S&P Global
Market Intelligence

Aflac Incorporated NYSE:AFL

Earnings Call

Thursday, November 2, 2023 12:00 PM GMT

Call Participants

EXECUTIVES

Albert Angelo Riggieri
Senior VP & Global Chief Risk Officer

Bradley Eugene Dyslin
Deputy Global CIO, Senior MD, Global Head of Credit & Strategic Investment Opportunities

Daniel Paul Amos
Chairman & CEO

David Young

Frederick John Crawford
President & COO

Koichiro Yoshizumi
Senior Managing Exec. Officer, Asst. to the Director of Sales & Marketing and Director

Max Kristian Broden
Executive VP & CFO

Virgil Raynard Miller
President of Aflac U.S.

ANALYSTS

Jamminder Singh Bhullar
JPMorgan Chase & Co, Research Division

Joel Hurwitz

John Bakewell Barnidge
Piper Sandler & Co., Research Division

Joshua David Shanker
BofA Securities, Research Division

Marly Ann Reese
Goldman Sachs Group, Inc., Research Division

Ryan Joel Krueger
Keefe, Bruyette, & Woods, Inc., Research Division

Suneet Laxman L. Kamath
Jefferies LLC, Research Division

Thomas George Gallagher
Evercore ISI Institutional Equities, Research Division

Wesley Collin Carmichael
Wells Fargo Securities, LLC, Research Division

Wilma Carter Jackson Burdis
Raymond James & Associates, Inc., Research Division

Presentation

Operator

Good morning, and welcome to the Aflac Incorporated Third Quarter 2023 Earnings Conference Call. [Operator Instructions] Please note this event is being recorded. I would now like to turn the conference over to David Young, Vice President of Investor and Rating Agency Relations. Please go ahead.

David Young

Good morning, and welcome. This morning, we will be hearing remarks about the third quarter related to our operations in Japan and the United States from Dan Amos, Chairman and CEO of Aflac Incorporated; and Fred Crawford, President and COO of Aflac Incorporated. Max Broden, Executive Vice President and CFO of Aflac Incorporated, will provide an update on our financial results and current capital and liquidity, which can also be found with the materials that we posted along with our earnings release and financial supplement on investors.aflac.com. We also posted under financials, on the same site, updated slides of investment details related to our commercial real estate and middle market loans.

In addition, Max provided his quarterly video update, which you will find there also. Other members of our executive management team who are joining us for Q&A include: Virgil Miller, President of Aflac U.S.; Charles Lake, Chairman and Representative Director, President of Aflac International; Masatoshi Koide, President and Representative Director, Aflac Life Insurance Japan; Brad Dyslin, Global Chief Investment Officer, President of Aflac Global Investments.

Before we begin, 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 annual report on Form 10-K for some of the various risk factors that could materially impact our results. As I mentioned earlier, the earnings release is available on investors.aflac.com and includes reconciliations of certain non-U.S. GAAP measures. I'll now hand the call over to Dan. Dan?

Daniel Paul Amos
Chairman & CEO

Thank you, David. Good morning. We're glad you joined us. Reflecting on the third quarter of 2023, our management team, employees and sales distribution have continued to work tirelessly as dedicated stewards of our business. This has allowed us to be there for the policyholders when they need us most, just as we promised. Aflac Incorporated delivered very strong earnings for both the quarter and for the first 9 months.

Beginning with Japan, I am pleased with our 12.4% year-over-year increase in sales, which was largely driven by a nearly 23% increase in cancer insurance sales with a significant contribution from Japan Post Company and Japan Post Insurance. I am also pleased to see continued improvements in cancer insurance sales through our other alliances, Dai-ichi Life and Daido Life. These alliance partners, along with agencies and banks, combine to form our extensive distribution channels that are so important to being where the customer wants to buy insurance and providing them with financial protection. We continue to work hard to support each channel.

We also introduced our new medical insurance product on September 19. The product design is simple to appeal to younger policyholders with basic needs and older or existing policyholders who desire additional or updated coverage. While it's too early to evaluate the success of this product launch, early indications show that it's being well received. We continue to gain new customers through WAYS and Child Endowment while also increasing opportunities to sell our third sector products.

Since the launch of our refreshed WAYS product, approximately 80% of our sales are to younger customers below the age of 50, and the level of concurrent third sector sales remains approximately 50%.

We -- thus for, our product strategy in Japan has served us well, and I'm encouraged by our progress so far.

Turning to the U.S., I'm encouraged by our sales increase of 7.5% in the quarter. This reflects continued productivity improvements and the contribution from our growth initiatives of group life and disability, consumer markets, network dental and vision, we remain focused on driving scale, stabilizing new platforms and leveraging our ability to bundle essential product lines as we work with brokers on larger groups. Agents and brokers contributed to the growth of our individual business. Our group platform benefited significantly from the sales of group life and disability. I am very excited about our new cancer protection assurance policy, which provides enhanced benefits at no additional cost. We know that when people experience the value of our products it increases persistency, which benefits our policyholders and lowers our expenses.

