EXECUTIVE INSIGHTS VOLUME XVI, ISSUE 22

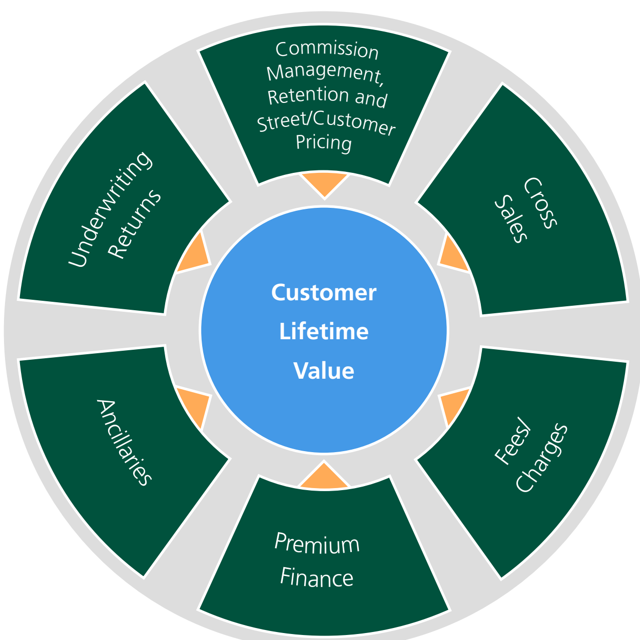
Time to Get Streetwise: Unlocking Value-Based Pricing in Personal Lines Insurance

Countless times every day, direct personal lines insurers lose out on new customers due to uncompetitive pricing. What is for many consumers a simple lowest cost purchase scenario is, for many insurers, a source of unending consternation.

Yet the solution is within their grasp. L.E.K. Consulting analysis has estimated that the profit which flows from distributing personal lines insurance in the UK amounts to c. £1 billion annually or an average of c. £40 per policy. By contrast, the technical underwriting component is consistently loss making. As senior executives of personal lines insurers question their value chain participation choices and ask themselves where profitability and growth can be found, this reality would seem to point strongly to their whereabouts.

Figure 1

Customer Lifetime Value Elements



Source: L.E.K. Consulting analysis

Pricing is one of the key levers available to insurers as they focus on how to win in a direct environment where they own the customer. However, reliance on traditional pricing models alone is not sufficient to win the battle to acquire and control customer relationships.

In an environment where data richness increases each day, the arms-race in pricing sophistication continues to intensify and direct insurers could well benefit by stepping back to reconsider the key sources of value creation. In L.E.K.'s experience, central to success in the industry is the creation of a value-based pricing architecture involving a separation of:

- product level views of net or technical pricing and underwriting profits
- customer-centric views of 'street pricing' and distribution profits

This clear separation has proved to be a successful business model, most notably where sophisticated distributors using technical pricing from insurers have isolated the variables that matter for creating distribution profits. Treating these separately

Time to Get Streetwise: Unlocking Value-Based Pricing in Personal Lines Insurance was written by **Ashish Khanna** and **Peter Ward**, Partners in L.E.K. Consulting's London office. Please contact L.E.K. at financialservices@lek.com for additional information.

avoids the unmanageable complexity of customer and behavioral factors being forced into a pricing model that was not built for this purpose. Refreshingly, this also places emphasis on the lifetime value of the customer, rather than on a particular product, and allows for agility and responsiveness to market conditions.

Direct insurers can assimilate the key learnings from these models, but doing so requires specific skills, organizational structures and incentives.

Out With the Old: A Pricing Evolution

Personal lines insurers have traditionally used a 'cost plus' approach to pricing, often based on achieving a desired level of economic return anchored around a combined operating ratio of 100. Multi-variable generalized linear pricing (GLM), or burning cost models, are the most common 'state of the art' tools for this purpose today, particularly for motor insurance. These are used to predict claims performance based on a smorgasbord of variables including driver history, postcodes and vehicle characteristics. As aggregators have grown and ever more customer information has become available, an inevitable arms race has resulted. "My model is bigger than their model" or, worse, "their model is bigger than my model" is often heard in the corridors of insurance companies.

Most direct insurers now compete directly with brokers on aggregator sites in the UK and have similar access to the information provided directly by customers. However, sophistication in data capture in these environments can create richer, customer-centric data sets which inform:

- shop-around behavior, for new policies and renewals;
- brand affinity and loyalty;
- propensity to purchase or be sold additional core products;
- propensity to require or desire financing (*service subject to regulatory review*); and
- ancillary purchase propensity (*service subject to regulatory review*).

None of these factors are directly relevant to technical pricing, but they do represent key inputs into customers' lifetime value to an insurer (see Figure 1). Yet many insurers have not yet fully adapted to this environment, with complex overlays to technical pricing models often seeking to combine this customer-centric data with existing, highly complex 12 month-focussed GLMs. The resultant muddled process often yields prices which are inappropriate for that risk and customer, to the detriment of the customer and the insurer's performance alike.

To avoid such cumbersome complexity and to reorient focus towards value creation, the most successful insurers isolate the technical premium, basing it purely on underwriting and risk-rating considerations. At the same time, they establish standalone functions, which develop more sophistication in how to set customer pricing based on an understanding of marketing and consumer behavior, a practice at which some brokers in particular (and also some direct insurers) have become increasingly adept in recent years.

A more sophisticated, customer-centric pricing system also places insurers in a better position to understand and control their customer relationships and affords the opportunity to create value for both customers and themselves. Even in the relatively immature environment that existed in 2011, the rewards of such positioning were evident: L.E.K. analysis of 2011 UK industry data shows that technical underwriting itself exhibited a significant loss, while customer management and distribution, where the customer relationship lies, generated profit of c. £1 billion.

