S&P Global
Market Intelligence

Aflac Incorporated NYSE:AFL

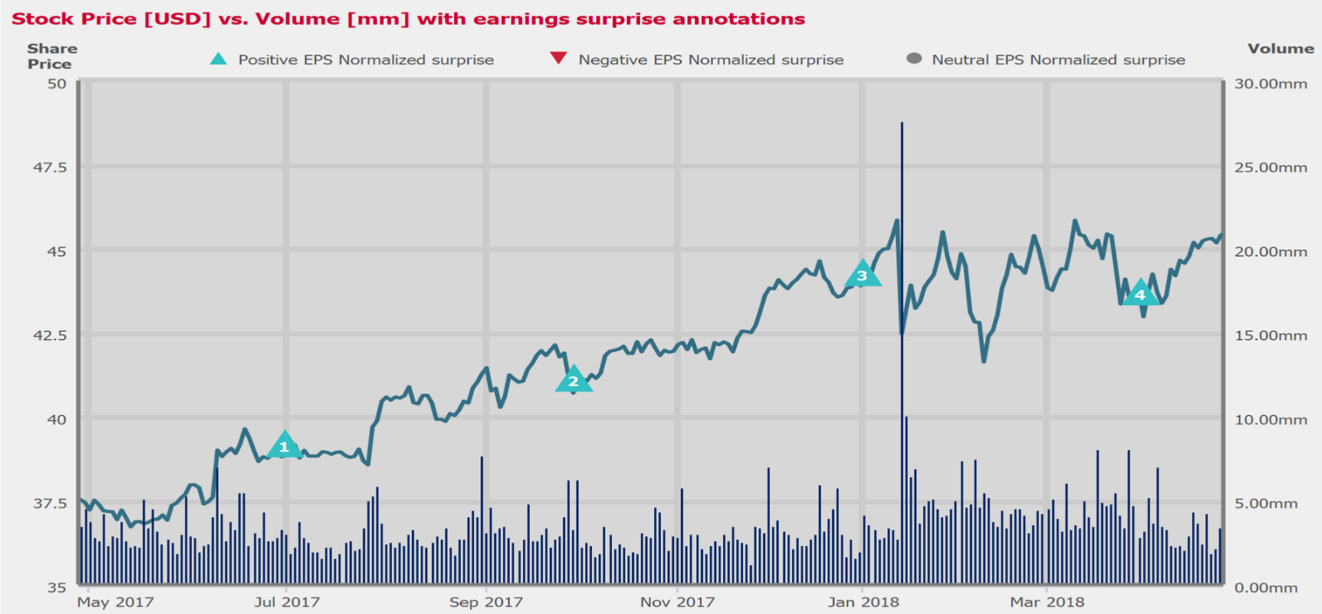
FQ2 2018 Earnings Call Transcripts

Friday, July 27, 2018 1:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ2 2018-			-FQ3 2018-	-FY 2018-	-FY 2019-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.99	1.07	▲8.08	0.99	4.01	4.12
Revenue (mm)	5522.93	5589.00	▲1.20	5377.57	21745.79	21905.79

Currency: USD
Consensus as of Jul-27-2018 11:30 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ2 2017	0.82	0.92	▲1 12.20 %
FQ3 2017	0.81	0.85	▲2 4.94 %
FQ4 2017	0.78	0.80	▲3 2.56 %
FQ1 2018	0.97	1.05	▲4 8.25 %

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EXECUTIVES

Daniel Paul Amos
Chairman, President & CEO

David A. Young
Vice President of Investor & Rating Agency Relations

Frederick John Crawford
Executive VP & CFO

James Todd Daniels
Executive VP & Principal Financial Officer of Aflac Japan

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Executive VP and Director of Marketing & Sales - Aflac Japan

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JP Morgan Chase & Co, Research Division

John Bakewell Barnidge
Sandler O'Neill + Partners, L.P., Research Division

John Matthew Nadel
UBS Investment Bank, Research Division

Nigel Phillip Dally
Morgan Stanley, Research Division

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

Suneet Laxman L. Kamath
Citigroup Inc, Research Division

Presentation

Operator

Welcome to the Aflac Second Quarter Earnings Conference Call. [Operator Instructions] Please be advised, today's conference is being recorded.

I would now like to turn the call over to Mr. David Young, Vice President of Aflac Investor and Rating Agency Relations.

David A. Young
Vice President of Investor & Rating Agency Relations

Good morning, and welcome to our second quarter call. This morning, we will be hearing remarks from Dan Amos, Chairman and CEO of Aflac Incorporated about the quarter as well our operations in Japan and the United States. Then Fred Crawford, Executive Vice President and CFO of Aflac Incorporated will follow with more details about our financial results, outlook and capital management. We will then open our call to questions.

Joining us this morning for Q&A are members of our Executive management team in the U.S., Teresa White, President of Aflac U.S.; Eric Kirsch, Global Chief Investment Officer; Rich Williams, Chief Distribution Officer; and Albert Riggieri, Global Chief Risk Officer and Chief Actuary; and Max Broden, Treasurer.

We are also joined by members of our executive management team in Tokyo at Aflac Life Insurance Japan. Charles Lake, President of Aflac International and Chairman, Representative Director; Masatoshi Koide, President and Representative Director; Todd Daniels, Principal Financial Officer; and Koji Ariyoshi, Director and Head of Sales and Marketing.

Before we start, let me remind you that some statements in this teleconference are forward-looking within the meaning of federal securities laws. Although we believe these statements are reasonable, we can give no assurance that they will prove to be accurate because they are prospective in nature. Actual results could differ materially from those we discuss today. We encourage you to look at our annual report on Form 10-K for some of the various risk factors that could materially impact our results. The earnings release is available on the Investors page of aflac.com, and also includes reconciliations of certain non-GAAP measures.

I'll now turn the call over to Dan.

Daniel Paul Amos
Chairman, President & CEO

Thank you, Dave. And good morning, everyone, and thank you for joining us today.

Let me begin by saying that the second quarter of 2018 established a strong first half of the year for Aflac. I am pleased that we were able to upwardly revise our 2018 adjusted earnings per share outlook.

