S&P Capital IQ

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Aflac Incorporated NYSE:AFL

FQ3 2014 Earnings Call Transcripts

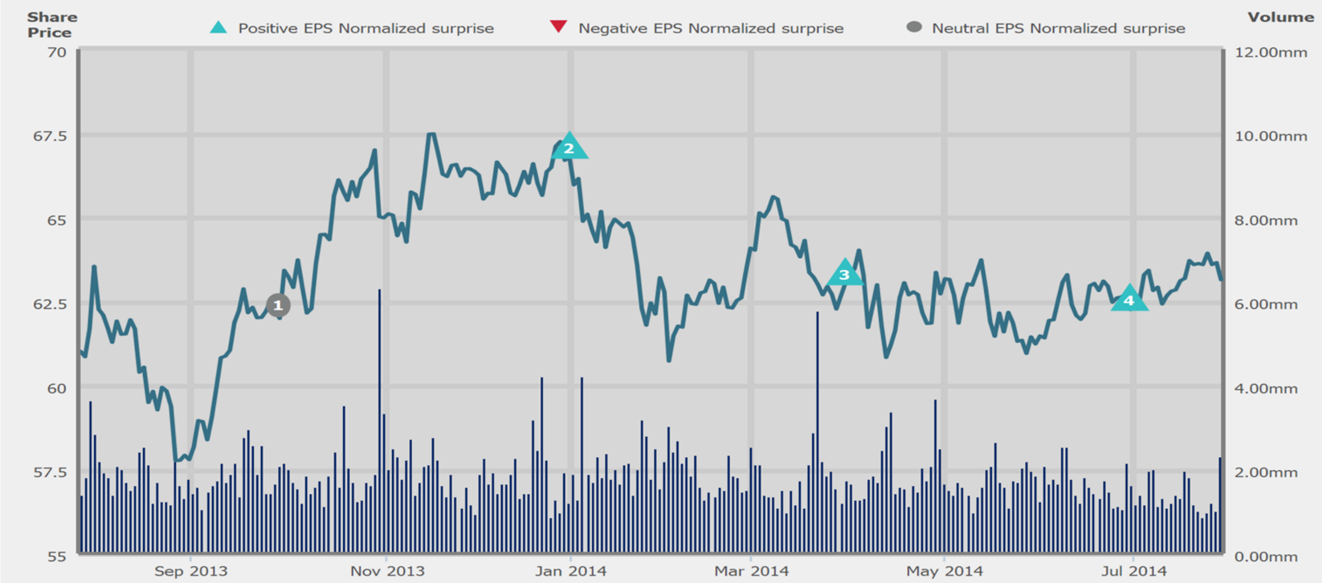
Wednesday, October 29, 2014 1:00 PM GMT

S&P Capital IQ Estimates

	-FQ3 2014-			-FQ4 2014-	-FY 2014-	-FY 2015-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	1.43	1.51	▲5.59	1.34	6.19	6.31
Revenue (mm)	5709.68	5736.00	▲0.46	5586.99	22728.47	22503.92

Currency: USD

Consensus as of Oct-29-2014 12:03 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2013	1.47	1.47	(1) 0.00 %
FQ4 2013	1.39	1.40	▲(2) 0.72 %
FQ1 2014	1.59	1.69	▲(3) 6.29 %
FQ2 2014	1.59	1.66	▲(4) 4.40 %

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

Paul Shelby Amos
Former Director

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

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President of Aflac US

Tohru Tonoike
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Seth M. Weiss
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Steven David Schwartz
Raymond James & Associates, Inc., Research Division

Yaron Joseph Kinar
Deutsche Bank AG, Research Division

Presentation

Operator

Welcome to the Aflac Third 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. Ms. Wilkey, you may begin.

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

Thank you, and good morning. Welcome to our third quarter call. Joining us this morning is Dan Amos, Chairman and CEO; Kriss Cloninger, President and CFO; Ken Janke, Executive Vice President and Deputy CFO of Aflac Incorporated; Teresa White, President of Aflac U.S.; Eric Kirsch, Executive Vice President and Global Chief Investment Officer. Also joining us today from Tokyo are Paul Amos, President of Aflac; and Toru Tonoike, President and COO of Aflac Japan.

And before we start, let me remind you that some statements in the teleconference are forward looking within the meaning of federal securities laws. Although we believe these statements are reasonable, we can give no assurance they will prove to be accurate because they're prospective in nature. Actual results could differ materially from those we discuss today. We encourage you to look at our quarterly release 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 brief comments about the quarter and our operations in Japan and U.S. And then Ken will provide further details about our activities in the quarter and our EPS guidance. Dan?

Daniel P. Amos
Chairman & CEO

Thank you, Robin. Good morning, and thank you for joining us. Let me start about by saying I'm very pleased with Aflac's financial performance for the third quarter and for the first 9 months of the year. I'm even more pleased that our financial strength is allowing us to deploy more capital to our shareholders. We met and, in many cases, exceeded our financial targets for the third quarter. Notably, with 9 months under the belt, we are well positioned to increase of operating earnings per share about 3% to 4% for the year before the effect of currency. At the same time, we continue to anticipate operating return on equity will be strong and exceed 20% excluding currency.

Now I'd like to comment on our operations, starting with Aflac Japan, our largest earnings contributor. Although third sector sales were down in the quarter, we like the initial results we've seen so far in October, which are up 20%. As we previously communicated, we anticipated third sector sales for the full year will come in at the low level of the expectations of 2% to 7% increase. While fourth quarter comparisons will be challenging, we continue to enhance our distribution opportunities on offer in Japan, which I believe will benefit our sales.

