



Institute of Actuaries of Australia

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Evolution of the Industry

Controlling Profit Margins through Component Pricing

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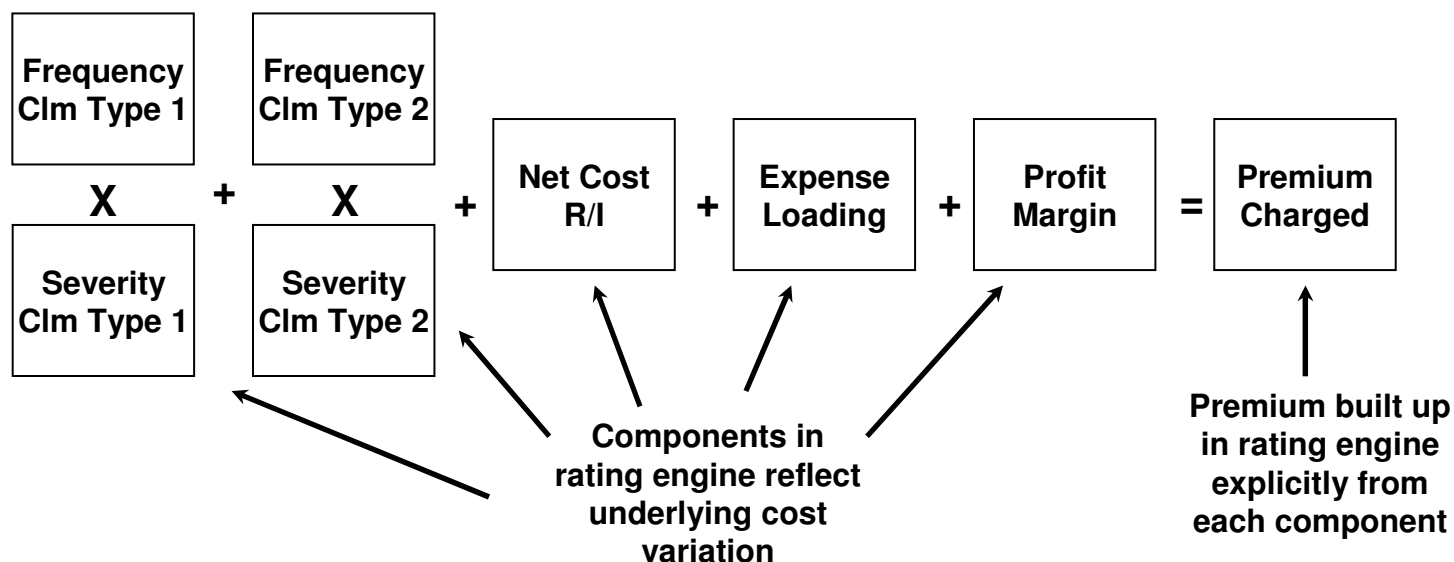
Agenda

- **What is Component Pricing?**
- **A Simple Example**
- **Benefits of Component Pricing**
- **Implementation in Practice**



What is Component Pricing?

- Rates delivered built up separately for each component





Simple Example of Component Pricing

	Peril 1	Peril 2	Profit
	Base Cost	Base Cost	Base Profit
Base Premium	100	120	4

Sum Insured	Risk Rel	Risk Rel	Profit Rel
Low	100%	100%	100%
Medium	120%	80%	100%
High	140%	120%	100%

Risk Area	Risk Rel	Risk Rel	Profit Rel
NSW	100%	100%	100%
Vic	110%	100%	100%
Qld	90%	110%	100%



Fitted into a Traditional Structure

Total Premium	
Base Premium	224.29

Sum Insured	Relativity
Low	100.0%
Medium	97.9%
High	128.4%

Risk Area	Relativity
NSW	100.0%
Vic	104.9%
Qld	100.0%



Profit by Segment using Traditional Approach

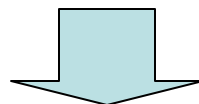
	NSW	Vic	Qld	One-Way Ave
Low	4.29	5.30	2.34	3.98
Medium	3.62	2.40	6.06	4.03
High	4.06	4.20	3.72	4.00
One-Way Ave	3.99	3.97	4.04	4.00



More Complex Example

Results of simple example still apply even with a more realistic rating structure

Constrained Rating Structure



Unavoidable dispersion of profit margins at policyholder level



Benefits of Component Pricing

- **Control of Target Profit at Segment Level**
- **Improved Monitoring and Faster Response by**
 - **Pricing Practitioner**
 - **Management**
- **Transparency in Pricing**
- **Better ability to conduct Market Testing**



Implementation in Practice

- **Large Project with Large Budget**
- **Requires buy-in and involvement from**
 - **Management**
 - **IT**
 - **Business Analysts**
 - **Actuaries**
 - **Underwriters/Product Managers**
 - **Project Office**



Specific IT Issues to Consider

- **Technical capability of system**
 - **Speed, Flexibility and Robustness**
 - **Ongoing Maintenance Requirements**
 - **Integration with existing systems**
- **Potential impact on end users/customers**

**Recent advances in IT systems make
Component Pricing a Practical Reality**



Utilisation of New Capability

- **Mindset change from “set and forget” to dynamic pricing approach**
- **Need clear protocols for:**
 - **frequency of monitoring**
 - **signoff on different components**
- **Increased complexity highlights need for good communication**



Summary

- **Targeted profitability at policyholder level requires the rating structure to reflect underlying cost drivers**
- **Benefits in monitoring and speed of response to changing markets**
- **Advances in IT make component pricing a practical reality**