Aflac Japan, our largest contributor, generated strong financial results. Fred will provide more details, but let me just say that in yen terms, Aflac Japan's pretax profit margin was ahead of expectations, both through the quarter and through the first 6 months.

Aflac Japan's outstanding third sector sales increase of 16% was well above our expectations. The strong results was largely due to April's introduction of our new cancer insurance product. There were few factors that drove sales beyond our expectations for the quarter.

First, the new cancer insurance policy offered popular enhanced benefit features, while carefully managing the risk profiles of the product as we've done in the past. In addition, we launched a targeted promotional campaign for all this cancers -- the new cancer product that incorporated television ads with the largest direct mail campaign we have ever done. And finally, we fully engaged our wide-reaching distribution network.

Over the last few years, following our agreement with Japan Post, we phased in our cancer insurance sales to postal outlets that were positioned for sales at the time. This new cancer product launch marked the first introduction that we've had access to all 20,000-plus Japan Post outlets at the same time. The results there were bigger than we had anticipated. In fact, this quarter reflected the highest production ever in Japan Post in terms of AP.

Our traditional agencies also had a stellar performance in cancer sales. And they continue to be vital to our success. Our extensive distribution network furthers our goal to be where people want to buy insurance.

All of these factors are reflected in strong cancer sales growth for both the independent corporate agencies and affiliated corporate agencies during the quarter. The quarter's results are laying the foundation for another strong year of third sector sales. We believe some of this reflects an acceleration of sales that we originally anticipated for the second half of the year, recognizing the strong launch of the cancer product. We have upwardly revised our projections and are now calling for growth rate in the low single digit for 2018 third sector sales.

Remember, we are coming off comparisons to an outstanding 2017 for third sector medical sales due to last year's introduction of the new EVER medical product. You'll hear more about this from Ariyoshi at our Financial Analyst Briefing in September.

Our focus on remaining our leadership position in the sale of third sector products that are less interest rate sensitive and have strong and stable margins. We will continue to refine our existing product portfolio and introduce innovative, new third sector products to maintain our market leadership.

Turning to Aflac U.S., we are pleased with our financial performance. The pretax profit margins exceeded our expectations, both for the quarter and for the first half of the year.

I am also pleased with our sales results for the quarter, which advanced our progress in achieving our anticipated full year sales growth of the 3% to 5%. You'll hear more about this from Teresa and Richard's Financial Analyst Briefing in September. But we continue to expect higher growth in broker sales.

Our team of broker sales professionals made great strides in successfully strengthening Aflac's relationship within the large broker community. Our product -- our partnering initiatives for True Group products is still early in its development but is already starting to take shape. As a result, Aflac is seeing a high rate of growth through brokers and strong sales growth in our group products.

Keep in mind, Aflac is different from our peers and that the majority of our sales comes from our independent sales agents. We are fortunate to have such a strong independent field force, which is truly unique within our industry. These career sales agents are best positioned within the industry to reach and, therefore, succeed with the smaller employers and groups with fewer than 100 employees.

Aflac's independent career agents have been the driving force behind Aflac's ability to dominate the smaller case market.

Recruiting remains a challenge in a strong employment marketplace. However, productivity continues to improve as our veteran agents further penetrate existing accounts and our investment in agent development gains traction. Equally important is the coordination between our powerful field force of sales agents and our growing network of broker sales professionals. It is very encouraging that our brokers look for solutions for their clients. They have found that Aflac's portfolio of products helps fill those needs. Brokers are looking for a strong brand like Aflac as they also leverage our outstanding track record of experience and extensive fulfillment capacities.

Our field force of independent agents are experts, who have demonstrated their ability to accelerate growth by working with brokers and broker sales professionals. We characterize this collaboration as broker influence business. As we look to the remainder of 2018, we will continue to expect sales to make way towards the fourth quarter as broker and broker influence sales are a growing part of our business.

Turning to capital deployment, Fred will provide more details shortly. We remain committed to maintaining strong capital ratios on behalf of our bondholders, shareholders and policyholders. At the same time, we are balancing our financial strength with increasing the dividend, repurchasing shares and reinvesting in our business. We continue to anticipate that we'll repurchase in the range of $1.1 billion to $1.4 billion of our shares in 2018. As always is the case, this assumes stable capital conditions and the absence of compelling alternatives.

Looking ahead, we believe our strong earnings growth will reflect the underlying earnings power of our insurance operations in Japan and the United States. It will also reflect our prudent approach to deploying excess capital in a way that balances the interest of all stakeholders. At the same time, it will also reflect our dedication to delivering on the promise we make to our policyholders.

I'll conclude by saying that this has been one of the best quarters in the company's history, and I am very proud of it.

I continue to be excited about Aflac's future growth, and now I'll turn the program over to Fred, who will cover the financial results. Fred?

Frederick John Crawford
Executive VP & CFO

Thank you, Dan. Building on a strong start to the year, our earnings results for the second quarter exceeded our expectations.

While it is early in the year, the strength of our performance year-to-date and stability in our margins gives us confidence we will exceed our original guidance range for the year. We have, therefore, updated our currency-neutral adjusted earnings guidance to a range of $3.90 to $4.06 per diluted share.

Key variables as we move through the year include continued strength in investment income, sustainability of benefit ratios and underlying claims trends and the pace of expense build as we continue to invest in the future growth and efficiencies.

For the quarter, adjusted earnings of $1.07 were driven by strong pretax margins, both in Japan and the U.S. Our reported results benefited modestly by a strengthening of the yen as compared to 2017 period, contributing $0.01 per share to the quarter's results.

Virtually, all key earnings drivers performed at or above our expectations. Japan branch conversion costs in the quarter were $40 million. We project less than $10 million in the remaining costs spread over the third and fourth quarter. We have effectively wrapped up the conversion with total project costs of approximately $120 million, consistent with the low end of our forecasted range.

