



Financial Literacy and P/C Insurance

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The Role of the CPCU Professional

Professional Conduct for CPCUs: Canon 7 and Related Rules

Insurance professionals should assist in improving the public understanding of insurance and risk management

- A CPCU shall support efforts to provide members of the public with objective information concerning
 - ◆ their risk management and insurance needs and
 - ◆ the products, services, and techniques which are available to meet those needs.

- A CPCU should also keep abreast of legislation, changing conditions, and/or other developments that may affect the insuring public.

Financial Literacy is the Skills Necessary to...

- Assess financial risks and opportunities
- Make informed choices, and
- Take effective action to improve one's financial well-being

Financial Literacy: A 3-Question Test

This test has been administered world-wide to provide a rough indicator of financial literacy among many populations.

The First Financial Literacy Question

If you had \$100 in a savings account with an interest rate of 2 percent per year, after 5 years, how much do you think you would have in the account if you left the money to grow?

- a. More than \$102
- b. Exactly \$102
- c. Less than \$102
- d. Don't know
- e. Refuse to answer

The Second Financial Literacy Question

If the interest rate on your savings account was 1 percent per year and inflation was 2 percent per year, after 1 year with the money in this account would you be able to buy

- a. More than today
- b. Exactly the same as today
- c. Less than today
- d. Don't know
- e. Refuse to answer

