's cash flow, as a holding company, is largely dependent upon the dividend capacity of its insurance company subsidiaries as well as their ability to advance funds to it through inter-company borrowing arrangements, which may be affected by factors influencing the insurance subsidiaries' RBC and statutory earnings performance. We currently expect to be able to meet the holding company's ongoing cash needs and to have sufficient capital to offer downside protection in the event that the capital and credit markets experience another period of extreme volatility and disruption. A decline in capital market conditions, which reduces our insurance subsidiaries' statutory surplus and RBC, may require them to retain more capital and may pressure our subsidiaries' dividends to the holding company, which may lead us to take steps to preserve or raise additional capital. For factors that could affect our expectations for liquidity and capital, see "Part I – Item 1A. Risk Factors" in our 2011 Form 10-K, as updated in "Part II – Item 1A. Risk Factors" below.

## 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. 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. For factors that could cause actual results to differ materially from those set forth in this section, see "Part I – Item 1A. Risk Factors" in our 2011 Form 10-K, as updated in "Part II – Item 1A. Risk Factors" below, and "Forward-Looking Statements – Cautionary Language" above.

Recent Accounting Pronouncements

See Note 2 for a discussion of recent accounting pronouncements that have been implemented during the periods presented or that have been issued and are to be implemented in the future.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We analyze and manage the risks arising from market exposures of financial instruments, as well as other risks, in an integrated asset-liability management process that takes diversification into account. By aggregating the potential effect of market and other risks on the entire enterprise, we estimate, review and in some cases manage the risk to our earnings and shareholder value. We have exposures to several market risks including interest rate risk, equity market risk, default risk, basis risk, credit risk and, to a lesser extent, foreign currency exchange risk. The exposures of financial instruments to market risks, and the related risk management processes, are most important to our business where most of the invested assets support accumulation and investment-oriented insurance products. As an important element of our integrated asset-liability management processes, we use derivatives to minimize the effects of changes in interest levels, the shape of the yield curve, currency movements and volatility. In this context, derivatives are designated as a hedge and serve to minimize interest rate risk by mitigating the effect of significant increases in interest rates on our earnings. Additional market exposures exist in our other general account insurance products and in our debt structure and derivatives positions. Our primary sources of market risk are: substantial, relatively rapid and sustained increases or decreases in interest rates or a sharp drop in equity market values. These market risks are discussed in detail in the following pages and should be read in conjunction with our consolidated financial statements and the accompanying notes to the consolidated financial statements ("Notes") presented in "Item 1. Financial Statements," as well as "Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A")."

Interest Rate Risk

Interest Rate Risk on Fixed Insurance Businesses – Falling Rates

In periods of declining interest rates, we have to reinvest the cash we receive as interest or return of principal on our investments in lower yielding instruments. Moreover, borrowers may prepay fixed income securities, commercial mortgages and mortgage-backed securities in our general accounts in order to borrow at lower market rates, which exacerbates this risk. Because we are entitled to reset the interest rates on our fixed rate annuities only at limited, pre-established intervals, and because many of our contracts have guaranteed minimum interest or crediting rates, our spreads could decrease and potentially become negative.

Prolonged historically low rates are not healthy for our business fundamentals. However, we have recognized this threat and have been proactive in our investment strategies, product designs, crediting rate strategies and overall asset-liability practices to mitigate the risk of unfavorable consequences in this type of environment. For some time now, new products have been sold with low minimum crediting floors, and we apply disciplined asset-liability management standards, such as locking in spreads on these products at the time of issue.

If we were to assume a hypothetical stress scenario where the 10-year U.S. Treasury rate remains static at approximately 150 basis points through the end of 2014 as compared to a hypothetical scenario where our current portfolio yields remain flat, we estimate the difference between these hypothetical scenarios would result in an approximate unfavorable earnings effect of $75 million in 2013 and $140 million in 2014. The earnings drag from this hypothetical stress scenario related to the effect of continued low new money rates is largely concentrated in our Life Insurance and Retirement Plan Services segments.

The estimates above are based upon hypothetical scenarios and are only representative of the effects of assumptions around rates through 2014 keeping all else equal and does not give consideration to the aggregate effect of other factors, including but not limited to: contract holder activity; sales; hedge positions; changing equity markets; shifts in implied volatilities; and changes in other capital market sectors as well as actions we might take to mitigate the effect of the low rate environment. In addition, the scenarios only illustrated the effect to spreads and certain unlocking and reserve changes. Other potential effects of the scenarios were not considered in the analysis. See "Part I – Item 1A. Risk Factors – Market Conditions – Changes in interest rates and sustained low interest rates may cause interest rate spreads to decrease and changes in interest rates may also result in increased contract withdrawals" in our 2011 Form 10-K for additional information on interest rates.

