

Non-life Insurance, E-commerce, and the Importance of Proper Risk Communication

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Purpose of this paper

I would like to report on current Japanese non-life insurance, E-commerce, and to study the characteristics of insurance purchase behavior from the viewpoint of strategic and sophisticated adoption of information technology (IT) and risk communication. Lastly, I would like to summarize the future challenge.

The current non-life insurance market situation in Japan

I think that recent drastic changes of Japanese insurance industry mainly owe to deregulation and IT development. Japan's current Insurance Business Law was adopted in May 1995 and came into force in April 1996. It permits life and non-life insurance companies to enter into each other's business through subsidiaries. In January 2001, the mutual entry into the "third sector" such as personal accident, sickness and nursing-care insurance, through their subsidiaries was allowed. Later, in July 2001 direct and mutual entry to the "third sector" was allowed.

Additionally, banks have been permitted to act as an agent in selling insurance to customers from 2001. However, at this point, only limited lines of insurance like long-term fire, long-term income indemnity, Credit Life, and Annuity can be sold through banks. Also, an amendment to the Law Concerning Non-Life Insurance Rating Organization has allowed the companies to set their

own premium rates from July 1998. Foreign insurance companies and the insurers formed by companies in other industries started to offer lower premium rates, specializing in automobile insurance. They use a direct marketing method, without using conventional Japanese insurance agency system. Furthermore, the government has liberalized the setting of commissions for non-life insurance agents. The above-mentioned factors have increased competition in the industry.

Information technology : The driving factors towards innovation

Deregulation enables insurers to take different marketing strategies based on their unique position, which they work out through 4P analysis namely, Price, Product, Place, and Promotion.

For example, domestic insurers provide wider coverage and distinguished services with the conventional agency system, large scale of claim service network, and 24-hours-a-day claim registry call center whereas foreign insurers usually provide a lower premium rate product to the targeting customers with the direct marketing method. This means that deregulation became a trigger for both intense competition and innovation.

The IT revolution has changed the insurer's business process and the way of communication with insurance agents and customers. Many insurance companies are now concentrating resources to information technology. They aim to strengthen knowledge management, improve value chain in process, and improve the customer services like an integrated call center with 24-hours-a-day, 365-days-a-year services.

The strategic area of IT investment is agency support system, cross selling of Life and Non-life, paperless and cashless process, etc. In order to build an efficient agency system, agencies' computer system and customer databases of insurance companies' computer system are

linked to each other. Such infrastructure is aimed to expedite scientific market analysis, and appropriate business decision-making.

Current situation of Japanese E-commerce

I would like to summarize the E-commerce situation in Japan as one of the examples which show the combination of IT application and marketing strategy.

<General>

The importance of E-commerce is growing increasingly. There seems to be a tremendous potential to improve customer service, reduce costs, enhance productivity, and expand markets.

Numerous challenges surfaced in various industries and the insurance sector is not an exception for such a trend. However, the E-commerce in Japan seems to be still in an experimental stage. Its development varies from industry to industry, depending on consumer purchase behavior which differs among goods and services.

<Non-life insurance industry>

A business model utilizing the Internet in the Non –life insurance industry must be more sophisticated to fit each customers' insurance purchase behavior. I think it needs more time to become familiar to people and to expand in the market, especially for the personal line business.

Internet use in the insurance business can be divided into two categories. One is the direct-sale type through the Internet, utilizing customer- center facility. This model is mainly conducted by foreign insurers in Japan. The other is the "click and mortar type" sales, utilizing an existing agency network which most domestic insurers adopted. Internet use in the Japanese

non-life insurance market began in 1999. Therefore it is just in the initial stage, where each company is struggling to find out the successful business model.

<Expand the device>

Recently the financial institutions can use the portal site on BS (Broadcasting Satellite) TV and or CS (Communication Satellite) TV, which have the two-way communication function with potential customers. However, the users of these TV systems seem not to be the same as Internet users. Insurers have the occasion to access potential customers who are frequent TV viewers but who do not use the Internet so much (for example household and/or elderly people).

