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Research Insights

Will the pandemic recession bring a jump in underinsurance?

If the role of insurance is to help in times of unexpected need, what happens when Australians need to cancel their insurance in times of unexpected crisis? An analysis of financial stress and insurance coverage in Australia.

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In uncertain and stressful times, people tend to drop their insurance. The long-term consequences can be dire.

The massive income supports introduced by the Australian Government in 2020 have, to date, insulated Australian households from the worst of the economic effects of the coronavirus pandemic. However, these supports are now being scaled back, despite employment and wages being likely to remain below pre-COVID-19 levels for some time to come. This raises the prospect of increasing numbers of households experiencing financial stress over the coming year. In this context, it becomes increasingly important to understand how households respond to sudden declines in income, and, in particular, how they manage their finances. To what extent do they reduce their expenditures, and on what items do we observe this reduction?

We study changes in expenditures at the time a household enters into a period of financial stress (see Box 1). Using data from the 2015 Household Expenditure Survey, we explore changes in spending patterns among Australian households during this critical period. We focus particularly on household decisions to reduce or drop insurance coverage.

The role of insurance is to help in times of unexpected need. A reduction in coverage will place a household in a more vulnerable position which could lead to even more stress or a further spiral of financial strain.

Given the recessionary pressures from the pandemic, this Research Insight sheds light on potential longer-term effects for households experiencing financial stress. As the Melbourne Institute's *Taking the Pulse of the Nation* survey has demonstrated, over the last year approximately 20 percent of households have indicated they are financially stressed. This study, thus, helps to shed light on potential longer term effects of the pandemic on household wellbeing.

In the early stages of financial stress, we find that households reduce or drop insurance coverage as their incomes fall. These findings suggest that, along with job losses and lower wages, the pandemic recession may bring with it a jump in underinsurance. Lower insurance coverage compounds the burden of financial stress that recession-hit households experience, exposing financially stressed households to even greater levels of financial risk. For unlucky households that have reduced their insurance coverage, a further setback down the road – such as a major weather event or a health shock – could spiral out into a deeper and more persistent state of financial stress as underinsurance exacerbates the impacts of recession. If this effect is widespread, the important role that insurance plays in insulating the economy from risk will be undermined.

Key Insights

1 Households in the early stages of financial stress spend significantly less on insurance than non-stressed households

Figure 1 shows the amount that financially stressed and non-stressed households spend every year on different types of insurance. Overall, the data show that financially stressed households spend around 25 per cent less on insurance than those with no indicators of financial stress.

This effect is strongest for life insurance, for which financially stressed households spend 27 per cent less than non-stressed households. However, the uptake of life insurance among Australian households is considerably lower than that for health and home and contents insurance.[1] This Research Insight focuses on health and house and contents insurance, which are the most common forms of insurance and are held by the majority of households.

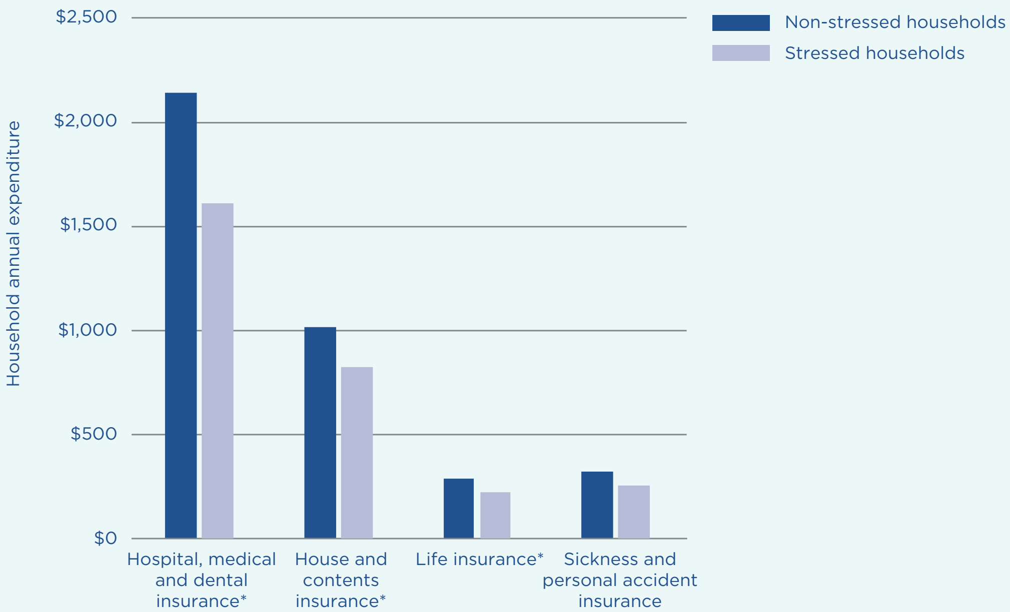
1 The Household Expenditure Survey (2015) shows that 13 per cent of households have life insurance, whereas 58 per cent have hospital, medical and dental insurance, and 80 per cent have house and/or contents insurance.

