Protecting residents against the financial failure of aged care providers

Richard Cumpston

(Dr Richard Cumpston is a director of Australian Projections Pty Ltd, a company formed in 2013 to make long-term projections of Australians, including their aged care needs. He can be contacted on [redacted])

Summary

This paper has been written to assist discussion of regulatory proposals being considered by the Department of Health. These proposals may reduce the already very low failure rate of aged care providers. But they will increase the capital requirements of providers, and increase the profits needed to service capital, while doing little for aged care residents.

About half of persons entering permanent residential aged care pay refundable accommodation deposits, averaging about $400,000. If a provider becomes insolvent, any unpaid deposits are met by a Commonwealth guarantee scheme. Failure of a large provider could involve about 7000 residents, and $1000 million in deposits.

In 2017 EY recommended a capital adequacy requirement for residential aged care providers. To meet this proposal, providers might need extra capital of about $11 billion at 30/6/18. Providing a 13% return after tax on this capital might require extra revenue of about $2 billion a year.

Restricting the holders of deposits to the owners of residential care facilities could help keep failure rates very low. Requiring providers to operate through entities whose major purpose is the provision of aged care in Australia would reduce the extra capital needed.

There can be protracted delays before the guarantee scheme is triggered, causing severe distress to residents and their families seeking deposit repayments. Changes are needed to allow repayments earlier than formal insolvency. Processes are needed to ensure continuing care to residents in failing providers.

1. Introduction

1.1 Who this paper is relevant to

- Politicians need to ensure continuing care and prompt deposit repayments, and to avoid wasting money on excessive regulation
- Consumer representatives need to draw attention to the problems of continuing care and deposit unavailability when a provider has financial difficulties
- Consumers need information to help them choose aged care providers and payment methods
- Media have a vital role in drawing attention to government mismanagement and waste
- Aged care providers are at risk of having costly regulation imposed, when simpler, cheaper solutions are available
- The Department of Health, which is trying to better protect payments made by aged care residents.

1.2 Background

In November 2015 the Minister for Health, Aged Care and Sport asked the Aged Care Financing Authority (ACFA) to examine the Accommodation Payment Guarantee Scheme. So far there have been published reports by ACFA, EY and the Legislated Aged Care Review, and unpublished reports by StewartBrown and PwC. In May 2018 the Department of Health announced a four-year program to develop stronger prudential regulation and reduce the risks of claims on the guarantee scheme. In August the Department issued a tender for accounting evaluations of EY's recommendations. A call for public submissions will be made early in September, and an issues paper released.

1.3 ACFA report on the protection of lump sum accommodation payments

ACFA "provides independent advice to the Australian government on funding and financing issues, informed by consultation with consumers, and the aged care and finance sectors" (ACFA 2018b). In preparing its report on the protection of lump sum accommodation payments, it received submissions from 26 stakeholders but no individuals. The introduction to its report said:

"Under the Guarantee Scheme, the Commonwealth provides residential aged care consumers with a guarantee that the refundable value of any lump sum accommodation payments … they have lodged with aged care providers will be returned to them, in the event that the provider becomes insolvent.

At 30 June 2016, the residential aged care sector held lump sum accommodation payments of approximately $21.7 billion. The average agreed accommodation price for a new resident in 2015-16 was just over $370,000. As lump sum accommodation payments are large sums, and may represent the majority of a resident's wealth, it is vital that these investments are secure." (ACFA 2017a 6).

It is not clear why the Minister asked ACFA to report on the guarantee scheme. Treasury may have wanted the scheme to be industry-funded, rather than be an open-ended liability for the Commonwealth. ACFA's report raised two important questions, as yet unanswered:

- Can delays in refunding deposits be reduced?
- Are evolving provider structures increasing failure risks?

1.4 EY report on accommodation payments

"*The Department of Health engaged EY to provide an independent study of the legislative, business and operational framework for Refundable Accommodation Payments."* (EY 2017 1)

The Department's objectives were described in an EY stakeholder consultation pack as

- the protection of residents
- the protection of the Government, both reputationally when an approved provider is non-compliant; and to reduce the reliance and use of the scheme
- to limit the compliance burden on approved providers (EY 2017 37).

EY recommended the introduction of transparent reporting on provider corporate structures and inter-party transactions (EY 2017 13). This paper notes that some providers have complex structures, where aged care is only a small part of the provider's overall operations (see 3.3).

They recommended the introduction of a capital adequacy metric, such as 20% equity on the balance sheet, noting that

"This is equivalent to what is required by financiers before lending against real property. Where a borrower is more highly geared, a financier will require them to take out insurance to secure the balance of the value of the property." (EY 2017 18)

EY recommended that intangible assets be largely excluded from eligible capital:

"Define quality of capital to include tangible assets such as land and buildings, and intangible assets which are able to be valued, such as bed licences." (EY 2017 18)

EY rated all these recommendations as likely to have major impact, and being of high priority. Like StewartBrown (see 1.5), EY were concerned about inadequate data:

"The primary finding of our Desktop Review was that the data that the Department is given is inadequate for it to assess whether or not Approved Providers comply with the Prudential Standards" (EY 2017 5)

EY's proposals were based on a desktop review, followed by consultation with the Department and 27 industry stakeholders. They made no quantitative estimates of the effects of their proposals. This paper provides some very approximate estimates of the extra capital and profits needed - see 3.7 and 3.8.

1.5 Legislated Aged Care Review

The review was asked to investigate nine matters, including the effectiveness of arrangements for protecting refundable deposits and accommodation bonds. 50 of the submissions to the review were about the protection of lump sum payments, including 11 from carers and the relatives of residents. It recommended that:

"the government reform prudential standards and oversight, taking account of the recommendations in the independent review of prudential standards conducted by Ernst and Young to:

- *correct gaps in prudential information received by the government*
- *strengthen the standards to improve liquidity, capital adequacy and disclosure requirements*
- *strengthen governance standards"* (Tune 2017 122)

1.6 Unpublished report by StewartBrown

"StewartBrown were engaged by the Department of Health to undertake a peer review of the Department's data collection and reporting activities with a view to enhancing current processes and future report content" (StewartBrown 2017 1).

A partly redacted version of the report was obtained under an FOI request. The main reason for redacting part of the report appeared to be that

"Disclosure would prejudice the Department's ability to assess the financial stability and viability of providers." (Department of Health 2018c)

StewartBrown recommended dropping the residential care balance sheet data

"Due to the high rates of non-disclosure and/or lack of item allocation the Residential Balance Sheet in the ACFR does not provide any reliable information for the Department and should be dropped." (StewartBrown 2017 1)

This is a surprising recommendation, given that the residential balance sheets have provided the asset and liability totals in each of ACFA's five reports of the funding and financing of the aged care sector - see for example ACFA 2017b 113-114. Confidentialised general purpose financial report data for each provider, including residential segment data, were published by the Department from 2006-07 to 2014-15 (see 3.1). Both overall and residential balance sheets will be important in any capital adequacy requirement.