I believe that the need for our products and solutions we offer is strong or stronger than ever before in both Japan and the United States. We are leveraging every opportunity in Avenue to share this message with consumers, particularly given that our products are sold, not bought. As we communicate the value of our products, we know that a strong brand alone is not enough. We must paint a better picture of how our products help address the gap that people face when they get medical treatments, even though they may have major medical insurance, knowing our products help lift people up when they need it most is something that makes all of us at Aflac very proud and propels us to do more and achieve more. We continue to reinforce our leading position and build on that momentum.

As always, we are committed to prudent liquidity and capital management. We continue to generate strong investment results while remaining in a defensive position as we monitor evolving economic conditions. In addition, we have taken proactive steps in recent years to defend our cash flow and deployable capital against a weakening yen. As an insurance company, our primary responsibility is to fulfill the promises we make to our policyholders. At the same time, we're listening to our shareholders and understanding the importance of prudent liquidity and capital management. We remain committed to maintaining strong capital ratios on behalf of the policyholder and balance this financial strength with tactical capital deployment.

I am very pleased with the Board's declaration of the fourth quarter dividend in declaring this dividend of 2023 marks the 41st consecutive year of dividend increases a record that we treasure. I am even more pleased with the Board's action to increase the first quarter of 2024 dividend by 19% to $0.50 per share. We also remain in the market purchasing shares at a historically high level of $700 million. As seen in the first 2 quarters of this year, we intend to continue prudently managing our liquidity and capital to preserve the strength of our capital and cash flows, which support both our dividend track record and tactical share repurchase. Overall, I think we can say that it has been a very strong quarter, especially when a vast number of factors are in our favor. Aflac Japan had a strong quarter for sales as we executed product and distribution strategy. Aflac U.S. continued to build on this momentum as it nears pre-pandemic levels.

Pretax profit margins remained strong in both Japan at 32.8% in the U.S. at 28.8%, plus our capital ratios remain very strong, and our quarterly share repurchase was like last quarter, one of the largest in the company's history.

Before I hand it over to Fred, I want to address an announcement of his retirement. I've enjoyed working closely with Fred over the last 8 years and certainly understand his desire to retire and spend more time with the family and personal interest. Fred, you will be missed. And I look forward to working with you and Aflac's executive team to ensure a smooth transition until your official retirement date. And I wish you many happy years. As for me and the company, we have some outstanding candidates who are capable of running Aflac. It is my responsibility to continue to train and watch the progress of these potential [era] parents while the Board oversees the process. To be prepared for any unknowns we have always had an interim CEO ready should something abruptly happened to me as well as a strong process within the Board's Corporate Governance Committee.

I recently had a physical at Emory University and received an excellent report. So I plan on being around to prepare our leaders for the future and drive shareholder value. With that, I'll now turn the program over to Fred. Fred?

Frederick John Crawford
President & COO

Thank you, Dan. As announced last night, I plan to retire in September of next year to spend more time with my family and pursue other interests. It's a personal decision but also a recognition of the very capable leadership team surrounding Dan and the company being in a very strong position. While I believe this is the best for me and my family, I also believe it is in the best interest of Aflac. I've enjoyed 25 years as an executive in the insurance industry and feel blessed to have worked with talented professionals and leaders throughout. However, the highlight has clearly been my time here working for Dan and for Aflac. Over the next year, I will be focused on transition and helping on select initiatives where I can add value. I'll now hand the call back over to Max. Max?

Max Kristian Broden
Executive VP & CFO

Thank you, Fred. For the third quarter, adjusted earnings per diluted share increased 27.8% year-over-year to $1.84 with a $0.06 negative impact from FX in the quarter. With this being the third quarter under the new LDTI accounting regime, we evaluate our reserve assumptions for morbidity, persistency and mortality at least annually to see if an update is needed. If necessary, these assumptions will be unlocked on a prospective basis as they were in this quarter, leading to remeasurement gains of $205 million.

Variable investment income ran $13 million or $0.02 per share below our long-term return expectations. We also wrote down certain software intangibles in our U.S. segment, impacting our results by $0.04 per share. Adjusted book value per share, including foreign currency translation gains and losses, increased 10.3%, and the adjusted ROE was 15.6%, a significant spread to our cost of capital. Overall, we view these results in the quarter as solid.

Starting with our Japan segment, net earned premium for the quarter declined 2.8%, reflecting the impact of paid-up policies, our January 1 reinsurance transaction and deferred profit liability. Lapses were somewhat elevated but within our expectations. However, if adjusting for all these factors, the earned premium declined an estimated 1.7%. Japan's total benefit ratio came in at 65.1% for the quarter, down 170 basis points year-over-year, and the third sector benefit ratio was 54.8%, down approximately 460 basis points year-over-year.

We continue to experience favorable actual to expected on our well-priced, large and mature in-force block. We estimate the impact from remeasurement gains to be 260 basis points favorable to the benefit ratio in Q3. Long-term experience trends as it relates to treatment of cancer and hospitalization continue to be in place, leading to favorable underwriting experience. Persistency remained solid with a rate of 93.5% but was down 80 basis points year-over-year. With product refreshments, we tend to experience some elevation in lapses as customers update and refresh their coverage, which was the case with the recently refreshed cancer and first sector products.