Box 1: What are financially stressed households?

This analysis defines financially stressed households as those reporting a single indicator of financial stress, or missing out on experiences, in the Australian Bureau of Statistics Household Expenditure Survey. The most common amongst these is the inability to afford a holiday for at least a week per year, but also included are indicators like the inability to raise $2000 in a week or to pay a utility or phone bill on time. By focusing on households that report a single financial stress indicator, we address the spending patterns of those in the earliest stage of financial stress. This allows us to separate households that are in deep and entrenched financial stress from those that are likely to slip into stress as a result of a shock such as recession.

These early-stage financially stressed households constitute around 15 per cent of all households and are spread fairly evenly across income and net worth brackets, although financial stress is slightly less prevalent amongst the top 20 per cent of households. Financially stressed households, like non-stressed households, are typically a double-income working family with dependent children, have a mortgage and less than 1 per cent of income earned from government pensions or allowances. See the ABS financial stress data cube at www.abs.gov.au for more details.

Figure 1: Annual spending on insurance by households in the early stage of financial stress and households with no financial stress



* Indicates that the difference between non-stressed and stressed households is statistically significant at the 5% level

Source: Household Expenditure Survey (2015)
Notes: See 'What are financially stressed households' (p. 1) for more detail on what defines stressed and non-stressed households.

2 Middle-income households exhibit the most consistent patterns of reduced expenditure on insurance in the early stages of financial stress.

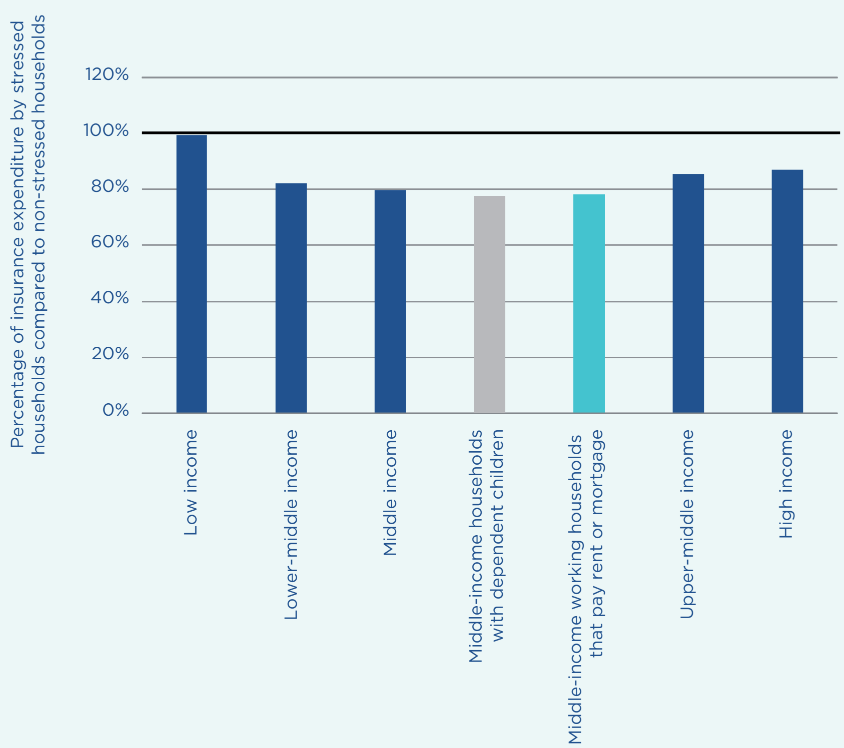
During the early stages of financial stress, do the patterns of insurance expenditures vary across household type? Figure 2 depicts the ratio of expenditures for stressed households relative to non-stressed households within different household groupings.

