Australian Government

Aged Care Financing Authority

THE PROTECTION OF RESIDENTIAL AGED CARE LUMP SUM ACCOMMODATION PAYMENTS

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GLOSSARY

Term	Definition
Accommodation payment	Unless otherwise indicated, in this report, it is used interchangeably with 'lump sum accommodation payment'.
The Act	The *Aged Care Act 1997.*
Accommodation bond	Prior to July 2014, a lump sum amount paid by a low care resident for their accommodation costs in a residential aged care facility.
Daily accommodation payment	An amount paid by a care recipient towards their accommodation costs in a residential aged care facility calculated on a daily basis and paid periodically.
Guarantee fund pool	A type of guarantee scheme, involving a fund that holds regular contributions paid by aged care providers. In the event a provider becomes insolvent, the contributions held in the fund are used to repay residential aged care consumers the refundable value of their lump sum accommodation payment.
Guarantee scheme	A scheme providing a guarantee to all residential aged care consumers that the value of any lump sum accommodation payments they have paid to an aged care provider will be returned to them, in the event that the provider becomes insolvent.
Lump sum accommodation payment	In this report, refers collectively to entry contributions, accommodation bonds, refundable accommodation deposits, and refundable accommodation contributions.
Refundable Accommodation Deposit / Refundable Accommodation Contribution	From July 2014, the amount paid as a lump sum by a care recipient for their accommodation costs in a residential aged care facility.
Reinsurance	A method for an insurer to reduce the risk of low probability, high impact events, through spreading their risk of payment across several insurers.
Residual liability	Any gap between the liability that a guarantee scheme will absorb, and the total costs that might arise from providers becoming insolvent.
Risk rating	Assessment of the risk that a default event will occur to an individual provider or across a class of aged care providers, relative to the risk that the event will occur across all aged care providers.

EXECUTIVE SUMMARY

ACFA's study

In November 2015 ACFA was tasked by the Minister for Health, Aged Care and Sport to examine the existing Accommodation Payment Guarantee Scheme (the Guarantee Scheme) and any alternatives, and provide advice to Government.

Under the Guarantee Scheme, the Commonwealth provides residential aged care consumers with a guarantee that the refundable value of any lump sum accommodation payments (referred to as bonds and entry contributions prior to July 2014, and refundable accommodation deposits since) 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.

There are many layers of protection afforded to consumers when they pay providers a lump sum accommodation payment. They are protected by:

- Australian consumer law;
- Contract law;
- The *Corporations Act 2001*;
- Aged care law including the *User Rights Principles 1997* and *Fees and Payment Principles 2014 (No 2)*. These are monitored and enforced through prudential standards and monitoring; and
- The Guarantee Scheme.

The Guarantee Scheme, which is the subject of this review and report, is not the primary protection of consumers' funds, but stands as a safety net when a provider has become insolvent. The Scheme is however important to consumer confidence. In considering different ways in which the protection afforded by the Scheme could be provided, ACFA is confirming that it is critical that consumers' funds continue to be guaranteed.

In addition to reviewing the effectiveness of the Scheme, ACFA examined alternative arrangements for achieving the Scheme's objectives, including their benefits, costs and risks. Consideration of alternatives was undertaken by preparing a number of options for further consultation and analysis. Evaluation of the options was undertaken through three main strategies:

- Analysis of options against a set of principles;

- Stakeholder engagement; and
- Expert modelling of how the different options might operate.

The range of options identified was:

1A. Retain the existing Scheme, noting that the decision to implement a retrospective levy on providers following a default event rests with the Minister;

1B. Retain the existing Scheme, but automatically trigger a retrospective levy on all providers following each future default event;

2. Create a guarantee fund pool through a prospective levy on all providers;

3. Industry arranged bank guarantee;

4. Private insurance model; and

5. Pooled insurance model.

The principles against which the options were assessed were:

1. Effectiveness;
2. Efficiency and Cost;
3. Simplicity;
4. Sustainability;
5. Equity;
6. Operability;
7. Encouraging right behaviour; and
8. Certainty.

Evaluation of options

Of the range of options under consideration, ACFA concluded that three warranted detailed examination: the existing Scheme; the automatic retrospective levy; and the guarantee fund pool with prospective levy. ACFA concluded that the bank guarantee, private insurance and pooled insurance options are either likely not to be viable, or not as effective as the first three options.

