**Senate Community Affairs Committee**

**Commentary**
**on the**
**Submission from OFM Investment Group Limited**

**by**

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## 1. Introduction

This commentary is made at the request of Senator Jan McLucas during the course of the hearing on the three aged care bills before the Community Affairs Committee in the afternoon of Thursday, 2nd March 2006. That submission is a proposal to use a type of life insurance policy, referred to as an "income bond", in parallel with the established accommodation bond as a means to ensure repayment of the balance of that accommodation bond after retention payments have been met.

## 2. Mechanics

The income bond is a life insurance policy for which bonus payments are regularly made, thus being akin to interest payments. The use of this financial instrument in the aged care situation is directed specifically to the proposal for guaranteeing the repayment of the accommodation bond.

The accommodation bond is an asset for the resident and a liability on the balance sheet of the aged care provider. It has the unique characteristic whereby the interest on the value of the bond accrues to the provider and not the assetholder, in this case the resident.

The income bond would be purchased by the aged care provider. The regular bonus payments on the life insurance policy would be paid to the owner thus preserving the income stream enjoyed under existing arrangements with accommodation bonds. The aged care provider as owner would be required to hold the income bond in trust for the resident being the original asset holder of the sums committed. The income bond as a life insurance policy would be in the name of the resident thus ensuring payment of outstanding balances at death. This payment might be made to a nominated beneficiary rather than to the estate of the deceased.

The submission treats the income-earning assets into which the funds associated with the income bond could, or should be placed. Distinctions are drawn between “capital guaranteed” and “capital secure” bonds reflecting commitments in official and bank securities in the former category and more corporate debt in the latter. The aged care provider would have an understandable wish to seek the higher return from the “capital secure” bond while the resident, or more particularly the resident’s heirs, in the “capital guaranteed” offering.

An additional advantage claimed for the income bond as a life insurance policy is the insulation from claims of creditors in the event of an aged care provider falling into bankruptcy proceedings. In as much the legislative proposals before Parliament are for a guarantee of the repayment of the bond, this feature means little for the resident or the resident’s estate. The advantage would accrue to the Australian Government in as much as it would not need to invoke the guarantee process. Note how this advantage accrues from an effective seniority of the income bond in the priority of creditors' claims in contrast to the absence of that seniority with the accommodation bond.[1]

## 3. Some Questions

### a. Funding Aged Care

The income bond transfers funds provided by accommodation bonds out of the aged care industry. The main purpose of the accommodation bond has been to provide additional funding to that generated by boards and management of aged care entities through equity raisings, debt issuance, borrowings mainly from banks and donations as in the case of "not for profit" aged care services. At a time when there is every reason to foster expansion of both residential and domiciliary facilities, the inauguration of income bonds would handicap funding.

Boards and management of aged care services not confident of managing their liabilities embodied in accommodation bonds, especially the liquidity requirements for prompt repayment, might find the transfer of responsibility to the writer of a life insurance policy a most welcome relief. However, the same boards and management might well ponder whether they should accept accommodation bonds at all.

Boards and management of aged care entities use funds provided by accommodation bonds to help fund the expansion of capacity in residential and domiciliary services. Some 75 per cent or thereabouts of providers accept accommodation bonds. The great bulk of these entities have managed the funds in ways allowing for repayment when called

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[1] Government might seek to remove this difference by seeking thje same seniority for accommodation bonds

upon to so do. No reasons have been advanced to think the task has been too demanding. Nonetheless, the experience of using accommodation bonds has been in a period when general economic circumstances have been benign and interest rates low, in real and nominal terms, and stable. In different circumstances some boards and management might be more risk averse than witnessed in the past fifteen years thus finding some attraction in income bonds and setting aside any advantages accruing from access to additional funding.

b. Transfers of Residents

The submission does not address the situation where a resident of an aged care facility being the beneficiary of an income bond, wished to transfer to another place. What provision could be made to pay out the income bond(as a life insurance policy) being the accommodation bond? The commitment sought by the new provider may differ from that sum placed with the existing provider so there would be no basis for transfer of the life insurance policy even were the two providers in agreement about the terms of that policy including the writer of the policy. Until this feature is clarified the proposal is defective.

