

Value to customers

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CUSTOMER PERCEPTION OF VALUE

Financial products could play a critical role in improving social mobility or providing safety nets to households in potentially precarious circumstances, in both cases raising the financial well-being of customers. Are these benefits worth the premiums paid for them, though? If they are not, we should question the contribution of the product to the well-being of the customer. The discussion that follows asks how customers assess the value offered by these products and whether these assessments are accurate or not.

Any market is built on the premise that a willing customer considers the value of a product to be higher than its price. If the value of the product is lower than the price being asked for it, the customer would be unlikely to purchase it, assuming there are suitable alternatives available.

For tangible goods, say those in a supermarket, value is often influenced by the price of alternatives and the extent of the need. Parents who need to feed their children, for example, place a high value on the available basic products but will generally buy an alternative of the same quality if it's cheaper.

However, the value of a financial product is difficult to assess. Value is linked to what economists refer to as the utility of the product – its perceived usefulness to the consumer – which can be even more difficult to conceptualise or measure than value. Every insurance product feels valuable if a claim has been paid, for example, but much less so if premiums have been paid without any monetary benefit having been received.

Products paying a premium refund after a number of years have increased the attractiveness of insurance. They may have done so at the cost of undermining a customer's understanding that insurance has real value even if a benefit is not paid.

The perceived value at the time of purchase depends a great deal on how much the customer trusts that the provider of the product will honour a claim if a defined trigger event occurs. For now, we set aside these difficulties of benefit uncertainty and provider credibility and consider the pure value of a product.

In theory

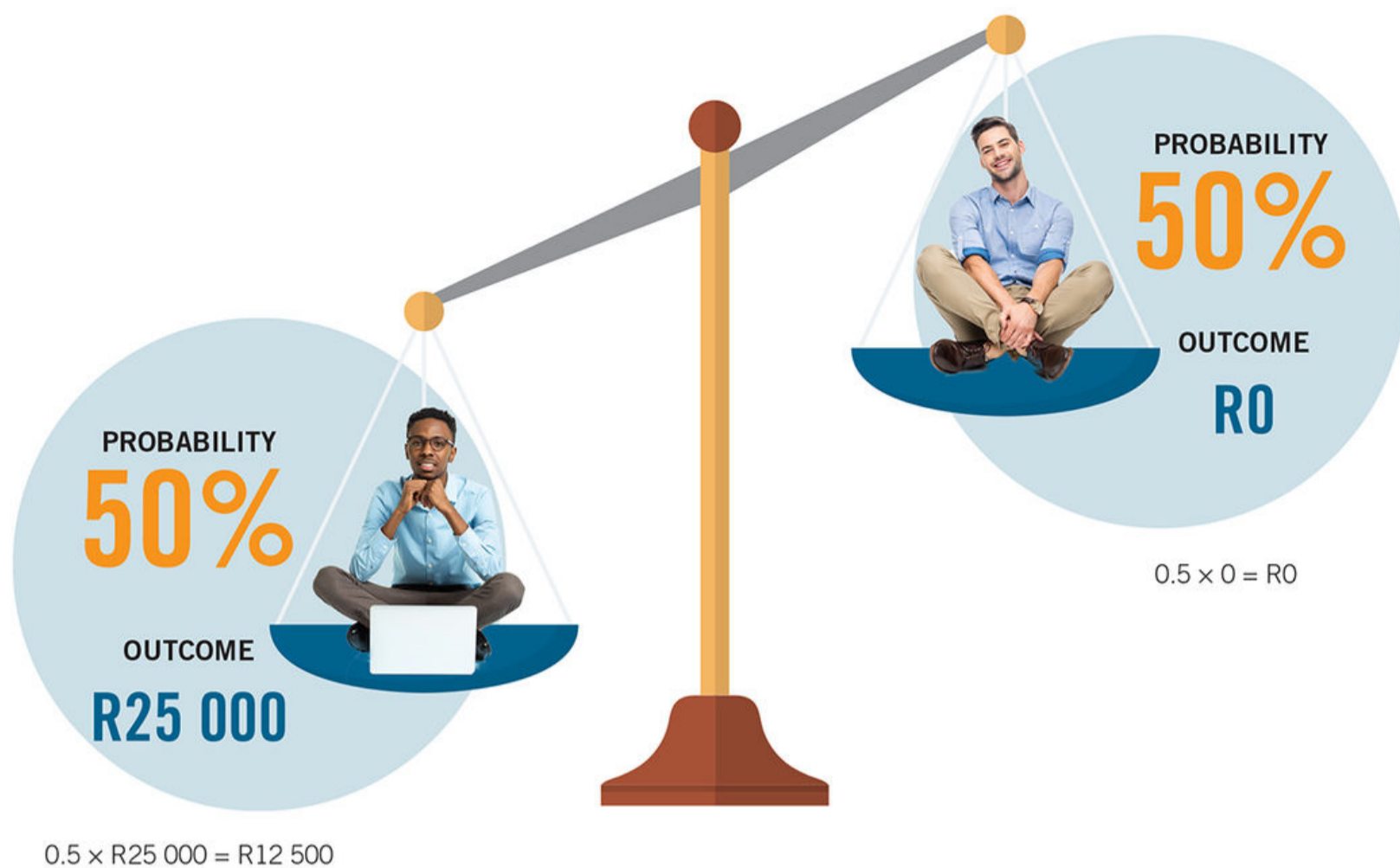
Consider someone facing a possible financial difficulty. Let's say they understand that if a specified event occurs, the loss is R25 000 and the probability of the event is 50% – it's equally likely to occur or not. Let's assume also that they'll know by the end of today whether the event will take place, so the time value of money is not material.

