Financial Services
Insurance

Profitable Growth: Manage Your Pricing or Lose Money

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The problem: where have the profits gone?

Insurance companies are simply not experiencing any profit growth. A recent study by the Credit Suisse First Boston of the world's largest insurance companies listed on the stock exchange paints a sobering picture: in the international profitability ranking, not one of the European insurers is listed in the top 20, and their market capitalization is equally weak. The potential threat is substantial: a wave of consolidation has already started in the banking sector. As soon as this trend spills over to the European insurance industry, the insurers' inde-pendence will be endangered. US groups in particular are often bigger and stronger, making higher profits a desperate requirement for European companies to increase their value.

Profit growth is a must.

To an escalating degree, it is exactly this value increase that European insurers are lacking. A number of negative influences have left their mark on the companies' balance sheets: business expansions based mainly on volume, the increasing number of informed and critical customers with even greater demands, the many insurance companies – like those in auto insurance – resorting to rock bottom prices and the difficult situation on the stock market. The result of these influences has been a strong devaluation throughout the entire industry. The Dow Jones sector index for European insurance companies shows a value decrease of 10% over the last five years. This dismal picture is also representative of the non-listed insurers in Germany.

In times of globalization and highly mobile investments, benchmarks are stricter and the consequences of failures strike more quickly and drastically. If the rate of return is not satisfactory, investors withdraw their money. This holds true for companies of all sizes. Stock market-listed companies are the first to feel the effects of investor withdrawals, whereas smaller companies experience the effects more gradually or even surprisingly.

Nonetheless, the basic fact does not change: the insurers' profits must rise again.

Despite the adverse market situation, there are also some clear opportunities. To name just a few, private retirement provisions could be strengthened, the potential in the so-called "silver market" for senior citizens could be explored or a company's marketing organization could be upgraded. The companies that can strategically and successfully confront the problems and opportunities of this situation will become the winners in the battle for higher profits.

The solution: fully exploit the profit potential of pricing

The conclusion is as prosaic as it is profound: to boost their company's profits, managers must either raise their sales volume, reduce costs or raise prices. While this may sound like your first lecture in business administration,

Figure 1: The price is the most effective profit driver

	Status Quo	Price + 10%	Volume + 10%
No. of contracts:	100,000	100,000	110,000
Price/Contract:	200	220	200
Sales volume:	20,000,000	22,000,000	22,000,000
Distribution costs: (Commission, etc.)	4,000,000	4,400,000	4,400,000
Risk costs: (Loss/Damage)	12,000,000	12,000,000	13,200,000
Administrative costs:	3,500,000	3,500,000	3,500,000
Profit:	500,000	2,100,000	900,000

	Status Quo	Distribution Costs - 10%	Administrative Costs - 10%
No. of contracts:	100,000	100,000	100,000
Price/Contract:	200	200	200
Sales volume:	20,000,000	20,000,000	20,000,000
Distribution costs: (Commission, etc.)	4,000,000	3,600,000	4,000,000
Risk costs: (Loss/Damage)	12,000,000	12,000,000	12,000,000
Administrative costs:	3,500,000	3,500,000	3,150,000
Profit:	500,000	900,000	850,000

its importance for the decision makers of German insurance companies should not be underestimated. Managers must ask themselves the same crucial question every day: which measure provides the best leverage? The answer is absurdly clear-cut: the price has by far the greatest power to increase profits.

Figure 1 illustrates this point. The basis of our consideration is the following cost structure of an insurance company. With distribution costs of approximately 20%, risk costs of approximately 60% and administration costs of 17.5%, there is a combined ratio of 97.5%. The effect of the individual profit drivers varies dramatically.

Regardless of whether the distribution or the administration costs are cut by 10% or the sales volume are raised by the same percentage, the combined ratio would improve by a mere 2% at the most. This is not true for the price. If the premiums are successfully raised by 10%, the combined ratio would improve by seven points.