Turning to our Japan segment results, we reported pretax profit margin of 21.8%. Our total benefit ratio came in below our guidance range of 70% to 72%, driven by a continued shift in business mix from first sector towards third sector, positive claims trends in our cancer business and associated reserve adjustments.

Our expense ratio in Japan reverted back to the midpoint of our outlook range of 19% to 21%. The sequential increase was expected, given promotional spend with the launch of our refreshed cancer product and continued build in IT modernization spend. We would expect to run towards the high end of our outlook range throughout the rest of the year.

Before moving on to the U.S. segment, as is common when introducing a new or refreshed third sector product in Japan, we typically experience elevated lapse and reissue activity as policyholders choose to upgrade their existing policies for the enhanced benefits.

In the short run, and depending on the mix of policies, this can apply downward pressure on our benefit ratio as we release reserves on lapsed policies and experience elevated DAC amortization on the same policies. While it is too early in the launch of our cancer product to have specific estimates on the impact, we believe this contributed to Japan's favorable benefit ratio, increased DAC amortization and provided a very modest net benefit to earnings in the quarter. We expect this impact will lessen throughout the year.

Turning to the U.S. results, our overall pretax profit margin in the quarter was 21.1%. Our total benefit ratio moved back to the midpoint of our guidance range of 51% to 53%. We have historically seen a lower first quarter benefit ratio followed by a modest increase in the second quarter, and that experience continues.

Our expense ratio in the U.S. came in below our expectations and is largely timing related. We expect accelerated spend in the second half of the year, which includes previously announced post-tax reform investments.

As mentioned in the first quarter, these accelerated investments will amount to approximately $0.03 per share in the second half of the year. Overall, we continue to see the year coming in around the midpoint of our guidance range of 34% to 36% with the second half running at the high end of the range.

Investment income performance both in Japan and the U.S. continues to deliver very strong results. The year-to-date outperformance has been driven primarily by the accelerated growth of our floating-rate portfolio, further benefiting from higher LIBOR rates, relative to our expectations coming into the year.

As we have previously commented, we elected to lock in the majority of our hedge costs for 2018, which mitigated the potential impact from higher U.S. interest rates. As hedge instruments roll off, we would expect to lose some of this relative outperformance heading into 2019.

As I discussed on the first quarter call, we continue to make progress on managing our economic exposure to the yen while lowering enterprise-wide costs associated with the Japan's U.S. dollar investment hedging.

We accomplished this by entering into an offsetting hedge position at the holding company with the financial impact recognized in our corporate and other segment. We have built this offsetting position to approximately $1.25 billion in the quarter, contributing $7 million on a pretax basis to the quarter's earnings.

Our strategy balance is securing Aflac's strong capital position in Japan, while lowering our enterprise exposure to a weakening yen. We will spend more time discussing this risk reduction strategy at our September Financial Analyst Briefing in Japan.

We ended the quarter in a strong capital position. Japan's solvency margin ratio is estimated in the 950% range. This is, particularly, strong result, recognizing our April 2 conversion from a branch to a subsidiary reduced SMR by approximately 130 points. As we have stated previously, we have plans in place to restore the SMR accounting impact over a 3-year period.

Our estimated U.S.-only risk-based capital ratio at quarter end stands at roughly 850% and includes an estimate of the full adoption of U.S. tax reform. It is our understanding the NAIC intends on adopting the full effect of tax reform in 2018.

With the impact of tax reform and dividend projections that include a drawdown of $500 million in excess capital in the second half of the year, we are projecting an RBC in the mid-600% range for year-end 2018.

We ended the quarter with just over $2 billion of capital and liquidity at the holding company. We set aside $1 billion for contingent capital and $500 million for liquidity in support of holding company derivative positions. Despite recent increases in volatility, overall credit conditions and asset quality remain strong with very little in the way of impairments in the quarter.

Including dividends and share repurchase, we returned approximately $500 million to our shareholders in the quarter. We repurchased 6.8 million shares of our stock for $306 million in the quarter and remain tactical in our approach. We are maintaining our current outlook range for repurchase of $1.1 billion to $1.4 billion in 2018.

As we move into the third quarter, we plan to make a $50 million contribution to our pension fund. This contribution is larger than normal and takes advantage of a 35% corporate tax deduction if funded prior to September 15. The contribution has no implications for our capital plans and represents a sound use of excess capital.

With the conversion behind us, we are hard at work to optimize our capital and liquidity profile. We will further develop these strategies at our September Financial Analyst Briefing.

I'll now hand the call back to David to begin our Q&A session. David?

David A. Young
Vice President of Investor & Rating Agency Relations

Thank you, Fred. Now we are ready to take your questions. [Operator Instructions]
We will now take the first question.

Question and Answer

Operator

[Operator Instructions] The first participant to ask question is Ryan Krueger of KBW.

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

Fred, could you help us size the potential impact of the roll off of the hedges that you locked in this year as we go into next year and they reset?

Frederick John Crawford
Executive VP & CFO

Yes, it had -- it certainly helped in -- mitigate, if you will, some of the rising rates. As you recall, we locked in approximately 80% of our hedge costs as we are entering into 2018. And we estimate for the full year on a pretax basis that benefits us by approximately $9 million for 2018. So that's the approximate benefit. So it's relatively modest. But again, we would note that as we roll into 2019, we'll start having a reset, if you will, of our hedge costs. And obviously, hedge costs have risen throughout the year. Again, that's offset by LIBOR benefiting us as we've built out the floating-rate portfolio.

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

And then just one other one on, you mentioned prudent investment in the business, I think, in regard -- the comment after your buyback comment for the year. As presumably, the ongoing business investments don't really have much impact on your capital position. So does that refer to -- are you referring to things like investments in some of the insured tech companies and things along that nature?