The existing Scheme provides coverage to consumers and providers, but its current operation creates some uncertainty and inequity for providers. For government, it is unusual because beneficiaries of the Scheme do not contribute to its cost. The Government remains fully exposed to an unknown future liability, the costs of which are impacted by factors generally outside its control. Providers also face uncertainty relating to whether and at what price a retrospective levy will be applied to recoup the costs of past default events, which hinders their ability to plan.

The existing Scheme with an *automatic retrospective levy* is likely be as effective as the existing arrangements. For government, the automatic levy would provide a greater sharing of costs and be more sustainable. There will always be uncertainty about the size of the levy in any given year because it is determined by the magnitude of actual default events, which are unknown. This

uncertainty regarding the timing and amount of default event costs will limit providers' ability to plan. The introduction of an automatic levy could provide a fairer sharing of costs for government, with a greater connection between the costs of the Scheme and its beneficiaries, although an inequity still exists for providers as a defaulting provider does not contribute to the default costs at any stage. This inequity can only be addressed through the application of a prospective levy.

The *guarantee fund pool with a prospective levy* could provide full protection to providers and consumers, as long as the Commonwealth guaranteed refunds if the costs of a default event exceeded the value of the funds accumulated in the guarantee fund pool. The guarantee fund option could be more equitable than both the existing Scheme and the automatic retrospective levy because all providers, including those that subsequently default, contribute to the costs of default. The guarantee fund option also offers greater certainty to providers about the size of the levy in any given year, facilitating their budgeting. The guarantee fund pool would be initially more complex to implement and would require significant actuarial modelling to define the total pool required and the size of annual levies. Once established, the ongoing operation of the fund could be straightforward.

Conclusions

ACFA agrees in principle with previous reviews, including by the Productivity Commission and the National Commission of Audit, which concluded that the Scheme's beneficiaries should contribute to the costs of the guarantee. This would bring the existing Scheme into line with other similar systems, such as building completion warranty, medical indemnity and student tuition fee protection. It would also limit the Commonwealth's liability. This should be the case whether the existing Scheme is retained, or another model is implemented. However, in practice, a levy or other cost sharing mechanism should only be implemented if the benefits of doing so outweigh the costs.

Continuing the existing Scheme is a viable option. If the Government chooses to retain the existing Scheme, ACFA recommends that greater certainty is given to providers by quarantining defaults to date from future levy imposition, and by formalising processes that will notify the sector of default event costs and the Minister's decision as to whether a levy will be applied.

The automatic retrospective levy option would be effective for consumers, but providers would continue to face issues of uncertainty and inequity. The guarantee fund pool has the potential to be effective for consumers, providers and government, providing an alternative solution to the issues of uncertainty and inequity.

Whether the existing Scheme is retained, or another option is chosen, the Commonwealth may wish to consider purchasing a layer of reinsurance to help manage risk, as currently occurs in several other schemes, including the Tuition Protection Service and the Australian Reinsurance Pool Corporation reinsurance scheme.

In the event that Government decides to move to an option other than the existing Scheme, consideration will need to be given to how to manage any residual risk (for example if a default requires refunds greater than a scheme's coverage). The key factor in managing residual risk is that scheme coverage be sufficient to ensure consumer and investor confidence.

Another issue worthy of careful consideration and analysis in the event the Commonwealth implements a levy, or moves to a different model, is the use of risk rating in determining the levy payable by each provider. ACFA concludes that a risk rating methodology is more complex to implement than a flat fee arrangement but can work effectively in practice to improve performance, as in professional indemnity insurance schemes. Cost differentiation using risk rating can be effective in achieving an equitable distribution of costs, but would require detailed consultation with the sector prior to implementation. Risk rating would also necessitate establishment of a process of review and appeal of risk rating assessments.

Finally, ACFA advises against providers being able to opt-out from a scheme and provide their own guarantees. It is likely to impair the sustainability of a scheme by necessitating a higher levy from fewer participants. It would also be complex to administer and manage.

CHAPTER 1

INTRODUCTION

1.1. Introduction

The Aged Care Financing Authority (ACFA) is an independent statutory committee whose role is to provide independent, transparent advice to the Australian Government on financing and funding issues in the aged care sector. ACFA considers issues in the context of maintaining a viable, accessible and sustainable aged care industry that balances the needs of consumers, providers, the workforce, taxpayers, investors and financiers.

