

---

**Financial Services  
Insurance**

---

# Professional Pricing

Room for Improvement in the Insurance Sector

---

Dr. Dirk Schmidt-Gallas, Dieter Lauszus



**SIMON • KUCHER & PARTNERS**

Strategy & Marketing Consultants

**Bonn • Boston • Cologne • Frankfurt • London • Luxembourg  
Madrid • Milan • Munich • New York • Paris • San Francisco  
Tokyo • Vienna • Warsaw • Zurich**

Pricing has the highest impact on profits

## The Goal: Higher Profits Through Professional Pricing

Managers have three ways to increase profit: increase price, reduce cost or increase volume (which again is influenced by price). Although this sounds like a beginner's lesson in business, its importance should not be underestimated in the insurance market. Which profit driver has the greatest influence on profits? This is the key management question, which has to be asked again and again. The answer is surprisingly clear; price is the primary profit driver.

For example, assuming a typical profit structure in property insurance (sales, cost elements etc.), reducing sales-costs or administration-costs by 10% or increasing sales volume by 10% has a small effect on profit since the Combined Ratio would increase by a maximum of 2%. On the other hand, if price is successfully increased by 10%, the Combined Ratio would improve by as much as 7%.

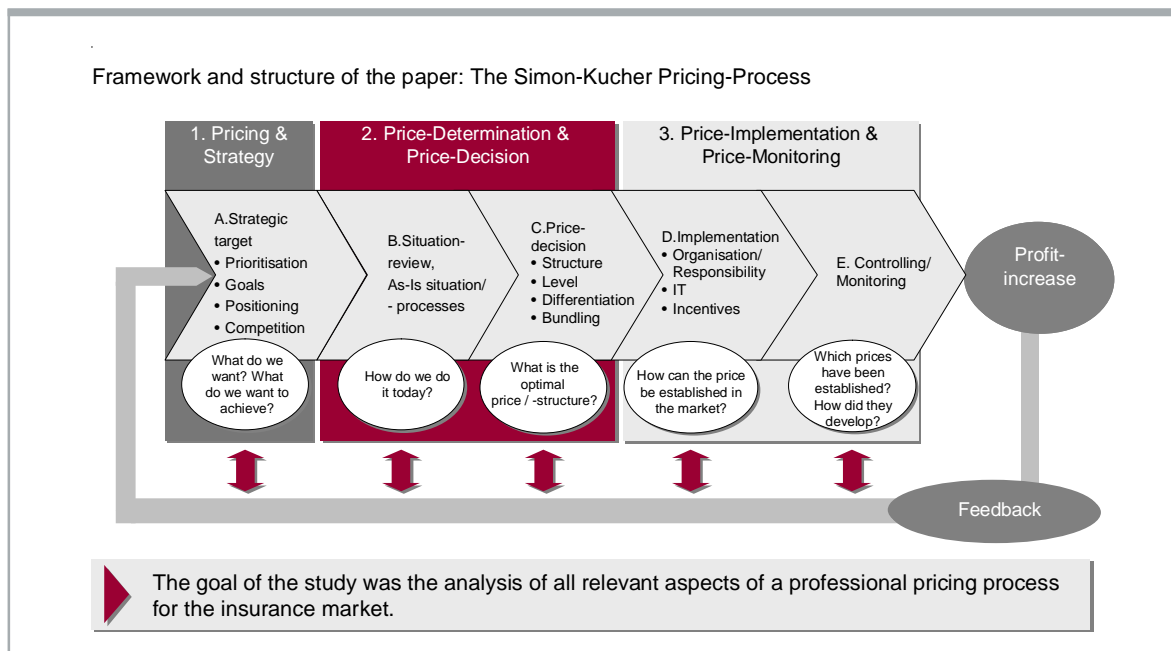


Figure 1: The five phases of a pricing process

**Systematic approach to pricing necessary**

## Pricing Processes: The Key to Success

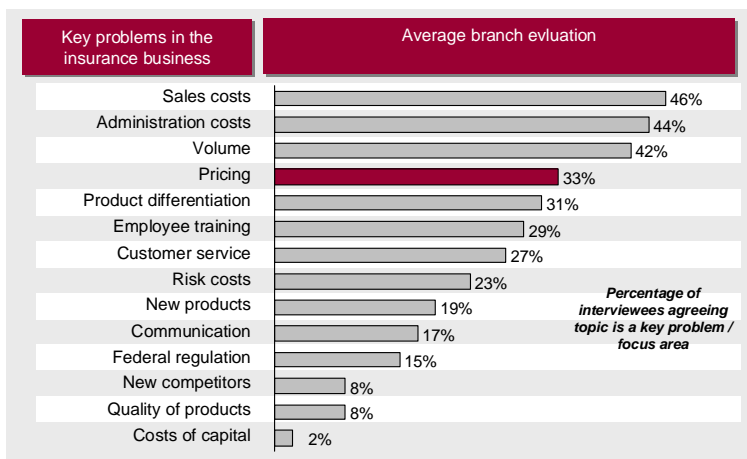
Increasing prices is not a stand alone solution as it is risky and generally does not result in the projected effect. In most cases the whole pricing process has to be reorganised and defined as a system of organisational rules, structures and actions. Only then, will the power of pricing be maximised. Figure 1 shows the five phases of a price optimisation process.

Does the insurance market pay enough attention to pricing? This was the main focus of a study conducted by Simon-Kucher and Partners where more than 50 insurance managers from 35 insurance companies were interviewed. The findings from this study are significant since more than half of the responses were given by top executives of large, medium and small insurance companies.

## Pricing: A Key Factor Neglected in the Insurance Sector

The results in Figure 2 list the main activities which top managers focus on in business. For most insurance companies cost cutting is at the top of the list, followed by increasing sales volume. Pricing is a distant fourth; less

The insurance market focuses heavily on cost reducing activities. Potential areas for growth (e.g. pricing, customer differentiation, new products) do not usually get the necessary attention.



▶ For most insurance companies, cost and volume appear to be the key focus areas.

Figure 2: The importance of profit is not recognised

than one third of all managers perceive price as an important profit driver in the insurance market.

## Pricing & Strategy: Turning a blind eye on the customer

Strategy decisions are positioning decisions that refer to the three corner stones of any strategy: customers, competitors and the company. Customers are at the starting point in this triangle since it is their needs that create the demand that is fulfilled by the insurance companies.

The indisputable fact is that there is no causal interrelationship between costs and margin expectations of the insurance company and willingness to pay of the customer. A price adjustment solely based on cost structures is nothing more than gambling.

