think piece

Promoting debate and fresh thinking in the financial services industry

Risky Business: "Nudging" you to make the "right" choices

Elizabeth Truss and Nick Bosanquet

Summary

- There are many cases where poor information or human psychology can impede effective decision-making. For example, one theory in behavioural economics warns that people taking decisions are inclined to draw incorrect mental references based on what they know.
- "Nudge theory" is a potential solution to some of the problems identified in behavioural economics. It advocates setting a default choice, to help individuals make "better" decisions. The 2008 book by Thaler and Sunstein gained critical acclaim and political momentum on both sides of the Atlantic, advocating a type of libertarian protectionism whereby individuals are nudged towards correct choices by setting the default option to enable the individual to revert to the better choice.
- At the heart of the thinking in *Nudge* is the idea of allowing a "choice architect" to set the choices to help users take the better decisions. However this proposed solution assumes that there is someone who knows all the factors and possesses greater expertise than members of the populace.
- But what if they don't? A more nudged world, with the government leading its citizens more and more towards particular, uniform behaviours, begins to look like one with a more technocratic, managerial state. Similarly nudge can go too far and erode the individual's ability to exercise basic judgement.
- The insurance industry demonstrates that nudge can work. Insurers are now offering products whose premium is linked to everyday use. For example some motor insurers have introduced products based on "telematics" technology whereby the policyholder's premium is adjusted according to driving habits. This contributes to road safety while also limiting congestion and pollution.
- The key to nudge working in society's best interest is openness and transparency: they should pass the publicity principle, i.e. if the government is happy to see them out in the open then they should adopt them.

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CII Introduction: One of the top reads in Whitehall and Westminster last year was the book by Richard Thaler and Cass Sunstein that described using behavioural economics to "nudge" customers towards making "better" choices on complex subjects. However the idea of subtly shaping the right choices has been a key element of insurance long before nudge theory, or even many of its preceding behavioural economics theories. Nevertheless nudge theory benefits both the insurer and the insured, who in these examples might expect to live longer or experience fewer accidents. The decision of the Government to automatically invest money in a child trust fund even if parents do nothing is another example of a nudge towards 'better' decisions. In this third article in the special Thinkpiece series on insurance and risk, Elizabeth Truss and Nick Bosanquet of the thinktank Reform provide an alternative perspective on nudge theory, exploring its potential rewards as well as risks.

Risks facing individuals are constantly evolving, with new risks arising from personal motivation that both individuals and the insurance industry are just beginning to get to grips with. People are unable to accurately assess their own risks, leading to problems such as inadequate saving. "Nudge theory" is a potential solution that advocates setting a default choice, to help individuals make "better" decisions. But there are dangers. Who chooses the nudge, and can one take every factor into account? Is there a risk that the person doing the nudging could overstep the boundary of freedom and choice? What about unintended consequences?

"…there are now risks arising from personal motivation which are new territory, which both individuals and the insurance industry are less equipped to deal with…"

Insurance is a solution to some of these concerns. Insurers have been mitigating risks for centuries and are already using nudge to help shape behaviour, for instance through health insurance that encourages gym use. But moral hazard remains a concern in that people cease to mitigate risk themselves on the assumption that it has already been done for them. By following the nudge principle of transparency around the more efficient disclosure of information to the users, personal capability can be boosted. When combined with insurance this could create a society better able to make its own decisions.

The invisible enemy

Insurance has been mitigating risk for over 300 years. After the Great Fire of London, insurers created the first building fire codes, which linked the cost of cover to the resilience and upkeep of buildings. They also created the world's first organised urban fire services to mitigate damage when it did occur. In the early 18th century, insurance companies had their own fire services, and they adorned metal "firemark" plaques to buildings to indicate that they were insured.