"The data management and analysis process should be improved by establishing a central data warehouse…" (Stewart Brown 2017 1)

1.7 Unpublished report by PwC on guarantee scheme costs

"PwC worked with the Departmental project team and ACFA in examining, assessing and developing possible alternative options… This included the development of a detailed cost model enabling the projection of a range of possible default scenarios and costs. The cost model was provided to the Department in November 2016." (ACFA 2017a 19)

PwC used confidentialised general purpose financial record data for 14-15 for each residential care provider (see 3.1). Similar data for 15-16 and 16-17 are being made available by the Department, to help update the estimates in this paper.

1.8 Current action by Department of Health

"The Government will strengthen standards and guarantees for older Australians who have made refundable accommodation deposits to residential aged care providers by

- *introducing a compulsory retrospective levy on residential aged care service providers where defaults exceed $3 million in any fiscal year*
- *developing stronger prudential standards applied to accommodation payments held by residential service providers; and*
- *raising the Government's prudential regulatory capacity to better protect the growing pool of accommodation payments - currently about $23 billion -else eu and reduce the likelihood of a claim on the government guarantee scheme…*

This will cost $4.8 million from 2018-19 to 2021-22." (Department of Health 2018a)

"The Government's response will consider the findings of the EY Review with the final position to be determined after further consultation with the sector." (Department of Health 2018b).

1.9 Current prudential requirements for aged care providers

The Department of Health (2018a) described the prudential requirements that aged care providers must meet where they hold lump sum refundable accommodation deposits paid by residents when entering care:

- Liquidity Standard, which requires providers to have sufficient liquidity to ensure they can refund amounts expected to fall due in the following 12 months
- Records Standard, designed to ensure accurate, comprehensive and up-to-date information on deposits
- Disclosure Standard, which requires providers to give information on their compliance with the Liquidity, Records and Disclosure Standards
- Governance Standard, requiring that there is an appropriate system to ensure that the provider complies with their prudential responsibilities in relation to refundable deposits.

These requirements fall short of prudential regulation as managed by APRA, as there is no requirement for capital adequacy. A provider can have enough liquidity to refund bonds as they fall due in the next 12 months, but only needs to have assets just exceeding its liabilities. Particularly if the assets are of uncertain value, the provider may have high probabilities of failure.

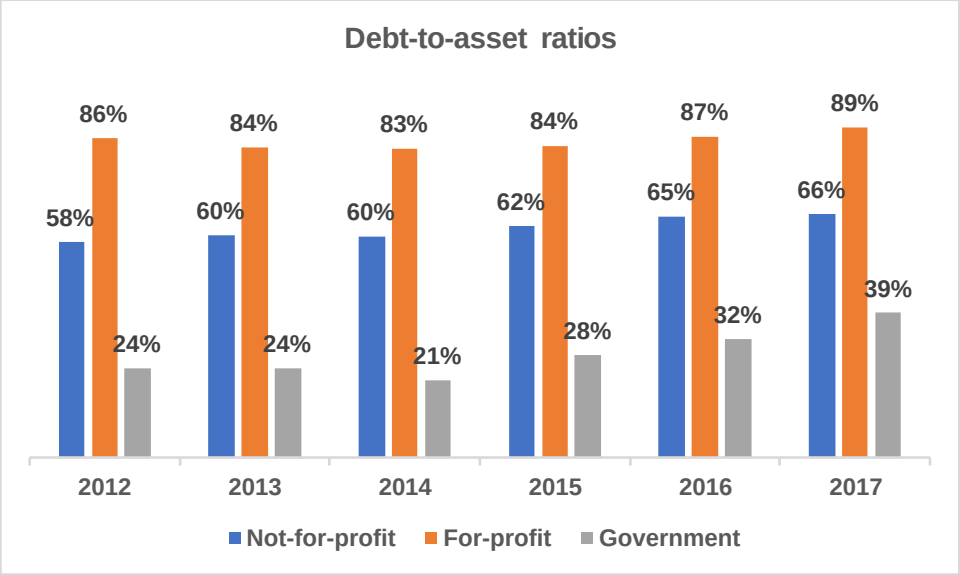
2. Data on aged care providers

2.1 Numbers of providers in each size band at 30/6/17

Places	Providers Not-for-profit	Providers For-profit	Providers Government	Providers Total	Places Total
100 or less	285	150	77	512	30229
101-200	113	94	12	219	30746
201-500	51	35	5	91	27425
501-1000	37	10	1	48	35403
1001-2000	12	5	1	18	26017
2001-5000	5	5		10	32090
5001 or more	1	2		3	18779
Total	**504**	**301**	**96**	**901**	**200689**

The above totals are from data supplied by the Australian Institute of Health and Welfare (2018a). "Places" are those approved by the Department of Health for operational use by residential aged care providers. At 30/6/17 there were 184,077 residents (AIHW 2018b), an occupancy rate of 91.7%. 57% of providers are in the lowest size band. For-profit providers are over-represented in the two highest size bands.

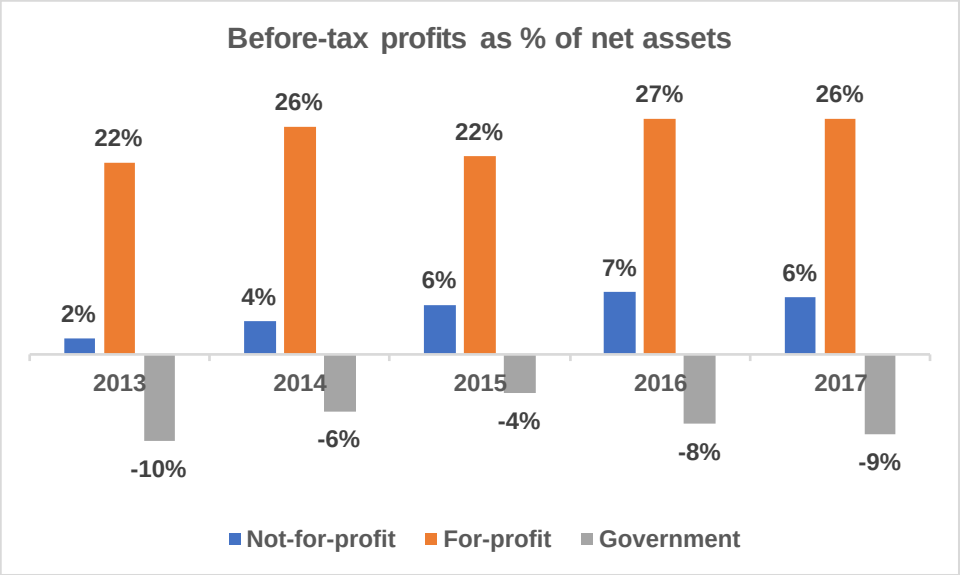
2.2 Debt-to-asset ratios for aged care providers



11-12 data on debt and assets are from ACFA (2013 38), 12-13 from ACFA (2014 52), 13-14 from ACFA (2015 131), 14-15 data from ACFA (2016 115), 15-16 from ACFA (2017b 114) and 16-17 from ACFA (2018 118).