On the distribution side, I'm very happy with the expansion of Aflac Japan's alliance with Japan Post. This strategic partnership brings together Japan Post the largest nationwide distribution network in Japan with Aflac Japan, the industry leader in cancer insurance. As many of you heard at the Analyst Meeting in Tokyo last month, Taizou Nishimuro, President and CEO of Japan Post Holdings announced expansion of the postal outlet selling our cancer products. Effective October 1, we will move from 3,000 to 10,000 postal outlets. We also talked about their plans to increase the number of post office selling Aflac cancer products 20,000 by the end of 2015. I think both Aflac Japan and Japan Post can enhance their synergies by working together to provide cancer products to large group of consumers, who regularly turn to the postal outlets to help their insurance needs.

Turning to products, as the pioneer of cancer insurance in Japan, I'm excited about our 2 newest cancer policy offerings. On October 1, Aflac Japan introduced the cancer product for the sale exclusively for Japan Post in Kampo. This new cancer product was designed to provide essential cancer-related benefit. It also complements the insurance coverage that is available to our products that Japan Post already offers.

On September 22, we introduced another new cancer insurance product available for sale through all of our distribution channels. This new cancer product provides an intense coverage, including additional outpatient benefits and treatments, multiple cancer occurrence benefits, while offering better pricing at many age groups.

Turning to Aflac U.S., I'm very excited about the changes that we've made in our management infrastructure. You recall that following a thorough evaluation of the market and our business model, we told you that we were going to be laser-focused on implementing a number of tactical initiatives designed to improve U.S. sales, and that's exactly what we've been working on. These initiatives, which were effective October 1, are primarily geared to our sales force. They center around competitive compensation that more closely tied to corporate goals and better performance management capabilities.

We had expected short-term disruption in the third quarter as a result of these changes, but things went very smoothly and Aflac U.S. sales were relatively flat in the quarter, just down 0.6%. These new sales initiatives have generated excitement, both at the career channel side and the broker side. Although it can tend to take a period of time for the sales results to follow the initiatives, I can already see that we're making progress and this tells me that we're on the right path.

Last quarter, you'll remember we thought sales for the latter half of the year would be down 4% to down 8%. However, with sales in the third quarter essentially being flat, we now believe sales for the second half of the year will be positive, which means sales for the full year will likely be in the range of down 2% to 4%. While I'm not happy with the prospect of sales being down for the full year, I believe we're heading in the right direction, and I expect to see an increase in the fourth quarter sales. We're also working on ways to extend our sales momentum in 2015.

Let me just say that I feel better about the opportunities in the U.S. and Japan, and our ability to effectively execute on our sales strategies over the next year. I also understand the importance of returning capital to our shareholders. While Ken will provide you more details, I want to you to know that I'm pleased with the action of the Board of Directors to increase the quarterly cash dividend by 5.4% effective with the fourth quarter of 2014. This marks the 32nd consecutive year of increasing our cash dividend.

I also believe we've listened to our owners and understand the importance of growing our cash dividend and our share repurchase amounts. Our capital strength has given us the confidence to increase our 2014 share repurchase objective from JPY 1 billion to JPY 1.2 billion of our common stock. Additionally, it is our current plan to repurchase JPY 1.3 billion of common stock in 2015. Let me leave you with this thought, you've already heard me say that my job is a balance of interest of all stakeholders. I think we did a good job for that this year, just as we have in the past. And I believe we're going to do it again next year by delivering on our promises to our policyholders and returning significant capital to our owners.

Now I'll turn the program over to Ken. Ken?

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

Thank you, Dan, and good morning, everybody. I'd like to give you a little more background into our forecast and the assumptions we have used to set our 2015 earnings objective. But first, let me begin with just a brief recap of 2014 and how that relates to the initial guidance that we set for this year.

You may recall that a year ago, we established the 2014 objective of increasing operating earnings per diluted share by 2% to 5% on a currency-neutral basis. At that time, we identified several headwinds that influenced the establishment of our earnings guidance. Frankly, based on those headwinds and other forecasting assumptions, which tend to be conservative, we would have not been surprised if this year's full year earnings would have been towards the lower end of the 2% to 5% range. However, as the year progressed, some favorable trends emerged. Our benefit ratios in Japan and the United States have been better than expected. And in addition, our consolidated operating tax rate has been lower than we initially projected. As a result of those favorable developments, we narrowed our earnings objective in July. Based on the financial performance for the first half of the year, we no longer felt the low end of the range was a reasonable expectation. However, we anticipated that benefit ratios would be higher in the second half of this year for both the U.S. and in Japan, and we also expected expenses to be higher for the last 6 months of the year, particularly in the fourth quarter. As a result, we reset the full year earnings objective to 3% to 4% in July. Although operating earnings per diluted share, excluding currency, have increased 5.4% for the first 9 months. We continue to believe that 3% to 4% is a likely outcome for 2014. The reason is that we still expect to see higher benefit ratios in the fourth quarter and expenses will be higher as well. That's especially the case in the United States as we begin to absorb the cost of the change that we made to the U.S. Market Director position.

As we indicated in our press release last night, we have established an objective for 2015 of increasing operating earnings per diluted share, 2% to 7% on a currency-neutral basis. I would first note that our earnings objective is predicated on 2014 earnings per share, increasing 3% to 4% for currency. Because we expressed our objective as growth rate, our guidance is influenced by the rate at which we grow earnings in 2014. In short, faster growth this year, somewhat challenges growth rates in the following year.

For our 2 reporting segments, we continue to anticipate the type of operating stability that you've come to expect from our business. In Aflac Japan, we currently expect to see operating ratios that are consistent with the 3-year average ratios that Kriss presented to you in May.