How much would that person pay a third party to take away the risk of losing R25 000? In theory, they would pay no more than the statistically expected value of the loss, which is calculated as follows:

The first part of this expression is $0.5 \times R25\,000$, which is R12 500. The second part is 0.5×0 , which is zero. This is roughly how the third party would price the insurance as well. To this, however, they would probably add a margin:

- > for the risk that the assumptions underlying the calculation are not correct
- > for the costs of administration
- > perhaps, also, for profit

If they could sell say, 1 000 such arrangements, at R13 000 each, then they expect to collect R13 million in premiums (1 000 at R13 000 each) and pay R12.5 million (500 at R25 000 each) in benefits, leaving a margin of R500 000 for those risks, expenses and profit objectives.



The theories of behavioural economics suggest that our customers may be willing to pay a little more than R12 500 for this arrangement, even if they were sure of the R25 000 loss and 50% probability. And they'd be willing to pay even more if they are risk averse, preferring the certainty of the R12 500 expense to the 50% probability of a much more painful outflow. The evidence suggests that most customers are indeed risk averse (see the end of this chapter for suggestions on additional reading on this topic).

Furthermore, if there's any uncertainty about either the amount and probability, our customer may be prepared to pay even more to settle the uncertainty. So, the value of the insurance arrangement to the customer may comfortably exceed the proposed R13 000 price tag, leaving both customer and insurer happy with the arrangement.

An efficient market for the product would help to refine the price of the product. Another insurer might offer it at R12 800, for example, forcing the first one to reconsider their R13 000 or find ways to offer better value. Markets for insurance are seldom characterised by price and product comparability of this level.

In practice

Reality is not as straightforward. In practice, customers may have a sense of the payment needed to provide adequate protection. In the case of a car or home, it may be the cost of replacing the vehicle or the house and restoring its contents. The cost of a funeral may be estimated. The income required by dependants after the death of the customer may be assessed. But very few customers have a sense of the probability of the event occurring and the claim being paid.

The occurrence of the event and the payment of the claim are not necessarily the same thing. Consider the case of motor vehicle cover with an excess, an amount payable by the customer in the event of a claim. A small bump on the vehicle constitutes the event but may not result in a claim being paid if the value of the damage falls below the level of the excess.

