

Annexe C

The Psychology of Consumer Credit Risk Management: The Case of Payment Protection Insurance in the UK

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EXECUTIVE SUMMARY

- 1 This report considers the findings of the consumer survey on payment protection insurance (PPI) commissioned by the OFT and conducted by GfK NOP in the summer of 2006. It begins with a discussion of the rational economic analysis of the decision to buy or not to buy a PPI policy, which prescribes that only if the expected financial benefits of PPI outweigh its cost should a consumer purchase the policy. It is argued that the very low claims ratio for PPI compared to other types of insurance suggests that many consumers are buying PPI when an economic analysis would recommend that they should not. In the next part of the report consumers' PPI decisions are examined from the perspective of psychology. It is proposed that consumers' decisions to purchase a costly PPI policy could be explained by several psychological factors. First, consumers may have a simplified conception of the cover PPI provides, in particular assuming that it covers more than it does. Second, their judgements of the probabilities of the insured events may be overestimated. Third, the financial losses associated with sickness or unemployment may loom large in consumers' minds relative to the costs of the policy. Fourth, the costs of PPI may be framed in terms of short time frames or low amounts that do not facilitate an assessment of the total cost of PPI. Fifth, consumers may use heuristics or simple decision rules to decide to buy PPI, without making relatively straightforward comparisons that would result in a better risk management solution. Finally, their decision may be driven more by worry than a rational appraisal of the options, and they may buy PPI in anticipation of the reduction of worry, or peace of mind, that it could bring. The final part of the report discusses some of the key findings of the consumer survey from the psychological perspective. Important issues for consumer education and the sales and regulatory environment of PPI are considered as well as how best to support the credit consumer and facilitate informed PPI decision making.
- 2 Evidence from the survey suggests that consumers construct a simplified representation of the insured events covered by PPI and assume that this simplified representation is sufficient to make an informed choice. From the point of view of the consumer advisor, however, the evidence suggests that the typical PPI purchaser's understanding of its cover is somewhat inadequate. It is important, therefore, that sellers give customers appropriate support, as the FSA's regulations require them to do. It is concluded that further steps may be needed to ensure that sellers comply with the FSA regulations on disclosure of information concerning cover.
- 3 The survey found that PPI purchasers often do not make their purchase on the basis of comparisons. A significant minority were under the impression that PPI was being sold as a package with their credit product and were unaware of its

cost, and sometimes even, unaware that it was an optional extra. This is despite the FSA rules that require clear disclosure of both the cost of PPI and the fact that it is optional. Furthermore, the majority of respondents did not make comparisons between the PPI product offered by the lender and alternative PPI products. It is concluded that PPI comparisons could be facilitated in several ways: (1) in order to enable consumers to compare the cost of credit with and without PPI, the cost of PPI needs to be given prominently and transparently early in the sales process, as is required under the FSA's rules; (2) information clarifying the separateness of the credit and PPI products should also be provided early; (3) the practice of recommending a PPI product for which the lender is sole supplier should be reviewed; (4) steps to increase consumers' awareness of alternative PPI products should be taken where this is possible, and comparisons of PPI products and their costs across different lenders could be facilitated.

- 4 The survey found that the cost of PPI was a major concern for both purchasers and rejectors, although more than half of the purchasers did not know how much a month they paid for their PPI policy. Some respondents were not informed of the cost of PPI separately, despite this being required by the FSA's rules. It is concluded that information concerning the cost of PPI could be improved as follows: (1) alternative APR cost measures for credit with and without PPI would facilitate the comparison of costs across alternative credit and PPI products, for example: *typical APR without protection 6.9 per cent, with protection 11.2 per cent*; (2) for fixed term credit, monthly repayments with and without PPI and the total cost of credit with and without PPI needs to be made available at the beginning of the sales transaction; (3) for store and credit cards, additional information reflecting the long term cost of PPI could be given, for example, *PPI at 76 p. per £100 per month; typical annual cost £75 for an outstanding balance of £1000 repaid at £50 per month*. This would counteract the effects of framing costs in terms of small amounts and short time spans.
- 5 In conclusion, the survey shows that the decision to purchase a PPI policy is not merely a financial decision, based on the cold calculation of costs and benefits in terms of money. Rather, many people worry about their credit commitments and purchase PPI in anticipation of the emotional benefits it can bring. The qualitative research accompanying the survey reported some of the ambivalence that people experience with credit. On the one hand, taking out a large credit commitment such as a mortgage, a loan for a car, or a credit card with a high credit limit, can bring considerable pleasure today. However, this can be spoiled to an extent by worry about whether future repayments can be maintained. When they are offered PPI many consumers anticipate that it will reduce their worries and give them peace of mind. The danger for the consumer is that the safety net their PPI policy offers can be smaller than they think. Unless the cost of PPI can be

reduced substantially, consumers may be better advised to develop alternative means of managing their credit risks and securing peace of mind, as many PPI rejectors seemed to have done successfully.

INTRODUCTION

- 6 The main aim of this report is to consider the findings of the consumer survey on payment protection insurance (PPI) commissioned by the OFT and conducted by GfK NOP in the summer of 2006 (see the GfK NOP main survey report). In the first part of the report the rational economic analysis of the decision to buy or not to buy a PPI policy is considered. In the second part this decision is examined from the perspective of psychology, considering in particular the bounded rationality framework of Herbert Simon (1957, 1990) and the role of emotion in risk protection (Peters & Slovic, 2000; Slovic *et al.*, 2004). The final part discusses some of the key findings of the consumer survey from the psychological perspective. Important issues for consumer education and the sales and regulatory environment of PPI are considered as well as how best to support the credit consumer and facilitate informed PPI decision making.

