S&P Global
Market Intelligence

Aflac Incorporated NYSE:AFL

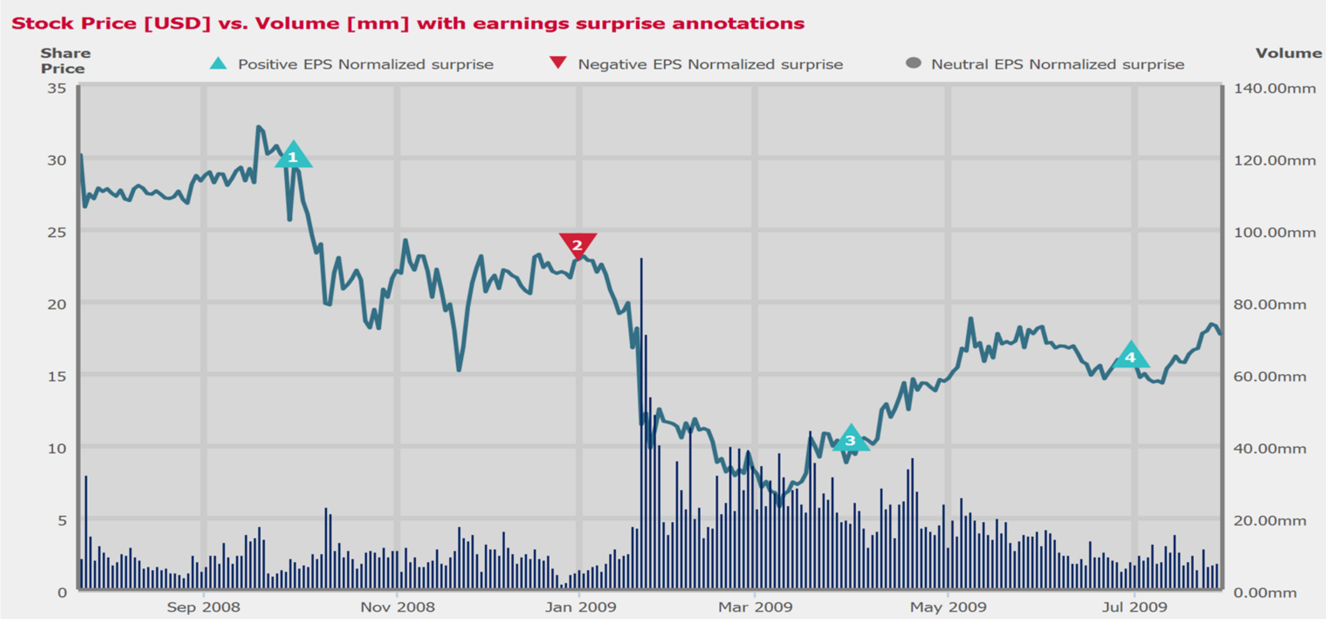
FQ3 2009 Earnings Call Transcripts

Thursday, October 29, 2009 1:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2009-			-FQ4 2009-	-FY 2009-	-FY 2010-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.60	0.62	▲5.00	0.57	2.40	2.64
Revenue	-	-	▲(4.79 %)	-	-	-
Revenue (mm)	4753.50	4526.00	-	4957.50	19153.94	20281.46

Currency: USD
Consensus as of Oct-29-2009 12:04 PM GMT



	- EPS NORMALIZED -		
	CONSENSUS	ACTUAL	SURPRISE
FQ3 2008	0.50	0.51	▲1 2.00 %
FQ4 2008	0.50	0.49	▼2 (2.00 %)
FQ1 2009	0.58	0.61	▲3 5.17 %
FQ2 2009	0.56	0.60	▲4 7.14 %

Table of Contents

Call Participants

EXECUTIVES

Dan Amos

Jerry Jeffery

Ken Janke

Kriss Cloninger

Tohru Tonoike

ANALYSTS

Andrew Kligerman
UBS

Colin Devine
Citigroup

Darin Arita
Deutsche Bank Securities

Ed Spehar
BofA Merrill Lynch

Eric Berg
Barclays Capital

Nigel Dally
Morgan Stanley

Randy Binner
FBR Capital Markets

Tom Gallagher
Credit Suisse

Unidentified Analyst

Presentation

Operator

Welcome to the Aflac Second Quarter Earnings Conference Call.

(Operator Instruction) I would now like to turn the call over to Mr. Ken Janke, Senior Vice President of Investor Relations.

Ken Janke

Thank you, Lori. Good morning. Don't worry, everybody, it is our third quarter conference call. Joining me this morning is Dan Amos, Chairman and CEO; Kriss Cloninger, President and CFO of AFLAC Incorporated; Paul Amos, President of AFLAC and COO of our US Operations; Jerry Jeffery, Senior Vice President and Chief Investment Officer; and joining us from Japan is Tohru Tonoike, who is President and COO of our Japanese business.

Before we begin this morning, let me point out the Safe Harbor language. I'd like to remind you that some statements in this teleconference are forward looking within the meaning of federal securities laws. While we believe these statements are reasonable, we can give you no assurance they will prove to be accurate because they are prospective in nature.

