S&P Capital IQ

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Aflac Incorporated NYSE:AFL

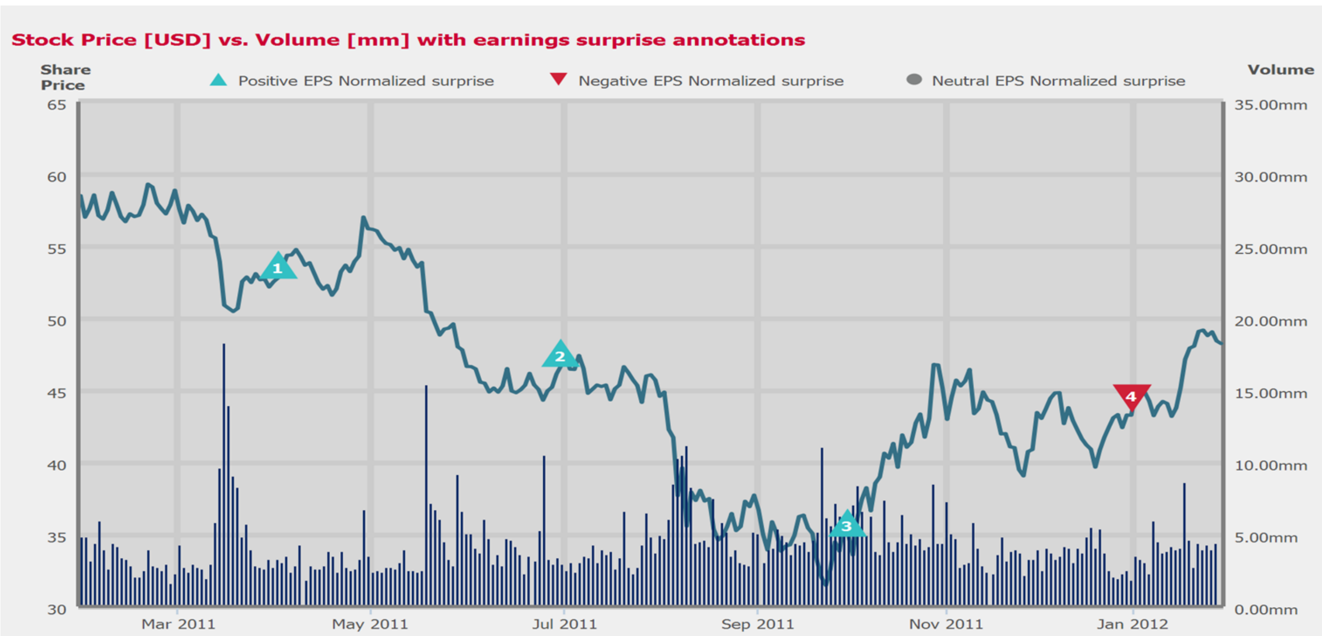
FQ1 2012 Earnings Call Transcripts

Wednesday, April 25, 2012 1:00 PM GMT

S&P Capital IQ Estimates

	-FQ1 2012-			-FQ2 2012-	-FY 2012-	-FY 2013-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.65	1.74	▲5.45	1.61	6.51	6.86
Revenue (mm)	6182.14	6240.00	▲0.94	6141.81	25112.00	26356.48

Currency: USD
Consensus as of Apr-25-2012 1:28 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ1 2011	1.51	1.63	▲7.95 %
FQ2 2011	1.54	1.56	▲1.30 %
FQ3 2011	1.60	1.66	▲3.75 %
FQ4 2011	1.51	1.48	▼(1.99 %)

Call Participants

EXECUTIVES

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Chairman & CEO

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Global Chief Investment Officer and Executive VP

Kriss Cloninger
President & Director

Paul Shelby Amos
Former Director

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Presentation

Operator

Welcome to the Aflac First Quarter Earnings Conference Call. [Operator Instructions] Please be advised, today's conference is being recorded. I would now like to turn the call 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

Good morning, and welcome to our first quarter conference call. Joining me this morning here in Columbus is Dan Amos, Chairman and CEO; Kriss Cloninger, President and CFO; 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 Paul Amos, President of Aflac and COO of U.S. Operations; and Toru Tonoike, President and COO of Aflac Japan, who's joining us from Tokyo.

Before we start, let me remind you that some statements in this teleconference are forward-looking within the meaning of federal securities laws. 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 discuss today. We encourage you to look at our quarterly report for some of the various risk factors that could materially impact our results. Now, I'll turn the program over to Dan, who will begin this morning with some comments about the quarter and our operations in Japan and the U.S. I'll follow up with a few highlights for the first quarter and then we'll be glad to take your questions. Dan?

