think piece

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Getting inside the consumer's head: the importance of psychology in bridging the insurance gap

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Summary

- The UK public are underinsured, and becoming more so. Failure to take out appropriate insurance has devastating effects on individuals and families, increases the burden on the state, and reduces revenue for the insurance industry.
- Insurance uptake can be improved by focusing on the way in which insurance is represented in consumers' minds, rather than what it is on paper.
- People are not 'economically rational', but use a number of cognitive short-cuts that lead to biases in the way risks, costs and benefits are represented. This can distort the attractiveness of insurance.
- Many of those who do not take insurance have a bury-the-head-in-the-sand mentality towards financial decisions, which leaves them uninsured but worried. It is relatively easy to encourage financial engagement by keeping things simple and allowing immediate action.
- To increase uptake, insurance needs to provide clear peace of mind. A perception that the insurance might not cover particular reasonable circumstances – either because of exclusions or because the policy is very complicated – destroys peace of mind, and makes insurance much less attractive.

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CII Group

CII Introduction: Underinsurance in the UK continues to be a growing problem, with people's inaction resulting in disastrous consequences for both individuals and society as a whole. One of the challenges is that while people may like the idea of insurance, few make the time to truly understand it—and its importance. In this Thinkpiece, Drs Henry Stott and Stian Reimers argue the way forward for modern insurance is to provide the necessary peace of mind through a better understanding of consumer psychology. Consumers are not always economically rational, and they will require a new representation of insurance based on emotional understanding and choice if uptake is to increase.

It was Brecht who observed that insurance had taken the place of religion in many people's minds: When the forces of nature encroach, people are less likely to pray and more likely to check their policy wordings. More recently, empirical research has supported the elevation of insurance as psychologically more than mere management of probabilities and expected values. People see insurance as special.

Part of the reason is that risk is one of the areas in which people flounder and use heuristics – simple, quick-and-dirty rules of thumb – rather than rational calculation to help make decisions. This means the cognitive tools to make risk-based decisions are different from those used for other purchasing decisions. And they're not perfect, so can lead to situations in which people insure when they shouldn't, or worse, fail to insure when they should. It is a problem that seems to be increasing, with recent research by Swiss Re (Fig. 1, p.5) showing that the insurance 'gap' – between the cover people have and the cover they should have – is widening.[1]

So how can this situation be addressed? We believe that looking into the mind of the consumer can give useful insights. Research into human decision making has identified a number of factors that affect individuals' insurance decisions. We will focus on three of the most important areas: the nuts and bolts of mentally representing probability, the reasons why insurance is perceived as more than the sum of its parts, and the general psychological factors – like inertia – that can mean some people take actions while others do not.

The problem of probability

Humans evolved to process real events, to learn about risk through direct experience. We – like most other animals – are fairly good at it, learning to go for the biggest rewards with the smallest risks, although individuals vary in the amount of risk they are happy to take. So why does this not apply to the more prosaic risks we insure against today?

Two things make us poorly adapted. One is that the chances of most of the insured events happening are, on a day-to-day level, very small, and we are prone to distort very small probabilities in complex ways. The other is that the small probabilities mean that most of us do not have the opportunity to learn from repeated direct experience with a risk. Instead we have to rely on our own intuition about risk.

When probabilities are low and we don't have direct repeated experience with a risky outcome, we tend to overestimate probabilities. The extent to which we do so depends on how readily the event we are insuring against comes to mind – a phenomenon known as the *availability heuristic*. This rule of thumb means that the more concrete and emotional the thought of the outcome, the more likely we think it is to occur. Thus, participants in an experiment were willing to pay more for a flight insurance policy that only covered death due to terrorism or mechanical failure than a policy that covered any cause of death.[2] By making the notions of terrorism or mechanical failure more available, people thought they were more likely to occur. In a similar vein, take-up of insurance tends to increase immediately after natural disasters like floods or earthquakes, as people find the events easier to imagine.

The availability heuristic means that people's perceived probabilities are distorted by the ease and vividness with which an outcome can be brought to mind. However, when an outcome conjures up strong negative emotions, people often ignore the probability of occurrence altogether. This means that they will not expose themselves to such a risk, even if the probability of the unpleasant consequence is vanishingly small, a phenomenon known as *dread risk*. In the aftermath of 11 September 2001, extra security measures meant the risk of hijacking was lower than it had ever been. Yet people's perception of the terrible events was strongly emotional, as they heard with horror about the last few minutes onboard the doomed flights, and a large proportion of travellers switched to their cars. The irony was that the increase in road traffic led to more accidents, and in the three months following 9/11, more people in the US died as the result of switching from flying to driving than had died on the hijacked planes.[3] People had tried to minimise their risk, and had got it wrong.

What makes insurance special?

So people's risk perception (hence propensity to take out insurance) is biased. But that's not the whole story, because it suggests that if only we could smooth out the distortions that people's minds introduce, people would choose along the lines of economic rationality. But insurance does more than simply maximise expected utility. It gives peace of mind, something for which people are willing to pay a premium, so to speak.