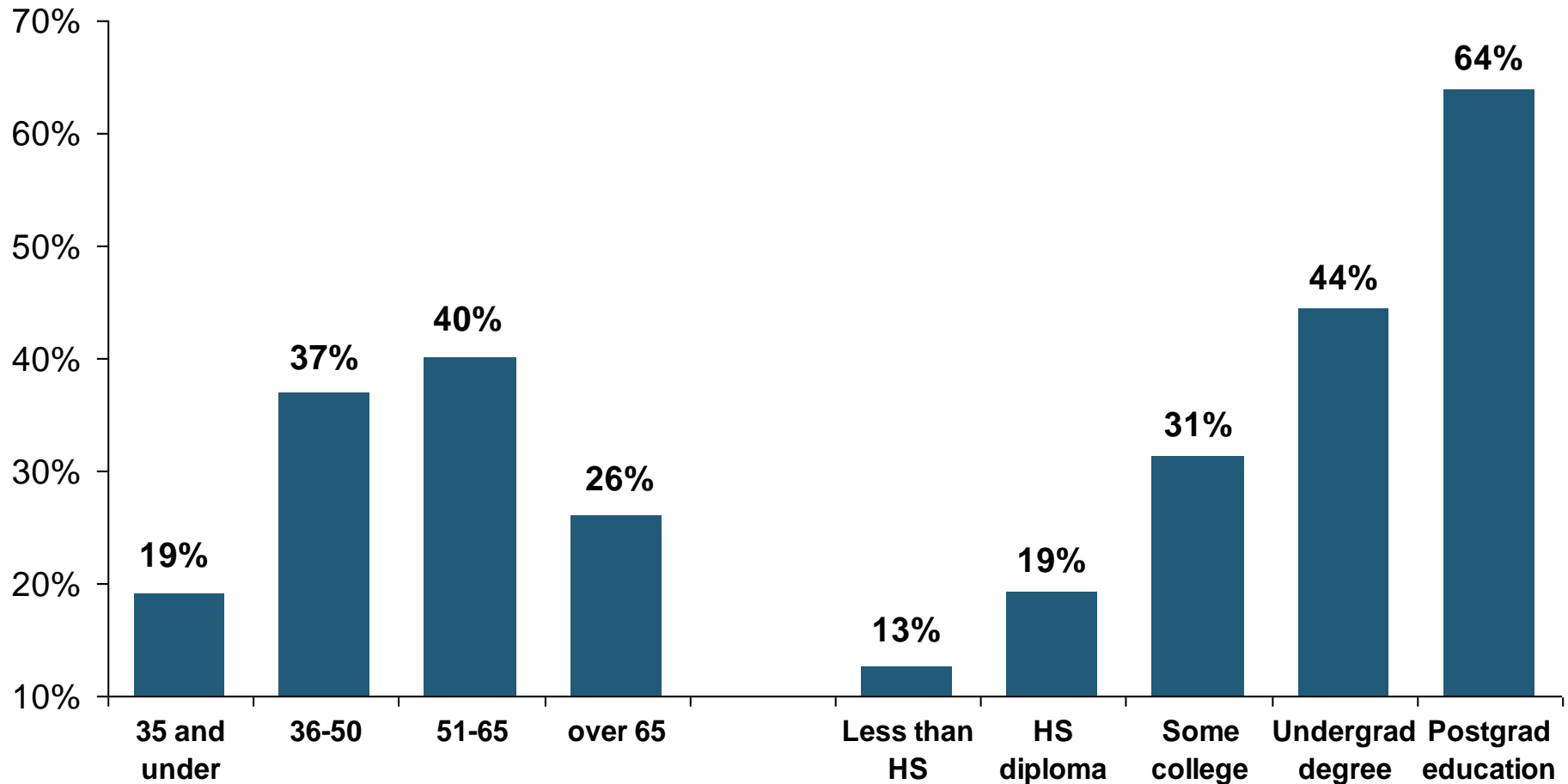
The Third Financial Literacy Question

“Buying a single company stock usually provides a safer return than a stock mutual fund.” This statement is

- a. True
- b. False
- c. Don't know
- d. Refuse to answer

Financial Literacy by Age Group and Education

Percent answering all three questions correctly



*The questions ask about interest rates, inflation, and risk diversification (comparing individual stocks vs. stock mutual funds). The details are on page 10 of the cited article and in other articles cited by the authors.

Source: Lusardi and Mitchell, "The Economic Importance of Financial Literacy: Theory and Evidence," *Journal of Economic Literature*, 2014 (pp. 5-44).

Why Is This Important?

To make good decisions regarding the types and amounts of P/C insurance to buy, consumers should understand

- The types of losses/claims that they might sustain
- The likelihood/probability of those various kinds of losses/claims—what we call “frequency”
- The potential severity of those losses

Do Financially Illiterate People Make Worse Financial Decisions?

**How Do Economists Determine Whether
a Person's Financial Decisions
Are Good or Bad?**

Economists: Good Decisions Are Consistent Decisions

The Concept: If your decisions are consistent, they're likely based on an underlying and well-understood view of financial choices—in short, they're “rational.”

- For example, if a policyholder chose similar low deductibles for auto and HO, that's consistent and could reflect little liquidity
- But if the policyholder chose a small deductible for one policy and a large deductible in another, we suspect that the policyholder isn't choosing based on his/her circumstances or preferences.