Daniel P. Amos
Chairman & CEO

Good morning, and thank you for joining us today. I'm very pleased that we met and, in many cases, significantly exceeded our financial and operational targets for the first quarter. Let me begin with an update on Aflac Japan, our largest earnings contributor. Following an impressive 2011, we again, are pleased with Aflac Japan's financial performance with their tremendous sales momentum in the first quarter. New annualized premium sales rose 53.8% to JPY 52.4 billion for the quarter, which surpassed our expectations and set a production record for the third straight quarter. Revenues grew 7.8% and pretax earnings were up 3.2% for the quarter. Bank channel sales has been a huge factor in the tremendous sales growth over the last couple of years. We told you at the end of the year that we expected new annualized premium sales through the bank channels in the first quarter to be up more than 150%, and they were actually up 208% over the first quarter of 2011. As you will recall, our unique hybrid whole-life product, WAYS, has been a significant contributor to the bank channel growth. There are 3 principal reasons why selling WAYS has benefited our business. First, due to its much higher premium, it's a strong contributor to the top line growth. Although our margins are lower than our healthcare products, WAYS contributes to the bottom line. It's important to note that the profit margin on WAYS sold using the discounted advance premium method is 8% to 12%, and more than 90% of the consumers purchasing WAYS through banks select this payment method. But I'd point out that if we use the new money yields for WAYS' cash flows, are just 25 basis points higher, the profit margin range would be 13% to 17%. At our analyst meeting next month, we will give you some additional color on the margins and the returns on the WAYS product.

The second reason we sell WAYS is because this product gives us access to new customers. I'll point out that 80% of the customers at the banks are new to Aflac. Also, the average age on WAYS purchasers is 43, which is appealing to us because that age is in the segment of the market, which is 25 to 49, where we are under penetrated.

The third reason we're selling WAYS is because this product helps us solidify the relationships we've worked hard to establish with banks. Aflac has agreements with 372 of the 403 banks in Japan. We believe this number is significantly greater than any of our competitors. Our bank channel has significantly reach into Japan with more than 20,000 branches. Japanese consumers rely on banks not only to provide traditional bank services but also to provide insurance solutions among other services. As such, our partnership with the banks provide us with a very different demographic of potential customers than we otherwise have been to reach. And it also allowed the banks to expand their products and offerings to consumers.

Low interest rates in Japan has been challenging for many years and even more so compared to this time last year. But understand, we are currently in the process of evaluating the pricing of our entire product line using lower interest rates. I can tell you that we will definitely be working on repricing our ordinary life products over the next year. Keep in mind this takes some time because it involves an alignment of sales and promotional programs as well as system changes. We are also looking at different asset allocations that would generate better returns on the premium income generated from WAYS.

Following an extensive analysis of our WAYS products, we concluded that 5 pay [ph] version of WAYS that we started selling through the bank channels in June of 2011 would be more susceptible to intermediation at its paid-up date. Therefore, we took action to limit the production of this particular version of WAYS for both the bank channel and our traditional agencies. Thanks to the strong relationship we have with banks, we've been successful at reaching production caps agreements for the 5 pay WAYS [ph] production channel. I would note that there are significant surrender penalties for this product until the paid-up date. Taking an extreme case, if every 5 pay [ph] WAYS product cancel their policy to paid-up date, we would not have the liquid investment. Instead, we would fund the payouts from the investable cash flows, which significantly exceed our cash surrender values that would be claimed. And this type of scenario would only be likely if interest rates, or interest yields, on new investments are significantly higher than they are today. Obviously, the higher rates would benefit our investment returns on net new money that we would have to invest.

With respect to Aflac Japan's traditional sales channel, the tremendous sales results in 2009 and 2010 from the EVER products in the Maneki Neko Duck campaign created tough comparisons in 2011. As you will recall, our traditional sales channels produced flat sales last year. As I said last quarter, that I expected sales from the [indiscernible] channels to be up in 2012.

First quarter sales results for this channel actually increased 9.1%. So we're off to a good start. Keep in mind that the foundation of Aflac Japan's product portfolio has been, and will continue to be, the third sector cancer and medical products. Aflac Japan remains the #1 provider in the third sector market by continually to revise and developing products that are relevant to the consumers' needs. It's our objective to retain the #1 position. In the first quarter, our cancer sales were up 14.2%. We also upgraded the new EVER product toward the end of January, and initial results of this product revision is being well received by consumers. We believe sales of this product will benefit the medical category.

Finally, I'd like to point out that excluding production of the 5 WAYS pay [ph], sales would still be up roughly 25.9%. Based on Japan's strong first quarter, we now expect total annualized premium sales to be up 10% this year.

Now let me turn to the U.S. operation. It has been and continues to be our long-standing vision to be the leading provider of voluntary insurance in the United States, a position we've held for many years. Aflac U.S. generated a 4.5% increase in new annualized premium sales in the first quarter, which is right in line with our annual sales expectations of a 3% to 8% sales increase. Keep in mind the majority of our enrollments were in the fourth quarter. Aflac U.S. revenues rose 5.2% and pretax earnings were up 8.1% for the quarter. I would also note that first quarter of 2012, our persistency remained very strong.

We continue to expand Aflac's potential to connect with employees at more companies, large and small. And as you'll recall, our strategy for growth is to offer relevant products through expanded distribution channels to reach those employees.

While the U.S. economy has shown some signs of recovery, we believe smaller employers continue to find the environment challenging and we still remain somewhat cautious until we see greater gains in the employment trend. However, the 2009 addition of group products to our existing portfolio has allowed us to leverage Aflac's strong brand and to provide more options for customers of both our traditional and broker distribution channels. We will continue to sell through smaller businesses while also engaging in large case market, which is dominated by the large brokers.

At the beginning of this year, we launched an initiative to address the largest insurance brokers. We believe that Aflac's potential for growth in the larger case market is tremendous. Keep in mind, building relationships and trust with larger brokers takes time. It is a process, not an event. But I can tell you that we are making tremendous inroads. You'll hear more about this at the analyst meeting in May.

