BRIDGE STRATEGY GROUP LLC

A View from the Bridge

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Behavioral Economics: A New Frontier for Insurance?

In this month's *View from the Bridge* we discuss how insurance companies can benefit from insights drawn from the field of *behavioral economics*. First, we provide a bit of background on the field and how it has helped us understand anomalies in human judgment and decision-making. We then look at examples of how companies have used this understanding in the real world. Finally, we provide ideas for how insurance companies might apply this knowledge when making product, pricing, promotion, and distribution decisions.

Introduction

Traditional economic theory has tended to treat individuals as calculating, self-interested, 'utility maximizers' who make entirely rational consumption and investment decisions. The facts, however, demonstrate that individuals regularly violate principles of rational judgment and decision-making. For example, individuals often have a bias for the status quo and will tend toward inaction, even when change would provide a clear economic benefit. The field of behavioral economics has sought to isolate such decision making anomalies and apply insights to areas such as finance, public policy, and consumer marketing.

These anomalies have major implications for how individuals respond to product offerings, price changes, promotions, and marketing messages. Insurance companies that bear them in mind when designing products and developing marketing strategies can improve sales, retention, and profitability.

Applications in the Real World

Insights from behavioral economics have been applied in a number of industries, albeit in a limited and somewhat unsystematic manner. Immediately below are two brief examples where they have helped companies dramatically improve performance against important goals.

<u>Save More Tomorrow</u>

In the late 1990's, Richard Thaler and Shlomo Benartzi, two leading behavioral economists, designed a novel program to increase savings rates in 401K plans. Working with companies and investment managers, they developed the "Save More Tomorrow" investment plan, with two basic components:

- Individuals were approached several months in advance of scheduled pay increases and asked to commit to increasing their 401K savings rate coincident with those increases, by an amount that would result in no visible decrease in take-home pay; and
- They were also asked to set up an automated increase in their contribution rate coinciding with each scheduled future raise up to a preset maximum.

The program addressed decision making anomalies that had traditionally been barriers to saving by:

- Creating a binding commitment to take action in the future, to overcome the common bias toward immediate gratification over longer-term rewards;
- Aligning savings increases with pay increases, to eliminate the feeling of loss caused by a reduction in take-home pay; and
- Making future savings rate increases automatic, to overcome the power of inertia.

The program has achieved dramatic results. In one case, nearly 80% of employees participated, 80% stuck with the program over 3 years, and savings as a percent of income jumped from 3.5% to 13.6%.

<u>Free Shipping at Amazon.com</u>

The extraordinary value of "free", a topic of interest to behavioral economists, has been applied by countless marketers over the years, e.g., using 'buy one, get one free' promotions. A particularly revealing example was highlighted by Dan Ariely in his recent book <u>Predictably Irrational</u>. He describes how Amazon.com began offering free shipping on orders over a certain dollar value and saw a significant improvement in sales as customers increased their order sizes in all markets except one - France. It turns out that Amazon's French operation had decided to charge the equivalent of twenty cents for shipping on large orders, and as a result, saw no increase at all in sales. A charge of just twenty cents was sufficient to deter customers from increasing their purchases, highlighting the irrational nature of the decision-making process, as well as the opportunity for those able to predict such behavior.

Insights for Insurers from Behavioral Economics

So what does this mean for insurers? Below we identify several common judgment and decision making anomalies and illustrate implications for insurance carriers based on work we've done and related research.

Decision-Making Anomaly	Implications for Insurance Carriers
Loss Aversion Individuals feel more pain from losses than pleasure from gains of equal magnitude	Premium increases upset insurance customers more than reductions please them. Customers whose rates fluctuate – down as well as up – are likely to be less happy than those with steady premiums.
Status Quo Bias Individuals tend toward inaction, with roots in loss aversion (to making a risky choice) and the 'endowment effect' in which people value what they currently own more than similar options available in the marketplace	Individuals and companies may go years without thoroughly assessing coverage adequacy or testing prices, even though they are aware that their needs have changed and opportunities to improve coverage and/or reduce premium exist.
Choice Overload In the face of too much information, individuals may freeze and make no decision at all	Insurance buying can be a complex process, with many terms, conditions, and risk tradeoffs to be considered. In the face of this complexity, buyers may refuse to add or change coverage, even for a recognizable benefit.
Value of Zero Individuals have a strong attraction to free goods (even when packaged with other non-free goods). 'Free' is critical – even a nominal fee will eliminate the attraction	Insurance buyers are no different than buyers of other products and services in their attraction to 'free'. As such, offering free loss control or loss data management services, for example, may increase satisfaction and perceived value, even when total costs to the customer are no lower.
Availability Bias Individuals assess the probability of events by the ease with which examples come to mind. Risk assessments can be biased by improbable but vivid personal experiences	Consumers may undervalue auto insurance after moving from a low-density, low traffic suburb to a high-density urban area. Similarly, part-time risk managers may fail to properly assess risk profiles after changing industries or relocating.

How should insurers respond in the face of these anomalies? We offer two examples below:

Status Quo Bias
We believe that status quo bias is weakening in personal lines insurance. The energy required to overcome inertia has dropped significantly in recent years as the Internet has dramatically reduced the cost and effort of search, and carriers have worked hard to simplify the buying process. As a result, customers long considered loyal are shopping and switching more often, particularly in the current economic environment.

With this in mind, carriers might want to consider:

- Conducting proactive insurance program reviews with existing customers to ensure the 'right' types and levels of coverage to (1) increase consumer confidence in the appropriateness of their coverage, and (2) preempt a competitor's recommendation of a different and supposedly better coverage mix. Both factors should discourage switching;
- Offering default automatic limit adjustments that track exposure values to help your customers maintain the right coverage levels; or
- Investing heavily to reduce switching costs for prospects by, for instance, making it easier for them to obtain accurate quotes and obtaining electronically information they would otherwise have to look up and provide themselves.

Choice Overload
Product and service proliferation has been a benefit and a curse to insurers and their customers. From the insurer's perspective, more choice should improve the company's ability to match product to needs. What often results, though, is a reduction in sales, as customers 'freeze' in the face of too much information and ultimately look elsewhere.
The lesson for carriers is not to sacrifice simplicity for variety. Begin by presenting a small number of preconfigured product options based on answers to key questions about exposures, risk tolerance, and price/premium sensitivity. Make customers aware that additional options are available for those who are interested in a more precise fit. Allowing the majority to pick from a set of preconfigured packages will increase the comfort level of most customers and the likelihood of a sale.

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Correct application of insights from behavioral economics offers insurance companies the potential for unique competitive advantages in product design, pricing, advertising & promotion, sales, distribution, and service. Companies intrigued by the topic should consider the following steps:

1. Put a team together to 'get smart' on behavioral economics and conduct a brainstorming session to generate insights applicable to your organization;
2. Identify and track the efforts of your competitors and companies in other industries, particularly investment management and consumer products;
3. Identify one or two promising opportunities to test, e.g., bundling a 'free' service with policies for new customers;
4. Conduct actual market tests to see responses to new vs. existing offerings;
5. If warranted, conduct a more thorough diagnostic to assess opportunities and threats *systematically* across your company, including marketing, product management, underwriting, sales, and service.

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