The following provides detail on the percentage differences between the September 30, 2012, interest rates being credited to contract holders based on the second quarter of 2012 declared rates and the respective minimum guaranteed policy rate (in millions), broken out by contract holder account values reported within our segments:

| | Account Values | | | | |
|---|---|---|---|---|---|
| | Annuities | Retirement Plan Services | Life Insurance (1) | Total | % Account Values |
| Excess of Crediting Rates over Contract Minimums | | | | | |
| Discretionary rate setting products (2)(3) | | | | | |
| No difference | $ 7,967 | $ 9,823 | $ 26,401 | $ 44,191 | 70.4 % |
| Up to 0.10% | 81 | 2 | - | 83 | 0.1 % |
| 0.11% to 0.20% | 57 | - | - | 57 | 0.1 % |
| 0.21% to 0.30% | 91 | 1 | 264 | 356 | 0.6 % |
| 0.31% to 0.40% | 121 | 15 | - | 136 | 0.2 % |
| 0.41% to 0.50% | 91 | 179 | - | 270 | 0.3 % |
| 0.51% to 0.60% | 59 | - | - | 59 | 0.1 % |
| 0.61% to 0.70% | 48 | 69 | - | 117 | 0.2 % |
| 0.71% to 0.80% | 43 | - | - | 43 | 0.1 % |
| 0.81% to 0.90% | 32 | - | - | 32 | 0.1 % |
| 0.91% to 1.00% | 22 | 121 | - | 143 | 0.2 % |
| 1.01% to 1.50% | 75 | 30 | - | 105 | 0.2 % |
| 1.51% to 2.00% | 5 | - | 162 | 167 | 0.3 % |
| 2.01% to 2.50% | 3 | 1 | - | 4 | 0.0 % |
| 2.51% to 3.00% | 5 | - | - | 5 | 0.0 % |
| 3.01% and above | - | 1 | - | 1 | 0.0 % |
| Multi-year guarantee and indexed annuity products (4) | 10,829 | - | - | 10,829 | 17.3 % |
| Total discretionary rate setting products | 19,529 | 10,242 | 26,827 | 56,598 | 90.2 % |
| Other contracts (5) | 2,116 | 4,000 | - | 6,116 | 9.8 % |
| Total account values | $ 21,645 | $ 14,242 | $ 26,827 | $ 62,714 | 100.0% |
| | | | | | |
| Percentage of discretionary rate setting product account values at minimum guaranteed rates | 40.8 % | 95.9 % | 98.4 % | 78.1 % | |

(1) Excludes policy loans.

(2) 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.

(3) The average crediting rates for discretionary rate setting products were 58 basis points, 2 basis points and 1 basis point in excess of average minimum guaranteed rates for our Annuities, Retirement Plan Services and Life Insurance segments, respectively.

(4) The average crediting rates were 162 basis points in excess of average minimum guaranteed rates for multi-year guarantee products; 6%, 17% and 77% of our total multi-year guarantee account values are scheduled to reset in 2012, 2013 and 2014 and beyond, respectively. Our indexed renewal business resets either annually or bi-annually. Upon reset, we are able to adjust product features to reflect changes in option prices.

(5) For Annuities, this amount relates primarily to immediate annuity and short-term dollar cost averaging business. For Retirement Plan Services, this amount relates to indexed-based rate setting products in which the average crediting rates were 1 basis point in excess of average minimum guaranteed rates and 93% of account values were already at their minimum guaranteed rates.

The maturity structure and call provisions of the related portfolios are structured to afford protection against erosion of investment portfolio yields during periods of declining interest rates. We devote extensive effort to evaluating the risks associated with falling interest rates by simulating asset and liability cash flows for a wide range of interest rate scenarios. We seek to manage these exposures by maintaining a suitable maturity structure and by limiting our exposure to call risk in each respective investment portfolio.

Derivatives

See Note 6 for information on our derivatives used to hedge our exposure to changes in interest rates.