With both operating segments continuing to perform well, as I've said, investments in capital management are my top priorities as CEO. In that regard, I'm extremely pleased with our activities in the quarter.

Let me begin with investments. Our realized investment losses for the first quarter were $29 million. Let me take you back to our discussions at the end of the fourth quarter. You'll recall we identified a group of assets with larger risks to European countries with the intent to sell those assets. We impaired those assets to fair market value at the end of the fourth quarter. This strategy did not reflect the change in opinion on the credits of these assets, but rather well-defined plan to reduce our overall exposure to Europe, particularly in the financial sector. Our goal was to reduce our exposure to European financials by approximately JPY 150 billion by June 30. I am pleased to report to you that we have liquidated more than 85% of that target. I'm also very encouraged that we have substantially completed this program, and on top of that, the prices we received for these securities were generally better than the price that we had impaired them to at the end of the fourth quarter.

With respect to derisking, I'm very pleased that we made significant progress in enhancing the quality of our overall investment portfolio. Volatility in Europe lessened in the first quarter, but since the end of March, it's increased somewhat. Keep in mind we reduced our overall European exposure from $29.5 billion at the end of 2011 to $27.2 billion at the end of the first quarter. So potential impact to further European volatility on our investment portfolio is lower.

While we still view Europe as an area of investment risk, I believe our portfolio is better positioned to accommodate market volatility in the future. As always, we will closely monitor, evaluate and reevaluate our portfolio with an eye for credit issues that may emerge.

Let me remind you of how successful we've been in substantially enhancing our investment portfolio over the last few years. From January 2008 to the end of the first quarter of 2012, we've dramatically cut our holdings in sovereign and financial investments in the PIIGS countries from 5.9% to 2.1% of total investments in cash. We also lowered our investments in perpetual securities by more than half, going from 14.7% of total investments and cash to 5.5% or $5.5 billion. I'd also like to point out that none of the perpetual securities we currently own are in the PIIGS countries. As we pursue opportunistic investment transactions, we will continue to look for ways to reduce our exposure to European debt.

I'll also update you on a few other investment topics. As you'll recall, we engaged the services of McKinsey, a leading management consulting firm, to conduct a strategic and global review of our investment processes, people and system. McKinsey's analysis includes key recommendations relating to the creation of a global investment organization with complementary risk management, credit, asset allocation and outsourcing capabilities that enhance our ability to be a world-class investment organization. With the analysis complete, you'll hear more about this in May. But let me say I'm very pleased with our strategy to build and enrich the capabilities of our investment function, as is our Board of Directors.

Additionally, as we also discussed, we partnered with Goldman Sachs Asset Management to conduct a comprehensive strategic asset allocation project that accounts for Aflac's specific liabilities and capital requirements. We engaged this study to develop an investment program that will likely expand our investment opportunities beyond what our current programs afford us. We expect this analysis to be finished by the end of June and it will impact how we invest in different asset classes, including the implementation of outsourcing to third-party investment managers. Once we get the results, we will be able to share this with you in more detail. A global strategic asset allocation program that presents an opportunity for us to significantly improve the risk and return profile of our balance sheet.

We know that there are new investment opportunities that Aflac can take advantage of and we expect this project to help us with strategy going forward. We believe these efforts will improve benefits to the policy holders and shareholders in terms of higher quality of future investment earnings. The success of derisking activities included the receipt of deferred coupon that allowed us to accelerate the funding of this critical global initiative while still achieving our operating earnings per share objective this year. While it's too early to discuss our strategy in detail, Eric is on the call today and I'm sure he'll be happy to respond to your questions. What I can tell you is that we believe that by considering a broader set of asset classes and investment opportunities, we will improve the overall quality of the portfolio over the long term.

Now I'll turn to Aflac's consolidated financial performance. Operating earnings per diluted share rose 7.4% to $1.74 for the quarter, excluding the benefit from the stronger yen, operating earnings per diluted share rose 4.9% for the quarter. We also had a strong quarter with respect to our capital position. The strength of our capital ratios demonstrates our commitment to maintaining financial strength on behalf of our policyholders and bondholders as well as the shareholders. As we've communicated, over the past several years, maintaining a strong risk-based capital or RBC ratio remains a priority for us. Although we have not yet finalized our statutory financial statements, we estimate our RBC ratio was between 500 and 540 at the end of March, which is considerable increase from our year end of 493. As you know, our capital adequacy in Japan is particularly -- is principally measured by our solvency margin ratio. We also expect that Aflac Japan's solvency margin ratio improved significantly over year end 2011.

I believe we've done a good job at protecting our policyholders' interest while also being mindful of the shareholders. 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 our earnings per share before the impact of the yen. I believe dividends are an important component of the value we provide the investors. We will again evaluate a dividend increase as the year progresses, but I am confident we will extend our consecutive annual dividend increases to 30 years.