The actual results in the future could differ materially form those we discuss today. And I would encourage you to look at our most recent press release for some of the various risk factors that could impact our future results.

With that, I'll turn the program over to Dan who as usual will begin with some comments on the quarter and the outlook for the year and then I'll follow up with just a few financial highlights. Then we'll be happy to take your questions.

Dan Amos

Thanks, Ken. Good morning, everyone. I hope you got a chance to look at our third quarter press release. Before I discuss our insurance operations in Japan and the United States, let me comment on our current financial results and balance sheet. We're very pleased with the third quarter from an operating earnings perspective. Operating earnings were $1.25 per diluted share, up 22% over the third quarter 2008. Excluding the impact of the yen, operating earnings rose 13.7% for the quarter and 13.9% for the nine months.

Based on year-to-date financial results, we're confident we will achieve our annual objective of a 13% to 15% growth before the effect of foreign currency. Net earnings in the third quarter were again influenced by realized investment losses. However, our realized losses were significantly lower than a year ago and also below second quarter levels. The vast majority of the realized losses in the quarter resulted from impairments of perpetual securities.

As we communicated on our second quarter conference call, we had anticipated impairments on certain perpetual securities in the third quarter, because they were below investment grade and were expected to be below book value for a specific period of time. You may recall that in July we projected $265 million of equity impairment charges on the perpetuals in the third quarter.

The actual after-tax impairment charge related to the perpetual securities in the third quarter were $212 million. The amount was lower than expected, improved market values, which were partially offset by the stronger yen at the end of September, compared to the end of June.

We did not book corresponding impairment charges to the perpetual securities on our statutory financial statement as we continued to believe that we will receive the interest in principal payments that are contractually due. Assuming the yen dollar exchange rate and the pricing of the perpetuals remain unchanged from the end of the third quarter, and no additional downgrades to below investment grade, we expect to incur a GAAP charge of $100 million in the fourth quarter under the equity impairment method.

However, I want to again remind you two important points. First as we discussed before, these charges will not impact GAAP shareholder equity because all the perpetual securities are categorized as available for sale and are carried at fair value on the balance sheet. Second and most importantly, we would not be required to record comparable impairment charges on a statutory accounting basis if our credit analysis continues to demonstrate the securities are money good.

Our risk-based capital ratio remained high at the end of September, based on the estimated statutory financials, our RBC was 405% at the end of the quarter, which is above our internal target of 375%. The decline in the ratio since the end of 2008 has resulted from a increase in the required capital component of the RBC formula. The required capital increase has been primarily driven by the downgrade of credit ratings and securities we own, particularly perpetual securities.

Despite certain credit rating downgrades, we remain pleased with the overall quality of our investment portfolio. At the end of September 92.9% of the holdings were investment grade. Among our holdings of perpetual securities, 81.3% were investment grade. Through the first nine months of the year, all the perpetual securities we own were current on interest payments. Throughout our entire portfolio, we have only one company who deferred the coupons this year and that was a fixed maturity security.

It is possible that we will see coupon deferrals in the future, especially to the extent that certain coupon payments are based on capital profitability test on 2009 financial results. However, I would remind you that among our perpetual holdings, approximately 72% are Upper Tier II instruments, which are all deferrable cumulative coupon provisions.

I would also point out that the deferral of the coupon does not automatically result in an impairment charge. Instead a coupon deferral would trigger a thorough analysis of the credit to first make sure that the security we still want to own and second to determine if the impairment charge is warranted.

Furthermore, we have seen a strong recovery in the market values of our perpetual holding. In fact, they are priced at approximately 83% of par value at the end of September, that's up from 71% at the end of March. Overall we remain pleased with our balance sheet in general and in our capital position specifically. Importantly we believe our business will continue to build capital through strong statutory earnings growth.

Now let me turn to our insurance operations starting with AFLAC Japan. AFLAC Japan had a strong third quarter. Our persistency rate remained high and although it was slightly lower than a year ago it's been stable throughout 2009.

In addition, our financial results met or exceeded our expectations for the third quarter. We were especially pleased with the third quarter sales results, which exceeded our expectations. Total annualized premium sales in the yen were up 6.5% for the quarter.

For the first nine months, total new sales were up 3.7%. Based on these results, we have confidence that we will achieve our goal of flat to 5% increase for the year. Sales in the third quarter were led by a significant increase in the medical category, which was up 13.8% for the third quarter 2008.

As you'll recall, we launched a revised medical product in late August. This was the first major revision of our popular EVER product since it was initially launched in 2002. The most notable change in this revision is the enhanced surgical benefit. In addition, the revised EVER premium rates are gender specific.

Rates for the most female buyers are lower than the original version of EVER and most ages issued. Male purchasers generally pay less at the younger ages and more at the older age. Overall, the profitability of the new plan is similar to our original EVER product.

During this first five weeks on the market, we sold 104,000 of the revised EVER products. We are very pleased with the initial response to the newest EVER product and we’re excited about the prospects for future medical sales growth.

