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Aflac Incorporated NYSE:AFL

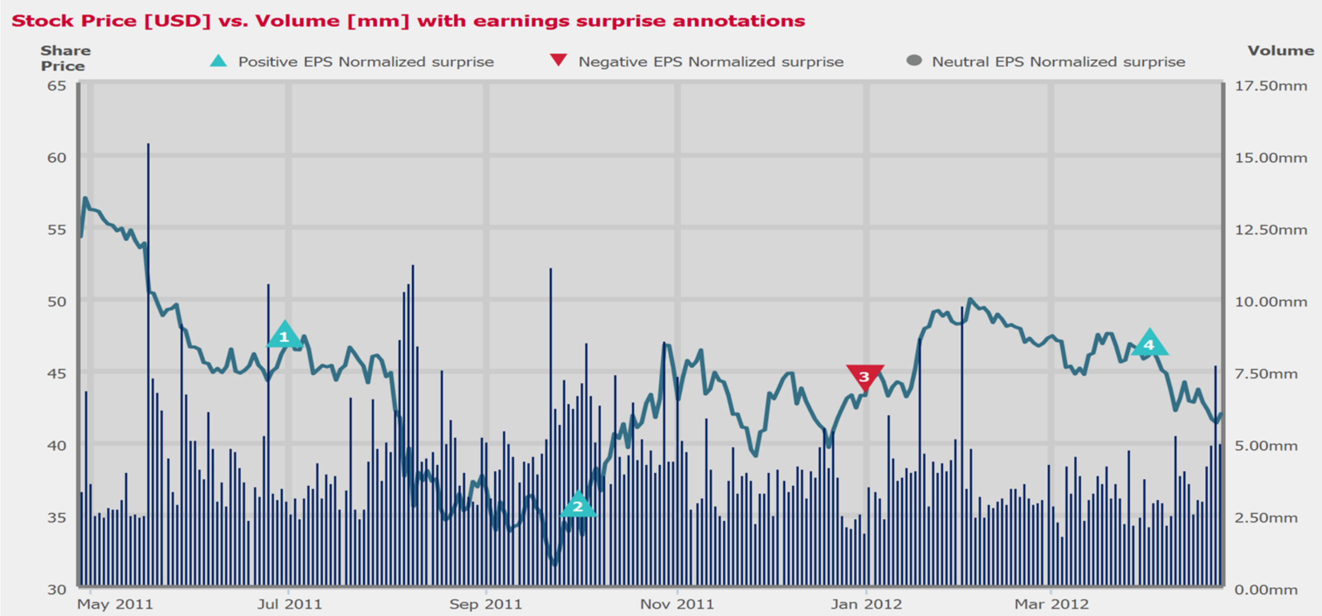
FQ2 2012 Earnings Call Transcripts

Wednesday, July 25, 2012 1:00 PM GMT

S&P Capital IQ Estimates

	-FQ2 2012-			-FQ3 2012-	-FY 2012-	-FY 2013-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.62	1.61	(0.62 %)	1.64	6.52	6.90
Revenue (mm)	6274.25	5902.00	(5.93 %)	6443.72	25497.72	27137.51

Currency: USD
Consensus as of Jul-25-2012 12:09 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2011	1.54	1.56	1.30 %
FQ3 2011	1.60	1.66	3.75 %
FQ4 2011	1.51	1.48	(1.99 %)
FQ1 2012	1.65	1.74	5.45 %

Call Participants

EXECUTIVES

Daniel P. Amos
Chairman & CEO

Eric M. Kirsch
Global Chief Investment Officer and Executive VP

Kenneth S. Janke
Former Executive Vice President and Head of Corporate Finance & Development

Kriss Cloninger
President & Director

Robin Y. Wilkey
Former Senior Vice President of Investor & Rating Agency Relations

Tohru Tonoike
Vice Chairman of Aflac Japan

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UBS Investment Bank, Research Division

Presentation

Operator

Welcome to the Aflac Second Quarter Earnings Conference Call. [Operator Instructions] Please be advised today's conference is being recorded. I would like -- I would now like to turn the conference over to Ms. Robin Wilkey, Senior Vice President of Aflac Investor and Rating Agency Relations.

Robin Y. Wilkey
Former Senior Vice President of Investor & Rating Agency Relations

Thank you, and good morning, everyone, and welcome to our second quarter conference call. Joining me this morning is Dan Amos, Chairman and CEO; Kriss Cloninger, President and CFO; Paul Amos, President of Aflac and COO of U.S. Operations; Ken Janke, Executive Vice President and Deputy CFO; Eric Kirsch, First Senior Vice President, Chief Global Investment Officer. And joining us remotely this morning is Toru Tonoike, President and COO of Aflac Japan, who joins us from Tokyo.

Before we start this morning, let me remind you that some of the statements in the teleconference are forward-looking within the meaning of federal securities law. Although we believe these statements are reasonable, we can give no assurance that they will prove to be accurate because they are prospective in nature. Actual results could differ materially from those we discussed today. We encourage you to look at our quarterly reports for some of the various risk factors that could materially impact our results.

Now I'll turn to program over this morning to Dan who will begin with some comments about the quarter and our operations in Japan and the United States. I'll then follow up with a few financial highlights for the second quarter, and then we'll be glad to take your questions. Dan?

Daniel P. Amos
Chairman & CEO

Thank you, Robin. Good morning, and thank you for joining us today.

Let me begin this morning with a review of Aflac Japan, our largest earnings contributor. We were again pleased with Aflac Japan's strong financial performance and sales momentum that continued in the second quarter. Following 2 tremendous years and an impressive first quarter, new annualized premium sales rose 47.4% to JPY 53.2 billion in the second quarter. These results, again, greatly surpassed our expectations and set a production record for the fourth straight quarter. For the first half of the year, Aflac Japan's totaled new annualized premiums in yen rose 50.5%. Aflac Japan's revenues grew by 9.2% for the quarter and 8.5% for the first 6 months. Pretax earnings for the quarter were JPY 77 billion, up 2.4%; and for the 6 months, pretax earnings were JPY 160 billion, up 2.8%. Premium income increased 9.7% for the quarter and 8.8% for the 6 months, benefiting from the stronger sales of our WAYS product. I would also note that persistency remained strong. The bank channel generated JPY 24.7 billion in sales, which represents an increase of 224% over the second quarter of 2011. The bank channel accounted for 46.5% of Aflac Japan's total sales and the traditional accounted for 51.9%.