As we have indicated, given our capital structure, our ability to repurchase shares is largely tied to profit repatriation. We mentioned on our fourth quarter call, we estimated 2012 profit repatriation to be about JPY 25 billion, assuming no additional material investment losses through Aflac Japan's FSA fiscal year end. We still believe that's a reasonable estimate. We will make a decision about the amount of money we will transfer from Japan to the U.S. around mid-year. In thinking of that decision, we'll be taking into consideration the needs of our stakeholders in Japan, including our policyholders, but we will continue to be cautious about deploying that capital. If we do purchase any shares this year, it would be late in the fourth quarter. Keep in mind there are many factors involved in this decision and we'll closely monitor our options. Importantly, we don't need to repurchase shares to make our 2012 earnings. Furthermore, assuming we incur no material investment losses between now and mid-2013, we would expect to maintain a strong solvency margin ratio and significant capacity for profit repatriation and share repurchase. You'll recall, we previously shared that our 2012 operating earnings objective was 2% to 5% growth before currency. We expect the new accounting for DAC to lower earnings per share by approximately $0.05 this year. However, we believe we can cover that impact and still achieve our original target of $6.46 to $6.65 per diluted share before the currency. That means our range for this year increased actually to 3% to 6% over the restated 2011 numbers. We will give you details about 2013 outlook at the analyst meeting next month, as we do each year. But I can say that we still expect the rate of earnings growth in 2013 to improve over 2012. I am very excited about the opportunities ahead for Aflac. 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.

Now, I'll turn the program back over to Robin. Robin?

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

Thanks, Dan. Let me briefly go through some first quarter numbers, starting with Aflac Japan. In terms of the top line, revenues, were up 7.8% and investment income was up 8.7%, benefiting from the receipt of a previously deferred coupon payment that was received as the results of the derisking activities in the first quarter.

Our annualized persistency rate was strong at 94.5% compared with 94.3% in 2011. The benefit ratio to total premiums increased over last year, going from 69.7% to 71.5%, primarily caused by the growth of net benefit reserves for ordinary life's line of products. The expense ratio was 18.1%, down from 18.7% a year ago, primarily impacted by lower net commissions associated with the sale of life products. As a result, the higher benefit ratio, the pretax margin declined from 22.3% in the quarter to 21.3%.

Turning to Aflac U.S., total revenues rose 5.2% in the first quarter and the benefit ratio to total premiums increased slightly to 55.1% compared with 54.9% a year ago. The operating expense ratio decreased from 32.1% to 31.4% primarily due to lower advertising expenditures. Reflecting the decrease in the operating expense ratio, the profit margin for the quarter was 19.6% compared with 19.1% a year ago.

Turning to some other items in the quarter. As you probably read in the press release, on January 1, 2012 we adopted revised accounting guidance for DAC. The retrospective adoption resulted in an after-tax cumulative charge to retained earnings of $408 million or 3.9% of adjusted shareholders' equity as of December 31, 2010 and had an immaterial impact on net income in 2011 and the preceding years. The increase in interest expense was primarily impacted by the borrowings during 2011 and the first quarter in 2012. Due to those borrowings, it helped also increase Parent Company

[Audio Gap]

the end of fourth quarter, which was $942 million versus $385 million at the end of 2011. Parent Company and other expenses increased to $20 million compared to $14 million in the first quarter of 2011, primarily caused by several items, including foreign exchange losses on yen-denominated cash at the inc [ph] level and other general operating expense increases associated with personnel and special projects.

Total company operating margins decreased, reflecting the increase of the benefit ratio in Japan and caused by the increased sales of the ordinary life line of business.

On our operating basis, the tax rate remained relatively unchanged at 34.7% and net earnings per diluted share for the quarter were $1.68 compared to $0.83 in 2011. As reported, our operating earnings per diluted share rose 7.4% to $1.74. As previously mentioned, our operating earnings benefited by the $23 million or $0.05 per share from the onetime receipt of the previously written-off deferred coupon. The stronger yen increased operating earnings by $0.04 per diluted share, excluding the yen impact, operating earnings per share increased 4.9% for the quarter.

Lastly, let me comment on the earnings outlook for 2012. The new accounting for DAC will impact earnings per share by approximately $0.05. We expect to produce operating earnings of $6.46 to $6.65 per diluted share on a constant currency basis. This range represents an increase of 3% to 6% over 2011. If the yen averages 80 to 85 for the full year, we would expect operating EPS to be in the area of $6.21 to $6.64 per diluted share. And for the second quarter, if the yen averages 80 to 85, we would expect operating earnings to be $1.53 to $1.59 per diluted share.

I want to take this opportunity to remind all of you that our annual analyst meeting will be held in New York on May 15 and 16. There, we'll be able to provide you with further updates on our operations in both U.S. and Japan, along with our outlook for the coming year. Please register to attend.
Now to be fair to everybody, we're going to start Q&A, but limit yourself to only one question and a follow-up related to that one question. Now, we'll be glad to take your questions.

Question and Answer

Operator

[Operator Instructions] Our first question today comes from Randy Binner with FBR.

Randolph Binner
FBR Capital Markets & Co., Research Division

Great. Just wanted to clarify a piece of the more positive commentary on '13 EPS. I guess our assumption would be that there'll be buyback in there. And so, can you confirm that JPY 45 billion would still be the target for repatriation in 2013?

Daniel P. Amos
Chairman & CEO

Actually, the repatriation number for 2013, we cited was -- we previously said, I think, close to JPY 95 billion, and now our best estimate is about JPY 90 billion. So that amount would be available for transfer from Aflac Japan to Aflac U.S. and presumably, a portion of that would be available for share repurchase or other capital management activities, including funding of shareholder dividend.