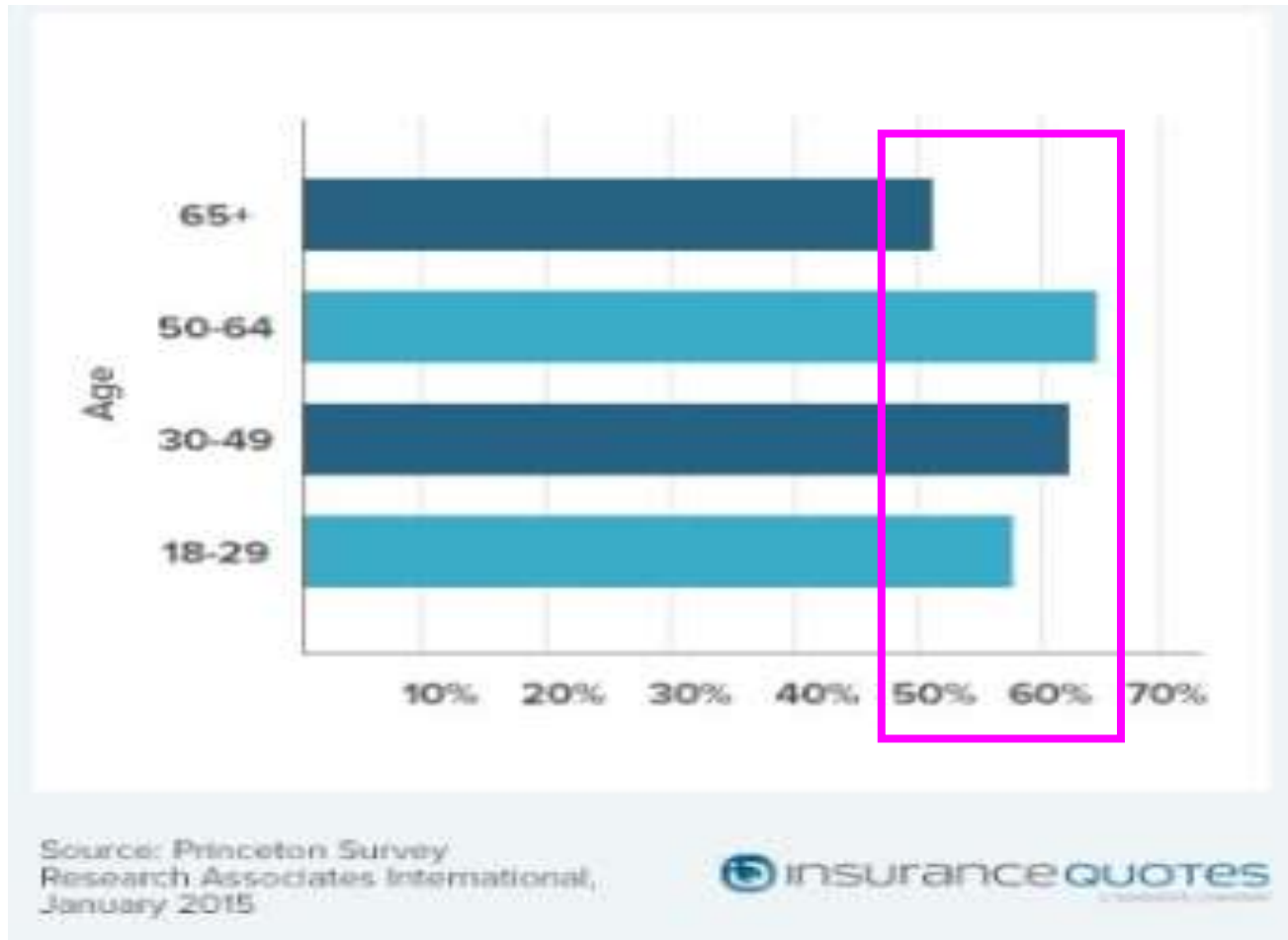
The Finding: Consistency in financial decisions is highly correlated with wealth, education, income, youth, and financial literacy.

Sources: S. Choi, S. Kariv, W. Muller, and D. Silverman, “Who is (More) Rational?” *American Economic Review* 104(6) [June 2014], pp. 1518-1550, and J. Brown, A. Kapteyn, E. Luttmer, and O. Mitchell, “Cognitive Constraints on Valuing Annuities,” Pension Research Council PRC WP 2014-21; Insurance Information Institute

Financial Literacy and P/C Insurance

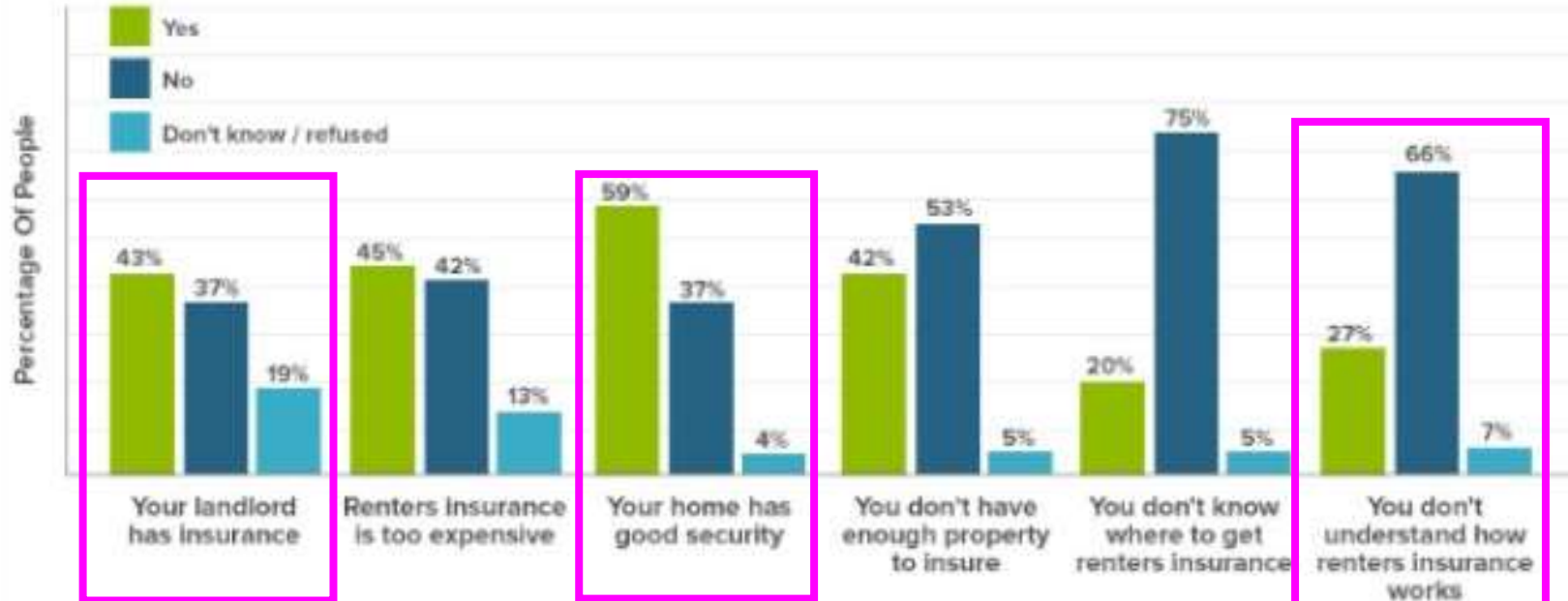
**A Low Level of Financial Literacy is
Probably At Least Partly Responsible
for a Number of Policyholder Problems**