Frederick John Crawford
Executive VP & CFO

No, not really referring to that. Although we have set aside some opportunistic money, if you will, to reinvest in those efforts. And those efforts are going well. But they represent a relatively modest allocation of our excess capital, when looking at any given year over a 3-year period of time. Really, the more important aspect of reinvestment back in the business platform, both in the U.S. and Japan, is that we're calling for some elevated expense ratios, if you will, as we move through the remainder of the year. We've been running at relatively low expense ratios in the early part of the year, both in Japan and the U.S. As you saw in the second quarter, Japan reverted back to more -- what we would expect in that 20% range as an expense ratio. But the U.S. was quite low, and that's largely timing related because we, for natural reasons, had back-end loaded, for example, some of our tax reform investments as we formulate the plan and remained very prudent in how we allocate that money. So some of that reinvestment is really related to expense ratio guidance and not so much a tax on our capital position or excess capital deployment.

Operator

The next question is coming from the line of John Nadel of UBS.

John Matthew Nadel
UBS Investment Bank, Research Division

Fred, just a question on the U.S. risk-based capital ratio. I think, you had mentioned that it's around 850%, and you expected to drop down to about 650% at year-end. I think there's 2 drivers there. One is the $500 million dividend that you're expecting to take out. The other one is the tax impact. Can you sort of give us a sense of the relative contribution to that 200-point decline from each?

Frederick John Crawford
Executive VP & CFO

Yes, yes, absolutely. So remember, the first half of tax reform was already adopted in the number. That was the DTA, that was adopted early. So the tax reform impact for 2018 is really in the denominator, if you will. And that has an impact of right around 75 points of RBC. In other words, if you were to look at our RBC before that implementation of tax reform, we would be running at or posting 925% RBC. So that tax reform implication had knocked it down to 850%. Now what brings it down to 650% is that we've largely back-end loaded our U.S. statutory dividend, and the removal of that excess capital all takes place in the second half of the year. In fact, the [removal] of excess capital, together with normal dividend of earnings that are produced in the U.S. entity, we are calling for upwards of just a touch over $1 billion of dividend activity up to the holding company in the second half of the year. So it's quite a bit back-end loaded. And a lot of that had to do with making our way through the conversion and settling into our post-conversion RBC estimates.

John Matthew Nadel
UBS Investment Bank, Research Division

Okay. So that $1 billion of dividends is really the 200 points?

Frederick John Crawford
Executive VP & CFO

You got it. And it's a combination of statutory earnings and normal, what I would call, ordinary dividend capacity. And then the $500 million excess capital.

John Matthew Nadel
UBS Investment Bank, Research Division

Got you. That's very helpful. And then just to circle back on persistency in Japan. I know it's nitpicky, but that's ticked down a bit, maybe 1 to 1.5 percentage points over the last several quarters. Is that really related to what you discussed earlier, which is the sort of shift in lapsation of old policies and for the new ones?

Frederick John Crawford
Executive VP & CFO

That's right. That's right. And particularly, with cancer, because you're talking about having gone 4 years since upgrade. And so, with advancements in cancer treatment and diagnosis and then together with other beneficial features that Dan noted in his comments, you have much more in the way of an attractive upgrade opportunity for our policyholders. Recognizing that we age-band things in cancer, and so it tends to be some of the more recent policies that are more susceptible to this. And in that case, what ends up happening is, yes, you'll have elevated lapse activity, i.e. lower persistency. You'll have sales, obviously, benefiting from that activity. But then when you get to our P&L, you have a bit of a lower benefit ratio as you release reserves on the policy, higher DAC and DAC amortization. And that tends to balance out for a somewhat modest impact to earnings. So it's little less about an earnings story and more about the line items in the P&L. And I would note that it's very important to understand that in the second quarter of last year, we actually had the same dynamic, it's by coincidence, but we launched our medical product in March last year. And if you look at the trends in persistency, trends in benefit ratio, DAC amortization, you see the same phenomena last year, 1Q to 2Q as you see this year. That's coincidental. But it gives you an idea that, that tends to happen when you first launch the product. It calms down over time, obviously.

John Matthew Nadel
UBS Investment Bank, Research Division

Okay. And are you agnostic between cancer and medical sales?

Frederick John Crawford
Executive VP & CFO

I'll let Dan answer that because we talk about that. The answer is from a profitability perspective, yes. But Dan, why don't you talk about it?

Daniel Paul Amos
Chairman, President & CEO

Yes, I think we are. We've always said that when the profit margins are relatively similar, then to us, it doesn't matter. And agents, they always choose the path of least resistance. And the path of least resistance is always the newest product that's on the market. It gives some sizzle, and they can go straight to it. You saw that happen last year with the EVER product, and now you're seeing it this year with the new cancer product. So it makes it much easier than us to try to figure out how to balance every year which one they sell. If there was an enormous difference in profitability, then that's one thing. But there isn't. So from that standpoint, we feel very good about it. And it's nothing new. I mean we've been doing it since the inception of Japan, we've been working that way.

Operator

The next question is coming from the line of Nigel Dally of Morgan Stanley.

Nigel Phillip Dally
Morgan Stanley, Research Division

I just wanted to follow on from John's question. Is it possible to mention the portion of sales that represented the lapse then reissue activity on the new cancer product? And also just a question on accounting. When you do have a lapse and reissue, is it just the incremental premium book to the sale? Or is it the whole annualized premium on the new policy?

Frederick John Crawford
Executive VP & CFO

Yes, it's the overall premium because it's really treated as literally 2 separate transactions, meaning -- because it's really consistent with what the consumer has decided. They've decided to lapse their policy. And so you'll see that lapse accounted for and reported just as a lapse. So it hurts your persistency as you would expect, and it's consistent with accounting. The accounting guidance on this is if you've made material changes to the policy, particularly, the benefit structure of the policy, and more materially improved it, then you really account for it as a lapse and reissue. So that's the way it goes. The reissue then is marked and reported as a sale. And so, the accounting and the way we report it is consistent in that regard. And then in terms of sizing it, this has obviously been going on for many, many years. This is really always how it's been reported as a company.

