Losses Loom Large
by Chris Burand

A technician that makes eye glasses was explaining to me how he was being severely under-priced by a discounter. He was frustrated that “cut-price” eyeglass distributors were offering a much lower quality product and since customers did not understand the importance of the differences in the lenses, he was losing business. Having worn glasses for many years, I was curious about what he meant by differences in quality. He said, for example, the discounter sold children’s eye glasses for much less because the lenses were made of glass. He, however, refused to sell glass lenses to children. Plastic lenses, while more expensive, are much safer for kids because kids wrestle, rough house, and play sports. He said, “Just think about the horror of having a child blinded because their lenses were made of glass rather than much safer plastic!”

Many agencies buy the equivalent of glass lenses when they buy producer contracts. Many producer contracts are the result of a boilerplate contract the agency owner gave his or her attorney and the attorney, with a little tinkering, gave it back ready to use. This process saves significant legal fees. Unfortunately, many of these contracts lack proper protections which sometimes result in catastrophic failure, like glass lenses. The process though is so pervasive it perpetuates itself. The same poor contract gets passed around to one agency after another. I have seen many agencies lose tremendous value, lose customers, become unsaleable (literally), and/or become involved in very expensive law suits all because an agent’s attorney obliged the agent by providing a boilerplate contract for a small price, even though it was extremely inadequate. A few good attorneys have expressed their great frustration with their colleagues for going along with this practice. Just like glass lenses, these contracts work just fine until severely tested (but so does no contract).

Many insurance agents are similarly frustrated by other agents’ practices of not insuring buildings to value, mis-classifying risks, not offering the right coverage, and otherwise not providing the coverage the customer deserves. Yet these agents are doing to their customers the same thing so many agents do. They calculate what the customer wants to pay and work backwards to determine coverage. Agents do this even if for that price, the client does not get the coverage they need. If this is the way an agent prefers to work, perhaps it’s OK if the customer is adequately advised and prepared for the results. Unfortunately, as in the examples listed above, customers are not usually told about the implications of purchasing a lower priced policy.

These examples have something else in common. They are examples of professional services. Among professional services, an unwritten code exists stating that professional firms are not suppose to speak negatively about other professional firms. So how does the firm providing high quality service, albeit usually at a higher price, educate their clients and prospects about the benefits and the added safety of their higher priced service?

Use the psychology of the decision making process. Most people are “risk averse” toward gains and “risk seeking” toward losses (Kahneman and Tversky, 1979). In other words, losses loom larger than gains. We are often willing to gamble to prevent a loss but we are not willing to gamble to obtain a gain.

For example, most people will choose a 100% chance of gaining $8 rather than a 50/50 chance of gaining $20. Smaller, but certain gains are preferred over a gamble for a larger amount. Conversely, most people would choose a 50/50 chance of losing $20 over a sure loss of $8. A chance of avoiding a loss entirely is preferred over a sure loss of a smaller amount.

This behavior reveals itself in the examples above. In the eyeglasses example, people are more willing to risk the possibility of something going wrong with their glasses versus the certainty of paying a higher price up-front. When agents use a boilerplate contract, they gamble with the possibility that the contract may not be adequate for their needs over the certain loss of paying a higher price. When clients choose lower insurance protection, they are choosing to bear the risk that their coverage may be inadequate versus the certainty of paying a higher premium.

Risk adversity is a high barrier to overcome. The key is to reframe the way choices are presented. To present choices in a better light, we must understand more about how people interpret probability. People generally view the difference between 40% and 50% as trivial, while the difference between 90% and 100%, or 0% and 10%, as significant. As a result, sure gains are much more attractive and sure losses much more unattractive than highly probable gambles.

Another very important behavior is people treat very low and very high probabilities differently. Very low probabilities are given greater weight while very high probabilities are underweighted. This is why people play the lottery even though the chance of winning is minuscule and why the tiny likelihood of disease or disaster frightens people. The probabilities are low, but are still given great weight.

How can this information be used to package high quality services and products attractively? Consider some of the following possibilities:

- People are risk averse toward gains, so guarantee the benefits. Examples include plastic lenses will not shatter, stronger producer contracts will increase agency value, or all business assets will be properly covered.

- Make losses loom large. Place great emphasis on the risks of choosing a lower quality product or service. Also keep in mind, the way a message is phrased can have a huge impact on the visual image presented. For example, consider the following statement (remember this is only an example!): "A business has a 15% chance of going bankrupt if not properly insured." Compare that statement to: "15 out of 100 businesses go bankrupt when not properly insured." The second statement, though statistically the same as the first, creates a much stronger image of disaster if a business is not properly insured.

- Very low probabilities are given great weight, so even if the probability of the risks are low, emphasize their severity!

Not all customers will opt for higher quality services and products, but we can educate our prospects and clients about the genuine risks involved with a lower quality solution and provide true motivation for choosing a higher quality services and products.

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