Percentages of Renters Who Don't Have Renters Insurance, by Age Group



Why Renters Don't Have Renters Insurance

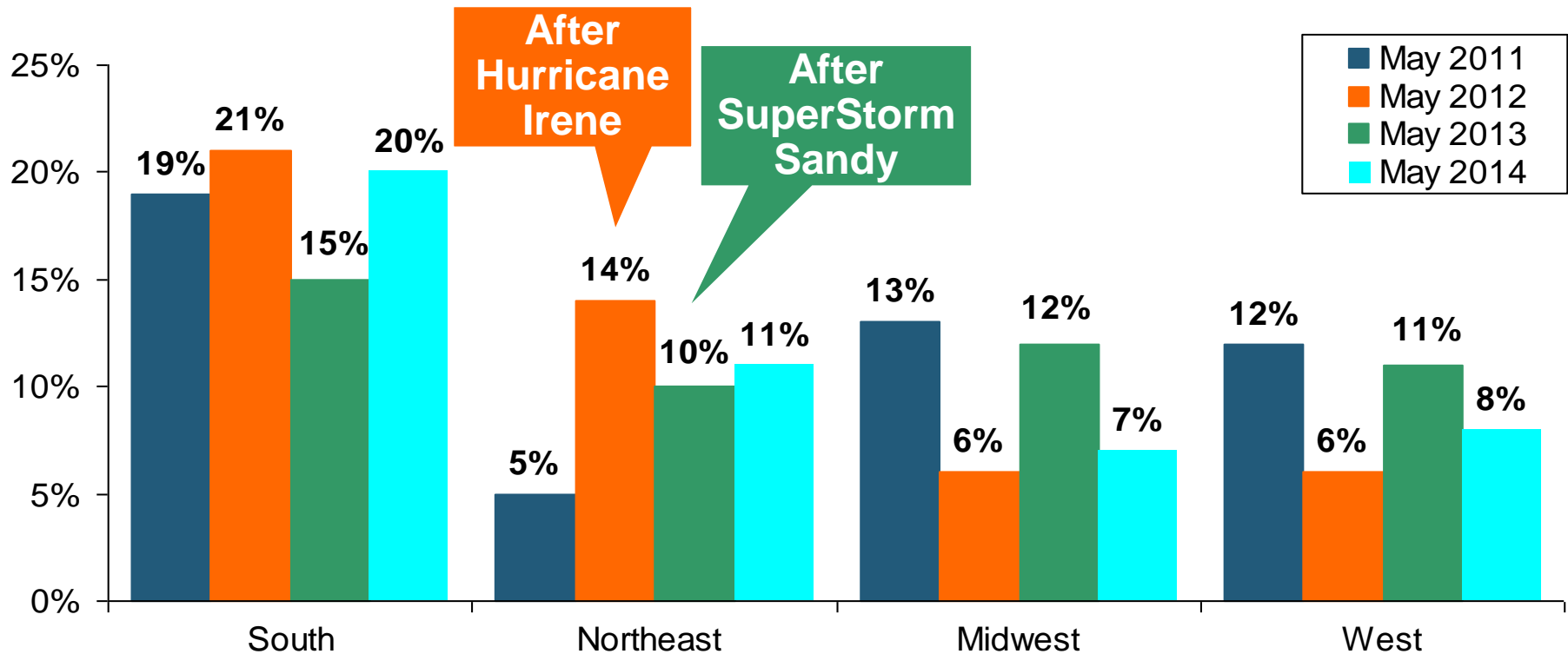
Is this an important reason for why you don't have renters insurance?