With first sector business accounting for a higher percentage of in-force premiums in 2015, we expect to see a higher benefit ratio next year compared with this year. However, it will still be in the 62% to 64% range we previously provided. We expect the operating expense ratio to be fairly stable to a bit lower next year. As a result, we expect the margin for Aflac Japan to be somewhat lower than it is this year, but again, well within the stated range of our expectations.

For Aflac U.S., we also expect to see operating ratios in 2015 that reflect the stable and predictable nature of our business. We are assuming that the benefit ratio will be higher next year than our full year projection for 2014. However, even with an increase in the ratio, we still expect it to be at the low end of 50% to 52% range we communicated in May. We expect the expense ratio on the other hand to be above our estimated range for next year. As we discussed in July, we made significant changes to the structure of our sales force and those changes impact our expenses. I would note that we are maintaining very good budget discipline in the U.S. segment and if not for the field force changes, our expense ratio would be at the low end of the range next year. We currently anticipate that the U.S. pretax profit margin will be towards the middle of the range we provided in May.

I'd point out that while we have a very large block of stable and predictable business, we clearly don't have a crystal ball. And there are many assumptions we need to make when setting an earnings objective. It's always been our practice to use realistic yet conservative assumptions. And given the conservative assumptions I just reviewed, I think the starting point for next year is to assume that operating earnings per share may grow towards the lower end of the 2% to 7% range excluding currency. However, just like 2014 and years passed, it's certainly possible that we could see our earnings emerge more favorably as the year progresses. For instance, benefit ratios may not rise as much as we're currently assuming.

Clearly, the ongoing challenge we face for the last couple of years has been generating better revenue growth through new sales in both markets as well as dealing with the low interest rate environment. As you heard from Dan, we believe the activities we undertake in both segments will help produce better sales in the future. But improving sales is a process, it's not an event and the results from these activities don't happen overnight. Additionally, as you likely know, it takes time for sales to be reflected and earn premium in earnings. But in the meantime, I do want to emphasize that the underlying nature of our business remains very silent, stable and profitable.

Next, I'd like to briefly comment on our sensitivity to the yen/dollar exchange rate. Although Aflac Japan makes up about 75% of our consolidated insurance earnings, about 50% of our total company earnings come from dollar sources. As we've done in the past when we released fourth quarter earnings, we will provide you with our expected currency sensitivities to per share earnings for 2015. In the meantime, we do believe our earnings will be a bit less sensitive to the weaker yen next year than they have been in the past. I think it's also noteworthy that our consolidated GAAP equity is not significantly exposed to foreign currency risk. For instance, although the yen weakened 7.4% from the end of June to the end of September, our consolidated GAAP equity, excluding unrealized investment gains, declined only 1.1%. One of our key objectives is to insulate shareholders' equity from currency fluctuations.

Finally, we are very pleased that our balance sheet remains strong and that our capital ratios exceed our minimum targets. You'll recall from our comments at our Analyst Meeting in May and in September, that we expect the profit repatriation to be in the range of JPY 110 billion to JPY 150 billion for 2015.

Based on our current forecast of FSA financials and the solvency margin ratio, as well as our most recent reinsurance transaction, we now expect repatriation to be at the high-end of that range. Please remember, as we've noted in the past, that repatriation could change depending on increases in interest rates, credit spreads, a strengthening yen or significant credit losses, but we do expect significant profit repatriation in 2015.

In addition, as we indicated in last night's press release, we're exploring the possibility of increasing the frequency of capital transfers from Japan to the United States pending the completion of our internal governance process. This will better -- enable us to better manage liquidity in the U.S. segment and at the parent company as well. And as I mentioned at our analyst meeting in September, we're currently working on a multi-year capital management plan. As a part of that plan, we're making good progress toward a retro session agreement with the reinsurer to assume some of their risks. Retro session of risk to an existing Aflac entity would improve the economics of our reinsurance program by effectively lowering the cost of reinsurance for Aflac. Given our strong capital position and expected cash flows from Japan, we believe we're in a good position to return capital to our shareholders through increase dividends and share repurchase. We look forward to producing good results for our owners in 2015.

Now I'd like to turn the program back to Robin.

Robin Y. Wilkey
Former Senior Vice President of Investor & Rating Agency Relations
Thank you, Ken, Thank you, Dan. [Operator Instructions] So now we'll be glad to start taking your questions.

Question and Answer

Operator

[Operator Instructions] Our first question is coming from Mr. Steven Schwartz from Raymond James & Associates.

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

Can you talk about the reinsurance agreement that you announced in this quarter, the -- I think it was JPY 55 billion. And obviously it's smaller than the last one you did, but how well does it differ from that -- from the initial deal?

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

Steven, it's actually very similar to the initial transaction that we executed in September of '13. In fact, it's really an extension of that same agreement. You'll recall that what we had done is ceded the premiums and the risk related to a portion of an old block of medical business, a close block, that -- about 1/3 of the hospitalization benefit and with this agreement, we simply took the percentage up to 50%. So we added another 17% or so to that on the same block of business. We're currently in the process, as I mentioned, of the multi-year capital management plan. Reinsurance will clearly be a part of that plan, and I think it's quite possible you'll see another transaction in 2015, perhaps more than 1. And in looking at that, we would be exploring other blocks of business for possible transactions.

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

Ken, just to follow up on that. Is this with the same reinsurers, so there's still no statutory benefit?

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

That's correct. But as we -- when we go through the RFP process, we are taking -- getting quotes from multiple parties, and we'll continue to do so in the future.