We will tend to see normal lapse and reissue activity ranging in the 10% to 15% in any given period, in any given year. But as I mentioned, in the period where you actually launch in that period, i.e. that quarter or perhaps a quarter or 2, it will naturally be elevated, upwards of 25% to 30%. And we suspect that's about the type of result we've seen this time around. When it comes to the outright earnings impact, it's quite a bit muted. It's very dependent on the cohort of what actually lapsed, older policies, for example, which is more rare when their lapse will release higher reserves. They oftentimes, as they're very old, may have cash value associated with it and very little DAC amortization. And so it hits the bottom line in a little more pronounced but positive way. But because many of the policies tend to be really younger, if you will, in terms of age of the policies, when they've been issued, last five years, for example, you'll have less in the way of reserve release and more in the way of DAC amortization. So it's highly dependent on the mix of business, which is why it's difficult to estimate. We would estimate in this period that may be earnings benefited from JPY 1 billion to JPY 2 billion, in that range. So relatively modest and, again, very similar to 2017.

Daniel Paul Amos
Chairman, President & CEO

But Nigel, you've been around long time. The cancer product before this one, that was the case. And the cancer product before that one, it was the case. So it's been going on over 20 -- plus 20 years. So it's nothing new.

Operator

The next question is coming from the line of Jimmy Bhullar of JPMorgan.

Jamminder Singh Bhullar
JP Morgan Chase & Co, Research Division

First, just on the expected RBC decline because of tax reform. Has that in any way changed your view of what the RBC threshold should be? I think you've mentioned 500% as being sort of an initial threshold for the RBC. Just trying to assess how the lower RBC affects your plans to free the $1 billion you'd mentioned from the U.S. conversion?

Frederick John Crawford
Executive VP & CFO

Yes, Jimmy, no impact to that. We are very comfortable. Not only with the tax reform absorbed in our capital plan and drawdown of excess capital, but I would also note that we're comfortable with any potential [move-in] related to the C-1 bucket, if you will, changes that are expected in 2019. We see neither of those events as disrupting our drawdown plans. We have settled in and expect to settle in around 500% at the end of 2019. As I've mentioned publicly, I think given the risk profile of our business, as we start to print blue books and are able to analyze and report our stability, if you will, and low risk profile as a U.S.-only entity, we'll continue to look to see whether there's further optimization opportunity in that. I think most observers would say that 500% RBC on the nature of our business is quite high, even for our high ratings threshold. And so, we'll work on that. But I think when working with rating agencies, and frankly thinking about our own risk management practices, it's important to start printing some of these statutory results on a U.S.-only basis to make sure we have a good handle on it and can support our case. So we think there's room there, Jimmy, but just to answer your question: No, tax reform nor the C-1 changes are going to disrupt our capital plans.

Jamminder Singh Bhullar
JP Morgan Chase & Co, Research Division

Okay, and if I could ask one more just -- overall, obviously, your sales are very strong in Japan. The one negative, I thought was just the medical sales continuing to shrink. And I think they're sitting around the JPY 6 billion, the quarterly range. And they [adjusted] lower steadily after you introduced the updated product last year. So I'm assuming you'd introduce a new product at some point next year. But do you -- is this sort of a normal level of medical sales? Do you expect in the absence of any new products? Or have the sales been pressured a little bit because of the whole focus on cancer recently?

Daniel Paul Amos
Chairman, President & CEO

I'd like either [Koide] or Koji to answer the question. Koide?

[Foreign Language]

Masatoshi Koide
President, Representative Director & COO of Aflac Japan

Well, one of the big reasons why medical sales maybe shrinking is because it's been more than a year since the new medical product was launched.

[Foreign Language]

And then, as you know, we've launched a new cancer product in April, and everyone is really shifting their focus to selling this product. As a result, medical sales in the second quarter declined. And this is something that we have assumed, and this is what we have been experiencing in the past as well.

[Foreign Language]

And as you know, the medical insurance area is very competitive. However, we are still maintaining a #1 position in new business policy number as well as AP. So please remember we are still maintaining that #1 position.

Operator

The next question is coming from the line of Humphrey Lee of Dowling & Partners.

Humphrey Lee
Dowling & Partners Securities, LLC

A question for Fred regarding the benefit ratio and the DAC amortization impacts from the lapses. I understand from a earnings impact, this is [more or less]. But like how should we think about the moving pieces in terms of the uplift to the -- I mean, the downward pressure on the benefit ratio and the uplift to the DAC amortization? And then also how should we think about it in the balance of the year?

Frederick John Crawford
Executive VP & CFO

Yes, I think in terms of the balance of the year, we would expect this impact to lessen, as I mentioned. So it will become less distinguishable from a line item perspective and really negligible in terms of any particular earnings impact. I think an easy way to think about it, Humphrey, is that as I mentioned in my comments, we would expect the benefit ratio in Japan to elevate back within the guidance range we have, which is 70% to 72%. And that's one way of thinking about the relative impact because that would be probably one of the features that would drive it back up. We also have particularly strong cancer claims trends. Don't forget, we're actually seeing just good [flat bed] experience particularly in hospitalization trends on cancer. And that led to not only positive claims activity but also some natural IBNR release, which is somewhat mechanical as we adjust for the trends we're seeing. So we continue to see that development, and that's very economic, if you will, in terms of the benefit. Very importantly, what I would say to you is that when looking at the benefit ratio overall in Japan, while our guidance range is 70% to 72%, we actually expect the full year to be coming in at the downside of that range. That has been a somewhat consistent pattern, and we expect some of that to continue. It'll be more elevated than what we had in the second quarter, but still, overall, year will fall very close to the bottom end of that range is what we're currently projecting. So that's the way to think about it. The actual line item impact was preciseness. There's more work to be done to be able to isolate that because it gets quick -- quite, quite technical. You're talking about really needing to isolate all the exact moving parts in the policy from particularly a lapsed policy dynamic. As I mentioned, the cohorts can be very sensitive as to what the impact is to the line items. We'll continue to do more work on that. It can provide more transparency. But from a bottom line perspective, it's not a big material mover. And again, you can kind of take both the benefit ratio guidance we've given as a little bit of the impact. DAC amortization, very similarly, and I would, again, call your attention to last year's 1Q to 2Q development. You can see the same thing happening. Benefit ratio drifted down when we launched the medical product in March, amortization drifted up. And those are reasonable proximities of what you see on those line items.

