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Insurance and Insurance Purchase Decision

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Insurance is a business of uncertainty. On the one hand, insurance works in the presence of uncertainty. On the other hand, insurance is supplied by organisations seeking to make profits out of the uncertainty. The business of an insurer is to manage the collective risks passed to it by its policyholders. Insurance is not the only tool to cope with risk or uncertainty. There are other tools to cope with risk and uncertainty, which fall under the area of risk management. However, insurance is useful for risks with negative consequences i.e. risks defined as the danger of incurring losses such as loss of an asset, loss of limbs and loss of life.

Insurance is a formal contract between two parties. One of the parties (the policyholder) purchases an insurance policy from another party (the insurance company). The policy can be redeemed for money if certain risk events stated or covered in the policy occur. The cost of the insurance policy is the insurance premium. The insurance contract is made prior to specific risk events occurring. The insurance company pays the policyholder in the event of losses suffered from risk events stated or covered by the policy. Insurance is always considered to be sold rather than bought. This is because we tend to treat risks and their consequences for example death and its financial impact as taboo subjects. We avoid the issue of insurance until it is too late to do anything about it. Therefore, in order to sell insurance, insurance companies (or their intermediaries) have to go out to us and remind us of our real insurance needs.

THREE TYPES OF PERSONAL RISK

We are exposed to three types of personal risk:

- **Mortality.** Death is certain. The timing is not. Mortality risk refers to early or premature death, particularly for breadwinners or main income earners. For example, the death of the main

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income earner will leave the survivors in the family with less income on which to survive thereafter. The event (death) constitutes a risk which, without insurance, is fully borne by the dependants of the person who dies. The dependants may be unable to meet their regular expenditures such as mortgage payment, rent, basic necessities such as food and clothing, or the cost of looking after the children while the surviving partner goes out to work. Even if the loss of income due to death is not financially crippling, it could cause a significant deterioration in the standard of living of the dependants. Insurance is a means of protecting the standard of living of those who are dependent upon a person's continuing income (or wealth). On the other hand, living too long is also a mortality risk, so the case for insuring or guarding against outliving our assets. We may have accumulated a significant amount of wealth by the time we retire. However, if we live too long, we could run out of money before we die. Annuities or similar arrangements can be used to provide replacement income that will be paid for as long as we survive.

- **Health**. Health risk is health conditions requiring medical treatments that are expensive. Health risks can be divided into two categories: short-term and long-term. Short-term health risks are variable medical expenses in a year that are generally covered by health insurance. Long-term health risks are expenses incurred to sustain daily living activities, such as nursing home care. Generally, long-term health care risk is covered by long-term health care insurance. The purpose of long-term health care insurance is to pay for nursing home care expenses that we could incur in the future.

- **Property and liability**. We own houses, cars, and valuable items that may burn, collide, break or get stolen. Property and liability insurance provides coverage for personal physical assets against various damages. Home-owners or mortgage insurance is required by mortgage lenders, and auto insurance is mandatory.

INSURANCE BENEFITS

As a tool to reduce risk and uncertainty, insurance provides the following benefits to individuals and society:

- **Insurance reduces or eliminates losses hidden in life's uncertainty**. Insurance provides financial means to make up the incurred losses such as when we fall ill, part of our income is lost to pay medical expenses. Insurance provides a financial means for making up the lost income. It covers the cost of medical expenses.

- **Insurance provides stability for wealth planning**. It levels out our income stream by shifting income from the productive to the retirement phase of life.

- **Insurance serves as capital or wealth accumulation**. Certain life insurance contain a savings component and are viewed as a combination of insurance and precautionary savings. For example, an insurance paying a capital benefit to an insured surviving up to a given age, such as 60 years. The savings mark-up and investment income are used to build up the insured capital during the life of the contract.

- **Insurance provides financial relief to society**. By purchasing insurance, we protect ourselves against the risks of daily life. Without insurance, the consequences of the risks will often be borne by the community. By the principle of solidarity, the community cannot refuse to help its members in adversity. People could be suffering a loss such as ill health, accident or death of a breadwinner. They could be victims because of negligence such as failure to operate an effective public fire department. They could also be victims of natural disasters such as flood. Insurance provides an efficient way for us to cope with risks rather than having society make up for the losses.

INSURANCE PURCHASE DECISION MISTAKES

There are three types of mistakes when making insurance purchase decisions:

- **Viewing insurance as an investment**. Therefore, when the insured event does not occur, we stop our insurance policy. We feel that the insurance is not paying off. We regret paying premiums for the insurance policy and feel that insurance wastes our money.

- **Suffering a loss and regret not having insurance**. In this situation, a loss event occurs and we regret not having an insurance policy to compensate the loss.

- **Choosing an insurance coverage that does not fully protect us to keep the premium low**. When we suffer losses, we are unhappy that not all losses are covered by our policy. We regret choosing a cheap insurance policy.

