bcg.perspectives
by THE BOSTON CONSULTING GROUP

The Six Steps to Pricing Power in Insurance

By Jean-Christophe Gard and Ofir Eyal

Although pricing has become an increasingly critical factor in achieving competitive advantage in the global insurance industry, many companies are still trying to find the right balance in their pricing schemes. Simply put, insurers need a system capable of attracting new business and retaining profitable existing business. But the schemes must also be sufficiently robust to overcome severe cost challenges.

Why are so many insurers struggling with pricing? The reasons vary and tend to be country specific. And they are not mutually exclusive.

For some companies, the problem is that despite price increases, their systems and processes have not reached a level of sophistication capable of delivering their intended pricing strategy. For others, overcapacity in their markets is driving prices down. One overarching trend, particularly in mature markets, is that customers are increasingly discerning and price sensitive. In addition, the entry of direct players and price aggregators has meant greater transparency, which allows customers to choose the least expensive deal. This transparency has contributed, in particular, to the commoditization of the motor-vehicle insurance industry. Some companies are feeling the effects of many of the above circumstances simultaneously.

Fortunately, there are concrete actions that insurers can take to improve both pricing strategy and price realization. We call these actions the six steps to pricing power in insurance.

Building a Sturdy Pricing Process

In our view, insurers can enhance their pricing capabilities by acting on the following six imperatives:

Improve portfolio price management. Too few insurers have reached their potential in terms of maximizing retention of the most profitable clients and improving the profitability of low-value clients. This goal can be achieved only by gaining a deeper

understanding of one's own client base and by developing increasingly granular segmentation. The ability to generate deep client insight from comprehensive data collection is critical, particularly for identifying prospects for cross selling and for adding higher-margin auxiliary coverage alongside principal policies.

Sharpen new-business pricing. Many insurers are tempted to attract clients with initial deep discounts, hoping for price appreciation at renewal time. But this strategy is proving increasingly ineffective. Insurers need to leverage data not only from their own client portfolios but also from a thorough examination of industry-wide buying behavior in order to both optimize the pricing of new business and reinforce risk management. Insurers should also incorporate more realistic assumptions into customer lifetime-value projections in order to avoid being taken unawares when customers choose not to renew policies.

Minimize the variation between list and street prices. Sales forces always have a certain amount of leeway in offering price discounts. But discount budgets are often abused, resulting in a distorted overall pricing structure and the generation of unprofitable portfolios. Minimizing the discrepancies in intended price, rating structure, and actual price is especially important in a business intermediated by agents and brokers. Moreover, the distribution of discount budgets must be controlled and linked to agents' overall performance. Agents who misuse their discount budgets should be penalized by having their pricing discretion curtailed going forward.

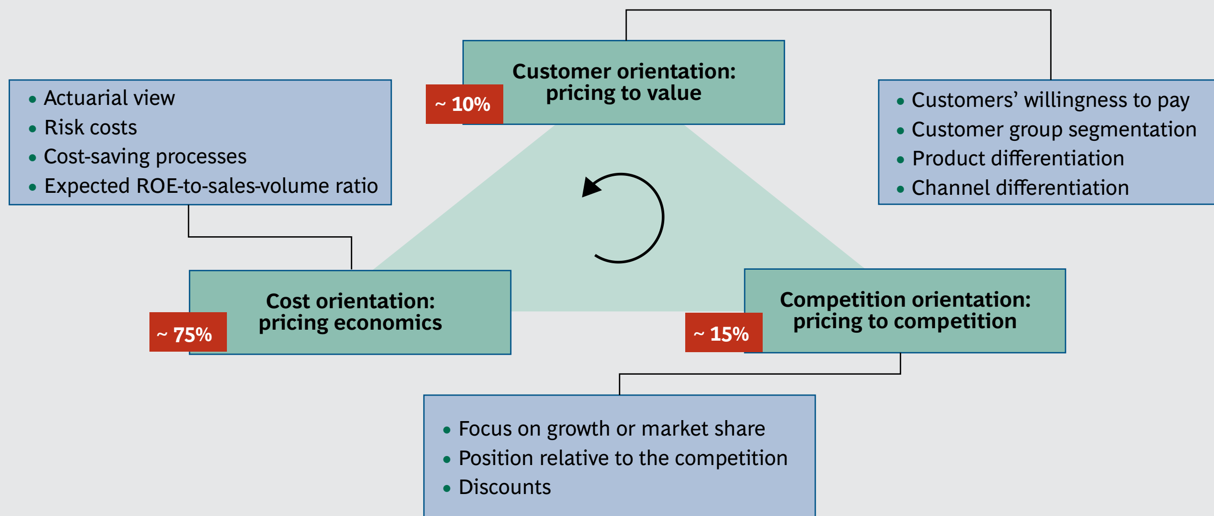
Align distribution objectives with companywide goals and pricing strategy. Insurers' distribution networks are typically remunerated on the basis of top-line performance only. And in some cases, new business earns higher commissions than renewals. The result of such compensation schemes can be insufficient focus on retention and sales that lack the potential for long-term profitability.