In addition, we experienced strong sales in our ordinary life category, which were up 45%. The strong growth primarily resulted from the child endowment product we introduced during the spring. During the quarter we sold 21,400 child endowment products at an average premium of 154,400 yen, which is significantly higher than the premium than our core medical or cancer products.

We believe we can continue to attract customers to our new life products like child endowment. We also believe we can effectively cross-sell life products to customers with other AFLAC products. In fact, for every 10 child endowment plans that were purchased, we sold two additional policies of other products to the same customers.

We were also excited with the improvement in the bank channel sales. In the third quarter, bank channel sales rose 55.2% over the second quarter to a record 2.2 billion yen, compared with a year ago bank channel sales were up 66.1%.

At the end of September, a total number of 351 banks represent AFLAC Japan. Of that amount, 282 have been selling AFLAC Japan's core products like cancer and medical to the customers since the full deregulation of sales through banks in December of 2007. We hold a very strong position in the bank channel and have significantly more banks selling for us than any other insurer operating in Japan.

We've also been expanding our distribution beyond the bank channel. In that regard, recruiting remains strong at AFLAC Japan. In the third quarter, newly recruited agencies were 21.1% higher than a year ago. And for the first nine months, we experienced 16.5% increase in recruited agencies. We believe our recruiting has not only benefited from the weak economy, but also from the strength of our brand and improved recruiting techniques.

For the remainder of the year, we expect to see continued strong sales growth, and we believe we will extend the sales momentum into 2010 as well. We remain convinced that Japan remains a large and attractive market for our products. Despite the weak economic conditions and a competitive marketplace, we believe our strength and adaptability have positioned AFLAC to capitalize on the opportunities in the Japanese market.

Turning to our US operation, as the case of most industries, the most difficult economic conditions have continued to pose challenges to the sales growth. During the third quarter, total annualized premium sales were down 7.2, which was not a surprise. For the nine months, sales were 6.4% below a year ago.

As you know, our persistency rate has been impacted by the extended recession. That was especially true in the first quarter. Fortunately, persistency rate of the US business has improved as the years progressed. Although the rate is not where we'd like it to be, our persistency rate in the third quarter was better than our financial modeling assumption.

Like the first quarter of the year, the basic activities of the US operation that normally led to sales growth remained strong. Recruitment of new agents has benefited all year long from the weak labor market as salaried positions have become more difficult to find. In the third quarter, recruitment of new agents was up 9.4% to more than 7,000 new sales associates. For the first nine months of the year, recruitment of new agents was 16.4% higher than a year ago.

The average number of weekly producing sales associates in the third quarter was a little change from last year. However, the average number of weekly producers rose 8.1% in the quarter. New payroll accounts growth was also strong, rising 15% over the third quarter 2008. Payroll accounts opened by new agents was up 24% in the third quarter and 20.7% for the nine months. We believe strong increases in recruiting and new weekly producers coupled with significant payroll accounts growth will provide a solid foundation for future sales as the US economy continues to recover.

As I hope you noted, we completed the acquisition of Continental American Insurance Company or CAIC on the first of October. You'll recall that CAIC is a specialty insurer that focuses on selling the same time of voluntary products at the worksites that AFLAC offers but on a group basis rather that's on an individually underwritten basis.

Although the financial impact of this purchase is small, we believe it has potential to greatly benefit in the US marketplace in the long-term. Specifically, CAIC will help us meet the product needs of the field force when they pursue larger payroll accounts. It also helps the broker community know that we are committed to growing the broker distribution channel and accessing the large employer market. We believe that CAIC is a very good fit for AFLAC for both business and cultural perspectives.

We are continuing to work on an integrated CAIC marketing and administration into the US business, and the process is moving along very well. We will be formally introducing CAIC products and training to our sales force in a couple of months at our annual December kickoff meeting. But our sales force is already excited about welcoming CAIC into the AFLAC family.

As we think about fourth quarter sales, we will continue to be challenged by the weak economic environment. In addition, the loss of Wal-Mart, re-enrollment will also dampen fourth quarter sales. Although that will be somewhat offset by the sales through CAIC. It's still a bit too early to project sales outlook for CAIC group business for next year. However, as I mentioned on the second quarter call, our 2010 sales objective will reflect the combined outlook for AFLAC and CAIC.

Our earnings outlook for AFLAC incorporated has not changed for this year and remains unchanged for 2010 as well. Our objective is a 13% to 15% increase in operating earnings per diluted share in 2009, excluding the impact of the yen. For 2010, our objective is 9% to 12% increase in operating earnings per diluted share before the impact of the yen/dollar change rate. But, I want to remind you that my number one priority is to maintain strong capital position.

Overall, I believe AFLAC remains well positioned in the two best insurance markets in the world. As our commercials indicate, when people get sick or hurt in this work, they need cash to cover the uncovered expenses that arise. This is true in good times and bad and whether you're talking about the US or Japan.

Although we've certainly faced challenging times along with the rest of the world, our operations continue to perform well and our balance sheet remains solidly positioned. I have every confidence in our business model and the fundamental need for our products and the future for AFLAC. Ken?