THE RATIONAL ECONOMIC PERSPECTIVE

- 7 In making personal financial decisions, such as taking credit and buying insurance, people want to be rational: that is, they want to make choices that are in their own best interests. According to expected utility (EU) theory (von Neumann and Morgenstern, 1947) people should buy insurance if that option has greater expected utility than does not buying insurance. In fact, there is much evidence that actual insurance behaviour does not follow this prescription (Kunreuther *et al.*, 1978; Kunreuther, 1996). Nevertheless, it is useful to consider what information consumers would need in order to make informed PPI decisions according to this rational economic theory.

INSURED EVENTS AND THEIR PROBABILITIES

- 8 A PPI policy offers financial benefits to compensate for certain unforeseen events that cause a loss of income and consequent difficulties in making credit repayments, should these events arise during the course of a loan repayment period. The events covered vary, but typically include death (life cover), accident, sickness or injury, and unemployment. While this seems straightforward, as with all insurance policies there are eligibility conditions and exclusions. For example, consider the main events insured by a PPI policy currently offered by a high street bank with their personal loans. The main cover is summarised below. This particular policy also gives a benefit in the event of writing off a vehicle, but as this is an unusual component of PPI it will not be considered further.

Life cover

- 9 A benefit is paid if you die. You must be between 18 and 70 years of age to be eligible for this cover, and a claim will not be met in the case of suicide within 12 months of the start date of the policy.

Accident, sickness or injury

- 10 A benefit is paid if you become unable to work as a result of accident, sickness or injury for at least 30 continuous days during the period covered by the policy. Further benefits are paid for each additional 30 continuous days up to a maximum of 60 periods. You must be between 18 and 65 years of age to be eligible for this cover, and in addition, you must be working for more than 16 hours a week. The main exclusions are for pre-existing or chronic medical conditions. Also, some illnesses are excluded unless supported by clear medical evidence (*e.g.* stress-related conditions or backache).

Unemployment

- 11 A benefit is paid if you become compulsorily unemployed and remain unemployed for 30 continuous days during the period covered by the policy. Further benefits are paid for additional periods of 30 continuous days up to a maximum of 12 periods. The same age eligibility conditions as for accident, sickness and injury apply, and the employment condition is again to be working for at least 16 hours per week (not permanently retired). In addition, you have to have been working for at least six months prior to becoming unemployed. There are other eligibility conditions for the self-employed, those who have to leave their job to become a carer and those who obtain temporary work after becoming unemployed. Also, there are several exclusions, such as knowing that you were going to be unemployed at the start of the policy, becoming unemployed during the first 30 days of the start date, and becoming unemployed as a result of misconduct.

- 12 The above example shows that in many ways the events insured by PPI are quite complex, and in fact the details of the policy reveal even more complexity. For example, benefits will not be paid if your employer is not a UK registered company. Clearly, a prerequisite for making a rational PPI decision is to properly understand the insured events, including any eligibility conditions and exclusions. After that, according to EU theory, the first aspect of insured events that needs to be considered is their probability of occurrence. However, it is difficult to acquire this knowledge, especially as the time dimension has to be taken into account. For life cover, for example, the basic question for a three year loan is: *What is the probability that you will die in the next three years?* It can be argued that the UK death statistics for a male or female of your age can provide the answer. However, the answer is not as straightforward for the other events insured by PPI, such as the question: *What is the probability, over the next three*

years, that you will suffer an accident, illness or injury that results in 30 continuous days off work? In this case national accident and illness statistics seem less relevant and it is reasonable to assume that the probability of this event is unknown. The rational model developed to deal with unknown probabilities is subjectively expected utility (SEU) theory (Savage, 1954), so named because it assumes that people's decisions should be based on their personally held beliefs about the probability of the event, *i.e.* their subjective probabilities, rather than the objective probabilities used in EU theory. Unfortunately, as we shall see later, people's perceptions of future hazards are influenced by many factors not related to their probability of occurrence.

FINANCIAL BENEFITS AND COSTS OF ACCEPTING OR REJECTING PPI

- 13 The second aspect that must be taken into account in making a rational PPI decision, according to both EU and SEU theory, is the subjective value, or utility of possible future financial outcomes. These can be represented as a decision tree in which the first branches are the two alternatives accept or reject PPI, and the second level branches are the possible outcomes that could follow those actions. Whether PPI is purchased or not, we can assume that the basic outcomes following the decision to take out a loan are either that an insured event occurs, or that another unforeseen event causing repayment difficulty occurs, or that no such events resulting in repayment difficulties occur. Consumers will receive a benefit if they accept PPI and an unforeseen event covered by the policy occurs. For example, consider the benefits and costs of PPI to cover a loan of £7,500 over three years from the high street bank discussed earlier. The monthly repayments with PPI are currently quoted at £259 with total cost £9,329 (5.9 per cent APR). The benefit of life cover under the PPI policy (summarised earlier) is the amount still to be repaid, up to the total cost of £9,329. Alternatively, the benefit after accident, sickness, injury or unemployment is a sum equal to the repayment due each month, in this case £259, amounting to £3,108 for repayment difficulties lasting a year. If PPI is not taken, obviously these benefits are not payable, but the loan costs less: £227 per month (rather than £259 including PPI premium and interest), or £8,172 in total (rather than £9,324). This is a typical policy for full PPI cover including unemployment benefit, and one of the main complaints of consumer advisors is that the costs of such policies are very high relative to the financial benefits that can be received.
- 14 To make a rational decision based on EU or SEU theory one must consider the subjective value, or utility, of all the possible financial positions that could result after accepting or not accepting PPI. As with probability judgements, the temporal dimension complicates such evaluations since the utility of future outcomes should be discounted in comparison with the same ones in the

present, and the number of monthly benefits that might be received is variable. What are the possible financial outcomes resulting from accepting PPI or not? The best outcome is to not purchase PPI and then not experience repayment difficulties. The worst outcome is to purchase PPI and then experience difficulties not covered by the policy. In the case of significant repayment difficulties covered by PPI, however, most people would judge that they would be better off buying it. For example, in the above example, a six months period off work through sickness without PPI results in £1,365 repayment difficulties, whereas this is avoided if PPI is taken out, at a total cost of £1152. Had the period off work only been three months, however, the better outcome would have followed rejecting PPI.