From a product perspective, WAYS, our unique hybrid whole-life product, continued as the top seller in the second quarter, generating an increase of 259% over 2011 and accounting for 45% of the total second quarter sales. Our cancer and medical insurance accounted for 13.4% and 16.9% of total sales in the quarter, respectively.

I would point out that we expect our new nonstandard medical product introduced this week to benefit medical sales in the second half of the year. You may recall that we started selling the 5-pay version of WAYS product through the banks in June of 2011. As we've previously discussed, we have taken action to limit the production of the 5-pay version of WAYS to address the possibility of disintermediation risk in the event of interest rates increase significantly. Now, virtually all banks have reached their sales cap by 5-pay WAYS for the year. Our traditional sales channels will stop sales of all 5-pay WAYS on August 1. Except for a little spillover business, we don't expect the contribution of 5-pay WAYS to impact third quarter sales.

Banks have a very strong distribution outlook for Aflac Japan. Compared with the U.S. banks, Japanese banks interact with the customers and consumers through more touch points offering a broader scope of transaction. As such, consumers in Japan tend to have more face-to-face interaction with the banks, often developing strong loyalties. This is true from the smallest villages to the largest cities. The bank channel networks of about 20,000 branches gives us a far-reaching access to consumers we've never had the chance to do business with otherwise. The bank channel helps expand our customer base. Today about 80% of the bank channel sales are new customers.

Over the past 6 years, we've invested significant efforts in the developing relationship with banks. I will remind you that we secured agreements with more than 90% of the banks in Japan, a number we believe is significantly greater than any of our competitors.

Selling WAYS appeals to banks because this product, is significantly higher premium, generates attractive commissions. Consumers like the WAYS product because it provides a safe and more appealing alternative to bank accounts that pay less than 10 basis points. From Aflac's view, as I've said before, WAYS gave us the opportunity to generate about a 10% profit margin for life insurance while providing a new distribution channel. If there was a choice, I'd prefer to sell more profitable third-sector products over the first-sector products like WAYS. But let me remind you, swapping out first-sector sales with third-sector sales simply isn't an option. However, we have tremendous access through the bank channel and that gives us an opportunity to cross-sell our more profitable medical and cancer products.

We're also employing our strategies to enhance the profitability of child endowment in WAYS product. This is especially important in the current low interest-rate environment. Starting in October, the discounted advance premium rate, or DAP purchase option, available for both products will be reduced. While we're in the process of communicating with the FSA, our plan is to reduce the rate by 50%, going from 1% to 0.5% credit. You'll recall that the DAP is the interest we credit to the policyholders when they choose to pay their premium upfront. Additionally, as we told you at the Analyst Meeting, we will lower the assumed interest rate on pricing for the sales of WAYS in child endowment products starting in April of 2013.

I would add that the second half of 2012 sales results will be impacted by several factors: first, we will stop the sale of 5-pay WAYS, which, of course, will hurt sales; second, the tough sales comparison from the second half of 2011 will make the latter half of 2012 challenging; and third, it's important to note that even with the headwinds I've just mentioned, the popularity of the products and the broad selection, especially with WAYS, continues to appeal to consumers. As such, we believe new annualized premium sales in the second half of the year will be flat to up 5%. However, combining the second half sales expectation with the tremendous sales growth we produced in the first half of the year, we are revising our numbers upward in terms of the sales target to 22% to 25%.

Now let me turn to the U.S. operation. Aflac U.S. revenues grew by 5.2%, both for the quarter and for the 6 months. Pretax earnings were up 6.3% for the quarter and 7.2% for the 6 months. Premium income increased 5.5% for the quarter and 5.3% for the 6 months.

I would also note that policy persistency remained very strong. We believe there are several reasons for this including some factors that we have control over and some we don't. One, with the economic uncertainty over the last several years, workers have been more reluctant to switch jobs. Additionally, we enhanced communication with our policyholders at critical decision-making times, which we believe has contributed to make an improvement in the policyholder retention rate. We believe these efforts have contributed to better persistency both for the policyholders and the payroll accounts.

Aflac U.S. new annualized premium rose 1.5% for the quarter. For the first half of the year, total new sales rose 3%, which is in line with the annual sales target of 3% to 8% increase.

Keep in mind with the majority of the enrollments occurring in the fourth quarter, we expect sales results to improve.

Sales for our group products remained strong. Our veteran associates continue to benefit from the ability to offer group and individual products.

While some aspects of the U.S. economy have shown slight signs of improvement this year, we continue to see the economic landscape is challenging. Given that our products are primarily sold at small businesses, gains in employment increased our universe of potential policyholders. Until we see sustained growth in employment levels, we remain cautious.

While we can't control the challenging economic climate in the U.S., we certainly can position our business to maximize the potential for success in the current environment. That's exactly what we've done over the last several years and we are closely monitoring the proposed changes in the U.S. health care delivery system. Health care reform was never intended to address voluntary or supplemental insurance. Therefore, the Supreme Court's decision last month does not directly impact our business or the need for our products. However, we believe that it can have an indirect impact. It could present with opportunities for continued growth in this market. For Aflac, voluntary insurance sold at the work site, large and small, remains our primary focus.

As we've seen in Japan, a system of national health care, actually enhances the awareness in the need of our product such as ours. Our competitive advantage as the market leader in the U.S. gives us new opportunities. For example, many brokers are looking to Aflac's supplemental of voluntary insurance for solutions for a couple of levels: first, we're seeking to replace lost commissions from declining major medical business; second, employers that are subject to Affordable Care Act have been asking brokers for ways to help control their health care costs. Whether the answer is to shift more costs to the employees, reduce benefits or both, we believe Aflac can be a big part of the solution for employers and their employees.

