Applying Behavioral Economics to The Insurance Sector
What Is Behavioral Economics?

Behavioral economics is an interdisciplinary science blending psychology, economics, finance, and sociology to understand human behavior and decision-making. Behavioral economics recognizes that constraints in time and mental resources prevent us from optimally evaluating every decision. To deal with our limitations we rely on “mental” shortcuts or heuristics in our decision-making processes. These shortcuts act as interpretive mechanisms used for decisiveness in the face of uncertainty, and they can lead to predictably irrational behavior.

Companies often expect consumers to invest time and energy to fully explore the value of their offerings. The strategy is typically to expound on multiple features and benefits trying to rationally persuade customers to make a specific decision. However, this approach falls short because it goes beyond the time and energy most consumers are willing or able to invest in this process. Companies must therefore have other techniques to engage with prospective customers. BEworks understands how to develop behavioral nudges and helps companies apply them to solve their business challenges. Behavioral economics provides powerful insights into human motivation and behavior. As its experiments move from academic laboratories to the real world, the lessons from the field are being applied to improve people’s lives.

Challenges Behavioral Economics Can Solve in the Insurance Sector

- Increase Participation Rates
- Increase Individual Coverage
- Increase Retention Rates
How Do Our Minds Handle Insurance Decisions?

We have to make choices involving risks and trade-offs everyday, but the decisions facing a prospective insurance consumer are quite far removed from day-to-day decision-making. These insurance choices involve consequences that unfold over long periods of time. Also, the sheer amount and complexity of information that an insurance choice involves is an uphill battle for our minds. All of these features make people especially reliant on shortcuts (heuristics) when making insurance decisions.

When relying on these shortcuts in insurance decision-making, we are susceptible to many biases that lead to a series of patterns that include under and over-insuring against future risks. Sometimes we under-invest in future outcomes due to short-sighted thinking, while at other times we over-insure to avoid regret. Choosing to over or under-insure is not primarily based on individual differences in risk preferences. Explanations based on “tastes” for risk or personalities are very insufficient in explaining the widespread patterns of insurance choices that are observed. It is an interaction between individual preferences and the context of the choice that determines behavioral outcomes. Our aim is to understand these behavioral patterns, identify the pervading decision heuristics based on contexts, and to predict how this will affect under or over-investment in insurance for future outcomes.
How We Act Irrationally

Decisions Across Time Periods – Present Focus

A central finding of behavioral economics is that people tend to overweight present outcomes relative to future outcomes. This natural “present bias” causes us to use a very large discount factor (i.e., under weight the future) when making choices where the implications span across time periods. In our evolutionary past it made sense for humans to place a huge amount of weight on the present just for the sake of survival (long-term hedging against possible future outcomes isn’t a particularly good strategy when you face daily threats and scarcity). Today, however, most people in the western world have the luxury to do more extensive planning for the future, but this underlying present bias remains. Time inconsistent preferences contribute to many ways in which we underinvest in our future health and financial well-being. For instance, patients often fail to take medicines as prescribed for chronic conditions. The UK National Health Service estimates that nearly 40% of medicines for long-term conditions are taken improperly. People also frequently procrastinate getting screened for cancer or tested for HIV. We fail to exercise properly to avoid future health conditions and we often neglect to purchase adequate health insurance.

Overprotecting Gains – Regret Avoidance

Evidence from behavioral economics does not show that people simply always under-invest in insurance due to temporal biases. There are many circumstances in which people will purchase inappropriate insurance products. For instance, despite exorbitantly high costs, many people still frequently purchase extended warranties (essentially an insurance policy for consumer goods). People also have a strong aversion to deductibles and will choose policies with higher overall costs to avoid them, even when the risks are very small relative to their wealth (Pauly, 2008). The decision to over-insure and avoid deductibles is influenced by the context of the choice. When people feel that they have just received a gain (perhaps they have just purchased a house that they are very happy with at a below-market price) they are more likely to over-insure to ‘protect’ that gain. In this context, “regret avoidance” may over-power present-focus bias. People realize that they will evaluate their decision in hindsight based on what actually happens, instead of based on how well they weighed their options given the information at the time of the decision. To avoid the future regret of not having insurance coverage, people will sometimes engage in this kind of ‘emotional hedging.’
How People Think About Risk

People’s risk perceptions are often skewed compared to objective statistical data due to the influence of motivations, desires and emotions, as well as universal features in how the mind processes risk information.