The blue bars in Figure 2 compare insurance spending between stressed and non-stressed households in different income brackets. This shows that there is little difference in insurance spending among households in the bottom income bracket. These low-income households spend roughly the same amount on insurance, regardless of if they are in the early stages of financial stress or are experiencing no indicators of stress at all. All other income groups show some reduction in insurance spending in the early stages of financial stress. However, it is the middle-income group that drop their insurance spending the most.

This pattern is even stronger for middle-income groupings that are alike not only in income but also in household composition, housing tenure, and employment status. The grey and light blue bars in Figure 2 show that middle-income households[2] that are in the early stages of financial stress and have dependent children, spend 22 per cent less on medical and house and contents insurance than their counterparts who are not financially stressed. The pattern is broadly the same for middle-income working households who rent or pay mortgage.

Within middle-income households, the consequential drop in spending on insurance appears to be only weakly correlated with differences like family structure and income. This implies that reduced insurance spending among stressed households does not happen because these households have different needs for insurance (such as fewer children that will likely need dental care). Nor is the cut in insurance simply the result of income differences (such as where poorer, financially stressed households spend less on insurance than wealthier, non-stressed households). Given that the stressed and non-stressed households that are compared in Figure 2 are otherwise similar in terms of income, family structure and housing tenure, the data suggest that it is financial stress that is driving these households to reduce their insurance expenditure.

Figure 2: Insurance expenditure by stressed households as a percentage of insurance expenditure by non-stressed households, by household groupings



Source: Household Expenditure Survey (2015)

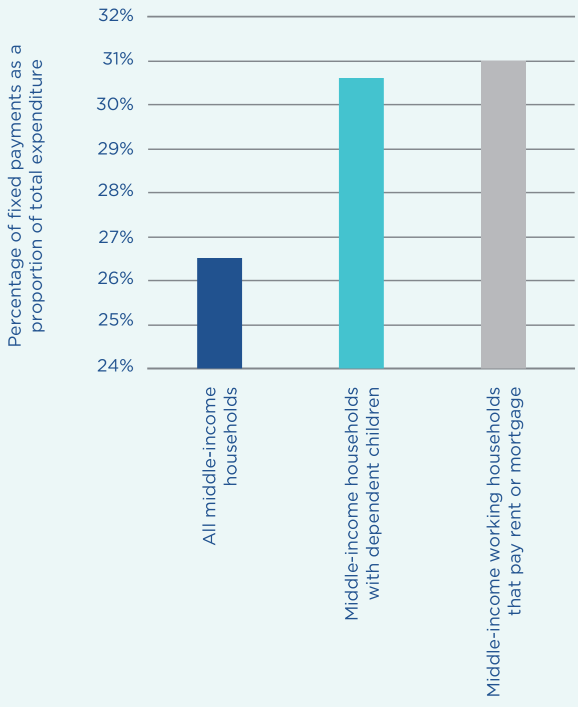
2 Middle-income households that have dependent children and middle-income working households who rent or pay mortgage are those in the second, third and fourth quintiles of household income, adjusted for household size.

3 Reduced insurance spending among middle-income households may reflect limited options for cutting expenditure amidst high fixed payments

Those that reduce their spending on insurance the most when they enter into financial stress are also those with the highest proportions of spending devoted to fixed payments, such as rent or mortgage, childcare fees, and locked-in phone and internet plans. The blue bar in Figure 3 shows that middle-income households spend 26 per cent of their total expenditure on fixed payments. Yet, the light blue and grey bars show that fixed payments are even higher for middle-income households with dependent children and working middle-income households who rent and pay mortgage.[3] As Figure 2 shows, these are also the household groupings that cut their insurance the most in the early stages of financial stress.

