

Quantifying Search and Switching Costs in the U.S. Auto Insurance Industry

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Abstract

Consumers making purchases in service categories such as insurance potentially face search and switching costs. On the one hand, incomplete information about the various alternatives necessitates search behavior which could lead to consumers switching from the current provider to a different provider. On the other hand, brand loyalty, the prospect of dealing with a new provider, and other psychological factors result in switching costs that introduce frictions in the market. Both search and switching have been studied in the empirical literature albeit separately. In this paper, our objective is to distinguish empirically between search and switching costs in the context of consumers' choices in the U.S. auto insurance industry. Our data contain information on respondents' search behavior in terms of their consideration set of insurance providers; the corresponding premia for those providers; the actual provider chosen; the identity of the previous insurer and the demographic and psychographic characteristics of the consumers and their policies. The unique aspects of this information enable us to identify separately both search and switching costs. To quantify the magnitudes of these costs, we develop an integrated utility-maximizing model of consumers' decisions of how many companies to search; the identities of these companies and from which company to purchase. Our modeling approach rationalizes the observed consideration set as being the outcome of a search process by a consumer. Using this approach we learn about the levels of search and switching costs, and their relative magnitudes. Taking our model to the data, we find that there are substantial search and switching costs in the U.S. auto insurance industry. The cost of collecting a price quote through an online channel are about \$45, the cost of collecting a price quote offline

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vary from \$70 to \$110. The average switching costs a consumer incurs are about \$85. We find consumer search costs and customer satisfaction to be the two main drivers of the high retention rate observed in the U.S. auto insurance industry. To support managers in their decision making about investments in measures to increase customer satisfaction, we calculate additional profits resulting from a maximization of customer satisfaction. And finally, we study whether insurance companies should increase or decrease insurance premia to new and existing customers. We find insurance companies lose money by offering discounts to new customers and increase their profits by increasing premia to existing customers. Our results are consistent with the “invest-harvest” strategy found in the switching cost literature.