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The Insurance Industry

Transformation: Evolution or Revolution?

Summary of a Roundtable held on 17th May 2018 to examine how ***Behavioural Economics*** can help shape, transform and create opportunities in a changing landscape?

Summary of Roundtable

With market challenges, the emergence of new technologies and the recent publication of the FCA's 2018-2019 business plan with culture as a key priority, the Insurance market is on the cusp of transformation.

Recent years have seen a growing use of behavioural economics in the Financial Sector or with organisations looking to understand better the influences on consumer behaviour, which can lead to competitive advantage. The FCA's latest discussion paper on cultural transformation once again brings behavioural economics firmly back into the limelight, this is looking at employee behaviour.

The insurance sector is beginning to look at its organisational mechanics, using behavioural insights to explore some of the root causes of issues that still need to be addressed with a focus on fostering greater trust and employee accountability. Will better culture lead to better customer outcomes? And how can behavioural economic principles be used to drive these changes? These were some of the topics explored by the Behavioural Economics team at City, University of London, alongside a panel of leading experts at a Roundtable on 17th May 2018, held at Cass Business School.

The focus of the Roundtable was to tackle the nebulous topic of 'culture' in the insurance sector, the importance of cultural transformation and how behavioural economics can be utilised to meet the FCA's objectives of securing consumer protection and promoting effective competition within markets.

The Roundtable was opened by the academic sponsor for the event, **Philip Corr**, Professor of Psychology, City, University of London, and followed by three expert speakers: **David Blunt**, Head of Conduct Specialists Financial Conduct Authority; **Pantelis Solomon,** Principal Advisor & Head of Evaluation, Behavioural Insights Team and **Peter Ayton**, Professor of Psychology City, University of London. The session was facilitated by **Darren Munday,** Visiting Fellow of Cass Business School.

The following summary provides an overview of the key themes (purpose, leadership, incentives, governance) from the discussion and the views of the panellists and guests.

City, University of London, welcomed a panel of senior executives to a Roundtable held at the Cass Executive School on 17th May 2018.

The FCA on *Culture*

In March 2018, the FCA published a new Discussion Paper on "Transforming Culture in Financial Services", looking at key drivers for changing culture and providing differing perspectives on how cultural change can be delivered. This Discussion Paper included 28 brief essays from CEOs, senior managers in the Financial Services Sector, as well as academic commentary. Although views were conflicting over the nature, development and measurement of culture, the paper provided useful indicators as to how to create a positive environment in which good culture can flourish – such as the importance of speaking out and learning from mistakes.

Opening the Roundtable discussion, David Blunt, Head of Conduct Specialists at FCA, gave a brief overview of the latest publication, explaining the FCA's perspective on culture as an assessment of habitual behaviours and mindsets that characterise an organisation. Although the FCA considers there to be various drivers of behaviour, assessment will be measured in four key areas:

Purpose*:* What and how is this communicated?
Leadership*:* What are the behaviours being modelled and what are the characteristics shown across all levels?
Incentives*:* What are the types of incentives? Social and psychological should also be recognised, not only remuneration.
Governance*:* What policies and systems specify expected behaviours and decisions?

The FCA considers culture and governance as root causes of the conduct failings within the Financial Services Sector over recent years, which led to harm for both consumers and markets. The FCA argue that for firms to be successful they need to foster a healthy culture and rebuild trust both internally with their employees and externally with consumers. The FCA understands there is no "one size fits all' approach and it is not their responsibility to prescribe what a firm's culture should be.

The new regulatory guidelines on culture were viewed positively by the Roundtable guests, who recognised that it provides them with a practical framework for best practice and operations in order to deliver effective cultural transformation. During the open floor discussion, there was considerable debate around the complexity of culture. For example, firms have multiple units, all with their own 'operating rhythm', and these nuances need to be taken into consideration when understanding culture, especially where firms have teams based overseas, where differences of culture are often found.

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Behavioural Economics

and Cultural Transformation

The second speaker, Pantelis Solomon, Principal Advisor & Head of Evaluation at the Behavioural Insights Team (BIT), stated culture is not a *thing in itself*, which in any case can be nebulous and ill-defined; rather, it is a reflection of all aspects of the organisation's behaviour. Culture is about components – specific behaviours. It is when these components come together that we can sensibly talk of 'culture'. Pantelis provided some practical tips and on how behavioural insights can help firms to build and maintain a positive culture - these are included in the four sections (cultural drivers) below.