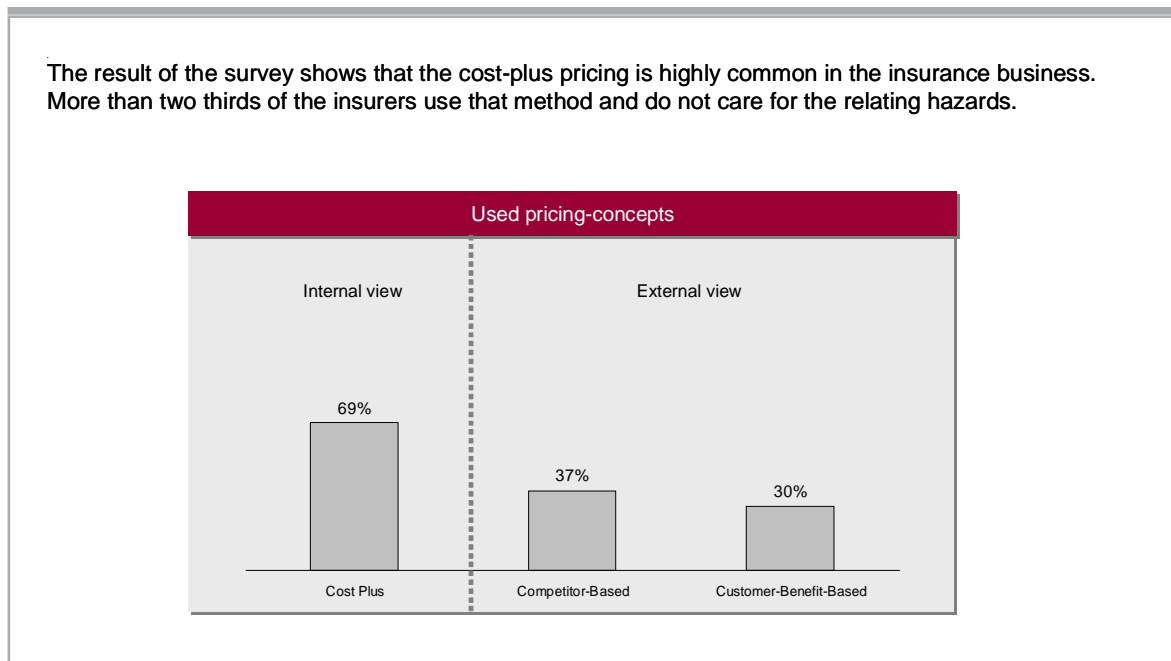


Figure 3: The internal view dominates pricing

In light of this the results of our study are highly alarming; the proportion of insurance companies who base their pricing on customer value is less than one in three. In contrast, there is a clear dominance of internally driven cost focus since nearly 70% of the respondents stated that they adjust their pricing according to their costs. Moreover, 37% of insurance companies surveyed base their pricing

on competitors' actions. Thus, this might explain why cost base pricing is not even higher.

## Two types of insurance companies today

Another interesting finding from the study was the discovery of two fundamentally different types of insurance companies: active and reactive insurers. Active insurers pay more attention to pricing issues than reactive insurers. Although active insurers still have room for improvement with regard to the pricing process, they are far more proactive and value the profit potential of pricing. Consequently, we will outline the different results for both groups whenever necessary.