Humphrey Lee
Dowling & Partners Securities, LLC

Got it, that's helpful. And then on the third sector sales in the quarters. So obviously, there are a lot of the moving pieces. Part of it because of the new product launch and then also kind of being -- having a very successful targeted promotional campaign. And then I'd believe there's also some pent-up demand from the first quarter in anticipation of the launch. So when we think about kind of the product itself, like excluding the impact of the pent-up demand from the first quarter, like how would you kind of characterize the product itself, [kind of] addressing the need of the consumer that was not available in the marketplace before this product? And how should we think about the -- kind of the sales impact in the balance of the year?

Daniel Paul Amos
Chairman, President & CEO

Koide or Koji.

[Foreign Language]

Koji Ariyoshi
Executive VP and Director of Marketing & Sales - Aflac Japan

Yes, I will take the question. This is Koji. [Foreign Language]

We have always incorporate -- tried to incorporate features by always thinking about that what is needed by the customers as well as what is going on in the medical treatment area. For example, at this time, we have implemented a specified premium waiver feature of palliative care, et cetera.

[Foreign Language]

We also have features to be able to cover a broad range of customers that includes new customers as well as our existing customers.

[Foreign Language]

And we are also providing our product to those consumers or the customers who have concerns about their health or even to cancer survivors.

[Foreign Language]

And particularly at this time, our main feature is to add a specified premium waiver feature which has been long wanted by the JP customers, or Japan Post customers.

[Foreign Language]

And we have also added our coverage that can be added to our existing policyholders' policies. And this was very much wanted by our agencies, and these have contributed to the sales this time.

Daniel Paul Amos
Chairman, President & CEO

I'd like to add more -- one other thing. And that is product is important here, but it's also just a strong distribution channel. I mean, we are truly going to the places that people want to buy our product. And then don't forget, our domination of the cancer insurance market is something that stands out worldwide, that what we've been able to do in that market. Medical is more competitive. Back -- if you go back to 2001, when we deregulated the market, a lot of people thought Aflac would be out of business and all of the big competitors would put us out. And instead, you saw the Dai-ichi Life sell for us. You saw some of the other competitors get in and then pull back. You've seen Japan Post, you've seen the post up -- I mean, the banks. I think it's part distribution, but it also is those products as well. But it's a one-two punch of both of them that makes us stand out.

Humphrey Lee
Dowling & Partners Securities, LLC

I guess, just to kind of clarify a little bit. So like for the -- almost JPY 21 billion in cancer sales in the quarter, here we think about some of this is probably because of the pent-up demand from first quarter, and then the other is just because of the -- you have a new and better product. So we kind of bifurcate between some of the pent-up demand versus the -- what do you expect is a more normal kind of quarterly sales for the cancer product? How should we think about that?

Frederick John Crawford
Executive VP & CFO

What I would say to your point, if this is what you mean by pent-up sales, you might recall, and we've commented on this publicly, that as it starts to become well understood that we're refreshing a cancer product, particularly when we filed with the FSA, and we're in motion and starting to build, you will see a natural anticipation of the new product and a pull-back in some of the distribution systems as they prepare for it. So you do have some shift from a 1Q pause to a 2Q jump out of the gate and strong sales. But then as Dan had mentioned and Koji mentioned, it's natural both in medical and cancer that's as the year goes on, you start to see things taper from a sales perspective. So you have a little bit of acceleration of what we anticipated in the second half of the year into the second quarter, and then you have exactly what you're saying, a little bit of that delayed start or pent-up demand, if you want to call it, from 1Q to 2Q.

Daniel Paul Amos
Chairman, President & CEO

You can't get more than about 2 quarters of it.

Operator

The next question is coming from the line of John Barnidge of Sandler O'Neill.

John Bakewell Barnidge
Sandler O'Neill + Partners, L.P., Research Division

Given the strong first-half third sector sales this year, should we start viewing the Japan segment, now that we've had the product portfolio composition shift to third sector and away from the first sector, as more heavily weighted toward the first half in any given year to maybe balance out the U.S.' increasingly 4Q weighting for sales?

Daniel Paul Amos
Chairman, President & CEO

I think it's a function of when we introduce new product. And that is approval based on the FSA. And the minute we decide we're coming out with a new product, we want it as quickly as we can, so we don't hold for anything. So I think that's what's driving it more than anything else.

John Bakewell Barnidge
Sandler O'Neill + Partners, L.P., Research Division

Okay, then with the new cancer product rolled out, driving strong sales, can you talk about other new products or product enhancements, please?

Daniel Paul Amos
Chairman, President & CEO

Japan?

John Bakewell Barnidge
Sandler O'Neill + Partners, L.P., Research Division

Yes, that would be great.

Daniel Paul Amos
Chairman, President & CEO

Okay. Koide or whoever wants to do it?

Masatoshi Koide
President, Representative Director & COO of Aflac Japan

[Foreign Language] And in terms of new products, we'll be focusing -- we have been focusing on medical and cancer. And especially, in cancer product we were -- we needed to develop very attractive product at appropriate timing. And then looking at medical product because the medical area is more competitive compared with [indiscernible] use the product in much more quicker pace. And we are also considering some products in the protection-type area, and we are considering them. For example, one of the areas that we are currently [indiscernible] promotion area, which could be very attractive.

Operator

The next question is coming from the line of Erik Bass of Autonomous Research.

Erik James Bass
Autonomous Research LLP

In the U.S., you're seeing some nice improvement year-over-year in agent productivity. Can you just talk about which of your initiatives have had the biggest impact to date? And where you still see opportunity to improve performance?

Daniel Paul Amos
Chairman, President & CEO

Teresa?

Teresa Lynne White
President of Aflac US

So Erik, this is Teresa. I think in the area of -- where we're seeing most of our improvements, it's distribution expansion and all of the activities that we have around our broker tools and services. I think we've started to see the investments pay off in that area. We also have executed on product partnership and other solutions that we're bringing to the employer, which I think provide -- have helped us to provide lift on that side as well. As to what may not be performing as well, at this point, I feel like we're operating on all cylinders. We -- what I'm seeing is a disciplined execution on our strategy. Obviously, I'd love to have more recruits, increased productivity, et cetera. But we continue to see very positive movement in many of our metrics. So hopefully, that will answer your question.

