Navigating individual financial well-being

Insuring what matters

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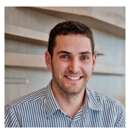

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But unlike health insurance products (which we'll discuss in the next section) the risk events covered by both long- and shortterm insurance products happen so rarely and unpredictably that we often fail to see the value in holding the insurance product at all. In each year, the vast majority of policyholders pay premiums but receive absolutely no monetary benefit in return. If insurance was viewed like an investment, policyholders would rationally feel like they had invested in a dud. The result is that where people have a choice about buying insurance, they often don't.

Fundamentally, buying insurance is more about managing fear than making a financial decision, which is why it is so critical for an adviser to have a conversation with the individual that goes beyond product details.

If you add to this the fact that insurance premiums can run into several thousands of rands a month, you've got a conundrum on your hands: why should anyone buy an insurance product that cost a fortune, and provides only the promise of a benefit on the off-chance that the insured event happens at some point in the future?

Since the State offers limited protection against the asset risks that formal insurance products cover and often not at the level required by many employed people, it's largely up to the individual to decide on the best way to manage these risks. The options available to the individual that the adviser needs to help navigate them through include:

- Buy a formal insurance product
- Use informal insurance mechanisms, such as stokvels, which pay out on certain events
- Self-insure by using savings or income as an offset
- Rely on your family or community for support
- If all else fails, readjust your lifestyle should the event occur.

Too often an adviser will jump to the first option of formal insurance products, without helping an individual to think through other options. In this chapter we examine a framework the adviser can use to help an individual trade off the various points against each other to see which option delivers the greatest value.

While different people have different risk tolerances, levels of adaptability and cognitive biases, there are good guidelines we can follow when helping them determine whether to buy an insurance policy. We need to answer two main questions to establish these guidelines:

- Is there a significant enough probability of the event happening?
- Can the individual deal with the impact if the event does in fact happen?

What is the probability of the event occuring?

Life is full of uncertainty and risks. There are various methods individuals use for dealing with the risks they face in life. The two most extreme modes for dealing with uncertainty:

1. **THE FEAR MODE**
   Individuals who respond to the fear model tend to exaggerate the probability of occurrence and underestimate their ability to deal with the consequences if these events do happen. This leads to irrational purchasing behaviour and sometimes being over-insured. Anxiety tends to be the driving force.

2. **THE FAITH (DENIAL) MODE**
   On the other extreme, someone employing the faith model puts no protection mechanisms in place. Either they believe the probabilities of the event occuring are low or they don't engage with the possibility at all.

> **The fear model may lead to people being overly cautious while the faith (denial) model can put them in serious danger of removing all safety nets. By identifying what mode an individual leans on most heavily, the adviser can help the individual to find a more moderate balance between them.**

FAST THINKING TO ESTIMATE PROBABILITY AND LOSS

Most insured events are more likely to not happen each year than they are to happen. People tend to understand this. But do they really understand the probabilities? We have to turn to behavioural finance to understand how people determine the chances that an event will occur and therefore whether they need the protection.[1]

Anchoring
This term explains how people produce estimates. They start with an already established view on the occurrence of an event and will anchor to that view. This can lead to incorrect assessments of the chances of an event occurring.

Prospect theory
This is the theory of how people make decisions when faced with risk and uncertainty. This moves away from traditional views of utility to a concept of value defined in terms of gains and losses relative to a reference point.

If we apply prospect theory to disability insurance for a 40-year old male, we would be comparing the following alternatives:

1. A 100% loss equal to the sum of the premiums paid for the insurance protection (say R10 000 per month).
2. A 1% chance of becoming disabled and incurring a loss of say R1 million.

Although the two alternatives lead to the same expected outcome, people would choose alternative 2 because it has a smaller probability of occurrence, even though the potential loss is far greater than that under alternative 1.

Availability bias
The ease with which something can be brought to mind influences our judgement of how likely that event is to happen. For example, there may be more deaths from cancer than car accidents in this country, but car accidents are much more widely publicised, so we tend to believe that car accidents are more likely.

Myopic loss aversion
Myopic loss aversion refers to an excessive focus on short-term losses when a longer-term time frame, that acknowledges short-term losses, is more appropriate. This results in some people buying excessive amounts of insurance in the belief that the event may happen in the next year when it may only occur once every five years.

How can an adviser respond
Research shows that it is not the magnitude of the potential loss that leads people to buy insurance, it is the frequency with which the loss is likely to occur[2]. You can only respond appropriately if you perceive the risk correctly. How can we help individuals with that decision-making process?