Recently, some of our colleagues have looked at how describing risks and payments in different ways affect the attractiveness of risk taking versus playing it safe. Participants in an experiment were asked to choose between a small loss for certain and a low probability of a much larger loss. People were more likely to choose the former if the decision was framed in terms of taking insurance against a risk, relative to when the same raw probabilities and financial losses, without the insurance description, was given. Similar results have been found in other studies.[4] This suggests that people see insurance as intrinsically a 'good thing', and in buying insurance are purchasing something more than the numerical reduction of financial risk.

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We think that the extra they are buying is a sense of security. This becomes clear when we look at probabilistic insurance. With probabilistic insurance, people can receive a reduction in their premiums for accepting a small probability that the insurance will not pay out on a claim. Participants in an experiment demanded a 20-30% reduction in their premium to compensate for a 1% chance of an insurer not paying out. This may be intuitively understandable, but it is economically irrational. After all, the expected value of any claim settlement would have been 99% of that from complete insurance. The upshot of this is clear: People want to know they are completely secure should anything happen, and are willing to pay for it. It also suggests that any stories about insurance companies failing to pay out on what appear to be reasonable claims could have very negative consequences for the attractiveness of that insurance scheme, and perhaps insurance in general. Similarly, insurance policies that exclude particular causes of a claim (such as acts of God, accidents under the influence of alcohol, or pre-existing medical conditions) will be particularly unattractive.

The fact that consumers are not economically rational actuaries can also be seen in the factors that affect people's choice of insurance product. In many areas of consumer psychology, the way in which a financial option is framed has a potent effect on its attractiveness. The same is true for insurance. For example, it is well-known that people do not like having to pay an excess on their claims. But the idea is aversive enough that in an American study people preferred paying $1600 for car insurance cover that had no excess, and for which they received a rebate of $600 if they did not make a claim, than paying $1000 for insurance with a $600 excess, even though the two are identical.[5]

People are also affected by the apparent status quo. For example, researchers investigated people's willingness to pay higher premiums for a car insurance policy that covered the right to sue for pain and suffering after an accident. Of participants who were told that the standard policy included the right to sue, but who could choose to exclude the right in return for a 10% reduction in premium, 53% chose to retain the right. Of participants who were told the standard policy did not include the right to sue, but they could pay 11% more to include it, only 23% decided to.[5]

One size does not fit all

Although we have talked about people as a homogeneous group, in reality, preferences vary from person to person. Some overinsure, others get it about right, and many others underinsure. Although demographics can help predict patterns of financial behaviour, we have found repeatedly that people's personality is a better predictor of their money choices, as well as the comfort they feel about making those choices.

We recently conducted research for AXA, examining the factors affecting people's decisions around acting on financial advice. Specifically we looked at how likely people were to take action when they had to wait a couple of hours before they could act on advice. We used a simple scenario where people chose between several financial products, and received payment related to the quality of their choice. The results were clear (Fig. 2, page 6). When people could take action immediately, around 70% did. With a two-hour delay, although around the same percentage said they would return to take action, in reality very few actually did. In particular, of the people who were given information to make their own decision, but received no recommendation, fewer than 15% returned. We were able to increase people's action-taking in the delayed condition by providing an explicit recommendation for a course

of action and motivational statements to encourage return.

What was particularly interesting was that personality, more than demographics, was closely associated with people's decision to return to complete the task or not. Inertia was particularly important: people at the inert end of the spectrum were much less likely to complete the task. The people who did return were those who already generally made good decisions, suggesting that people high on inertia also make worse financial decisions. Innumeracy had a similar effect – people who did not feel confident with numbers were put off taking a decision, even though in this situation they had nothing to lose.

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Unfortunately, this is a common trend, and people who feel they lack the skills and knowledge to deal with their finances – and hence underinsure, fail to save for a pension, and often spend more than they earn – not only shy away from taking action that could improve their situation, they also worry about their finances more. These are also the people for whom the consequences of having too little insurance cover would be most devastating. Ironically, people who show the cluster of poor efficacy and impulsivity that lead to poor decision making are also most likely to be swayed by the heuristics like availability, and dread risk. They are the people who – if they stopped and thought about it – would be easily persuaded to take out insurance. The fact that we were able to increase people's action taking using a very basic combination of recommendation and motivation suggests that there are ways in which the insurance industry could overcome some of the psychological barriers to action.

Bridging the Insurance Gap

So what implications do we see from our psychological perspective for insurance provision? The overarching implication is that consumers in general are neither economists nor actuaries, and so the objective reduction in a quantifiable risk for a specific price is only one aspect of people's insurance decisions. This means that emotion, framing, and other heuristics are important, and need to be considered when designing and marketing insurance products.

The idea of peace of mind is particularly important, so we think it is important that consumers see two clear alternate worlds: uninsured where they have to bear the risk of the many disasters that might befall them; and insured where they can rest easy knowing that they are safe. For the former, it is easy enough to create dire scenarios of the various eventualities that can befall the uninsured, but people risk developing a feeling of helplessness: they cannot insure against everything, so they won't bother at all. Or they become bewildered by the number of different types of insurance available—with niche products such as water supply pipe cover and water and drainage cover—so switch off to all of it. A more productive approach would be to ensure the consumers' peace of mind gained by taking out insurance, by making it easier for consumers to feel that having taken out insurance they do not have to worry about claims refused on a technicality, or exclusions that might render the insurance worthless.