The two groups showed a significant difference in their answers when asked: "How often do you [the insurer] use discounts and what are your reasons for using them". Nearly 80% of reactive insurers use discounts, whereas only half of active insurers use them. Both groups justify the use of discounts by either stating that their aim was to increase sales volume or that there was a need to react to competitors' actions. It should be noted that these two reasons were more common with reactive insurers, which can be seen in figure 4.

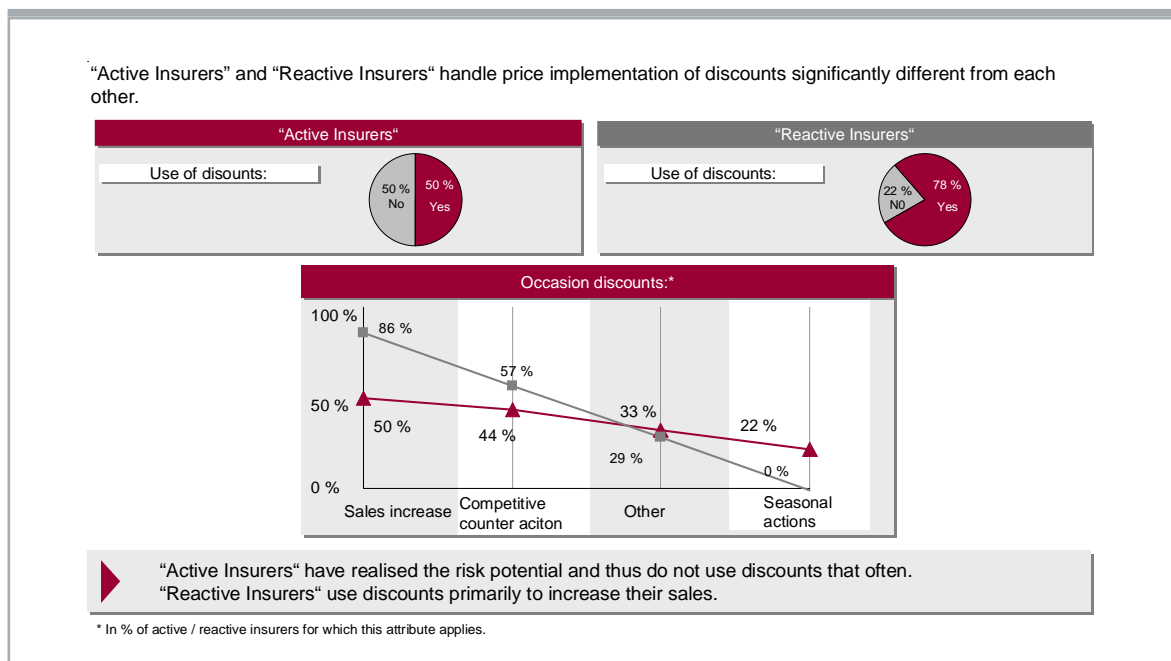


Figure 4: Today's discounts are often acts of competitive retaliation

## Price-Determination: More Market Knowledge is Needed

The fundamental requirement for the success of every pricing decision is knowledge of the price elasticity as it shows the responsiveness of demand to changes in price. This information is essential for price optimisation but it is rarely known in the insurance market. Conjoint Measurement is the only statistical method capable of doing this reliably.

