

THE SCIENCE BEHIND WHY WE NEED LIFE INSURANCE



Life insurance protects our future financial circumstances against unexpected illness or injury. Deep down, most of us probably know that's a good investment in our future. But the truth is many people struggle to engage with life insurance enough to actually buy it, and for those that do, more struggle to keep it, review it and feel comfortable with it.

Some of the issues are based on effort – life insurance isn't an easily accessible product, and it requires people to read an entire Product Disclosure Statement (PDS) or spend a lot of time with financial advisers if they really want to understand it.

However, some of the issues people have in engaging with life insurance are rooted in natural human behaviour, and research in behavioural science allows us to understand what those causes are.

1. We're overconfident

Try a simple exercise:

On a scale from 0–10, rate how safe you are as a driver compared to others –where 0 is least safe, 5 is average, and 10 is the safest.

Simple tasks like this have been replicated time and time again in science. One of the more famous examples in America found that 93% of American drivers rate themselves as better than average.¹

What this means

Given how averages work, that result is statistically impossible and can't be true. However, people often fall prey to something called **comparative optimism**, which simply means we often think we're "better than average". We think that good things are more likely to happen to us, whereas bad things are more likely to happen to others.

This overconfidence tends to make us think life insurance is more relevant for other people than it is for us, even though that's probably not the case.

So who can blame us for thinking that we won't be the one to suffer the unlucky injury, or an unfortunate illness – we all think we're more invincible than average!

2. We only respond to things that come to our mind easily

Another exercise to try:

If you pick a word at random from the dictionary, which of the following do you think is most likely to occur?

The word you picked starts with a K; or

The word you picked has a K as the third letter?

What do you think?

This was a real question that Nobel-winning behavioural economists Tversky and Kahneman tested. They found that people overestimate the occurrence of words that begin with “K” and underestimate the occurrence of words with “K” as the third letter.ⁱⁱ

They concluded that because words beginning with “K” come to mind more easily, people judge them to be a more common occurrence. It’s obviously much easier to think of words that begin with “K” – the way our memory works means we start from this first letter and build out words from there: kangaroo, kitchen, knife. But it takes a much more concentrated effort to think of words that have the third letter “K”: ask, acknowledge.

The truth, however, is that there are three times more words with “K” as the third letter than words that begin with “K”.

This behaviour is called the availability heuristic. Simply put, things that come to mind more easily are believed to be far more common and more accurate reflections of the real world.

Similarly, reports of shark attacks and airplane accidents often lead people to believe that such events are much more typical than they truly are.

This sheds light on why surfers on Australia’s east coast have started taking out shark attack insurance. About 15 people are attacked by a shark each year, and around 1 is fatal.ⁱⁱⁱ Yet statistically, people are more likely to be struck by lightning (about 10 people die each year from lightning strikes in Australia, with a further 100 injured)^{iv}, let alone suffer a heart attack like over 7,000 Australians each year^v.

Because a lot of the events that lead to life insurance claims aren’t necessarily newsworthy, or don’t come to mind as easily, we tend to underestimate the likelihood of them happening to us.

3. We dislike uncertainty and ambiguity

Which of these two games would you prefer to play:

Game 1: A fair coin will be flipped. You receive \$100 if it lands heads.

Game 2: A ball will be drawn from a bag of 100 that are an unknown mix of blue and yellow balls. You receive \$100 if a blue ball is drawn.

Made your choice?

Most people in this situation tend to choose the coin flip – a known 50% chance of a win. But why? There is no information given in the exercise about how many blue balls are in the bag, and there’s a good chance there might be more than 50, meaning your odds would be better than ½.

What this means

First formulated by Daniel Ellsberg in 1961 as the **Ellsberg Paradox**, this exercise shows us that we have a tendency to favour the known over the unknown – including known risks over unknown risks.^{vi} When faced with choices like the one above, we like to take risks that we know, even if the odds may not be in our favour – an exercise in "preferring the devil you know to the devil you don't".

Another simple example is that this avoidance of uncertainty leads people to avoid participating in the stock market due to the unknown risks, with many preferring to lock in a known interest rate.^{vii}

With our health, and therefore our life insurance, it's difficult for us to estimate our chance of ever needing to claim, which can make it very hard to see the relevance of life insurance.

4. We struggle to empathise with our future selves

Think about how you're feeling right now.

Are you in a hot state, feeling overly happy, angry or emotional? If so, do you have a firm grasp of how your emotions are affecting your decision-making right now? Or, perhaps you're in a cold state, feeling calm, relaxed, thinking logically. Do you think you could accurately predict, right now, how much your decision making would change if you were suddenly provoked into a more emotional state?

What this means

People naturally find it very hard to imagine what it's like to be in any emotional state other than the one they're currently in. This is called the **hot-cold empathy gap**^{viii}.

5. We sharply discount the future compared to the present

Try a simple exercise:

Would you prefer \$100 today, or \$120 in a month? Make your choice. Got it?