With our strong brand, we believe consumers will be more receptive to hearing how Aflac products can help. This opens up greater possibilities for traditional sales force and the broker channel alike.

Having updated you on the operational side of the business, let me give you some details about our Global Investment division. For the last several years, our primary focus has been on investment risk management while investing our significant cash flows and assets that are relatively higher quality and liquidity. As you know, we have made significant progress into proactively derisking our portfolio over the last 3 years to enhance the strength of our balance sheet. In the process, we've been reducing our exposure to riskier asset classes including perpetual, [indiscernible] and financials especially in Europe. You've heard us say many times before that we expect to see volatility in Europe, and that's exactly what we've seen in the second quarter. Our second quarter net after-tax realized investment losses were $272 million. These losses are primarily attributable to the decision to impair 2 Spanish holdings. In addition, we experienced further declines in the value of several securities we've previously impaired in the fourth quarter of 2011 related to the intent to sell.

Although our total realized losses in the second quarter were higher than the first quarter of this year, they are significantly lower than the second quarter of last year. We still view Europe as an area of potential risk. As always, we closely monitor and reevaluate our portfolio with the eye for credit issues that may emerge. However, I believe our portfolio is better positioned now to accommodate market volatility.

Now I'd like to share with you the progress that we've made on various initiatives related to transforming our investment management organization. As you'll recall, we engaged McKinsey to conduct a strategic global review of our people, infrastructure, technology and processes. We are in the process of implementing some of those recommendations in the second quarter. One recommendation relates to the organizational structure. Our new framework encompasses the Global Investment group led by executive management team of seasoned professionals and key investment functions. Recruiting talented investment and business professionals is a top priority we've made significant progress on. We hired a global chief operating officer for investments along with the chief operating officer for U.S. investments, a head of global credit and a head of trading. We also hired a number of other professionals in various support roles in both Japan and the United States. We will continue to build out our staff with talent and expertise to complement our investment strategy going forward. But let me just say that I am extremely impressed with the caliber of investment veterans Eric Kirsch has hired. They represent an enormous amount of Wall Street's experience and [indiscernible].

As we move into the third quarter, we will be addressing traditional recommend -- additional recommendations such as work stream and technology. We also engaged Goldman Sachs Asset Management, or GSAM, to conduct a comprehensive asset allocation review. This review identified asset allocations that allow us to improve our overall risk return profile by maximizing diversification while accommodating the various constraints to our portfolio such as the RBC and SMR ratios. GSAM is wrapping up phase 1 of the project this month, making it too early to discuss specific asset allocation details today.

However, I can highlight several of the findings. Currently about 99% of the holdings are fixed maturity category, primarily invested in JGBs and privately issued securities. As I've suggested prior to the GSAM engagement, we will be looking to invest in a more liquid public securities while still supporting our yen liability. This week, we began investing in dollar-denominated public fixed income securities diversified by the sector and we'll purchase currency hedged to the yen. This strategy will provide greater liquidity over flexibility of the portfolio. Further, it will help provide opportunities to diversify the investment of significant cash flows beyond JGBs with the objective of producing higher returns.

Our strategic asset allocation will be reviewed on an annual basis, and we will make tactical asset allocations continually to reflect current market and business conditions.

Now, I'll turn to Aflac's consolidated financial performance. Operating earnings per share rose 3.9% to $1.61 for the quarter. Excluding the benefit of the stronger yen, operating earnings per diluted share rose 3.2% for the quarter.

We had another strong quarter with respect to capital position. The strength of our capital ratio demonstrates our commitment to maintaining financial strength on behalf of our policyholders and bondholders, as well as shareholders.

As we've communicated over the past several years, a strong risk-based capital ratio remains a priority to us. Although we have not finalized our statutory financial statements, we estimate our RBC ratio was between 560% and 600% at the end of June, which is up from the year-end number of 493%. The significant increase in the ratio from year end is due to the first quarter 2012 implementation of the new statutory accounting standards for income taxes. As you know, our capital adequacy in Japan is principally measured by the solvency margin ratio. We expect that Aflac Japan's solvency margin ratio will remain at the high end of the 500% to 600% target.

As we've indicated, given our capital structure, our ability to repurchase shares is largely tied to profit repatriation. Our 2012 profit repatriation was a bit higher than our estimates at JPY 37 billion, but we continue to be cautious about deploying capital. I'll remind you that we don't need to repurchase any shares to achieve our 2012 operating earnings objective. Given the ongoing European debt and related market volatility, we believe it's prudent to be cautious about deploying capital. However, it's still possible that we will repurchase shares in the fourth quarter. Furthermore, we still expect to have significant capacity for profit repatriation and share repurchase in 2013 if we incur no material losses between now and the end of the FSA fiscal year.

I believe we've done a good job in protecting our policyholders' interests while also being mindful of shareholders' needs. We increased our cash dividend to shareholders in 2011 for the 29th consecutive year. Our objective is to grow the dividend at the rate in line with the earnings per share growth before the impact of the yen. I believe dividends are an important component for the value we provide investors. I am confident that the fourth quarter, we will extend the consecutive annual dividend increases to 30 years.

I also believe we've done a very good job in managing our operation including expense control. However, with investments as one of the highest priorities, we remain committed to building a world-class investment function. This transformation requires additional financial resources, primarily for personnel, improved processes and investment systems. Fortunately, because the first quarter receipt of the deferred coupon, we were able to accelerate the funding of this critical global initiative while still achieving our operating earnings per share objectives.

I want to affirm that even with the historically low interest rates, excluding currency, we expect to achieve our 2012 operating earnings per share of a 3% to 6% increase although toward the end of the low range. We believe it is reasonable.

Looking ahead, I also want to reaffirm 2013 target we gave you at the analyst meeting. We expect operating per diluted share to increase 4% to 7% in 2013 on a currency-neutral basis. This earnings objective assumes no significant impact on investment income from losses and no further meaningful decline in interest rates. We remain focused on our vision to be the leading provider of voluntary insurance in the United States and the #1 provider of supplemental insurance in Japan. I have confidence in our business model, the fundamental need for our products, and most importantly, the future success of Aflac. Robin?