Not all residents leave aged care services because of death which is the implicit assumption of the submission. Residents do change locations and the expectation would be, in my judgement, for more in coming years than hitherto. Lesser features of this position relate to the costs of revoking the insurance policy and which party would bear the costs. It could not be the resident so this would rest between provider and entity offering the policy.

c. Prudential Aspects

A claim made for the income bond is the security of the life insurance policy. The position of OFM is made clear believing in the need for the monies to be prudently invested. No doubt this stance would be followed in practice by OFM were income bonds to be endorsed for use in aged care. However, OFM could not be the only writer of life insurance policies as income bonds. Other writers may explore placement of funds to secure higher returns which would in turn be more attractive to the aged care providers as owners and, more importantly, recipients of the income stream.

d. Monitoring and Supervision

Inauguration of an income bond scheme, partial as the coverage might be, would shift the supervision of the integrity of the financial arrangements with respect to accommodation bonds from the Department of Health and Ageing as under proposals before Parliament to the twin scrutiny of the Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulatory Authority (APRA).[2] Reflection on the recent history of the insurance industry in Australia might suggest OFM has a misplaced confidence in the quest for security of asset allocations.

e. Repayment Issues

The submission makes much of the flexibility at termination of the income bond owing to the death of the insured. The sums might accrue to the estate or to nominated recipients, the latter not necessarily beneficiaries of the estate. Much is made of the speed of the payout where there are nominated recipients. There is some need for caution in the age

[2] Note well how ironic this situation would be recalling the Australian Government's rejection of the proposal for an independent watchdog, separate from officialdom, in the recommendations from my Review.

care setting where experiences dictate not all residents to be in command of their destiny owing to the ravages of ill-health such as arises with neurodegenerative diseases. Providers may on occasion call upon official guardians to protect the interests of their residents. Some families may be dysfunctional.

The submission is silent on provisions about the determination of nominated recipients of the life insurance policy being the income bond. Not all residents on entry command their faculties; this being a reason for entry into residential aged care. This places the aged care provider as the owner of the income bond in a most testing position as a trustee for the resident. The enthusiasm exhibited in its submission does not reflect the necessary scrutiny of the practicalities of aged care experiences.

The claimed speedy repayment of the balance of the accommodation bond through the income bond would not be a concern for the deceased. That aspect is of interest to the heirs of the estate and, if different, the nominated recipients in the life insurance policy being the income bond. This feature should be made clear as to whose interests are being served. At this point it is important to note the provision in the proposed legislation to ensure the accommodation bond is repaid to the right person or persons.

4. Other Matters

a. Transactions Costs

The proposal for an income bond introduces an additional transaction into the provision of funding through aged care residents. There must be costs associated with the taking out of a life insurance policy and there would be continuing administrative costs including those generated on termination. As noted earlier, in Section 3b, this could not be the resident because the value of the accommodation bond must be preserved. Why would a resident pay an initial fee for the policy when the government-guarantee for return of monies is in place. No good purpose is served by paying fees for no gain. This is important because should the resident be unable to act in her or his own right, then those acting on his or her behalf may be tempted to see matters differently, especially should the recipients of the income bond as a life insurance policy on the death of the resident, not be the estate but some other person or persons.

The writer of the life insurance policy would not offer the instrument were the costs sufficient to impede the fostering of the income bond for aged care. The weight of possibilities points to the provider experiencing some reduction in the bonus(interest) payments compared with might have been achieved when managing the funds tied to accommodation bonds. This feature would be an incentive to providers to seek insurance policies with higher returns and more risk than would otherwise be the case. This is an extension of the same feature taken up earlier in Section 2 on “capital guaranteed” and “capital secure” approaches to investing funds.

b. Reverse Mortgages

OFM notes in an opening statement to its submission how it has been prominent in the offering of reverse mortgages enabling people to borrow funds against the equity held in the family home. Some explanation should be offered about reconciling the conditions of the reverse mortgage to the provisions in the life insurance policy being the income bond, allowing recipients of the repayment sum from the original accommodation bond to be other than the estate.

The family home will be a part of the family estate and the reverse mortgage will be a liability of the estate. If no provision is made in these circumstances to provide for the bond repayment sum to accrue to the estate there could well be a serious financial dislocation, especially should the deceased resident be survived by a spouse or another family member of the same generation requiring support which was expected to come from the estate. This is another matter where the information is deficient and thus thwarts any good purpose to which the income bond proposal was directed.

5. Summing Up

The proposal for introduction of an income bond is redundant in light of proposals embodied in the legislation now before Parliament and being considered by the Senate Community Affairs Committee. It might appeal, in principle, to those boards and management of residential aged care facilities who are highly risk averse about use of accommodation bonds. As observed those entities should not accept such bonds in the first place.

The proposal is derelict in the failures to treat issues. Before any further consideration be given to the proposal, these issues should be addressed.

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