Here are some points an adviser can include in their discussion with an individual:

1. Don't consider probabilities over too short a period into the future.
2. Understand how your chances of experiencing the event may differ from someone else's. For example, if you have a history of heart disease in your family, this puts you at greater risk of a heart condition than the average person.
3. Do not think that because it hasn't happened recently that it will not happen in the future.
4. Avoid overconfidence in your ability to estimate probabilities. If you choose not to buy insurance, each day that you don't experience the loss event affirms your decision not to buy the insurance. But every insurance product is developed from a need that existed in the market and is driven by the fact that the probability of occurrence was great enough that it warranted an insurance contract.
5. Consider the risk probability together with the potential loss. This means going against your mental biases as captured by anchoring and prospect theory. To assess whether you need the insurance it is fine to consider how likely the event is to happen, but you also need to ask yourself: "If the event happened, could I cope with the loss?"

CAN YOU DEAL WITH THE IMPACT OF THE EVENT IF IT DOES IN FACT HAPPEN?

An adviser can be critical in helping you assess whether you can cope with loss on the basis of the following questions. If our default position is no insurance coverage then the answers to these questions will help an individual to determine whether their savings, income or additional support systems would be adequate to provide the needed protection.

Is the maximum potential loss uncapped?
For certain types of loss events it's simple to estimate how much cover is needed. Vehicle insurance should cover the value of your car, and life insurance should be enough to cover the daily living costs of your family after your death for a reasonable time period. In these cases an adviser can help an individual calculate whether they have enough savings or income to cover the expected loss. There are also instances where the loss might be unlimited. For example, you may experience a rare disease and your medical costs could run into the millions. Your savings would be inadequate.

Third party insurance is a specific type of cover that provides indemnification against losses incurred by someone else as a result of your actions. If you drive a car and you don't decide to buy third party insurance, you could crash into a Ferrari and you may be liable for millions of rands in compensation. The upward bound of this type of liability is not known. Savings alone would be inadequate. Insurance should be treated as a priority.

Do you have enough emergency funds to absorb the loss?
If we return to the example of life cover above, we could calculate how much you need to cover your family's daily living costs in your absence. You might consider factors like the outstanding bond amount on the house so that your family has somewhere to live; the cost of education for your children up to a university degree; estimated medical costs; and the cost of food, to name a few. We can then look at your existing asset holding to see if you have enough to act as a substitute for insurance. You might count the value of your retirement fund savings, emergency savings, existing cover from your employer, and so on.

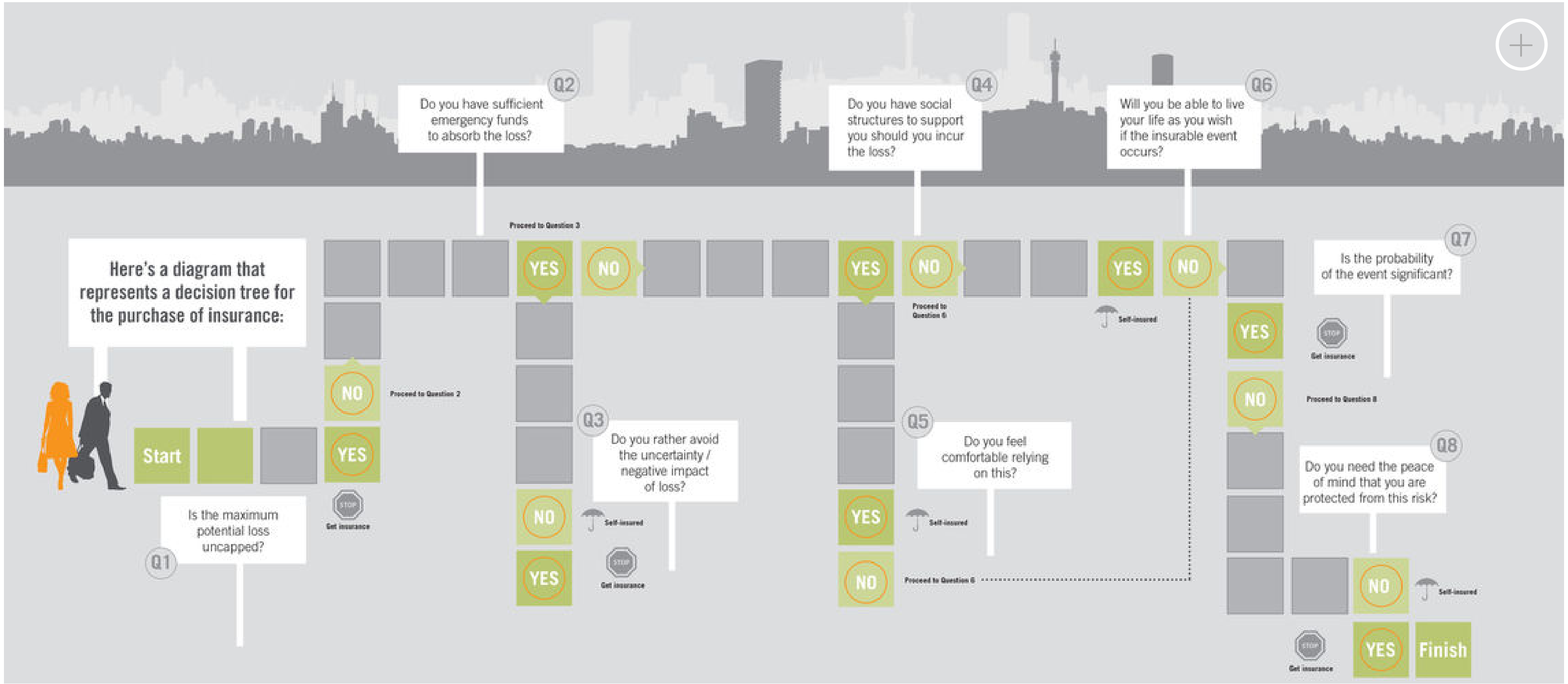
The decision to buy insurance for losses that do have an upper limit depends on the assets you have at your disposal to absorb such a liability. Accumulating and managing these assets will often require the adviser to discuss an individual's saving and investing decisions.