Daniel P. Amos
Chairman & CEO

Let me just comment that the statutory treatment is something that we have under consideration and it's true that in the first agreement, we did not take any statutory reserve credit, but we're examining the conditions that would be required for us to qualify for such a reserve credit in the future. We haven't taken it off the table, Steven.

Operator

Our next question comes from Nigel Dally.

Nigel Phillip Dally
Morgan Stanley, Research Division

Just a couple of more on the reinsurance side. Given there is more of a capital rise in rate reduction or into transaction, any pushback that you're getting from the FSA on those top [indiscernible] the transaction going forward? And also, just a commentary on increasing the frequency of the capital transfers. Just -- I hope we can get some additional color there as well the [indiscernible]?

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

Well, first, with respect to communications with the FSA regarding reinsurance, we made sure that they were fully briefed on the transaction that we executed in '13 and the same was true with this transaction as well. It's a fairly straightforward simple transaction. And we make sure, quite frankly, that it's not only the FSA that's briefed, but also our lead regulator in Nebraska, the Director of Insurance there as well as the regulator in South Carolina for instance as well. With respect to the capital transfer, Nigel, remind me what the frequency? Remind me...

Nigel Phillip Dally
Morgan Stanley, Research Division

Yes, just with regards to increasing the frequency, what are the changes that you kind of moving towards more of a quarterly repatriation from stand? Or kind of what's the plan there?

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

Well, the starting point is to simply get cash more frequently on a more consistent basis. Quarterly would be ideal, but we're working through the final governance for that right now to determine the best way to do it. Historically, what we have done is we have transferred a portion of the profits that were earned in a given fiscal year for Japan, and we are investigating the options for moving not only earnings on an annual basis, but also moving a portion of retained earnings as well. But that would be entirely dependent, as we've said before, in our view of our solvency margin ratio, in our ability to protect our policyholders and also to maintain that ratio in a manner that provides an adequate buffer for risks that affect the ratio above our minimum requirement of 500% to 600% range. But we are optimistic. We do believe that we can move forward with more frequent transfers that will give us a much better ability to smooth out our cash flows, better manage our cash at both Aflac and Aflac Inc. when it comes to deploying capital.

Kriss Cloninger
President & Director

Nigel, Kriss Cloninger again. I'm sorry to interrupt. But I just want to make it clear that the reinsurance we've done between Aflac Japan and an outside reinsurer is clearly a risk-transfer arrangement. Even though some of the motivation is capital management, it's not a financing agreement. It is a risk transfer agreement and there's no question about that. So we don't anticipate any pushback from that perspective from any of our regulators.

Operator

Our next question comes from Yaron Kinar.

Yaron Joseph Kinar
Deutsche Bank AG, Research Division

My first question, I guess, is for Ken. I appreciate the color on the year-over-year kind of changes and headwinds and with regards to the EPS growth target. But if I strip out the share repurchase impact, I think if I look at the lower end of the target range for 2015, earnings are still -- would be a negative territory. And even when I account for a higher benefit ratio in Japan, I guess I would have expected maybe a little bit more abatement of previous or prior headwinds to maybe see a little more earnings growth on a dollar basis. I was hoping to get a little more color and clarity on that.

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

Well, again, when I try to get through in kind of that segment commentary related to the ratios, the issue that we have, frankly, is we've got to do a better job at revenue growth. So you're going to see relatively low rates of revenue growth both in Japan and the United States. The revenue growth is muted a little bit further because of the reinsurance transactions and the seated premium. But when you look then within the operating ratios that are going to influence our profitability in Japan, the business mix is pushing the ratio up a bit at Aflac Japan because first sector is a larger portion. The expense ratio, again, should be a bit lower than next year than it is this year, but it still does pressure earnings. In the United States, we've gone -- since 2011, we've had an improved benefit ratio and it's improved much better than we ever anticipated it would. Actually, when we entered into 2014, we didn't think the improvement would continue, and we assumed a much higher benefit ratio than we've actually experienced. So we still expect it to return to some type of normalcy at some point and, again, we believe that could begin to happen in 2015, but there' is additional pressure in the U.S. segment in 2015 because of the added expense related to our -- going from the commission-based SSC position to the salary-based Market Director position. So when you put all that together, and again, these are -- we deal with fairly conservative assumptions. We'd rather surprise on the upside than the downside, but we would see both segments this year, producing slight declines -- or excuse me, in 2015, potentially producing slight declines in operating earnings versus where we expect them to fall in 2014. The good news is that we are able because of our capital strength that more than compensate that with very strong capital deployment plans for the latter part of this year and next year as well. And again, hopefully, as we saw in 2014, we will see some things emerge favorably. These are our assumptions.

Daniel P. Amos
Chairman & CEO

And it will also depend on what we are in 2014.

Yaron Joseph Kinar
Deutsche Bank AG, Research Division

Okay. I appreciate the color. And then my 1 follow-up is on third sector sales, actually, for the fourth quarter. It seems like if I take kind of the run rate from medical over the last 3 quarters, and I take the reiterated the guidance for the full year, I get to roughly doubling of cancer sales, if I'm modeling this correctly. And I wanted to just get a sense if that is kind of roughly how we should be thinking about it. And if -- how much of this growth comes from the Japan Post partnership as opposed to the other cancer product that you launched?

Daniel P. Amos
Chairman & CEO

Toru or paul.

Paul Shelby Amos
Former Director

Toru, you want to start then I'll comment?

Tohru Tonoike
Vice Chairman of Aflac Japan

Yes, yes, let me start. Yes, you're right. In order to make the 2% growth for the entire year, we will need to basically double the sales of the cancer in the fourth quarter. And that's what we are feeling that we will be able to make it. So based on that numbers, we feel pretty good about the profits we're making at least 2% of the entire profit for sales for the full year.

