THE UNIVERSITY OF MELBOURNE

MELBOURNE INSTITUTE

60 YEARS IMPACT

Research Insights

Household insurance and financial stress: Securing the family home in a changing climate

Financial stress is on the rise, and so are insurance premiums. As Australians struggle to cope with the rising cost of living, are they cutting their insurance coverage to shore up household finances?

No. 08/23

October 2023

What are the drivers of underinsurance?

Underinsurance poses an urgent threat to Australian households. As climate change gives rise to more frequent and more damaging weather-related events, households face growing risks to their most important asset—their home. But the forces that drive greater risk to homes also drive up insurance premiums. With home insurance costs rising by almost 300% between 2008 and 2022 compared to 55% for car insurance, households are experiencing new affordability pressures on their homes.[i]

In Australia, the family home is the most valuable asset on the household balance sheet. Through home ownership, households secure not only a stable place to live but an asset that provides economic security all the way into old age. The potential impacts of underinsurance can thus be economically catastrophic for Australian households.

Yet we still know relatively little about who is underinsured and why. We know that insurance is poorly suited to the needs of low-income households, and that affordability is a key part of this problem (Collins, 2011; Banks and Bowman, 2017). The emphasis on low-income households extends to the academic literature, where insurance is deemed unaffordable for households whose income falls below a certain threshold (Kunreuther and Michel-Kerjan, 2009; Hudson et al., 2016; Tesselaar e al. 2020). But evidence that underinsurance permeates much broader sections of our society mounts with the media coverage of each new weather-related disaster. Home insurance may be unaffordable for low-income households, but why would relatively well-off households risk losing their most important asset by not insuring adequately?

We use Household, Income and Labour Dynamics in Australia (HILDA) Survey data to track insurance coverage over time in order to explore the relationship between financial stress and underinsurance. We ask, do households cut their insurance coverage as a way to shore up their finances in the wake of a shock like unexpected job loss, illness or family breakdown? Skipping insurance payments exposes insurable assets to a level of risk that might result in economic catastrophe. But it might also free up cashflow when money is tight, allowing households to keep up with bills, like mortgage payments and utilities. Investigating whether the decisions to reduce coverage may be taken in response to the experience of financial stress could help us to better understand underinsurance among middle-income households.

This is an urgent question in the current economic environment. Inflation and interest rate rises have hit Australian households hard, driving financial stress up (Botha, Rondinel and Payne, 2023). Understanding how insurance expenditure fits into this nexus is of growing importance as the stakes rise amidst increasing risks and higher insurance costs.

Our analysis tracks annual insurance expenditure at the household level over a five-year period, from 2014 to 2018. We begin with a sample of households who do not report any indicators of financial stress in 2014 and track their spending over the following years along with their reporting of indicators of financial stress.[1]This allows us to observe if the onset of financial stress drives households to reduce insurance expenditure.

[i]These figures are in inflation-adjusted terms. See the Insurance Council of Australia datahub at https://insurancecouncil.com.au/industry-members/data-hub/.
[1]We use eight indicators of financial stress available in HILDA, which include being unable to heat the home, seeking help from a charity, and being unable to pay rent or mortgage on time. Of these, asking for help from friends and family is the most commonly reported indicator amongst our sample.

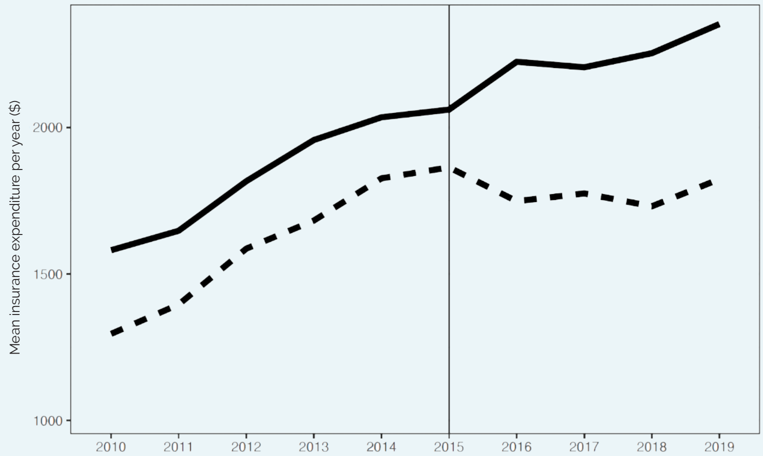
Key Insights

1 Financial stress leads to underinsurance

Figure 1 extends the sample to the four years that precede 2014, showing how annual insurance expenditure evolves amongst households who do not report any financial stress at any point between 2014 and 2018 (the black line) and those that are not stressed in 2014 but report financial stress at some point between 2015 and 2018 (the dashed line). The figure shows that households who experienced financial stress in the years after 2014 tend to have lower levels of insurance expenditure even in the years prior to experiencing stress when compared with households who didn't experience stress at any point. Yet the trajectory of insurance expenditure is similar. Only in 2015, when the stressed group starts to report experiencing financial hardship, does insurance expenditure diverge from the non-stressed group.