Ok, what about: Would you prefer \$100 in a year's time or \$120 in a year and one month?

What this means

In the first scenario, most people prefer \$100 today, but in the second they would choose \$120 to wait the extra month. In both of these questions, a one-month wait is valued at \$20, yet our choices are inconsistent – so what's going on here?

The explanation is that our judgements about time and value are not fixed – rather, they depend on how far we're projecting into the future. The perceived difference in time between today and a month away feels much bigger than the difference between one year and one year and one month.

The further out in the future the benefits are, the less value they are perceived to have. So \$120 in a month doesn't feel as valuable as \$100 today. But in the distant future, over a year away, the differences between the two times is compressed, so it's easier to value the extra \$20^{ix}.

This carries through to other parts of life. We have wonderful intentions for ourselves. Our future selves have excellent self-control, make responsible financial decisions and choose to eat healthy. But most of the time our diet starts tomorrow, and that rainy day saving keeps getting pushed back.

In the present moment our choices are impatient and we seek immediate gratification. This is called our **present bias**.

Research has shown that we make drastically different choices for ourselves in the near future than we do for the distant future.

Simply put, we behave more impulsively the sooner our decisions will take effect. We find it hard to resist buying something today, and will deal with the fact that we have to pay it off later.

It's no wonder we find it difficult to pay small insurance premiums today for the benefit of larger protection in the future – we're just not wired for it.

6. We can become overloaded by options

Think about this:

Think about almost any section of products at the supermarket, such as pasta sauce or toilet paper.

Do you feel that because of the large amount of choice, it takes too much effort to make a new decision every time?

Do you usually just go with what you know, and what you've used before?

What this means

The abundance of options we're presented with is well intentioned and based on a simple assumption: more choice means more freedom – and we all value more freedom, right?

But having too many options is actually associated with lower satisfaction, sometimes even unhappiness, causing us to simply go with a default option, and even delay or avoid making the choice altogether. This is an experience called **choice overload**^x.

Intuitively we know this, and people naturally tend to have a number of shortcuts to deal with an abundance of choice. In some situations, we may simply go with whatever choice we made before, like with toilet paper. In other situations, we just go with whatever the most popular choice is – because if everyone else is doing it, there must be something to it!

In the case of life insurance, we'll often outsource our decisions to experts, whether that's a professional in the field such as a financial adviser, a ratings agency or comparison site which simplifies the choice to a recommendation score. That can help us make confident choices from a vast array of product offerings.

The conclusion? Life insurance saves us from ourselves

We've evolved to make decisions in the present about simple trade-offs and risks we face right in front of us. But the modern world is full of complex decisions involving risks and far-off future benefits, which can make it hard to know what's best for us.

Life insurance can help you avoid the traps and pitfalls of complex decisions, as it's designed to accurately assess and price your personal risks.

Additionally, if you have life insurance, you help to control some of the natural behaviours people tend to exhibit. Having cover in place helps to mitigate against any negative outcomes associated with these behaviours, such as a tendency to be overconfident, or avoid uncertainty.

Importantly, life insurance allows you to be confident that you've got the protection you really need for yourself and the people you love.

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- ⁱ Svenson, Ola (1981). Are we all less risky and more skilful than our fellow drivers? *Acta Psychologica*. 47. 143–148.
- ⁱⁱ Tversky, Amos; Kahneman, Daniel (1973). Availability: A heuristic for judging frequency and probability. *Cognitive Psychology*. 5 (2): 207–232.
- ⁱⁱⁱ Vally, Hassan (2017). What's most likely to kill you? Measuring how deadly our daily activities are. *The Conversation*.
- ^{iv} Rääbus, Carol (2017). How to stay safe from lightning strikes during a storm. *ABC News*.
- ^v Heart Foundation, Heart attack fact sheet.
- ^{vi} Ellsberg, D. (1961). Risk, ambiguity, and the savage axioms. *The Quarterly Journal of Economics*, 75(4), 643-669.
- ^{vii} Easley, D., & O'Hara, M. (2009). Ambiguity and non participation: the role of regulation. *The Review of Financial Studies*, 22(5), 1817–1843.
- ^{viii} Loewenstein, G. (2005). Hot-cold empathy gaps and medical decision-making. *Health Psychology*, 24(Suppl. 4), S49–S56.
- ^{ix} Laibson, D. (1997). Golden eggs and hyperbolic discounting. *Quarterly Journal of Economics*, 112, 443–477.
- ^x Schwartz, B. (2004). *The paradox of choice: Why more is less*. New York: Ecco.

This information has been prepared by OnePath Life Limited ABN 33 009 657 176 AFSL 238341 (issuer of OnePath life insurance products) and Zurich Australia Limited ABN 92 000 010 195 AFSL 232510 (issuer of Zurich life insurance products). The information is current as at March 2020 but may be subject to change without notice. Updated information will be available by contacting your Business Development Manager or Relationship Manager.