People are biased in their perception of risk and insurers have an information advantage to the extent that they understand probabilities better.

This means that, even in the very simplest of insurance arrangements, customers really do not have the means to assess the intrinsic value of the offering. A funeral product is a good example of a simple insurance offering. If a policyholder dies, their spouse receives the stated sum assured, say R10 000. The chance that they'll die in the next year is, say, 1.2%. (Actual probabilities vary substantially, mostly depending on the age of the customer.)

Furthermore, in most types of insurance, an average probability across the entire group is considered, ignoring certain differences between members of the group. For example, all the employees at a company, or both male and female policyholders in a typical funeral policy across all ages may be given the same rate. Following the same logic as before, the intrinsic value of the offering is R120 a year, or R10 a month. If the policyholder is willing to pay R40 a month, is it because they've reckoned that the value of the cover to them is more than four times its intrinsic value? Not very likely.

Why would they be prepared to pay such a large amount? Risk aversion is one of the strongest reasons for their thinking:

One well-known explanation linked to the expected utility theory is that insurance is a trade-off between an uncertain but potentially huge loss (occurring if the uninsured has to pay for the risk) and a certain but small loss (incurred by paying a premium that eliminates the unaffordable risk). The implied assumption is that all people are risk-averse.²

The example considered concerns a straightforward arrangement. Assessing the intrinsic value of insurance on household goods or healthcare, each of which pays out various amounts on a number of different events, is well beyond the ability of most customers.

What does our customer do to decide whether to purchase the funeral product or not? They consider how badly they believe they need it and assess that cost against using the same money for something else, including a different funeral product. They may also determine value by the extent to which friends have purchased the product, how attractively the product is presented, or the reputation of the product provider for staying in business and paying claims rapidly and reliably. We quickly gain a sense of the intangibility of the trade-offs and the potential for the (sometimes misleading) positioning of the product to influence their decision.

Refer to the discussion in '[Thinking with mental models](#)' which presents the models customers use to evaluate their need for insurance and the product most appropriate for meeting this need.

From the perspective of the insurer

How does the insurer approach the potential transaction? As before, the insurer considers the expected cost of paying benefits and adds margins for risk, expenses and profit. So, for a large number of customers seeking the same product and with a similar risk profile to this customer, it estimates R120 a policy, a year to pay benefits, or R10 a month. This is frequently called the risk premium. To this, the insurer adds:

- > an appropriate allowance for the risks that it estimates are incorrect
- > the expected costs of selling the policy, which may include a commission payment on each sale
- > the corresponding costs of managing the receipt of premiums, assessing and paying claims, and any other administrative expenditure and overhead costs
- > a margin for profit

The monthly cost of distribution may be estimated at R7 a policy and the cost of administration R8. An allowance for risk and profit of R5 a month would take the total premium to R30 a month, the **gross premium**. Our customer is prepared, for a number of reasons, to pay R40 and is happy with the offer.

The market for this product seems to work. The customer pays R40 each month for it. The insurer can produce it, not allowing for risk or profit, at R25. The price of R30 appears to be fair.

But what if the customer finds the R30 offer attractive only because of the R40 charged by the most prominent competitor? Customers rely on market testing to obtain benchmarks of value because the assessment of intrinsic value is beyond their means and requires information they do not have. The product we have considered here is very simple. In many cases, products are much more complex and customers cannot make meaningful comparisons between offerings. The market mechanism fails, almost always to the detriment of the customer, not the insurer.

Finally, is it fair that the actual average cost of the claim itself (R10) is only one-third of the premium (R30)? Surely there is scope for another insurer to find a way to cut costs and margins and offer the same product for R20, or less?

Our discussion turns now to some of these market challenges.

The existence of markets for insurance and saving

We have described how a market for insurance might exist and how the products offered might be priced. We now ask if these dynamics really serve to meet the needs of customers. We consider whether similar questions may be asked of savings products. And we consider the duty of financial product providers to educate consumers about personal finance and the products available to them.