Ken Janke

Thank you, Dan. Let me just briefly take you through some of the third quarter numbers beginning with AFLAC Japan and then we'll get to your questions. Starting with the top line in yen terms. revenues rose 2.6% for the quarter. Investment income was down 2% reflecting the impact of the stronger yen on AFLAC Japan's dollar denominated investment income.

Excluding the effect of the stronger yen, investment income was up 2.9%. The annualized persistency rate excluding annuities was 94% for the first nine months of the year, down from 94.6% for the comparable period of 2008, but up slightly over the first six months of 2009.

In terms of operating ratios for the quarter, the benefit ratio continued to improve as we had expected. It was 59.9% in the quarter compared with 62.2% a year ago, excluding the impact from the stronger yen and investment income, the benefit ratio was 59.4%. The expense ratio for the quarter was 20.1%, up from 19.5% a year ago. The increase in the expense ratio reflected in part higher advertising expense and increased DAQ amortization.

Reflecting the improvement in the benefit ratio the pre-tax margin expanded from 18.3% to 20% in the quarter. And with the improvement in the margin, pre-tax earnings increased 11.8% for the quarter in yen terms. And again, unwinding the impact of the strong yen on AFLAC Japan's dollar investment income pre-tax earnings were actually up 16.7% on a currency neutral basis.

For the quarter, we invested cash flow in Japan in yen securities at an average yield of 2.77%, including dollars the blended rate was 2.89% for the quarter. The lower new money yields compared with prior quarters reflect spread compression around the world. The portfolio yield was 3.8% at the end of September, down five basis points from the end of June and 16 basis points lower than a year ago.

Turning to AFLAC US, total revenues rose 2.2% for the quarter. The annualized persistency rate for the nine months was 71.3%, which is down from 73.5% a year ago, but up very nicely from the first half of this year.

Looking at the operating ratios from the US segment, the benefit ratios was 51.9% compared with 52.7% a year ago. The improvement in the benefit ratio reflected favorable claims experience on some lines of business as well as the [impact of high] lapses compared with a year ago. The operating expense ratio was little changed from a year ago at 30.6% compared with 30.4%.

The pre-tax profit margin improved as a result of lower benefit ratio to 17.5% up from 16.9% a year ago and as a result pre-tax earnings rose 5.7% for the quarter. For US investments, the new money yield for the quarter was 7.36% versus 7.48%. And the yield on a portfolio at the end of September was 7.2%, down two basis points from the second quarter and 15 basis points above a year ago.

Turning to some other items for the quarter, excluding FAS-115, the ratio of debt to total capital was 19.9% at the end of September compared with 17.5% a year ago. Non-insurance interest expense in the quarter was $24 million, compared with $6 million a year ago. The higher interest expense reflected the debt issuance of $850 million of senior notes earlier in the year as well as the impact of the stronger yen on our dollar denominated debt.

Parent company and other expenses were $21 million in the third quarter compared with $9 million a year ago. The higher parent company expenses in the quarter resulted from a reduction in the discount rate on unfunded pensions, pre-acquisition costs associated with the purchase of Continental American and lower investment income at the corporate level. The operating margins improved for the quarter, the pre-tax margin rose from 17.5% to 18.4%, and the after-tax margin increased from 11.5% to 12.1%.

On an operating basis, the tax rate was little changed at 34.3% compared with 34.5% in 2008. And as Dan mentioned, operating earnings per diluted share rose 22.5% to $1.25, which exceeded our guidance. The stronger yen increased operating earnings by $0.09 per share for the quarter and $0.23 for the first nine months. As you heard operating earnings per share increased 13.7% for the quarter excluding the impact of currency and 13.9% for the nine months.

Finally, let me comment on the earnings outlook for the balance of the year. As Dan reiterated, our objective for 2009 is a 13% to 15% increase ex-currency on a per diluted share basis. If the yen averages 90 to 95 yen to the dollar in the fourth quarter, we would expect to report operating earnings of $1.08 to $1.16 per diluted share. For the annual number that would equate to $4.75 to $4.83 reflecting that currency scenario. This morning the first call estimate consensus was $4.77 for the full-year.
We're ready to take your questions so Lori you can begin the polling process. We do want to make everyone has a chance so please try to limit your questions to one and then hopefully we can get back with you if you have a follow-up. Lori?

Question and Answer

Operator

(Operator Instructions) Your first question sir is from Colin Devine, your line is open.

Colin Devine
Citigroup

If Ken or if Kriss is there I'd like to talk about the investment impairment policy. I must say it's a struggle. I can't recall any other insurer that we've covered that has this sort of two processes, one for GAAP and one for stat. With Lloyds now in the paper this morning over and talking about a recapitalization and convergence of the press, what might that mean for AFLAC? It would seem to me that they are going to be converted at discounts and par, which I don't know, then how that's not going to hit statutory capital. Then the other thing that I'd like to know if we even just took the losses this quarter so your impairment of Lloyds and ran that through stat, it seems to me that your RBC ratio will be down to 350%, basically. Is that when you have to step in and raise capital?