Source: Princeton Survey Research Associates International, January 2015

Even Frequent & Severe Floods Haven't Changed Flood Insurance Ownership Much

Q. Do you have a separate flood insurance policy?¹



Despite extensive flooding (and wide publicity), few U.S. homeowners say they have a flood insurance policy; moreover, there is no upward trend.

¹Asked of those who have homeowners insurance and who responded "yes".

Source: Insurance Information Institute Annual *Pulse* Survey.

Financial Literacy and Psychological (or Mental) Accounts

Source: Barry Schwartz, *The Paradox of Choice: Why More is Less* (New York: Harper, 2004), pp. 66-67

What is a “Psychological Account”?

- An amount of money a person considers acceptable spending for a particular purpose
 - ◆ Classic example: you paid \$100 for a ticket for a concert but when you arrive to see it the ticket is gone. Another ticket is available for another \$100.
 - Do you spend another \$100 or
 - Have you spent the money in “the concert account” and go home?

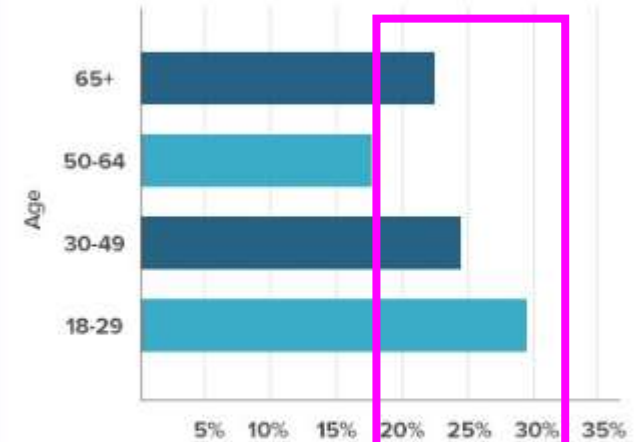
- I argue that the reason why some people don’t buy certain insurance coverages is that they have a psychological or mental account that is too small

Renters Seem to Have A Psychological Account for Renters Insurance

45% of renters say renters insurance is too expensive



Percentages of Renters Who Thought An Annual Renters Insurance Policy Cost \$1,000 or More



Source: Princeton Survey Research Associates International, January 2015

Inconsistent Financial Behavior

A Risk Preference Test, Part 1

Imagine you have this choice:

- You may choose a gamble that offers an 80 chance of winning \$4,000 and a 20% chance of winning nothing, or
- You get a guaranteed \$3,000.

Which choice do you make?

4 out of 5 people chose the \$3,000.

A Risk Preference Test, Part 2

Now imagine you won \$4,000 and you now have this choice:

- You may choose a gamble that offers an 80 chance of losing the \$4,000 and a 20% chance of keeping it, or
- You pay \$3,000 of your \$4,000.

Which choice do you make?

92% of people chose the gamble.

Source: David Rolpeik, *How Risky Is It Really?: Why Our Fears Don't Always Match the Facts* (New York: McGraw-Hill, 2010), p. 40, citing Kahneman and Tversky.

Risk Preference Test Observations

- In the first test, involving only positive (or at worst non-negative) outcomes, most people are risk-averse. They choose the “sure thing.”
 - ◆ In part this is because the first dollars are more valuable to them than the higher amounts.

- In the second test, **involving only negative outcomes**, most people are loss-averse. They choose the gamble, hoping the worse outcome doesn't happen.
 - ◆ In part this is because the first dollars lost are more valuable to them than the higher amounts

Source: David Rolpeik, *How Risky Is It Really?: Why Our Fears Don't Always Match the Facts* (New York: McGraw-Hill, 2010), p. 40, citing Kahneman and Tversky.