The point I want to make is that frequent TV viewers' behavior tends to be rather passive, whereas that of Internet users is proactive. This is because Internet users tend to have clear intention to search and purchase particular goods or services when hooking on the net.

E-commerce penetration in Japanese B to C insurance market

Wharton on Dynamic competitive strategy (1997, pp. 99-101) warned as follows:

"Technology-driven environmental shifts are one of the most powerful forces changing the nature of competitive advantage.changes in technology and regulation have enabled new pricing structures and new distribution channels. These changes create significant opportunities for new entrants, who apply IT and database marketing to attract the most profitable segments away from the incumbent."

With 75 percent of households in Hong Kong holding accounts at Hong Kong Shanghai Bank Corp. (HSBC), it is difficult to imagine a bank with broader marketplace presence, or with

more apparent marketplace dominance. But beneath this dominance is a strategic vulnerability that is shared with many dominant firms; Citibank has not attempted a frontal assault on all segments of HSBC's broad market share. It has, instead, gone straight for the "love'em" segment, developing distribution channels and pricing strategies for its products and services that are attractive primarily to the most profitable Hong Kong customer segments.

The newly-contested consumer banking market in Hong Kong has opened up an avenue for opportunistic cream skimming by Citibank, which is now HSBC's most dangerous and profitable rival.

Deregulation of the Japanese insurance market enabled some players to make a similar approach like in the Hong Kong banking market. Based on statistical data of direct marketing insurers' market share, it is recognized that the penetration of the new marketing methodology is different from country to country, which is indicated in the table below. However, direct marketing is yet to be cultivated enough in Japan. Unfortunately, there is no internationally-standardized definition of direct marketing or E-commerce in the insurance industry internationally and also there is no official segmented data for E-commerce available.

Therefore, just to look at a trend for the Japanese market, I try to presume the market share of foreign companies who mainly adopt direct marketing; it seems to be around 1.2%, in the area of voluntary automobile insurance and when we add the volume of the direct insurers entered from other industries, this figure reaches around 2.3% as a total.

Table 1: Direct marketing share

| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|------|------|------|------|-----------|-----------|-----------|
| England(Non-Life Personal) | 19% | 20% | 20% | 21% | 25% | 22% | 27% |
| Germany(Non-Life) | | | | | 1.32 % | 1.39 % | 1.59 % |
| France(Non-Life) | | | 3% | 3% | 3% | 3% | 3% |
| Italy(Non-Life) | | | | 4.7% | 3.8% | 4.7% | 4.8% |
| U.S.(Direct response companies Non-Life Personal Line) | 7.1% | 7.0% | 7.1% | 7.3% | 7.9% | 8.5% | 8.4% |
| Japan(Foreign insurers Auto) | | | | | 0.8% | 1% | 1.2% |

(Resources : These figures based on local market statistics with some assumption)

Risk communication and human risk sense

Insurance seems to be different from other financial sectors like banking or securities. First, an insurance transaction is usually a once-a-year renewal, as in the case of property and casualty insurance.

An insurance claim does not happen frequently like a security trade or bank transaction. Secondly from the era of Adam Smith insurance is not purchased with consumer's positive consciousness unlike fashion goods. In addition, its importance tends to be underestimated due to low probability of claim occurrence.

As insurance is a risk solution tool for people, an insurance purchase is closely related to their risk decision. However, risks are vague and ambiguous and hard to identify whether they are immediate or distant. Therefore, risks are easily ignored, even though people may be disposed to tremendous risks that endanger their life and welfare.

Also I would emphasize that being entirely logical about all the risky decisions in our life is very difficult. Empirical studies in the field of risk psychology indicate that there are many obstacles to rational decision-making about risks which are deeply rooted in human psychology.

Simple survey with the Urn game

The use of the Urn game was intended for surveying how insurance demands were stimulated depending on the combinations of loss probability and magnitude (all combinations were designated the same expected loss).