Figure 5 shows the shortfalls in the insurance sector. The results indicate that it is only a small minority of companies that use Conjoint Measurement. Most companies do not even use the more classical and easier methodologies. Pricing on the basis of risk management via actuarial practice dominates the insurance industry. This implies total orientation on internal cost-plus methods.

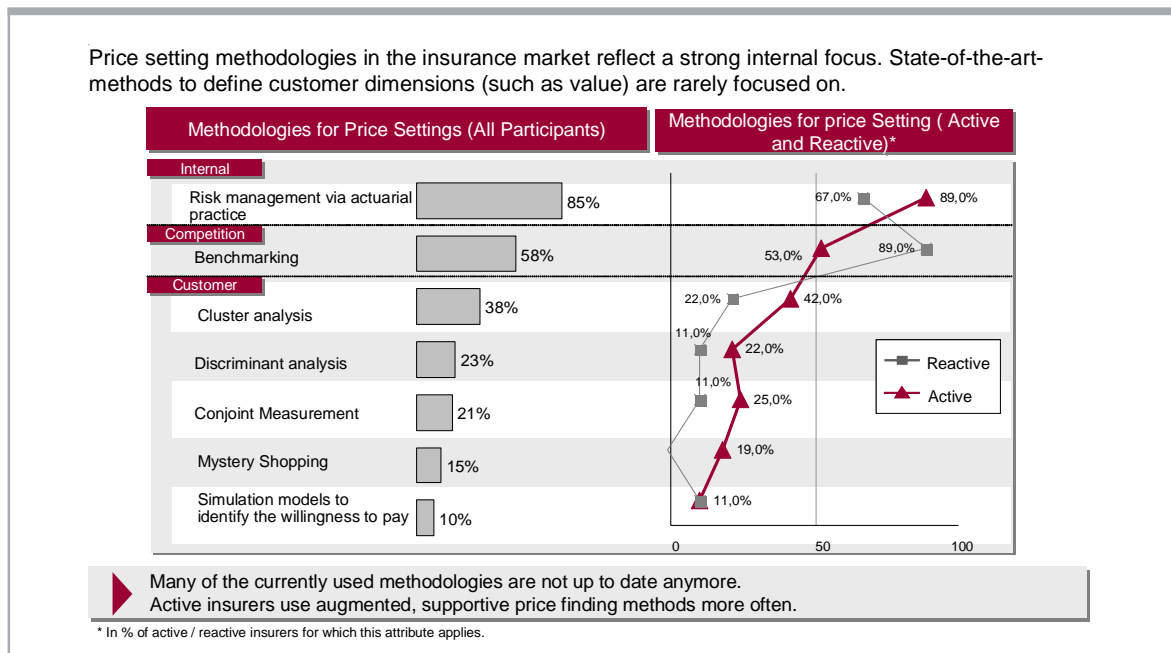


Figure 5: In practice, modern and more effective pricing methodologies are rarely used

As well as pricing issues it is also necessary to focus on price differentiation; another fundamental necessity for the insurance market. It is generally the case that price differentiation is not used enough or effectively. Current price differentiation methods used should also be checked because of the perception that they are not focused enough on customers' needs. This is another area where the insurance sector could be more proactive.

Figure 6 shows that active insurers use price differentiation more than reactive insurers, 74% and 50% respectively. However, both groups believe that price differentiation can generate higher profits and, therefore, it should be a key tool for every insurance company.