Robin Y. Wilkey
Former Senior Vice President of Investor & Rating Agency Relations

Thanks, Dan. Let me get through some second quarter numbers, starting with Aflac Japan. Beginning with the top line in yen terms, revenues were up strongly at 9.2% for the quarter and investment income was up 6.9%. The annualized persistency rate, excluding annuities for the first half of the year, was 94.7% compared with 94.3% a year ago. In terms of quarterly operating ratios, the benefit ratio to total premiums increased over the last year, going from 69.9% a year ago to 72.2% in the second quarter. This was caused primarily by the growth of the net benefit reserves for our ordinary life line of products, most notably our WAYS product. The expense ratio for the quarter was 18.4%, down from 19.4% a year ago. The expense ratio was primarily impacted by the lower net commissions associated with the increase in sales of our life products. As a result, the higher benefit ratio with the pretax profit margin declining from 20.9% to 19.6% in the quarter.

For investments for the quarter, our cash flows were invested in yen securities at 1.80%, and including dollars, the blended rate was 1.97%. The portfolio yield was 3.1% at the end of June, which is 8 basis points lower than the end of March and 41 basis points lower than a year ago. 10-year JGBs at the end of June 30 were 0.84%, a 15 basis points decrease from March 31. 20-year JGB yields as of June 30 were 1.67%, a 9 basis points decrease from March 31. And 30-year JGB yields as of June 30 were 1.89%, a 5 basis points decrease from March 31.

Now turning to Aflac U.S. Total revenues rose 5.2% in the second quarter. The benefit ratio to total premiums increased slightly to 57.5% compared with 57.0% a year ago. The operating expense ratio decreased from 31.3% to 30.6%. Reflecting the decrease in the operating expense ratio, the profit margin for the quarter was 18.3% compared to 18.1% a year ago.

In terms of U.S. investments, the new money yield for the quarter was 4.37% versus 5.72% a year ago. The yield on the portfolio at the end of June was 6.59%, down 7 basis points from the first quarter and 17 basis points from the year ago.

Turning to some other items in the quarter. Noninsurance interest expense in the second quarter was $45 million compared to $41 million a year ago. The increase in interest expense was primarily impacted by the increased borrowings during 2011 and in the first quarter of this year.

Parent company and other expenses increased to $18 million compared to $16 million in the second quarter of 2011. This increase was caused by several items, primarily general operating expenses increase with personnel projects and also other special projects. Total company operating margins decreased, reflecting the increase of the benefit ratio in Japan. Also our pretax operating margin decreased from 19.3% to 18.3%. After-tax operating margin decreased from 12.6% to 11.9%.

On an operating basis, the tax rate remained relatively unchanged at 34.8%.

Net earnings per diluted share for the quarter were $1.03 -- $1.03 compared with $0.58 in 2011. As reported, operating earnings per diluted share rose 3.9% to $1.61. The stronger yen increased earnings by $0.01 per diluted share for the quarter. Excluding the yen's impact, our operating earnings per share increased 3.2% for the quarter.

Lastly, let me comment on the earnings outlook for the remainder of 2012. As we mentioned at our analyst meeting and also as Dan reiterated a while ago, given the continued low interest rate environment especially in Japan along with the ongoing volatility seen in Europe in the second quarter, we expect to see an increase in operating earnings per diluted share excluding the impact of the yen this year toward the low end of the range of 3% to 6%. Assuming the low end of 3% to 6% range in operating earnings growth, we would expect to earn $6.45 to $6.52 if the yen averages JPY 80 for the year. With the same exchange rate assumption of JPY 80 to the dollar for the third quarter, we would therefore expect operating earnings to be $1.64 to $1.69 per diluted share.

Now I'll be glad to take your questions. And to be fair to everybody, please make sure you limit yourself to 1 question and 1 follow-up. We're now ready for the questions.

Question and Answer

Operator

[Operator Instructions] Our first question will come from Nigel Dally of Morgan Stanley.

Nigel Phillip Dally
Morgan Stanley, Research Division

With the strategy of investing in the U.S. and swapping back to Japan, can you discuss how much incremental yield you expect to pick up from that strategy? And if rates remain unchanged from current levels, what type of Japan new money yields do you expect to achieve in the back half of the year?

Eric M. Kirsch
Global Chief Investment Officer and Executive VP

Sure. It's Eric Kirsch, and I can give you a range of estimates. I can't give you a precise number just because yields and spreads and different types of purchases could be different depending on market conditions. But by way of example, with this new program that we've initiated that Dan mentioned today, we're buying publicly available U.S. corporate bonds focused in A, BBB type of credits. This strategy will give us greater liquidity, greater portfolio flexibility in the future, and we're looking at maturities anywhere from 10 to 30 years across the curve. So ultimately, as we build this new portfolio, it'll be a combination of those things. But after taking into account the cost of currency hedges, because our strategy is to have this hedged back into our yen liabilities, you could be looking at anywhere from, again let me emphasize based on current market yields and spreads, anywhere from 2.5% to 3.25%. So if yields and spreads stay where they are today, which isn't likely, they move, as you all know, we'd probably be building a portfolio that, on average, had that kind of yield after the currency hedging costs. As you know, year-to-date, because we've been cautious and conservative, not buying private placements, being much more stringent on our credit standards, a majority of our new money was going into JGBs, which, as Robin mentioned, overall, year-to-date new money yields is somewhere around 1.85%, but on our whole portfolio new money at about 2%. You could see, based on my comments, we'll be able to increase the returns fairly significantly while at the same time improving the overall quality, diversification and investment opportunities for the portfolio. The program just got initiated, so we will start off in a modest sense as the team is coming together, as we work very closely on a global basis. But I'm confident as each month goes by, the impact to that new money yield and our overall investment results will continue to be a great contributor from this new investment program.

Operator

Our next question will come from Chris Giovanni with Goldman Sachs.

Christopher Giovanni
Goldman Sachs Group Inc., Research Division

Eric had mentioned potentially invested 2.5% to 3.25%, so curious what that would do to the margin for the WAYS product versus where you're investing today at 2%?