Subjects were told that each game consisted of drawing one ball each from a set of urns; each urn contained a different mixture of red and blue balls. Drawing a blue ball incurred a loss, unless the subject had purchased insurance at some fixed premium. The cost of the premium was set at one point for each urn and the loss (L) and probability of loss, $P(L)$, were adjusted so that the expected loss $[P(L)/L]$ from drawing one ball from the urn was also one point.

Hayakawa, Hamano, and myself did research on Japanese insurance purchase by using the Urn game. The 302 subjects (121 men and 181 women) were the consumer monitors of Mitsui Sumitomo Insurance Co., Ltd.

It was asked if people would like to buy insurance in the different situation with a various combination of loss probability and magnitude under the same expected loss (in this case an insurance premium is equal to the expected loss). We modified the game to be more realistic with consideration of the actual insurance-purchasing situation as follows:

? The unit of loss magnitude and insurance premium was changed from the point to the Japanese yen.

? An annual insurance premium was set up in 70,000 yen. It is almost equal to the average insurance premium of the standard consumer automobile insurance contract in Japan.

The actual questionnaire is attached in Appendix A.

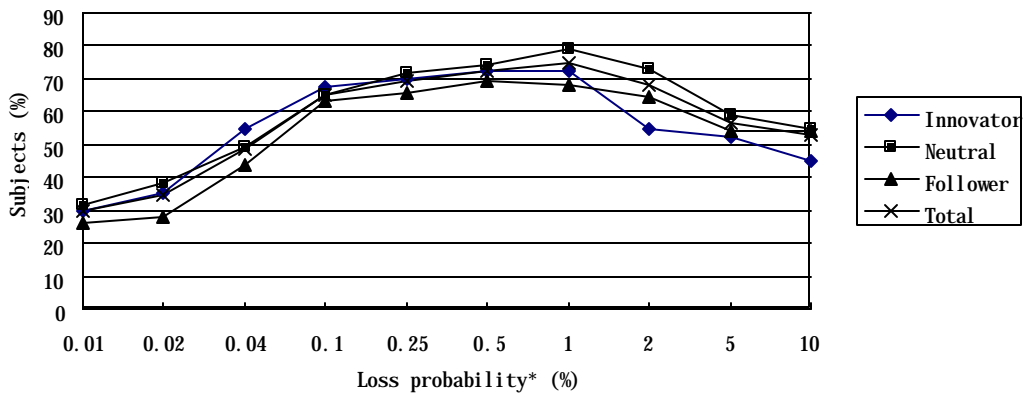
In order to analyze the data from a psychometric point of view, we added questions on the coin toss

game for checking the degree of risk averse and questions for checking the degrees of innovativeness and pessimism/optimism. Its questionnaire is attached in Appendix B.

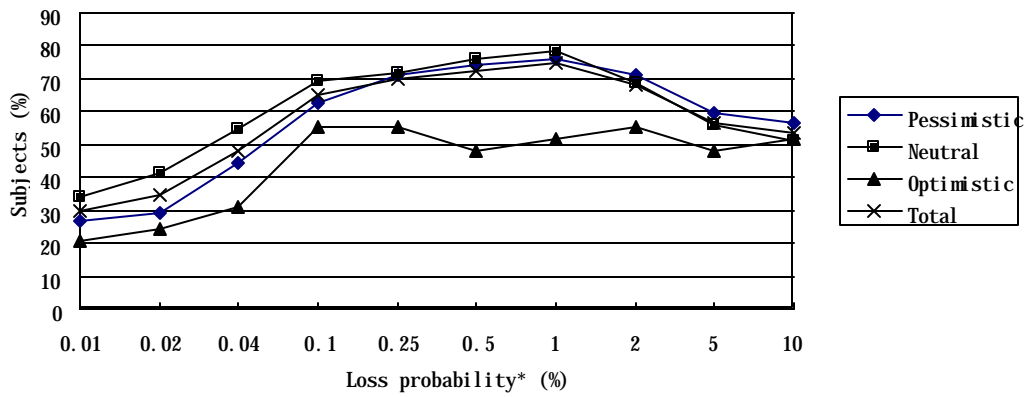
The observation is as follows:

The demographic elements seemed not to have influence on decision-making patterns for buying insurance, instead psychometric characters would have significant impacts on decision-making. More specifically, the degree of pessimism or optimism had influence on insurance purchase behaviors. The subjects with optimistic answers tended to answer not to buy insurance in any cases and characters on the degree of risk averseness based on the coin toss test would not have significant impacts for insurance purchase behaviors.