Making mistakes mentioned above because insurance is a complex and complicated financial product. The insurance purchase decision is among the most difficult tasks we have to do. Issues such as evaluating personal financial needs and choosing an insurance package are confusing. To make purchase decisions, we have to be able to predict the likelihood and magnitude of highly unlikely and largely unfamiliar future events such as predicting the likelihood of dying and the magnitude of the financial impact of death. Most of the time, people fail in properly evaluating the extent, frequency and probabilities of the future events, and in interpreting them correctly. People also face difficulties in choosing and evaluating insurance price, quality, and benefits, and in comparing different insurance products in the market. Time, effort, and costs associated with obtaining information on a particular insurance product aggravate the purchase decision problem. People may be reluctant, unable to collect, or unable to process the information necessary to make insurance purchasing decisions.

MENTAL SHORTCUTS TO AVOID IN INSURANCE PURCHASE DECISION

Facing the difficult and complicated purchase decision, people rely on their mental shortcuts to decide whether to purchase insurance. According to Nobel Memorial Prize in Economic Sciences winner, Professor Daniel Kahneman, people use mental shortcuts or simple procedures when making decisions on difficult, complex, and complicated problems. According Professor Gerd Gigerenzer, Director Emeritus at the Max Planck Institute for Human Development in Berlin, the mental shortcut or simple procedure is a conscious or unconscious strategy that ignores part of an information of a problem to make fast decisions. However, fast judgements in an uncertain environment such as in insurance purchasing expose us to bias, and interfere with rational judgements.

The following discusses the mental shortcuts or simple processes discovered by Professor Daniel Kahnemann that we normally use to make decisions on difficult, complex, and complicated problems:

• What You See Is All There Is (WYSIATI)

The WYSIATI mental shortcut is failure to consider missing critical evidence of a problem. It occurs when information regarding a problem is scarce. In consequence, we make decisions based on limited information. Instead of asking what we need to know before forming an opinion, we make a decision based on incomplete critical information. The decision to buy insurance is influenced by available information. One way people hear about a particular product is through informal conversations with family members and friends. The information is considered to be more reliable and has a greater impact than that promoted by the media or insurance agents. However, insurance products are complex and they may not fully understand how a product benefits them. WYSIATI makes us base our decision on information of poor quantity and quality, and on evidence at hand. Instead of jumping to conclusions or a fast decision, we need to ask what we need to know and consider all ranges of plausibility before we accept or reject an insurance product.

• CHERRY PICKING

This refers to showcasing the most attractive features and hiding the unattractive ones. People cherry-picking in all areas from philosophy, economics, medicine to politics, even in academia. We say what we do instead of what we do not do. If we achieve our goals or objectives, we talk them up. If we fail in achieving our goals and objectives, they are not even mentioned. To control cherry-picking, ask about the leftover cherries i.e. the omitted information. Dig deeper into the situation. The omitted information may be one piece of information that completes the whole story or situation. Knowing the whole story gives us a complete understanding and helps in making better insurance purchase decisions.

• REPRESENTATIVENESS

This refers to seeing a pattern that is not there. Examples are faces in the clouds, outlines of animals in rocks or words on trees. It is normal for the human brain to seek patterns and make associations between events. If the brain finds no familiar patterns, it invents a pattern. For example, simultaneously seeing the words 'banana' and 'vomit' causes the brain to make a connection between the banana and vomit. In this scenario, the banana is causing the sickness. The representativeness mental short-cut causes us to perceive certain risks as existing or not existing based on our experiences or patterns even though experiences are not accurate predictions of future events. Yet, our brain makes the connection or creates a pattern between past and future risk events when in reality an associative connection or a pattern does not exist. Representativeness results in a less rigorous or rational assessment of risks in the current situation. We rely on perceived similarity or pattern with a situation previously experienced.

• AVAILABILITY

This refers to assessing the frequency or probability of an event by the ease of recall of a similar event. For example, the effect of witnessing a house burning causes us to judge fire as being a high frequency risk, compared to reading about a fire in a newspaper. Vivid and easily recalled causes of death (e.g. tornadoes) often receive a high estimate of probability compared to less vivid causes (e.g. asthma attacks) even though more deaths are caused by asthma attacks than tornadoes. Death associated with terrorism is considered more serious and dangerous compared to death associated with sun bathing. The risk of a terrorist attack is given a higher probability compared to the risk of skin cancer. The availability mental shortcut causes us to overestimate the likelihood of spectacular or loud events. Silent or invisible events are downgraded in the brain. We think dramatically instead of quantitatively. This is the reason why in the aftermath of an earthquake, the purchase of earthquake insurance increases sharply. However, purchases decline steadily as vivid memories recede. If we live in flood prone areas, we are less likely to purchase flood insurance if floods have not occurred in the immediate past. On the other hand, if we know someone who has experienced a flood, we are more likely to buy flood insurance for ourselves regardless of the flood risk we actually face.