Paul Shelby Amos
Former Director

Let me just follow up and say, we knew third quarter was going to be extremely difficult. We had the August 19, 2013 launch of our EVER plan. We had also preannounced our October 1 launch this year of our new cancer plan. So we faced headwinds in the third quarter for both cancer and medical sales. And we are confident that, going into the fourth quarter, especially given what Dan has already announced that we are up 20% so far this month, we feel very strongly that we'll finish within the range of 2% to 7%.

Yaron Joseph Kinar
Deutsche Bank AG, Research Division

And how much of that growth in cancer products do you anticipate coming from Japan Post?

Tohru Tonoike
Vice Chairman of Aflac Japan

We cannot disclose that exact number of the sales from the Japan Post. But I can tell you that the largest part of the growth of the cancer comes from the Japan Post.

Daniel P. Amos
Chairman & CEO

Well, I can also say that we are very pleased with what's going on with Japan Post. And excited about the future growth of it.

Operator

Our next question is coming from Seth Weiss.

Seth M. Weiss
BofA Merrill Lynch, Research Division

Question, if I could -- if we could just get a little bit of granularity in terms of some of the expenses next year, curious if you could give any commentary on the cost of the reinsurance transaction or how much that affects gross earnings next year. And also, I believe on the last quarter you mentioned that the cost of the U.S. sales initiatives would be $0.02 in the fourth quarter and then you'd give updated guidance on what the impact would be in 2015, perhaps if you could give us a little bit of commentary around that, that would be helpful as well.

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

Yes. First of all, I would say that we really didn't -- we didn't isolate the expense of the reinsurance -- the second tranche of reinsurance for 2015 because we're currently working on a retro-session agreement, again, it would effectively lower that cost. But what I would say is that it was incorporated. The cost before retro session was incorporated into the 2% to 7% range we established for next year. So to the extent that we're able to successfully execute a retro-session agreement, it will help a bit on the margin of lowering the expense and enhancing earnings in 2015.

Daniel P. Amos
Chairman & CEO

And I would just add that the cost of the second tranche is proportionate to the cost for the first tranche. The economics are essentially identical. And to the extent that we retro seed [ph], the costs will either be proportion or potentially more favorable than the direct cost.

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

And the second question related to the cost of the Market Director change, in particular, it really hasn't changed. It may be modestly better than what we had originally anticipated, but our -- the estimates that we had communicated in July are really still on. What I will say, and I'm really proud of the team in the United States because, excluding that, our expenses were flat year-over-year, '15 compared with '14. And you'll recall my comments that we wanted to try and find a way to mitigate as much as we could to those expenses. And I still think that that's possible that we could see improved expenses as next year develops. But we really haven't seen any material impact or any material change.

Seth M. Weiss
BofA Merrill Lynch, Research Division

Okay. Perhaps I'm misremembering them. I thought the commentary was $0.02 in the fourth quarter and then maybe updated guidance this quarter. It's fair to say then that net-net, no headwind from the U.S. sales initiatives?

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

Yes, maybe a little bit more or maybe closer to $0.03 a quarter in '15. It's not terribly material and it'll also depends on how well we do on the sales side because remember that we've added fixed costs, and we're taking off variable costs. And the amount of variable costs that are removed from the income statement will depend on sales through lower commission expense. The cost in year 2 will -- the offset will be significantly higher in the second 12 months than it would be the first when it comes to an offset to the increased fixed expense.

Seth M. Weiss
BofA Merrill Lynch, Research Division

Okay. It sounds I could -- I'm sorry.

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

[indiscernible] materially changed.

Seth M. Weiss
BofA Merrill Lynch, Research Division

If I could just sneak one more in just on margins. And I understand the 2 % to 7% growth margins in the context of normalizing margins in both the U.S. and Japan. Is it fair to categorize '15 as a normal margin year? Or will mix shift continue to cause margins to slightly deteriorate going forward?

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

No. I think, again, if you look at the expectations that we laid out in May and then for Japan reiterated in September, the margin should be very stable year-over-year and, again, really consistent with what we had communicated at prior meetings on our expectations for a 3-year period.

Operator

Our next question comes from Mr. Jimmy Bhullar.

Jamminder Singh Bhullar
JP Morgan Chase & Co, Research Division

Most of my questions are answered. But just on U.S. recruiting, I would have thought that trends would have gotten worse given the changes that you're making, but recruiting was up and the agent kind of declined a little bit less than it declined in previous quarter. So just wondering if you could talk a little bit more about how the restructuring is going on and do you expect further improvement from here or will the results get worse before they begin to improve.

Daniel P. Amos
Chairman & CEO

Well, I'm very pleased with the results so far. I thought there would be more disruption, as I said earlier, because people just don't like change. But I have to compliment our field management for understanding that we've got to pay for performance and accepting that is being a way of life and moving on with it. Saying that, I -- what I see is I see the fourth quarter is being easier comps than the first quarter. And I see the second quarter of next year being the easiest comp. So I would anticipate us having being up. I would like to be up 5% for the fourth quarter. That's my goal. But I want it to absolutely be up, but that's my goal. And then I think, probably the first quarter will be maybe up, flat to up 5%. And then I expect at the end of the second quarter to be up 5%. So I'm counting on at least having 5% growth. I'd like to do better than that. We have a new Director of Sales who came from being in-charge of North and South Dakota, which is our highest penetration in the country. And he is concentrating on accounts of 100 or less, which is what we've said, we've got to do. He's also been working on the expansion of our district and regional levels, which ultimately will increase recruiting, and I think that's what's taking place right now. There could be a little disruption that we're still unaware of. These people are adjusting because it went into effect on October 1, but I am in contact with Teresa daily, as well as with sales daily about keeping up with how this is going and -- this is a major, major change. This is in the last -- my 30 years -- or 25 years as CEO, this is, structurally, probably the biggest change we've made to the sales force. So I don't take it lightly that there could be a few more bumps, but I'm not seeing them as of today. I think it's all coming together nicely.