Equity Market Risk

Our revenues, assets, liabilities and derivatives are exposed to equity market risk. Due to the use of our reversion to the mean ("RTM") process and our hedging strategies, we expect that, in general, short-term fluctuations in the equity markets should not have a significant effect on our quarterly earnings from unlocking of assumptions for deferred acquisition costs, value of business acquired, deferred sales inducements and deferred front-end loads. However, earnings are affected by equity market movements on account values and assets under management and the related fees we earn on those assets. Refer to "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – Introduction – Critical Accounting Policies and Estimates – DAC, VOBA, DSI and DFEL" in our 2011 Form 10-K for further discussion on the effects of equity markets on our RTM.

Effect of Equity Market Sensitivity

The following presents our estimate of the effect on income (loss) from operations (in millions), from the change in asset-based fees and related expenses, if the level of the Standard & Poor's ("S&P") 500 Index® ("S&P 500"), which ended at 1441 as of September 30, 2012, were to decrease to 1153 over six months after September 30, 2012, and remain at that level through the next six months or increase to 1729 over six months after September 30, 2012, and remain at that level through the next six months, excluding any effect related to sales, prospective unlocking, persistency, hedge program performance or customer behavior caused by the equity market change:

| | S&P 500 at 1153 (1) | S&P 500 at 1729 (1) |
|---|---|---|
| Segment | | |
| Annuities | $ (84) | $ 45 |
| Retirement Plan Services | (8) | 8 |

(1) The baseline for these effects assumes a 4% annual equity market growth rate, depending on the block of business, beginning on October 1, 2012. The baseline is then compared to scenarios of the S&P 500 at the 1153 and 1729 levels, which assume the index moves to those levels over six months and remains at those levels through the next six months. The difference between the baseline and the S&P 500 at the 1153 and 1729 level scenarios is presented in the table.

Refer to "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – Introduction – Critical Accounting Policies and Estimates – DAC, VOBA, DSI and DFEL – Reversion to the Mean" in our 2011 Form 10-K for discussion of the effects of equity markets on our RTM.

The effect on earnings summarized above is a hypothetical scenario for the next 12 months. The effect of quarterly equity market changes upon fee revenues and asset-based expenses is generally not fully recognized in the first quarter of the change because fee revenues are earned and related expenses are incurred based upon daily variable account values. The difference between the current period average daily variable account values compared to the end of period variable account values affects fee revenues in subsequent periods. Additionally, the effect on earnings may not necessarily be symmetrical with comparable increases in the equity markets. This discussion concerning the estimated effects of ongoing equity market volatility on the fees we earn from account values and assets under management is intended to be illustrative. Actual effects may vary depending on a variety of factors, many of which are outside of our control, such as changing customer behaviors that might result in changes in the mix of our business between variable and fixed annuity contracts, switching among investment alternatives available within variable products, changes in sales production levels or changes in policy persistency. For purposes of this guidance, the change in account values is assumed to correlate with the change in the relevant index.

Credit-Related Derivatives

We use credit-related derivatives to minimize our exposure to credit-related events and we also sell credit default swaps to offer credit protection to our contract holders and investors. See Note 6 for additional information.

Credit Risk

See Note 6 for information on our credit risk.

In addition to the information provided about our counterparty exposure in Note 6, the fair value of our exposure by rating (in millions) was as follows:

| | As of September 30, 2012 | As of December 31, 2011 |
|---|---|---|
| Rating | | |
| AA | $ 9 | $ 23 |
| A | 41 | 56 |
| BBB | - | 2 |
| Total | $ 50 | $ 81 |

Item 4. Controls and Procedures

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 and forms, and that such information is accumulated and communicated to the Company’s 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 required 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.

Changes in Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that occurred during the quarter ended September 30, 2012, that has materially affected, or is reasonably likely to materially affect, our 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 1. Legal Proceedings

Information regarding reportable legal proceedings is contained in Note 9 to the consolidated financial statements in “Part I – Item 1.”

Item 1A. Risk Factors

The risk factors set forth below update those set forth in Lincoln National Corporation and its majority-owned subsidiaries' ("LNC" or the "Company," which also may be referred to as "we," "our" or "us") Form 10-K for the year ended December 31, 2011. You should carefully consider the risks described in our Form 10-K and those described below, as well as other information contained in the Form 10-K and this Form 10-Q, including our financial statements and the notes thereto, before making an investment decision. The risks and uncertainties described in our Form 10-K and below are not the only ones facing our company. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also impair our business operations. If any of these risks actually occur, our business, financial condition and results of operations could be materially affected. In that case, the value of our securities could decline substantially.

