Insurance Fraud and Behavioural Economics

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Fraud Prevention, Detection and Deterrence

Recent discussion at the Insurance Fraud Taskforce focused on ensuring that fraud can be readily detected by increased sharing of claims and application data. Data sharing is of real significance in combatting repeat (and organised) fraud, particularly when combined with increased efforts to 'know your customer'. However, insurance fraud can also occur as the first incidence of criminality, and here the underwriting and claims environment play a significant role in controlling fraud.

The reasons people commit insurance fraud, and the nature of the frauds, vary enormously.[1] However, there are identifiable trends in consumer and corporate behaviour that can inform the design of the underwriting and claims process in order to reduce the incentives to commit fraud. This requires an understanding of the thought processes of those who commit fraud. Our understanding of economic decision-making has developed considerably in recent years and insurance can look to the measures taken across government to reduce opportunistic fraud. This note gives an introduction to the principles of behavioural economics, and how it is being used by HMRC, the Department of Work & Pensions and the Financial Conduct Authority to change market behaviour.

The Core Principles of Behavioural Economics

The development of behavioural economics occurred largely in US university psychology departments over the last 40 years. It has been popularised in recent years with 'pop-science' paperbacks such as Kahnemann's *Thinking Fast & Slow* and Thaler & Sunstein's *Nudge*. This has coincided with considerable political attention on behavioural economics as a tool for policymakers. In the UK, the Cabinet Office utilises the Behavioural Insights Team and the Financial Conduct Authority has stated its intention to develop financial services regulation on this basis.

Behavioural economics differs from standard law & economics in that it does not imagine that all market participants are engaged in rational choices to maximise their self-interest. People often act irrationally, but the patterns of their irrationality can be predicted and systems can be designed to reflect these insights. Much of marketing is designed to encourage product purchase by appealing to this mixture of rational and irrational motivations. Insurance is commonly sold as a precaution against an uncertain future and exploits purchasers' limited (and often irrational) understanding of risk.[2]

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[1] See eg Gill & Randall *Insurance Fraudsters* (2015).

[2] It is recognised that risk pooling can be an efficient response to risk, but insurance is often marketed to appeal to motivations other than economic efficiency. See, for example, the sale of 'extended guarantees' alongside consumer electronics and white goods as discussed in FCA 'How does selling insurance as an add-on affect consumer decisions? A practical application of behavioural experiments in financial regulation' at http://www.fca.org.uk/your-fca/documents/occasional-papers/occasional-paper-3 and T

Behavioural economics identifies patterns of consumer behaviour by data collated in a range of environments: first, by undertaking experiments on volunteers, often revolving around hypothetical bargaining situations. This led to insights on how people establish 'value' in respect of goods and services. In recent years this has been supplemented by a second source: experimental economics in the real world. This will commonly involve randomised controlled testing of a representative group of the general public. In insurance, this might involve testing variations of claims, complaint or proposal forms to investigate whether the design of those forms influences the level of opportunistic fraud. How this might be achieved is best shown by reference to similar experiments carried out across government services.

Implementing Behavioural Economics across Government: Combatting Fraud & Error

The Behavioural Insights Team wrote a guide to minimising fraud and error across government services in 2012.[3] It listed seven key actions that could be taken to influence consumer behaviour. I suspect that many of these would be familiar to marketing departments of major insurers. Claims and proposal forms would normally be designed carefully, with significant input from marketing, legal and other departments. Much of this is consistent with the 'improved customer journey' discussed at the meeting. In doing so, best practice can be established in how to minimise fraud, without (overly) affecting the competitive nature of underwriting and customer systems:

Insight 1. Make it easy: Make it as straightforward as possible for people to pay tax or debts, for example by pre-populating a form with information already held.

Insight 2. Highlight key messages: Draw people's attention to important information or actions required of them, for example by highlighting them upfront in a letter.

Insight 3. Use personal language: Personalise language so that people understand why a message or process is relevant to them.

Insight 4. Prompt honesty at key moments: Ensure that people are prompted to be honest at key moments when filling in a form or answering questions.

Insight 5. Tell people what others are doing: Highlight the positive behaviour of others, for instance that '9 out of 10 people pay their tax on time'.

Insight 6. Reward desired behaviour: Actively incentivise or reward behaviour that saves time or money.

Insight 7. Highlight the risk and impact of dishonesty: Emphasise the impact of fraud or late payment on public services, as well as the risk of audit and the consequences for those caught.

The Behavioural Insights Team then details eight experiments it arranged to implement these approaches across UK government departments. I summarise three relevant examples below:

Baker & P Siegelman 'You Want Insurance with That? Using Behavioral Economics to Protect Consumers from Add-on Insurance Products' (2013) 20 Connecticut Insurance Law Journal 1.

[3] Cabinet Office: Behavioural Insights Team 'Applying behavioural insights to reduce fraud, error and debt' (2012), available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/60539/BIT_FraudErrorDebt_accessible.pdf.

Trial 1. Using social norms: investigates whether informing people that the vast majority of those in their area have already paid their tax can significantly boost payment rates.

The HMRC measured the effect (by comparison to a control group) of referencing the socially desirable behaviour (prompt payment of tax) of the 'honest, prompt majority' in tax demand letters. Referencing behaviour of the recipient's locality (rather than national standards) improved the return rate from the control level of 67.5% to 83%. The data presented at the recent meeting suggested that more than 80% of people thought it wrong to defraud an insurer. Stressing the desirable conduct of the majority may influence an insurance claimant to be honest.

Trial 6. Prompting honesty: examines whether simplifying key messages, emphasising the consequences of fraud and getting people to sign forms upfront results in more honest declarations.

The redesign of a letter for the claiming of 'Single Person's Discount' on council tax payments led to up to 6% reduction in claims for this benefit. Proposal and claims forms could do likewise. If insurers are not prepared to do this- for fear of 'scaring the horses'- then it ought to recognise that it is living with an 'acceptable' level of fraud. Supermarkets accept a level of shoplifting as inevitable, as the cost of further prevention outweighs the benefit gained.

Trial 8: Using beliefs about tax

This is an ongoing experiment into the effect of reminding business of commonly expressed personal and corporate views on tax and society. Most individuals and corporations state that they firmly believe in the prompt and accurate payment of tax, even if they fail to do so. This experiment tests whether reminding people of their beliefs at the time at which they are asked to pay changes their approach. Similar experiments could be used to affect the level of claims and application fraud.

Proposal: Involve Behavioural Insights Unit (and Others) in the Anti-Fraud Movement in Insurance

These proposals are targeted primarily at the mass, low value fraud (such as exaggeration of consumer claims) that is unlikely to be prosecuted, or caught by other proposals. Insurers have to bear the cost of designing claims and proposals forms. Future regulatory intervention is likely to revisit the provision of information to insureds at point of sale, point of contract and at claims. Assuming this cost is already included within current business models, then testing and developing anti-fraud measures could be done at modest cost. I recommend that the expertise already available at FCA and Cabinet Office level should be included in the battle against fraud, particularly opportunistic fraud.

This could be readily achieved with a focused one day conference. Internationally renowned experts are due to present at a conference on behavioural science in London in September 2015. This might provide an excellent opportunity to initiate a spin-off project on insurance fraud.