Operator

Our next question is coming from Mr. John Nadel.

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

A couple of real quick ones. Does the -- maybe for Ken, does the buyback assumption for 2015 at JPY 1.3 billion, does that assume any benefits from incremental reinsurance transaction? And if so, how much?

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

Not in -- not transactions in '15, if that's what you're referring to. When you look at the transaction that we announced that took effect on October 1, that gave us the opportunity to reevaluate the SMR and then reevaluate the capital. We felt comfortable deploying for both '14 and '15. So I'd say it's a good starting point. At this point, it does not contemplate any additional transactions per se that might occur in '15.

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

Okay. Appreciate that. And then for 2015, we haven't had any real discussion about what you guys are assuming in terms of new money yields in Japan and the U.S. I mean, obviously, here in the third quarter and I guess, pretty -- most of 2014 and maybe I'm wrong, but the investments in Japan have been largely JGBs and this quarter JGB's in U.S. treasury. I mean. what are you thinking about in terms of new money yields for 2015? Can we see some incremental investment in maybe credit-related assets?

Eric M. Kirsch
Global Chief Investment Officer and Executive VP

This is Eric. First, as you look year-to-date of our invested cash flows, and I mentioned this earlier in the year. Early in the year, we did overweigh JGBs because of the nature of our cash flow timing. But as you look at overall cash flows now, we've put about 48% or so of our Japan cash flows into U.S. dollar assets. And of that allocation, about 60%, 65% were in U.S. credit and the rest in treasury. So the credit investments we anticipated did come on online, particularly in the second half of the year or second and third quarter. So they were there. But recollect, I have said, in the investment-grade credit space -- credit spreads with all-time tights, and we did a fair amount of purchasing of credit back in '12 and '13. So we lightened up this year on purpose. We're totally fine with the fundamentals of investment credit. We think those are strong as they've ever been. But the technical spread being so tight, make them pretty expensive to buy. Having said that, as we're planning for '15, first, it's important for me to note, but it has helped Fed raise its rates and we have higher yields. But we are a consumer of the macro environment and that's going to be very challenging. So we assume in our plan. We don't assume necessarily that rates will go up, we try to be very conservative and come up with ranges. But what we certainly want to look at going into next year is a good mixture. Obviously, we'll have some traditional JGB investments that help with yen interest rate matching and interest rate risk and duration matching, but to expand not only in investment-grade credit, but other places as well. And I've said this, we've seen some disruptions in the market recently. We've seen spreads on high yields, bank loans, some other asset classes start to widen out, and we want to see that as a buying opportunity. So as we go into '15, we're hoping to be able to take advantage of that, and start to get into sort of some other asset classes beyond just traditional investment-grade credit. But that will be a function of markets where spreads are. We're not going to chase spread just on the interest of yield. We try to work with Kriss and Ken to have risk-adjusted NII, net investment income budget, if you will, and give us the flexibility at the same time to take advantage of those dislocations and invest at a good point in the cycle as opposed to force that investment.

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

Okay. And then if I can sneak one more on just for Kriss or Ken. Just thinking about Japan margins, I think over the last couple of years, particularly during the period of very strong pace, first sector sales, particularly WAYS, there was, I guess, a first year, if I can characterize it that way, sort of headwind on the pretax margin because commission rates were high and I guess these -- those products were maybe a little bit more surplus strain. With first sector sales having declined at least in terms of growth so significantly, I would have thought we would have been getting some of that back as we looked forward. Is that in your guidance? Or are you seeing that? Can you talk about that a little bit?

Kriss Cloninger
President & Director

John, this is Kriss. I will say that the surplus strain affects the regulatory reporting, FSA and U.S. staff, more heavily than it does U.S. GAAP that were are primarily focused on today, just because we are allowed to defer a significant amount of the acquisition expenses. Actually, the strain, John, on the third sector is almost significant on the third sector it is -- as it is on the first sector. One reason is that the cost per policy as opposed to percent of premium are somewhat higher on the lower premium products and the first sector products have 9x to 10x of premium that the third sector product sales. So there haven't been a lot of relief, so to speak, on that in percentage terms. Now in absolute terms, clearly, as the first sector premiums declined, the surplus strain in absolute amounts has declined, but kind of not on a relative basis. I want to go back to a previous comment that was made and somebody mentioned the 15% margin is kind of normalized. That's a pretty low number in my opinion for any kind of normal margin. Once we repriced the first sector products effective April 1, 2013, the margins increased from, say, an expected margin over the lifetime of the product given the net investment yields, we realized that, at that time, the margins increased from about 10% to closer to 20% on the first sector products. Now we weren't able to sell as much product because they weren't as competitive versus other financial products in the marketplace. That affected us as well as other life companies compared to other financial products issued by other organizations. So while our margins went up, our sales went down. And our overall margin is affected by the mix of business, and I pointed that out in the FAB guidance materials, sort of said okay, here it is for life insurance, here it is for third sector business. You got to look at the mix that you anticipate or what we actually have achieved in order to get to have a so-called normalized margin. But I did want to make a point that the move from about a 20-plus percent profit margin were realized on Japan right now through '15. On an aggregate basis, we'd take a heck of a move, and I don't anticipate margins will decline near that fast.