Economists may refer to the market for insurance products as broadly imperfect. Even for a simple product like the funeral insurance arrangement described earlier (a single payment on the occurrence of a clearly defined event), the transparency of intrinsic value is poor. The costs of getting the product to market tend to be high. As insurers compete to sell their products, they are prepared to pay intermediaries, both individuals and organisations, large amounts to bring them customers. The actions of the intermediaries are frequently not consistent with the needs of customers. Neither are the corresponding actions of the insurer. Scope for mis-selling exists, in other words.

Call centres as a channel to market do not appear to be any cheaper. To add further to the pressure, insurers tend to incur high capital expenditure when setting up their businesses or preparing a new product for market. The higher their sales, the more likely they are to recoup this cost, so the incentive to sell in large numbers is strong.

In a complex environment such as saving and insurance, concerns regarding market imperfections and their impact on how such products could meet customer needs are valid. This is problematic if these products are to play a part in contributing to social mobility or social protection, or both.

Unfortunately, identifying the most appropriate intervention is seldom easy. Consider an example from a related field. Interest rates on loans may be regarded as problematic. The tempting approach is to specify a maximum rate of interest (a ceiling). The problem is that a ceiling interest rate in the regulated sector creates an incentive to product providers to take their chances with the unregulated market, in other words, not to register with the supervisor as a product provider. (This is illegal, but common to many markets: a part of the supply side chooses to stay beyond the reach of the regulatory framework.)

That might be risky for these providers, but they don't have to work within the specified limit. So they may regard the potential additional income as worth the risk. A possible result is that people who most need loans offering fair value are least likely to find them. This is partly because only unregulated lenders are accessible to them and partly because their risk profiles are such that regulated lenders won't lend to them.

A key question for providers in the formal, regulated market is why informal markets for savings, loans and funeral products, for example, continue to operate at great strength despite the risks to customers and providers. Surely the simplicity, credibility and accessibility of offerings has something to do with this.

Some have suggested that, for insurance products based on the life of the policyholder, the **risk premium** should be some minimum proportion of the **gross premium** – 50%, say – in contrast to the 33% in our example. This has a certain appeal but may introduce market distortion. What if a set of potential customers living in a remote part of the country cannot be reached by insurers under such terms? The regulatory intervention, in that case, has produced another form of market imperfection.

Insurance customers can change their minds, often rationally. They may mistakenly assess the premium against the size of the potential benefit rather than against alternative uses of the money for the monthly premium. The pressure on insurers to meet their fixed costs by selling their products in large numbers is high. But keeping customers on the books is just as important as making the sale. Customers who do not believe they are receiving good value for money are much more likely to let their policies lapse than those who do. High lapse rates can be a disaster for insurers which, by then, have incurred expenditure both to complete the sale and to bring the new customer onto the administration system.

In conclusion, imperfect markets in insurance may benefit product suppliers because their opacity permits higher profit margins. The advantage is likely to last only as long as the imperfection. In the meantime, it detracts from the value provided to customers and damages their financial well-being. It can undermine consumer confidence in providers, even fatally damaging the market. In an article later on called '[Product Options](#)', we assess the segments of South Africa's insurance and savings markets, asking how well each is operating to the benefit of its customers.

How could we apply these lessons to the market for savings products? We've seen how effective saving can be in managing risk for a low-income household. Saving in cash can be risky, though, so alternatives need to be considered. These typically include informal options in the community, like savings clubs. Their formal counterparts may provide additional services – for example, a transaction facility, interest-paying fixed or notice deposits, or potentially higher-return arrangements through insurers or unit trust arrangements. These products are typically characterised either by long minimum terms or volatile returns.

These attributes and limitations can be difficult to unravel. Few truly understand the risk–return trade-offs inherent to asset classes, let alone the other product limitations, or the fees – a sometimes bewildering array of costs and charges. It's not clear how customers evaluate the options available to them, but it is evident that efforts to improve the transparency of these charges (we consider this in more detail in the following article) can hardly come fast enough.