The last speaker, Peter Ayton from City, University of London, gave a whistle-stop tour of behavioural economics showing even the brightest and most informed people are prone to a number of systematic biases, looking at how people make decisions under uncertainty and risk. Visual illusions were used to show the constructive power of the brain and how perception is influenced by reference points. In 2002, Daniel Kahneman (a psychologist) and, in 2017, Richard Thaler (an economist), won the Nobel Prize in Economic Sciences for very significantly advancing knowledge of the ways people deviate from a purely rational model of judgement and decision making. As Peter pointed out, behavioural economic principles are being applied effectively across a wide range of business sectors, and can provide insurance firms an additional toolkit for assessing, understanding and influencing behaviour, helping to deliver on the FCA's four key cultural drivers: purpose, leadership, incentives, and governance.

The Power of *Framing*

Framing is a powerful tool in the insurance sector and can affect the consumer in both positive and negative ways, as well as how employees behave. This has been demonstrated in a study conducted by George Lowenstein and colleagues[1].

Although the recent expansion of health-plan choice has been touted as increasing competition and enabling people to choose plans that best fit their needs, Lowenstein's study provides new evidence challenging these proposed benefits. The authors examined health-insurance decisions of employees at a large U.S. firm where their health-insurance choices included An extensive share of financially dominated options - these options offered a unique litmus test for evaluating choice quality since standard risk preferences and beliefs about health cannot rationalize enrolment into the dominated plans.

The majority of employees - and in particular, older workers, women, and low earners – chose dominated options, resulting in substantial excess spending. Most employees would have fared better had they instead been enrolled in the single actuarially-best plan. In follow-up hypothetical-choice experiments, the researchers observed similar choices despite far simpler options – in particular, choices reflected a severe deficit in health insurance literacy and naïve considerations of health risk and price, rather than a sensible comparison of plan value. The results challenge the standard practice of inferring risk attitudes and assessing welfare from insurance choices and raise doubts whether recent health reforms will deliver their promised benefits.

[1] Bhargava Saurabh, Loewenstein George, Sydnor Justin, "Do Individuals Make Sensible Health Insurance Decisions? Evidence from a Menu with Dominated Options," NBER Working Paper No. 21160, 2015.

The *FCA's four drivers*

culture change and what we learned from the Roundtable

PURPOSE

The power of Middle Managers. How can a firm articulate its vision and purpose? Middle managers can be a powerful way to help drive cultural change. They are in a position to challenge senior leaders and can act as more immediate role model for junior employees. Firms need to look at how this group of individuals could be engaged in order to spread the purpose of the business and how their User Journey could be preventing them from engaging effectively with their teams. Understanding the employee User Journey and possible behavioural barriers that inadvertently can have a disproportionally large impact on engaging with business culture, reflecting the 'butterfly effect' of small changes. For example, changing the default times shown on Outlook calendar that defines the 'working day' can have an influence on work/life balance. In addition, evidence shows that employees mirror the working habits of the manager – they set the example that others follow.

LEADERSHIP

'Culture in organisations can change fast, especially with new leaders – they can make a big difference, for good or ill'.

Leadership and clarity of responsibility are key for FCA. Although culture is typically set at the top of the organisation, it has no meaning unless it permeates all levels. It is seen as the responsibility of everyone in the firm, at all levels, to play a pivotal role in influencing culture and helping to shape the firm's narrative.

Form a team of challengers. Firms need to create an environment where employees feel empowered to challenge, feel supported and safe in an ever changing and complex world. Some organisations are designing teams of 'Challengers' - their purpose is to question business decisions and help foster a psychological safe environment where employees can speak up and make positive change.

Listen to your consultants: Third parties can be useful because they can say things that people within the firm may be reluctant to express and can provide an independent, critical perspective (this Devil's Advocate perspective can be valuable – especially when unpalatable truths need to be spoken).

INCENTIVES

Previous business models created commercial incentives for behaviours, which led to poor outcomes for consumers, with behaviour motivated by short-term factors (e.g., bonuses); their effects are often seen only in the future when these factors are "untouchable". The FCA see the use of behavioural economic principles as fundamental tools when designing incentives and encourage firms to look at alternative options and non-financial incentives to motivate performance.

Incentives and Reciprocity. One technique organisations use to enhance culture is *reciprocity* – financial and other types of rewards (e.g., public recognition) for demonstrating desirable behaviours. The Behavioural Insights Team (BIT) gives £200 bonuses for outstanding performance: the recipient is then asked to give half of it to another person in the business they feel is deserving.

The influence of framing: Given an identical logic structure of a problem, whether it is framed in terms of a loss (e.g., how many people may *die* from a disease) or gain (e.g., how many people may be *saved*) has a large impact on decision making – although the outcome is identical in logical terms.