More generally, we suggest it is important to consider the way in which an insurance product is represented in the consumer's mind, rather than simply what it is on paper. By taking consumer psychology into account, it should be possible to market insurance that is lucrative and at the same time allows the consumer to feel they have bought a product that is more than the sum of its actuarial parts.

Notes:

1. Swiss Re (2007), *The Insurance Report: Life at the Crossroads.*

2. E. J. Johnson et al. (1993), Framing, probability distortions, and insurance decisions. *J. Risk Uncertainty, 7,* 35-51.

3. G. Gigerenzer (2004), Dread risk, September 11, and fatal traffic accidents. *Psych. Sci. 15,* 286-287.

4. R. Connor (1996), More than risk reduction: The investment appeal of insurance. *J. Econ. Psych., 17,* 39-54.

5. Both examples discussed by E. J. Johnson et al. (2000), in *Choices, Values, and Frames* (Cambridge: CUP).

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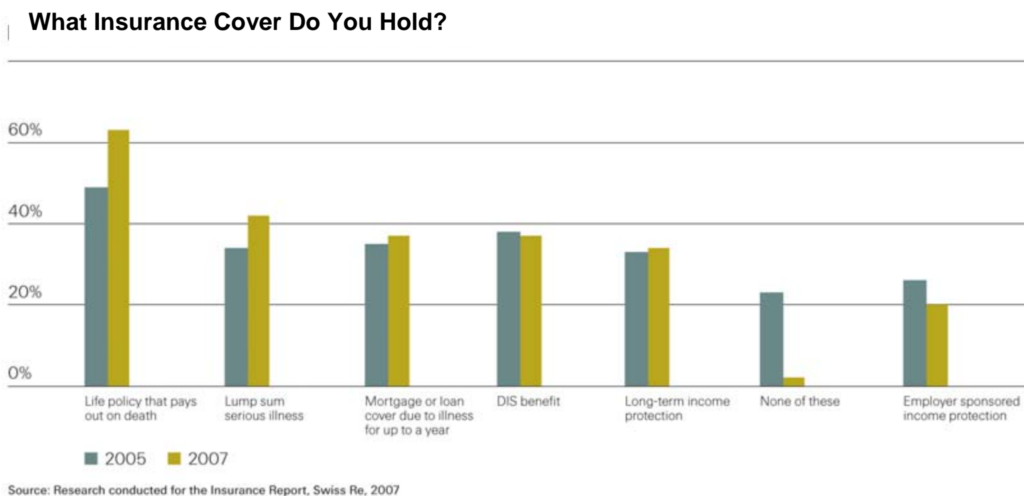
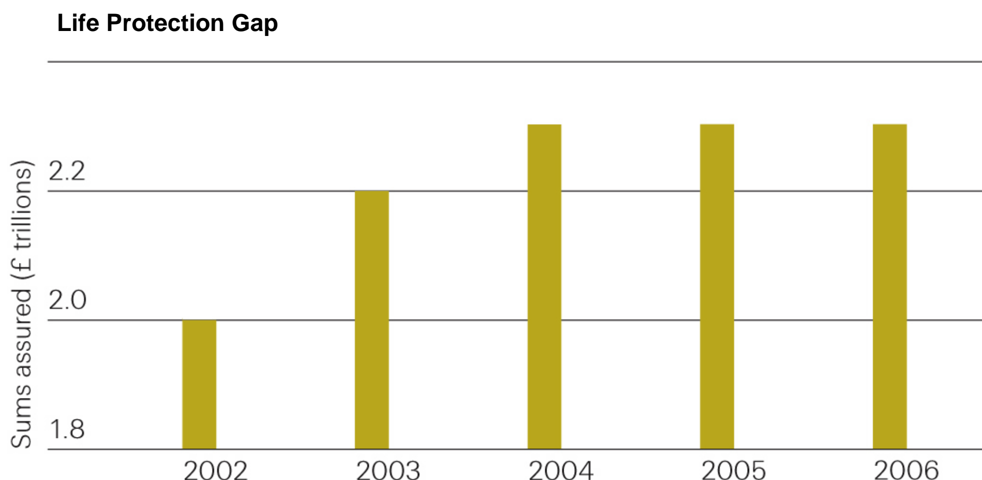
Fig. 1: Swiss Re research into the insurance gap





Source: Term and Health Watch, Swiss Re, 2007

Fig. 2 Task Completion Rate (The full report can be found here: http://www.dectech.org/Links/Brief-AxaPart2.pdf)

The proportion of people who completed a simple financial task, which was well paid, varied according to delay. Around two thirds of people who could take action immediately did, whereas fewer than 15% of people who had to wait two hours returned, even though most said they would. An explicit recommendation and motivation improved the return rate.