This tells us two things. Firstly, it shows that households tend to reduce their insurance expenditure after experiencing financial stress in comparison to households that do not experience financial stress. Secondly, the common trajectory of insurance spending up to 2015 indicates that declining insurance expenditure in the wake of financial stress is unlikely to be driven by other factors.

Figure 1: Trends in insurance expenditure amongst stressed and non-stressed households, 2010-2018 ($)



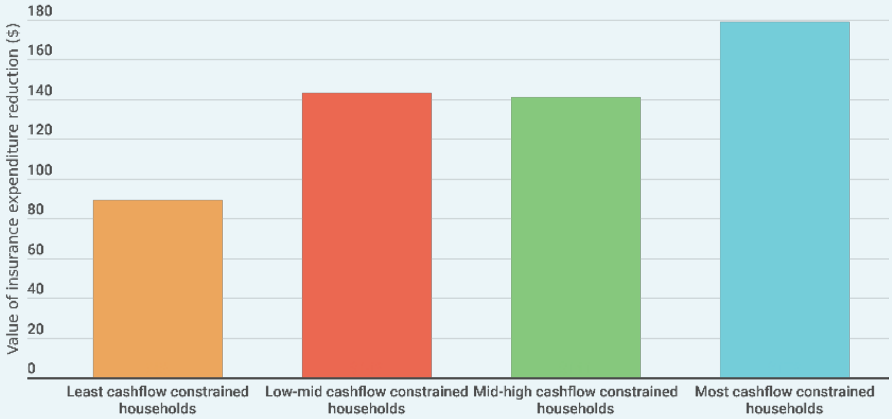
Notes: The black line represents average insurance expenditure amongst households who did not report any indicators of financial stress at any point between 2010 and 2018. The dashed line represents households who report at least one indicator of financial stress in 2015 or later. Source: HILDA, 2010-2018

2 Reductions in insurance coverage are strongest amongst cashflow-constrained households

Grouping households by varying expenditure patterns shows that the strongest reductions in insurance expenditure occur amongst households that have the highest proportions of their incomes locked into pre-committed payments, such as mortgage payments, childcare and utilities bills. These are payments that cannot be easily reduced or reversed, at least in the short term. High proportion of pre-committed payments relative to income leaves the household with little cashflow left over, equating to slim buffers with which to respond to an unexpected shock (Lim and Tsiaplias, 2017).

Figure 2 groups households by the proportion of income spent on pre-committed payments.[2] The figure shows the amount by which financially stressed households reduce their insurance expenditure within these groupings. The figure shows that the highest reductions in insurance expenditures occur amongst households who have the highest proportion of income tied into pre-committed payments (and who thus have the tightest cashflow positions). Amongst these households, those who experience financial stress respond by reducing insurance expenditure by an average of $179 in comparison to households with equally tight cashflow positions who do not experience financial stress.[3]For households who have the lowest proportion of income tied into pre-committed spending (and who thus have the most flexibility in their monthly budgets), financial stress drives a reduction of $89 compared to non-stressed households.

Figure 2: Reductions in insurance expenditure amongst financially stressed households across four categories of cashflow constraint



Notes: Categories of cashflow constraint divide households into four groups in accordance with the proportion of each household's income that is captured by pre-committed spending. Pre-committed spending includes rent, mortgage (including on an investment property), childcare, education, fuel for driving and heating the home and health insurance. All results are statistically significant at the 5% threshold. The underlying statistical model controls for the value of insurable assets, as detailed in the text. Source: HILDA 2014-2018

[2]This measure is based on Chetty and Szeidl's (2007) 'commitment goods', which include rent, mortgage (including on an investment property), childcare, education, fuel for driving and heating the home and health insurance.
[3]With median insurance expenditure in 2018 at $1,400, these effects thus correspond to around 10% of spending.