Kriss Cloninger

Well, I'm going to let Jerry talk about some of the impairment policy. You know this is Kriss. Regarding raising capital, the 350% is a little bit below our target RBC number, but it's still well in excess of the level at which you would face any regulatory intervention, so to speak. The point at which you have to start producing plans to adjust capitalization is well below 350%.

As you probably know, I mean, we've said it time after time, we strive to maintain higher than average risk-based capital ratios for various reasons, one of which is our exposure to the yen/dollar exchange rate. The yen/dollar exchange rate happens to be very strong at the moment. So that's, we think fairly fully reflected in our RBC model.

Regarding other impairments, Colin, we're just following the accounting rules basically, you know we have to. The accountants changed the rules on us in the third quarter of 2008 regarding the treatment of hybrid securities. They required them to be all treated as equities, essentially for the purpose of addressing impairment policy.

So the equity impairment model requires that if a security is underwater by a certain percent by a specified amount of time, you're required to impair it, regardless of your evaluation of the credit worthiness of the security. And the credit worthiness of the security is what we use on a statutory basis and that's consistent again with statutory accounting rules.

So we've got two sets of rules. We always followed the credit worthiness model on our perpetual portfolio up until third quarter 2008. At that time, as I said the accountants kind of changed the rules on us. So that's why we've had these equity model impairments.

I'll let Jerry specifically address Lloyds, but let me just …

Colin Devine
Citigroup

Kriss, just two comments. I'm not in any way suggesting that AFLAC faces a solvency issue, okay. The point is, even if we just took this quarter's impairment and recognized that on a stat basis, so just the 200-odd million, you're at a 350 RBC ratio. And the other point, and I appreciate what you're talking about what accounting practice. To the best of my knowledge, this is the only company that we certainly look at that isn't essentially booking on a stat basis or the books on the GAAP.

I remember when this happened the first time, Bill Wheeler, who like you is no slouch as a CFO, he never even heard that it was possible. And we're now over 1.1 billion in impairments in the last five quarters. All of a sudden, if you are following through on a stat basis it does seem to me the RBC ratio is in trouble and it's going to be the rating agencies I think can force the hand on capital raising, not the regulators.

Ken Janke

Colin, let me add just one thing to emphasize what Kriss has said. There is no basis to impair those perpetual securities is on a stat basis, because they're being evaluated for their credit worthiness and the ability to return interest and principal to us. The equity impairment method that was handed to us last October does not speak to that at all on a GAAP basis. It is purely a function of price decline and the length of time of which that security is underwater. That's not what happens on a stat basis. So, you can say this is what RBC would be if you took the 212 million and through stat. There is no basis and no reason to take it to stat.

Colin Devine
Citigroup

Well depending on where Lloyds is going on the through cap, I guess we may see it, Ken.

Ken Janke

Let me comment on Lloyds, Colin. You've obviously followed the situation. I think as with many of these perpetual securities, there is a tremendous amount of confusion. So let me start by outlining what our Tier I exposure is to Lloyds. It totals $7 million.

Let me talk a little about what the recapitalization speculation is and some of the comments Lloyds has made. It's nothing official, but based on everything that we've heard and in our conversations with Lloyds and others, they plan a capitalization that may negatively impact Tier I holders, and if as recapitalization were not fully subscribed, there is a possibility it could impact Upper Tier II holders as well.

However, I'm sure you read the statement this morning and so you must know that in that statement, they said they are confident and just hope that this offering will in fact be fully subscribed. So there is yes, a possibility to cramp down on the Tier I exposures. And we acknowledge that that's a risk, but we still haven't seen the detail of this. If when the details emerge we find that the Tier I’s are in fact in jeopardy of having coupons canceled, then we'll re-evaluate the $7 million holding that we have. And absolutely it will be up for stat impairment at that point. Does that answer your question?

Colin Devine
Citigroup

We're getting there. Thanks.

Kriss Cloninger

Let me make one or two other comments just as a follow up to that. First of all, Colin, we think one of the difficulties or I'll say, even a fallacy with the GAAP equity impairment model is that once you write something down, you're not allowed to write it back up. If we wrote everything down to market at the end of March, we would have foregone the opportunity to reflect the $2 billion increase in market value on those available for sale securities. They'd have had to then carried the March 31st value forever. I think that's absolutely ridiculous. Our unrealized gains have declined substantially since March -- the end of March and we would have foregone the opportunity to write that up.

Second thing is that relative to RBC, I'm sure other people have questions about this. We came in at an estimated $405 million at the end of this quarter, but that didn’t count over $540 million of cash at the holding company that some of which we could have contributed to the life company if we wanted to window-dress RBC ratios.

We didn't choose to do that. RBC only matters at the end of the year when it's counted officially for statutory. We're going to take a look at all that. At the end of September, we chose to maintain our flexibility in terms of how we deploy those resources available to us. I'll just wait, I'm getting on a soap box, but we've got several things we're able to do and we're evaluating relative to where we want to be in terms of RBC at year end. I'll just stop right there and take further questions.