Randolph Binner
FBR Capital Markets & Co., Research Division

Okay. And then the related follow-up to that is that I guess the way we heard it, the active derisking program is over. And so is that a correct conclusion, meaning that we probably wouldn't expect as much proactive credit losses working against that JPY 90 billion going forward?

Kriss Cloninger
President & Director

Let me just say we'll ask Eric Berg to -- Kirsch, Berg, Berg on my mind, okay. I apologize for that. But we'll ask Eric to respond to that.

Eric M. Kirsch
Global Chief Investment Officer and Executive VP

Thank you, Kriss. In terms of a targeted active derisking program, we are primarily complete. As Dan said, we have gone a little over JPY 130 billion, our target is JPY 150 billion so we still have a little bit more to go with respect to that program. Beyond that, there isn't any specific targeted program. But let me remind everybody, of course, Europe continues to have volatility with respect to the political and the monetary situation. And we of course continue to have holdings there. So we will be vigilant on our analysis both from a macro standpoint as well as from a credit standpoint. But at this juncture, we don't see a reason to have an active program. So you could see us take tactical actions as might be appropriate, but no large targeted program other than the completion of what we've got going, which is well over 80% complete.

Operator

Our next question comes from Jimmy Bhullar with JPMorgan.

Jamminder Singh Bhullar
JP Morgan Chase & Co, Research Division

I had a question for Eric as well. At first, on the new money yield, it continues to drop, I think it was 203 basis points in the first quarter, almost 100 basis points lower than last year. So can you discuss where you're allocating new money and what the investment environment's like? It seems like it's still challenging. And then related to rates, Dan, you mentioned you're expecting to reprice some of your products over the next year or so. How do you expect that to affect your sales? And are you assuming that other competitors will follow suit when you raise prices as well?

Eric M. Kirsch
Global Chief Investment Officer and Executive VP

So, I'll handle the first part of that question before handing it over to Dan, with respect to where we're investing new money. In the short term, meaning since I've joined in November, I am currently operating under our existing global investment policies and guidelines. Between the McKinsey project and the GSAM project, we will expect to see very positive changes, all of those that allow us to take advantage of new and different opportunities for Aflac. But in the meantime, relative to our investment universe, we're investing approximately 70% to 80% of our new money, in JGBs somewhere around 20% plus or minus, in private placements primarily out of Asia. As you all recollect, we stopped investing in Europe given our macro exposures shortly after I joined. So those opportunities are resulting in a yield of about 2% plus or minus. And my expectation is, for the foreseeable future, at least interest rates in Japan, our base currency for the Japan business segment, aren't going to change all that much. They might go up or down a few basis points. And I don't necessarily expect the allocation in the short term between JGBs and privates, and I should add, we have increased our allocation to bank loans, and we'll continue to fund that through the end of the second quarter, to materially change. However, a broader question, which I'll just touch on briefly, we do expect the results of our GSAM study to be complete June and that will allow us to amend our global investment policies with the continued buildout of people and infrastructure from the McKinsey project, we'll be able to add resources. I would expect later this year, most likely in the fourth quarter, where you'll see us actually investing in different things than we have historically because we'll have everything ready for that. I also want to mention that with respect to new dollar money yields, our target is 3.25% and we're well exceeding that, we're at a number over 4% with respect to new investments in the U.S.

Daniel P. Amos
Chairman & CEO

And in regard to the repricing, let me just say first of all, we're not pleased with interest rates where they are, which is no shock to any of you. And we are adjusting to this lower interest rate environment. This goes back to, I can remember in the '80s, I had a situation where we were selling single premium dementia. The difference was is that all of a sudden interest rates dropped so much, I had to cold turkey just stop everything. In the case of what's going on with WAYS and the interest rate environment, we are not in that position. It's not -- the interest rate is not where we want it to be, but it's still a profitable situation for us. Saying that, we are adjusting quotas and trying to get less production. We are in the process of looking at repricing. I can't speak for other companies, but what I can say is, is in the past, it's been more of a herd mentality than an individual company. Everyone seems to go at the same time because all of us are impacted in the same way. So I would think that when we go back, that you'll find others, but I can't speak for other companies, and what will take place. We had such a downward spiral so quickly, we're moving as fast as we can to reposition and do that. But it just is a little slower than we ever like for it to be. The good news is, is later on if it spikes back up, it's slower also on the other side. So in the meantime, we are working toward that, Jimmy, and I can't give you specifics on what the interest rate assumption will be, but it will be in line to where our profit margin is back to where it used to be, is what we're working toward.

Operator

Our next question comes from Ed Spehar with Bank of America Merrill Lynch.

Edward A. Spehar
BofA Merrill Lynch, Research Division

Dan, the question I have is, is it fair to say that you would not be pleased with the sales momentum of WAYS if you anticipated no change in new money yields in the second half of the year?