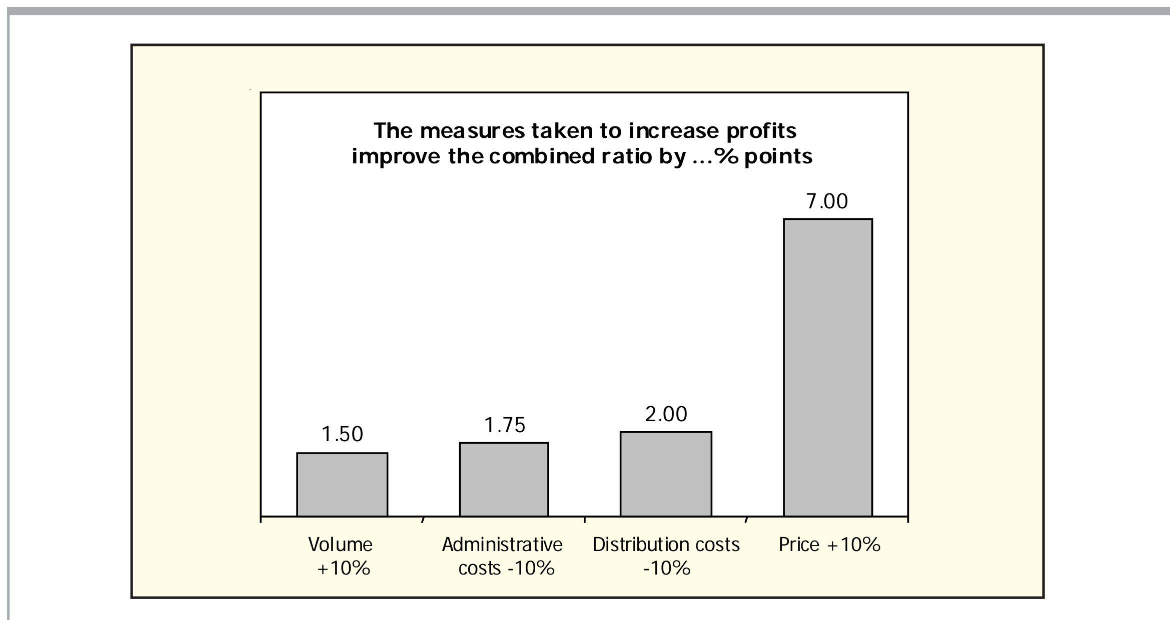

Figure 2: Pricing improves the combined ratio significantly

All of these considerations are based on the assumption that the rest of the profit drivers will remain unchanged. Cost cutting should not have any negative influence on the earning power (e.g. slackening market development and service quality), the prices should not be affected by the augmentation of the sales volume (e.g. crowding-out effect)

and the price increase should not affect the sales quantity (e.g. customer loyalty and disposition to change). One thing is clear: the price is by far the most potent profit driver. A price increase of even 3% would double the profit in the example given earlier. No other management tool has the ability to render such a significant profit increase.

In practice, many insurers act in direct contradiction to our findings. All too often pricing is dealt with over-cautiously. The information basis for making decisions is often fragmentary, competencies are unclear and the fulfillment of pricing targets is not monitored. In reality, pricing is more of an accidental outcome rather than the result of a systematic approach. This is what really weakens the profits, not the adverse market situation.

The price is the strongest lever to increase profits.

There is no such thing as a patent remedy in pricing. The insurance business is complex, the strategies are diverse and customers' requirements are extremely heterogeneous. To fully reveal the profit potential of pricing, the entire marketing value chain – from the product to its price to the distribution – must be professionally managed. This involves mastering five tasks.

1. Value pricing and segmentation

The price is more than the sum of loss expenses and administration costs. The price must optimally skim the customers' entire willingness to pay. In light of this, each product requires thorough analysis: Which parameters offer "must-have" value to the customer? Are there any innovative new parameters and what market potential do they provide? How much is the customer willing to pay? What are the competitors doing?

Value pricing can answer these questions in that it orientates the policies and premiums strictly on customer value. The implications are far-reaching: products that provide the customer with too little value and therefore cannot be sold profitably must be subjected to a cost reduction or be eliminated. Products that offer the customer high value, in contrast, are positioned carefully and their value is constantly exploited.

To achieve this, precise knowledge about the market structure is imperative. Customer requirements today are more diverse than ever before. Insurers have to react at a very early stage to the inevitable shifts in the market structure, like the growth of the "silver" market.

As a result, segmentation approaches that help to structure the often bewildering complexity of wishes and requirements of the customers are essential. These approaches apply to B2C markets as well as the mostly multi-personnel decision-making structures in the B2B market. Only a product and price configuration that allows for the differences between the segments can generate an optimum value boost.

2. Knowledge about the price elasticity

A crucial pre-requisite for the success of every pricing measure is knowledge about the price elasticity. The price elasticity indicates how the quantity of sales changes if the prices are increased or lowered. What most insurance managers erroneously assume is that a lower price leads to much higher sales volumes. As a consequence of this error, profits diminish because the lost profit per contract is not compensated by the amount of additional contracts. The situation deteriorates even further if the competitors react by lowering their prices. Not only is the moderate competitive advantage lost, but the product is also subsequently devaluated industry-wide. The strongest example of this situation can be found in the car insurance industry in Germany. Here the price war between the competitors has caused a loss of value running into several billions of Euros.

Boosting profits involves fully exploiting the willingness to pay.