For-profit providers had a debt-to-asset ratio of 87% at 30/6/16. This was about 5 times the 17.2% average debt-to-asset ratio of Australian non-financial companies from 2000 to 2015 (Kenney, La Cava and Rodgers 2016 15).

2.3 Before-tax profits as a % of net assets for aged care providers



12-13 before-tax profits are from ACFA (2014 51), 13-14 from ACFA (2015 117), 14-15 data from ACFA (2016 96), 15-16 from ACFA (2017b 96) and 16-17 from ACFA (2018c 95). Net assets are from the sources for the preceding chart.

Not-for profit providers averaged 5% pa before-tax return on net assets in the five years to 30/6/17, and for-profit providers averaged 24%. The returns for for-profit providers have been much higher than the 13% average after-tax returns for authorised deposit taking institutions, general insurers and life insurers in the ten years to 30/6/17 (APRA 2017 26, 28 & 30).

Commenting on the higher returns of for-profits, the Aged Care Guild said

"..a greater number of Guild member facilities provide extra/additional services and most of their facilities are located in major cities or large regional centres which can therefore attract a higher accommodation payment…"

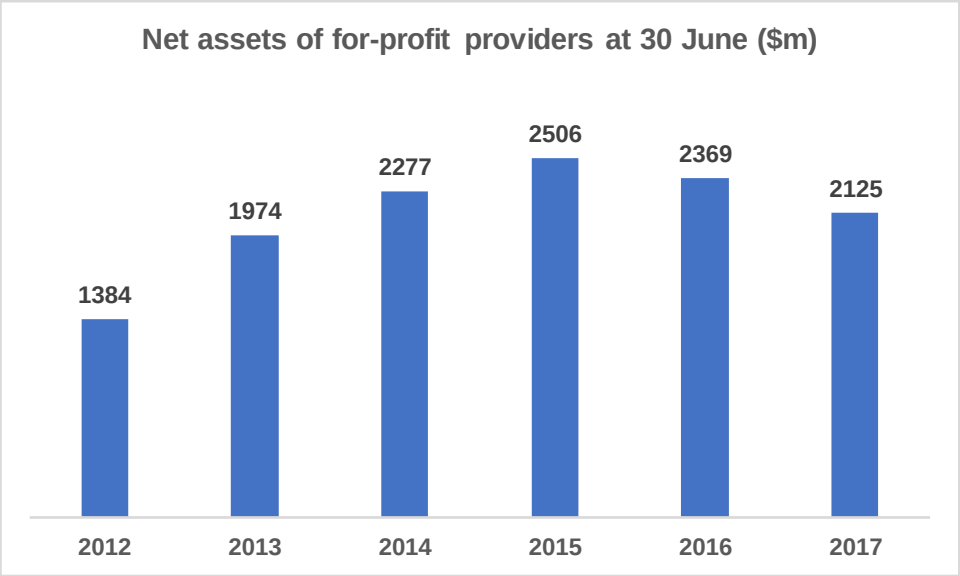
"…the FP sector also contributes taxes to various levels of government in addition to income tax including payroll taxes, stamp duties, council rates and fringe benefits tax. The NFP sector is exempt from paying most of these taxes, either in part or in full." (Aged Care Guild 2018 6)

Note that the Guild and ACFA quote returns on total assets, rather than returns on net assets. APRA uses the latter when looking at the profitability of financial institutions.

2.4 Estimated profit withdrawals by aged care providers

Statistic	Not-for-profit $m	For-profit $m	Government $m	Total $m
Profit 5 years to 30/6/17	1844	2755	-470	4128
Net assets 30//6/12	6781	1384	1448	9613
Net assets 30/6/17	8259	2125	942	11326
Increase in net assets	1478	741	-506	1713
Profit withdrawals	**366**	**2014**	**36**	**2415**

For-profit provides made before-tax profits of about $2755 million in the five years to 30/6/17, but their net assets only increased by about $741 million. This suggests that for-profit providers withdrew about $2 billion in dividends in the 5 years to 30/6/17. Their net assets rose initially, then fell:



For-profit providers have been reducing their net assets since 30/6/15, while their liabilities have continued to grow.

2.5 Intangible assets and loans to related parties

Intangible assets were $5.5 billion at 30/6/17, up 62% from $3.4 billion a year earlier (ACFA 2018c 119). Loans to related parties were $4.6 billion, up 28% from $3.6 billion. Together, intangible assets and loans to related parties were $10.1 billion at 30/6/17, compared with net assets of $10.4 billion. These figures exclude government providers, which apparently have no intangibles or loans to related parties.

EY recommended that intangible assets, other than bed licences, be excluded from eligible capital in a capital adequacy requirement. But ACFA notes that the 2018-19 budget included funding for an impact analysis of allocating residential aged care places to consumers instead of providers. If this proposal were adopted, bed licenses might cease to have commercial value.

APRA excludes loans to related parties when measuring the capital adequacy of banks and insurers. Aged care providers might thus not be able to count any of their intangible assets or loans to related parties if a capital adequacy requirement were introduced. Effectively, they would have no eligible assets, and would have to find fresh capital to meet the requirement.

3. Estimates for capital adequacy proposals

3.1 General purpose financial record data

General purpose financial record (GPFR) data for each aged care provider for 2014-15, together with some financial data for their residential care segments, are available from Department of Health (2016). Similar data are available from 2006-07 to 2013-14. The

Department confidentialised the data by expressing all the figures as dollars per average number of residents in the year, with the provider's size only being identified as lying within one of 9 broad bands. The highest size band is 501+ residents, which accounted for 51% of all residents at 30/6/15. In releases of similar data for any year later than 14-15, it would be helpful to subdivide the 501+ band into several bands, and show whether each provider is not-for profit, for-profit or government.

The data are in the form of a single record per provider for each year. These "unit record" data are particularly helpful in estimating the effects of proposed capital requirements, which may depend strongly on the individual circumstances of each provider.

