

The Price of Avoiding Minor Financial Loss

BY BECKY JOHNSEN

Much economic research has focused on how people avoid or embrace financial risk. Justin Sydnor, a microeconomist at Case Western Reserve University, focuses in a recent paper on the phenomenon that, as he puts it, many consumers “appear to pay a large amount to insure against very modest financial losses.” He cites the demand for extended warranties, mobile phone insurance, and low insurance deductibles as evidence that many consumers are highly averse to risk. In particular, Sydnor finds that there is “a surprising level of risk aversion over modest stakes” in the market for homeowners’ insurance.

Sydnor analyzes data from a random sample of 50,000 standard homeowners’ policies issued by a large insurance provider. The policies were all issued in a single unnamed western state in the past decade. In choosing coverage, customers had a choice of four available deductibles that they would pay in the case of loss or damage: \$1,000, \$500, \$250, \$100. As usual in insurance markets, choosing lower deductibles meant higher premiums. Sydnor finds that a plurality of customers, 48 percent, chose the \$500 deductible; 35 percent chose \$250; 17 percent chose \$1,000; and less than 1 percent chose \$100. He then quantifies the average difference between the cost and value of the different deductibles by comparing the additional costs and claim rates of the lower deductibles. He calculates that “those who held lower deductibles paid [five times] more than the expected value for that extra insurance.”

Sydnor also analyzes the decisionmaking processes behind these purchases. In studying the participants, he finds that customers who have held policies for longer “were actually more likely to hold one of the lower deductibles.” He speculates that such decisions by this segment of homeowners may be due to “consumer inertia,” where despite rising insurance costs, individuals fail to adjust their initial choices. “It is likely that the observed choice of lower deductibles partially reflects inertia and not solely an active choice reflecting risk preferences.” He predicts that this phenomenon would apply to the U.S. homeowners’ insurance market as a whole and calculates that by switching to the highest available deductible, U.S. homeowners could save around \$4.8 billion annually.

Sydnor concludes that those in his sample “overinsure[d] modest risks when making home insurance purchases” and proposes six potential explanations for this phenomenon. The first, and the most obvious, according to Sydnor, is that consumers may simply misjudge the level of risk to their

homes. Second, consumers may prefer to smooth costs over the long-run rather than risk suddenly having to pay a significant amount. Third, some individuals could have significant borrowing constraints, making them unable to cover sudden financial loss. Fourth, homeowners could be “influenced or pressured to take the more expensive lower deductible contracts by the company’s sales agents, who earn partial commissions.” Fifth, the selection of deductibles offered by the provider may influence the consumer. “People have a tendency to avoid picking the extreme options from a menu and may be reluctant to pick the highest or lower deductible available,” says Sydnor. Finally, consumers may have other personal reasons to avoid risk. For example, previous research has concluded that consumers want to avoid the

“(Over)insuring Modest Risks.”

Justin Sydnor. *American Economic Journal: Applied Economics*, October 2010, vol. 2, issue 4, pp. 177-199.

psychological pain of sudden financial loss.

Sydnor also looks at the extent to which consumers’ choices of deductibles affected profitability. In view of his findings that consumers pay more for low-deductible policies than the expected value of the additional coverage, one might assume the low-deductible policies are more profitable to the insurance provider, but this is not the case. The insurance provider earned roughly similar profits from both groups. Sydnor argues that this is partly because low-deductible customers have higher claim rates than those with high deductibles. In short, it appears that the prices charged by insurance companies may be consistent with a competitive equilibrium.

Thus, while some *individual* consumers could save money by switching to higher deductible plans, if *all* consumers changed their behavior, the insurance company would have a difficult time distinguishing more and less risky customers. This might force the provider to raise insurance costs or to create a new higher deductible.

As a result, Sydnor does not recommend government policy changes to “correct” consumer behavior. “In particular, a given individual might benefit from [altering the biases] that caused him to avoid purchasing [a more appropriate deductible], but a policy aimed at changing all consumers’ behavior is unlikely (at least in home insurance) to improve the equilibrium for the consumer.” And while Sydnor looked at only homeowners’ insurance policies, he concludes that similar research could usefully be applied to other insurance markets as well. “Doing so may open up new insights about behaviors,” he suggests, “and may generate policy prescriptions in areas such as health insurance and annuities.”

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