Our expense ratio in Japan was 19%, down 100 basis points year-over-year, driven primarily by good expense control and, to some extent, by expense allowance from reinsurance transactions and DAC commission true-up. For the full year, we would expect to end up towards the low end of our expense ratio range of 20% to 22%. Adjusted net investment income in yen terms was up 7.2% as we experienced higher yields on our U.S. dollar-denominated investments and related favorable FX and a return on our alternatives portfolio, more in line with our long-term return expectations. This was offset by transfer of assets due to reinsurance.

In the quarter, we reduced our FX forwards and increased FX put options notional, leading to lower run rate hedge costs and a more efficient use of our investment risk capital. The pretax margin for Japan in the quarter was 32.8%, up 350 basis points year-over-year, a very good result for the quarter.

Turning to U.S. results, net earned premium was up 3.2%. Persistency increased 80 basis points year-over-year to 78.7%. This is a function of poor persistency quarters falling out of the metric and stabilization across numerous product categories, especially group voluntary benefits. Our total benefit ratio came in lower than expected at 35.9%, a full 890 basis points lower than Q3 2022. We estimate that the remeasurement gains impacted the benefit ratio by 12.1 percentage points in the quarter. Claims utilization remains subdued. And as we incorporate more recent experience into our reserve models, we have released some reserves.

For the full year, we now estimate our benefit ratio to be materially below our outlook range of 47% to 50%. Excluding remeasurement gains, however, we are tracking well within the 47% to 50% outlook range. Our expense ratio in the U.S. was 40.6%, up 70 basis points year-over-year. This includes a 190 basis point impact from a software intangibles write-down. Adjusting for this write-down, we are trending in the right direction. Our growth initiatives, group life and disability, network dental and vision and direct-to-consumer increased our total expense ratio by 330 basis points. We would expect this impact to decrease over time as these businesses grow to scale and improve their profitability.

For the full year, we now expect our expense ratio to come in slightly above our outlook range of 37% to 40%. Adjusted net investment income in the U.S. was up 13%, mainly driven by higher yields on both our fixed and floating rate portfolios and variable investment income in the quarter more in line with long-term return expectations. Profitability in the U.S. segment was solid with a pretax margin of 28.8%, driven primarily by the remeasurement gains from unlocking.

As you know, the commercial real estate markets are going through the worst cycle in decades, especially in the office subsector. We're seeing most property values quoted down 25% to 40%, but some distressed situations are driving market values down as much as 60%, far exceeding the 35% to 40% declines of the financial crisis. Our total commercial real estate watch list remains approximately $1 billion, with around 2/3 of these in active foreclosure proceedings. As a result of these current low valuation marks, we increased our CECL reserves associated with these loans by $34 million this quarter.

We also moved 2 properties into real estate owned, which resulted in a $53 million write-down. We do not believe the current distressed market is indicative of the true intrinsic economic value of the underlying properties currently undergoing a foreclosure process. We continue to believe our ability to take ownership of these quality buildings and manage them through this cycle will allow us to maximize our recoveries.

In our Corporate segment, we recorded a pretax loss of $49 million, which is somewhat smaller than a year ago, primarily due to our reinsurance transaction. Adjusted net investment income was $8 million lower than last year due to an increased volume of tax credit investments. Higher rates began to earn in and amortized hedge income increased. These tax credit investments impacted the corporate net investment income line for U.S. GAAP purposes negatively by $64 million with an associated credit to the tax line. The net impact to our bottom line was a positive $3.8 million in the quarter. To date, these investments are performing well and in line with expectations.

We are continuing to build out our reinsurance platform, and I'm pleased with the outcome and performance. In Q4, we intend to execute another tranche with similar structure and economics to our first transaction from January this year. Our capital position remains strong, and we ended the quarter with an SMR above 1,000% in Japan. And our combined RBC, while not finalized, we estimate to be greater than 650%.

Unencumbered holding company liquidity stood at $3.3 billion, $1.6 billion above our minimum balance. These are strong capital ratios which we actively monitor, stress and manage to withstand credit cycles as well as external shocks. U.S. stat impairments were $4 million and Japan FSA impairment's JPY 2.9 billion or roughly $20 million. This is well within our expectations and with limited impact to both earnings and capital. Leverage remains at a comfortable 18.8%, just below our leverage corridor of 20% to 25%. The decline in the quarter is primarily driven by the weakening yen. As we hold approximately 2/3 of our debt denominated in yen, our leverage will fluctuate with movements in the yen-dollar rate. This is intentional and part of our enterprise hedging program, protecting the economic value of Aflac Japan in U.S. dollar terms.

We repurchased $700 million of our own stock and paid dividends of $248 million in Q3, offering good relative IRR on these capital deployments. We will continue to be flexible and tactical in how we manage the balance sheet and deploy capital in order to drive strong risk-adjusted ROE with a meaningful spread to our cost of capital. Thank you. I will now hand the call back to David to begin Q&A.

David Young
Thank you, Max. [Operator Instructions] We will now take the first question.

Question and Answer

Operator

[Operator Instructions] Our first question will come from Tom Gallagher with Evercore ISI.

Thomas George Gallagher
Evercore ISI Institutional Equities, Research Division

Dan, wanted to start with your comment about succession planning and having several strong candidates. Should we take that to mean you won't be looking to do an outside search to replace Fred? And are you looking to replace Fred in the COO role? A little bit of color on what you're thinking overall there.