MAXIMISING THE UTILITY OF PPI: TO BUY OR NOT TO BUY?

- 15 The above discussion illustrates that considering the possible future outcomes of a PPI decision involves substantial mental effort: counterfactual thinking to imagine alternative scenarios and the evaluation of the associated financial costs and benefits. The basic choice dilemma is that you would be better off buying PPI if significant repayment difficulties covered by the policy did occur, but you would be better off not buying it if they do not. The EU and SEU solution to this dilemma is to take the option with the better expected, or subjectively expected, utility. For each choice alternative this is defined as the average of the utilities of each possible outcome that could occur after choosing that option, weighted by its probability (or subjective probability) of occurrence. This is rather a difficult calculation to make in the case of PPI, although it is technically feasible using the techniques of decision analysis (Edwards, 1992).
- 16 The rational economic analysis prescribes that only if the expected benefits of PPI outweigh its cost, as defined by EU theory, should a consumer purchase the policy. In their super-complaint on PPI, Citizens Advice complained that consumers pay an excessive price for PPI and in their initial response, the Office of Fair Trading (2005) discussed evidence supporting this complaint from claims ratios for PPI. The claims ratio, which is the ratio of the total benefits paid out to the total premiums received by an insurer, is very low for PPI in comparison to other types of insurance, around 15 to 20 per cent. This very low claims ratio indicates that overall many consumers are buying PPI when the economic analysis prescribes that they should not. In the next part of the report some of the psychological factors that could explain this are considered.

PSYCHOLOGICAL PERSPECTIVES

Bounded rationality

- 17 Herbert Simon (1957, 1990) first introduced the notion of *bounded rationality*. This takes account of the limited cognitive abilities of humans to carry out the calculations necessary (even if they could access the relevant information) to realistically assess the probabilities and evaluate the losses associated with the risks that they face. On this view consumers operate within a very much simplified mental model of their financial world. They also use *heuristics*, or simple procedures to make decisions. Simon himself expressed the idea as follows:

Because of the limits on their computing speeds and power, intelligent systems must use approximate methods to handle most tasks. Their rationality is bounded (Simon, 1990, p. 6).

There are several important implications of bounded rationality for consumers' PPI decisions. First, rather than think about all possible future outcomes following their decision, consumers will have in mind a simplified representation of the insured events and their consequences, neglecting to consider all the details specified in the policy document. Second, the consumer's judgements of the probabilities of the negative events that could cause repayment difficulties will be based on heuristics and subject to bias (Tversky & Kahneman, 1974). Furthermore, such judgements will not be precise, they will be rather coarse (Huber, 1997). Third, the consumer's evaluations of the financial losses caused by repayment difficulties and of the financial costs and benefits of PPI will be subject to framing effects (Kahneman & Tversky, 1979; Tversky & Kahneman, 1981). Finally, consumers will use simple decision rules or heuristics to decide whether or not to purchase PPI, rather than the elaborate maximisation procedure specified by the EU model.

BIASES IN PROBABILITY JUDGEMENTS

- 18 The rational model discussed earlier predicts that perceptions of the likelihood of future repayment difficulties will be related to preferences for taking PPI. However, people often underestimate the probability that negative events will happen to them in comparison to other people, a phenomenon known as the *optimism bias* (Weinstein & Klein, 1996). For example, Weinstein (1987) found that people generally believe they are less likely to be fired from their job than other people. Optimism bias is one factor that may underlie people's failure to protect themselves against risks or avoid risky situations. Weinstein and his colleagues found that previous experience of the negative event in question can

reduce the bias, which in general would lead to an increased take-up of insurance. We found evidence that this was the case in one of our studies of PPI decisions (Ranyard *et al.*, 2001).

- 19 While the number of previous experiences of an event is clearly relevant to its probability of occurrence, other research on risk perception has found that judgements of event probability can be substantially influenced by irrelevant factors such as how easy it is to recall or imagine the event, or its vividness (Tversky & Kahneman, 1974; Johnson *et al.*, 1993). Judgements, therefore, can be biased in either direction, either overestimation or underestimation of the probabilities of future problems. Another important factor is that the perception of a risk such as repayment difficulty can trigger negative emotional responses of varying intensity – dread, fear, anxiety or worry (Drotzz-Sjoberg & Sjoberg, 1990; Sjoberg, 1998; Slovic *et al.*, 2004). Such emotions may mediate the link between risk perception and risk protection behaviour such as taking insurance, an issue we will return to later.

FRAMING OUTCOMES: CREDIT REPAYMENTS AND INSURANCE COSTS

- 20 Prospect theory is perhaps the most influential theory of the psychology of decision making (Kahneman & Tversky, 1979). One of its important insights is that people tend to think about the future outcomes of their decisions in terms of gains and losses relative to a reference point (which can shift) rather than in terms of the final asset positions assumed by EU theory. Furthermore, Kahneman and Tversky showed that, as they put it, losses tend to loom larger than gains in people's minds. Often people use the *status quo* as the reference point for evaluating gains and losses, in which case receiving a loan would be perceived as a gain and a loan repayment would be seen as a loss. In addition, financial outcomes are evaluated relative to a time frame. Following the work of Thaler (1985, 1999) on mental accounting, we have proposed that consumers typically evaluate credit repayments within two alternative time frames (Ranyard & Craig, 1995; Ranyard *et al.*, 2006). First, each successive monthly repayment can be segregated from the others and considered as an item of expenditure within a *monthly budget period account*. Alternatively, repayments can be evaluated in terms of a *total account* within which all repayments are integrated, or added together, so that the total cost of the loan is evaluated. In our research we have shown that when consumers are presented with the total cost of a loan they tend to prefer shorter loans with lower total cost rather than longer loans with lower repayments (Ranyard *et al.*, 2006; Ranyard & McHugh, 2005).
- 21 PPI costs can also be framed in terms of monthly budget period and total accounts, and we have found, consistent with the above credit repayment preferences, that consumers given information on the total cost of credit with