It isn't always easy to assess all the costs that you could face if you experienced the loss event. When it comes to disability insurance, for example, there are many costs you may have to pay for, like physiotherapy, that you don't think of when assessing whether you have enough money to offset the risk. This is where an adviser can help an individual to consider all angles.

Do you have social structures to support you should you incur the loss?
Some communities have strong social ties and sharing of medical costs and income support are common. If you're comfortable relying on this support system to protect your family when you're gone, you may be less inclined to buy life insurance. However, the costs you may incur are difficult to estimate with accuracy and can be unlimited. Consider how comfortable you are relying on such a support system. This is a very personal decision.

Will you be able to live your life as you wish if the insurable event occurs or could you adapt your lifestyle?
Humans are much more adaptable to losses than we think. If your cellphone is stolen, you could adapt and buy a cheaper one. However, if you don't insure your car and it is stolen, would you be able to adapt to taking the bus? If you became disabled, would you be able to survive or adjust to a life with no income? You have to think about whether you could adjust your lifestyle without compromising your well-being.

When it comes to short-term cover for a home or a vehicle, specifically, if you are still paying off either of these assets, you should probably hold insurance equal in value to the asset themselves, or at the least, the value of the outstanding debt. If you were involved in a car accident and the vehicle is so badly damaged that it could not be repaired, you would be stuck having to pay off the outstanding amount on the car but wouldn't have any car to drive.



When you *do* buy insurance cover ...

If you conclude that formal insurance is the preferred option, here are the considerations that will provide peace of mind:

- **Excess payments**: This is the first amount of any loss that you must pay, with the insurer covering the remainder of the loss, up to a specific maximum. The greater the excess the cheaper the cover will be. You need to determine whether you have enough in savings or disposable income to cover the excess or whether you may need to borrow to cover the excess, ultimately affecting your well-being in a negative way.

- **Exclusions:** Most policies contain standard exclusions. For motor vehicle insurance this includes that the insurer will not pay any claims for an accident caused by the insured while under the influence of alcohol or drugs. This seems sensible. But these exclusions can mean that you are not protected against the very thing that you sought insurance for. An example of this is where you have a history of cancer in your family, and choose to take out dread disease cover, but the insurer stipulates that cancer is not one of the conditions that they will pay out a benefit for because of your family history. Exclusions need to be carefully checked.

- **Indemnity or fixed compensation:** The principle of indemnification states that the individual will be returned to the position they were in before they suffered the loss. This is good as it means that your well-being should be left unaffected. But some types of contracts only offer a fixed benefit, leaving you uncovered for any amount over and above the sum insured. Again, it's a question of whether you have enough net assets to absorb that loss.

- **The comprehensiveness of cover:** Be careful to not simply choose the cheapest option available to you because it may mean that you are only covered for certain things and not others. For example, the cheapest form of vehicle insurance available is third party insurance. That means that if you are involved in a car accident, the insurer will not compensate you for the cost of repairs.

> **A helpful framework for advisers is to start with the presumption of no coverage and the interrogate whether the individual has adequate alternatives.**

Concluding thoughts

- Insurance products don't provide instant gratification and often only provide a pay-out when the worst happens.
- Many people handle risk by gravitating towards a faith or fear model.
- When considering whether to take out insurance, people tend to focus on their perception of their probability of the event, rather than the potential magnitude of the impact.
- A helpful framework for advisers is to start with the presumption of no coverage and to interrogate whether the individual has adequate alternatives.
- Only after determining that a formal insurance product is the appropriate way to offset a risk should the conversation about product details take place.
- Make sure to understand the fine print around excess payments, exclusions, fixed compensation and comprehensiveness of coverage.

References

1 All descriptions of mental biases are adapted from the study material for actuarial examinations for subject F105, developed by the Actuarial Education Company.
2 Schade, Kunreuther Koellinger (2011)

Article tags

INSURANCE | DECISION-MAKING | INFORMAL INSURANCE | STOKVELS | SELF-INSURANCE | ANCHORING | PROSPECT THEORY | AVAILABILITY BIAS | MYOPIC LOSS AVERSION | LOSS | EMERGENCY SAVINGS | EXCESS PAYMENTS | INDEMNITY