Daniel Paul Amos
Chairman & CEO

Sure. First, I would say that you have to understand that one of the reasons that we created the Chief Operating Officer and also for Fred to go to Japan, part of it was due to the COVID period of time and that we had a situation where with COVID, we wanted more interaction with Japan. And so Fred was willing to go over there and do that. And that was very helpful to us. And we continue to rotate people over to Japan and from Japan to the United States. And it's -- for example, Steve Beaver, who you probably know has been around a long time, will be working with him.

As far as how and what will evolve, these decisions ultimately come from the Board. I think there's always 2 ways to look at transition and what would take place would be the broadness of something happening and then well it was structured. So we work with the concept that this will be planned over a long period of time and we've had internal candidates. It's always been my preference that it'd be internal candidates because of the Japanese operation and the uniqueness that we have there.

Saying that, I would say the Board would -- the Corporate Governance Committee specifically and then the full Board would be reviewing every aspect to make sure you have the best person for the job. And so we would also take that into consideration as we're moving forward. As I said in my comments, I'm enjoying life. I'm enjoying working with the company and want to continue to do so. At the same time, these adjustments of people retiring and moving on happens, and I've been around to see a lot of them. But I think there's a little element of pride that keeps me around because of the family. And frankly, I just enjoy doing it.

So I look forward to working with these people. There are several that are on the horizon. We continue to add new people that have potential so I'm encouraged about that. And I think we're in a strong position. And I think this quarter sent a signal of how strong we are, managerially-wise, and we'll continue to do that.

Thomas George Gallagher
Evercore ISI Institutional Equities, Research Division

Got you. And just an operational question for my follow-up. Max, can you comment on what's behind the bigger reserve release in the U.S. and if there's a go-forward earnings impact associated with that? I would have thought there might have been a bigger benefit coming from Japan, just given how strong and this efficiency of margins there are. So any -- maybe any color comparing and contrasting how the actuarial review stacked up U.S. versus Japan?

Max Kristian Broden
Executive VP & CFO

Thank you, Tom. So obviously, this is the first year we're running on an LDTI basis, and the third quarter is when we do the unlockings, including prospective unlockings. When you think about it, if you go back and look at the last couple of years and you see the morbidity trends and also trends in hospitalization and outpatient treatment, and you compare and contrast Japan and the United States, in the U.S., we shut down a lot more than what you ended up doing in Japan as it relates to how people went to the hospital and how people changed their behavior. And that is coming through in our morbidity experience.

So we did see, for example, accident hospitalizations, et cetera, drop a lot more in the United States than what you saw in Japan. And that was simply a factor of the COVID virus had a much more significant spread in the U.S. than what it did have in Japan. In Japan, you really had a big spike in the third quarter of 2022. But outside of that, it was a significantly lower spread than what we had in the U.S. And that is why you're now seeing that having a much more pronounced impact on the morbidity experience that is feeding into our actuarial models that is then leading to the outcome that you saw this quarter.

Operator

Our next question will come from Jimmy Bhullar with JPMorgan.

Jamminder Singh Bhullar
JPMorgan Chase & Co, Research Division

So Fred, I'm sure we'll be dealing with you a little bit more over the next year, but good luck in the future. I had, first, a question on just any updates you have on the potential tri-agency rules. And in sort of the worst-case scenario, what are the products that are in scope and what could be the impact on your business, assuming that the industry does not get any concessions from the rule as it's initially written?

Virgil Raynard Miller
President of Aflac U.S.

This is Virgil Miller from the U.S. I'll take that question for you. So we continue to advocate on behalf of our policyholders to provide them the protection when they need it most. The comment period is closed, but you can see and review our comments out there as well as others. I'll just say that we saw no impact in the third quarter to our sales. If you think about it, our hospital indemnity product could be 1 that's impacted. We had relatively flat sales in third quarter.

But you've heard Dan mentioned in his comments about our cancer insurance protection plan. We saw our cancer sales up in the third quarter. I would say this also that remember, one of the considerations as part of the proposal is around pretax implications. Aflac has been selling, we were selling our policies without those pretax benefits long before it actually occurred years ago. So I think we'll be positioned well even if the rule were to pass.

Daniel Paul Amos
Chairman & CEO

Let me make 1 other comment. I was in Washington for 3 days about 3 weeks ago and met with probably 18 senators and congressmen to just see their positions on it. I want to go back to the pretax situation that Virgil was talking about because it was an anomaly. What actually happened was it ended up being passed. And we, as a company back 20-something years ago, we didn't sell pretax for the first 2 years because the Congress said it was a mistake and it was never really meant to happen.

And so once it was in the bill, then when they tried to take it, they thought about taking it out, there would -- it looked like it was a pretax. If they took it out, it became a tax on the average American. And you take, for example, a school teacher that has come down with cancer to, all of a sudden, say you're going to tax their benefits will not sit well with the contingency of people that they deal with. And so we were able to talk to a lot of people about it, and we had no feedback that thought that it should be the opposite.