and without PPI tend to prefer credit without PPI more than do consumers not presented with this information (Ranyard & McHugh, 2005). It is useful for consumers to consider credit and PPI from both perspectives. The total account is a useful frame of reference because, although a simplification of a credit arrangement, it summarises the long term consequences of taking a loan and PPI. Similarly, the monthly budget period account is also a useful frame of reference because it indicates the short-term stress on the monthly budget caused by a loan and PPI.

SIMPLE DECISION STRATEGIES AND HEURISTICS

- 22 The final important consideration from a bounded rationality perspective is how, in deciding whether to purchase PPI, people actually combine their judgements of risk probabilities and evaluations of possible financial losses and costs of insurance. Simon (1957) argued that the EU theory solution to such decision dilemmas is impractical and beyond the capacities of the typical adult's bounded rationality. Lipshitz *et al.* (2000) have observed that people often reduce the complexity of a decision problem by avoiding comparisons. For example, rather than shopping around for the best product, consumers consider the first option they come to, and match it to their goals and values to judge whether it is close enough to be acceptable. Only if it is not do they consider alternatives. Simon described such a decision process as *satisficing* (rather than the maximising process of EU theory). The limitations of such a decision process are rather obvious: it may result in a decision to accept a PPI policy when a better solution to the credit risk management problem may be just around the corner. A comparative decision procedure is much more likely to lead to good decisions, although it may require a little more effort (Payne, Bettman & Johnson, 1993).

Huber's model of risk management

- 23 Using evidence from scenario-based risky decision tasks, Oswald Huber (1997) has shown that people often use another general heuristic to manage the risks they face in everyday life that is quite straightforward, rather better than satisficing, and can be very effective. Huber's theory proposes that people construct relatively simple mental representations of decision problems in which the main question is whether the perceived probability of a negative outcome following a particular decision exceeds a risk detection threshold. If a risk is detected people then search for a suitable *risk-defusing operator* that can be applied to manage the risk. If this search is successful and if one of the risk defusing operators is judged to be effective then that decision is confirmed. Huber has identified several risk-defusing operators, including the following two:
- Precaution* – doing something at the time of decision which will compensate for the negative outcome if it occurs.

Worst-case plan – mental activity at the point of decision anticipating the negative outcome by drawing up a plan to be executed if it occurs.

For example, suppose someone is considering a particular credit arrangement but they detect a risk of future repayment difficulties. The obvious precaution they could take is the PPI policy on offer. However, there is a cost to this which has to be weighed against the benefit of defusing the risk. As an alternative to this a worst case plan could be devised as a means of managing the risk with no up-front costs. The choice for someone who detects a risk, then, is not between accepting PPI or not, but rather between PPI and an alternative risk defusing operator such as a worst case plan. These are compared and evaluated in terms of their costs and how effective they would be with respect to defusing the risk.

- 24 We found evidence supporting Huber's theory in a study of consumer's PPI decisions in a hypothetical scenario (Ranyard et al., 2001). In our study we used a conversation-based process tracing method that involved presenting participants with a minimal description of a credit decision problem in which they also had to decide whether to take out PPI to cover future repayment difficulties. We also elicited concurrent and retrospective verbal reports. Those made in the course of PPI decisions contained several examples of risk defusing operators, including taking PPI as a precaution and worst case plans. Some examples of the latter are shown below.

'Well, hopefully the car would be worth quite a bit, so I'd get rid of the car I'd take that chance.'

'No, I wouldn't do that ... 'Cos hopefully I would have somebody who would help me out there I think ... you know, say, a friend who would help me out with the repayments'.

'You pay a lot of money for it [PPI] and you probably wouldn't end up needing it and there'd be Possibly other ways around it if you couldn't keep up the repayments. You'd probably get a ... I don't know, a bank loan or something to cover it, so I don't think it's worth it'.

Other risk-defusing operators involved taking measures in advance of repayment difficulties, for example, alternative precautions to PPI, either shopping around for an alternative policy, or regularly saving the equivalent of the monthly premium as a buffer against future problems:

'... The cost is quite high, actually and you'd be better off putting the money in the bank every month rather than paying it for insurance'.

PPI DECISIONS AND BOUNDED RATIONALITY

- 25 In conclusion, rather than weighing the probabilities of negative events and the utilities of final asset positions in making PPI decisions, people simplify the

problem and use heuristics such as satisficing or selecting a risk defusing operator if a risk is detected. These are often effective means of making a good decision with limited cognitive capacities, although if non-comparative strategies such as satisficing are used, better ways of dealing with a risk may be overlooked. Consumer education and advice, and the PPI sales and regulatory environment need to be based on an understanding that people approach financial risk management in this way and need support in avoiding its pitfalls. For example, if consumers are concerned about the cost of PPI, they could be supported in developing robust and viable worst case plans, or other strategies for managing possible repayment difficulties.

