Paying for disaster recovery: Australia's NDRRA and the United States' NFIP.

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ABSTRACT

This paper examines the issues surrounding financial recovery from natural disasters with an emphasis on floods. Prompted by the flooding in Queensland in 2010-2011 and the National Disaster Insurance Review, the discussion focuses on the current recovery program administered by the Commonwealth government, the National Disaster Relief and Recovery Arrangements and compares this with the federally funded flood insurance program which operates in the US – the National Flood Insurance Program. The paper concludes that a national insurance scheme similar to the National Flood Insurance Program is not appropriate in Australia. Ⓡ

Introduction

Australia is prone to significant and frequent natural disasters. It is expected that the 'sea change' phenomenon will lead to an increase in the costs of disasters due to an increase in urbanisation of coastal regions (Thomas *et al*, 2011). (The 'sea change' phenomenon refers to a trend for people to move, and often retire to coastal areas, and increasing the population and urbanisation of these areas. Every disaster has the potential to impact a larger population where local knowledge and experience of risks has been diluted leading to a decrease in community resilience). While there may be doubt about the impact changes in weather patterns may have on the frequency of natural disasters, concentrated population along the coast gives scope for greater damage and therefore greater financial costs for recovery.

The question of how to cover the financial costs of natural disasters in Australia is particularly relevant after the release of the report of the National Disaster Insurance Review (Trowbridge *et al*, 2011) which was prompted by recent natural disasters particularly the Queensland floods of 2010-11. This paper will examine the Australian National Disaster Recovery and Relief Arrangements and compare them to the National Flood Insurance Plan in the United States. This comparison is important to make clear that although there have been calls to reform flood 'insurance' there are significant differences between schemes that are designed to protect community infrastructure (such as the NDRRA) and those to assist homeowners (such as the NFIP). Communities need to understand the difference in order not to be confused and to believe that reforms to one will resolve issues in the other. It will also be shown that there are risks in adopting a national domestic disaster insurance scheme and such a scheme, such as the NFIP, may not be appropriate in Australia.

The Queensland floods

Between December 2010 and January 2011 over 70 towns in Queensland were subject to flooding. Heavy rainfall across the state led to flash flooding. Towns were cut off when highways were closed and a significant proportion of the state's infrastructure was damaged or destroyed. The damage bill was estimated as being close to $30 billion (ABC News, 2011). In the aftermath, the Commonwealth imposed a levy on taxpayers across Australia (*Tax Laws Amendment (Temporary Flood & Cyclone Reconstruction Levy) Act 2011* (Cth); *Income Tax Rates Amendment (Temporary Flood & Cyclone Reconstruction Levy) Act 2011* (Cth)) to help fund the Commonwealth's contribution to the disaster relief.

The systems in place for financial recovery have been brought under increased scrutiny as a result of the Queensland floods and other natural disasters which occurred around that time and it is argued that there are ways in which arrangements for financial recovery can be improved.

Australia's Natural Disaster Relief and Recovery Arrangements (NDRRA)

It is generally assumed that under the Constitution it is the responsibility of the states and territories to manage disaster relief in their individual jurisdictions (Eburn 2011, p. 82). The Commonwealth government provides funding to assist with financial recovery from natural disasters under the Natural Disaster Relief and Recovery Arrangements (NDRRA). The NDRRA is administered by the Attorney-General's Department and is governed by the National Disaster Relief and Recovery Arrangements Determination 2011 (McClelland, 2001). States may claim NDRRA funding when a natural disaster occurs and where they have spent more than the prescribed threshold amount in responding to the event.[1] The Commonwealth will provide funding of between 50 and 75 per cent of the state or territory's expenditure to repair or rebuild infrastructure and loans it may have made to businesses or others in need (McClelland, 2001, [3.3]). The NDRRA is intended to assist states in their recovery from disasters and not to be the only means by which they are protected from the financial costs of disasters (McClelland, 2011, [3.3.2(e)]). States may also protect themselves from the financial costs of recovery by insuring against losses. Funding from the NDRRA is provided to states although individuals may indirectly receive assistance through grants given to needy individuals (McClelland, 2011, [3.3.2(e)]).

