Pricing of Non-life Insurance Product
In De-tariffed Regime and
How to Obtain Competitive Edge

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With the unfolding of time-bound de-tariffing road map by IRDA, the pricing aspect of general insurance product is once again under sharp focus. The demise of tariff in any insurance market is an unsettling time and the insurance companies have to gear themselves up to come out with innovative products and competitive prices. This would become a survival necessity for them.

A tariff is a schedule of premium rates and policy terms and conditions applicable to risk in a particular class of business. The insurance business in India is basically governed by Insurance Act of 1938 which under section 64 U refer to the establishment of TAC to control and regulate the rates, advantages, terms and condition to be offered by insurer of general insurance business. So legally speaking as on to-day any violation of rates, terms and condition as prescribed by TAC in the tariff would mean violation of Insurance Act 1938.

When tariff come to England, the same came to crown colonies as well including India. The main purpose of tariff was

- To ensure stability and vibrancy of the insurance market.
- To ensure long term financial strength of insurance companies to be able to meet their commitment and thereby safeguarding the policyholders interest.
- To ensure non-discriminatory and equitable rates and terms.

The tariff's were abolished in UK market more than 40 years ago under laws relating to monopoly and restrictive trade policies. However it continued in India. With liberalization being the order of the day the world over and India emerging as an economic power and important player is the global markets, it was being felt that India must move from the protected tariff regime to a regime governed by market conditions. Most of the insurance market around the world do not have tariff. The government accordingly constituted Malhotra Committee (1993) which inter-alia suggested –

- Dismantling of tariff over a period of time
- Keeping tariff for big complex risk.
- Encourage competition by way of liberalization
- Felt price – competition a necessity.

The government opened up the insurance sector by passing IRDA Act in 1999. Lot of private players opened their shops and this created a competitive environment where both the public and private insurance companies are to compete with each other and amongst themselves also. The liberalization is expected to bring about:

- Product and price innovation
- Market expansion
- Focused penetration
- Improved customer service
- Updating of technology

Liberalization and tariff regime cannot go together. And while it was a forgone conclusion that tariff will finally go, the regulator has to ensure the robustness of the market and protection of policy holders interest and hence the de-tariffing has to be a gradual well calibrated process. As per IRDA road map, India will be a totally de-tariffed market w.e.f. 1.1.2007

More than 70% of the business in Indian market operates on a tariff basis, prices of the product and relevant terms and condition being determined by TAC. Insurance companies were never involved directly with fixing of price of their product and whatever little area was outside the purview of tariff, the pricing was not based on data and scientific method. It was more of a judgmental kind of rating. In fact the need was never there for insurance companies to price products as per the risk evaluation and other relevant factors. That being the position, no serious effort was made by public sector undertakings to create relevant data bank or train and develop necessary manpower and skill to create underwriters in the real sense. A beginning is now being made in view of the road map for de-tariffing issued by IRDA. Briefly the road map envisages discontinuation of all tariff w.e.f. 31.12.2006 and preparation of interim internal tariff (base don available U/W information with the company) by 31.3.2006. The companies are required to modify their IT system so as to capture data relating to U/W and claim w.e.f. 1.4.2006. They are also required to review and modify the terms and conditions of policies and get IRDA approval for the same. This is a time bound programme.

In pre-liberalization days, whatever price competition was there was not competition in the real sense. It basically consisted of the interpretation of tariff provision and its wordings – the intelligent of the lot followed it intelligently to their advantage and other followed it blindly to their great disadvantage. People always find ways in getting round hurdles. With the opening of insurance sector and de-tariff road map taking a definite shape, all insurance companies in general and public sector undertakings in particular have to pay greater attention to developing skills in underwriting and create data base for the purpose of working out competitive pricing based on proper evaluation of the risk.

What would de-tariff mean for insurance companies? The insurance company fear worst kind of rate-cutting (with all its consequences) and unethical practices. This would also mean absence of cross subsidy for them. Are there lessons to be learnt from Marine Cargo de-tariff of 1994? Whether all the players will behave with responsibility, remains to be seen. It is not clear as to whether the regulator will intervene on account of solvency adequacy concerns arising out of uneconomical pricing and if so in what way.

In the context of insurance, pricing refers to the cost of an insurance products and the terms and conditions that goes with it. In view of uncertainties of claims, the pricing of insurance product is unique and differs from pricing of tangible products and services, where input-costs are known. Pricing, obviously, is very important. For the insured it is a major differentiating factor while purchasing insurance. For the insurance company, price adequacy is important for its long-term financial health and performance.