The role of emotion in the consumer's credit and PPI decisions

- 26 People with significant credit commitments, the largest of which is usually a mortgage, differ widely in the extent to which they worry about them. In our recent study, most bank customers reported that they would worry about future repayment difficulties only a little if they took out a loan of £7,500 over three years, although some said they would worry a lot. Loewenstein *et al.* (2001) and others have developed the *risk as feeling* framework to understanding people's risk protection behaviour. They argue that taking protective action in the face of a risk depends on both the cognitive appraisal of the risk and emotional considerations. In the case of credit, this means that both the perception of the probability of repayment difficulties (cognitive appraisal), and worry or anxiety about them are relevant. In the above authors' review of the risk behaviour literature they found that quite often these two factors are strongly related: the more probable the negative outcome is perceived to be, the more people worry about it. However, Loewenstein *et al.* have also identified cases where cognitive appraisal and degree of emotion are not correlated and in these cases it is the emotional response that is more likely to determine whether people protect themselves against risk. This suggests that a modification to Huber's theory is necessary: *risk-defusing operators will be activated if a risk is detected which leads to feelings of worry or anxiety*. In our earlier study (Ranyard *et al.*, 2001) a minority of participants indicated that they perceived a risk of repayment difficulties but did not seem to worry about it and did not plan to defuse the risk in any way. In contrast, expressions of worry often accompanied taking PPI or developing other means of defusing the risk such as making a worst case plan.
- 27 A second aspect of emotion that is relevant to insurance decisions is the concept of peace of mind, much used in insurance sales. This relates more broadly to the role of *anticipated* emotions in decision making. That is, not currently experienced emotions, but cognitive appraisals of future emotions; expectations of how you will feel if you take a particular decision and a certain outcome occurs. Anticipated regret and anticipated disappointment have been

found to have significant influences on decisions involving risk (Loomes & Sugden, 1982; Zeelenberg *et al.*, 2000). For example, you might take out PPI partly because you anticipate that you would regret not having done so if you had a serious accident that kept you off work for a long time. Similarly, negative emotions such as dread, fear, anxiety and worry can also be anticipated prior to making a decision. Thus, when contemplating taking on a significant credit commitment you could anticipate that the possibility of future repayment difficulties would cause you some anxiety. All risk defusing actions have the emotional function of reducing such worries about the future. Therefore, people may often take out PPI because they anticipate that it will reduce their future worries, thereby giving them peace of mind. Clearly, this is a psychological benefit of insurance not included in a conventional economic analysis.

- 28 We found some evidence of the above factors in one of our recent studies of PPI decisions in hypothetical scenarios (Ranyard & McHugh, 2005). First, self-reported worry about repayment difficulties was predicted partly by how likely such difficulties were perceived to be. Second, whether PPI would give peace of mind was partly predicted by extent of worry about repayment difficulties. Finally, the extent that PPI would give peace of mind directly predicted intention to purchase PPI to some extent. In addition, the extent to which PPI was perceived as expensive partly predicted the decision *not* to purchase PPI. Thus, the emotional value of PPI and its financial cost combined to predict whether or not people would buy PPI.

Psychological factors influencing the decision to buy PPI

- 29 The debt problems of many UK households nowadays have been well-documented, recently by the *Task Force on Overindebtedness* (Directorate of Consumer Affairs, 2001). The psychological factors discussed earlier, relating to bounded rationality and emotion, apply as much to credit decisions as they do to PPI purchase decisions, and can partly explain why people undertake new credit commitments without taking steps to manage the risk of future credit repayment difficulties. From the point of view of the overall debt problem, purchasing PPI can be seen as a sensible risk management strategy. However, the economic analysis discussed earlier suggests that in purely financial terms PPI is currently not a good option for many people, and may increase their credit risk by adding a significant cost.
- 30 Consumers' decisions to purchase a costly PPI policy may at least partly be explained by the psychological factors discussed above. First, they may have a simplified conception of the cover PPI provides, in particular assuming that it covers more than it does. Second, their judgements of the probabilities of the insured events may be overestimated. Third, the financial losses associated with

sickness or unemployment may loom large relative to the costs of the policy. Fourth, the costs of PPI may be framed in terms of short time frames or low amounts that do not facilitate an assessment of the total cost of PPI. Fifth, they may use heuristics to decide to buy PPI without making relatively straightforward comparisons that would result in a better risk management solution. Finally, their decision may be driven more by worry than a rational appraisal of the options, and they may buy PPI in anticipation of the reduction of worry, or peace of mind, that it could bring.

THE OFT CONSUMER SURVEY OF PPI: COMMENTARY ON KEY FINDINGS

- 31 This part of the report considers the key findings of the survey, the quality of information available to consumers and how the information could be improved upon. It should be noted that the report's remit did not include looking at the broader competition issues affecting the market. The first section considers the consumer's understanding of the extent of cover, the second examines the way that the sales context inhibits the comparison of PPI with alternatives and the third discusses the way the cost of PPI is framed. The final two sections reflect on the emotional appeal of PPI and consider differences in PPI products for different forms of credit.

The consumer's understanding of PPI: The insured events

- 32 Most of the survey's respondents were selected because they had bought a PPI policy in the previous 12 months. Those who had (n = 981) were asked a number of questions about their knowledge and understanding of what their PPI policy covered. One series of questions asked how satisfied they were with their understanding of the extent of cover, the exclusions, the explanations the salesperson had given, and the contents of literature and leaflets. Between 30 and 40 percent were extremely or very satisfied and between 44 and 51 percent were fairly satisfied with their understanding of these aspects. Only five to ten per cent were dissatisfied while four to eight per cent did not know. Similar percentages were satisfied that the documentation was easy to understand. Thus, a very high proportion of respondents were satisfied with the information they were given about PPI cover at the time of purchase and were also satisfied with their understanding of it. Indeed, when asked to say what PPI did cover, most were able to identify the main events (death, sickness, accident and unemployment). However, when respondents were asked more specific questions it became clear that their knowledge was rather limited. First, only just over a quarter thought that their policy contained exclusions whereas in practice

all policies contain them. Moreover, only half of those who believed that their policy had exclusions could name one. Second, nearly two thirds of respondents did not know how long they would have to wait before they could make a claim on their PPI policy, which indicates a lack of knowledge of the initial exclusion period (usually 15 or 30 days) stipulated in all policies. Of course, it could be that policy holders knew about these things at the time of purchase but had forgotten by the time of the interview. Nevertheless, the findings suggest that the typical purchaser of PPI has only a basic understanding of what PPI covers rather than a detailed knowledge of the extent of cover, eligibility conditions and exclusions.