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

Really, in looking at our plan and formulating guidance to follow up on that, we're looking to maintain roughly a 20% margin both this year and next year, a little bit higher this year, perhaps 20% or just tad lower next year. But again, consistent with what we've expressed in and basically very similar to what we've seen.

Operator

Our next question is coming from Joanne Smith.

Joanne Arnold Smith
Scotiabank Global Banking and Markets, Research Division

Yes, I just wanted -- most of my questions have been asked and answered. But just as a follow-up to John's question on the first sector product. What is the average duration of those products? Because if I recall correctly, they either had a 10-year premium period or a 7 -- there was 5, 10, and a 7, I believe. What is the average duration, I'm just wondering when we can expect those to start running off, if it's going to be anytime or a lifetime? The second question is just with respect to the U.S., and that is on -- now that we're about a year into ACA, are you seeing things in the market settle down a bit?

Kriss Cloninger
President & Director

Okay, Joanne, Kriss here. I'll take a shot at the first part and let somebody else comment on ACA. But let me say, I hope we all have long lifetimes and live to see some of the developments in these first sector products. I will point out that the durations, you referred to relate to the premium payment periods, and that's the period for which surrender charges are in effect. And we expect very strong persistency during the premium period, both because of the surrender charge and because of the fact that a lot of the first sector products we wrote in 2011 and 2012 came with the advanced premium deposit arrangement where the peopled pay most of the premium upfront. So we're going to see strong persistency throughout the premium period on those first sector products. At the end of the premium period, the surrender charge goes away, but on the WAYS product, the real optionality of the product kicks in, not at the end of the premium period, but at an age like 60 or 65, that the policyholders elect when they buy the coverage, and that's the point in which they have the option to elect -- to continue the product as life insurance, or the claim conversion to a medical policy, or to continue it as an annuity certain-type payout or perhaps to convert to a care-type product. And we have some limited experience emerging on that, but it's not enough yet to be credible. I will say that the tendency that I think we've seen so far is toward inertia where people allow a coverage to continue his life insurance, which is the original form. But they do have to make an election a couple of years prior the optionality date and we do communicate with the policy holders regarding the option they have to elect changes to the form of their coverage. But we haven't seen any adverse persistency develop at all so far, Joanne, in that regard. So we anticipate that the duration of these first sector products will be pretty long.

Joanne Arnold Smith
Scotiabank Global Banking and Markets, Research Division

Okay, so we shouldn't be expecting them to run off any time soon.

Kriss Cloninger
President & Director

No, you shouldn't. Now we've talked to you about the impact of the paid-up premiums on revenue, and we'll be talking more about that throughout 2015 as we see some of the blocks that are significant, start to hit the end of the premium period in 2016. But I will remind you that I've told you, we recognized profit over the term of the contract, not over the term of the premium period. And so what we're going to see is the continuation of the amount of profit for policy, but a significant increase in the profit as a percent of revenue, because revenue is essentially going to go away except for investment income.

Joanne Arnold Smith
Scotiabank Global Banking and Markets, Research Division

And would you say that, that would kick in sometime around year 7 or 8?

Kriss Cloninger
President & Director

'16 or '17 is where...

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

Joanne, just as a follow-up on that and to John before. One of the things that's influencing next year's benefit ratio, as I mentioned, was mix towards first sector. The persistency of the first sector products has generally been quite a bit better than third sector, even though third sector is very, very high, and it's actually improved a little bit year-over-year. With the third sector, it has been modestly lower year-over-year. So that's also influencing the mix of business and the expected benefit ratios.

Joanne Arnold Smith
Scotiabank Global Banking and Markets, Research Division

Okay. And then just on the ACA?

Teresa Lynne White
President of Aflac US

This is Teresa. You asked about confusion in the market. I think, right now -- now the regulations are set. At least for the moment, they're set. You still have employers who are having to comply and then at the end of the year and then in 2015, we have employee that have to comply. I would not say, I wouldn't characterize their -- the environment investment as one where there is no confusion. But I think all our employers are opting to public exchanges and then it's creating gaps from a product standpoint as well, as far as the Affordable Care Act. So our opportunity is still a great opportunity from an Aflac perspective. And so I think our strategic focus on the market, in the less than 100 markets, is to focus our field force there and then grow the broker side of the market. I think our strategy is a winning strategy going forward. So I feel good about that.

Operator

Our next question is coming from Mr. Randy Binner.

Randolph Binner
FBR Capital Markets & Co., Research Division

Great. I guess, I'll just pick up there with the last commentary on ObamaCare. Clearly, Aflac has a big opportunity, at least in my mind, given the brand awareness to capitalize in the exchange environment. And so when you all talk about U.S. sales recovering, I feel like those 2 things are linked. So is the exchange opportunity not something we should expect to help your sales in 2015? Or is that part of the recovery in sales you hoped for in '15?

Teresa Lynne White
President of Aflac US

I think the exchange is another tool that we utilize as part of our sales process. So from -- and I don't know if you recall earlier or last time we spoke, we talked about the enrollment platforms and benefit admin platforms. Many of those platforms are now being characterized as exchanges today. So we've always been engaged in enrollment via these benefit enrollment platforms. Now we have specific strategies today to engage and being on specific exchanges with large brokerage houses. And those are the activities that we're doing today that we think will help us in sales going forward in 2015.