Daniel P. Amos
Chairman & CEO

Well, what I think I would say is, is that the 5 pay [ph], we definitely do not want and are working toward, although it is profitable because of the disintermediation, we would prefer not having it. So we're moving away from that. The thing I want is the bank channel. I think it offers great opportunity for us. Our products are more profitable than the life insurance products that we would compete with. So we have an advantage over the competitors in that respect, that we hold that market. In the meantime, I want to see the others. So am I -- do I like the interest rate environment we have right now in the yield? No. Do I think it's better to have it than not have it? Yes. I think it's better and I think -- and Kriss will go over in much detail, but as I said in my little talk, it's 8% to 12% profit margin. And although I wish it was 13% to 17% at 2.25%, I'm still glad to get it. But I'd rather write -- let me be clear, I'd rather write medical insurance than I had WAYS or life insurance products. But that's not an option. It's not that you replace one with the other. If our existing distribution channel was changing to where they were stopping the sale of one and changing to the other, that would be very alarming and something we would have to stop immediately. But this is a new channel that is brought on with a profit margin of 8% to 12%. And although I like the higher profit margin last year, I still like getting 8% to 12%, but I wish it was much better.

Edward A. Spehar
BofA Merrill Lynch, Research Division

All right. Dan, I guess the follow-up is that you said a couple times about how it's still profitable. I think you just mentioned that it's a better return than the life competitor products that are in the channel. I guess though that that's a very -- that could imply a very different marginal return for the company that's historically had a 25% ROE. So I guess, I'm hoping that, either now or certainly at Investor Day, that we can get into sort of very specifically, what type of marginal returns we're thinking about for this business because there's a long way between a profitable product and a 25% ROE.

Daniel P. Amos
Chairman & CEO

Well, what I would say to that, and I'll have Kriss respond is, we want our profitable product of our medical to stay in that range and that's ultimately our objective. But our objective is to try to find a way to expand that medical product. And one way to expand that medical product is to bring on new customers. And the way you bring on new customers can be many ways. We can spend money on advertising to do it or we can offer a WAYS product that brings on new people. But ultimately, I want to get more people on the books to where I can add medical and other products in the future that will be in line with the profit margins that we like to attain. Kriss, you want to make any comment?

Kriss Cloninger
President & Director

Yes, Ed, I promised you all to give you more information on the split between health and life. And I'll do that in detail at the FAB and give you some indication on margins there. But today, let me just give you a few brief observations that we've got. Today, roughly 75% of our profits are coming out of health products and 25% out of other products. And we don't expect that mix to change a lot between now and the next 2 or 3 years, even though we're writing a lot of WAYS. We have been writing some other nonhealth products and the like and WAYS has taken place of that some and WAYS is actually somewhat more profitable than those other nonhealth products that we had, like annuity and dementia and the like. So the margins on the life products as a percent of premium are going to be, going forward, about the same as they are today to slightly less. I'm looking at numbers as a percent of premium like 14% margin this year, 12% last year. I think we're going to maintain that 12% to 14% on the life products for the next 3 years. And I think the health products will continue to have a margin in the neighborhood of 24% of premium going forward and that'll be 75% of our profits 3 years from now. So we're not going to see a major, major decline in overall profitability. I'll just leave it there for right now, Ed.

Operator

Our next question comes from Eric Berg with RBC Capital Markets.

Eric Noel Berg
RBC Capital Markets, LLC, Research Division

First things first. How about I ask questions about the...

Daniel P. Amos
Chairman & CEO

[indiscernible] on investments for us, Eric?

Eric Noel Berg
RBC Capital Markets, LLC, Research Division

No, no, no. I was going to say how about I -- I was going to start by saying how about I ask the questions about your investment portfolio, and I will leave to your new Chief Investment Officer, who is an excellent choice, the business of answering the questions, how does that sound?

Daniel P. Amos
Chairman & CEO

You're on my mind, Eric. That's all.

Eric Noel Berg
RBC Capital Markets, LLC, Research Division

I appreciate it very much. All joking aside, I actually have just one question only about this disintermediation that you've been referencing several times. My question is this, one, to what extent is it already going on? And, two, why is it going on in the sense that historically, Aflac's products have not had much cash surrender value? At least, that's what [indiscernible] historically or most of the history of the company. So presumably, there couldn't be much -- I'm trying to get a sense for the incentive of the surrender charges. Surrender charges are only powerful -- only have a powerful incentive if there's a lot of cash value in there. So it's sort of a two-part related question, to what extent is the disintermediation going on and to what extent will these surrender charges really make a difference given the historical low cash surrender value of your products?

Daniel P. Amos
Chairman & CEO

Eric, I'll handle that. Disintermediation is not going on at the moment. It's something that we've started examining internally as a potential issue. I mean, anytime you sell a product that has high cash value, which 5 pay [ph] WAYS does at the end of the premium period, relative to where it's going to be, you have to worry about -- if you get a spike in interest rates, is that going to be hot money to the policyholders? Are they going to take the money that they invested in a product priced at 1.85% and move it to a product priced at some higher interest rate, assuming interest rates move up? So we've been sensitive to that, but we have not observed it so far. What we've concluded is that if interest rates did spike, say from the 2% zone to the 3% zone, and you did get policyholder behavior to try to replace the old product with a newer product, what would be the impact on our net cash flow. And we've looked at it and if 100% of the people surrendered their products, it'd be a fairly low percent of our net cash flow that we would have to pay out as surrender values, we would not have to liquidate any existing investments and incur capital losses. Obviously, we would forgo investment income on those proceeds but we would have the benefit of the higher investment yields on the remainder of the new money. And so we think that on balance, that we're pretty good in that regard. At present, though, we are taking steps to limit the production of 5 pay [ph] WAYS just to be defensive for the future. Just a little insight in the product design, our current product has a surrender charge of about 30% of the ultimate value at the end of 5 years when the policy becomes paid up. And it's only when the policy becomes paid up that the cash value's 100% of the reserve. So you and I both know, from having lived through the annuity stuff in the '80s in the U.S, not nearly 100% of consumers surrender policies even if we've got higher interest rates in the environment. So I don't think it's going to be that extreme if interest rates spike. And I, to tell you the truth, I'd almost prefer that they spike to some extent. That's all.