To understand how insurance products are priced, it is necessary first to identify the elements that go into the making of the price. These elements are –

- Claims cost – this includes claims paid along with settlement expense, estimate far outstanding claim, and provision for reserves for IBNR & IBNER.
- Business acquisition cost – this include commission, brokerage and business development cost, etc.
- Management expenses – this include salaries, rent and such other expenses essential for running an organization.
- Profit – return on the cost of capital.

The premium part that takes care of only claims cost is called pure / risk premium. This part is then sufficiently loaded to take care of other elements to arrive at the final premium. Apart from this the contingencies like risk of catastrophe / conflagration should also be kept in mind alongwith reinsurance support and cost there of. While pricing, the following commercial aspect can not be ignored:

- Inflation : Claim – cost may rise due to fall in the value of money
- Interest rate : Change in interest rate will directly affect investment income.
- Exchange rate : In present day globalised set-up, exchange rate will have obvious bearing on insurance transactions.
- Price competition from other players: Insurance companies have to do the balancing act between offering competitive price and its adequacy.

In order to arrive at claims cost, the insurance companies depend upon the statistical principle of what is called law of large numbers. As per this principle the accuracy of projection of future losses will increase, if the number of exposure units increase. However, the exposure unit must be similar and independent of each other. In other words, the uncertainty associated with an insurance pool can be minimized if the number of observation is increased. This calls for proper classification of risks and collection of data for each risk. Obviously, this will vary geographically from one place to the other as also from one class to other and even from one segment to the other within the same class. Therefore, there is no need to have strictly uniform all India rate structure. If the risks brought are of new types for which no past experience is available or for which data base is inadequate, then insurance companies individually evaluate the risks and risk-perception based rate is quoted which is judgmental in nature rather than being based on sound actuarial footing. However, a system should always be in place to build the data-base for risks of all kinds and magnitude.

Insurance companies being, commercial organization, must earn some profit at the end of the day. This in simple language means that premium earned over a period should be more than all outgoes during that period. The difference between the premium earned and the outgoes constitute what is called **"U/W Profits."** The insurance companies, generate huge revenues by way of premium collection which are invested and they in due course generate investment income. Due to pricing competition or due to some other adverse factor, frequently it so happens that insurance companies do not make U/W profit. But it is always their endeavour to ensure that they make a net profit by taking into account their investment income.

In the pricing war that is going to ensue, the insurance company must have to examine each element of pricing to ascertain as to the extent to which they can manoeuver with them to bring down the price to the level at which they are competitive and fulfills adequacy criteria also.

On the claims cost front insurance companies have to build up data base to accurately predict the occurrence of claims its frequency and severity. Proper IT support will be of immense help. Efficient and effective claims management, prevention of leakages and frauds in claim will definitely result in reduction on account of claims outgo. These two measures may help insurance company to have some leverage in pricing.

As regards management expenses, the public sector undertakings insurance companies have already gone far VRS and merging of offices. This will reduce the management expenses no doubt but much more is required to be done by way of major IT intervention and development of efficient team at each operating office level which shares the same vision and goal as the corporate team. The strategy of private insurance companies seems to hire limited number of highly qualified technical and competent people and use technology to operate effectively.

Special efforts are to be made by insurance companies to increase investment income. The higher the investment income the higher is the ability for an insurance company to sustain itself even in the face of tough competition and uneconomical pricing. The Public Sector Undertakings are at a definite advantage here.

There are certain pricing constraints also which insurance companies can not ignore more so if it is regulatory requirements e.g. adequacy of rate, not being excessive and unfairly discriminatory, solvency aspects, etc. As a general principle the rate should be stable, be encouraging of loss control measures and should take into account social sensibilities. But why do the rates of similar products vary from one company to other? This is because each company has different budgeted level of income, targeted market share, targeted return on capital as also different investment performance. Marketing strategies also vary from company to company.

Looking into the various aspects as discussed, we can say that an insurance company with efficient and effective U/W capability, claims settlement practices and office management with sound investment policy would be in a position to charge lower premium.

Of late attempts are being made to draw parallel between an insurance company operating in free market and a physical system. Mathematical model depicting mechanical stability is being used to describe economic equilibrium, where price is one of the factors. This is a new way of looking at price calculation on the basis of physical concepts. However, a lot of empirical work is to be done before this concept can be used in real world.