Erik James Bass
Autonomous Research LLP

And to follow up on one thing you mentioned. You talked about the build out of your product set including some of the partnership relationships. Can you just comment on the impact that this is having on sales?

Teresa Lynne White
President of Aflac US

Well, we're seeing increase in quotes from many of our many larger-case brokers and actually in the mid-market as well. And so we see that as a great, leading indicator for sales. But we've also seen the close rate increase as well. Enhancements to our new cancer product has also been a part of that as well.

Erik James Bass
Autonomous Research LLP

Got it. I would assume the biggest benefit from that you would see on sales would be in the fourth quarter as well?

Teresa Lynne White
President of Aflac US

Yes.

Operator

The next question is coming from the line of Suneet Kamath of Citi.

Suneet Laxman L. Kamath
Citigroup Inc, Research Division

I wanted to talk about Japan in the annualized premiums in force. Even with the strong third sector sales, it looks like that number is still coming down. I know there is 5-pay WAYS still kind of coming through. But any sense of when you think that annualized premiums in force number will start to grow again?

Frederick John Crawford
Executive VP & CFO

Yes, this is Fred, Suneet. I think it does take a while. We are still seeing the paid-up policy dynamics come through in first sector. First sector, in general, has about a 1 -- little north of 1% lapse rate generally. And then the paid-up policies are running around JPY 30 billion for the year. And that will continue to come down, but modestly. You'll still see a level of paid-up policies. Not just related to 5-pay but just in general, other forms of paid-up policies that we have on the books. And then eventually, there's a 10-pay product that's sold far less than the 5-pay, but that comes into play as well. So first sector premium, in general, is going to continue to be modestly down, but it's slowly starting to get overwhelmed by the growth rate of third sector, particularly when we post consecutive years of third sector growth rate. And so the third sector earned premium is now about 75% of our total earned premium. That's up about 200 basis points over last year this time. It gives you an idea of the mix shift. And that third sector premium, as we've said, we anticipate growing in the 2% to 3% range. And we're certainly hitting that nicely. So you'll start to eventually turn the corner. I think, for sure, you're into very low growth rates once you do turn that corner just by virtue of the sheer size of our block of business and natural lapsation that takes place. But what's really important is the embedded value, if you will, and profitability of that shift in mix away from first sector towards third sector is a very good development for the company over time. And you end up seeing the evidence of that in improved FSA earnings, which means improved cash flow and excess capital and deployment opportunities. So we're happy with that trend line.

Suneet Laxman L. Kamath
Citigroup Inc, Research Division

Got it. And then just on the third sector sales, it looks like cancer is going to carry you guys for this year. I think medical was pretty strong last year. I think there was a question on this earlier, but just to follow up. Is there another sort of key product launch that you guys are thinking about for 2019 to kind of overcome what's becoming some difficult comps in '18?

Daniel Paul Amos
Chairman, President & CEO

I'll let Japan touch on that again.

Masatoshi Koide
President, Representative Director & COO of Aflac Japan

[Foreign Language] And of course, for our growth, it is our responsibility to really inject new products into market in a well-planned manner.

[Foreign Language]

So we are steadily preparing for our new product launch.

[Foreign Language]

However, I am not able to really disclose the specifics of the product that we are thinking of.

Daniel Paul Amos
Chairman, President & CEO

That's a requirement of the FSA. That's not just us at Aflac not wanting to tell you.

Suneet Laxman L. Kamath
Citigroup Inc, Research Division

No, that's fine. Just one last one just on the income support product. I think in the past, you'd talked about maybe that product is -- sort of the third leg, and the product's still in Japan cancer and medical and then income support. And I realize there has been a lot of emphasis on cancer certainly this quarter. But sales, they really haven't budged much. In fact, they're down a little bit. Is that still a product that you think has the potential to be that third stool? Or any thoughts around that?

Daniel Paul Amos
Chairman, President & CEO

I'll answer that. I'm disappointed with the sales of the product. But it is a new product. It's not a revised product. Like when we say, "Okay, it's a new cancer product." This is new thing that's never really been out there. And what we're seeing is the Shinkin banks are being successful with it. And we think that it will growth from there. So we are -- what I would say is I'm still encouraged that there's real potential with it. But it hasn't taken off yet. And I was hoping it would be doing a little bit better. But make no doubt about it, when you're constantly introducing new products that are stable products that everyone knows about, used to and it's a revised product, the new product, like in the case of this one, they lose focus on it. Our distribution network does. So it becomes a little bit harder. But that -- but we still think it has potential is the answer. But I'm disappointed that it isn't doing a little bit better.

Operator

The next question is coming from the line of Tom Gallagher of Evercore.

David Kenneth Motemaden
Evercore ISI Institutional Equities, Research Division

This is David Motemaden, asking on behalf of Tom. I guess, I just wanted to ask a question on this dynamic of the lapse and reissue. And just get a sense for the margin or IRR on the new product versus the old. And I know it's sort of -- was a bit elevated this quarter at around 30% of the sales. But you mentioned it can be anywhere from 10% to 15% in any given year. So just wondering how that sort of will roll through into results? And just the margin and IRR on the new versus old?

Frederick John Crawford
Executive VP & CFO

Both medical and cancer are priced with very similar margins. So while the premium will fluctuate in terms of the nature of the benefits and features of the products, the economic IRR, if you will, is -- both the IRR as well as profit margin is priced in a very similar range. And so this is really less about an economic issue, if you will, to the company. We're relatively indifferent. We leave it up to the customer to decide what's in their best interest related to the improved benefits and structure of it. And so we're not motivated by, necessarily, economics. And I would keep in mind that those economics can really go both ways depending on the age of the policy and the nature of the policy, they can both contribute to GAAP profitability in a particular period, they can also take away from GAAP profitability depending on how recent the product was sold and the nature of the product. So we really don't try to model in, if you will, that type of activity. It's entirely a consumer-driven action and what's in their best interest. And we remain agnostic to the dynamic.