In our client work, we have observed that aligning distribution incentives with organizational objectives is crucial to success. Insurers need to base their design incentives on the bottom line (loss ratio) as well as on the top line. Furthermore, insurers need to provide agents with tools such as alternatives to monetary discounts (including higher deductibles, free supplementary coverage, and vouchers for future renewals) and access to first-rate customer-relationship-management systems that can help them retain their best customers. Agents should also receive regular training updates on how to retain customers and provide the best possible sales experience.

Incorporate customer and competitor elements into pricing. Many insurers are adept at setting cost-oriented pricing structures that are based on claims experience. But few excel at incorporating client price sensitivity and prevailing market prices (those of competitors) into their own pricing. Although some insurers might say that regulations in their market do not allow demand-based pricing or that their agents do not like it, we have seen organizations find innovative ways to work within regulatory frameworks, ultimately earning returns of up to 5 percent of gross written premiums. (See the exhibit, "Insurers Need to Incorporate Both Customer and Competitor Elements into Pricing Strategies.")

Strengthen the organization's infrastructure. To ensure that pricing initiatives can evolve smoothly, insurers need to put in place "enabling" organization structures and processes. These should include a strong actuarial team, as well as sharp managerial oversight capable of translating the business strategy into a disciplined pricing strategy. Most insurers need a step change in pricing processes, including better dialogue among actuarial, marketing, and senior-management teams—with the last being truly able to understand, monitor, and critique the work of the actuaries. In addition, insurers need more frequent and dynamic updates to their pricing systems. Updating, in many cases, involves a fair amount of organizational courage and

Insurers Need to Incorporate Both Customer and Competitor Elements into Pricing Strategies



Source: BCG analysis.
Note: ROE = return on equity.

willingness to try new systems, conduct pricing tests, and stretch boundaries in terms of common practices.

Doing It Right

Some insurers are ahead of the curve in developing pricing systems that strike an effective and efficient balance. They achieve sufficient margin, overcome cost pressures, and at the same time attract new customers—first-time buyers and those previously served by competitors—and retain the best existing customers. Such companies tend to have systems and methods that have emerged as best practices in the industry.

For example, some insurers have developed and integrated elasticity curves into their pricing systems for several hundred microsegments in motor vehicle insurance. Such players are able to optimize microsegment-level pricing decisions on the basis of sophisticated analysis of the microsegment's attractiveness, its historic behavior in response to price increases, and competitors' previous pricing moves.

In a similar vein, our client work and proprietary research have enabled us to develop a customer insight methodology aimed at identifying customers' rationales and decision-making processes in purchasing or renewing insurance—with possible behaviors segmented into what we refer to as customer "pathways." The pathway choice can depend on a variety of factors, such as how and when the customer becomes aware of a price increase and whether the increase is expected. Applied to a motor-vehicle insurance portfolio, pricing decisions can be optimized if insurers anticipate the likely reactions of each customer to a price increase or decrease at renewal time. Such knowledge helps insurers tightly manage the tradeoff between premium increases and customer churn.

We have seen that customer reactions can be segmented along a few typical pathways. Each pathway presents contrasting elasticity curves, allowing for differences among customers with distinct characteristics normally used to assess technical risks—such as the type of motor vehicle, age of the driver, and frequency of claims filing. By incorporating behavioral data into pricing decisions, insurers can generate significant impact: up to 3 percent in

premium increases (with a given churn rate) or a reduction, by one-third, in departing customers as a result of a given average premium increase.

Getting Started

Insurers considering a program to improve pricing should ask themselves questions such as the following in order to put themselves on the right path:

- Is our pricing strategy bringing us all the benefits it should?
- Do we truly understand the dynamics of customers' reactions to price changes?
- Do we have the organizational capabilities to deliver a pricing step change that will give us a significant edge over our competitors?
- What investments should we make in order to close any gaps in our pricing abilities?

INSURERS THAT TAKE the initiative to address the many pricing-related challenges (and opportunities) will very likely find themselves benefiting from their efforts in the years to come. They will be surer of having a finger on the pulse of their customers and will be well positioned to react with pricing moves. They will also know which moves will bring the best net result. Insurers that fail to take action may end up playing a guessing game that will diminish their pricing power going forward.

About the Authors

Jean-Christophe Gard is a partner and managing director in the Paris office of The Boston Consulting Group. He can be reached by e-mail at gard.jean-christophe@bcg.com.

Ofir Eyal is a principal in the firm's London office. He can be reached by e-mail at eyal.ofir@bcg.com.

The Boston Consulting Group (BCG) is a global management consulting firm and the world's leading advisor on business strategy. We partner with clients from the private, public, and not-for-profit sectors in all regions to identify their highest-value opportunities, address their most critical challenges, and transform their enterprises. Our customized approach combines deep insight into the dynamics of companies and markets with close collaboration at all levels of the client organization. This ensures that our clients achieve sustainable competitive advantage, build more capable organizations, and secure lasting results. Founded in 1963, BCG is a private company with 77 offices in 42 countries. For more information, please visit bcg.com.

© The Boston Consulting Group, Inc. 2012.
All rights reserved.
10/12