ACFA was tasked by the former Minister for Health, Aged Care and Sport to study alternatives to the existing Accommodation Payment Guarantee Scheme (the Scheme) and provide advice to government.

In addition to reviewing the effectiveness of the Scheme, ACFA examined a number of alternative arrangements for achieving the Scheme's objectives, including their benefits, costs and risks.

ACFA was not asked by the Minister to provide recommendations to the Australian Government on change to the existing Scheme or the introduction of alternatives to the existing Scheme.

This Report has been prepared by ACFA to provide advice to the Government on the existing Scheme and the feasibility of any identified alternative arrangements. Any decision to make changes to the existing Scheme rests with Government.

1.2. The context of the study

1.2.1. What is the Scheme?

The majority of people entering residential aged care contribute to the costs of their accommodation. This contribution is often made by paying a lump sum upon entry, called a bond or entry contribution (prior to 2014) or a refundable accommodation deposit or contribution (since 2014). Collectively, in this report, these payments are referred to as **lump sum accommodation payments**. These payments are returned to residents (or their estates) when they leave residential care, less any amounts that have agreed to be deducted.

Lump sum accommodation payments have a critical role in the capital financing of the residential aged care sector. For many decades, residential aged care providers have been able to receive upfront lump sum accommodation payments from consumers. These have served as interest-free loans to support the provision of their accommodation. These payments have assisted the sector to create and renew the building stock required to support the current and future demand for services.

At 30 June 2016, the residential aged care sector held lump sum accommodation payments of approximately $21.7 billion, and at this time, the average new agreed accommodation price was $370,541.[1] Because lump sum accommodation payments are large sums that may represent the majority of a resident's wealth, it is vital that these investments are secure. For this reason, their refund is guaranteed in the event that the provider that holds them becomes insolvent. This guarantee is what the Scheme provides.

[1] Based on 89 per cent provider responses to the Survey of Aged Care Homes 2016.

1.2.2. Why was this study needed?

Currently, the Scheme operates by the Commonwealth Government providing a guarantee on all lump sum accommodation payments. Aged care residents and service providers make no direct contribution to its costs. Successive recent reviews and reform processes have recommended changes to the Scheme (including a 2011 Productivity Commission report, the 2012 Living Longer Living Better reform package and the 2014 National Commission of Audit), with a common theme that aged care providers should contribute in some way to the cost of guaranteeing lump sum accommodation payments.

Most recently, the aged care reforms implemented in July 2014 have made a number of changes that could impact on the existing Scheme's response to any future unforeseen provider failures.

- Providers must advertise a price for their accommodation. This has improved a consumer's ability to compare services and clearly understand the value of their accommodation. In parallel, the average cost of accommodation has increased to $370,000 (during 2015-16) which has potentially increased the future total value of lump sum accommodation payments protected by the Scheme ($21.7 billion at June 2016).
- The restriction on receiving lump sum accommodation payments for consumers with high care needs on entry has been removed. This means that the total value of payments guaranteed by the Scheme has increased noticeably.
- Consumers can choose how they pay for their accommodation: either using a refundable lump sum, a daily payment or a combination of both. This means that the Scheme could guarantee more lump sum accommodation payments but of lesser individual value.

It is also timely to consider the impact of future aged care reform activity with respect to how lump sum accommodation payments are guaranteed. The future reform objectives of Government, including its consideration of the Aged Care Sector Committee's Aged Care Roadmap, could lead to the implementation of a range of reforms that could change the way that government regulates the supply of aged care places and access to aged care services.

There are other policy considerations that ACFA has also noted. There is the question of whether the Commonwealth has the most appropriate systems in place to manage risk. Currently the Scheme is underwritten by the Commonwealth government through a contingent liability equal to the total value of lump sum payments held by providers. This means that the Government is carrying the risk for services of which it is neither owner nor operator. The scale of the contingent liability also does not reflect the likely scale of default in any period. Clearly, the whole industry would not default at once.

There is uncertainty for providers with the operation of the existing Scheme. Currently, the Government may charge all providers a levy to recover payments made under the Scheme. Providers do not know, however, whether or when it will be charged, so cannot plan for levy costs in an orderly way. The legislation also does not set out how the levy would be calculated, or which classes of provider might be charged. In this environment, providers face a degree of uncertainty relating to if and when they might face a levy in the future, as well the basis on which it will be calculated.