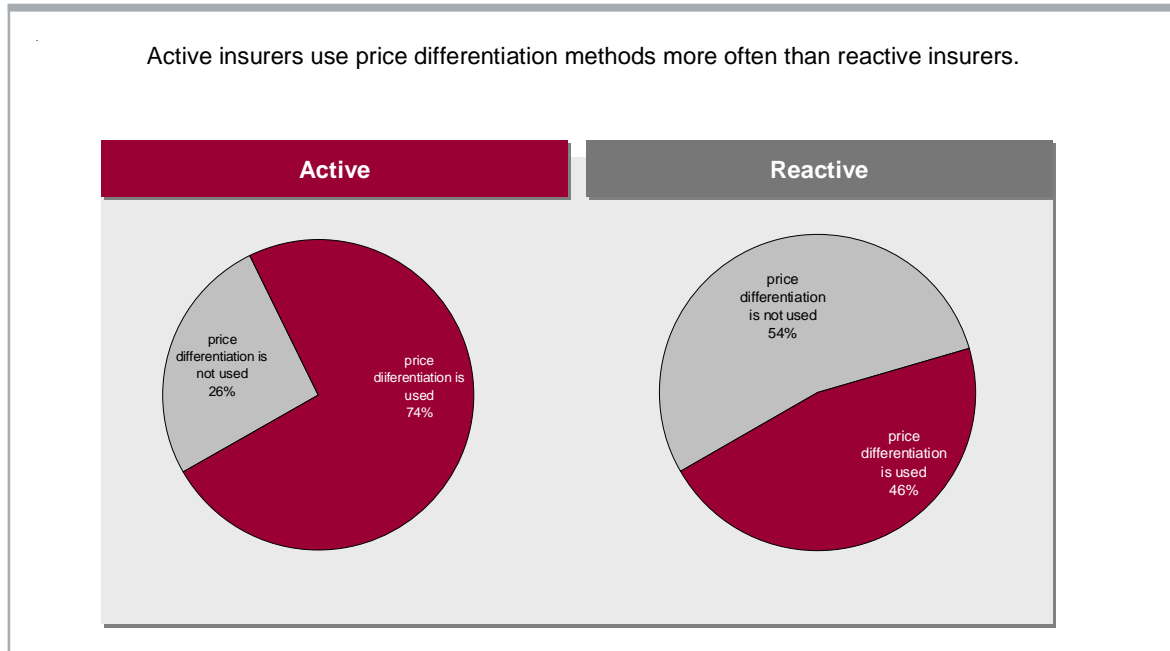


Figure 6: Price differentiation is not used as much as it could be.

## Pricing Decisions: Technicians Before Managers

Pricing decisions in the insurance market are generally dominated by an internal view rather than a market perspective. Actuaries and underwriters make pricing decisions in 64% of the companies surveyed. Market related departments such as marketing, product management or the sales department only participate 40% of the time (Figure 7).

Actuaries and underwriters are seen as the pricing-experts in most cases. Decision-makers with market-knowledge are not given sufficient importance.

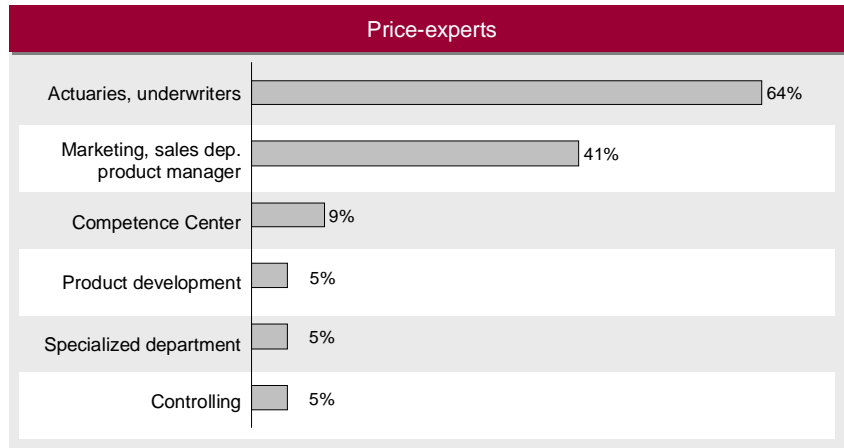


Figure 7: Overall, the price deciders are not related enough with the market

## Price-Implementation: Misdirected

### *“What gets rewarded, gets done.”*

This insight is not new, but it is still very important. In order to implement pricing decisions, a highly effective incentive system is needed that links and communicates the final selling price to the agents' commission. This ensures that the sales force use whatever leeway they have in the final selling price more efficiently so that the company and themselves both benefit.