- 33 The above findings can be interpreted from the viewpoint of bounded rationality theory. As discussed in the introduction, PPI is a complex insurance product relating to multiple insured events each including a detailed list of eligibility conditions and exclusions. Consumer organisations have complained about the complexity of PPI. Unfortunately, however, complexity is an inevitable property of such insurance. Faced with this complexity, since their rationality is bounded consumers construct a simplified representation of the insured events covered by PPI and assume that this simplified representation is sufficient to make an informed choice. From the point of view of the consumer advisor, however, the evidence from the survey suggests that the typical PPI purchaser's understanding of the cover afforded by PPI is somewhat inadequate: for example, there is a danger that they may buy it when they are not eligible because their employment history is not sufficiently stable. Furthermore, consumers may overestimate the extent of cover because they are unaware of the important exclusions. In fact, the survey found that some PPI claimants were dissatisfied because their claims had been rejected on the grounds of exclusions, at least some of which they may not have been aware of at the time of purchase.

IMPROVING KNOWLEDGE OF COVER

- 34 What can be done to avoid problems arising from limited understanding of PPI cover? First, further steps could be taken to help consumers to understand the terms and conditions of their policy before committing to it, and to educate and persuade them to put some effort into this. Given the bounded rationality approach that consumers naturally adopt, however, which is to be satisfied with a rather basic understanding, it is likely that many will not heed such advice. Nevertheless, a clear understanding of PPI cover is a prerequisite for informed decision making and more could be done, for example, to point out common misunderstandings about PPI cover.

- 35 In view of the typical consumer's tendency to be satisfied with a rough and ready picture of PPI cover, it is likely that attempts to improve their understanding of cover may fail in many cases. Therefore, it is important that sellers give customers appropriate support. In fact, a number of aspects of the FSA's regulation already require sellers to do this. For example, the regulations require firms to take reasonable steps to check that the customer is eligible to claim under the policy before it is sold. Also, they must provide clear written summaries of PPI cover in plain English (key facts leaflets) and in addition, take customers through the key facts either face-to-face or over the 'phone. Finally, the FSA requires sales staff to be trained and competent to carry out compliant sales. Since this is the case, some of the problems identified in the report may be due to non-compliance. Consequently, further steps may be needed to ensure that sellers comply with the FSA regulations.

The context of PPI purchase

- 36 As discussed earlier, decision research has shown that the context in which decision alternatives are encountered can have a dramatic influence on how they are evaluated. One function of the sales context is to provide a frame of reference within which the evaluation of a product can take place. An important aspect of this is the way that related products are presented. A secondary product such as PPI can either be bundled with the primary product (in this case the credit on offer) or it can be identified as an optional extra. That is, the seller can either present the credit offer and PPI as a package: *That's £259 a month with protection*; or the PPI can be identified separately: *That's £227 a month credit repayments plus £32 a month for payment protection*. In some contexts, for example car sales, the bundling of extras is seen as an acceptable way of making a product more attractive: *The standard model includes stereo and sunroof*. The problem, however, is that the cost of the optional extra, whether it be a car stereo or PPI, can be hidden. In fact, the survey found that most PPI purchasers said that at the time of purchase they had been informed of the cost of PPI separately to their credit repayments, as is required under the FSA's rules. However, nearly one fifth said that either they were not given the cost separately or were not informed of the costs at all, which indicates that a substantial number of respondents may have been sold their credit and PPI as a package. Hsee et al. have found that people often evaluate options more favourably when they are presented singly (for example credit with PPI as a single option) rather than jointly (credit without PPI presented alongside credit with PPI). It is likely that at least some PPI purchasers who saw the credit and PPI option as a package would not have accepted it if they had been given the opportunity to make an informed comparison between these two basic options.

- 37 Even if PPI is identified separately the consumer may mentally bundle the two products and add the costs together. An important finding of the survey suggests one factor that could contribute to this tendency: respondents were not always aware that PPI is an entirely optional extra with no implications for the credit transaction itself. While only 4 per cent said that the sales person had hinted that taking PPI could help their loan application, about one fifth of PPI holders believed that it would. Clearly, consumers who link the credit and PPI in their minds in this way are not in a position to make an informed choice: if they wanted the credit they felt obliged to buy the PPI.
- 38 Finally, another way that the credit and PPI products can be seen as part of a whole package is in terms of where consumers believe they can buy a PPI policy. Except for certain policies mainly for mortgages, PPI can usually be purchased only from the credit provider, so in most cases the two products look to be firmly linked. Some respondents in the survey said they were aware that PPI could be bought from sources other than the lender, which was probably an incorrect belief for most of them. In general, consumers cannot shop around for different PPI products for a given credit option. The only way they can shop around or otherwise make comparisons between the PPI offered by the lender and that offered by competitors is by comparing two different credit and PPI bundles. If this packaging of credit and PPI is an intrinsic part of certain sectors of the credit market, consumers need to be advised to include a comparison of the PPI policies on offer in their credit comparisons. The findings from the survey suggest that most PPI purchasers did not do this.
- 39 In conclusion, the survey findings show that PPI purchasers often do not make their purchase on the basis of comparisons. The first problem revealed by the survey was that a significant minority were under the impression that PPI was being sold as a package with their credit product and were unaware of its cost, and sometimes even, unaware that it was an optional extra. This is despite the FSA rules that require clear disclosure of both the cost of PPI and the fact that it is optional. The second problem revealed by the survey was that the majority of respondents did not make comparisons between the PPI product offered by the lender and alternative PPI products. Unless consumers are able to make the above two basic kinds of comparison it is difficult to argue that they are making a fully informed decision.