3.2 Published financial data for residential care in 14-15

Sector	Revenue $m	Expenses $m	Assets $m	Liabilities $m	Bonds $m
Not-for-profit	8742	8340	19191	11968	9536
For-profit	6199	5642	15778	13272	8328
Government	869	921	1617	445	349
Total	15810	14903	36586	25685	18213

The above totals are for the residential care segments of aged care providers. Published revenues and expenses are from page 96, assets and liabilities are from page 102, and bonds are from page 115 of ACFA (2016). These published data were used as checks on totals derived from the unit record data.

3.3 Aged care specialists, and others

Total assets as proportion of RCS assets	Number of providers	Number of residents	Total assets $m	RCS assets $m
less than 1.1	565	75405	14709	14619
1.1-1.5	116	32215	5280	4066
more than 1.5	285	70225	28388	7159
Total	**966**	**177845**	**48376**	**25844**

Of the 966 providers with unit records at 30/6/15, 565 had total assets less than 1.1 times their residential care assets. These appear to have been aged care specialists. Another 116 had total assets of between 1.1 and 1.5 times their residential care assets. These could be described as having residential aged care as their main business. The remaining 285 had total assets about four times their residential care assets.

3.4 Providers with assets less than liabilities

Of the 966 providers with unit record data for 14-15, 66 had assets less than liabilities, with the asset shortfall for the 66 being about $252m. It is not clear how these 66 providers were able to continue operating. Were they not-for-profit or government, with the Department of Health willing to accept a guarantee from a parent organisation? Or was the Department aware of significant undervaluation resulting from the use of historic asset values?

To supervise any form of capital adequacy requirement, the Department will need financial data prepared on a market value basis. External parties, such as potential residents and investors, also need market value data (see 6.2).

3.5 Approximate process used to split providers by sector

The AIHW data on providers at 30/6/15 were used to approximately subdivide providers in the 9 bands of the GPFR data into not-for-profit, for-profit and government. Any providers with non-zero tax amounts were assumed to be private. Government providers were assumed to have RCS debt-to-asset ratios below 0.4, and assets below a limit for each band selected so as to give the correct number of government providers for the band. For-profit providers were assumed to have RCS debt-to-asset ratios above 0.4, and assets above a limit for each band selected so as to give the correct number of for-profit providers for the band.

Estimates derived from the confidentialised unit records differ substantially from the published figures, particularly for bonds and intangibles. The estimates for each provider may however be useful in providing indicative estimates of the costs of different capital adequacy proposals. More reliable estimates could be made if the Department chose to release current financial statements for each provider.

3.6 Assumptions made in estimating extra capital needed at 30/6/18

The extra capital needed at 30/6/15 was estimated from the unit records at 30/6/15, using total assets and total liabilities. Extra capital was calculated for each provider as the amount (if any) needed to meet the proposed equity requirement, plus a 50% margin. APRA-regulated institutions normally choose to have margins of at least this amount (see 4.5).

The total extra capital needed by not-for-profit providers was assumed to grow at 8% a year from 30/6/15 to 30/6/18, as this was the actual liability growth rate from 30/6/12 to 30/6/15. The total extra capital needed by for-profit providers was similarly assumed to grow at 16% a year.

3.7 Extra capital needed at 30/6/18 under different proposals

Proposal	Maximum liability as % of eligible assets	Intangible assets eligible?	Extra capital needed Not-for-profit $b	Extra capital needed For-profit $b	Extra capital needed Government $b	Extra capital needed Total $b
1	0.9	Yes	0.5	1.7	0.0	2.1
2	0.8	Yes	1.4	4.3	0.0	5.6
3	0.7	Yes	3.6	8.2	0.0	11.8
4	0.9	No	1.2	6.1	0.0	7.3
5	**0.8**	**No**	**2.2**	**9.1**	**0.0**	**11.3**
6	0.7	No	4.7	13.4	0.0	18.1

Proposal 5 is similar to EY's proposed 20% equity on the balance sheet, after excluding intangible assets from eligible capital (see 1.4).

3.8 Extra before-tax profits needed in 18-19

Proposal	Maximum liability as % of eligible assets	Intangible assets eligible?	Extra profits needed Not-for-profit $b	Extra profits needed For-profit $b	Extra profits needed Government $b	Extra profits needed Total $b
1	0.9	Yes	0.1	0.3	0.0	0.4
2	0.8	Yes	0.2	0.8	0.0	1.0
3	0.7	Yes	0.5	1.5	0.0	2.0
4	0.9	No	0.2	1.1	0.0	1.3
5	**0.8**	**No**	**0.3**	**1.7**	**0.0**	**2.0**
6	0.7	No	0.6	2.5	0.0	3.1

Authorised deposit-taking institutions, general insurers and life insurers have averaged after-tax profits of about 13% a year over the last 10 years (APRA 2017 27, 29 & 31). The above estimates of extra profits needed were made assuming after-tax profits of 13%, together with a company tax rate of 30% for for-profit providers. Under proposal 5, extra capital of $11.3 billion would need about $2 billion of extra before-tax profits a year.

3.9 Exclusion of intangible assets may not be desirable

EY suggested that eligible capital for a capital adequacy test should exclude most intangible assets. This is similar to APRA's policy of excluding all intangible assets (see 4.6).

Phil Green, former CEO of Babcock & Brown, referring to the company's abrupt collapse in 2008 after its share market price fall triggered a banking covenant review, said

"We shouldn't have leveraged to the to the extent that we did, we didn't need to. [But] we had massive growth, and we wanted to take advantage of that growth because debt was cheap….

Relative to our market capitalisation, our gearing wasn't high, but relative to our hard assets, we were gearing against a lot of goodwill and our goodwill then collapsed." (Sui-Lin Tan 2018)

Providers who have grown rapidly by acquisitions in recent years may have intangible assets greater than their net assets. Excluding intangible assets from eligible capital would create immediate difficulties, and a transition period of up to 5 years might be needed. But intangible assets are an accepted consequence of company purchases, which may often help efficiency and innovation.

4. Prudential regulation by Australian Prudential Regulatory Authority (APRA)

4.1 Functions of APRA

"APRA is an independent statutory authority that supervises institutions across banking, insurance and superannuation, and is accountable to the Australian Parliament.

APRA was established by the Australian Government on 1 July 1998 following the recommendations of the Wallis inquiry into the Australian financial system. Prudential regulation is concerned with maintaining the safety and soundness of financial institutions,

such that the community can have confidence that they will meet their financial commitments under all reasonable circumstances.

APRA oversees

- *authorised-deposit taking institutions (such as banks, building societies and credit unions)*
- *general insurers*
- *life insurers*
- *friendly societies*
- *private health insurers*
- *reinsurance companies, and*
- *superannuation funds (other than self-managed funds).*

Under the legislation that APRA administers, APRA is tasked with protecting the interests of depositors, policyholders and superannuation fund members." (APRA 2018a).

