

Economic Insights

Behavioural economics: shaping optimal decision making, including fraud prevention, in insurance buying

Key takeaways

- Claims fraud has been a long-standing drain on insurer profits.
- BE helps understanding of why insureds may inflate claims: group behavioural norms, endowment effect and mental accounting.
- The way choices are presented can persuade consumers towards increased disclosure.
- Reframing the act of fraud whereby the broader policyholder population is presented as victim also helps.
- Shaping consumer behaviours can also help insurers improve claims process efficiency.

About Economic Insights

Analysis of key economic developments and their implications for the global re/insurance industry.

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In a nutshell

Behavioural economics (BE) facilitates better understanding of consumer biases that may lead to sub-optimal decision making. Insurers can use this information to influence consumer behaviours across the value chain, including to reduce fraud, improve efficiency and ultimately also profitability.

BE incorporates the learnings from psychology to explain human decision making. Unlike classical economics which assumes people to be rational beings, BE seeks to explain irrationalities in behaviour by identifying population level heuristics and biases.¹ In recent years, BE has been applied in many fields including public policy, healthcare and charity,² and are also being applied in insurance to improve sales and reduce lapse rates, for example. In a recent global survey, 35% of re/insurers said they plan to use insights from BE to "shape new customer experiences".³ Knowledge of behavioural biases can also be used to combat insurance fraud, a consistent drain on insurer profitability. In the US alone, the insurance sector loses around USD 80 billion to fraud every year, according to Coalition Against Insurance Fraud. The end customer is also negatively impacted when subject to increased premiums as insurers seek to offset the fraud-induced losses.

To counter fraud, re/insurers have focused mainly on detection, with heavy investment in advanced analytics. In our view, understanding why people commit fraud in the first place is equally important, and here BE can help. Different behavioural biases can lead consumers to commit opportunistic claims fraud, especially soft fraud or *claims padding* (inflating claims amounts to more than actual values), the most common type of insurance fraud.⁴

Three key biases drive insurance fraud, in our view: social norms, the endowment effect and mental accounting. Norms is when people tend to follow what others do. If a majority of consumers in a social sub-group are perceived to pad their claims as a matter of course, others in that same group are likely to follow suit. The endowment effect is when people think their possessions are worth more than they are and inflate associated insurance claims in the case of a loss event. Another factor at play is mental accounting, when people mentally separate their money into specific accounts. If they perceive a deductible to be high and/or unfair, mental accounting may lead them to effectively compensate for this higher price by padding claims.

¹Much of the initial work on BE theory was done by Daniel Kahneman and Amos Tversky in the 1970s (see *Prospect Theory: An analysis of Decision under Risk*, Econometrica, 1970). It received increasing attention when traditional economic theory failed to explain a number of recessions since.

²*Behavioural Insights and Public Policy: Lessons from Around the World*, OECD, 2017.

³*Insurance Technology Vision 2017*, Accenture, 2019

⁴Miyazaki, A.D. "Perceived ethicality of insurance claim fraud: Do higher deductibles lead to lower ethical standards?" *Journal of Business Ethics*, 87(4), 2009.

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Figure 1 below indicates areas where, using insights from BE, insurers can take actions across different points of the claims process to influence consumer biases and decision making. Beyond behavioural biases, BE also focuses on the environment in which a decision is made. This is why considering the format, context, and presentation of choices is so important.

Figure 1
Behaviours that can be influenced during the claims process



Blue text: area with evidence for impactful BE intervention
Source: Swiss Re Institute

One way to minimise fraud is to move the honesty declaration to the beginning of the claims filing form from the end. By identifying themselves as honest at the outset, insureds are more likely to maintain that personal projection as they progress through the whole form. Studies conducted by Swiss Re find that this format of form leads to an average 3.4% increase in honest and increased disclosure in underwriting forms.

According to choice architecture, introduced by Thaler and Sunstein,⁵ the way choices are presented to consumers can influence decision-making. With this in mind, another experiment with respect to declaration of smoking habits saw a 3% improvement in the disclosure rate when insureds were given a variety of answers to choose from (ie "daily", "once a week", "once a month") compared to when they were simply asked if a smoker: "yes/no".

Insurers can also influence behaviour by "re-framing" the act of fraud. Explaining that claims payouts come from a pool available to a larger group of policyholders, individuals may be dissuaded from submitting fraudulent claims given the realisation that other insureds will be impacted by their actions, such as through higher premium rates for all. These are just a few cases where BE has proven its value in insurance. Teams, including the Behavioural Research Unit at Swiss Re, already in its sixth year of discovery, are key to translating BE theory into real-world insurance practice.⁶

⁵ Thaler R, Sunstein C. *Nudge: Improving Decisions About Health, Wealth, and Happiness*. Yale University Press, 2008.

⁶ Swiss Re's Behavioural Research Unit has conducted more than 150 trials to leverage BE to improve the efficiency of insurance value chain. Listen to our CEO talking about how insurers can better utilise BE: <https://www.youtube.com/watch?v=rwypNQ1TdOo>

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