There are plenty of positive risks that enable innovation and new discoveries to be made. Risks, as conventionally perceived, used to be mainly external, such as disease, industrial accidents and fire. These external risks have been much reduced both by better prevention and by economic change, for example less risk in a service economy. However, there are now risks arising from personal motivation which are new territory, which both individuals and the insurance industry are less equipped to deal with. Health, for example, used to be seen as a battle against an "invisible enemy" – the microbe. Now there is a new invisible enemy: personal decisions on lifestyle change.

Polarised risk

The new risks are highly polarised. Among the six million adults of working age who are out of the workforce poor lifestyle choices are all too common. More than 50% undertake high risk behaviours such as smoking, diet and lack of exercise.[1] State programmes have produced a huge problem of dependency. It may however be quite rational to put immediate gratifications first where few resources or opportunities exist. Among higher income groups around 10% have poor lifestyles with diet, activity levels and smoking rates showing a big improvement in the last two decades.[2]

The problem with risk

"If enough difficult contingencies are imagined, it can have the effect of making the risk seem exceedingly dangerous even though this does not represent their likelihood of occurring. Conversely, risks may be overlooked if they do not easily come to mind."

There are many cases where poor information or human psychology can prevent the right decision from being taken. Behavioural economics warns that people taking decisions are inclined to draw incorrect mental references based on what they know. One application of this is a consumer will choose to insure risks based on their available knowledge of those potential risks. For example, Kunreuther et. al. suggest under-reaction to threats of flooding may arise from "the inability of individuals to conceptualise floods that have never occurred … Men on flood plains appear to be very much prisoners of their experience … Recently experienced floods appear to set an upward bound to the size of loss with which managers believe they ought to be concerned."[3] People living *near* areas

[1] NHS Information Centre (2008), *Statistics on Obesity, Physical Activity and Diet: England, 2008*.

[2] Ibid.

[3] Kunreuther, H., Hogarth, R. and Meszaros, J. (1993), "Insurer ambiguity and market failure", *Journal of Risk and Uncertainty*, 7: 71-87.

prone to flooding may over-estimate the risk of being flooded themselves. Conversely people living *in* flood plains that have not been flooded for many years may underestimate the risk. If enough difficult contingencies are imagined it can have the effect of making the risk seem exceedingly dangerous even though this does not represent their likelihood of occurring. On the other hand, risks may be overlooked if they do not easily come to mind.

This creates problems in people being able to assess their own risk. Even if it is a rational decision for them to invest in insurance, they may not make that calculation. It has been argued that the so-called protection gap in the UK arises in many cases because consumers do not see a potential health problem arising in their immediate lives, and there is therefore no apparent need to invest in insurance.

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Another example is saving. Many people might know (or suspect) they are not saving enough for their retirement. However few have a real grasp of how much they should be saving to avert poverty in their old age. Meanwhile those who can afford to save struggle with willpower, the temptation being to procrastinate in order to spend now. We need a new approach which will help people to make positive choices. One option is to use subliminal "nudging": Big Brother without television screens.

Nudge

Being protected against the risks of life and not suffering accidents or stress because you have failed to do something is obviously desirable. Thaler and Sunstein's book *Nudge* has gained critical acclaim and political momentum on both sides of the Atlantic, advocating this kind of protection across public life. The idea is that "libertarian paternalism" is used to encourage people to make the "right" choices. Rather than being forced into a course of action, the default option is set to enable the individual to revert to the better choice.[4] The concept of nudging people into the right behaviour rather than being compelled appeals to those on both the right and left of the political spectrum as it is superficially non-intrusive and positive in outcome.

Saving, for instance, is an area where nudge can significantly alter behaviour. Thaler and Sunstein cite the example of pension plans with employer contributions – effectively offering free money to the employee. Yet up to 40% of people either do not join their employer's plan or do not save enough to get the full employer contribution. Nudge can help. Automatically opting new employees into a scheme can result in people making the decision they "wanted" to make but didn't get round to. In one study the participation rate after three years jumped from 65% to 98% of employees when an automatic opt-in was introduced.[5] The UK government is looking at introducing a similar scheme from 2012.[6]

The "choice architect"

At the heart of the thinking in *Nudge* is the idea of allowing a "choice architect" to help guard against some unforeseen risks or uninsured-against eventualities. The choice architect is someone who sets the parameters for a decision – for example laying out the vegetables in greengrocers or designing the welfare system. The authors of *Nudge* believe that "it is possible for the government to hire a competent expert to design a choice environment in which individuals have an easier time making good decisions".[7] However this proposed solution assumes that there is someone who knows all the factors and possesses greater expertise than members of the populace. But what if they don't?