Operator

Your next question is from Andrew Kligerman.

Andrew Kligerman
UBS

Good coverage there on the capital. Other issue is the benefits ratio in Japan, year-over-year it improved a 170 basis points, in line with your 150 to 200 basis points year-over-year improvement, but historically, I think you were guiding towards 50 to 100 basis points a year. What are we looking to see next year and maybe even longer term, what kind of improvements can we expect in the Japanese benefits ratio?

Kriss Cloninger

It will continue to improve. We've continued to see a decline in the number of days in the hospital for cancer treatments this quarter and really for some time now. That's one of the principal driving forces behind the decline in the benefit ratio.

How long can it last? In Japan, they still have much longer hospitalizations than you see worldwide for cancer treatment. So there's still some room for additional improvement. As in the past, we've got some contribution due to mix of business, but I'd have to say that above expectation improvement and benefit ratio has been driven by the decline in the hospital days, Andrew.

I don't know how to forecast how much longer it's going to go on. It certainly has gone on for sometime and the Japanese government is still putting pressure on the providers to reduce the healthcare costs in Japan to help control budget expectations and the population's aging and the like.

Andrew Kligerman
UBS

Kriss, what's the average hospital stay currently? What do you think you might be able to guide to next year in terms of the improvement, but not as much as you saw this year?

Kriss Cloninger

I think the average stay is around four weeks, it's around 27 to 28 days. Don't absolutely hold me to that, but for cancer hospitalization, that's in the ballpark. It used to be 60, Andrew. It's come way down, but it's got room to go further. I think relative to next year's guidance, it'll probably be in line with what we guided to for 2009.

Operator

Your next question is from Nigel Dally.

Nigel Dally
Morgan Stanley

Going back to the capital issue, it seems that beside from impairments, the impact of yen strengthening is also an area that many investors are concerned about. The exchange rate is headed down to say around 80, would it seem that you would have a potential problem. So Kriss, what can be done to reduce or eliminate that sensitivity of the capital ratios to the yen? Is that something that you're presently looking into?

Kriss Cloninger

One way to handle that is to build more yen capital. We've got a bias toward building yen capital. We left some 40 billion yen there this year than we otherwise could have repatriated, but because we suspended a share repurchase, we didn't need that cash in dollars, so we left that in Japan.

We'll have a bias toward retaining yen denominated capital in AFLAC Japan in the future. We've got several issues of Samurai notes outstanding at the present time, but the one due in 2010 is about 40 billion yen. One of our options is to look into refinancing that in yen and taking the sum of 15 billion yen or so we presently hold in corporate and contributing that as capital to AFLAC Japan if we feel like that's appropriate or necessary.

So we've got some options there. 80 yen to the dollar might cost us another 30 or 40 basis points in RBC, but again, that's one of the reasons we maintain above average RBC ratios. I think we've got the flexibility to deal with 80 yen to the dollar. Once we talk about 50 yen to the dollar, if that ever came true, we'd have probably some more thinking to do, but I think 80 is certainly something we could stand.

Operator

Your next question, sir is from Randy Binner.

Randy Binner
FBR Capital Markets

Quick one on Takafuji. There was downgrades there in the fourth quarter and I was hoping perhaps, Jerry could shed light on how those downgrades may affect the risk-based capital ratio?

Jerry Jeffery

I don't think I'm the right one to comment on the risk-based capital ratio, but what I can say about Takafuji in the event that you don't know is that our exposure has been significantly reduced in the fourth quarter. We owned 50 billion yen or we had a 50 billion yen exposure to Takafuji in our yen portfolio this month. We exercised a put option which was promptly accepted by Takafuji on 20 billion with that 50 billion exposure. So that cash will be redeployed into NAIC one alternatives, and with the lower exposure from 50 to 30 billion of Takafuji, I would expect the impact on RBC to be minimal.

Randy Binner
FBR Capital Markets

You're swapping NAIC levels basically with two pieces of the 50 billion? It sounds like the Lloyds plan may specifically affect Tier 1 holders and maybe or hopefully not affect upper tier two holders, but ING is obviously going through a restructuring situation as well. What kind of read-through from the Lloyds and ING situation should we have for all the other tier one and upper tier two holdings you have with other European banks?

Jerry Jeffery

The ING situation is entirely different. They have a lot of different subsidiaries and they are not consolidated in anywhere near the way that Lloyds is with HBOS and Bank of Scotland. So I don't read a lot into it other than to say that the EU is a very activist organization and it's being very pragmatic and looks at banks the same way we do which is case by case, in the same way you should as well. So I think that is the take away from this. Unfortunately it's not a take away with which you make any sweeping predictions about how they're going to treat bank capital overall. What you can say definitely is that they are looking at this on very much of a spot basis.

Randy Binner
FBR Capital Markets

Is there an official running total of the total GAAP OTTI that has not been pushed over to stat?

Kriss Cloninger

It would be the perpetuals. I think in every quarter since the third quarter of last year when we had a $191 million of OTTI on a GAAP basis related to perpetuals. We've disclosed that. I don't know the number off hand. This year, I believe, it was in the area of about $340 million. But we've got that in our releases where we could go and piece that together.