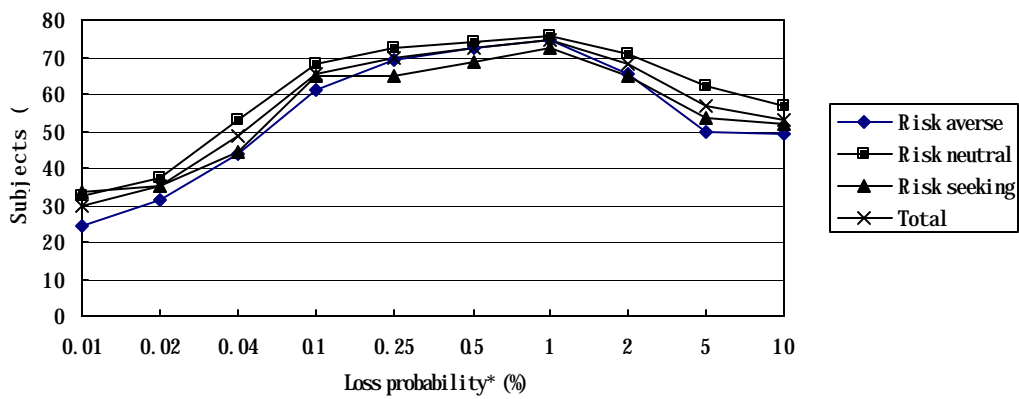
Although we usually use the coin toss test, or recognition for the gambling, to examine subjects' risk averseness, our results might show that it would not be appropriate for insurance purchase situations. Since we presume that the subjects usually did not expect a case of gaining something, when they buy insurance, characterizing subjects' insurance purchase behaviors could be equivalent to testing subjects' utility curve of negative side, not a test for examining its positive side like coin toss test. This seems to endorse the Prospect Theory, which said human's utility curve has different shapes on positive and negative sides. The result is summarized in the following graphs.



(1) Innovator/follower scale ($N = 295$)



(2) Pessimistic/optimistic scale ($N = 296$)



(3) Risk averse/seeking scale ($N = 297$)

Patterns of decision-making

There are particular patterns in our decision making behavior that appear again and again -- habits of mind that interfere with our ability to make rational risk decisions.

Many of the psychological biases are described in the work of Tversky and Kahneman, like overconfidence, optimism, hindsight, pattern seeking, overcompensation, myopia, inertia, complacency and zealotry. In *The Book of Risk* (2001, pp.85-99) Dan Borge illustrates these affections properly so I would like to quote as follows:

? Overconfidence, optimism

We are more likely to underestimate the risks. Nearly all of us believe we are better-than-average drivers but only half of us really are.

? Hindsight, Pattern seeking

Most people are very reluctant to believe that a sequence of events is random or unexplainable. We prefer order to chaos and are comforted by predictable cause-and-effect explanation. We try to find patterns, even when they are not there, that sometimes mislead to the wrong analysis.

? Overcompensation

Our success in reducing one type of risk tempts us into behavior of taking too much of other types of risk. For example, suppose you buy a car that's equipped with antilock brakes. Your higher confidence in the safety of your car could cause you to drive faster when the roads are slippery.

? Myopia

One form of myopia is to look only to the recent past for clues about the future. Suppose you are deciding whether to buy a house in a beautiful river valley. You look around you and see no signs of flooding. If you had looked further back in time before making your decision, you might have discovered that though the river has not flooded in twenty years, it has flooded five times in the last century.

? Inertia

More often, we feel safer by doing nothing than by doing something. Like deer

frozen in the headlights, we fail to act in time.

? Complacency

Complacency causes us to be unduly comfortable with familiar risks. Driving is such a frequent, familiar activity that we rarely think about its dangers.