### Update of incentive schemes necessary

Analysis of the current compensation systems in the insurance market (Figure 8) shows that sales volume targets dominate current incentive schemes. This is true for new customer business and for the existing customer base. Consequently, the company's profit margin will be eroded or worse still unprofitable sales volume will be sold. Moreover, the insurance company could be selling at a loss while the agent still earns commission on his unprofitable sales.

Currently, incentive schemes reward “quantity” rather than “quality” and as a result profit is sacrificed. The solution is a margin-based incentive system. The closer the agent gets to the target price defined by the insurance company (and market), the higher the commission.

Current payment systems are primarily volume oriented. Margin-based incentive systems are rarely used.

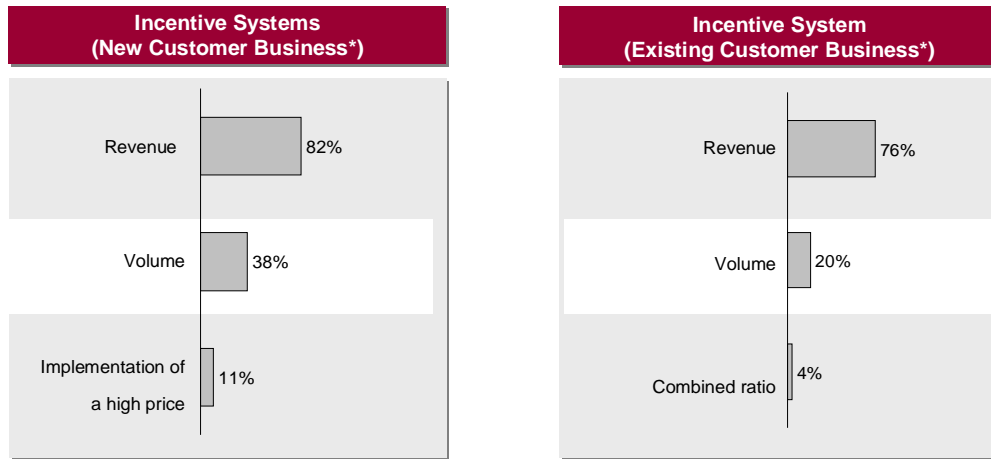


Figure 8: Compensation systems currently reward "quantity" rather than "quality"

### Recommendations:

1. Managers' top priority is to see pricing as the number one profit driver.
2. The customer, his needs and his willingness to pay have to play a key role in the pricing process.
3. The use of modern methodologies to analyse customers and their needs has to be significantly improved.
4. The internal and market view have to be merged into one interrelated picture on the decision level to come up with an optimal profit solution.
5. Current compensation systems have to be tailored from "quantity rather than quality" to a margin-based incentive system.



*Dr. Dirk Schmidt-Gallas is a Partner in the Financial Services division of Simon-Kucher & Partners and is managing director of the Frankfurt office. Together with Dieter Lauszus, he is head of insurance services.*



*Dieter Lauszus is a Senior Partner and head of the Financial Services division of Simon-Kucher & Partners in Bonn.*

*Simon-Kucher & Partners is an international consulting firm with a focus on strategy, marketing and sales. We are one of the world's leading organizations in the field of pricing. The Professional Pricing Society in the USA, Business Week and The Economist called Simon-Kucher & Partners "the leading pricing experts in the world".*

**For further Information:**

## **SIMON • KUCHER & PARTNERS**

Strategy & Marketing Consultants

**Bonn • Boston • Cologne • Frankfurt • London • Luxembourg  
Madrid • Milan • Munich • New York • Paris • San Francisco  
Tokyo • Vienna • Warsaw • Zurich**

Office Bonn:  
Haydnstrasse 36  
D - 53115 Bonn  
phone: +49 228 9843-253  
fax: +49 228 9843-448  
e-mail: dieter.lauszus@simon-kucher.com

Office Frankfurt:  
Mainzer Landstrasse 51  
D - 60329 Frankfurt am Main  
phone: +49 69 905010-0  
fax: +49 69 905010-649  
e-mail: dirk.schmidt-gallas@simon-kucher.com

Internet: <http://www.simon-kucher.com>