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The pricing model must be right

Who remembers the TV game show 'The Price is Right,' where contestants guessed the price of various items to win prizes? Corny as it was, it serves to illustrate a vital element of business success: you have to get your pricing model right.

The fundamentals of pricing models lie in risk management. It's all about understanding every single risk that a particular line or portfolio faces, measuring the impact they can have and how this in turn can impact your capital position, and then – for insurers – translating this into the premium.

While an insurer can seemingly get the price right, it doesn't always look right to the consumer. Sadly there is little correlation today with the cost of manufacturing an insurance policy and the price the market is willing to pay.

The price of products has never been more visible. In the world of financial services, the rise of aggregators has facilitated the consumer's ability to shop around and compare prices like never before. Consumer research carried out by Mintel last year revealed that more than 26 million people always shop around when a policy is due for renewal to find a better deal.

Perhaps the financial services community hasn't helped itself. In the benign economic environment of the decade leading up to the credit crunch, it was all too easy to lose sight of applying the fundamental disciplines of risk management to pricing models. In the seemingly endless boom time businesses got caught up in the drive to win their share of the customer's increasing spending power. This led to rate reductions across many lines of business to win the customer. As a result, many financial products have simply become commoditised.

This is particularly true of personal lines insurances and, as a result, combined operating ratios now often exceed 100%.

So if consumers are now entirely driven by price – as evidence suggests – what can be done to achieve the right price to ensure a business can continue to drive volume without losing sight of the need to generate profit? It all goes back to getting the pricing model right.

I think it is true to say that insurance pricing models have tended to look back to review behaviour of risk in the past in order to predict the future.

If we take the creditor insurance market as an example, rates have traditionally been set based on historical data sets. In the current economic downturn, however, the buying behaviour of consumers changed, demonstrating a greater propensity than before to buy as they became exposed to the risk of unemployment. The behaviour of mortgage brokers also changed. Reliant on procurement fees from the sale of mortgages, they had to seek alternative revenue streams when the bottom dropped out of the housing market and so turned to selling general insurance products including ASU. As a result of these two previously uncharted factors, claims frequency experienced a far greater increase than historical data dictated.

No one – not even amongst the august ranks of economists around the world - expected the recession to dig quite so deep, nor last so long. It wasn't that the pricing models ignored the possibility of an economic downturn; rather they lacked sophistication in terms of capturing and measuring potential risk impacts to the fullest extent.

There is a need for a shift in vision to look forward as well as back. We should not ignore the known facts based on historical data; however, it is essential to look for correlation of risk and acknowledge the compound effect this could have on a portfolio of products in the future. The importance of conducting sensitivity analyses cannot be stressed enough. It is clearly important to project claims volumes based on the risk scenarios identified and how this could impact return on investment. However, it is equally important to think about the impact if these scenarios were 10% greater or 10% less than projected.

It's not just a question of setting the benchmarks and forgetting about them. Think about it as continually moving timeline with performance against these benchmarks, measured constantly in order to facilitate a swift reaction to correct any imbalance.

Combining historical data with a clear view of what all the future risks could be and the impact they could have together with constant measurement will lead to a far more robust and sustainable model – and one that is better placed to flex according to market conditions and a business's own appetite for risk. This is a better outcome, I think you'll agree, not just for insurers but, equally important, for the distributors they work with and their customers.

But what about the lack of correlation between the appropriate price according to the risk and the price the customer is willing to pay? What can insurers do to avoid falling back into the commodity trap?

To justify the margin we need to strike a balance with the distributors of our products and find ways to differentiate the overall proposition. To do this, we have to stop thinking like insurers and start thinking like solution providers, developing activities that can be charged separately but that add value to both the distributor and customer. In my opinion, this means demonstrating that we can improve the distributor's top line, help them manage their risk and increase the lifetime value of the customer.

As I said at the beginning, pricing is the key to success of any business. But while the insurance products we provide have to be affordable for consumers, there's no getting away from the fact that they also have to be profitable. If we fail to build accurate pricing models based on a sound risk management framework, we will fail to build a sustainable business, which in turn fails our partners and their customers.