Finally, when the aged care reform legislation was passed in 2013, it included a legislated requirement that the effectiveness of arrangements for protecting refundable payments and

accommodation bonds be reviewed in 2016-17. As explained later in this chapter, this study is contributing to that review, being conducted by Mr David Tune and due to report in August 2017.

For these reasons, ACFA is required to review the Scheme and consider whether it has the right design, and strikes the right balance, to ensure sustainable protection of accommodation payments into the future.

1.3. ACFA's approach to the project

ACFA's approach was to:

- Consider the role and importance of lump sum accommodation payments in the aged care sector;
- Understand the history and objectives of the Scheme;
- Describe how the Scheme fits with other policies and laws that protect lump sum payments, and how the Scheme currently operates;
- Identify possible alternatives to the existing Scheme (options); and
- Evaluate the existing Scheme and those options, including their feasibility.

A history and explanation of the role of lump sum accommodation payments in aged care investment is provided in the next chapter. The report then provides a detailed description of the existing Scheme in Chapter 3.

Consideration of alternatives was undertaken by preparing a number of options that could then be subject to consultation and analysis. Evaluation of the options was undertaken through three main strategies:

- Analysis of options against a set of principles;
- Stakeholder engagement; and
- Expert modelling of how the different options might operate.

1.3.1. Identification of options

In conjunction with the Department, ACFA drew on a range of information to develop several possible alternatives to the current Scheme. These options were derived from suggestions made by stakeholders, proposals considered by government, and existing arrangements in Australia and overseas designed to protect investments of different kinds. These provided ACFA with potential models for the protection of accommodation payments. The main alternatives ACFA identified are listed in the following tables.

Table 1: Existing Scheme and variant

Existing Scheme and variant	
1.A	Retain the existing Scheme, noting that the decision to implement a retrospective levy on providers following a default event rests with the Minister

Existing Scheme and variant	
1.B	Retain the existing Scheme, but automatically trigger a **retrospective** levy on all providers following all future default events

Table 2: Alternative approaches to the current Scheme

Alternative approaches to the current Scheme	
2	Create a guarantee fund pool through a **prospective** levy on all providers
3.	Industry arranged bank guarantee
4.	Private insurance model
5	Pooled insurance model

Option 1A: Status quo: retain the existing Scheme, noting that the decision to implement the levy following a default event rests with the Minister

The current Scheme enables the Australian Government to pay an aged care resident an amount equal to the accommodation balance owed to them by an approved provider. In exchange for the payment, any rights the resident had to recover the amount from an approved provider are then transferred to the Commonwealth. The Scheme assures the refund of accommodation payments to residents in the event that a provider is unable to refund payments because they are insolvent.

Under the existing Scheme the Government may elect to apply a levy on some or all providers in the event of the Scheme being activated. The Government has not yet chosen to apply the levy provisions, but can do so at any point – there is no time limitation in the levy legislation – nor is there a prescribed method as to the basis of calculation or the applicable period.

This option involves the continuation of the existing Scheme and the provision of coverage automatically to all approved providers. The existing Scheme could continue to operate at no cost to the provider, regardless of default events.

Following a default event, the Commonwealth would repay accommodation payment balances and then consider whether or not to exercise its current right to recover any costs to the Commonwealth through its levy power.

The historical scheme figures show that, if the levy had been implemented in the past, the largest amount levied in a single year would have been slightly less than $20 million.[2]

Option 1B: Retain the existing Scheme and implement the levy following a default event

This variation on the status quo involves the continuation of the existing Scheme and the provision of coverage automatically to all approved providers. The existing Scheme would continue to operate at no cost to the provider *until a default event occurs.*

[2] In the 2008-09 financial year there were two defaults totalling $18.2 million.

Following a default event, the Commonwealth would repay lump sum accommodation payment balances to residents, and then recover the cost through a retrospective levy imposed on all providers.

The Commonwealth can adopt an instalment approach in applying the levy, which could diffuse the impact of individual default event costs for providers. ACFA considered this option with the retrospective levy being calculated as a third of the costs of default events of the preceding three years. Under this option there would be no ceiling on the recovery of costs from providers.