It therefore appears that middle-income households reduce expenditure when they enter into financial stress because they have limited discretionary spending capacity left after meeting fixed payments. Middle-income households are effectively treating insurance as discretionary spending, rather than as essential coverage to counter risk exposure. Indeed, Figure 4 shows that households in the early stages of financial stress tend to reduce expenditure on recreation – from holidays to televisions and camping equipment. Yet their expenditure on basics is, if anything, higher. Thus, financially stressed households reallocate spending away from both luxuries *and* insurance while maintaining spending on things like electricity, petrol and basic food items.

Figure 3: Fixed payments as a percentage of total payments, by household groupings



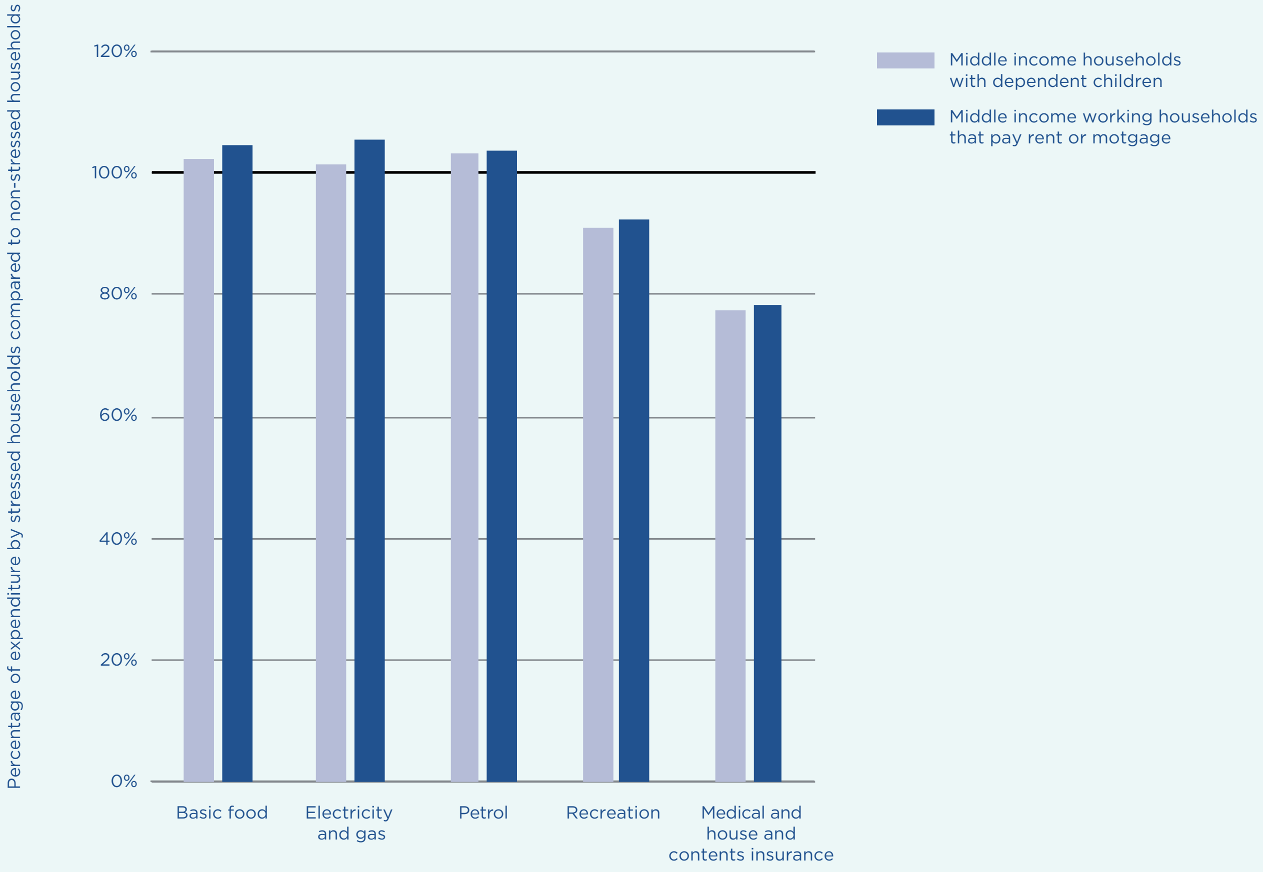
Source: Household Expenditure Survey (2015)

3 Corresponding with Figure 2, these statistics refer to households that either report one indicator of financial stress or report no indicators of financial stress.