Legislative, Regulatory and Tax

Changes to the calculation of reserves and attempts to mitigate the impact of Regulation XXX and Actuarial Guideline 38 may fail in whole or in part resulting in an adverse effect on our financial condition and results of operations.

The Valuation of Life Insurance Policies Model Regulation ("XXX") requires insurers to establish additional statutory reserves for term life insurance policies with long-term premium guarantees and universal life ("UL") policies with secondary guarantees. In addition, Actuarial Guideline 38 ("AG38"), commonly known as "AXXX," clarifies the application of XXX with respect to certain UL insurance policies with secondary guarantees. Virtually all of our newly issued term and the majority of our newly issued UL insurance products are affected by XXX and AG38. The application of both AG38 and XXX involve numerous interpretations.

On September 12, 2012, the National Association of Insurance Commissioners ("NAIC") adopted revisions to AG38. Effective for year-end 2012, reserves on in-force business written between July 1, 2005, and December 31, 2012, will be subject to a new minimum floor calculation. This floor calculation is based on assumptions that are generally consistent with the principles-based reserving framework developed by the NAIC. While there are certain judgmental interpretive issues with the floor calculation, at this point, we do not expect the AG38 revisions to have a material impact on our total in-force reserves. Reserves on new business written after December 31, 2012, will be calculated using a modified formulaic approach that will generally result in higher reserves.

We have implemented, and plan to continue to implement, reinsurance and capital management actions to mitigate the capital impact of XXX and AG38, including the use of letters of credit to support the reinsurance provided by captive reinsurance subsidiaries. These arrangements are subject to review by state insurance regulators and rating agencies. For example, the NAIC has established a subgroup to study the use of captives and special purpose vehicles to transfer insurance risk in relation to existing state laws and regulations. Therefore, we cannot provide assurance regarding what, if any, regulatory, rating agency or other reactions may be to the actions we have taken to date or the impact of any potential reactions.

We also cannot provide assurance that we will be able to continue to implement actions to mitigate the impact of XXX or AG38 on future sales of term and UL insurance products. If we are unable to continue to implement those actions, we may have lower returns on such products sold than we currently anticipate and/or reduce our sales of these products.

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, 2012 (dollars in millions, except per share data):

| Period | (a) Total Number of Shares (or Units) Purchased (1) | (b) Average Price Paid per Share (or Unit) | (c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs | (d) Approximate Dollar Value of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs |
|---|---|---|---|---|

| | | | | |
|---|---|---|---|---|
| | | | (2) | (2)(3) |
| 7/1/12 - 7/31/12 | 364 | $ 23.48 | - | $ 240 |
| 8/1/12 - 8/31/12 | 2,630,625 | 23.62 | 2,612,644 | 938 |
| 9/1/12 - 9/30/12 | 1,544,579 | 24.70 | 1,544,547 | 900 |

(1) Of the total number of shares purchased, no shares were received in connection with the exercise of stock options and related taxes and 18,377 shares were withheld for taxes on the vesting of restricted stock units. For the quarter ended September 30, 2012, there were 4,157,191 shares purchased as part of publicly announced plans or programs.

(2) On August 8, 2012, our Board authorized an increase in our securities repurchase authorization, bringing the total aggregate repurchase authorization to $1 billion. As of September 30, 2012, our remaining security repurchase authorization was $900 million. The security repurchase authorization does not have an expiration date. 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. The shares repurchased in connection with the awards described in Note 19 to the consolidated financial statements of our 2011 Form 10-K are not included in our security repurchase.

(3) As of the last day of the applicable month.

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/ RANDAL J. FREITAG<br>Randal J. Freitag<br>Executive Vice President and Chief Financial Officer |
| By: | /s/ DOUGLAS N. MILLER<br>Douglas N. Miller<br>Senior Vice President and Chief Accounting Officer |

Dated: November 7, 2012

LINCOLN NATIONAL CORPORATION
Exhibit Index for the Report on Form 10-Q
For the Quarter Ended September 30, 2012

| | |
|---|---|
| 10.1 | Amendment No. 2 to the Severance Plan for Officers. |
| 10.2 | Amendment No. 3 to the Severance Plan for Officers. |
| 12 | Historical Ratio of Earnings to Fixed Charges. |
| 31.1 | Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | 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. |
| 32.2 | 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. |
| 101.INS | XBRL Instance Document. |
| 101.SCH | XBRL Taxonomy Extension Schema Document. |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document. |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document. |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document. |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document. |