The 2011 amendments

Following the 2011 Queensland floods, the NDRRA was amended to require states to insure their own losses and to ensure access to 'reasonably adequate capital' (McClelland, 2011, [4.5.1]). States are required to have their insurance arrangements assessed by an 'independent and appropriate specialist' and to make this assessment available to the Commonwealth (McClelland, 2011, [4.6.1]).

Senator Xenophon made it clear that he wanted the requirement for insurance so that the Commonwealth was not forced to make such significant payments in the future and to avoid any temptation for the states to rely on the Commonwealth.

> There is an enormous amount of public money that needs to be spent, quite justifiably, to assist Queensland and the policy question is whether less money could have been spent if there were appropriate insurance policies in place (Senate Economics Legislation Committee, 2011, p. 34).

The concept of 'reasonably adequate capital' was not defined and is therefore a subjective standard. However, given that this requirement was included in the legislation to seek to reduce the amount the Commonwealth might have to pay, it is reasonable to expect that the states would have access to enough capital to cover the cost of all but the most extraordinary of natural disasters. They should have access to enough capital to ensure that a levy to help fund recovery is not required in the future.

The requirement for states to have their own disaster insurance may reduce the amount which the Commonwealth will be required to pay for future natural disasters. However, given the cost of taking out insurance, states may only be able to afford to take out coverage for a small proportion of their infrastructure and may still be underinsured. When the amendments were announced, the acting Premier of Queensland, Paul Lucas stated that the insurance requirements were a win for overseas insurance companies, not the people of Queensland:

> 'Make no mistake, insurance of this type – if you can get it – is not delivered by local insurers over the counter. It is delivered by international insurance conglomerates that do it to make a profit' (Lucas, 2011).

If a state or territory does not comply with the requirement for insurance coverage, the level of NDRRA assistance available may be reduced. This may leave states in the difficult situation where they cannot afford, or obtain, insurance but may be disqualified from NDRRA assistance if they do not obtain the required level of cover. This leaves them facing significant costs to repair infrastructure which they may struggle to meet.

The United States' National Flood Insurance Program (NFIP)

Established in 1968, under the *National Flood Insurance Act* (US), the National Flood Insurance Program (NFIP) is administered by the Federal Emergency Management Agency (FEMA). Before the program was established it was nearly impossible to obtain flood insurance from the private insurance industry (FEMA, 2002, p.1). The program now provides insurance to individuals for properties and contents through arrangements with private insurance companies as well as policies purchased directly from FEMA (FEMA, 2002, p. 22).

Unlike the NDRRA, which is primarily intended to provide assistance to states for infrastructure, the NFIP provides insurance to both communities and individuals. Individuals may only purchase insurance if their community is involved in the Program. Although participation is voluntary, communities which are classified as flood-prone will not be given Federal assistance for buildings in hazard areas unless they are involved in the NFIP (*Housing and Urban Development Act 1986*, s 202).

Communities that are involved in the NFIP are required to engage in floodplain management including adopting a floodway and the construction of levees or floodwalls to a required standard. Buildings in areas of high flood risk which are mortgaged must be protected by flood insurance *(Housing and Urban Development Act 1986).*

As part of the NFIP, States provide technical assistance to communities to help them comply with their floodplain management obligations.

1. Each state has two different thresholds based on State revenue. The amount the Commonwealth will pay is determined according to whether expenditure on disaster recovery meets these thresholds. The thresholds for 2011-12 can be found at http://www.em.gov.au/Documents/NDRRA.+-+2011-12+NDRRA+State+Territory+Thresholds.pdf.

The National Flood Insurance program is administered by the U.S. Federal Emergency Management Agency.

Problems with the NFIP

Temporary measures

The original purpose of the NFIP was to 'provide *temporary* flood insurance to property owners who were unaware they were in flood-prone areas' (Black, 2005, p. 1, emphasis added). Buildings constructed before the implementation of the scheme are subject to lower, subsidised insurance fees even though they may be at more risk than more recent buildings. Although the fees for newer buildings are 'actuarially fair', they are not high enough to adequately compensate for the discounted price on older buildings.