FACILITATING PPI COMPARISONS

- 40 There are several ways that PPI comparisons could be facilitated. First, in order to enable consumers to compare the cost of credit with and without PPI, the cost of PPI needs to be given prominently and transparently early in the sales process, as is required under the FSA's rules. Also, in view of evidence that

some consumers believe that credit and PPI are closely linked, information clarifying their separateness should also be provided early. Second, the practice of recommending a PPI product for which the lender is sole supplier should be reviewed. Third, in order to facilitate comparisons between PPI products, steps to increase consumers' awareness of alternatives should be taken where this is possible. For example, sellers could be required to inform consumers of other PPI products where these exist. Where alternative products are not currently available, comparisons of PPI products and their costs across different lenders could be facilitated.

Framing the cost of PPI

- 41 An important aspect of the basic comparison between credit with and without PPI that was not covered by the survey was whether the cost of PPI is framed in terms of the monthly or the total cost. Previous research on insurance has found that the way the cost is framed is important (Johnson *et al.* 1993). Certainly, PPI sellers are aware of this, and often frame the cost in advertisements in terms of pence per day. One publicity leaflet uses the slogan: *Real Peace of Mind from 98 p. a day*. Similarly, the cost of PPI for credit cards is presented as, for example, 76 p. per £100 per month. Framing the cost in terms of pennies a day, or pennies per £100 per month, clearly frames PPI as a low cost item. Previous research has shown, however, that when people consider the long-term costs of expenditure they make different consumer decisions, perhaps ones more consistent with their long-term interests (Read & Powell, 2002). For example, as discussed earlier, our research showed that for hypothetical choices between credit with and without PPI, bank customers who were informed of the total cost as well as the monthly cost were significantly more likely to reject PPI compared to a group who were only presented with the monthly cost (Ranyard & McHugh, 2005).
- 42 The survey found that the cost of PPI was a major concern for both purchasers and rejectors. Two in five of the latter cited cost as a reason for not purchasing PPI, and half of the PPI purchasers agreed that it was expensive. Although most purchasers agreed that *PPI is value for money* (61 per cent) and disagreed with the statement *PPI isn't worth the money* (59 per cent) about a third of them took the opposite view. Paradoxically, more than half of the purchasers did not know how much a month they paid for their PPI policy. As with knowledge of PPI cover, it may be that they knew the cost at the time of purchase but had forgotten it at the time of interview. In fact it has been argued that people integrate regular outgoings into a monthly mental account in which the important feature is the overall monthly regular expenditure (Thaler, 1985, 1999). However, other findings of the survey suggest that it is not just a matter

of forgetting, since some respondents were not informed of the cost of PPI separately in the first place, despite this being required by the FSA's rules.

AVOIDING PROBLEMS DUE TO THE FRAMING OF PPI COSTS

Developing the APR measure of cost

43 In view of the survey findings on consumer's attitudes and knowledge of costs, and research on the framing of insurance premiums, it is important to consider the best way to inform consumers of the cost of credit and PPI. In the UK, consumer credit must be presented in terms of the legally defined true cost of credit, the Annual Percentage Rate (APR). In addition for fixed term credit, cost can be presented in terms of the monthly repayment amount or the total cost in pounds. For flexible credit, store and credit cards, it can be presented as a monthly percentage rate, or monthly amount of interest payable in pounds. Longer term cost information, however, is not routinely available for flexible credit.

44 Turning to the cost of PPI, this can be presented in same ways as for credit costs, except there is no equivalent to the APR measure that includes PPI costs. The survey and qualitative findings, as well as our own research (Ranyard *et al.*, 2006) show that most credit consumers shop around for credit and use the APR measure to make cost comparisons. However, they may then include PPI in their credit purchase, which is not reflected in the APR. It may be useful, if it is technically feasible, to present alternative APR cost measures for credit with and without PPI. This would facilitate the comparison of costs across alternative credit and PPI products, and of credit costs with and without PPI. For example: *typical APR without protection 6.9 per cent, with protection 11.2 per cent.*

Long term cost information: fixed-term credit

45 Our research has shown, consistent with the bounded rationality perspective, that people naturally frame credit costs in simplified ways in terms of both monthly repayment amount and total cost, in pounds. It is therefore important that for fixed term credit, in order to facilitate informed consumer decisions, any specific credit and PPI combination should be accompanied by monetary cost information as follows: monthly repayments with and without PPI; total cost of credit with and without PPI. Some of this information is already required by the FSA's rules, but the qualitative and quantitative findings of the consumer survey revealed cases where salespersons did not spontaneously volunteer monthly costs without PPI, or the total costs with or without PPI. Such practices clearly need to be eliminated and full disclosure of cost information needs to be made at the beginning of the transaction.

Long term cost information: credit and store cards

- 46 The issue of cost information for credit and store cards is rather more problematic. Credit and PPI cost is usually framed clearly, but in terms of small amounts and short time frames that give the illusion of a low cost product (e.g. monthly percent interest at 0.79 per cent; PPI at 76 p. per £100 balance per month). In addition, the actual cost in pounds that cardholders see is limited to the monthly amount of interest and PPI charged. One option would be to develop ways of presenting the long-term, cumulative costs of PPI in relation to actual outstanding balances. These are actually quite difficult to calculate precisely, but consider the example of a credit card holder with PPI at the typical cost mentioned above who has an outstanding balance of £1000 and wishes to repay £50 a month. The first month will include £7.60 in PPI costs and just a little more in interest charges, £7.90. This means that the PPI holder's first £50 will reduce his or her debt by less than £35 with more than £15 going in charges. If the cardholder borrows no more on the card and repays £50 monthly for 12 months the cost of PPI will have accumulated to more than £75, which could have otherwise gone to reduce the outstanding balance. By the time the debt is paid off at this rate of repayment, the total cost of PPI will have risen substantially.
- 47 In view of the above, it would be useful to present additional information reflecting the long term cost of PPI. That is, typical annual and total costs of PPI could be presented as in the above example: *PPI at 76 p. per £100 per month; typical annual cost £75 for an outstanding balance of £1000 repaid at £50 per month.* This should help consumers be better informed about the long term cost of PPI for credit and store cards, and the effects of framing costs in terms of small amounts and short time spans may be counteracted.

