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Risk

To Get People to Buy Insurance, Change How You Talk About Risk

By Howard Kunreuther, Robert Meyer, and Erwann Michel-Kerjan September 22, 2014

Photograph by Justin Sullivan/Getty Images

Earthquake-damaged household items are cleared away in Napa, Calif., on Aug. 26

The Napa Valley earthquake in August offered another instance of a well-known phenomenon: Homeowners are radically underinsured against natural disasters. In California, 9 out of 10 homeowners don't have earthquake coverage. When Hurricane Sandy struck in 2012, 8 out of 10 affected residents didn't have flood insurance. This year's hurricane season is forecast to be mild, but there will be no shortage of opportunities to revisit these statistics.

Homeowners' insurance is normally a prerequisite for obtaining a mortgage, but these basic policies don't insure against earthquake and flood, which require the purchase of separate coverage. Daniel Kahneman's *Thinking, Fast and Slow* provides insight into why so many people forgo this protection. Intuitive, fast thinking works for most everyday actions but can fail us when it guides decisions that we should make carefully, like determining whether to buy insurance against low-probability high-consequence events such as natural disasters.

When deciding whether to take protective measures, we tend to rely on our own experience in the recent past: We believe it will not happen to us, because it has not happened to us recently. It had been more than 50 years since a coastal storm of Hurricane Sandy's intensity hit the Northeast. Adding to homeowners' false sense of security, when Hurricane Irene made landfall the year before, the predicted large-scale flooding never materialized in the New York City area.

Immediately following a disaster, the calculus changes. The uninsured who suffered damage wished they had purchased coverage, and many decide to buy a policy. If there are no disasters within a few years, many homeowners are likely to cancel their insurance because they then feel their premiums have been wasted. Our analysis of the National Flood Insurance Program database revealed that about half of new flood insurance policies were canceled after just three or four years.

In other words, fast thinkers view insurance as an investment rather than as a protective measure, as revealed through dozens of empirical studies in several disciplines. It is hard to convince individuals that they should celebrate the serious loss that didn't happen, rather than bemoan the premiums paid for naught.

Are there ways to deal with this problem? Research shows that homeowners can be persuaded to consider insurance simply by recharacterizing the risks they face. Property owners in a flood-prone area are far more likely to take the flood risk seriously if they are informed that there is a greater than 1-in-5 chance (precisely 22 percent) of at least one flood occurring in the next 25 years, instead of learning that they are in a "one-in-100-year flood plain" (as defined by the Federal Emergency Management Agency). These two probabilities are equal, but they don't seem the same to homeowners.

It also helps to create a scenario about the potential property damage from another earthquake or hurricane, and to ask homeowners to consider how they would handle their recovery process if they were uninsured. Telling homeowners that $4,000 is the average amount of post-disaster individual assistance grants provided by FEMA may lead more households to purchase insurance.

A proposed plan of action to reduce future disaster losses: Develop long-term programs based on slow and data-rich deliberative thinking, combined with short-term strategies that satisfy immediate needs stimulated by fast intuitive thinking. Our future pieces on Businessweek.com will suggest strategies for achieving these objectives to protect ourselves against potentially catastrophic risks.

Editor's note: This is the first in an occasional series by the directors of the Risk Management and Decision Processes Center at the Wharton School at the University of Pennsylvania. The Risk Center works with businesses and policymakers on how to deal with events ranging from natural disasters and terrorism to the financial crisis and manmade environmental catastrophes.

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