Now saying that, we know that this has been submitted by the branch outside Congress through the executive branch, and we've got to handle it and we plan on talking to them. But it is -- it will absolutely be a direct tax. But we sold in that environment. I'm one of the ones -- 1 thing about me being around a long time is I remember a lot of things. And we sold -- I was around when we sold in a pretax environment. In fact, I was in the sales force for 10 years and saw it. And so it's a matter of adjustment no matter what happens. And what I've always said is with change comes opportunity. And so no matter what happens, we're going to find a way to do well in that environment.

Jamminder Singh Bhullar
JPMorgan Chase & Co, Research Division

Okay. And if I could ask just 1 more. Your comments on CRE seem fairly negative and the environment is pretty challenging as well. But how do you square the watch list of over $1 billion or around $1 billion with your CECL reserve, which seems pretty modest at around $34 million?

Bradley Eugene Dyslin
Deputy Global CIO, Senior MD, Global Head of Credit & Strategic Investment Opportunities

Jim, this is Brad Dyslin. I'll take that. There's a couple of things behind the relatively modest reserving that you've seen so far compared to that $1 billion watch list. One is the average LTV of the portfolio and the price declines we've seen. What happens when we go through the foreclosure process is we have to mark that asset to the lower of the principal balance of the loan or the value of the asset. So when you're starting at a 60% LTV, you've got a fair amount of cushion before you start to realize losses on that mark.

The second dynamic at play here is we are still in process on about half of that $1 billion of watch list, which means we are in workout negotiations with the borrower. Those can be very long-lasting, very intense and they can ebb and flow a lot of different directions. Once we get certainty that we expect to foreclose, we have to order a third-party appraisal. Those take time to come in. And as they come in, that's when we end up re-marking our assets. So it's a combination of our relatively conservative LTVs and the fact that we've still got about half that portfolio subject to appraisal.

Operator

Our next question will come from Ryan Krueger with KBW.

Ryan Joel Krueger
Keefe, Bruyette, & Woods, Inc., Research Division

My first question was on the changes you made to the FX hedging program. And I just wanted to confirm, you had a pretty major decline in the hedge costs in the third quarter versus the last couple of quarters. Just wanted to confirm that, that's a reasonable expectation on the hedge cost going forward for the foreseeable future.

Max Kristian Broden
Executive VP & CFO

Thank you, Ryan. Yes, I think what you saw in terms of hedge cost for the third quarter, it's a blend of us rolling into our new structure, so it's a mix between the old structure and the new structure. In terms of run rate hedge costs going forward, I do think that the third quarter hedge cost that you saw, it's certainly not going to be higher. It would probably going to, on a run rate basis going forward, be at this level or slightly lower going forward in terms of actual hedge cost.

That is obviously subject to capital markets inputs and everything that impacts the cost of a put option and also, to some extent, if we decide to increase our forward exposure in the future as well. So things like the FX volatility, interest rates, et cetera, will come into play here. But in the near future, I would expect our hedge cost to be similar to the third quarter level or slightly lower.

Ryan Joel Krueger
Keefe, Bruyette, & Woods, Inc., Research Division

And there's no offset anywhere else, right, that would drop to the bottom line?

Max Kristian Broden
Executive VP & CFO

Sorry, Ryan, I didn't quite catch that. Can you repeat that?

Ryan Joel Krueger
Keefe, Bruyette, & Woods, Inc., Research Division

I just want to -- there's no offset anywhere else that would drop to the bottom line?

Max Kristian Broden
Executive VP & CFO

The way to think about this in terms of the P&L, this will drop to the bottom line. When you think about the P&L here, what we have done when we move gradually from using forwards to put options, what happens is that we are now increasing the volatility for small moves in the yen-dollar as it relates to our capital ratios in Japan, i.e., the SMR and ESR.

So for a strengthening yen or a weakening yen, you're going to see slightly higher volatility in that ratio for small moves. But what the put options give us is that we have dramatically reduced [details]. So any dramatic moves or shock moves in the yen-dollar, we have reduced our risk exposure to those kind of events. And we feel that this is a very good risk reward for us.

Ryan Joel Krueger
Keefe, Bruyette, & Woods, Inc., Research Division

And then on the reinsurance transaction, the transaction you did last year, I think, freed up $900 million of capital. But then I think around half of it or so was retained and then the other half was available for redeployment to shareholders. On this next transaction, would you expect closer to all of it to be available to return to shareholders?

Max Kristian Broden
Executive VP & CFO

We will deploy the capital appropriately in the respective business units, and if we have good opportunities to deploy the capital there, we will do so. If we feel that we have significant surplus capital, it will be moved up to holding company. And the holding company will deploy it in the different sort of capital distributions that the holding company generally does, i.e., dividends, buybacks, et cetera.

Operator

Our next question will come from Suneet Kamath with Jefferies.

Suneet Laxman L. Kamath
Jefferies LLC, Research Division

I just wanted to follow up to Tom's question on the U.S. reserve releases. It sounded like some of the benefit here was lower hospitalizations in the U.S. due to COVID. And I just want to understand, are you assuming that kind of that lower level of hospitalization sort of persist going forward? Or are you assuming some sort of reversion to historical trend?

Max Kristian Broden
Executive VP & CFO

Let me kick off on that question, and I would ask Al Riggieri to fill in any blanks and add his color as well. But the fact of the matter is that we have seen lower levels, generally speaking, in terms of hospitalizations come through. And we've also seen changes in the way treatments are being done, i.e. more outpatient treatments as well. So we believe that we have seen a shift in both the way hospitals are operating and also the way individuals are going for their treatments. And we have factored that in to some extent.