Kriss Cloninger
President & Director

Yes, and I'll just say, we're not counting on this national health care plan to increase sales. I think there is the potential to do that, but I don't like to count on that. We do know that our enrollments when they take it through our exchange, increases from 30% to about 42%. So we have much better enrollment when we do that. Interestingly enough though, those would be on the account of 100 or less, and they are going to go and buy it on the public exchange, which can be routed through us. One of the things I was a little worried about was, is that our agents would make so much commission on major medical. Although it's a small percentage, it's a large premium. But if you buy it through the government exchange which comes through ours, it's a very low commission. So that means for them to make money, they still got to push our products and services. So I think that will be very beneficial to us, and we'll ultimately give a good return to the policyholders, fill the gaps for them and ultimately increase our sales.

Randolph Binner
FBR Capital Markets & Co., Research Division

Okay, I understand. Let me -- If I could just on Japan, just another kind of top-down question on sales. With the -- ostensibly, the new -- this new CEO of Japan Post is there to turn things around, and it seems like a spinoff/IPO process is still realistic. Do you have any update on whether or not that's going to happen for Post [ph] next year? And if so, should we think it as potentially being a tailwind for sales there? Meaning that they would have a motivation to sell more product to get more fees to get their next earnings numbers up?

Kriss Cloninger
President & Director

I think, any way, they can -- any company that it can ultimately increase profits before they go public is going to enhance the shareholder value. But you have to understand how private Japan Post is. We don't get any information in regard to that, those are our decisions that they make. But we have a very close relationship with Taizou, who is the President, and what's going on there. But we're very cautious in making any comments regarding their particular business. Other than just, say, what they had done with us and what is going on was slow at first, it is now picked up. And they are doing very well now, and we're excited about 2015 and the future growth there. Because we think we helped fill a void with the products and the services that they offer. Japan Post and this new product will help fill the gaps that they want that will ultimately make consumers buy it.

Operator

Our next question comes from Mr. Erik Bass.

Erik James Bass
Citigroup Inc, Research Division

Just hoping you could provide a little bit more detail on what's driving the stronger-than-expected benefit ratios year-to-date and why you think that those should normalize next year rather than experience potentially continuing.

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

Well, in Japan, we have seen -- even though there's been a mix shift, we have seen just pays emerge at a lower rate than we had expect it as we came into the year. So it's really been driven by slightly lower paid claims than we had expected. We've seen a much larger change in the ratio for Aflac U.S. And again, this is a trend that we've seen since 2011. Pays are increasing slightly. We have made some modifications to IBNR to reflect our program or our initiative of emphasizing the speed at which we pay claims because that may stimulate claims to some degree. But we've also seen in part because of lower volumes from new sales, as well as the sales at which relaxation [ph] has occurred, even though overall persistence [ph] has been fairly stable. We're seeing a smaller increase, or in this case, declines in the change in future policy benefits. So quite simply. The additions to U.S. reserves are growing at a slower rate than we have expected. And all in all, that's this year, especially, that's what's brought down the U.S. benefit ratio. But we do -- we don't expect this to hockey stick and to shoot right back up to where it was in 2011 or '12, but we would not be surprised if it came back to a higher level than we've experienced in '14.

Erik James Bass
Citigroup Inc, Research Division

Got it. So -- I mean, are you seeing any differences in kind of consumer behavior in terms of either utilization of benefits or other trends?

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

Nothing particular, but I think we have concluded it, utilization. And it's not just with our products and our company, but utilization coming out of the very weak economy for the last few years has been lower than normal. People have not accessed the health care system as they did prior to the financial crisis. And I think that's the overall trend that's really influenced our business in the U.S. for the last few years.

Robin Y. Wilkey

Former Senior Vice President of Investor & Rating Agency Relations

All right. We've reached the top of the hour. So we have time for one more quick question, please.

Operator

Our final question will be coming from Mr. Jay Gelb.

Jay H. Gelb
Barclays PLC, Research Division

Could you give us your updated perspective on whether you expected Japan consumption tax increase to go through in 2015. And if you look at what the impact was on sales in 2014, if you have any views on that, that would be helpful as well.

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

I'll let -- perhaps Toru and/or Paul to opine on whether they think that it will go through. The proposal is that it could increase from the current level of 8% to 10% in October of 2015. And for budgeting purposes, in our forecasting, we have assumed that, that will occur effective with the fourth quarter of '15. Paul or Toru, can you comment on when you think it will go through.

Tohru Tonoike
Vice Chairman of Aflac Japan

Yes, this is Toru Tonoike and let me speak first and then Paul may chime in. That issue is now being heavily discussed in the diet, and there is no decision made at this point of time. And there is no way for us to know which is more likely, for some are in favor of the tax increase and some are not. So at this point, nobody knows what would be the end result in 2015. And even if, just assuming if it happens, we do not anticipate a big impact on our sales. Certainly, not being the 2014 and not a substantial impact on the 2015 either.

Paul Shelby Amos
Former Director

Yes, I just want to make it clear. Expect that the Prime Minister Abe will make his final decision in December, and we really won't know thing until then. They're going through the standard process here, but as Toru said, we feel that this is not going to have any form of a major impact.

Jay H. Gelb
Barclays PLC, Research Division

And based on the increase this year if you evaluate the trends, do you have a sense of how much the headwind on sales that may have been to the initial consumption tax increase?

Tohru Tonoike
Vice Chairman of Aflac Japan

We did not see any notable impact on our business coming from the tax -- consumption tax increase last time.

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

All right. Thank you for joining us this morning. If you want to follow up with any questions, please call our office, and we'll be glad to do any follow-ups. Thanks very much. Bye-bye.

Operator
And this does conclude today's conference. You may disconnect all audio lines at this time. Again, this does conclude today's conference. You may disconnect all audio lines at this time. Thank you.