Kriss Cloninger
President & Director

I'll take that one. This is Kriss. At the FAB meeting, we reported that at a 2% new money rate, the WAYS profit would range from 8% to 12% of premium. If that increases at 2.25%, the range of profit goes up to 13% to 17% of premium. And at 2.5%, we get up to 17% to 21%. So I'm looking at this as an opportunity to $1 average up our net investment yield by pursuing this new strategy compared to what we've done over the last 6 to 12 months.

Christopher Giovanni
Goldman Sachs Group Inc., Research Division

Okay. And then with this investment strategy in place, would you guys consider sort of reallowing the 5 WAYS product to be sold in the back half of the year if these are the type of margins you can be generating with a higher investment return?

Kriss Cloninger
President & Director

I think that what's more likely to happen is that we'll move to a 10-pay WAYS. I think that's what the bank channel is going to do.

Daniel P. Amos
Chairman & CEO

They're already doing it.

Kriss Cloninger
President & Director

They're already doing it. The difference there is that the policy is not paid up as quickly. The full cash values aren't available to the policyholders quite as quickly, and therefore, it stretches out the period associated with becoming fully paid up and having access to full cash values and what that does is it reduces the risk of potential disintermediation by stretching out the period between the issue date and the paid-up date. Not that disintermediation is going to occur necessarily in the event of a spike in interest rates, but it is a possibility and so we're comfortable that we're doing the right thing, and we will probably not reintroduce 5-pay WAYS.

Christopher Giovanni
Goldman Sachs Group Inc., Research Division

Okay. And then lastly, Dan, you'd mentioned the opportunity to cross-sell the cancer and medical products via the bank distribution. So curious when you expect that this could take hold just given sales are essentially flat or down for those products despite the robust sales in the bank.

Daniel P. Amos
Chairman & CEO

Well, actually, it's taking place now. Our sales of medical and cancer are the same number as WAYS. The difference is, is the premium is so high. So it's actually been taking place. I think what will drive our increase in sales immediately is going to be the introduction of this new -- what do we call the cancer product, the one that -- I mean the medical product -- Gentle EVER, which is a higher risk but higher premium. It's a substandard. And I think that's going to drive in the second half of the year's sales. But actually, the bank channel's doing quite well on medical and cancer sales. It's just one night the premium is the problem.

Operator

Our next question will come from Steven Schwartz with Raymond James.

Steven David Schwartz
Raymond James & Associates, Inc., Research Division

Just to follow up on the new money rate and the effect of WAYS. So if I understand this correctly, in October, you're going to reduce the discount on the advance, is that correct?

Daniel P. Amos
Chairman & CEO

That is correct.

Steven David Schwartz
Raymond James & Associates, Inc., Research Division

And then beginning next fiscal year, you're going to raise the price of WAYS?

Daniel P. Amos
Chairman & CEO

That is correct.

Steven David Schwartz
Raymond James & Associates, Inc., Research Division

So both of those things are going on. So I guess the question is, if you're doing that, and Eric could get you 2.50% to 3.25%, are we looking at much higher margins than we've seen in the past on this product?

Daniel P. Amos
Chairman & CEO

Absolutely. Assuming there's no change from where we are at this moment in interest rates and what's going on, that is correct.

Steven David Schwartz
Raymond James & Associates, Inc., Research Division

Okay, all right. And then if I may just stick with Japan as a follow-up. I know your -- I guess this is a revision of Gentle EVER. I mean Gentle EVER's been out there, right?

Daniel P. Amos
Chairman & CEO

It's a revision of Gentle EVER.

Steven David Schwartz
Raymond James & Associates, Inc., Research Division

Okay. Are you happy, Dan, with the second quarter in traditional? The way I figure it, traditional was probably flat quarter-over-quarter.

Daniel P. Amos
Chairman & CEO

No. I'd like stronger sales and certainly it's something that we're looking at and trying to concentrate on in the second half to have our traditional channel pick up. So I would say that no, it's not where I'd like it to be. But Japan's economy has not been the greatest in the world either. So not where I want it, but we're working on it and I think we'll see improvement going forward.

Steven David Schwartz
Raymond James & Associates, Inc., Research Division

Is it just a stale product issue, or do you think there's something else?

Daniel P. Amos
Chairman & CEO

No, I think a little bit of our salespeople are selling some of the life insurance that's moved them a little bit; we're moving them back. And I think they need new products occasionally and I think this Gentle EVER introduction will help them as well.

Operator

And our next question will come from Randy Binner of FBR.

Randolph Binner
FBR Capital Markets & Co., Research Division

I had a question on the SMR. I guess from our perspective, it seemed surprisingly good considering a few headwinds and still maybe we're wrong in identifying those as headwinds, but the repatriation number, I'm assuming, is out of the SMR you referenced. I assume the credit loss is out of there too. The yen was a little bit stronger. And so those would be headwinds and then a tailwind would be a lower JGB yield. So just trying to look for clarification and kind of the moving parts that kept the SMR favorable in the quarter?

Kriss Cloninger
President & Director

Yes, you're essentially correct. The repatriation is, in fact, out of the SMR number. The investment losses for the quarter are in there. But again, we had strong operating earnings and there wasn't that much change in the yen, it was 1% and 1.5%, something like that. So there wasn't much of an impact on converting the dollar portfolio to yen compared to what it was at the end of the first quarter.

Randolph Binner
FBR Capital Markets & Co., Research Division

Okay. So then, I guess 2 kind of related follow-ups. So one, the FSA standard reserving rate, is that -- is there any update on that and would that materially impact the SMR? And then with this level of SMR, would it be fair to say this is an adequate level that would enable kind of the larger repatriation looking to 2013?

Kriss Cloninger
President & Director

Let me think about the first part of that question again. Let's see, what was the first part?

Randolph Binner
FBR Capital Markets & Co., Research Division

Just the standard reserving rate, is there any update on that from the FAB?