Ken Janke

347.

Operator

The next question, sir from Darin Arita.

Darin Arita
Deutsche Bank Securities

Hoping from Kriss to get a little more color on the RBC ratio change in the quarter going down to 405 from 459. The movement was a little more than I would have thought, but was wondering if you could separate the components for us in terms of the effect from the yen, the effect from new credits downgraded and also further migration of existing credits?

Kriss Cloninger

Well, the required capital or the required risk-based capital went up about 20% in the quarter. And our total adjusted capital went up about 5.6% in the quarter. I'd say there was very little yen effect in the quarter. I think the quarter-end exchange rates were pretty close between June 30 and September.

So most of it is related to ratings migration and also there is a size concentration factor in the mechanics of the RBC formula where you have to take your top ten holdings that are not rated in NAIC category one and Takafuji migrated into that category at the end of the third quarter. Of course, 20 billion of it came out in the forefront when we exercised that put option. But at September 30, it was there and caused that size concentration factor to increase fairly significantly.

So most of the decline in RBC ratio related to the increase in the required capital due to the ratings changes. We did build capital. I was pleased with the 5.6% increase in capital during the quarter. So we're watching the outlook for additional ratings changes, obviously, and we're going to have to consider that as we plan for the year-end RBC position.

Darin Arita
Deutsche Bank Securities

Can you put a number in terms of either RBC ratio points or the change in required capital from the 20 billion on Takafuji?

Kriss Cloninger

It might be ten points just guessing off the top of my head, something on that order or magnitude.

Operator

The next question is from Tom Gallagher.

Tom Gallagher
Credit Suisse

If the RBC risk charge, Kriss, just follow up on the point you just made is really what's driving the reduction in RBC, why wouldn't you consider a risk reduction program by disposing or at least shrinking a considerable amount of your below-investment grade holdings? If I just use rough numbers and I say you're getting at least a 10% risk charge for these assets and also some concentration hits as well, why wouldn't you consider selling those if the sale was not meaningfully greater than 10% relative to where you currently carry it?

And on the yen impact on RBC, can you tell us economically speaking, why is it that there's that much sensitivity? Is it because of the reversal of currency bonds or is there something else driving that?

Kriss Cloninger

We've, for a number of years, have said that we wanted to have most of our equity denominated in dollars because we've got primarily dollar shareholders, and we think our shareholders have accepted the notion that earnings are sensitive to yen and we report, including the effect of yen and excluding the effect of yen. But once the dollars and earnings have flowed into equity, we thought that stability of the dollar capital was fairly important. We knew that we had some exposure when yen strengthens and we've accepted that.

I think depending on where the yen sorts out, if it stays in the 90 end of the dollar range, as I’ve said, we've had a bias towards building yen equity for sometime now, and we've taken steps to build yen equity, and we'll continue on that position. People have asked, well don't you hedge the P&L and do futures contracts? The cost of doing that is very high.

The second question; it's a simple matter of economics versus financial reporting. We look at the credit worthiness of our investments, if we had sold them all at the end of March, Tom and taken $5 billion realized loss, we'd all be fired by now because the instruments have come back in market value, I wouldn't be talking to you today if we had done that at the end of March.

Tom Gallagher
Credit Suisse

I agree with that comment. That was a very different time. The securities have rallied massively since then. Now, to me to trade off now, relative to not only the current hit you have on the below investment grade securities, but also where they're going, these securities will continue to be downgraded. There's clearly momentum behind it. My only point is now to me there's a much harder decision to make looking at what my charge to capital will be relative to the costs-- to the hit I would take by is selling them. Is that something you're contemplating, are you going to stick with your current course?

Kriss Cloninger

It’s a matter of judgment, that's all part of management. That's part of what we're charged with doing, and we're certainly paying a lot of attention to it. Investments occupied 95% of my time over the last nine months than it never did before.

Jerry Jeffery

The momentum is behind the back of the downgrade road here. I don't know where the momentum is. I don't think anybody does. Ratings have historically been lagging indicators, not leading indicators That’s clearly been the case here. We've had an unprecedented rally in credit over the last six months, something that we’ve never seen and the downgrades have continued to occur.

Who's right, the rating agencies or the markets? I don't think any of us knows. All we can do is rely on fundamental credit research. I would point out to you that as of today none of our perpetual securities have failed to meet their financial obligations. It's not clear to me that there's any benefit to go on a wholesale selling spree. The world in March was saying prices are going lower, valuations are going to zero. That prognostication is clearly wrong too. Trying to forecast is not something that we find very profitable, credit fundamentals drives our profits.

Kriss Cloninger

If we did sell securities and they're high yielding securities that are not presently in default. If we sell them and take the hit, we've got less money to invest at much lower yields. That's the alternative, putting the money out today is much harder than it has been historically. It's a much lower yield environment and that’s another operating point we have to consider.

Operator

Sir, your next question is from Ed Spehar.