Worry, peace of mind and PPI

- 48 The survey found that many of those who had rejected PPI had done so because they did not expect to need it, often because they did not see the insured events as very probable. This is consistent with our earlier study of PPI in which we also found that many PPI rejectors did not worry unduly about possible future repayment difficulties since they did not perceive this, or events that could cause it such as ill health, to be very likely (Ranyard *et al.*, 2001). We found that some of them had controlled the risk of repayment difficulties, for example, by choosing a credit arrangement with a low monthly repayment relative to their income, or taking out a loan over a shorter time, within a relatively predictable time horizon. The survey also found that rejectors who may have perceived a risk of repayment difficulties had other ways of managing the risk, such as by using savings. This is consistent with Huber's theory which considers insurance to be just one of a range of procedures that consumers could adopt to defuse

the risk. As discussed earlier, we found that some PPI rejectors had developed worst case plans, such as selling their car in the event of illness, or long term plans, such as building up savings as a buffer to deal with financial crises. The adoption of alternative strategies such as these was often accompanied by an intuitive cost-benefit analysis of the PPI option and rejecting it on the grounds of cost. This is consistent with the present survey's finding that cost was the most frequent reason for rejecting PPI.

- 49 In contrast, the reasons given in the survey by those who had taken PPI in the last year indicated a significant degree of concern about problems of future repayments. Sometimes this was expressed generally, as a desire to 'protect the payments' (26 per cent of credit card holders), but a significant minority expressed more specific concerns, such as worry about payments if their circumstances changed or because their job wasn't as secure as it used to be (18 per cent and 8 per cent of mortgage holders). Furthermore, more than one in three purchasers saw PPI as a means of giving them peace of mind, thereby alleviating their credit worries and concerns for the future, while at the same time being able to enjoy the benefits here and now that their credit had brought them. As discussed earlier, the survey suggests that PPI was seen as expensive by most purchasers, but they also recognised its emotional benefits.
- 50 In conclusion, the survey shows that the decision to purchase a PPI policy is not merely a financial decision, based on the cold calculation of costs and benefits in terms of money. Rather, many people worry about their credit commitments and purchase PPI in anticipation of the emotional benefits it can bring. The qualitative research accompanying the survey reported some of the ambivalence that people experience with credit. On the one hand, taking out a large credit commitment such as a mortgage, a loan for a car, or a credit card with a high credit limit, can bring considerable pleasure today. However, this can be spoiled to an extent by worry about whether future repayments can be maintained. When they are offered PPI many consumers anticipate that it will reduce their worries, or to put it another way, give them peace of mind. This is not news to the lenders who sell this benefit of PPI very prominently. The danger for the consumer is that the safety net their PPI policy offers can be smaller than they think. As discussed earlier, the survey found that a proportion of the claims made by respondents to the survey were rejected on the grounds of exclusions. Unless the cost of PPI can be reduced substantially, consumers may be better advised to develop alternative means of managing their credit risks and securing peace of mind, as many PPI rejectors seemed to have done successfully.

Differences in PPI for different forms of credit

- 51 The survey identified some important differences in consumers' attitudes and experience of PPI for different forms of credit. This means that the kind of support that would be useful for PPI decisions is different for different products.

Mortgages

- 52 The survey found that MPPI was purchased for mortgages mainly via a broker or in face to face contact with the salesperson. Also, two in three had planned in advance to buy MPPI to cover their mortgage and a similar number were aware that it could be purchased from other providers. It seems, then, that opportunities to compare MPPI providers and credit with and without MPPI are greater than for other types of PPI. The main problem for consumers seems to be the cost of the policy which is likely to significantly contribute to repayment difficulties for some mortgage holders.

Store and credit cards

- 53 The survey found that about one in five of those who had bought PPI for a credit or store card were not working, and therefore may not have been able to benefit from accident, sickness or unemployment cover. There may be good reasons for their PPI purchase (e.g. they may have wanted life cover and may have been informed that they were not eligible for the accident, sickness and unemployment cover), but such sales could be in breach of the FSA's rules. In contrast to mortgage PPI, only one in three respondents had planned in advance to take out PPI with store cards, and one in two with credit cards. Also, some people said they had taken PPI because it came with the product (18 per cent store and 13 per cent credit cards). Although 86 per cent of respondents had bought their store card (and also their PPI) via a face-to-face channel, purchases of credit cards were quite evenly split between four main channels: face-to-face, 'phone, online and post. Another difference between store and credit cards was that many took the former either to obtain 0 per cent interest or a discount on goods. In the case of both credit and store cards, though, the picture that emerges from the survey is of unplanned purchases, without any shopping around, of a PPI policy that was tightly bundled with the primary product.
- 54 Another major problem with PPI for store and credit cards, as discussed earlier, is the way its cost is framed as a low cost per month per £100. As we saw, even at relatively low percentage rates, PPI can add significantly to the debt burden, and the survey found a lack of awareness of its cost. In view of these significant problems it could be argued that the detriment of store and credit card PPI to consumers substantially outweighs its value as a means of managing credit risk.

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