Albert Angelo Riggieri
Senior VP & Global Chief Risk Officer

Yes. This is Al Riggieri. Just to add in a little bit on that. Remember, the COVID period dropped all hospital utilization, treatment patterns. Many of that during COVID would have some ups and downs during the period as hospitals had more capacity and people would return and get like elective surgeries and all of that. What we did this year was begin to recognize that 2022 was the first year in the United States where you would say that the pandemic was kind of in the rearview mirror. So we broadened the experience for 2022.

We did still remove the experience very low experience during COVID period. We brought in the post-COVID period, we called it, for 2022. And as Max was saying, continued to see even in that period in '22, that we did have lower experience. So we've built that into the experience base or updating the assumptions.

Suneet Laxman L. Kamath
Jefferies LLC, Research Division

And I think, Max, you said you factored some of that into your reserve. Is it -- does that mean that if things sort of persist the way they are, that there would be the potential for some more reserve releases down the road?

Max Kristian Broden
Executive VP & CFO

We believe that we have adequately reflected sort of the new paradigm or the new experience that we're seeing now into our models. Now please remember, these are obviously models. So what that means is that if these trends were to improve further than what we have experienced to date, there is the potential for further unlocking, favorable or negative. It can go the other way as well. We believe that we have reflected it to our best -- the best way we can, given the data that we see. And it's important that we do reflect it to the best way we can. But I also want to make sure that you understand that these are estimates and they can go both ways.

Suneet Laxman L. Kamath
Jefferies LLC, Research Division

Yes. No, that makes sense. My other 1 is on Japan and the earned premium drop of 1.7% sort of adjusted. I would have thought at some point, the impact of the paid-up policies would sort of have run its course. And I know some of those policies were very long-dated, but I believe that they were sold quite a bit ago. So are we getting closer to the point where that impact is expected to fall off?

Max Kristian Broden
Executive VP & CFO

So when we look forward into the paid-up schedules, you are going to see a little bit of a drop in 2014 -- sorry, 2024, and then a further drop in 2025. And that's where I would say that I would expect us to run more on a normalized basis for paid-up. Keep in mind that the big sales that we had of the WAYS product, they really occurred in the 2012 through 2014 time period, and there was 5-year pay and there were 10-year pay. So when you roll that forward, that's when you see that you get a little bit of a drop off in 2024 and then further in 2025.

That being said, paid-up is something that we generally build into our products, both first sector and third sector. But when we -- I wanted to mention 2024 and 2025 because that's when we move into a more normal schedule, and you're not necessarily going to see these more significant year-over-year deviations.

Operator

Our next question will come from Alex Scott with Goldman Sachs.

Marly Ann Reese
Goldman Sachs Group, Inc., Research Division

It's Marly on for Alex. I was hoping you could provide a little more color on the Japan Post sales and partnership. It looks like it's been progressing, so I was hoping to hear a little more on this versus the longer-term sales guidance.

Koichiro Yoshizumi
Senior Managing Exec. Officer, Asst. to the Director of Sales & Marketing and Director

[Interpreted] This is Yoshizumi. I oversee the entire sales in Japan. The sales of our cancer insurance, new cancer insurance Wings and also lump-sum serious disease benefit guider continues to be very strong. We will continue to aim at growth in cancer insurance sales by providing sales support to the sales offices and post offices of Japan Post Company and Japan Post Insurance nationwide, including sales process management and the sharing of good practices. We are also actively working on the training and also developing of the sales agents across all the branches nationwide by sharing good practices and best practices. And we are expecting to have growth in sales even more by having all these activities done in a solid manner. And that's all for me.

Daniel Paul Amos
Chairman & CEO

Yes. I want to make 1 other comment. We've been waiting for Japan Post to come back for several years now. And we had assurances that they would do that and I'm happy to see it take place. They are our largest shareholder. And so what is good for us is good for them and vice versa. So I believe this is a strong alliance and will continue to be strong as we move forward.

Marly Ann Reese
Goldman Sachs Group, Inc., Research Division

And then just as a follow-up, if we could turn to capital a little bit, would you mind providing an update on what you view as near-term versus longer-term capital management priorities or capital deployment?

Max Kristian Broden
Executive VP & CFO

So obviously, the capital ratios in our subsidiaries, they are strong, and that's obviously priority #1 to make sure that we have adequate and strong capital in our operating subsidiaries. And then obviously, we want to move operating cash flow up to the holding company and then deploy it from there. You did see that in the quarter, we bought back $700 million of our own stock. I view that as quite a strong capital deployment. And we also increased the dividend by 19% starting in the first quarter of next year. So overall, the company is generating significant cash flow, and we are deploying significant cash flow as well.

Operator

Our next question will come from John P. Barnidge with Piper Sandler.

John Bakewell Barnidge
Piper Sandler & Co., Research Division

Fred, congrats on the retirement. Question is around Japan and the expense reduction efforts. I know there was a paperless effort and other expense efficiencies. Have you already completed any required software installations or do you have any planned upcoming?