GOVERNANCE

Formal governance processes and policies ultimately affect behaviour and decision-making. Having a well-defined risk framework and systems in place to control risk, are essential to a healthy culture. However, 'Risk management' is a problematic concept, because 'risk' stops people doing things – especially for the good of the business – whereas if risk is framed as 'uncertainty' which is more positive, can lead people to think differently.

Conduct a 'pre-mortem'. Teams need to imagine a project has failed and consider all the ways it did. Looking at potential risks is much better done at the outset than after the event! Considering the "known unknowns" will help to mitigate the negative effects of 'group think' (the research evidence suggests group discussions are often riskier and less optimal that those taken separately by the individuals of the same group).

Measuring Culture

Although culture may be hard to define and measure, the FCA believe there are a number of key indicators that firms can consider. Are people able to “speak out” without fear? Is there a “learning culture”? In particular, is there a culture of “psychological safety over fear”? Although there is an agreement of no one silver bullet solution, firms should look at their own specific culture as part of the annual “stock take” of their operations.

HOW GOVERMENTS USE BEHAVIOURAL ECONMICS AND HOW IT CAN BE USED IN BUSNIESS

A behaviour change initiative was undertaken by the Institute for Government, along with the Cabinet Office, in 2009. This had the aim of providing a simple checklist for policymakers. The result was MINDSPACE - a Nudge framework - which stands for nine principles that influence human behaviour – summarised below. These principles have wide-spread application to the business world.

MINDSPACE

***M – Messenger**: we are heavily influenced by who communicates information*

The messenger of information matters (e.g., their perceived authority). Findings show that people more favourably receive information from experts (e.g., a doctor in a white coat). Perceived similarities between the information giver and receiver are also important – for example, the sign: “Kill your speed, not a child” is communicated better by a smiling child than a sour-faced local authority official. The feelings we have towards the messenger are also relevant – if we dislike them, then their advice is more likely to be discounted or even ignored.

***I – Incentive:** our responses to incentives are shaped by predictable mental shortcuts such as strongly avoiding losses.*

Incentives are widely used by government, but their influence depends on such factors such as timing, type and magnitude. Incentives can be about money (i.e., the costs and benefits associated with different behaviours); but social incentives are important too. We need to consider a number of psychological factors when thinking about incentives. For example, we use bundles of money when deciding what and how to save and spend – known as *mental accounting*.

N – Norms: we are strongly influenced by what others do

What people expect about social behaviour influences how they behave. Social norms can be obvious (“No smoking here”) or more covert (social conventions when you meet someone for the first time). We tend to take our social norm cues from observing what other people are doing. Simply informing people about the existence of social norms can be enough to influence behaviour. For example, telling people that most people in hotels recycle their unused towels encourages similar behaviour.

D – Defaults: we “go with the flow” of pre-set options

Much of our everyday behaviour is just going with the flow – it is a form of taking the easy option, the path of least resistance. Defaults are pre-selected options which do not involve an active choice: we tend to take what is on offer. For example, automatic enrolment in an organ donation programme leads to significantly more people going along with this default option – few people bother to opt out.

S – Salience: our attention is drawn to what is novel and seems relevant to us

Information to which we are attentive attracts cognitive processing. Although attention is not required for all forms of processing, it is often important for certain types of messages. We are more likely to process information that is novel, accessible and simple – other forms of information can be pre-consciously filtered and, thus, ignored. The problem with the brain/mind is that it is bombarded with stimuli and it must make a choice what to process – grabbing attention by salience is helpful in this respect.

P – Priming: our acts are often influenced by sub-conscious cues

Exposure to stimuli – sights, sounds and smells – can prime (i.e., make more likely) subsequent behaviour. These stimuli can be complex (e.g., words) or simple (freshly baked bread). Priming can happen outside of cognitive awareness and does not need elaborate processes for it to be effective. For example, regarding exposure to words, when people make a sentence out of scrambled, fitness-related words (e.g., ‘fit’ and ‘lean’) they are then immediately more likely to use the stairs instead of the lift.

A – Affect: our emotional associations can powerfully shape our actions

Emotion affects judgement and decision making, and these effects can be automatic and fast. For example, being in a good mood can lead to being overly optimistic and being in a bad mood to being inappropriately pessimistic – both can lead to suboptimal and biased judgement and decision making. Even the mood-inducing effects of background music can do this, and it need not be task related – for example, cheery music in the background can lead to risk-prone financial investments. One example is seeing an attractive, smiling face on a loan advertisement which leads to increased demand, similar in magnitude to the demand created by a 25% reduction in the loan’s interest rate!