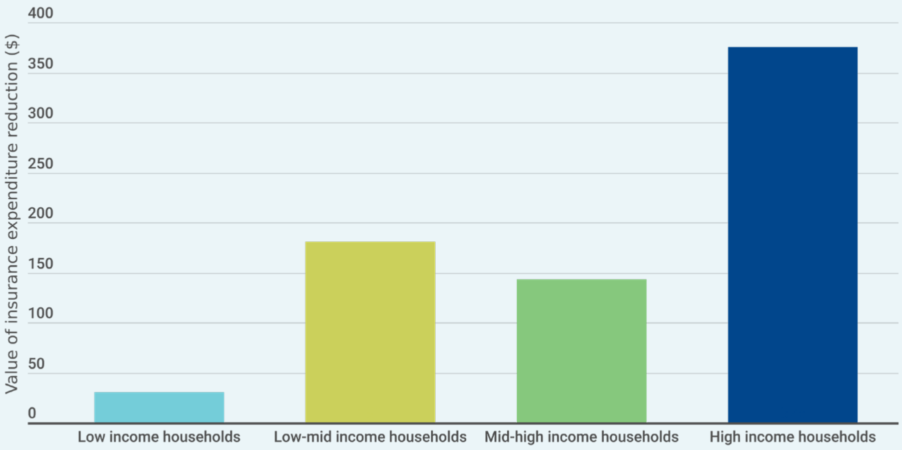
This suggests that financially stressed households are choosing to reduce insurance coverage in order to free up cashflow with which to meet whatever shock it is that put them into financial stress in the first place - be that typical drivers like unexpected job loss, illness or family breakdown; or simply the pressure of higher mortgage rates and other cost of living pressures. These households are typically highly indebted, leaving them few options when money gets tight.

It is important to note that these results are not attributable to changes in the value of insurable assets. We account for households reducing insurance expenditure due to having moved to a smaller home, having moved from home ownership to a rental, having sold an investment property or driving a cheaper car. As such, Figure 2 shows changes in insurance expenditures over and above any changes of insurance expenditures driven by reductions in insurable assets.

3 Even relatively wealthy households cut their insurance in the wake of stress

Analysis of the income distribution of households who reduce insurance coverage in the wake of financial stress shows that financial stress drives underinsurance amongst middle-income, and even relatively wealthy households. Figure 3 shows the amount by which stressed households reduce their insurance expenditure within four income groupings. To illustrate, the expenditure falls by $181 for stressed low-mid income households compared to non-stressed households from the same income bracket, and by $143 for stressed mid-high income households compared to their non-stressed counterparts. The largest reductions arise amongst the wealthiest households, which reflects the higher value of insurable assets and associated higher insurance expenditures.

Figure 3: Reductions in insurance expenditure amongst financially stressed households across four categories of household income



Low income households are those in the bottom 25% of household income distribution; low-mid income are within the 25th-50th percentile; mid-high income households are in the 50th-75th percentile, and high income households are those in the top 25%.

The finding of middle-income and relatively wealthy households cutting insurance coverage in the wake of financial stress is similarly visible in insurance expenditure reductions amongst cashflow constrained households. Table 1 depicts the income profiles of stressed households who reduced their insurance expenditure within the groupings of cashflow constraint used in Figure 2. This shows that the households who are most cashflow-constrained are remarkably similar in income to those in the low-mid cashflow constrained group and the mid-high cashflow constrained group. This suggests that reductions in coverage driven by constrained cashflows is not the domain of low-income households struggling to make ends meet but of an array of households that have varying incomes, many of which have middle and even relatively high incomes.

Table 1: Income profiles for households that reduced expenditure following the experience of insurance stress in categories of cashflow constraint

	Income at the 25th percentile	Median income	Income at the 75th percentile
Least cashflow constrained	$36,596	$65,430	$113,053
Low-mid cashflow constrained	$51,537	$86,956	$128,406
Mid-high cashflow constrained	$47,749	$89,756	$127,554
Most cashflow constrained	$48,190	$84,532	$116,077

Notes: As per Figure 3, categories of cashflow constraint divide households into four groups in accordance with the proportion of each household's income that is captured by pre-committed spending. Pre-committed spending includes rent, mortgage (including on an investment property), childcare, education, fuel for driving and heating the home and health insurance. Source: HILDA 2014-2018

Responding to underinsurance in middle Australia

Insurance premium price rises pose serious barriers to adequate insurance coverage amongst low-income households. But the problem of affordability reaches much further. Our findings provide empirical evidence that underinsurance has become a mainstream problem. While policies for low-income households - such as the targeted subsidies proposed by the ACCC (2020) - remain vital, the problem has grown substantially broader, requiring more diverse policy responses.