Ed Spehar
BofA Merrill Lynch

You haven't disclosed the nine-month statutory operating gain, but given the build in total adjusted capital, it would seem like your statutory operating earnings were perhaps not that much different than the quarterly run rate we had seen in the first half. Is it your sense if that's the case?

Kriss Cloninger

Yes, it’s accurate.

Ed Spehar
BofA Merrill Lynch

That would suggest that your statutory earnings for the first nine months of this year would be more along the lines of what the annual earnings were last year on an operating basis.

Kriss Cloninger

Right, we've said the run rate's close to $2 billion.

Ed Spehar
BofA Merrill Lynch

You are almost at $2 billion through the nine months and you are probably at $1.8 million through the nine months.

Kriss Cloninger

Yes and part of that is the yen. That's correct. $2 billion is what's in my mind based on last year and we've seeing some strengthening. Probably the $300 million, 15% yen strengthening or so.

Ed Spehar
BofA Merrill Lynch

On the GAAP statement, the parent company expense was very high this quarter versus other quarters. I think there were some unusual items in there. It looks to be like $18 million higher number than it had been running would be considered a 3Q event versus something we should be looking going forward?

Kriss Cloninger

About $7 million of it was related to the change of the discount rate when we booked the full amount in the third quarter.

Ken Janke

There was a $2 million dollars of investment income lower than a year ago and I think the pre-acquisition expenses of CAIC were $1 million. You won't see that going forward.

Kriss Cloninger

The biggest item that's going to continue is the increased interest expense obviously.

Ed Spehar
BofA Merrill Lynch

The discount rate was just a 3Q event not going forward?

Kriss Cloninger

Yes, right. That's over and done with.

Operator

The next question is from [Mark Hughes].

Unidentified Analyst

Could you just quickly give us your evaluation of the Japanese economy right now? Then any thoughts on the flow of new products in the pipeline and the potential effect on new sales in coming quarters.

Tohru Tonoike

This situation of Japanese economy is somewhat in line with what we have been seeing in the last couple of months. It seems to be improving, not very fast, but still improving. Since we have just had a new government in place and their policies, including their common policies, are not very clear, so we have a great deal of uncertainties in the future.

We are looking at various opportunities, but at this point, there is nothing we can tell you about new products which are scheduled to be launched in the near future.

Dan Amos

Regarding the economy; I used this analogy that if you think of a sports injury, the US versus Japan is the US is shocked over being injured, meaning the economy, and therefore they're tentative and reluctant to push hard and recover.

On the other hand, Japan's economy has been bad so long, you reach a point with a sports injury where you say look, if I don't go ahead and just push myself, I'm never going beat this, so they tend to push on. I feel like Japan's economy has been so bad, so long even though it hit probably the worst stage in the last 12 months that we've seen in the last ten years, they still were not as shell shocked as the US economy. I feel like our introduction of a new distribution system with the banking system has played a big role in helping us offset some of the issues that are out there today.

This new medical product that we've introduced, I'm expecting big things from it. As I mentioned in the speech, we've written 104,000 policies. I think that's going continue, and I think you'll see strong sales from medical products in the fourth quarter, and first quarter for sure. It may even carry us through next year, new products are not an issue right now. I think making sure we take care of this new EVER product is the issue and that will be the driving force for AFLAC Japan.

Unidentified Analyst

Any effect on persistency from the new medical product?

Kriss Cloninger

No, persistency in Japan has been very stable. We don't expect any changes in persistency due to that product.

Ken Janke

Lori, we have time for one more quick question, then we'll have to conclude the call.

Operator

Your final question will be from Eric Berg.

Eric Berg
Barclays Capital

Jerry, I certainly understand and appreciate that your portfolio is very different from those of other large North American-based life insurers with the (inaudible) and long duration and heavy component of privates.

Still, credit spreads across all rating categories have improved especially in the below investment grade. My question is why don't you think your unrealized losses have shrunk percentage wise nearly to the degree that some of the large admittedly incomparable portfolios have as your big US life companies? Why don't you think you've seen the same reduction percentage-wise that they have?

Jerry Jeffery

There's no way to answer your question by comparing us to other insurance companies obviously because just the composition of their portfolios is so different, but I would agree with you and in fact, one of the things that I've been looking at the (inaudible) evaluations, these valuations are extremely conservative, but it's the discipline we use and the process we use, so I have gone back to the pricing services not to challenge the prices which I think in some cases are too low, but just to point out to them some data points for them to look at in subsequent quarters when evaluating some of our securities.

Some of our large holdings and some of our large below investment grade holding have not been revalued to the level they ought to be. Look it's better that we're too conservative than too aggressive in our pricing. I also would say going forward, pricing is a totally imprecise process and it will never be perfect, but we are looking at a couple of different alternatives right now to improve pricing anyway, because we do want to get as much precision as we can, but again, given the nature of our portfolio, it is impossible to be as precise as an equity mutual fund for example.

Ken Janke
Thank you all for joining this morning. If you do have any follow-up, please feel free to give Robin or myself a call at your convenience. We're here all day. Thanks again.