4.2 Delays in introducing prudential requirements for general insurers

APRA was established on 1 July 1998, and in September 1999 issued three discussion papers on general insurance regulation. Draft prudential standards followed, but the industry consultation process was interrupted by HIH Insurance Ltd going into provisional liquidation on 15 March 2001. A new prudential framework for general insurers was introduced on 1 July 2002.

4.3 Failure rates of entities regulated by APRA

Financial years	Number of failures	Losses $m	Average number of insti-tutions	Failure rate %
1999-03	26	5809	4057	0.128
2004-17	7	73	1119	0.045
Total	**33**	**5882**	**1892**	**0.092**

Numbers of failures, losses and institutions are from APRA (2017 67). The losses in the first 5 years of APRA's operation include $5.3b for HIH Insurance Ltd, based on liquidator's advice to creditors in April 2002.

4.4 Reasons for the failure of HIH Insurance Ltd in March 2001

"With $8 billion in assets, HIH was considered one of Australia's largest insurance firms. However, after offsetting the assets with debts and potential insurance claims, HIH was left, on paper, with net assets of only $133 million…

In 2001, the board appointed a provisional liquidator to take control of HIH and 17 of its controlled entities. (The provisional liquidator) attributed the HIH company failures to rapid expansion, unsupervised delegation of authority, extensive and complex reinsurance arrangements, under pricing, reserve problems, false reports, reckless management, incompetence, fraud, greed and self-dealing." (Wikipedia 19/6/18)

4.5 APRA-regulated entities should have a failure rate of much less than 0.5% a year

"The prescribed capital amount in respect of a regulated institution determined under the Standard Method is intended to be sufficient, such that if a regulated institution was to start the year with a capital base equal to the prescribed capital amount and losses occurred at the 99.5% confidence level, then the assets remaining would be at least sufficient to provide for the central estimate of the liabilities and other liabilities at the end of the year" (APRA 2013a).

Regulated institutions normally choose to have eligible capital at least equal to 150% of the prescribed capital amount. For example, general insurers had capital equal to 184% of their prescribed capital at 30/6/17 (APRA 2017 28). Given that the prescribed capital is set aiming at a 0.5% failure rate, it seems likely that a failure rate of much less that 0.5% a year should result. From 4.3, the failure rate for the 19 years of APRA's operation was about 0.09% a year, with most of the failures occurring in the first 5 years of operation.

4.6 Zero value for intangible assets

Under APRA's Prudential Standard GPS 112 (APRA 2013b), general insurers must exclude from eligible capital

- goodwill and other intangible assets arising from an acquisition, net of adjustments to profit to profit or loss reflecting any changes arising from impairment of goodwill
- other intangible assets as defined by Australian Accounting Standards, including costs associated with debt raisings and issuing capital instruments, capitalised information technology software costs and other capitalised expenses.

4.7 Costs of APRA regulation

Source	Levies $m	Number 30/6/17	Average levy $m
Superannuation funds	110.326	214	0.516
Deposit-taking institutions	79.167	149	0.531
Life insurers & friendly societies	22.042	41	0.538
General insurers	34.471	104	0.331
Private health insurers	4.136	37	0.112
Total	**250.142**	**545**	**0.459**

Levies are Financial Institutions Supervisory Levies (APRA 2017 123). Numbers of entities are from pages 26, 28, 30, 32 and 34 of that report. Numbers of superannuation funds are for APRA-regulated funds with more than 4 members. These APRA supervision costs exclude compliance costs for the regulated entities, which are likely to be comparable or higher than APRA's costs.

5. Failure rates

5.1 Provider failure rates 2006 to 2017

Sector	Not-for-profit	For-profit	Total
Average number of providers that held bonds	533	322	855
Assumed number of failures	1	11	12
Estimated failure rate per year	0.016%	0.29%	0.12%

Numbers of providers that held bonds in 12-13, 13-14, 14-15 and 15-16 are in ACFA (2014 126), ACFA (2015 159), ACFA (2016 159) and ACFA (2017b 142). Total numbers of providers in each sector from 2006 to 2017 are from AIHW (2018a). The proportions of providers in each sector holding bonds prior to 12-13 were assumed to be as in 12-13, and the proportions in 16-17 assumed to be as in 15-16. Assumed numbers of provider failures leading to guarantee claims are the 10 shown in ACFA (2017a 57-58), plus one advised by ACFA (2018a), plus one recent event that may lead to guarantee claims.

The 0.016% failure rate for not-for-profit providers was estimated as the assumed number of failures, divided by the average number of providers holding bonds, and divided by 12. It is lower than the 0.045% failure rate estimated for APRA-regulated institutions from 2004 to 2017 (see 4.3).

5.2 Data used in Reserve Bank of Australia failure analyses

Kenney, La Cava & Rodgers (2016) analysed data on 23,000 Australian companies from 2000 to 2015. Data for listed companies included all domestically domiciled non-financial companies listed on the Australian Stock Exchange, covering more than 2400 companies. Data on unlisted companies were from Dun & Bradstreet, based on annual data for more than 20,000 companies. There were 532 failures, an annual failure rate of 0.6%. Companies that failed had a mean debt-to-assets ratio of 0.24, while non-failures had a ratio of 0.172.

5.3 Failure rates fitted to RBA data

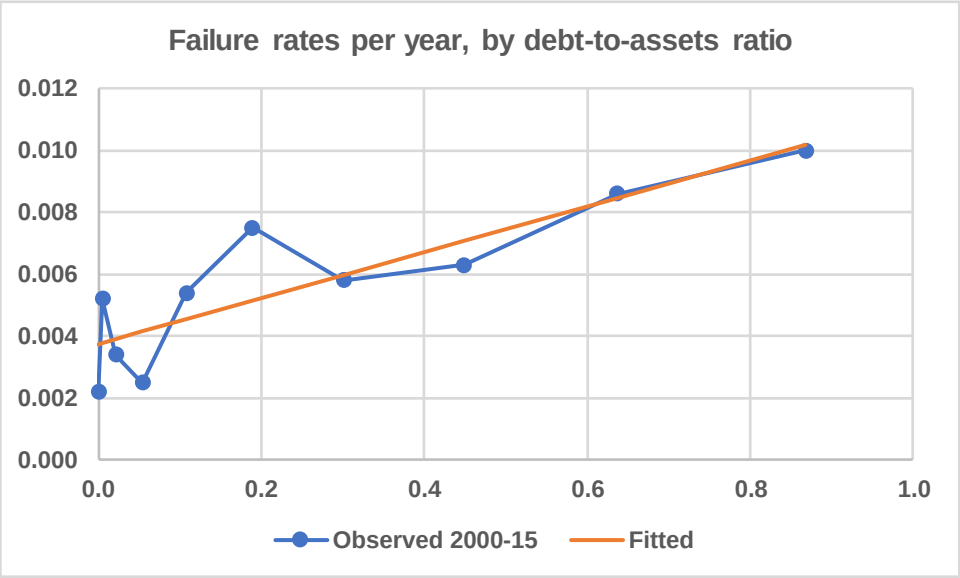


Figure 2 of Kenney, La Cava and Rodgers shows a failure rate of about 0.0064 a year for companies with zero debt, then a roughly linear trend up from about 0.0022 for companies with little debt, rising to about 0.01 for companies in the highest debt decile. The mean debt-

to-asset ratios for with-debt companies in each decile were estimated from their Figure 1. The linear trend line, fitted by least squares, has a value of 0.0037 for zero debt-to-asset ratio, and a value of 0.0111 for unit debt-to-asset ratio.