One way to improve the effectiveness of financial markets is to reduce the knowledge gap between providers and their customers by giving clear product information to customers and educating them. We turn to this subject next.

Consumer education

The responsibility for overseeing broad-based financial education to consumers lies with the Financial Services Board, now the Financial Sector Conduct Authority, which has devoted a department to consumer education for more than 10 years.³ In truth, until formally introduced into legislation as part of the duty of the Financial Services Board,⁴ the role of the supervisory authority in financial education has not been clear.

The question raised here is not whether the Consumer Education Department of the supervisory authority is backing up its responsibility with appropriate effort. Its activities include baseline studies into financial literacy, developing a national strategy, conducting workshops, putting in place material for radio and television, appearing at exhibitions, producing booklets and developing online material such as a trustee toolkit and **MyLifeMyMoney**.⁵ The question is whether the supervisory authority should be responsible for delivering consumer education or merely overseeing it. The efforts of the supervisor have been supported by industry body, the Association of Savings and Investment South Africa, which provides specialised training through its academy and financial literacy and training through its foundation. These are steps in the right direction ... but are they sufficient?

*Consumer education [...] involves a systematic effort to teach risk management strategies and the role of insurance in order to promote better risk management practices amongst low-income households. The goal of consumer education is to provide households with knowledge and skills that enable them to make informed financial decisions. [...] Consumer education is often considered to be an integral part of microinsurance schemes; it is intended to benefit both microinsurance practitioners and their clients. It is supposed to help low-income households make sound choices and practitioners stimulate demand.*⁶

The authors quoted above, Dror et al., make the case that the education of consumers should form part of a national effort. Some may argue that this exact model has been pursued in South Africa. The updated Financial Sector Charter demands an increase in the expenditure on financial education by providers, along with independent assessment of quality. We acknowledge the problems that banks and insurers may have in overcoming perceptions of bias in their presentation of educational content. The revised Financial Sector Charter has rules to address these perceptions:

*There are strict limits on the use of branding for consumer education not to cross the thin line into marketing. Branding will be allowed because it can assist companies to develop a trusted brand in the education market. [...] However [...] any image branding should not overwhelm the educational content [and] content should be generic and product-type related, not related to brand-specific products.*⁷

Another way to overcome this is to partner with credible non-government organisations to provide this information, as Bajaj Alliance did with CARE India, an organisation that aims to alleviate poverty and social injustice, focusing on the empowerment of women and girls. This partnership provides a programme covering risk education, insurance education, product education and product logistics.⁸

People live complex lives and typically have a range of needs that are not easily prioritised. Product marketing highlights the benefits (and hopefully the associated costs) of a particular product but cannot realistically provide the information needed to set or refine these priorities. Consumer education plays a key role in identifying the most important financial needs and finding products that best match these needs. Education is not just about presenting static material. Nudges, defaults and incentives, carefully and responsibly used, are tools in the education kit that can produce helpful outcomes.

The need for financial education gives employers an ideal opportunity to put forward pertinent information focused on the specific needs of their employees.

A mining house recently trained its employees on how to manage personal debt. Why? It recognised that inappropriate indebtedness had a direct impact on employee well-being and, as a result, productivity.

We argue that the winners of tomorrow will have shown their commitment to meeting the needs of their customers by providing comprehensive, high-quality education and information that enables them to make sound financial decisions. South Africa already has examples of systematic financial education that financial services companies provide to previously disadvantaged communities. A commitment to such effort needs to be part of the fabric of our financial product providers, not merely an element of compliance with industry norms. We consider the importance of the culture of these organisations in the next article.