Kriss Cloninger
President & Director

The JGB yields -- within your JGB yields still remain well below what would be required to change the notion that the standard interest rate will be lowered effective April 1, 2013. I think it has to go up to something like 1.2% or more for the remaining period between now and the determination date. So it's highly likely that the standard reserve rate will come down. That only affects us going forward for new business, so there's no immediate impact on the SMR of a change in the -- of the rate. And as far as -- we've got a pretty strong SMR, future repatriations will primarily be a function of our Japan net after-tax income that reflects both operating earnings and investment losses after tax. And historically, we've repatriated about 80% of that number and we have to look at the level of solvency margin ratio to make sure we're taking care of the policyholders in Japan before we repatriate funds. But historically, we've been able to repatriate about 80% of the after-tax net income and still build our capital level in Japan. So that's what I expect next year.

Operator

And our next question will come from Jimmy Bhullar of JPMC.

Jamminder Singh Bhullar
JP Morgan Chase & Co, Research Division

I had a -- just a follow-up on profit repatriation. Given that the losses in the second quarter were relatively high, at least higher than they were in the first quarter, what do you -- what's your sort of range for profit repatriation from Japan that you expect for 2013 assuming that you don't have material losses from here on out? And then on U.S. sales, they've been weak for the past few quarters. Just wondering how much of this is because of the economy versus not having the capacity or the infrastructure to be able to train recruits?

Kenneth S. Janke
Former Executive Vice President and Head of Corporate Finance & Development

Jimmy, this is Ken. Let me address the proper repatriation question. The current estimate based on losses that we've incurred so far in Japan's fiscal year would put it likely around JPY 65 billion next year, which is down from about JPY 90 billion that we had expected earlier. Remember, when we talked about the JPY 90 billion, we assumed there were no additional losses. So updating that number, that's a little over $800 million to $810 million.

Jamminder Singh Bhullar
JP Morgan Chase & Co, Research Division

And that would assume nothing major for the next 3 quarters?

Kenneth S. Janke
Former Executive Vice President and Head of Corporate Finance & Development

Correct, correct.

Daniel P. Amos
Chairman & CEO

U.S.?

Kenneth S. Janke
Former Executive Vice President and Head of Corporate Finance & Development

Second part of the question?

Daniel P. Amos
Chairman & CEO

U.S. sales.

Eric M. Kirsch
Global Chief Investment Officer and Executive VP

I would say that when we put out the original range for 2012, the range of 3% to 8% was based upon some improvement in both the U.S. economy, and more specifically, on employment itself. The 3% range, as I've said previously, represented a poor economy. The 8% of the range represented an improved economy with an average execution on our part. I would tell you at this point I think you've seen nationally with GDP, with unemployment across-the-board, with the Fed considering taking action this morning that the economy has not improved. And therefore, we continue to see slightly weaker results. That said, as Dan mentioned in his speech earlier, I believe that we will have a strong second half of the year with specific increase in the fourth quarter as the group business continues to drive success as well as the broker business. Our broker sales continue to be strong. And I feel like the changes that we've made recently in our sales and marketing structure to realign ourselves to better improve our training and to make our recruits more effective by recruiting and turning them into average weekly producers will set us up better for internal execution. All that being said, I feel confident and reaffirm the range of 3% to 8% with hope that we will continue to move up within that range from where we are today.

Operator

Our next question will come from John Nigel (sic) [Nadel] of Sterne Agee.

John Matthew Nadel
Sterne Agee & Leach Inc., Research Division

I have a question on the new asset allocation strategy. Is this something where we should expect you will only be investing new cash flows? For instance, into these -- into U.S. public corporate securities and swapping or hedging into yen. Or might you be willing to sell some of your more recent JGB investments and reinvest proceeds from that as well into the strategy?

Eric M. Kirsch
Global Chief Investment Officer and Executive VP

It's Eric again. First, for sure, the majority of new cash flows will be used to invest per our new asset allocation strategies that are still being finalized, but you've heard a lot about with the GSAM project. Having said that, we will certainly look at opportunities for current assets in our portfolio to swap them in essence where it makes sense to do so. Having said that, that's not a conclusion we can make today. We're still finalizing the asset allocation results. Secondly, we always have to consider liquidity needs in our portfolio, other types of market events. But to the extent we have assets and JGBs are certainly one example if they're in AFS, where that possibility exists, and we would certainly look at that. As you know, the majority of our non-JGB assets are primarily in private placements. So those opportunities are limited just because of the liquidity constraints on those type of assets. So we'll explore those opportunities and report -- if we see good investment opportunities to make that type of swap, we would certainly entertain doing those. But nothing is planned for it at this early stage of the new asset allocation strategy.

Kenneth S. Janke
Former Executive Vice President and Head of Corporate Finance & Development

John, this is Ken. Just as a reminder, we came into the year thinking that we've have about JPY 800 billion of investable cash for the year. It's now at about JPY 1.3 trillion primarily because of the much better sales that we've had, coupled with very strong persistencies. So the big -- there may be swap opportunities, but the big challenge remains to putting that significant cash flow to work.

Daniel P. Amos
Chairman & CEO

We're talking about JPY 15 billion in new money this year.

John Matthew Nadel
Sterne Agee & Leach Inc., Research Division

Yes, I understand. I was thinking about it from the perspective of your JGB investments given the direction of rates are probably capital gains that might be helpful for your capture of some of the NOLs.

Kenneth S. Janke
Former Executive Vice President and Head of Corporate Finance & Development

That's on our mind, too.

Daniel P. Amos
Chairman & CEO

That's on our mind.

John Matthew Nadel
Sterne Agee & Leach Inc., Research Division

Okay. Then the second question I have is another one maybe for Eric and it's just recognizing how much conditions in Europe have deteriorated here in at least the recent several weeks, if not little a bit longer, thinking about, for instance, Spanish sovereign debt as one example. I'm just wondering what your watch list looks like. How that's perhaps changed over the past few months.