5.4 Provider failures expected from RBA data

Type of provider	Not-for-profit	For-profit
Number providers 30/6/15	519	340
Expected number failures per year	4.13	3.07
Expected failure rate	0.80%	0.90%
Actual failure rate 2006-17	0.016%	0.29%
Actual/expected failures	2%	32%

The numbers of providers in the above table exclude those with no residential care assets, or with debt-to-asset ratios for their residential care segments exceeding 1. Failure risk was calculated from the debt-to-asset ratio for each provider, assuming the fitted relationship in 5.3. Expected failure rates are the summed failure risks divided by the numbers of providers. Actual failure rates are from 5.1.

The actual failure rate of about 0.016% from 2006 to 2017 for not-for-profit providers is only about 2% of the 0.80% failure rate expected from the RBA data on non-financial companies. The extremely low failure rate for not-for-providers possibly reflects the inherent safety of the traditional model for residential aged care, where land and buildings are owned by the organization accepting accommodation deposits. Particularly for sites in or near large cities, land value increases are likely to have been larger than building depreciation.

The actual failure rate of 0.29% for for-profit providers is about 32% of the 0.94% failure rate expected from RBA data. Many for-profit providers may behave in similar ways to not-for-profit providers, with simple ownership structures, limited debt and little expansion. But some of the larger for-profit operators may have more complex structures, more debt and more intangible assets, and as a result may have failure rates similar or higher than those of non-financial companies in general.

5.5 Industry and macroeconomic effects on failure rates

Kenney, La Cava and Rodgers (2016 22) found that failure rates varied between industries. For example, they found that health care and social assistance had a failure rate of about 0.36% a year, compared with 0.6% for all industries. They also found that macroeconomic effects matter:

"The observed pattern in the time dummies suggests they represent macroeconomic conditions. For instance, they typically spike during slowdowns, as demonstrated during the 2001 and 2008-09 periods. There is also evidence of a spike around 2012 and 2013, suggesting the decline in commodity prices and the fall in mining investment were associated with a relatively high rate of company failure."

5.6 Using company data to model the effects of intangible assets

Depending on the extent of company data publicly available, it may be possible to examine the effects of debt-to-asset ratios if intangible assets are included or excluded from assets. This would help decide whether intangible assets should be excluded from eligible capital in

any capital adequacy requirement for aged care providers. Any prudential regulation should be evidence-based.

6. Low-cost suggestions to help protect aged care residents

6.1 Making the Department of Health responsible for prompt repayment of all deposits

"…in the event that a consumer has difficulty in recovering a lump sum accommodation deposit, they have rights to undertake legal proceedings against the provider to recover those funds … The options available … may include bringing an action against the provider under contract law…Where the provider is a corporation ... the consumer could issue a statutory demand to the provider … Exercising this kind of recourse may impose a cost on the consumer in terms of legal advice and fees." (ACFA 2017a 43)

If a provider is determined to delay a refund, the consumer will often not be able to afford a court battle. A resident may need the refund urgently, to help move to a resident care facility better moving their needs.

"There may be a considerable interval during which the resident, estate or government seek retrieval of the funds before a formal insolvency event … ACFA recognises that in some cases there may be protracted delay in the refund of an accommodation payment" (ACFA 2017a 59)

"The legally prescribed conditions for the triggering of the refund scheme were not adequate to address a case where a rogue operator resisted declaration of insolvency. This resulted in a situation where residents and their families were in a stressful state of uncertainty for several months until one of them, independently of the Department, brought on a successful insolvency action through the courts." (Council on the Ageing ACT 2017 10)

Of the 965 providers submitting Annual Prudential Compliance Statements for 2015-16, 111 reported instances of non-compliance with refunding responsibilities (Department of Health 2017 91). This high non-compliance rate suggests that a system is needed to help residents obtain overdue refunds, well before the guarantee scheme is formally triggered. This would involve the Department paying all refunds overdue for more than a short period, and seeking repayments and penalties from the providers. This would help the Department monitor the performance of providers, and take prompt corrective action. It would also help identify legislative gaps. For example, where a deposit has been paid by persons other than the resident, can this be refunded directly to the payers when the resident dies?

To allow the Department to ensure that all deposits are promptly repaid, providers should be required to notify the Department immediately of any deposit payments, notices of departure, departures, probate or letters of administration, and deposit repayments.

6.2 Requiring providers to submit financial accounts in standard format

"General purpose financial reports are prepared as per accounting standards and there can be various interpretations of those standards by each provider" (StewartBrown 2017 p10).

A standard format would allow better analysis and control. Note that the Australian Taxation Office requires self-managed superannuation funds to report in standard format.

One important variation between providers is the use of historic values for land and buildings, rather than fair market values. This can make comparisons between providers misleading, as well as create problems with interpreting summary data published by the Department. There may be generally accepted market values for residential care. For example, an EBIDTA yield of 12% to 15%, plus the amount of any accommodation bonds held, is a current market value yardstick. The better the location and facilities, the lower the yield multiple that may apply (Bailey 2018). All providers should be required to report market values.

6.3 Requiring providers to supply copies of their aged care accounts on request

Under section 58 of the Fees and Payments Principles 2014, providers are required to supply the most recent audited accounts of their aged care component on request from a prospective care recipient. A request on 9/2/18 to the 8 largest for-profit providers (excluding the 3 listed providers) showed that only one was willing to provide these audited accounts for research purposes. One provider was only willing to supply its accounts to a person already approved for residential care. Section 58 should be amended to require supply in response to any request. This would allow individuals to compare potential sources of residential care, well before they or a relative are approved for residential care.