Unintended consequences

"Taking bad decisions and enduring their consequences can be an essential learning experience, honing one's ability to make everyday judgements, an important element in being a sentient adult and being able to handle the vicissitudes of life."

A more nudged world, with the government leading its citizens more and more towards particular, uniform behaviours, begins to look like one with a more technocratic, managerial state. This can have problematic impacts; innovation and altruism can be stifled by over-centralised guidelines. Many of the systems that we operate in today are organic such as the market where trade takes place. In fluid circumstances the ability to amass knowledge about the right thing will be diminished. If nudge is used too broadly there is a danger of stifling innovation in other ways to reduce risk.

Thus nudging could lead to the unintended consequence. If people are encouraged to do one thing wholesale they may cut off other avenues. Many chance discoveries are made by taking a risk. If we live in a more managed world are these opportunities less likely to arise? With less divergence of activity the consequences of unforeseen circumstances might be greater.

A sat-nav society

Nudge should be about making it easier for people to make a better choice. However it can go too far.

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[4] Thaler, R. and Sunstein, C. (2008), *Nudge: Improving Decisions About Health, Wealth And Happiness*.

[5] Ibid.

[6] Department for Work and Pensions (2006), *Personal accounts: a new way to save*. For a summary of this policy, see for example "Personal Accounts: Encouraging People to Save for their Retirement," by Tim Jones, CII *Thinkpiece*, Aug 2009 http://www.cii.co.uk/downloaddata/TP21_Jones_Personal_Accounts_Aug2009.pdf

[7] Thaler and Sunstein op.cit.

In much the same way as satellite navigation devices have been accused of making people over-reliant on technology; nudge theory may also erode peoples' ability to exercise basic judgement more generally. Taking bad decisions and enduring their consequences can be an essential learning experience, honing one's ability to make everyday judgements, an important element in being a sentient adult and being able to handle the vicissitudes of life.

This will be particularly important for those who start off with less capability, since the new risks are more focussed on individual behaviour. *Reform*'s June 2009 paper *A new level* found that the direction of qualifications in recent years has discouraged innovative thinking.[8] In fact these exam papers are partly devised in a response to risk, where concerns about levels of appeals or perceived unfairness push people into taking out discretion and value judgements. A multiple choice question carries no danger of being misjudged. Students are nudged or hand-held into taking particular choices. However they are consequently weaker.

The role of insurance

Our means of modelling risk have got better. Insurance companies are in a position to understand the nature of risk. They can also manage it for their customers. So it is not the case that the state always has to be the choice architect – the concept can be adopted by private actors. But is it in their interest to do this? Why does the uninsured population in the US remain stubbornly high, and the proportion of people saving remain stubbornly low?

The insurance industry demonstrates that nudge can work. The financial sector has long relied on the principles of nudge theory and is using them more and more. It is now common to find health insurance that offers a discount on gym membership, and further reductions if the individual uses it for regular exercise. In this way nudge can benefit both the insurer and the insured. The 18th century "firemarks" remain a pertinent example of insurance providing a market solution that effectively shaped the conduct of firms and the economy. A more recent example is usage-based motor insurance (also known as telematics) whereby the insurer electronically monitors the policyholder's driving frequency and habits and adjusts the premium accordingly. Drivers are thus financially incentivised to drive safer and less often, benefiting road safety while also limiting congestion and pollution.

"A system whereby the public is guided to choose particular products over others may work well when the overall system is intact. If however there is a systemic level fracture, do we risk more by everyone having been guided in a particular direction?"