Frederick John Crawford
President & COO

Why don't I just make a couple of comments on that, and then Koide-san can comment. But what we are focused on in Japan from an efficiency perspective is digitizing the platform. That's the major thrust of what we're looking at, which is a long-term plan of investment followed by returns. And that is a plan to digitize or increase the usage of digital applications away from paper applications, the use of digital self-service where policyholders go online and serve themselves through technology as opposed to inundating our call center and then claims payments or digital claims.

We've been making steady progress on both the digital application front and on the customer self-service, but we are engaged currently in updating those tools. Think of it as no different than your iPhone 1 to iPhone 11. We are updating those tools to modernize them and improve the customer experience. We have been in a proof of concept over the last year and, in fact, have moved those digital adoption rates up. And so with that will come natural efficiencies over time but it will take time. So it's a long-term progress of moving customer and agent experience to digital and away from paper, but that will yield benefits.

The claims side of it is more stubborn. And the reason for that has nothing to do with Aflac. It's because the Japanese health care system is a paper-based health care system that requires the exchange of paper forms when one goes to the doctor. That's really requiring a modernization of the health care system in Japan. And interestingly, they actually do have an effort underway to attempt to modernize or digitize the health care system. But until that takes place, our ability to process claims digitally will be somewhat contained. But over time, we expect to improve.

So what you should expect as investors is that over the long time, we will be increasing that digital adoption. It will yield a lower per policy expense outcome from an administrative standpoint, but it will be over multiple years of slow and steady progress because this is about adoption, it's not about installing software, okay?

John Bakewell Barnidge
Piper Sandler & Co., Research Division

Very helpful. And then on the investment portfolio, those properties you took keys, can you maybe talk about the occupancy rates in those versus the ones that remain on the watch list?

Bradley Eugene Dyslin
Deputy Global CIO, Senior MD, Global Head of Credit & Strategic Investment Opportunities

Sure, thank you. The 2 properties that we took back, the current occupancy levels are in the low to mid-50s, which has been pretty stable since we first got involved and did the loan. The occupancy across the portfolio, it does range a fair amount. We've got a few that are below 50%, given the nature of the asset class, the nature of transitional real estate. But for the most part, our averages are right around the 55% to 65%.

Operator

Our next question will come from Wilma Burdis with Raymond James.

Wilma Carter Jackson Burdis
Raymond James & Associates, Inc., Research Division

Is it fair to think that Aflac can rewrite its hospital indemnity policies to comply with the potential DOL-HHS rule without compromising the attractiveness of the product? And has Aflac worked on this? If so, does the burden appear manageable?

Virgil Raynard Miller
President of Aflac U.S.

This is Virgil from the U.S. We absolutely are taking precautions to make sure that we prepare just in case the proposal does go through, and we are confident that we can do that. We've been continuing to enhance our benefits while current policies are out there. I think Dan stated earlier, we were clear that we've sold before in an environment without some of the pretax benefits that currently exist, and we're confident we'll be able to do that again.

We have a random process here that we are always looking to innovate and reinvent our products and enhance our benefits. We demonstrated that this past year with our cancer enhancements we did that really had no additional cost to our policyholders. So you can expect more of the same related to that.

Wilma Carter Jackson Burdis
Raymond James & Associates, Inc., Research Division

And then I just want to confirm. I know you guys sort of said it but I just want to make sure that I understand. In the reinsurance deal that you just recently completed, you freed up around $900 million of capital, and it sounds like that could either be used to reinvest or maybe ultimately for shareholder returns.

Max Kristian Broden
Executive VP & CFO

Yes. Obviously, our priorities with all the capital that we have is always to deploy it into writing new business and use it in our operating entities. That is where we get generally the best IRR on that capital. If we cannot deploy it in our operating entities, then it will flow up to the holding company.

Wilma Carter Jackson Burdis
Raymond James & Associates, Inc., Research Division

But it was around $900 million is what you freed up for that?

Max Kristian Broden
Executive VP & CFO

Yes, that is our estimate, yes.

Operator

Our next question will come from Josh Shanker with Bank of America.

Joshua David Shanker
BofA Securities, Research Division

When I think about the commercial loan portfolio, are the properties most at risk, those that have been more recently loaned to or the ones that have a longer vintage in terms of when they were established? And along those lines, when did you cool the deployment of new investment flows into commercial loans?

Bradley Eugene Dyslin
Deputy Global CIO, Senior MD, Global Head of Credit & Strategic Investment Opportunities

Sure. Thank you, Josh. The loans that we're dealing with now that are on the watch list are those that were made a couple of years ago. The transitional real estate book is our biggest focus area, and that differs from a more traditional CML book in that the maturities are much shorter. They tend to be 3-year fixed maturities with options to extend up to 5, in some cases, up to 7 years based on certain thresholds and the operating metrics being met.

So what we're dealing with now are those maturities predominantly in 2023 and a few in 2024 as obviously, the maturity is coming up and when those loans need to be addressed, either being repaid or if that is not an option, then we get into the workout discussions.