Eric Noel Berg
RBC Capital Markets, LLC, Research Division

I would think that with a [indiscernible] people would want to cash in their contracts.

Daniel P. Amos
Chairman & CEO

You broke up a little bit, Eric. Tell me again.

Eric Noel Berg
RBC Capital Markets, LLC, Research Division

I was saying that with the 30% haircut, I would think that very few people would want to cash in their contracts.

Daniel P. Amos
Chairman & CEO

Well, that's what I'm saying. That's not going on today. We don't have any disintermediation occurring at the moment. We're just looking down the road, 5 years from now, on contracts we're writing today, what's our exposure to that. We're going to be sure that as part of our investment strategy, if we can work that in as an exposure, we want to try to integrate that into our strategy, even though, I don't think it's that big a deal at the moment.

Operator

Our next question comes from Nigel Dally with Morgan Stanley.

Nigel Phillip Dally
Morgan Stanley, Research Division

Great. Just on the 5 pay [ph] WAYS, where you're limiting sales. Can you clarify just how large a portion of your total WAYS sales that represents? Are there any other products where you're also looking at putting in caps? And was the margin on that product meaningfully different to your other WAYS products?

Daniel P. Amos
Chairman & CEO

Nigel, I don't know if I caught all of that but let me address the margin portion of it. With regard to the 5 pay [ph] WAYS, clearly the margin is lowest when a policyholder surrenders at the end of the paid-up period or 5-year premium period. We don't get to hold the funds. We don't earn any more spread. We go ahead and have to pay out. So that's the lowest margin. But the policyholder does have the option to continue it under the life option. And the life option is kind of the medium version of profitability and that's the one we primarily focus on when we're quoting profit margins. They also have the option to convert to medical insurance at a specified age and we believe that the policies that do convert to medical will have more medical-like profitability going forward after that election date. The medical coverage would be obtainable at rates in effect at the date of the election but without regard to evidence of insurability. So that's the case. And then the other products are primarily designed to be paid up at a retirement age that the policyholder chooses, like 60, 65 and the like. So some of those are bought by people in their 50s and they're relatively shorter pay, too. But it's primarily the 5 pay [ph] that we thought we had some exposure on and we're trying to make sure we recognize the risk and built it into our planning.

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

Nigel, to give you a flavor for the impact of WAYS on our in-force, only about 2% of our in-force policy are WAYS. And of the WAYS sales this quarter, somewhere between 40% and 50% was the 5 pay [ph]. But remember what Dan said, we only started selling 5 pay [ph] during mid year last year.

Operator

Our next question comes from John Nadel with Sterne Agee.

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

Since you're sort of giving us a couple of, I guess peeks into more of the detail that you'll provide to us next month at the FAB meeting, I was hoping you could give us a peek at what you believe the return on equity is, or the differential in return on equity is for WAYS, let's say, versus your more traditional medical or cancer products.

Daniel P. Amos
Chairman & CEO

Okay, John. I'll start that discussion. At a 2.5% yield rate, which is where we were at the beginning of 2011, we estimated that our ROE used in the statutory type investment target, our ROE would be about 20%. 20%, 21% on WAYS at the 2.5% investment yield. Now the required capital doesn't go down and it doesn't go up much with the change in the interest rate. So to the extent that the return goes down, the ROE's going to go down. So instead of a 21% return or 20%, you get closer to 10% at 2%. So that's kind of the overall flavor of that. Now you can say well, 10% ROE, does that exceed the cost of capital and then you have to start discussing, well, what kind of capital do you require to support that? And typically, we've thought of our yen-denominated Japanese products as requiring a lower cost to capital than U.S.-based production. And that could be the subject of discussion. But that's the concept, as equity, the invested equity doesn't change much, the return's lower, so the return on equity is lower.

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

And then just as a follow-up, that's very helpful. Just as a follow-up, I think Robin, in response to Nigel's question, mentioned that only about 2% of in-force policies today are WAYS. Is that 2% of the actual policy count or is that 2% of your in-force premium?

Kriss Cloninger
President & Director

That's policies and about 8% of the in-force premium today is WAYS.

Operator

Our next question comes from Steven Schwartz with Raymond James & Associates.

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

Just as a comment, I guess the most important question would be at 2% to wherever you reprice WAYS. The question is whether the capital would be better used for share repurchase? That's just my 2 cents. But on that topic of capital in Japan, RGA's recent investor day, your former CFO of the Japanese operations, Allan O'Bryant, was talking about activity in Japan surrounding foreign companies doing reserve securitization. And apparently, the FSA accounting for life products is even much more conservative than you, than the statutory requirements used here. I was wondering if you guys can comment on that and were possibly looking at such a transaction?

