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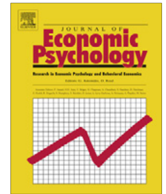

Defusing the risk of borrowing: The psychology of payment protection insurance decisions

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A R T I C L E   I N F O

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A B S T R A C T

Consumers can defuse the financial risks of credit default by taking payment protection insurance (PPI). In two studies, predictions derived from Huber's risk defusing operator theory of decision making were tested. We investigated the effects on PPI judgements and decisions of previous experience, cognitive appraisal, emotion and changes in PPI cost and level of cover. In Study 1, a randomized groups experiment, 241 high street bank customers were presented with scenarios in which they chose whether or not to purchase PPI. Logistic regression showed that previous experience, the anticipated worry reduction (peace of mind) afforded by PPI, and its perceived value for money, all had direct effects on PPI decisions. In addition, standard regression analysis found that: (1) PPI cost and level of cover significantly predicted the perceived value for money of PPI; and (2) the subjective probability of repayment difficulties predicted anticipated worry about repayment difficulties, which in turn predicted the anticipated worry reduction of PPI. In Study 2, a survey of 300 bank customers, the above direct and indirect effects on PPI decisions were further investigated by path modeling. The final path model was a good fit to the data and confirmed the main relationships described above. Thus, in addition to judgements of the value for money of PPI, worry concerning repayment difficulties, and its anticipated reduction, are strong determinants of consumer credit insurance decisions.

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1. Introduction

Some personal financial risks faced by consumers are rather complex. One of these, the risk of future difficulties in making credit repayments, can be managed by taking out payment protection insurance (PPI) which offers financial benefits to compensate for loss of income due to certain unforeseen events during the course of a loan repayment period, and consequent difficulties in making credit repayments. This paper aims to contribute to understanding the psychology of personal financial risk management, focussing on the case of UK credit consumers' PPI decisions. We report two studies that follow up an earlier process tracing study (Ranyard, Hinkley, & Williamson, 2001) which Kamleitner and Kirchler (2007) identified as the only previous empirical study of consumer credit risk management (see also, Gärling, Kirchler, Lewis, & van Raaij, 2009; Ranyard, 2006).

PPI policies offer different levels of cover, typical ones being a higher level we refer to as Premium cover, and a lower level we refer to as Basic cover. Table 1 shows the main events insured by typical Premium and Basic PPI policies at the time of Study 1, together with their typical costs and benefits. As shown, Basic cover was limited to 12 months for accident and sickness, to 3 months for hospitalization, and there was no redundancy cover. In the example shown,

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Table 1
The main events insured by, and benefits of, typical Premium and Basic PPI policies offered with UK high street bank loans at the time of Study 1.

Premium PPI*
(1) *Life cover*: if you are over 18 years and below 70 – the balance of your loan in the event of death would be paid in full
(2) *Accident and sickness cover*: if you are working, and over 18 and under 65 - after 30 days off work, repayments would be paid until you returned to work
(3) *Redundancy cover*: If you work more than 16 h a week, your repayments met whilst you are out of work
(4) Hospitalization cover: if you have retired from work or are over 65 and under 70, cover for periods of hospitalization up to 12 months (1/30th repayment covered for each day in hospital)

	Monthly repayment	Total cost
Cost of credit *(loan of £7500 for 36 months, APR 5.9%)*		
Without PPI	£227	£8172
With basic PPI*	£244	£8784
With premium PPI	£259	£9329

* Basic PPI cover was limited to 12 months for accident and sickness, to 3 months for hospitalization, and there was no redundancy cover.

the Premium PPI policy cost an additional 14% of monthly repayments and the Basic an additional 7%. It should be noted that one of the main complaints of UK consumer advisors recently has been that the costs of both levels of cover are very high relative to the financial benefits that can be received (Ashton & Hudson, 2009; Office of Fair Trading, 2005; Office of Fair Trading, 2006a; Office of Fair Trading, 2006b). One of the aims of the first study is to examine the influence on PPI decisions of changes in PPI cost and level of cover relative to the effects of other key psychological variables described below. The main aim of the two studies reported here, however, is to test predictions of direct and indirect effects on PPI decisions of cognitive appraisal, emotion and previous experience. These predictions, presented in the next section, are derived from Huber's (1997, 2007, 2012) risk defusing operator (RDO) theory of decision making with the addition of emotion-based variables.

2. Direct and indirect effects of variables on PPI decisions

2.1. Cognitive appraisal of risk and PPI Value for Money

Huber's (1997, 2007, 2012) theory of decisions involving risk and uncertainty proposes that people construct relatively simple mental representations of decision problems in which one of the main questions is the perceived possibility of a negative outcome following a particular decision, and whether the subjective probability of such a risk exceeds a detection threshold. Another relevant consideration is whether the amount of potential loss exceeds a threshold (Kunreuther & Pauly, 2005; Ranyard et al., 2001). If a risk is detected people then search for a suitable r*isk-defusing operator* (RDO) that can be applied to manage the risk. If this search is successful, and if one of the RDOs is judged to be effective, then that decision is confirmed. Huber has identified several types of RDO, including *planned, pre-outcome compensation*: doing something at the time of the decision which would compensate for the negative outcome if it occurred; and *worst-case plans*: mental activity at the point of decision anticipating the negative outcome by drawing up a plan to limit the effects of the loss if it occurs. A key difference between these two RDOs is that the former incurs a cost at the time of the decision whereas the latter does not (see Huber & Huber, 2003; Kirchler, Hoelzl, & Huber, 2010).

In the present context, suppose a consumer is considering a particular credit arrangement but they detect a risk of future repayment difficulties. The obvious RDO they could consider is the PPI policy on offer. However, PPI incurs a cost that has to be weighed against the benefit of defusing the risk. As an alternative, 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 RDO such as a worst-case plan. These are considered in terms of their costs and how effective they might be with respect to defusing the risk.

Previous research has found evidence supporting Huber's theory in studies of extended warranty and consumer's PPI decisions in hypothetical scenarios (Ranyard et al., 2001; Williamson, Ranyard, & Cuthbert, 2000). These studies 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 insurance. Concurrent and retrospective verbal reports were also elicited, and those made in the course of PPI decisions contained several examples of RDOs, including taking PPI and worst case plans.

In the present studies, we test the hypothesis that cognitive appraisal of both the risk of repayment difficulties and the quality and cost of an RDO are factors determining whether an RDO is adopted. We operationalize two key aspects of such cognitive appraisal: the subjective probability of future repayment difficulties (denoted Risk SP); and the perceived value for money of PPI (denoted PPI Value for Money).

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