Doing a better job

In closing, what should insurers and other financial product providers do to ensure the products they offer help to enhance social mobility and raise the financial well-being of customers? We suggest that four types of actions are crucial (the first two are considered in this article and the last two in the following article):

- > **Design and price efficiently.** Insurers cannot (sustainably) price their products at a loss. But they should not charge so much that customers are being unfairly treated and competitors will, in due course, undercut them. They should also not price so low that breakeven is only achieved by selling enormous volumes of the product. This puts the business under great strain to sell the product at all costs, rather than match it to those customers who need it most.
- > **Educate.** The products offered by a bank or insurer should be supported by transparent, helpful, unbiased information that shows how that product meets a common personal or household need. If necessary, product providers should enlist the support of a credible independent organisation to help spread this information responsibly. Educating customers also means using nudges, defaults or incentives – responsibly, of course – to encourage appropriate behaviour.
- > **Engage with customers.** Few policyholders sing the praises of their insurers from the rooftops, and aiming for such an outcome may be asking a little too much. But providers should communicate with customers in ways that suit the customers, enough to build their confidence in the suitability of their products and the integrity of their service. If they also allow customers to give feedback, they have an even better chance of retaining a satisfied, loyal customer.

Organisations like IDEO U put customers in the middle of the design process, using rapid prototyping and iterative user feedback to refine and perfect initial concepts. Their website, www.ideo.com, provides training on IDEO U methodology.

- > **Understand and meet needs.** On the back of the clichéd wisdom that ‘insurance is sold, not bought’ – in other words, that customers have to be convinced to buy life or short-term products – insurers have tended to fall into the trap of aggressively marketing their offerings. With a little more expenditure and time, they can work with potential customers to ensure that products match a need. An element of education may be required, as insurance is not often the first thing that comes to mind when a customer has spare change.

These recommendations are directed at insurers but apply equally to banks, unit trust companies and other types of financial product providers. Employers are in a strong position to provide helpful, unbiased information to their employees in the interests of their well-being. Meeting customer need is surely the cornerstone of enhancing well-being. We consider the legal and business obligations to do so in Part 4: Chapter 3.

Further reading

For an exploration of loss aversion and the impact of risk on loss aversion:

- 1 Johnson, EJ, Gächter, S & Herrmann, A. 2006. Exploring the nature of loss aversion, IZA Discussion Papers No. 2015, Institute for the Study of Labor (IZA), Bonn (discussion paper).
- 2 Gächter, S, Johnson, EJ & Hermann, A. 2007. Individual-level loss aversion in riskless and risky choices, CeDEx Discussion Paper No. 2007-02, Centre for Decision Research and Experimental Economics, University of Nottingham (discussion paper).

Some reader-friendly publications on behavioural economics:

- 1 Shefrin, H. 2002. *Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing*, Oxford University Press, New York (book).
- 2 Sunstein, RH & Sunstein, CR. 2009. *Nudge: Improving Decisions about Health, Wealth and Happiness*, Penguin, New York (book).

References

- 1 SA Government. 2017. Long-term Insurance Act: Replacement of Policyholder Protection Rules, Government Gazette No. 41321, 15 December 2017.
- 2 Dror, D & Koren, R. 2012. *The elusive quest for estimates of willingness to pay for health microinsurance*. In Churchill, C & Matul, M (eds.): *Protecting the Poor: a Microinsurance Compendium*, Volume II. International Labour Organization, Geneva (book).
- 3 Peyper, T. Undated. Consumer Education Department, Financial Services Board (FSB), 5 March 2018 (online).
- 4 South Africa. 2013. Financial Services General Act (No. 43 of 2013).
- 5 FSCA website, home page (www.fscaconsumered.co.za), 18 July 2018.
- 6 Dror, I, Dalal, A & Matul, M. 2012. *Emerging practices in consumer education on risk management and insurance*. In Churchill, C & Matul, M (eds.): *Protecting the Poor: a Microinsurance Compendium*, Volume II, p. 286. International Labour Organization, Geneva (book).
- 7 Greenblo, A. 2018. *Today's Trustee*, Feb/April 2018, p. 6 (industry publication).
- 8 Dror et al. (2012).