? Zealotry

Zealotry may not be a distinct category because it may involve overconfidence, inertia, complacency, and overcompensation, but it is so extreme and disturbingly common.

Statistical thinking

The nature of the risk might be hard to identify and quantify. When information is lacking, logical analysis seems so hard therefore you are tempted to just rely on instinct, habit, or rules of thumb which are based on a past experience. Humans have stored up some useful knowledge and experience and developed instinctive responses to danger.

Instinctive responses work well in situations that resemble the environment in which they were developed.

When the stakes are low, people often trust his or her instincts facing up to the uncertain situation. When they are in the serious situation they try to gather evidence, consult experts, and analyze the situation on logically. Rational risk decision based on statistical thinking is like decision on the basis of ten tosses of the coin instead of a hundred.

We always make a " selection and concentration " decision under the limited resources during every day life. According to the degree of the impact caused by risk, we should treat it carefully,

we try to evaluate it with statistical thinking or rational decision rather than instinctive response.

For statistical thinking on risk, probability is helpful. In such cases, Gigerenzer (2002), in *Reckoning with Risk*, warns that the failure to communicate risk in an understandable way and urge medical, legal, and other associations to subscribe to an ethical policy that demands reporting risks in clear terms such as absolute risks and natural frequencies, rather than in ways that are more likely to confuse people.

Then he illustrates the difficulty of risk communication in regards to ambiguity about the interpretation of statistics, as follows:

Statements about the probabilities of single events--such as "you have a 30 to 50 percent chance of developing a problem" -- are fertile ground for miscommunication. This is because a reference class is not specified.

There are three major forms of risk communication that invite miscommunication: the use of single-event probabilities, relative risks, and conditional probabilities. He takes an example like common arguments of "planes are safer than cars," yet these arguments do not change their behavior--because of habit, fear of flying, or love of driving. However, he said knowing the actual risk allows individuals to make up their own minds, to weigh the risk against the individual benefits of driving, and to arrive at an informed decision.

What is the chance of one's dying in a motor vehicle accident over the course of a lifetime? It does not take much time to figure this out. In an average year, 40,000 to 45,000 people die on the roads in the United States. Given that the country has about 280 million inhabitants, this means that

about 1 in 7,000 of them is killed on the road each year. We can also figure out the chance of dying on the road during one's life. Given a life span of 75 years, the result is roughly 1 in 90. That is, 1 out of every 90 Americans will lose his or her life in a motor vehicle accident by the age of 75.

Finally he indicates the solution of overcoming innumeracy as follows:

The first step is to defeat the illusion of certainty. The second step is to learn about the actual risks of relevant events and actions. The third step is to communicate the risks in an understandable way and to draw inferences without falling prey to clouded thinking.

Risk management and insurance

The essence of risk management lies in maximizing the areas where we have some control over the outcome while minimizing the areas where we have absolutely no control over the outcome and the linkage between effect and cause is hidden from us.

Even when a risk management model fails to be realistic enough to give answers that can be trusted on their own, the process of trying to construct the model often helps you make better judgments and therefore better decisions.

For example in the process of the decision tree drill, you may identify decision alternatives and uncertain events that you might have otherwise overlooked, which may sometimes change your decision.

It is sometimes hard to find a cause where there seems to be none, but he also warns against the tendency to assign a particular cause to an outcome when in fact only the laws of probability are at work.

We can assemble big pieces of information, but we can never get all the pieces together. If we could insure against every future possibility, then people would be more willing to engage in

risk-taking, without which economic progress is impossible.

In reality, insurance is available only when the Law of Large Numbers is observed. The law requires that the risks insured must be both large in number and independent of one another. The number of risks that can be insured against is far smaller than the number of risks we take in the course of a lifetime.

The premium we pay the insurance company is only one of many certain costs we incur in order to avoid the possibility of a larger, uncertain loss, and we go to great lengths to protect ourselves from the consequences of being wrong.

Characteristics of Japanese insurance purchase behavior

Hayakawa, Fischbeck, and Fishhoff conducted open and semi-open questions to Japanese subjects intended to elicit subjects' mental models of their insurance decisions important to have automobile insurance.