It is likely that the reduction in recreational spending is less than the reduction in insurance spending because financially stressed households can fine-tune their recreational spending without cutting it entirely. Fine-tuning expenditures can be harder for insurance; households can increase their deductibles and change their optional coverage, but they can only choose from a limited menu offered by insurers. Consequently, some financially stressed households could be forced to drop their insurance policies altogether, rather than reducing their coverage, thus generating the bigger drop in insurance spending than recreation spending, that we see in Figure 4.

Taken together, the data suggests that households wind back their spending on insurance and recreation to free up income to put towards fixed payments. Yet, as households downgrade insurance coverage, underinsurance compounds the effects of financial stress by exposing households that already bear the brunt of the recession to the risk of greater financial calamity.

Figure 4: Expenditure by financially stressed households as a percentage of expenditure by non-stressed households, households with dependent children and working households that pay rent and mortgage



Source: Household Expenditure Survey (2015)

Policy Conclusions

The current recession will likely cause a surge in underinsurance, particularly among middle-income families

The analysis shows that risk exposure among Australian households is likely to spike during the current recession as greater numbers of households reduce their insurance coverage in response to financial stress. This may be especially pertinent to households with high fixed costs such as those who rent or have mortgages, and those with dependent children. For these households and others like them, options for cutting discretionary spending in the face of financial shocks may be limited.

This is bad news for both households and the insurance sector. Recession-hit households that cut insurance coverage risk spiralling into a deeper and more permanent state of financial stress if they are unlucky enough to be impacted after cutting insurance coverage. A major weather event or health shock, for example, could mean large unexpected costs or time out of the workforce that recession-hit households can ill-afford. These kinds of events compound the financial stress imposed by recession and risk dragging households into a deeper state of stress from which they have less capacity to recover.

For the insurance sector, maintaining broad uptake across the population is key to long-term viability. This is particularly pertinent to the private health sector, which can be expected to see the long-term decline in private health insurance coverage accelerate as the full fallout of the pandemic recession is realised.

Similarly, maintaining premiums is crucial for the troubled life insurance sector as well as the home insurance sector, where managing pressure on premiums and profitability is a major challenge.

Moreover, the potential damage of underinsurance can be further concentrated within certain economic sectors. A combination of underinsurance in housing and a bad bushfire season, for example, could impose a very real strain on economic recovery in bushfire-hit regions.

Given the important role that insurance plays in preserving economic resilience, the impacts of recession on insurance coverage pose an important issue for the economy as a whole. Policymakers and the insurance sector need to carefully consider how households can be supported as income support payments, and mortgage and rent freezes – which have eased financial pressures on households – wind down. Developing measures to bridge financial stress without sacrificing insurance coverage would not only protect recession-hit households from the compounding effects of underinsurance on financial stress, but would benefit the insurance sector – and the economy.

Further Information

Datasets and methods

This study uses data from the 2015 Household Expenditure Survey, which is a nationally representative household survey collected by the Australian Bureau of Statistics. The full sample for the Survey is 10,046 households, of which 5,754 report zero indicators of financial stress (identified in this paper as 'non-stressed' households) and 1,457 report one indicator of financial stress (identified in this paper as 'stressed' households). See Box 1 for further details on indicators of financial stress. The sample for households with dependent children refers to those in the second, third and fourth quintile, and pertains to 914 non-stressed households and 333 stressed households. The sample for working households who rent or pay mortgage pertains to 1501 non-stressed households and 539 stressed households. For more details on the Household Expenditure Survey, see www.abs.gov.au.

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Further reading

Settle, A. (2020) Financial Stress and Household Consumption: Exploring households' commitment to contractual payments, Melbourne Institute Working Paper

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Glossary of terms

Fixed payments: includes mortgage and rent, rates, water and sewerage rates, local government rates, interest payments, childcare, education (excluding HECS), internet and mobile phone bills and costs associated with any other property

Basic Food: includes bakery products, flour and cereals; processed meat; poultry; eggs; dairy; edible oils and fats; fresh citrus, apples, pears and bananas; vegetables; sugar, condiments; canned spaghetti and baked beans, canned and bottled baby food, frozen prepared meals, packaged prepared meals.

Recreation: as designated by the ABS, excludes gambling and pet costs.