Motivational Factors

One of the most robust psychological biases is the desire to see oneself in a positive light. People tend to have an optimism bias that often defies concrete statistical data. We are motivated to think that we are more likely to succeed in an entrepreneurial venture than the base rate data suggests. We also believe we are less likely to get into a car accident and less prone to health risks than the average person, and we act on these feeling as if they were actually facts. For instance, we might ignore marketing campaigns that aim to educate us on health risks because we feel that these risks don’t apply to us.

Affective & Cognitive Factors

People don’t like to think about the terrible health risks that an insurance product might cover, especially death. We avoid these uncomfortable conversations, and if we must think about it, we tend to underestimate the probability that it could happen to us. We are extraordinarily adept at devising seemingly logical arguments for why we are above the odds. Numerous biases also exist when we are presented with new information about risks. We often do not follow objective statistical principles; instead our tendency is to find ways to confirm our pre-existing, emotionally-contrived beliefs. This “confirmation bias”, and the creativity with which we can find caveats in the statistics, can make our skewed risk perceptions particularly resistant to change. Further, our recall of information is flawed. When faced with a decision involving risk, we try to remember relevant facts and information, but this recall process involves a host of biases. We don’t necessarily recall the information that is most relevant in the decision-making. Rather, we are subject to availability bias or the tendency to recall information that is most readily ‘available’ to us. For example, we tend to best remember information that is recent, extreme or emotionally-laden. Available information is recalled more quickly and we tend to weight it more heavily when making decisions.
Contextual Factors

The influence of subtle contextual factors in judgment and decision-making is a foundation of behavioral economics. When it comes to insurance decisions, the complexity of the choice environment makes it very difficult for us to accurately assess what is relevant and important. Overwhelmed by many choices, we are often influenced by the mere presence of contextual cues such as alternative options. Instead of evaluating each insurance choice on its own merits we use these other options as points of comparison, which can lead to some very biased and malleable preferences.

Risk perceptions often change depending on how an option is positioned and described. Consider the example of an insurance policy that covers fires but not floods. This policy could be framed in terms of full protection against a specific risk (fires, in this case), or partial property insurance. Research has shown that consumers dramatically undervalue ‘contingent’ insurance policies (coverage that involves numerous caveats) and reductions of a given hazard, compared to elimination of a hazard altogether1,2.

Individual Differences

While individual preferences are certainly not enough to understand fluctuations in insurance demand and uptake, they do matter. Individual differences are one part of the equation. Several of the biases that we have discussed have differences based on age, gender, culture, personality and priors (past health history), among other factors. For instance, a large amount of evidence has shown that women tend to be less risk-taking than men3. Also, optimism biases tend to be weaker amongst people from specific cultural backgrounds such as Japanese and Chinese individuals as compared to people from other cultural backgrounds such as Americans and Canadian individuals4. Within the domain of health risk in particular, this can lead to differences in how much control individuals from different cultures feel they have over their risk of getting cancer5, which in turn would likely have a major impact on insurance choices. In addition, optimists (as characterized by personality tests) are less likely to change their beliefs in response to new information.

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How BEworks Can Help You

It is important for insurance providers to recognize the significance of biases in decision-making. BEworks designs and implements carefully controlled experiments and data collection techniques to determine optimal strategies for optimizing consumer choices in the insurance sector.

About BEworks

Founded in 2010, BEworks is the world’s first global management-consulting firm that specializes in applying behavioral economics to real-world challenges. Using a tried-and-tested methodology grounded in empirical testing, BEworks offers Fortune 500 businesses and public sector organizations a suite of services to drive evidence-based strategy and innovation. BEwork’s mission is to help business leaders apply scientific thinking to their marketing and operational challenges.

Dan Ariely co-founded BEworks, with one of the top marketing scholars Nina Mazar, business/technology innovation experts Doug Steiner and Louis Ng, and the firms’ CEO Kelly Peters, who is a unique hybrid of both behavioral and business expertise. The team combines leading academics from the fields of cognitive and social psychology, neuroscience, and marketing with consulting experts.
Contact us to find out how we helped a Fortune 500 Insurance provider increase their participation rate by 33% and increase their premium per customer by 40%.

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