He compared its reasons with the result of the same kind of question conducted in the U.S. The differences of the two countries were summarized in the table below (see next page).

Table 2 : Reasons why it is important to have automobile insurance

| Reason | Percent who mentioned | | |
|--|-----------------------|--------------|-----------------------------------|
| | Japan (N=42) | US (N=72) | Significance Test ^a |
| Concern with liability | | | |
| Protect from lawsuits | 0 | 35 | * |
| Cover injuries to others | 40 | 24 | NS |
| Cover property damage to others | 2 | 14 | NS |
| Cover unspecified damage to others | 0 | 6 | NS |
| Coverage for damage to self | | | |
| Cover damage to own vehicle | 0 | 31 | * |
| Cover medical costs for self | 0 | 19 | * |
| Protect from uninsured motorists | 0 | 7 | NS |
| Cover unspecified damage to self | 0 | 8 | NS |
| Others | | | |
| Required by law | 0 | 29 | * |
| Concern with unspecified financial burdens | 40 | 8 | * |
| Unspecified concern with assets | 2 | 4 | NS |
| Reduces worry/stress | 64 | 1 | * |
| Responsibility of drivers | 17 | NA | NA |
| Fault can happen any time | 19 | NA | NA |
| Accident experience | 10 | NA | NA |
| Other | 7 | 8 | NS |

a. Two-tailed pooled-proportions test, for each reason category,
 *= $p < .0031 (= .05/16)$; NS=not significant; NA=not available.

< IT application to the Business model >

IT is a tool: what matters to a firm is how that tool is used. The companies should take the time to understand the context of the industry in which they operate, namely to understand how the Internet as a channel can serve the industry. The companies build Websites that aggregate buyers and sellers to help facilitate both the decision-making process and the subsequent delivery of products or services. They also understand the features and specifications a customer would typically evaluate to make a purchase decision. In addition, the company understands what type of value proposition (ex. operational excellence, customer intimacy, or product leadership) is

regarded as their core competence or competitive edge. These essential factors should be built into the value chain in process.

As a new technology will introduce the different factors to the legacy business process, we should check and adjust the whole process from the viewpoints of legal compliance and process efficiency.

Successful firms have an articulated, conscious strategic link between technology and market objectives based on technology, people, and organization. This means technology and personnel practices must be closely integrated.

The IT system should accommodate the existing organization, practices and routines. Developing the company-specific sets of rules and routines would contribute to their advantages.

The IT system is a catalyst for a codification of tacit knowledge. Tacit knowledge retains in each staff's brain, his or her skill, and know-how etc. IT enables us to share an individual tacit knowledge as an organization in the process of knowledge management; externalization, combination of tacit and explicit knowledge which yield lasting competitive advantages.

“Click and mortar communication” reflecting an insurance purchase behavior

Usually it is believed that net transaction is simple and convenient, because people find the goods as soon as possible by hooking on the net at any time and anywhere through handy PC, PDA, or cellular phone. It is convenient for the people who already have a clear idea of the goods to search for. However, for the people who don't have clear needs, the process of collecting the information is not always an easy task and people sometimes step into a sea of information and eventually get lost on net.

Also what we should bear in mind is that human risk sense depends on one's

personal value and experience. Therefore, one's risk management plan varies among each, depending on his or her purpose, situation, and or timing of the transaction. It is very difficult to prepare all the materials leading to the suitable risk solution for each person only through Net. Its solution is how we can provide human touch factors into the communication both in virtual and real stage.

Future challenge

<Development of a Comfortable Environment>

The comfortable transaction environment should be developed further for net users. For example, the development of a feasible payment system is important. Its payment system should be balancing both the aspect of security and utility, because these are in trade-off relations. Also, appropriate personal data protection policy should be ruled.

<Requirement of Underwriting and Compliance >

For insurance transactions, the underwriting process is necessary, where customers are required to provide fairly enough information to the insurer. Also from the viewpoint of consumer protection, we are required to give proper counsel to consumers about product by law.(Law on Sales of Financial Products and Consumer Contract Law) However, I have to say that insurance transactions are still rather complicated to many consumers.