On the other hand, a raise of premiums in the insurance industry results in a comparatively smaller loss on the volume side. The effects on profit from the price increase in business with existing and new customers by far counterbalance the moderate losses in the new customer business.

Nevertheless, insurance managers shouldn't stretch their good results too far, otherwise the surplus profits could be swallowed by the declining sales quantity.

In the example shown in figure 1, an additional 25% in sales would be necessary in order to compensate for a price

reduction of 5%. In contrast, sales volume could go down by 15% if the prices are raised by 5% and the price increase would still be profitable.

Software systems for price optimization have been offered for quite some time in the insurance industry. Unfortunately, these systems do not render the desired effect. When the initial euphoria over the multiple analysis options and the attractive graphical preparation passes, disillusion is often the next step. The reason for this is simple: most of the systems are based on the price elasticity analysis from the insurance company's internal database. The stored price-volume relationships reveal a variety of effects that are impossible to isolate ex post. Consequently, price decisions are made as indiscriminately as before, but they are now made under the false security of the "black box" computer model.

It is critical to recognize how the sales volume reacts to price changes.

Only exact knowledge about the actual price elasticities allows the effects of pricing measures to be accurately forecasted. For this purpose, a survey of primary market data is the only viable method.

3. Cross-Selling

Price wars are frequently being waged in the area of high-volume standard policies. One means of evading this war lies in the targeted bundling of insurance benefits and their conjoint offering in the market. The starting point is the customer orientation. The only benefit combinations that belong together are those that are perceived by the customer as making sense. From the insurers' point of view, only profitable combinations are suitable for cross-selling. The combination of both perspectives can create immunity against the competitors' price attacks and improve the exploitation of the individual customers' risk portfolio.

Reality often shows a different picture. Bundling offers like "buy two insurance products and get 10% off, for three get 15% off and for four get 20% off" lead to volume increases, at least on the short-term. Yet a problem often overlooked here is that this additional business can never be profitable, because the price discounts are simply to high.

What seems simple in theory often turns out to be extremely difficult to put into practice. The creation and evaluation of product bundles is one of the most complex tasks in insurance pricing. Only the application of modern analytical tools can help to make decisions based on clear cut facts instead of guesses.

4. Sales Optimization

The sales department holds a key position, particularly for insurers. Despite the clear increase in sales via the electronic distribution channels, the on-location sales representative is often the most important and frequently the only contact person from the customer's perception. Moreover, the sales team must explain the policies and communicate the merits of the product. They must establish themselves as reliable contact persons and persuade the customer to make a contract.

Pricing is an ongoing process that has to be optimized.

The management has to strategically position sales to create a balance between effectiveness (proximity to customers) and efficiency (costs), e.g. by optimizing the mixture of distribution channels or the branch network. The creation of target-oriented and clear-cut incentive systems must enable the sales team to hear, understand and implement targets set out by top management.

5. Optimization of the pricing processes

In companies with a high "pricing IQ", all price-related decisions are organized systematically and clearly. Information, rules for decision making and competencies are defined. Moreover, the implementation of well-defined pricing targets is subjected to careful monitoring. If deviations from the targets are spotted, it is dealt with immediately.

Three decisive elements characterize a pricing process: the components, the input dimensions and the chronological structure. The components are the information, methods, models, guidelines for decision making, qualifications, competencies, incentive systems and timing. Aside from objective information such as data on revenue, customers and competition, the input dimensions are subjective dimensions

like the assessments and experiences of the management. Finally, there is the chronological structure: Supported by the pricing strategy, an audit must objectively and honestly check the current practices, success and improvement potential of pricing. Based on this review of the status quo, price decisions concerning the key aspects discussed above have to be made and established in the market by means of a systematic implementation plan. It is not uncommon that pricing projects fail at this decisive interface between the insurance company, the customer and its competitors. A systematic controlling of the implementation results in the market ensures the sustainability of the profit improvements and guarantees that the past bad habits are not resorted to upon the first signs of resistance in the market.

The consequence: pricing is a task for top management only

No other area has such serious implications for an insurer like pricing does, which is why every pricing measure has to be based on data, facts and analysis. Gut feel-ing and experience are important assets, but they alone are not a sufficient means of achieving the required profit boost.

Pricing is a task for top management.

Indeed, what is needed are analyses deploying state-of-the-art technology, far-sighted strategies and good judgement in the implementation process. In the insurance business today, price decisions are often left to the actuaries– which is appropriate, as long as their decisions are restricted to the determination of price floors.

The coverage of loss expenses and administrative costs still is the prime task of the price, and this requires the expert knowledge of actuaries. Yet when it comes to profits, this one responsibility belongs exclusively to the top management. Ultimately, managers who do not exploit pricing risk an (even greater) profit loss. Plainly put, they would be throwing money down the drain.

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