Eric M. Kirsch
Global Chief Investment Officer and Executive VP

Yes, actually, in terms of our watch list, it hasn't necessarily increased in total because our watch least has a number of parameters that factor in price movement, ratings agency actions and a few other variables. So things like Spain and sovereign debt were on our radar screen. However, within the watch list, of course, we have different grades of sort of how much we're concerned about it or not. So that part has changed within the watch list. And as I have said earlier in the year, certainly at our FAB, there's no doubt you all understand what our European exposures are, so we will be impacted by the volatility in Europe and actions by the rating agencies. And as I've said, I certainly expect it on our holdings ratings migration. I think that was fairly well forecasted by the agencies and therefore would impact our holdings. But with respect to the volatility, in the first quarter, as we know, Europe calmed down; second quarter, extremely high volatility, similar to what we've seen last year. And I said if that volatility was high, then the financial impact to our holdings would be greater. If that volatility stayed lower, then the financial impact would be lower while we had some ratings migration. And the second quarter is just, unfortunately, an example of that volatility going very high and having some impact to our holdings, particularly in Spain with the 2 bonds we decided to impair.

Operator

Our next question will come from Joanne Smith of Scotia Capital.

Joanne Arnold Smith
Scotiabank Global Banking and Markets, Research Division

Okay. So I just want to go back to the sales guidance or sales objective for Japan for a minute because you said that you expect 0% to 5% growth in the second half in Japan. You're expecting the sale of this 5-pay WAYS to go away basically. I know that they've reached the cap in the banks. With sales, excluding WAYS in the second quarter relatively flat, what are you doing to offset what you're going to see in terms of that huge decline in the sale of WAYS?

Daniel P. Amos
Chairman & CEO

Well, I think, first of all, I think this low interest rate environment is going to drive people to look at the 10-pay or 15 or even 20-pay WAYS that we have. So I think there'll be some shift from the 5 to the 10 and 15. I think even the discounted advance premium cut in half from 1% to 0.5% is great for us, but it's still the best buy out there for consumers that are spending money. So I think, although it will slow down some, I still think you're going to see that it's still the best -- one of the best buys out there in the market. And then finally, I think the introduction of the new Gentle EVER is going to impact sales and so all of those things, together, I think, will make us fall in that 0% to 5%. And you'll remember that fourth quarter is a monster of a quarter. So I think third quarter will be up slightly, but fourth quarter's the one we're going against the really big numbers.

Joanne Arnold Smith
Scotiabank Global Banking and Markets, Research Division

And Dan, what is it about the cancer product right now that's causing sales to be weak? Is it that you need a refresher for that product? Is it the tax benefit that went away? Do you have anything planned in terms of new introductions on cancer?

Daniel P. Amos
Chairman & CEO

Yes, we have plans to reengage the field force and our marketing guys are working on that. We believe that we'll engage them in the medic -- they take path of least resistance. So whatever the new product is, they move to. So right now we just expect them to move to Gentle EVER. It's not they won't be interested in cancer. It's just that Gentle EVER is the path of least resistance, so they'll start selling that. But we will look at more advertising to encourage the sale of the cancer products. We'll look at more advertising in regard to the medical sales as well. Contest, we basically give now no -- we cut the commissions in half on the sales of our endowment and so they'll shift from that because there's no convention credit or any credit whatsoever and it's half the commissions. So that'll move them back to the other products. So it's just several things that tie together that, I think, will push it that way.

Operator

Our next question will come from Mark Finkelstein of Evercore.

A. Mark Finkelstein

Evercore ISI, Research Division

Just one clarification, please, I think for Eric. Should we be assuming that the majority of cash in the back half of the year will be invested in this new strategy? I mean I know you're still finalizing the allocation, but how should we think about this 2.5% to 3.25% yield?

Eric M. Kirsch
Global Chief Investment Officer and Executive VP

Yes, I would think of it as a gradual walk that'll become a power walk that'll become even stronger. So we've just initiated the program. Our intent is as market conditions allow and investment teams find good opportunities, to increase that allocation to the investment grade corporate space. So over the third quarter, at least, my current expectation is approximately 2/3 of our new money that comes in up to that could go into this investment program. But it will be dependent on market conditions and investment opportunities that we see. As we gain more confidence in the workings of this program and assuming market conditions remain favorable, towards the end of the third quarter we'll reexamine the fourth quarter and decide on the asset allocation there. So if things go well, I would expect this program to continue to gain momentum and be a more significant portion of our new money cash flows.

A. Mark Finkelstein
Evercore ISI, Research Division

Okay. And then just one follow-up. At the May Investor Day, you talked a little bit about strategies and structures to maybe accelerate monetization of the deferred tax asset. Is there any there any update on that?

Kenneth S. Janke
Former Executive Vice President and Head of Corporate Finance & Development

Yes, Mark, this is Ken. There are actually a -- there's a couple of strategies that we're pursuing. I still can't get into a lot of details, but we remain pretty optimistic that we'll be able to generate some gains and hopefully address the combination of taking care of some current period losses and also the carryforwards in future periods. But it involves a lot of market work, legal work. There's -- we want to make sure we -- that the regulators are aware of it, for instance. So we're continuing to work at it and it's a pretty high priority here, but I just can't give a lot of detail at this time.

A. Mark Finkelstein
Evercore ISI, Research Division

Do you think it could be a 2012 event?

Kenneth S. Janke
Former Executive Vice President and Head of Corporate Finance & Development

Yes, yes. Remember, though, that when you generate gains, those gains first go to current -- to offset current period losses. And with the LME exercise that we had largely completed, the program, in the first part of the year, we had generated significant losses, about $0.5 billion. So the first $0.5 billion of gains will go towards offsetting that. So we've got to think a little bit strategically about when we would pull the trigger to take care of some of the losses this year while also keeping some of the powder dry to try and address some of the carryforwards over the next few years.

Operator

And our next question will come from Suneet Kamath of UBS.

Suneet Laxman L. Kamath
UBS Investment Bank, Research Division

My first question, I guess, is a bigger question for Dan. As you think about the Japan business and the mix of new products coming on the books, as you look beyond this year and even next year, just kind of looking further out, do you ever think we'll get back to a period of time where the third-sector products are a larger or the dominant contributor in terms of mix or the contributions to growth, or has the market changed so much where kind of going forward you're still going to be focusing on the these investment-oriented types of products?