We have really substantially reduced our deployment into the asset class this year. Part of that is the market -- well, not part of it. It is frankly driven by the market. Very much a lack of activity. We're seeing a large bid ask between buyers and sellers. The increase in rates has really put valuations upside down. Buyers are trying to get -- take advantage of the current levels. Sellers are trying to get yesterday's prices, and we're just not seeing a lot of good, solid transactions, and there's a lack of liquidity in the market. So that's really limited our opportunities. And of course, we always adjust our underwriting standards to the current experience, to the current market. So we're being a little bit more difficult in our terms and conditions as well.

Joshua David Shanker
BofA Securities, Research Division

And then related, is there any way you can frame the capital consumption or rating agency charge for those 2 properties? What was it before they were converted into wholly-owned properties and what is it now?

Max Kristian Broden
Executive VP & CFO

Yes. So when they move from being a CML to real estate owned, there is a significant uptick in terms of the capital charge associated with that. For us, it's still very small. So if you think about RBC points, it's very -- I would estimate it to be low single digits. And as it relates to SMR, the same applies.

When you then think about the -- you generally should think about the distribution on what balance sheet or capital base if they go into as follow it the same way the size of the investment portfolio is between the 2 segments, i.e., roughly 85% falls into Japan and 15% falls into the U.S.

Operator

Our next question will come from Wes Carmichael with Wells Fargo.

Wesley Collin Carmichael
Wells Fargo Securities, LLC, Research Division

Just wanted to follow up on capital a bit. Max, I know you said that your first priority is to deploy that within the subs on organic. But to the extent that there's not that opportunity, I just wanted to get your thoughts around potential M&A and given that you've got pretty significant excess at the holdco and subs.

Max Kristian Broden
Executive VP & CFO

Yes. We -- if you think about what our track record, you have seen what we have done historically. Aflac has not been an acquisitive company. This is a company that is built selling 1 policy at a time. We've done a number of, I would call it, tuck-in acquisitions in the United States to broaden our product portfolio. And we do feel that we are in a good spot in terms of the products that we have to offer in our go-to-market strategy. So at this point, I don't see that we have any holes that need to be filled using M&A.

Wesley Collin Carmichael
Wells Fargo Securities, LLC, Research Division

Got it. And then maybe just a follow-up, on the middle market loan book away from commercial real estate, it seems like that's -- the book yield now is near 11%. So just wondering if you're seeing any terms and any collateral deterioration. And if interest rates remain high for a year or so, like you expect defaults within that portfolio?

Bradley Eugene Dyslin
Deputy Global CIO, Senior MD, Global Head of Credit & Strategic Investment Opportunities

Yes. Thank you. So far, we have been extremely pleased with the performance of the middle market loan portfolio. It is, frankly, performing better than we expected, given where we are at this point in the cycle. There are several reasons for that. And that ultimately, it boils down to fundamentals, underwriting and then how we've chosen to build the portfolio. We have a very small average loan size. We have maintained a discipline around only first-lien secured structures. We've kept leverage at a very modest level. We have maintained our use of strong covenants.

And then ultimately, it's about good businesses, good companies with sound business plans that are seeing good top line growth and have the margins and cash flow, avoiding cyclical companies, and that's really played out. We have built this as our primary below-investment grade portfolio. So we do expect to incur some losses. But relative to the outsized yields we've received, they are really quite modest. And as I said, it is doing better than we expected at this point in the cycle.

Going forward, we're going to have to wait and see just how the macro environment does. It does look like we've got the possibility of a soft or at least a soft-ish landing. And then how quickly rates turn around is something that we're going to watch very closely.

Operator

Our next question will come from Joel Hurwitz with Dowling & Partners.

Joel Hurwitz

So RBC is strong at over 650%, well above your 400% target. Can you just talk about plans in managing that down towards the target?

Max Kristian Broden
Executive VP & CFO

So obviously in the U.S., we are seeing some growth, and we're seeing some growth in lines of business that are driving a little bit more new business strain. And that's why we have, in the pandemic, we wanted to run with a little bit more capital and then coming out of pandemic, we see a little bit higher strain associated with that growth that we are starting to see and expect to see come through.

That has led us to run with a little bit higher RBC than what -- than the 400%. But we are at a point in time now where I would expect us over the next couple of years to really get down to that 400% level long-term.

Joel Hurwitz

Okay. And do you expect that to be driven by the needs for growth or do you expect to actually draw that down with outsized dividends to the holdco?

Max Kristian Broden
Executive VP & CFO

The preferred option would be to drive it by growth because that's where we're getting the best returns on our capital by just writing more policies. At the same time, our -- even though we have some lines of business that are consuming a little bit more capital, overall, we're a relatively capital-light business. So given that we're operating at a 650% RBC right now, I don't see that growth alone will necessarily drive us all the way down to 400%. In order to do so, we probably would, over time, need to address our capital base through special dividends, et cetera.

Operator

This concludes our question-and-answer session. I would like to turn the conference back over to David Young for any closing remarks.

David Young

Thank you, Anthony, and thank you all for joining us this morning. While we are not hosting our financial analyst briefing this year, we will be in 2024, but we will also be giving an outlook for 2024 on our fourth quarter 2023 earnings call. In the interim, please reach out to the Investor and Rating Agency Relations team if you have any questions, and we look forward to speaking to you then. Everyone, have a great day. Thank you.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.
[Portions of this transcript that are marked [Interpreted] were spoken by an interpreter present on the live call.]