Pricing Overhaul: How Separation Works

In this new system, already implemented in the marketplace, the direct insurer's street price is a combination of two separate components:

- a net rate, founded on technical factors and a GLM model, and designed to cover expected claims and underwriting expenses; and
- a customer lifetime premium, reflecting the expected lifetime distribution profits of that customer founded on

consumer behavioral characteristics. This premium includes an estimated multi-year view of customer renewals and their price elasticity, the profits stemming from cross-sold and ancillary products, and the true costs required to generate these income streams, including the net rate.

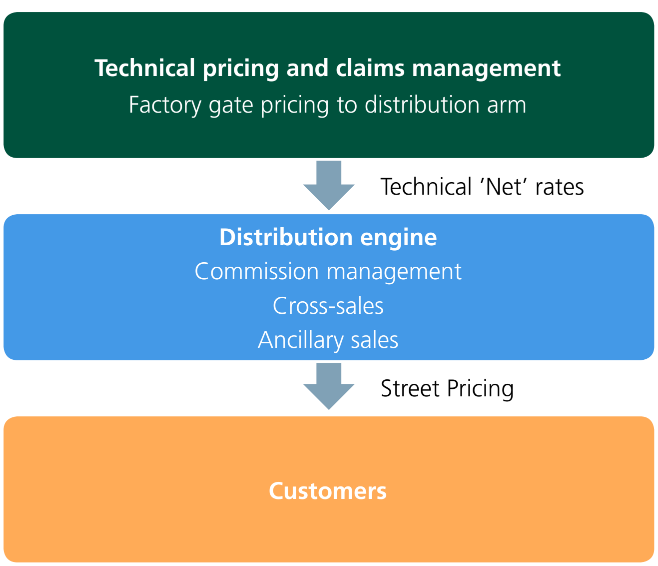
This architecture places customers, their needs and behaviors at the heart of the insurer's decision-making process. This is not only in line with the direction of regulatory travel, but also, critically, lays the foundation for driving innovation in product and service offerings.

Prepare to Grow: Organizational Change

Separating technical and customer pricing requires some refashioning of organizational structures, incentive systems and skill sets. In their current form, most direct insurance companies contain a pricing division, where technical and customer pricing are indistinguishable, and a claims division – each silos in their own right.

To realize the benefits of the modern architecture, two different functions are required: one to handle technical pricing and claims management, responsible for technical profit, and the other to lead the customer interaction and take responsibility for distribution profit (see Figure 2). This division between technical profit on the one hand and distribution profit on the other can create tension within the organization if not structured appropriately, since the net rate is the revenue driver for one function and a key cost driver for the other.

Figure 2
The Architecture of Separated Pricing Functions



Source: L.E.K. Consulting analysis

To ensure that everyone is working for the good of the whole company, successful incentive structures mirror this dichotomy. On one hand, the customer pricing division is geared towards maximizing distribution profitability and improving customer metrics. On the other hand, the technical function is directed towards a combination of hitting a desired return on deployed capital and claims improvement metrics.

Furthermore, successful customer pricing functions demonstrate skills and capabilities very different from those traditionally found among technical insurance specialists. They are more customer-oriented, more motivated by getting to grips with customer needs and improving customer lifetime value, and more focused on working to maximize profit on that basis, all underpinned by a retail-style understanding of consumer behavior.

Future-Proofing the Organization

Separating the technical and customer pricing functions is all the more necessary in the light of developments on the horizon. For example, we are already witnessing the growth of telematics for motor insurance, where real-time and rich data about an individual's driving habits can determine the technical premium.

With 'big data' growing in importance, the measurement of behavioral aspects will demand more attention. For example, it may be possible to glean relevant information about particular customers from content on social networking sites or from other online activity – such as how price conscious they are, or how likely they are to renew, or their broader product/service needs. In both cases, trying to combine increasingly complex and incompatible information with more traditional underwriting data can only lead to further confusion and poor performance. By structuring along two separate functions, companies will be ideally placed to respond appropriately and nimbly as and when such new developments arise and then mature.

The advent of aggregators has provided personal lines insurers with unprecedented access to the customer. But many companies have not yet fully acclimatized to the new rules of play, and this disadvantage could well be multiplied as further technological progress takes hold.

It is now essential to their success that personal lines insurers pursue the benefits of value-based and customer-centric pricing mechanisms, which combine the best of their technical capabilities and their customer insight. By adopting this approach and the organizational structures required to deliver it, companies can sharpen their competitiveness and grasp the value that is within their reach.

For further information contact:

London
40 Grosvenor Place
London SW1X 7JL
United Kingdom
Tel: +44 (0) 20.7389.7200
Fax: + 44 (0) 20.7389.7440

Milan
Piazzale Biancamano 8
20121 Milano
Italy
Tel: +39 (02) 8646.2761
Fax : +39 (02) 8646.2791

Munich
Neuturmstrasse 5
80331 Munich
Germany
Tel: +49 (89) 922.0050
Fax : +49 (89) 922.0520

Paris
3 rue Paul Cézanne
75008 Paris
France
Tel: +33 (0) 1.4703.1950
Fax : +33 (0) 1.4296.1138

Wroclaw
ul. Pilsudskiego 13
50-048 Wroclaw
Poland
Tel: +48 (71) 790.16.30
Fax : +48 (71) 790.16.35

International Offices:
Bangkok
Beijing
Boston
Chennai
Chicago
Los Angeles
Melbourne
Mumbai
New Delhi
New York
San Francisco
São Paulo
Seoul
Shanghai
Singapore
Sydney
Tokyo