Daniel P. Amos
Chairman & CEO

No, I think there'll be a shift back more toward third sector. I still believe there's the potential for the co-pays and deductibles to go up again. I mean, we're at 30%. I've seen it go from 0% to 10% to 20% to 30%. I still believe there's the potential for it to go to 50%. If there is, there'll be more demand for our products than ever before. That isn't to say that it'll happen, but I never thought it would get to 30%. One of the things that's driving the market right now and the sale of the life products is low interest rate environment. If interest rates move up, that's positive for us in many ways. I think that if the interest rates move up, we won't see as much life insurance sold through WAYS, so that'll move down. So I think it's a balance. But I think, it's been a surprise how much life insurance we've written and I'm excited to see the profit margin, the opportunity for expansion in that. But I don't see that as our main thrust going forward.

Suneet Laxman L. Kamath
UBS Investment Bank, Research Division

Okay. And my follow-up question is again on the Japan business and the banks. Obviously, you're preparing for the potential for disintermediation if rates spike. But I guess my question is even if rates don't spike and we get 5 years out and the surrender charges go away, I mean why wouldn't the banks just churn the product anyway to get another commission? And I guess the example I'm thinking about is like the U.S. variable annuity business where once the surrender charges are up, the advisor sort of churn the product through 1035s or whatever, get a new commission and obviously that has an impact, adverse impact, on the underlying company that's offering the product. Why wouldn't the banks do that?

Kriss Cloninger
President & Director

This is Kriss. I'm going to just speculate that the FSA does watch agent behavior in Japan. And if the agents did something not in the interest of policyholders, then there are potential problems associated with that. There was a lot of agent training that went to preparing the banks to sell the WAYS products. And keep in mind that even though surrender charges go away, there are still significant benefits in the optionality associated with the WAYS product at the maturity age. So I think that we would argue with the banks that they would be doing a disservice to their policyholders to rewrite things, almost even in the event of change in interest rates.

Daniel P. Amos
Chairman & CEO

And Toru, do you have any comments you'd like to make on that? You were a banker before you were an insurance man, how about you?

Tohru Tonoike
Vice Chairman of Aflac Japan

I think that Kriss is absolutely right. In the eyes of the Japanese regulator, the thought of the action is probably will look like something very inappropriate from the viewpoint of the consumer's interest. Banks are very, very ultrasensitive to their reputation. So I don't think that any bank would like to do that just simply because they wish to increase the commissions. The reputation is more important for them. Just a small -- it's a relatively small portion of that profit for the banks anyway. So I don't think that, that's going to happen in Japan.

Daniel P. Amos
Chairman & CEO

And remember, we've only been selling it a year and we'll be out of it.

Operator

And our last question will come from Ed Spehar of Bank of America.

Edward A. Spehar
BofA Merrill Lynch, Research Division

The question I have is on the WAYS profit margin. Kriss, I think the examples you gave that FAB with the 2.5% new money was based on the current product, is that correct? So it wasn't taking into account lower assumed interest rate or a change in the discount advance premium?

Kriss Cloninger
President & Director

You are absolutely correct, Ed. It was a current product priced at 1.65% interest. If the standard interest rate goes down to 1%, which we expect it will, we will reprice at a lower yield and achieve a greater spread, which would improve the profitability of the revised product. The competitors would have to do similar pricing action. So we wouldn't be at a disadvantage competitively.

Edward A. Spehar
BofA Merrill Lynch, Research Division

I guess my question is what's the risk that you're overshooting now? If the new money yields are going to be 2.5% at the low end and you're making 2 pricing changes, it would seem like the margin you're going to be getting as you look out into next year on this product could be 30%. I mean that's -- I think the margin was pretty close to the internal rate of return on the product, at least that's how you described, I believe, in the past. I mean, is the 30% internal rate of return really a -- I mean are you going to the point where the sales are going to go away?

Daniel P. Amos
Chairman & CEO

Well, let me just make a comment about that. I think the real question becomes how competitors will view this. If we move with a herd mentality as we always have, and I'm really not talking about the discounted advance premium; that's kind of a no-brainer and won't be any trouble. It would be the rate decrease -- I mean the interest rate decrease or the rate increase in April. We would view it at that time according to what was going on. And we would move with everybody else. So -- but I think the trend that you're seeing is a very strong trend in the right direction of what we want to see. And the way things have moved in today's world, I think we've just got to wait a little closer and watch it, but I think that there is that upside for that happening.

Kriss Cloninger
President & Director

Let me just add that this life insurance stuff is a long-term business. It's not just a quarter-to-quarter business and you need to have a bit of a long-term perspective on it. We've suffered low margins here recently over the last year, 1.5 years. And I think we would like to have opportunity to restore some of those margins and to help fund some of the realized losses we've taken due to the weak investment environment. So a concern about making too much money is not at the top of my list right now, Ed.

Edward A. Spehar
BofA Merrill Lynch, Research Division

I guess I'm not worried about making too much money. I'm just worried about the idea that the WAYS, which is a big contributor to sales, go to 0.

Daniel P. Amos
Chairman & CEO

Well, don't worry. We're not going to let that happen. I'm worried about that. I meet on that all the time. There's a balance in everything we do. Just like everybody is panicked when they saw interest rates heading down and worried about WAYS becoming unprofitable. I said, calm down, we'll have it fixed. And we have and got the thing -- we can't let it get too high either. You're absolutely right. Everything is about moderation, nothing in excess. And that's the way we look at this.

Robin Y. Wilkey
Former Senior Vice President of Investor & Rating Agency Relations

All right. Finally, I would like to remind everybody that we're going to be holding our Tokyo Analyst Meeting on Monday, September 10. And hopefully, we'll able to update you on many of the things that we discussed today. So please, make sure that you call us or register online if you would like to attend. Also, I want to thank you for joining us today. And if you'd like to follow up on any of the items, please feel free to call Tom or myself, and we'll be glad to follow up with anything. Thank you again, and we hope to see you in Tokyo on September 10.

Operator
Thank you for participating in the conference today. You may now disconnect.