6.4 Making available summaries of provider general purpose financial reports

Under section 86.3 of the Aged Care Act 1997, the Secretary of the Department of Health has the discretion to disclose information relating to a provider if it is necessary in the public interest to do so. This discretion has apparently been used since 2003 to publish electronic lists of aged care services, showing their locations, providers, approved places and Commonwealth subsidies. Publication of general purpose financial report summaries, together with residential care segment data, would allow comparative analyses, a better-informed market and better advice to individuals seeking care. Note that detailed financial statistics for each general insurer have been publicly available since 1975 - for example, APRA 2018b.

6.5 Restricting the holding of resident deposits to the owners of residential care facilities

"One of the business models attracting interest and market activity is the separation of aged care operations from the property holding operations. Depending on how the models are structured, and the subsequent transactions that occur, this may give rise to an actual or perceived heightened level of risk…" (ACFA 2017a 34)

For-profit providers have had far higher failure rates than not-for-profits, even though both have had high debt-to-asset ratios (87% for for-profits at 30/6/16, compared with 65% for not-for-profits - see 2.2). This suggests that direct ownership of residential care facilities may be important. We know from Ward (2018) that some large for-profit providers have complex ownership structures, where ownership of facilities is separated from provision of care. It would be straightforward (but tedious) to research the ownership of facilities for both for-profit and not-for-profit providers, to see if significant differences exist.

"Obstacles have been raised by multiple financiers and investors with regard to OpCo and PropCo structures, with increased risks of moving assets away from liabilities." (EY 2017 40)

"The Guild supports increased prudential supervision of the industry, which will increase the Commonwealth's understanding of risk (e.g. freehold vs leasehold)" (Aged Care Guild 2017 13)

Even if it is not feasible to insist on direct ownership of existing facilities, it should be feasible to require all providers to clearly inform prospective residents about the ownership of the facility, and whether their accommodation bond will be held by the owner. This information should be on MyAgedCare, and on service lists published by the Department.

6.6 Requiring providers to operate through entities whose major purpose is the provision of aged care in Australia

70% of the 966 providers with unit records at 30/6/15 had total assets less than 1.5 times their residential care assets (see 3.2). All of these could probably be described as having residential aged care as their main business. The remaining 285 had total assets of $28 billion, compared with residential care assets of about $7 billion. Particularly for these 285, losses in their other businesses could be a significant threat to their viability as residential aged care providers.

The Commonwealth provided 71% of the total residential service income of aged care providers in 15-16 (ACFA 2017b 97). The Commonwealth also provides means-test exclusions for aged care deposits, and guarantees the refund of deposits. Given these high levels of Commonwealth assistance, it may be reasonable to require that aged care be provided through entities whose major purpose is aged care. This would help in their supervision, and make comparative analyses more meaningful.

6.7 Requiring arrangements similar to those acceptable to financiers

In preparing its 2017 report to the Department of Health, EY consulted with 27 industry participants, including 4 financiers:

"One of the participating financiers explained that the bank has basic arrangements in place with certain rules, similar to Permitted Uses, where they generally don't allow movement of money outside the disclosed group structure.

One of the participating financiers agreed that improved transparency and reviews of incoming shareholders, share transactions and movement of money related to approved providers is required.

Multiple participants required clarity of how to identify the reporting entity "group". There were mixed views about what should be excluded from the group if the intent is to have sight of the financial viability of the group overall." (EY 2017 40)

"The financier's view was that the Department of Health should be taking action to ensure that approved providers can be sold as going concerns prior to administration commencing". (EY 2017 42)

Banks and other financiers lend on a secured basis, ranking ahead of the unsecured interest-free deposits made by residents. On behalf of residents, the Department should be insisting on structural and reporting arrangements at least as stringent as those required by financiers.

6.8 Requiring the controlling entity of a group to be responsible for all of them

Some groups have separate Department of Health approvals for many separate residential care services, under different provider names. The adequacy of assets of the group should be assessed as a whole, with the controlling entity ultimately responsible for all deposit refunds.

6.9 Process to ensure continuing care to residents in failing providers

At 30/6/17, there were 13 providers with 2000 or more places (see 2.1). Larger groups tend to have higher debt-to-asset ratios and more complex structures, and thus higher failure rates. Assuming a 1% failure rate for these 13 providers suggests a large failure about every seven years. There needs to be a process to ensure continuing care for the residents if a group with say 5000 residents collapses.

An industry consortium, formed by Mission Australia, the Benevolent Society, the Brotherhood of St Laurence and Social Ventures Australia, took over 570 ABC Learning Centres after the company went into receivership in November 2008 (Wikipedia 19/6/18). A similar industry consortium may be needed to provide continuing care when a large provider collapses. The liquidators of providers that have triggered the guarantee scheme should be able to advise about any structural issues that hampered continuing care.

7. Conclusions

The Department of Health has begun a four-year process to better protect payments made by aged care residents. The capital adequacy requirement proposed by EY may need about $11 billion of extra capital, and about $2 billion a year to provide reasonable profits on the extra capital. A transition period of up to five years may be needed, taking the reform process to over a decade.

The failure rates of not-for-profit providers have been extremely low, and those of for-profit providers have been below those of non-financial Australian companies. Controlling the structures of aged care providers could help ensure failure rates remain very low.

Low-cost measures to protect aged care residents could include making the Department of Health responsible for prompt repayment of all deposits. Ready availability of provider financial statements in standard form could help consumers choose providers. Steps are needed to ensure that continuing care is provided to residents of failed providers.

The Department's work on better protection for aged care residents could be helped by

- Better disclosure of the Department's data, operations and plans
- Advice from APRA on appropriate company structures for prudential regulation
- Analysis of data on company failures to estimate the effects of debt-to-asset ratios and intangible assets.
- Analysis of data on late deposit repayments to look for relationships with provider financial stress, and measures to relieve resident hardship
- Analysis of complaints data on late payments
- Analysis of reports by liquidators of failed providers
- Consultation with a wide range of consumer and industry representatives.

Acknowledgements

I am grateful for the help given to me by Anna Howe, Marijan Jukic, Ian Appleby and Jenni Joenpera of AIHW, Georgina McGrath of the ACFA Secretariat, Paul Feldman of Council on the Ageing ACT, Richard Rosewarne of Applied Age Care Solutions, Helen Rowell, Peter Kohlhagen and Nigel Boik of APRA, Guy Thorburn and Stuart Mules of the Australian Government Actuary's Office, Nigel Murray and Andrew Coll of the Department of Health, Stephen King of the Productivity Commission, Aaron Bruhn of the ANU Research School of Finance, Actuarial Studies and Applied Statistics, Hugh Sarjeant of Australian Projections, David Heath of Cumpston Sarjeant, Jason Ward of the University of Tasmania, Bruce Bailey and Joseph Zhang of Pride Living, Cecile Lefort of the RBA and David Sinclair of StewartBrown. The opinions expressed are however my own.