These factors would increase transaction time which would force customer's tolerance. In order to achieve comprehensive customer satisfaction, psychological factors should be reflected in the marketing.

<Beyond culture for new technological marketplace>

Globalization makes the business model more or less standardized over the world. But at the same time satisfaction, convenience and trust of consumers more or less depends on their culture's basic values and experience. When we construct e-commerce business models especially in the field of the invisible services like insurance, we should pay more attention to the individual mental factor and cultural values. We should "think globally, act locally" following insurance purchase behavior.

Beyond Culture, written by the famous anthropologist Edward Hall in 1976, still has valuable insight. That is "Despite our faith in technology and our reliance on technological solution, there are no technical solutions to most of the problems confronting human beings." I think his concept of "high context" would be useful for E-commerce as well. If we use his phrase, we can say that "we should share the high context with customers' purchase behavior like the couple that has been married for thirty-five years".

Of course today we don't need as long as thirty-five years. Information Technology would help us to shorten this time very much and to form high context quickly.

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Appendix A

Accident and Insurance

You will be presented with series of choices between accepting a risk (accident) or buying insurance. If you buy the insurance then you are not responsible for the losses associated with the accident. Insurance is not compulsory. For each scenario, please indicate whether you would accept the risk or buy insurance.

| No. | | <u>Accident?</u> | | <u>Annual premium</u> | <u>Would you buy?</u> |
|-----|-------------------|------------------|-----------|-----------------------|-----------------------|
| | | <u>Yes</u> | <u>No</u> | | |
| 1 | Probability | 0.0001 | 0.9999 | \70,000 | <u>Yes or No</u> |
| | Magnitude of loss | \70billion | \$0 | | |
| 2 | Probability | 0.0002 | 0.9998 | \70,000 | <u>Yes or No</u> |
| | Magnitude of loss | \35billion | \$0 | | |
| 3 | Probability | 0.0004 | 0.9996 | \70,000 | <u>Yes or No</u> |
| | Magnitude of loss | \17.5billion | \$0 | | |
| 4 | Probability | 0.001 | 0.999 | \70,000 | <u>Yes or No</u> |
| | Magnitude of loss | \7billion | \$0 | | |
| 5 | Probability | 0.0025 | 0.9975 | \70,000 | <u>Yes or No</u> |
| | Magnitude of loss | \28million | \$0 | | |
| 6 | Probability | 0.005 | 0.995 | \70,000 | <u>Yes or No</u> |
| | Magnitude of loss | \14million | \$0 | | |
| 7 | Probability | 0.01 | 0.99 | \70,000 | <u>Yes or No</u> |
| | Magnitude of loss | \7million | \$0 | | |
| 8 | Probability | 0.02 | 0.98 | \70,000 | <u>Yes or No</u> |
| | Magnitude of loss | \3.5million | \$0 | | |
| 9 | Probability | 0.05 | 0.95 | \70,000 | <u>Yes or No</u> |
| | Magnitude of loss | \1.4million | \$0 | | |
| 10 | Probability | 0.1 | 0.9 | \70,000 | <u>Yes or No</u> |
| | Magnitude of loss | \0.7million | \$0 | | |

Your age? _____

Gender? F / M

Family? Single, Married no children, Married with children

Appendix B

Please pick up one of the following options for each question.

Q1) You are..

1. A person who would buy a new product immediately after watching advertisement on TV.
2. A person who would buy a new product after you listen to opinions and/or experiences provided by your acquaintances

Q2) When you find a new item on a menu in a restaurant, you would..

1. Order an item that you have had even though you know you can order the new item.
2. Order the new item that you have never had before.

Q3) Suppose it has been cloudy today and you have not watched a weather forecast for today. Would you have an umbrella when you go out.

1. Yes
2. No

Q4) Suppose you are using the last roll of toilet tissues. You would...

1. Not be worry because you have extra rolls in your stocks because you always buy them so that you can stock them.
2. Have to go buy them because you do not have extras. You always buy them after all the rolls have gone.