David Kenneth Motemaden
Evercore ISI Institutional Equities, Research Division

Got it. Okay. And then I guess shifting gears to, Fred, you mentioned or you alluded to earlier on -- just thinking about capital structure. And I think we've mentioned the RBC ratio in the U.S. But also just looking at the leverage ratio, and that's pretty low under at -- under your 20% to 25% guidance range. Just thinking, I guess, how you guys are thinking about that. And then also just capital in Japan. And I guess also just an update on the ESR regime. And sort of how the FSA in Japan is thinking about maybe updating the SMR towards a more Solvency II-like calculation?

Frederick John Crawford
Executive VP & CFO

Yes, I -- let me try to do a little bit of discussion on this. I certainly welcome, either Max or Todd also to weigh in with any thoughts. But I'll give you my overview. Let's take it one at a time. In terms of U.S., I think we've covered that very well. I think there's opportunity to potentially do more optimization in the U.S., but that's dependent upon really settling into our U.S.-only statutory conditions. But again, I think there's opportunity there but bit more marginal as we're bringing a lot of that excess capital down to our current plans. When you go to Japan, we really are in a very nice capital position. SMR is very strong despite actually some whitening of spreads and, of course, some rising interest rates, particularly in the U.S. But also here just over the last few days, more modest increase in the rates in Japan with BOJ activities or comments. And so we remain in a very good SMR position. I think in Japan, the issue tends to revolve around what amount of our FSA earnings -- first of all, what's the trend in FSA earnings? As I mentioned, it's improving because of the economic shift in our business. And then what amount of those FSA earnings in any given year do we feel comfortable with moving out and into the holding company structure for deployment. And we'll develop that more in terms of dialogue at FAB. But right now, we have a policy of 80% of FSA earnings. We move back into the U.S. That's under the basic notion that we need to retain 20% of those earnings to support the overall growth rate and other reinvestment activities in our Japan franchise. But what we found is that with the runoff of first sector and the runup in third sector, we continue to produce increasing FSA earnings and can do more with that capital over time. So we'll discuss more about that, but that's really the optimization issue there. When you then come to the -- and to answer your question on ESR. ESR -- first of all, our ESR, when you incorporate an ultimate forward rate adjustment, it's still running at around north of 225%. And when rates in Japan rise a little bit, that improves from there. I would estimate -- is that about right, Todd? You can weigh in.

James Todd Daniels
Executive VP & Principal Financial Officer of Aflac Japan

Yes, that's about right. Internal model says about 225%.

Frederick John Crawford
Executive VP & CFO

And the ultimate forward rate, my memory is, that may have around a 60-point-or-so impact to that level. Is that about right?

James Todd Daniels
Executive VP & Principal Financial Officer of Aflac Japan

Yes, that's about right.

Frederick John Crawford
Executive VP & CFO

Okay. So it gives you an idea. But the punch line is with or without a UFR, that's an extraordinarily strong ESR, particularly as it relates to other peer companies in the industry, and that's because we're so dominated by third sector, which is a better dynamic to have under that type of solvency. In terms of where we are with adoption, I believe we're still in field testing, and I think it's still a little unclear. But Todd or anybody in Japan, if you've got any color on that, please provide it.

James Todd Daniels
Executive VP & Principal Financial Officer of Aflac Japan

Yes, the FSA kicked off another round of field testing this summer, which will be targeted to complete by the end of the year. And as far as adoption, going to an economic solvency regime, I do believe there's not going to be any movement until around 2025. The FSA is following what the IAIS is doing in their modeling and guidance. So we still have some time with SMR and further development of our SMR framework.

Frederick John Crawford
Executive VP & CFO

In terms of leverage, yes, we're running low but remember, we got kind of a booster on lowering leverage when we adjusted the deferred tax liability with tax reform. That added around $1.9 billion to our equity capitalization, and that really lowered us a bit on leverage. And so it's not been a proactive delevering activity on our part. It's been more the effects of accounting adjustments related to tax reform. Now having said that, our leverage is low, and our coverage is very strong, given we borrow -- roughly $3.4 billion of our $5 billion in borrowings is in yen. So we have room. I like to be somewhat tactical, if you will, in leverage capacity for opportunities and allows for absorption, should there be any other items, although we don't foresee anything. So we'll be looking at leverage optimization and what we may do there. I think -- I put that into the overall holding company capital structure dynamic. And as we've talked about here now a couple of times, including this quarter, we're looking for ways to optimize our hedge costs in Japan through setting up mirror trades at the holding company. And that serves to lower our net exposure to a weakening yen over time. So we think there's some real economic benefits both from an earnings standpoint and risk reduction standpoint to better optimizing or utilizing the excess capital that we have at the holding company. So that's a bit of a fly by. And Max, I don't know if there's anything you want to add from your perspective?

Max K. Broden
Senior VP, Treasurer & Head of Corporate Development

And just to add a little bit of color. So overall, our business has a low risk profile, and we have a liability structure that is very stable and low risk as well. So you combine that with the relatively low leverage range that we are operating within, and you quickly realize that we do have significant debt capacity, and we could go to higher leverage level. At the same time, in the post-conversion phase that we are in right now, we continue to travel and want to travel with relatively low leverage and high capital. So I will put it this way that we do have significant debt capacity, but it has to be for good-return projects. We will not lever up just for the sake of it, but as we find very good projects to invest in, we do have very significant debt capacity.

Operator

At this time, we don't have any questions on queue. I will turn the call back over back to Mr. David Young.

David A. Young
Vice President of Investor & Rating Agency Relations

Thank you all for joining our call this morning. Before we end, I'd like to remind you that we will be hosting a Financial Analyst Briefing in Tokyo on September 26. And I hope you'll join us there. In the interim, please free to contact our Investor and Rating Agency Relations department for any information or questions you may have. And we look forward to speaking with you soon. Thank you.

Operator
Thank you. This concludes today's conference call. Thank you all for joining. You may disconnect at this time.