Glossary

ACFA	Aged Care Financing Authority
ACFR	Aged Care Financial Report
AIHW	Australian Institute of Health and Welfare
APRA	Australian Prudential Regulatory Authority
EBITDA	Earnings before interest, taxes, depreciation and amortisation
FOI	Freedom of Information Act 1992
GPFR	General Purpose Financial Record
HIH	HIH Insurance Ltd
RAD	Refundable Accommodation Deposit
RBA	Reserve Bank of Australia
RCS	Residential care segment

References

ACFA (2013) "Inaugural report on the funding and financing of the aged care sector", June, downloaded 21/8/18 from https://agedcare.health.gov.au/sites/g/files/net1426/f/documents/05_2014/attachment_2_acfas_report_to_the_former_government1_0.pdf

ACFA (2014) "Report on the funding and financing of the aged care industry", July, downloaded 24/7/16 from https://agedcare.health.gov.au/2014-report-on-the-funding-and-financing-of-the-aged-care-industry

ACFA (2015) "Third report on the funding and financing of the aged care sector", July, downloaded 24/7/16 from https://agedcare.health.gov.au/aged-care-reform/aged-care-financing-authority/2015-report-on-the-funding-and-financing-of-the-aged-care-industry

ACFA (2016) "Fourth report on the funding and financing of the aged care sector", July, downloaded 24/7/16 from https://agedcare.health.gov.au/2016-report-on-the-funding-and-financing-of-the-aged-care-industry

ACFA (2017a) "The protection of residential aged care lump sum accommodation payments", May 29, downloaded 20/6/18 from https://agedcare.health.gov.au/reform/the-protection-of-residential-aged-care-accommodation-lump-sum-accommodation-payments

ACFA (2017b) “Fifth report on the funding and financing of the aged care sector”, July, downloaded 24/7/18 from https://agedcare.health.gov.au/2017-report-on-the-funding-and-financing-of-the-aged-care-industry

ACFA (2018a) email from ACFA Secretariat on trigger events on the accommodation payments guarantee scheme, January 16

ACFA (2018b) downloaded 9/8/18 from https://agedcare.health.gov.au/aged-care-reform/aged-care-financing-authority

ACFA (2018c) ““Sixth report on the funding and financing of the aged care sector”, July, downloaded 28/8/18 from https://agedcare.health.gov.au/reform/aged-care-financing-authority/2018-acfa-annual-report-on-funding-and-financing-of-the-aged-care-sector

Aged Care Guild (2016) Submission to the Legislated Age Care Review, downloaded 27/8/17 from https://agedcare.health.gov.au/reform/aged-care-legislated-review/submissions

Aged Care Guild (2018) Submission 17 to the Senate Economics References Committee inquiry into the tax practices of for-profit aged care providers”, June, downloaded 13/7/18 fro https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Taxpractices-agedcare

AIHW (2018a “R1718_2706_Cumpston May 3.xlsx”, Excel file supplied May 3

AIHW (2018b) “Aged-care-data-snapshot-2017.xlsx”, downloaded August 13 from https://www.gen-agedcaredata.gov.au/

APRA (2013a) “Prudential Standard GPS 100 Capital Adequacy” downloaded 20/6/18 from https://www.apra.gov.au/sites/default/files/GPS-110-Capital-Adequacy-January-2013.pdf

APRA (2013b) “Prudential Standard GPS 112 Capital Adequacy: Measurement of Capital” downloaded 20/6/18 from https://www.apra.gov.au/sites/default/files/GPS-112-Capital-Adequacy-Measurement-of-Capital-January-2013.pdf

APRA (2017) “16/17 Annual Report”, Sydney, October 6

APRA (2018a) downloaded13/7/18 from https://www.apra.gov.au/about-apra

APRA (2018b) “Quarterly general insurance institution-level statistics March 2018” May 24, downloaded 20/6/18 from https://www.apra.gov.au/sites/default/files/0518-QGIPS-March-2018.pdf

Bruce Bailey (2018) personal advice August 13

Council on the Ageing ACT (2016) Submission to the Legislated Aged Care Review, downloaded 23/8/18 from https://agedcare.health.gov.au/reform/aged-care-legislated-review/submissions

Department of Health (2016) “De-Identified Data from the 2014-2015 General Purpose Financial Reports (GPFRs)” https://agedcare.health.gov.au/funding/financial-data-residential-aged-care/de-identified-data-from-the-2014-2015-general-purpose-financial-reports-gpfrs

Department of Health (2017) “2016-17 report on the operation of the Aged Care Act 1997” downloaded 20/6/18 from https://www.gen-agedcaredata.gov.au/Resources/Reports-and-publications/2017/November/2016%E2%80%9317_Report_on_the_Operation_of_the_Aged_Ca

Department of Health (2018a) “Better Quality of Care – managing prudential risk in residential care”, downloaded 9/8/18 from http://www.health.gov.au/internet/budget/publishing.nsf/Content/50647DE095E520E3CA25826D000635EA/$File/086_FINAL_FS_AAC_ManagingPrudentialRiskResidentialCare.pdf

Department of Health (2018b) “Inquiry into the financial and tax practices of for-profit aged care providers”, Submission 26 to the Senate Economics References Committee inquiry into the tax practices of for-profit aged care providers”, June, downloaded 13/7/18 from https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Taxpractices-agedcare

EY (2017) “Review of aged care legislation which provides for the regulation and protection of refundable accommodation payments in residential aged care”, report to the Department of Health May 26, downloaded 20/6/18 from https://agedcare.health.gov.au/sites/g/files/net1426/f/documents/08_2017/review-legislation-refundable-accommodation-payments-in-residential-aged-care.pdf

Rose Kenney, Gianna La Cava & David Rodgers (2016) “Why do companies fail?”, Reserve Bank of Australia discussion paper RDP 2016-09. Downloaded 9/8/18 from https://www.rba.gov.au/publications/rdp/2016/pdf/rdp2016-09.pdf

StewartBrown (2017) “Peer review of ACFA’s data collection and reporting activities”, report to the Department of Health, June, obtained on 16/2/18 in partially redacted form under FOI 146-1718

Sui-Lin Tan (2018) “Regrets, I have a few” Australian Financial Review Weekend 2 June

David Tune (2017) “Legislated review of aged care” July 31, downloaded 22/8/18 from https://agedcare.health.gov.au/legislated-review-of-aged-care-2017-report

Jason Ward (2018) “Tax avoidance by for-profit aged care companies: Profit shifting on public funds”, report to Taxation Justice Network - Australia, downloaded 20/6/18 from http://anmf.org.au/documents/reports/ANMF_Tax_Avoidance_Full_Report.pdf