The Government's recent financial services White Paper shows how nudge theory can be applied to improve access to fair and simple financial products. It argues that "an ideal system would … allow freedom over product design, while at the same time guiding people who would be best served by basic, cheap and accessible products in that direction and ensuring that wherever people do choose other options, they know about the basic alternatives." It considers a scheme similar to the "traffic lights" employed in food labelling to help consumers make the "right" choices.[9] However a number of problems arise from this that demonstrate some limitations of nudge theory in this regard. First, financial products are fundamentally more complex and difficult to judge in terms of safety than food products. Secondly, are safer products necessarily the better choice in every circumstance? Finally, what are the consequences of pushing every citizen in the same "safe" direction?

Unknown unknowns

The financial crisis arose from the existence of "unknown unknowns". A system where the public are guided to choose particular products over others may work well when the overall system is intact. If however there is a systemic level fracture, do we risk more by everyone having been guided in a particular direction?

The single biggest problem with the nudge concept is one common to all issues of insurance: by helping people choose, are we taking away their levels of responsibility? Moral hazard exists when people know that they will be taken care of because it will not be socially acceptable to allow them to sleep on the street, or starve, or suffer. There may be a growing appetite for reckless risk-taking if there is an element of safety in every decision. A more nuanced version of this may be that when they know that all of the default options are set, they have less concern about engaging in the principles.

Information is a good thing

If there are dangers with nudge, how can we achieve the policy goal of encouraging behaviour? There are some excellent principles behind the *Nudge* book. Thaler and Sunstein rightly argue that nudges should be open and transparent and that they should pass the publicity principle, i.e. if the government is happy to see them out in the open then they should adopt them. For example, they advocate that in financial services consumers should be provided with the appropriate information, making it easier and more transparent for them to make a sensible choice. If nudge theory is about eliminating information deficiencies and granularising decisions, then it is a positive force. In fact there is a continuum from compulsion through opt-out to opt-in.

[8] Bassett, D. et. al. (2008), *A new level*, Reform.

[9] HM Treasury (2009), White Paper in Financial Services, *Reforming financial markets*.

Towards capability: insurance is the way forward

The way forward has to be for government to focus on the information element of the nudge concept. However the default option should be set more neutrally than a guided default choice. We have to be wary of a sat-nav society, where people know that on any crucial decision the serious risks have been removed for them.

If we are to create a more capable society the role of insurance here is crucial. People must understand how to assess and manage risk. That is the only long term way to achieve a more capable society. The industry could champion the themes of personal choice and personal capability and relate to the positives as well as the traditional areas of risk negatives. This is already starting, with telematics in motor insurance and health insurance whose premiums can reflect the policy-holder's exercise habits. Other ideas may also be considered, such as health insurance that reflect key stages in the policy-holder's life cycle, as well as other innovations for the wider market beyond personal lines.

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- ***"The Politics of Risk: Is the Insurance Industry Promoting Itself," by Jonathan Swift***

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Recent articles in the series:

Emerging Markets: Upwardly Mobile Economies and New Consumerism (International Series No.6), by Vanessa Rossi of Chatham House (Published 18 September)

> In this sixth in the series by Chatham House, Vanessa Rossi looks at the prospects of the emerging markets after the recession. She argues that the fast rising ownership of consumer durables and property will enhance the demand for services such as bank accounts, credit and personal insurance.

Risky Business and the Politics of Risk: Is the Insurance Industry Promoting Itself? (“Risky Business” Series No.2), by Jonathan Swift, Post Magazine (Published 15 September)

> The UK insurance sector lies at a critical juncture in its long and eventful history. On the one hand, insurers are feeling the recessionary pinch in the form of a capital squeeze and a hardening market, but they can still benefit from escaping the contagion in global banking. Despite these facts, insurance still risks exposure to wider financial services regulatory sanctions and the current effort is to avoid this.

