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Achieved Pricing, the Business Plan and Implications for Business Operations.......or do you know when to walk?

By John Murray FCII

Recent years have seen an increased focus on the development of sophisticated pricing methodologies and more advanced types of business planning. The detail of both these subjects is outside the scope of this paper but it might be as well to remind ourselves of the principles.

Pricing methodologies have been developed to drive out the technical price for either individual risks or for risk cohorts where individual pricing is inappropriate. For standalone risks these models are usually capable of dealing with a range of cover and attachment point scenarios, as these are frequently requested by the informed customer.

The technical price is generally understood to be the price at which the insurer, provided that its assumptions are sound, will achieve its required return on capital. This itself is a function of capital intensity, i.e. the percentage of capital to premium required to support the line of business. In practical terms this becomes a calculation of what percentage of the premium is available, after expenses and profit margins, to meet the claims, or burning, cost: this percentage being known as the loss ratio.

Loss ratios play a significant part in the business planning process, as they will be used to calculate the profit contribution for each line. These days it is customary to run the plan with a number of different scenarios, for example different claims development patterns or a collapse in investment returns. This practical stress testing can be useful for developing strategies to address the question of what to do if events do not go to plan. Like many things, however, it is not immune to the law of diminishing returns, and there is a limit to how many iterations of the process are worthwhile before marginal utility has ceased to be visible to the naked eye.

Once a plan scenario has been adopted as the most probable and has become the one that will be used to inform, for example, communications with the regulator and investors, the most important issue then becomes the need to measure how performance is going against expectations. Here there are a number of leading indicators, such as sales volume and actual incurred

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expenses, both of which can readily be compared with the phased plan (e.g. how do sales at the end of February compare with the volume expected by that time?).

Critically important is the question of how actual achieved pricing compares with technical pricing. If, for example, the average price being obtained for a particular line of business, that is supposed to be being written to a loss ratio of, say, 60%, is only 90% of the technical price, then the loss ratio is going to be 67%. It is vital that this deviation from plan be mapped onto the plan model as quickly as possible, so that the impact on the business as a whole can be assessed and action determined to meet the new situation.

It is in the area of capturing this critical data and running it through the planning model, in respect of both new and existing business, that many insurers appear to be experiencing problems. Difficulties range from capturing the technical and achieved pricing themselves to having a system that permits instant remodeling. These are all areas in respect of which TGP's experience can help clients to deal with the requirements of regulators and meet the needs of their investors.

Of course, obtaining the information is all very well but it still leaves open the question of appropriate management action. Saying no to business when the technical price, or better, cannot be achieved is one approach, but things are rarely that simple. Fixed costs remain and there is a also the matter of maintaining relations with distribution channels. So, in addition to fixing the technical price, it is also vital to know how low you can go.

Here we come to the important question of walk away pricing: at what point to make that critical no decision? This approach recognizes that the underwriter is not some automaton, but actually a trader in the market, just as much as someone dealing in currency trades, for example. So the importance of knowing where this floor lies is equally as significant as knowing the technical price.

But although the concept of walk away price is well understood in connection with takeovers, for example, it is less well understood in insurance practice. This is particularly true when it comes to managing the idea in the workplace and making sure that the lowest price is not the one that is quoted first time.

If you are interested in how to work any of these ideas, then your first port of call should be John Murray on john@tgpadvisers.com.

An article such as this cannot, of course, deal with every subtlety and can hardly cater for the requirements of every business. Nonetheless it should, hopefully, have indicated the implications of the importance of achieved pricing as a leading indicator and some of the practical implications of its use in running your business.