Kriss Cloninger
President & Director

All right, Steven, I'll handle that. You are correct in that the FSA accounting and reserving standards are more conservative than both U.S. statutory standards and U.S. GAAP standards. So the surplus strain of the -- is significantly larger on an FSA basis than it is on a U.S. statutory basis and we're going to give you some more detail on that, again, at the FAB meeting. I will say that not necessarily because of that directly, but because of our interest in demonstrating our ability to take steps to protect our solvency margin in Japan, we did choose to enter a reinsurance agreement at the end of fiscal -- March 31, 2012, for FSA reporting and we did choose to enter what essentially is a surplus relief financing reinsurance arrangement with a company to reinsure the new business production or a portion of the new business production for our major health products. We realized a ceding [ph] commission that would be recognized as income on an FSA basis and go to surplus on an FSA basis of about JPY 19 billion. And that essentially is a financing transaction, Steve. And it's not recognized as risk sharing reinsurance for either U.S.

statutory or U.S. GAAP and therefore it's ignored on those bases. But the FSA does recognize that as reinsurance arrangement for FSA reporting purposes. And we did it not because we needed the surplus relief this year, but we did it partly to demonstrate that we could do it and that we had the mechanics in place in the event that we ever felt like we needed it. And it would constitute a buffer to the solvency margin ratio in the event of a significant increase in interest rates that would cause our available-for-sale assets to be carried into somewhat lower value on the balance sheet than they are today.

Daniel P. Amos
Chairman & CEO

I want to make -- go ahead, you all finish that and I got one other comment on that ...

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

Well, I was going to say, I was kind of interested if there was anything or if you were looking at anything on the life side as opposed to the health side?

Kriss Cloninger
President & Director

[indiscernible] I mean, the health side is still a substantial amount of our new business and the profit patterns on the health business are -- they've been there for years and years and years. It was easier for the reinsurer to get comfortable with that quickly than it was on the new life products.

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

Okay. Fair enough.

Daniel P. Amos
Chairman & CEO

Steven, I want to make one comment, when you said about the 2%. The only comment I want to make is I want to be clear, we're not satisfied with the 2%. That's the reason we're going to be filing for lower interest rate assumptions. We agree that, that's not where we want to be and either a, the rates have got to move back up. But in the meantime if they don't, then we're filing for lower. And then in addition to that, we're hoping that Eric and his team will find things other than JGBs to be buying that will give us higher investment yields that will help offset that, too. So let's just -- I just want to be very clear that we're not at all happy at 2% but -- and we'll be looking for ways to enhance that, the profit margin, going forward.

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

No, I understand that, Dan. My point simply was, is that, that all in, that -- where you're priced at all in, I think the key is that you can do better than buying back your stock at 6x earnings.

Daniel P. Amos
Chairman & CEO

Right. I got it.

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

Thank you. We're almost at the top of the hour so we've got time for one more question.

Operator

Our final question comes from Joanne Smith with Scotia Capital.

Joanne Arnold Smith
Scotiabank Global Banking and Markets, Research Division

Yes, I just wanted to follow up on the repricing question. Do you require FSA approval to change the pricing on the WAYS product? And I guess, I'm a little surprised that with the interest rates where they are in Japan, that the FSA hasn't imposed pricing increases as they had in the past.

Kriss Cloninger
President & Director

I'll give you a little color on that, Joanne. The FSA reviews the pricing activity for all the large companies. They do permit us to price within a range of interest rates and the like. And the reference interest rate is generally referred to as the standard interest rate. The standard interest rate has been 1.5% since, I think it was 2001, maybe 2002. But the standard interest rate is determined based on an average of 10-year JGB auctions, recent auctions. And there's a mechanical formula that dictates when the standard interest rate gets changed. And I think we're approaching the point where if the 10-year JGB stays at less than 1% for a number of months, then it's possible that the standard interest rate would be decreased to 1%. And that would be effective for reserving all new business written in Japan and that would tend to incentivize companies to change rates so that they could avoid excess reserves associated with policies priced at interest rates in excess of the standard valuation interest rate. So that's what Dan referred to, as everybody will probably move at once. And that's probably what we would react to. We do have some pricing flexibility, with respect to other portions of our products, such as the interest rate used in the discounted advance premium fund and the like that we have some more discretion with respect to and we're evaluating. Obviously, we can't speak for the FSA, I'm just giving you color as to what my understanding of the general situation is. But I know that we consult with the FSA when we're going to reprice products.

Joanne Arnold Smith
Scotiabank Global Banking and Markets, Research Division

Okay. And I just want to ask one unrelated question to this, really for Paul. The recruiting in the first quarter in the U.S. was pretty weak. Can you just comment on that?

Paul Shelby Amos
Former Director

Recruiting in the U.S. was up 0.6%. We still had a larger quarter than we did any of the 4 quarters in 2011. I feel comfortable with the number of recruits that we had in Q1. Obviously, we're looking to lever that number up over the longer term. But to be honest with you, Joanne, I think that our career channel is focused on a balance between growing our new agents as well as the strong success that we've had out of our veteran agents and then really, the growth side of the U.S. continues to be the broker market. And so I'm less concerned about the recruiting numbers at this time. And I think there are strong reasons for continued growth going forward.

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

Okay. Thanks very much. If you'd like to follow-up with any questions, my colleague Tom McDaniel and I will be here, so please e-mail us or call us and we'll be glad to follow-up on anything. Thank you and we look forward to seeing you at the analyst meeting in May.

Operator
This concludes today's conference. You may disconnect at this time.