Progress on the Skills Agenda: Are We Making Enough? by Steve Besley, EdExcel (Published 4 September)

> Despite the economic downturn the issue of skills has remained at the top of the political agenda – highlighting its importance to the prosperity of the nation. The present Government has invested heavily in skills, however the landscape is a crowded one. In this Thinkpiece, Steve Besley of Edexcel takes a look at the skills system, its development since the Leitch report and what might happen in the future.

Risky Business: Insurance and Society (“Risky Business” Series No.1) by Andy Haste, RSA Insurance Group (Published 18 August)

> The insurance industry provides a long-standing and often forgotten role of helping people and business do things without the fear of catastrophic loss should something go wrong. How can this be achieved in a sustainable manner? In this first in a special series exploring insurance and risk entitled “Risky Business”, Andy Haste, Chief Executive of RSA Insurance Group plc, gives the view of a major global insurer, and describes some techniques in place today and a few challenges confronting them.

Outsourcing: Continued Prosperity Despite the Economic Crisis? (International Series No.5) by Vanessa Rossi and Nora Burghart (Published 18 August 2009)

> Will outsourcing be a winner or loser from the global crisis? This sector has been a major beneficiary of the boom in business services trade since the mid-1990s, coinciding with the rise of emerging market economies. In 2001-2002, this growth survived and even boomed. But this time round it has been hit by the savage downturn in the global economy and the outlook for growth is less assured for a number of reasons, as discussed in this article.

Personal Accounts: Encouraging People to Save for Their Retirement, by Tim Jones, Personal Accounts Delivery Authority (published 6 August)

> As life expectancy increases so does the need for people to be well prepared for their retirement. However for many this will not be the case as the culture for saving in the UK has steadily eroded over time particularly for those on lower incomes. To counter this and help those not saving enough, the personal accounts scheme is being prepared for roll out for the onset of employer duties in 2012. In this article, Tim Jones, Chief Executive of the Personal Account Delivery Authority, provides background to the scheme, outlines the role of employer contributions and considers the investment strategies.

Women and Financial Advice: The New Model Financial Health Plan, by Carole Nicholls, FCII, FPFS (published 28 July)

> Carole Nicholls, former President of the Personal Finance Society, challenges the industry to evolve from the traditional 'product' driven offering to one based on 'outcomes' in this thinkpiece, suggesting a new model based on the massively popular WeightWatchers health plan. She highlights findings of recent CII research which show that women feel less confident and knowledgeable about making financial decisions than men, and recommends a model offering personalised financial plans to remedy this, making the connection between the product and the result in real-life terms.

Deflation Threats & Insurance Premiums: A Long, Deep Recession Means Greater Cuts?, by Vanessa Rossi and Nora Burghart of Chatham House (published 29 May)

> The property market has been hit hard by the current recession, and impacts of the decline have seen deflation reach new levels. Many assume that recovery is around the corner – but what will happen if prices continue to fall? Vanessa Rossi and Nora Burghart of Chatham House explain the serious implications of a prolonged recession, focusing on how insurance premiums, in particular, might cave in to ongoing market pressure.

ClimateWise: The Insurance Industry Challenging Itself to do More, by Andrew Voysey (published 15 April)

> In the second instalment of our climate change series, the ClimateWise secretary gives his personal view on the role the initiative and the industry more widely can play; and then explores some of the challenges confronting them.

Ageing and Migration Trends: Preparing for Change in the EU's Labour Market, by Vanessa Rossi and Nora Burghart of Chatham House (published 30 March)

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Pandemics – be Prepared, by Trevor Maynard of Lloyd's (published 18 March)

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An Inclusive Approach to Financial Products, by Jane Vass, CertPFS of Age Concern (published 2 March)

> Examines the industry's approach to delivering products and services to older people. She argues that there are large gaps in the design of mainstream financial products and services, with many providers ignoring the changing physical, cognitive, social and emotional needs of their older customers, and calls for the industry to take a new approach shaped by principles of inclusive design.

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