• AFFECT

This refers to letting our like and dislike determine our beliefs or preferences. We refer to affective feeling in judging the benefits of an activity. If we like an activity, we judge it as having high benefits. If an activity is disliked, the benefits are perceived as low. The affect mental shortcut causes us to avoid, reject, or distort any information or opinion that conflicts with our beliefs or preferences. If we favour a certain product or company, the product is judged as having high benefits. The affect mental shortcut creates a world much tidier and simpler than in reality, and rejects any information that conflicts with our beliefs.

• HALO EFFECT

Favourable first impressions influence our judgements. For example, if we think a football player is good-looking and athletic, the player is likely to be rated better at playing football (positive halo). If we think a player is not good-looking, the player's athletic ability is underrated (negative halo). Psychologist Edward Lee Thorndike discovered the halo effect nearly 100 years ago. The halo mental shortcut causes us to look at a single quality such as beauty, social status, or age to produce a positive or negative impression. It obstructs our view of the true characteristics of a person, product, or company.

• SUBSTITUTION

The substitution mental shortcut means replacing a difficult question with an easier question. For example, a difficult question such as 'What do I think about an insurance product?' is replaced with an easy question, 'How do I feel about the product?' 'How should insurance agents who prey on the elderly be punished?' is replaced with 'How much anger do I feel when I think of unscrupulous insurance agents?' 'How happy are you with your current life these days?' is replaced with 'What is my mood right now?' We use our emotional reactions to answer difficult questions.

• ENDOWMENT EFFECT

We hate losing. Losing make us twice as miserable as gaining the same things that make us happy. Losing $10,000 feels much worse compared to the good feelings of winning $10,000. If we have a great affection for an object, we are willing to pay more for an insurance policy compared to if we have less affection for the object. The more affection we have for the object, the more pain we will experience in the event of a loss. Therefore, the more our need is for consolation. Insurance provides the consolation. The more we need consolation, the more valuable the insurance appears, and the more we are willing to pay for it. Buying insurance is an investment for future consolation.

• CONFORMITY

The tendency of an individual is to follow group judgement. The conformity mental shortcut causes us to conform to or follow group decisions even though we know the decision is incorrect. We are more likely to conform if we are required to express our decisions verbally in front of others. Conformity is also called social proof or herd instinct. We feel we are making correct decisions by following the decisions of the majority. We choose to believe the majority cannot be wrong. The advertising industry benefits from our weaknesses to social proof. This is particularly so in unclear situations having ambiguous advantages and disadvantages such as deciding between various car makers, and cleaning, beauty and insurance products. Hence, there is a tendency for us to buy products from a company claiming its product is better because it is the most popular.

• **MENTAL ACCOUNTING**

Mental accounting is a process to record, summarize, and analyse our expenses and consumption. Mental accounting was discovered by Nobel Memorial Prize in Economic Sciences winner, Professor Richard Thaler. According to Professor Thaler, a decision whether or not to make a particular purchase such as the purchase of an insurance product is not made in isolation. The decision depends on one's budget, the nature of the expenses and the amount of similar expenses incurred, the prices and mental categorization of expenses. Expenses can be divided into different spending categories such as food, entertainment, utilities and transport. Spending in each category is constrained by the availability of a budget. One reason we may not buy insurance is we allocate our planned expenditures of income or salary into different mental accounts. The mental accounts set constraints or limits on how much we are willing to spend on certain activities. For example, we have an account labelled "expenditures on insurance" and are already committed to spending considerable funds on required insurance such as mortgage, automobile, life and medical insurance. The mental accounting shortcut makes us feel that we have reached the limit of our budget for insurance. Therefore, we do not want to buy additional insurance coverage for risk events such as health care or retirement. Or we may limit the amount we spend on the required coverage by taking the cheapest policy or not taking the highest limits of insurance coverage, or both.

CONCLUSION

Insurance purchasing is a complex process and among the most difficult decisions faced by consumers. The complexity of insurance purchasing is caused by issues and problems such as evaluating the likelihood and magnitude of uncertain future events, assessing personal financial needs, evaluating insurance price, quality and benefits, comparing different insurance products provided in the market, and choosing an insurance package. We also face difficulties in understanding our risks. We fail in properly evaluating the extent, frequency and probabilities of risks, and in interpreting them correctly. Facing difficult, complex and complicated problems, we use a mental shortcut or simple process to decide whether to purchase insurance. The simple process interferes with rational judgements and is influenced by feelings and emotions. Therefore, to make an optimum insurance purchasing decision, we need to have a deep understanding of the mental shortcuts that we consciously or unconsciously use. The in-depth understanding benefits both insurers and consumers.It contributes to better understanding of each party's motivation to sell and purchase. Insurers can understand why their products are difficult to sell. Consumers can understand why they find it difficult to decide whether to purchase insurance products.

We cannot know the future with certainty. Insurance is a product designed to help us cope with uncertainty in our life. We give up a certain amount of our money (the premium). In return, we are protected financially against a potential or future loss. It is inevitable that we will not get anything back from our insurance policy in any given year or nearly as much as we pay in premiums over time. That is the nature of insurance. When purchasing insurance, our mantra should be *the best return is no return at all.* ■