It has been suggested that in order to cover catastrophic years the discount for houses built before 1974 should be removed. It is argued that the owners of such houses are now aware of the high risk of flooding and should be required to pay the same premiums as other homeowners. Riggs (2004) suggested that subsidies for repetitive loss properties should be phased out.

High levels of debt

In January 2009 the NFIP was $19 billion in debt (Kousky, 2010, p. 3). This is largely due to the fact that the premiums are designed to cover years where there are 'average' levels of flooding. In years where there are 'catastrophic' levels of flooding the program does not have sufficient funds to cover all the claims and is forced to borrow money from the Federal government. There have been suggestions (Kousky, 2010) that premiums should be increased in order to save money for 'catastrophic' years. However, it has also been noted that stockpiling funds could lead to the perception that too much has been collected and calls for premiums to be reduced could follow. It is also possible that stockpiled funds might be diverted to other projects. Saving money to pay for natural disasters is likely to prove difficult unless the government were to prescribe an amount which must be saved or allocate funds to be invested to increase the overall level of funds available for disaster recovery. If there is no requirement to save then the money collected in premiums could be spent on other projects leaving little for the 'rainy day'.

Subsidised insurance encourages people to live in high-risk areas

The NFIP may actually encourage people to build and live in areas which are flood-prone: 'Federally subsidised flood insurance encourages people to build homes where they otherwise would not. It also encourages lenders to finance mortgages they otherwise would not' (Black, 2005, p. 1). Even after a property has been damaged by a flood there is no requirement to rebuild in a safer location and there is evidence that a substantial proportion of the claims for assistance under the NFIP relate to properties which have received assistance in the past (*Flood Insurance Reform Act 2004* (US), s. 2).

Comparing the NDRRA and NFIP

While both the NDRRA and the NFIP provide financial assistance to recover from floods, the scope of the assistance is different.

The NDRRA provides financial assistance to states to repair their infrastructure as well as to partially reimburse disaster relief payments (McClelland, 2011, [1.1.1]). It is, in effect, a national insurance scheme for the states although it is only intended to supplement measures taken by the states to pay for recovery; it is not supposed to cover the full cost (McClelland, 2011, [1.1.2]). The states must have some insurance arrangements to ensure that they can contribute to the costs of recovery, and they must have made payments, in excess of the prescribed threshold, before they become eligible for NDRRA assistance. Although some assistance may be provided to individuals through the reimbursement of grants to needy individuals (McClelland, 2011, [3.3.2.(e)]), this is incidental and does not usually provide sufficient assistance for people to rebuild or repair their houses. Instead, any benefit gained by individuals is likely to have come via the states as recovery payments. Individuals who wish to be insured against losses as the result of flooding are required to take out private insurance cover. The inclusion of flooding on insurance plans is an issue which is currently under consideration because it has become clear that many individuals who believed their plan covered flooding were not actually covered. However, this is a separate issue and does not relate to the NDRRA.

In comparison, the NFIP provides assistance to both governments and citizens. It is much more individualistic as it is designed to assist those in high risk areas to obtain insurance. Communities can receive assistance to help pay for infrastructure and individuals may also receive payments. Unlike the NDRRA, the scheme requires contributions from those who want to benefit from assistance. Communities are required to mitigate against flooding and also make financial contributions if they wish to receive assistance after flooding. Individuals may receive direct financial assistance if they have taken part in the scheme by paying for the insurance. The government lowers its risk by requiring that individuals who wish to take part in the scheme must be in communities which are also involved. The communities must have taken steps to mitigate and thus reduce the risk of flooding. The mitigation involves building levees and undertaking floodplain management. Communities may also undertake mapping to help determine which areas are most at risk of flooding. The cost of undertaking these programs is borne by the community and is a way of ensuring that communities do actually contribute to the mitigation of flood risk.

NFIP insurance is similar to private insurance except that under the NFIP, insurance premiums are subsidised and do not accurately reflect the risk. The result is that individuals are not required to make a contribution which is in line with their risk. This may lead to inequities whereby individuals end up living in areas where they should perhaps not due to the availability of insurance which reduces the real cost of flood damage.