Option 2: Guarantee fund pool and annual prospective levy

This option involves all approved providers in receipt of accommodation payments paying an annual contribution into a fund. The fund would hold and accumulate the annual provider contributions to meet future payouts. The contributions paid by providers would also need to cover the costs of setting up and administering the fund. Any income derived on the revenue held in the fund would add to the balance of funds accumulated.

When a default event occurs, a claim for payment would be made to the fund administrator. The fund would repay the outstanding accommodation payments to the care recipients.

The legal and operating structure of the fund could take a number of different forms, including a Commonwealth Special Account, a trust, a company structure or a statutory authority. It could be operated and managed by the Government, the sector or a combination of both. Additional oversight of the fund may be required through the Department of Treasury and/or the Australian Prudential Regulation Authority.

As the accommodation payment pool is so large ($21.7 billion and projected to grow), ACFA considers that the Government would always be required to be part of any alternative scheme.

An example of an existing fund pool can be seen in the operation of the Tuition Protection Service (TPS) and the Overseas Student Tuition Fund. This account is managed by the Department of Education and Training and is used to protect the course fees paid by overseas students. The TPS governance framework consists of a statutorily appointed Director and a 12-member Advisory Board.

Option 3: Industry arranged bank guarantee

This option is an alternative to approved providers paying amounts directly into a fund and assumes that the sector would arrange a bank guarantee for a fixed amount to cover the anticipated costs associated with repayment of outstanding lump sum accommodation payments. The bank guarantee is an unconditional promise from the bank to pay the consumer the amount owed to them in the event of a provider's default, and requires security in the form of a combination of cash held on deposit with the bank or other assets such as property. The deposit funds held as security will accumulate interest at the prevailing interest rate.

When a default event declaration is made by the Government and approval is given for repayment through the scheme, a demand for payment would be made by the Government against the failed provider's bank guarantee. The issuing bank would settle the debt and take possession of the cash or assets held as security upon settlement of the guarantee.

Option 4: Private insurance /model

This option involves each approved provider separately purchasing an insurance policy covering the total value of all lump sum accommodation payments that each provider holds. When a default event occurs, a lump sum payment holder (or their estate) would make a claim against the approved provider's insurance policy. The insurer would assess and process the claim, and then arrange for the payment of the net outstanding lump sum accommodation payments to the care recipients from their funds. Insurers may impose their own administrative or reporting requirements.

Insurance coverage would need to ensure that there is a safety net for residents in all circumstances, and this option would involve working with the insurance sector to create a 'without exception' insurance product that is suitable for this purpose. The insurance policy would need to cover all factors that contribute to an approved provider becoming insolvent. This includes extending to situations where a provider is insolvent, but wind up action has not yet commenced and the approved provider has an extremely low probability of being able to trade out of difficulty.

Option 5: Pooled insurance model

This option involves all approved providers collectively purchasing coverage under a national insurance policy to cover the aggregate lump sum accommodation balance held by the sector. When a default event occurs a claim would be made against the national insurance policy. The insurer would assess and process the claim, and then arrange for the payment of the net outstanding lump sum accommodation payments to the care recipients from their funds.

The national insurance policy would cover all approved providers and would be developed based on the aggregate lump sum accommodation payment balance held by the sector, and the risk profile of the sector, as assessed by the insurer.

1.3.2. Analysing the options: a principles-based approach

ACFA developed a principles-based framework within which to evaluate the options. This allowed ACFA to:

- Identify and describe the essential features that any scheme should have;
- Provide criteria which could be used to review both the existing Scheme and any alternatives on a consistent basis; and
- Consider these features from the perspective of all stakeholders: consumer, provider and government.

This provided criteria which could be used to review effectiveness of the existing Scheme as well as alternatives. ACFA believes that using the principles-based approach will allow Government to consider the regulatory impacts of any alternatives including alignment with the Government's red tape reduction agenda, in the event that it decides to make changes to the Scheme.

Development of the principles commenced by considering the criteria needed to assess the effectiveness of the existing Scheme. Members brought to bear their different perspectives and experience, as well as expertise from regulation and financial practice in other sectors and contexts.

Members noted first and foremost that the current Government guarantee provided consumers with confidence that their lump sum accommodation payments were secure, and that it was essential that this confidence could be retained in any alternative arrangement.

Access, efficiency, simplicity and sustainability were also considered essential criteria.