C – Commitment: we seek to be consistent with our public promises, and reciprocate acts

A lack of will power is a major reason why we do not always act in our own best self-interests. Commitment devices can be used to achieve long-term goals. Such devices tend to become more effective as the costs for failure rise. A good example is smoking. In one study, smokers were offered a savings account - they had to deposit money in this for 6 months, at which time they took a nicotine test. If they passed the test (i.e., they were nicotine-free) their money was returned, otherwise, they lost it. After twelve months, this commitment device raised the chances of quitting smoking by 30 percent. Much the same is found with exercise – the mere act of signing a contract which specifies the amount of exercise leads to adherence, despite no monetary consequences of succeeding or failing.

E – Ego: we act in ways that make us feel better about ourselves

We have a desire to be consistent in our behaviour, so if our behaviour and beliefs are in conflict, our beliefs often change (this is accounted for by cognitive dissonance). In addition, we tend to attribute good outcomes to ourselves and bad outcomes to other people: we take praise with one hand and give out blame with the other. Attributions to our own behaviour and others' is a central part of social psychology, and is used widely, especially in the commercial world. For example, males donate more to charity if they are approached by an attractive female, suggesting the giving of money reflects a desire to present a positive self-image. Also, if we place an expectation on someone, this is often sufficient to encourage them to perform better – they have internalised these expectations (i.e., assimilated them with their self-image) and used them to guide their behaviour.

APPLIED*terms*

How many of these behavioural economics principles can be applied to your business?

Affect Heuristic

A mental shortcut that allows people to react to novel stimuli quickly by relying on their emotional response (their 'gut feeling').

Allais paradox

A choice problem described by Maurice Allais in 1953, which was one of the first to demonstrate experimentally that actual observed choices are not always consistent with one of the major criteria of (i.e.., expected utility theory; see below).

Ambiguity Aversion (uncertainty aversion)

The propensity to prefer risk (where the probabilities of outcomes occurring are known) over uncertainty (where these are not known).

Authority Bias

We are overly influenced by who communicates the message; this is seen in trusting actors in a white coat selling a medical product and was seen starkly in Stanley Milgram's series of classic studies on obedience to authority.

Availability Heuristic

A mental shortcut that relies on examples that immediately come to mind when forming judgments. When an unlikely or infrequent event comes to mind easily, we tend to overestimate the probability of its occurrence.

Biases (cognitive biases)

A systematic error in thinking or deviation from rationality which affects judgments and decision making.

Commitment Device

A strategy chosen in the present to restrict future behavior in order to adhere to long-term goals, which may otherwise not be reached because of lack of will power or present bias. Commitment devices come in many different forms, for example study groups or pre-purchasing tickets for an event on a certain day to avoid procrastination.

Compromise Effect

The observation that consumers often prefer the middle option in a choice set as results of wanting to avoid extremes.

Confirmation Bias

The tendency to recall old information and interpret new information as evidence for supporting existing opinions and beliefs.

Efficient Market Hypothesis

An investment theory which assumes that the price of stock market shares reflects all relevant, available information. It should, therefore, not be possible to 'beat the market' in the long-run.

Endowment effect (divestiture aversion)

The finding that we value things we own more than the things we do not own.

Equity Premium Puzzle

Describes the anomalous observation that the observed returns on stocks over the past century are much higher than returns on government bonds, implying that the stock market is required to pay an equity risk premium to attract risk averse investors.

Anchoring

A cognitive bias that describes people's tendency to rely too heavily on 'anchors' (traits or pieces of information) when making decisions. This is often the first piece of information that is received and, thus, it has more influence.

Anchoring and Adjustment Heuristic

The tendency to base estimates (or decisions) on a familiar value or readily available number (when it is it totally arbitrary!), and then shift up or down from that 'anchor' to arrive at a final estimate/decision.

Animal Spirits

Term coined by John Maynard Keynes in 1936 to describe that economic decisions are much influenced by psychological factors (instincts and emotions), which, among other things, drive 'consumer confidence'.

Framing

The process of defining the context in which choices are presented.

Framing Effect

A cognitive bias which describes that the form in which content and information are presented is highly relevant for decision making (for example, presenting a choice as a discount or surcharge in a shop).

Heuristics

Mental shortcuts that are automatic, intuitive and do not require conscious thought. They were initially described by Tversky and Kahneman in 1974.

Bounded Rationality

Term first coined by Herbert Simon. It describes the idea that people must make decisions under constraints, such as limitations of knowledge, time and thinking capacity, which affect the ability to process information in an optimal (fully rational) manner.