There are no quick fixes but rapid policy responses are required in the face of significant and widespread community vulnerability. Mitigation is key because it reduces overall risk, bringing premiums down along with the cost of disasters. But as we develop a more resilient economy, we must accept that this is a community-wide problem that calls for the kind of community-wide approaches that build conditions for greater stability and security for households.

This is a multifaceted problem, ranging from consumer protection to town planning. Households must be given better tools with which to understand the risk that they face so that they can make better decisions. But it must also be accepted that there is a limit to the capacity of households to navigate this kind of complex and often technical information. Households also need more access to the kind of independent advice and support that financial counsellors make available so that they can better manage their finances, in and outside of periods of stress. Ensuring avenues for effective advocacy and accountability are also crucial.

Changes in insurance and beyond are important. Increasing transparency on premium pricing and building household level mitigation into that pricing will help deliver price signals to support households to make the home improvements that bring down premiums. Helping households to afford that household-level mitigation is another key issue alongside stronger regulations for new developments and rental properties, all of which can help to bring the cost pressures from insurance down. We also need better data, including reporting on household outcomes (and especially cash settlements) by insurers so that we can better understand underinsurance dynamics; as well as better risk disclosures in the home sales process.

Stepping up to the task of managing climate risk demands both regulation and spending as well as a willingness to confront difficult issues around the economic security of households. These are not easy policy responses to deliver. But if we are slow, we risk the lives and hard-earned savings of Australian households.

Further Information

Datasets:

Our analyses use the Household, Income and Labour Dynamics in Australia (HILDA) Survey. Started in 2001, the HILDA Survey provides policymakers with unique insights about Australia, enabling them to make informed decisions across a range of policy areas, including health, education, and social services.

The results use a final sample of 7,481 households. These households had positive insurance expenditure in 2014, did not report any indicators of financial stress in 2014 and continued to report their financial stress status as well as insurance expenditure in each of the five years between 2014 and 2018. The insurance indicator refers to annual spending on insurance including vehicle, home and contents insurance but excluding health insurance. In this research insight we focus on home insurance, which is the dominant component of insurance expenditure and is growing much faster than car insurance costs.

Authors

Dr Antonia Settle

2018 McKenzie Post-Doctoral Fellow and Visitor

Melbourne Institute: Applied Economic & Social Research, University of Melbourne

Dr Maxim Ananyev

Resarch Fellow

Melbourne Institute: Applied Economic & Social Research, University of Melbourne

Research Insights produced by the Melbourne Institute provide a clear and practical understanding of contemporary economic and social issues in Australia.

Supported by high-quality academic analysis, each Research Insight aims to make sense of complex issues to enable evidence-based decision making for policy and practice.

References:

1. ACCC (2020) *Northern Australia Insurance Inquiry: Final Report.* Australian Competition & Consumer Commission.
2. Banks, M., and Bowman, D. (2017). *Juggling risks: insurance in households struggling with financial insecurity*. Brotherhood of St Laurence.
3. Botha, F., Rondinel, A.G. and Payne, A.A. (2023) Most Australians, not just the poor, are facing constraints in covering basic needs. *Research Insight*. #04/23.
4. Chetty, R., & Szeidl, A. (2007). Consumption commitments and risk preferences. *The Quarterly Journal of Economics*, 122(2), 831-877.
5. Collins, D. (2011). Reducing the risks: improving access to home contents and vehicle insurance for low-income Australians.
6. Hudson, P., Botzen, W. W., Feyen, L., and Aerts, J. C. (2016) Incentivising flood risk adaptation through risk based insurance premiums: Trade-offs between affordability and risk reduction. *Ecological Economics,* 125: 1-13.
7. Kunreuther, H.C. and Michel-Kerjan, E.O. (2009) *At War with the Weather: Managing Large-Scale Risks in a New Era of Catastrophies*. MIT Press.
8. Lim, G. C., and Tsiaplias, S. (2019). Household income requirements and financial conditions. *Empirical Economics*, 57, 1705-1730.
9. Tesselaar, M., Botzen, W.J.W., Haer, T., Hudson, P., Tiggeloven, T., and Aerts, J.C.J.H (2020) Regional Inequalities in Flood Insurance Affordability and Uptake under Climate Change. *Sustainability*, 12, 8734.