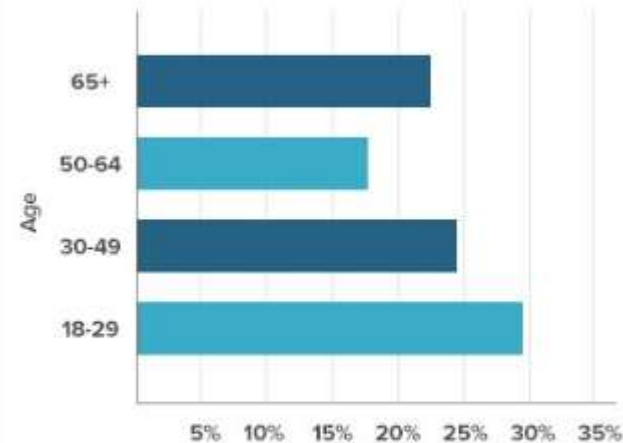
- If we have no information about a number, we estimate by starting from a “reference number” or “anchor” and adjust from there.

- The anchor can come from anywhere. An example: Two groups were asked, “What percent of countries in the U.N. are in Africa?” Before answering, each group spun a numbered wheel.
 - ◆ In one group, the wheel stopped at 65. The group then guessed **45%** of countries in the U.N. are in Africa.
 - ◆ In the other group, the wheel stopped at 10. This group then guessed **25%** of countries in the U.N. are in Africa

Are Renters Anchored to a High Number for Renters Insurance Premiums?

Is this the anchor?

Percentages of Renters Who Thought An Annual Renters Insurance Policy Cost \$1,000 or More



Source: Princeton Survey Research Associates International, January 2015

Anchoring Observations

- Anchoring seems to take place on an unconscious level
 - ◆ Your job, in helping your client, might be to
 - Try to detect any anchor and, if it is leading the client in an unsuitable direction, to
 - Try to suggest an alternate context or a new anchor.

- For example, change the time frame.
 - ◆ Most people consider a 1-in-100-in-a-year chance event quite unlikely and many are unwilling to insure against it, even if it could cause a devastating loss.
 - ◆ However, the chance of it happening some time in a 30-year period is 1-in-4.

Source: David Rolpeik, *How Risky Is It Really?: Why Our Fears Don't Always Match the Facts* (New York: McGraw-Hill, 2010), p. 40, citing Kahneman and Tversky.

Financial Numeracy and P/C Insurance

A Financial Numeracy Test Question

- Which is more likely?
 - ◆ 1 in 100
 - ◆ 1 in 1,000
 - ◆ 1 in 10

20% of people who were asked this question got it wrong

Another Financial Numeracy Test Question

- You buy a lottery ticket. In this lottery, 1 player in 1,000 wins.
- If 1,000 people (that is, 999 others) buy that ticket, what percentage will win?
 - ◆ 1%
 - ◆ 10%
 - ◆ 0.1%

80% of people who were asked this question got it wrong

Can/Should Financial Literacy Be Taught?

The State of Oklahoma is Trying

Oklahoma's 14 Financial Literacy Standards Required for High School Graduation

Standard 1 Earning an Income	Standard 2 Taxes	Standard 3 Banking & Financial Services	Standard 4 Managing a Bank Account	Standard 5 Saving and Investing
Standard 6 Retirement Planning	Standard 7 Borrowing Money	Standard 8 Online Shopping & Credit Cards	Standard 9 Fraud & Identity Theft	Standard 10 Renting vs. Buying
Standard 11 Insurance	Standard 12 Gambling	Standard 13 Bankruptcy	Standard 14 Charitable Giving	Personal Financial Topics General

STANDARD 11:
***THE STUDENT WILL DESCRIBE
AND EXPLAIN HOW VARIOUS
TYPES OF INSURANCE CAN BE
USED TO MANAGE RISK.***



Does Education for Financial Literacy Work? Research Is Mixed

A January 2014 report by the World Bank reviewed 188 studies of financial literacy education.

- Most showed some improvement in financial decision-making, but many studies were judged to be not rigorous.
- Nearly 1 in 4 studies showed little or no benefit from the education

“Financial education will not lead to improved financial behavior, Dan Ariely* believes.”