Buyer's Remorse (or buyer's regret)

The sense of regret that may occur after a (usually expensive or unnecessary) purchase.

Choice Architecture

Term first coined in 2008 by Thaler and Sunstein, which describes the careful design of how options are presented to people in order to influence their choices.

Loss Aversion

"Losses loom larger than gains" (Kahneman & Tversky, 1979); the tendency to prefer avoiding losses relative to achieving gains of the same magnitude.

Mental Accounting

It describes the tendency to allocate money to separate mental accounts based on individual criteria.

Mere Exposure Effect (familiarity principle)

The tendency to develop a preference for things or people that are familiar.

Consistency

People try to act in a consistent way; this means that they can be induced to behave in a certain way (e.g., allowing a small 'speed kills' sign on their front lawn) which, in consequence, in order to remain consistent, they are more likely to agree to a much larger sign because they see now see themselves as a civic-minded citizen.

Decision Utility

The utility (satisfaction) people assume a specific choice will bring them.

Defaults

A pre-set option the decision maker will receive if no decision is made. An important tool for the choice architect.

Preference Reversal

A situation in which preferences change between alternatives options; this could be due to a change in context, framing, the method of eliciting the preference or the point in time at which the outcome of the choice will be realized, among other reasons.

Present Bias

The tendency to prefer immediate rewards over delayed rewards.

Priming

A nonconscious memory effect in which exposure to a stimulus affects how people react to another stimulus. The brain networks are activated by an initial 'prime' which then affects subsequent behavior.

Expected Utility Theory

A theory of decision making under risk or uncertainty, which states that rational decision makers will choose the option with the highest expected utility.

Expected Value (expectation)

The expected value of X is the weighted average of all the values that X can take. To calculate the expected value of X, each possible outcome of X is multiplied by the probability of the outcome occurring, and all these values are then summed. In a gamble, it is the anticipated value of the bet.

Experienced Utility

The utility (satisfaction) that choices actually bring.

Reactance Theory

A theory which describes that people often do the opposite of what rules and regulations mandate if they feel that their freedom to choose is being curtailed; they do not like being told what to do.

Reference Dependence

Outcomes are evaluated relative to a reference point; an important aspect of prospect theory.

Representativeness Heuristic

A mental shortcut which people use when estimating the probability that an event or object belongs to a certain class, by looking at how representative that event/object seems to be of that class – this can lead to base rate neglect.

Hyperbolic Discounting

A specific form of the discount function, in which discount rates are not constant over time - discount rates are steep for earlier delay periods and smaller for longer delay periods.

Intertemporal Choice

The study of choices that people make at various points in time, whereby current choices may affect available future options. Choices indicate how we value consumption today compared to future consumption.

Latent Preferences

Hidden preferences which are not directly observed and may be inferred by revealed preferences in choice behavior.

Money Illusion

The tendency to think of income/wealth in terms of the face value (the nominal value; e.g., £1) rather than in terms of its purchasing power (the real value which takes inflation into account.

Nudge Theory
(nudge)

An aspect of choice architecture that influences behavior in a non-coercive way; a nudge is said to be liberty-preserving and does not involve regulation or bans; it must be easy to opt out of the behavior if it is not desired.

Peak-end rule

Experiences are not remembered in the same way; we tend to remember the most intense (peak) moments as well as the concluding moments (e.g., we prefer a longer, cumulatively more painful, dental treatment to a shorter one that contains a higher peak moment of pain).

Prospect Theory

Developed by Kahneman and Tversky in 1979; a theory that describes decision making under risk.

Psychological Value

In marketing, the customer-perceived value of a product that often exceeds the functional or monetary value by making the consumer feel better (i.e., subjective utility).

Rationality

In neoclassical economics, rational consumers maximize their utility and rational firms maximize their profit. Rational behavior follows axioms (assumptions), including completeness, among others.

Revealed Preferences

An economic theory which posits that the best way to measure preferences is to observe actual choice behavior; the theory assumes that actual choices (e.g., purchases) reveal latent preferences.

Rhyme-As-Reason
Similar sounds, sights, etc. are encoded more readily; when using words, a rhyme is better remembered and may be seen as more persuasive (this is why commercial forms of communication often use them, e.g., “naughty but nice” - in the court case of O. J. Simpson, “If the glove doesn’t fit, you must acquit” is thought by some to have been decisive in the Not Guilty verdict).

Risk

The probability of an outcome occurring is known.

Glossary taken from: Corr, P. J. & Plagnol, A. (2018). *Behavioral Economics: The Basics*. London: Routledge.

If you would like to know more about how *Behavioural Economics* can assist your business please get in touch with:

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