The methods of funding for the NDRRA and NFIP are quite different. The funds for the NDRRA are taken out of consolidated revenue and there are no dedicated funds for the scheme. Instead, the government is able to allocate as much or as little as required each year. However, with the extraordinary demands for assistance in 2011, the government imposed the flood and cyclone levy to raise additional funds (Gillard, 2011). The NFIP is funded by insurance premiums but is allowed to borrow money from the Federal government. This money is supposed to be repaid with interest (*National Flood Insurance Act 1968*, s 3) although it is possible that given the current high level of debt, the funds may not be repaid. Under the NFIP, communities and households are required to maintain NFIP insurance once they have received assistance from the scheme. There is clear evidence that 'repetitive-loss properties' make up a large number of the claims made under the scheme (*Flood Insurance Reform Act 2004*, s 2). This leads to significant losses for the scheme as the premium income from such properties is not enough to compensate for the losses caused by repeated flooding.

A national insurance scheme for Australia?

It has been stated that in Australia the cost of natural disasters increases in future years the funding situation will become unworkable if it is not changed' (Latham, McCourt & Larkin, 2010, p. 16). A proposal for a natural disaster insurance scheme was considered in 1976 but enthusiasm for the scheme waned and it never eventuated. There have been renewed calls for such a scheme particularly after recent, significant natural disasters. Chris Latham, a partner at PricewaterhouseCoopers, is a key advocate for a national insurance scheme as he believes that it would provide certainty: 'People need certainty around this sort of thing rather than just hoping someone will step in and look after them once they've lost their house' (Sexton, 2010). Latham believes that a national scheme would not be too costly as home insurance premiums might fall if natural disasters are no longer included in the cover.

However, not all insurers believe that a national scheme would be helpful. The Insurance Australia Group (IAG) stated that a national scheme would lead to higher premiums and encourage people to live in flood-prone areas because those living in such areas would not have to pay the real cost for protection (Johnston, 2011).

The National Disaster Insurance Review panel also recommended that an agency be created to 'manage the national coordination of flood risk management and to operate a system of premium discounts and a flood risk reinsurance facility, supported by a funding guarantee from the Commonwealth' (Trowbridge *et al*, 2011, p. 3). Although the details of the proposed body are not given, it does seem to bear some resemblance to the NFIP in several respects. The proposed agency would provide premium discounts like the NFIP and would also coordinate risk management. The NDIR does recommend that if a national insurance scheme were to be implemented then discounts would be phased out over time (Trowbridge *et al*, 2011, p. 10).

The NFIP experience should lead to caution when considering a national insurance scheme for flooding. Some of the problems experienced by the NFIP were examined above.

Conclusion

Following the Queensland disasters of 2011, there were calls to amend the NDRRA. Members of the Commonwealth Parliament were outraged that, rather than obtain private insurance, Queensland had relied on the NDRRA to establish the Commonwealth as the State's insurer. At the same time individuals were shocked to discover that their insurance policy did not cover them for damage caused by flood although some insurers did try to cover losses where possible even if this was not envisaged under the policy. As a result there were calls to amend the various schemes by which Australians pay for the costs of disasters, and in particular, floods.

There is however confusion between the schemes. The NDRRA is a scheme to assist the states to pay for the costs of restoring community assets and infrastructure. It was not intended to replace domestic insurance. Steps to amend the NDRRA scheme, to require the states to take out insurance in the private market may go some way to reduce the Commonwealth's exposure to costs during the next flood disaster; a disaster that is occurring in NSW and Victoria at the time of writing but will have little implications for individual citizens.

Amendments to the NDRRA should not, however, be confused with suggestions to give better protection to individuals. One suggestion to improve the level of domestic insurance is to introduce a national flood insurance scheme. As discussed above, the United States has such a scheme in the NFIP. Although the aims of the NFIP were noble, the fact that it does not discourage people from living in flood-prone areas and is in such a large amount of debt mean that the introduction of a similar system in Australia may not be wise. The federal government should encourage private insurance companies to provide sufficient flood protection for individuals and states should be encouraged to make their own arrangements to finance recovery where possible.

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Ruth Biggs has a Bachelor of Commerce and is now completing her Juris Doctor at the Australian National University. Her interest in disaster law was inspired by the significant media and political debate surrounding government assistance as a result of the Queensland floods of 2010-11.