“The real improvement will come from designing or enforcing mechanisms that make it easy for us to make the right decision, or prevent us from making big mistakes.”

*Dan Ariely, James B. Duke Professor, Duke University, is a leading thinker and writer in the field of behavioral economics

Sources:

The World Bank Development Research Group, “Can You Help Someone Become Financially Capable?” Policy Research Working Paper #6745; The Ariely quotes are from Allianz, Project M, #18, pp. 22-24; Insurance Information Institute

Insurance Literacy: A Proposed 3-Question Test

This test has never been administered to anyone but if it were it might provide a rough indicator of property/casualty insurance literacy.

My First Insurance Literacy Question

- If you had \$500 deductible in your insurance policy and you had \$2,000 of damage covered by the policy, how much would the insurance company pay?
 - ◆ \$2,000
 - ◆ \$1,500
 - ◆ \$500
 - ◆ Don't know
 - ◆ Refuse to answer

My Second Insurance Literacy Question

- If your insurance policy had a policy limit of \$50,000 and you had \$80,000 of damage covered by the policy, how much would the insurance company pay?
 - ◆ \$80,000
 - ◆ \$50,000
 - ◆ \$30,000
 - ◆ Don't know
 - ◆ Refuse to answer

My Third Insurance Literacy Question

- “Insurance policies usually cover several different types of losses in a single policy.”
This statement is
 - ◆ True
 - ◆ False
 - ◆ Don’t know
 - ◆ Refuse to answer

In Conclusion

Why the Issue of Financial Literacy Is Important for CPCUs

- Increasingly severe weather, new exposures (e.g., cyber risk), etc. increases the likelihood that policyowners will have a significant loss that could be insured.

- Research shows that financially literate people are more likely to act, while less-financially-literate people procrastinate and often don't act
 - ◆ This might help explain why so few people have flood or earthquake insurance

We Could Be Blamed for the Consequences of Financial Illiteracy

- People who don't understand their policies—or the events they insure against—and who have a loss are likely to blame, or be antagonistic to, insurers and agents
 - ◆ Legislatures might create organizations like the federal Consumer Financial Protection Bureau to “protect” unsophisticated policyowners
 - ◆ Growing numbers of policyholders will be age 80 and over. Many will have cognitive limitations and might become financially illiterate even if they were previously financially literate. Agents and insurers will have to develop strategies for dealing with these people.

Implications of Financial Illiteracy for CPCUs

- You should understand that many clients—even highly educated ones—have an inaccurate idea of the relevant frequency and severity of risks they face, and help them overcome
 - ◆ Anchoring
 - ◆ The Constraints of “Psychological accounts”
 - ◆ Ignorance of basic financial concepts,
 - ◆ Inconsistencies in financial choices, and
 - ◆ A tendency to inaction (because they aren’t sure what to do)

Implications of Financial Illiteracy for CPCUs

- It seems likely that financially illiterate people are...
 - ◆ Less likely to buy and renew P/C insurance when they are not required to do so
 - ◆ Less likely to buy and renew P/C insurance even when they are required to do so
 - Low financial literacy might help to explain high percentages of drivers who don't have auto insurance
 - ◆ Less likely to buy appropriate policy limits
 - ◆ Less likely to understand policy terms and features (e.g., hurricane deductibles)
 - ◆ More likely to focus on price (because they don't understand other aspects of the P/C insurance relationship)

Insurance Information Institute Online:

www.iii.org

***Thank you for your time
and your attention!***

A Simple Numeracy Test, Part 1

Imagine you are a physician working in an Asian village. 600 people have a life-threatening disease. Two alternative treatments exist.

- If you choose treatment A, you will save exactly 200 people.
- If you choose treatment B, there is a $\frac{1}{3}$ chance of saving all 600 people but a $\frac{2}{3}$ chance all 600 will die.

Which treatment do you choose?

Source: Barry Schwartz, *The Paradox of Choice: Why More is Less* (New York: Harper, 2004), pp. 64-65

A Simple Numeracy Test, Part 2

Imagine you are a physician working in an Asian village. 600 people have a life-threatening disease. Two alternative treatments exist.

- If you choose treatment C, exactly 400 people will die.
- If you choose treatment D, there is a $\frac{1}{3}$ chance that no one will die but a $\frac{2}{3}$ chance everyone will die.

Which treatment do you choose?