Achieving a Higher ROE

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A. There aren't any.

Overall Financial Context

Why Look at ROE?

- Insurers historically used IRR (ROI) or Profit Margin as a profit measure.
- Now there is increasing interest in Embedded Value.
- Among investors, the most popular measure of financial performance is ROE.

How Do We Stack Up?

Sector	ROE
Banks	12.67%
Financial Services	15.10%
Securities Brokerage	12.10%
Life Insurance	9.18%

How High is High?

- Insurance Co.’s average 10% - 15% ROE.
- Generally hasn’t been much (positive) variation from this range.
- The Beverage Industry averages 12% - 15% ROE.
- Ann.-Busch had a 72% ROE in 2003.

Total Company vs. Product Unit

- Investors and Analysts are only interested in ROE for the entire Company.
- Pricing each product to meet an ROE target may not assure the Company as a whole meets the target.
- Need for Complete Portfolio of Products.

High Product-Level ROE is Illusory

ROE Definition

$ROE = \text{GAAP Income}/\text{GAAP Equity}$

$\text{GAAP Income} = \text{Stat. Income} + \Delta DAC - \Delta\text{GAAP Benefit Reserve}$

$\text{GAAP Equity} = \text{Stat. Surplus} + DAC + \text{Stat. Reserve} - \text{GAAP Benefit Reserve}$

Std. Approach to ROE Pricing

- High Return
- Low Equity
- Combination of the two

Example: Term Insurance

ROE and ROI

- ROI and ROE have a mathematical relationship at issue for a single issue.
- The year-to-year relationship between ROE and ROI can vary significantly.
- Pricing to a higher ROI is probably the most common way of increasing ROE.
- Competitive pressure may not allow a terribly high ROI target.

Significant Land Mines

Effect of New Business

- Assume a product is priced to achieve an increasing pattern of ROE’s where the first few ROE’s are below target.
- Steady increases in new business may never allow entire block to meet the target.
- Reverse situation may require constantly increasing production levels from one year to the next.

Other Land Mines

- Non-deferred Acquisition Expenses
- Free Surplus
- Lack of diversity of products.

Managing ROE at the Macro Level

Effect of Investment Earned Rate

- Investment Earned Rate < ROE Target (or else why bother?)
- Surplus contributions from a product earn the investment rate.
- ROE is lowered.
- Paying out surplus should increase ROE.

Retention Comparison

Sector	ROE	Retention
Banks	12.67%	44.43%
Financial Services	15.10%	69.46%
Securities Brokerage	12.10%	76.43%
Life Insurance	9.18%	80.40%

Effect of Leverage

ROE = Earnings/Equity

= Earnings/Sales x Sales/Assets x Assets/Equity

= Profit Margin x Asset Turnover x Leverage

Leverage Comparison

Sector	ROE	Leverage
Banks	12.67%	167.77%
Financial Services	15.10%	316.71%
Securities Brokerage	12.10%	432.29%
Life Insurance	9.18%	24.50%

Effect of GAAP Adjustments

Adjusting DAC parameters changes ROE pattern.

- Interest Rate
- Mortality
- PAD