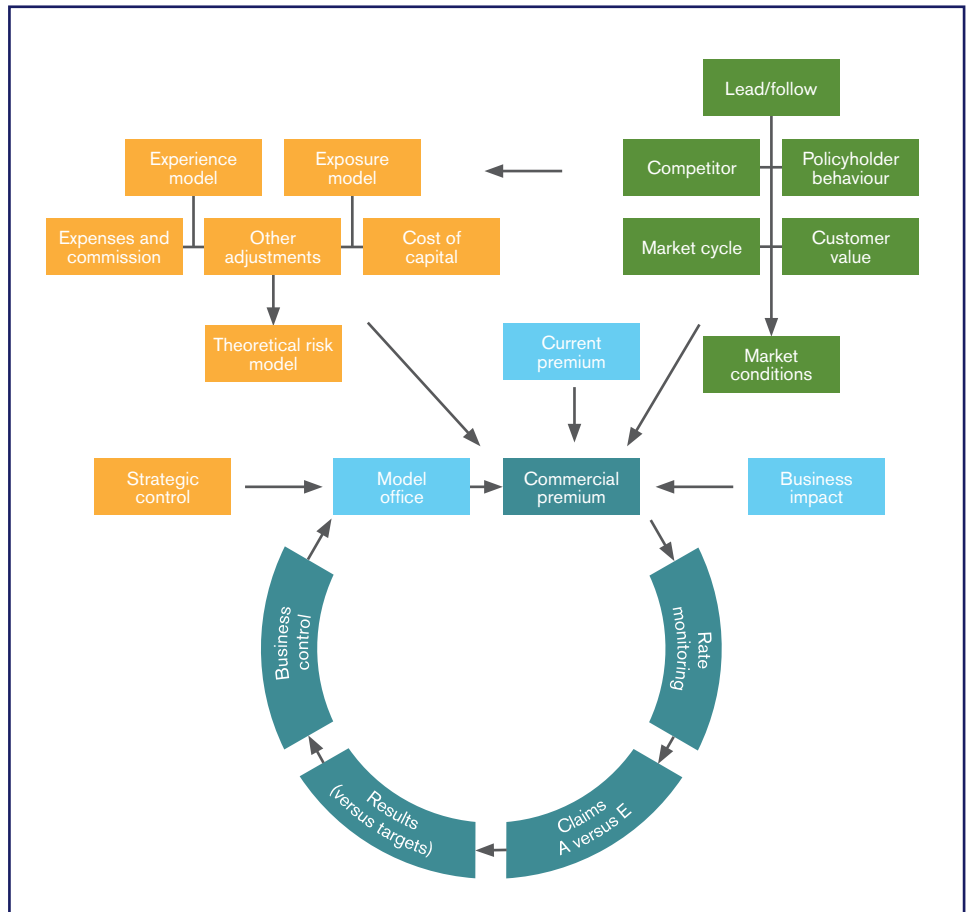




Best practice in pricing

Ryan Warren outlines best practice in the pricing function.

Figure 1 | The pricing process



Insurers are faced with soft market conditions, poor economic conditions and increasingly rigorous capital regimes. To prosper in this challenging environment, many insurers need to introduce greater governance and process to their pricing function.

Managing operational risk is increasingly seen as an important aspect of the business. While rigorous controls are the norm for claims and other functions within the company, pricing has generally received less attention even though it is fundamental to the profitability of the business.

One view of a robust and controlled rating process is set out in **Figure 1**. This process is likely to involve product managers, underwriters, analysts and actuaries.

Setting the price for a risk should involve consideration of the theoretical loss cost, the premium currently charged and the current market conditions. The potential impact on the business from writing this risk should also be taken into account, and in some cases the premium could be tested within a financial model to assess the potential return on capital for the policy within the context of the entire business.

While the specifics would generally vary depending on the class of business, the theoretical loss cost would usually involve modelling individual and/or market claims experience and making appropriate allowance for commissions, expenses, profits, reinsurance charges, investment income and the cost of capital to arrive at an estimate of the theoretical price.

The market condition considerations would usually include aspects such as the current market cycle, the competitive environment, whether the company is leading or following the cycle, potential policyholder behaviour, and the value of the policy to the policyholder.

Pricing work allowing for all of these issues should be iterative; for instance, once a product's terms and conditions are amended to better fit with market conditions, the theoretical price will need to be recalculated.

This should happen within a wider control cycle where, for example, the rate changes actually achieved are monitored, emerging claims experience is compared to that expected, and actions are taken by the business to ensure experience continues in line with the strategic and tactical directions set.

Ideally, this entire underwriting and pricing process should be fully integrated within the business. For example, the capital management function, the claims management, claims reserving, and pricing/underwriting should all be sharing information and, where appropriate, setting assumptions consistently.

Systemisation is key to ensuring a robust and successful process. This will also ensure that appropriate and adequate data is recorded for further analysis.