Members also wanted to include a criterion which considered the extent to which any scheme promoted appropriate stakeholder behaviour. Importantly members thought that the principles needed to consider the impact of implementing any alternative, including whether it could adapt to any future changes to the funding and regulation of residential aged care, and whether there was scope to reduce the administrative burden of regulation.

The issues were captured using eight principles:

1. Effectiveness;
2. Efficiency and Cost;
3. Simplicity;
4. Sustainability;
5. Equity;
6. Operability;
7. Encouraging right behaviour; and
8. Certainty.

In considering each of the eight principles, ACFA recognised that there would be a range of desired outcomes sought by consumers, providers and government. ACFA adopted these principles, and used a range of questions shared with stakeholders during consultations, to help collect information about the extent to which the different options might meet the needs of an accommodation payment protection scheme. Those questions were:

Effectiveness

- Is every consumer’s accommodation payment fully guaranteed?
- Is every provider fully covered?
- Is government only being called upon when all other avenues are exhausted?

Efficiency and cost

- If consumers or providers are making a contribution toward the cost of protecting accommodation payments, are they getting value for money?
- Is any cost borne by taxpayers appropriate?

Simplicity

- How easy is it for consumers to ensure their money is protected, and for them to recover it in the event of a provider default?
- Can providers ensure coverage with a minimum of administration?
- Can government ensure coverage, and have sufficient information to know the system is working, with a minimum of administration?

Sustainability

- Are any costs passed on to consumers appropriate and if so, fair and equitable, over time as the industry evolves?
- Are any costs borne by providers manageable over time as the industry evolves?
- Are any costs to government appropriate, sustainable and predictable?

Equity

- Do all consumers have access to protection of their accommodation payments, regardless of their circumstances?
- Do all providers have the same opportunity to participate in the scheme?
- Is government able to be certain that every consumer has equal protection?
- Do those who pay for the scheme derive a benefit from it?

Operability

- Would any change to the existing Scheme be achieved without affecting consumer or provider participation during the transition?
- Would the change be easy for consumers and providers to understand and accept?
- How much alteration to providers' business systems and processes would the change require?
- How much alteration to legislation and government business systems and processes would the change require?
- Would new stakeholders, such as new regulators, insurance companies or banks, be required to become involved and to become expert in a new industry?

Encouraging right behaviour

- Is lump sum protection likely to motivate appropriate changes in provider risk levels and behaviour?
- Will the scheme give government and providers the incentive to maintain appropriate prudential controls and to manage against the risk of insolvency?

Certainty

- How certain can consumers, providers and government be that accommodation payments are protected in all circumstances?
- Will the scheme support investor confidence in the sector?

1.3.3. Analysing the options: expert input

ACFA engaged PricewaterhouseCoopers to provide advice and analysis, including modelling the impact of the options. ACFA also consulted the Australian Government Actuary (within the Treasury) to provide relevant advice.

The Department of Health engaged PricewaterhouseCoopers (PwC) on 2 June 2016 to work collaboratively with the Departmental project team and ACFA in conducting a review of the existing Scheme, including an assessment of the costs, risks and benefits both as it operates now and its operation into future. PwC provided a team with actuarial, banking and finance expertise and

facilitated ACFA's consultation with experts from the banking and insurance sectors. PwC worked with the Departmental project team and ACFA in examining, assessing and developing possible alternative options, including an assessment of the costs, risks and benefits of each alterative identified. 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.

1.3.4. Analysing the options: modelling

The model of accommodation payments in the residential aged care sector provided by PwC was used by ACFA to analyse the future accommodation payment pool and the possible costs of guaranteeing it in different ways. PwC modelled a range of possibilities, based on Departmental data and the requests made by ACFA. These results helped inform the evaluations of guarantee scheme options.

ACFA and the Department worked with the consultants to build a model of accommodation payments in the aged care sector. The model considered:

- The population of consumers and their aged care choices;
- The range of providers and their accommodation payment history; and
- Government policy relating to accommodation payments and residential care.

Building linkages between the important variables in each area, the model predicts the size of the pool of accommodation payments, and looks at how the risk of default may translate into a levy on providers that would meet the cost of that risk. The model's variables are built across:

- Provider characteristics, operations and behavioural variables;
- Consumer demographic and behavioural variables;
- Regulatory variables; and
- Economic variables.

More detail about the variables and assumptions incorporated into the model can be found in Appendix 1.

The modelling has been used by ACFA to examine the way that particular options for the protection of lump sum accommodation payments would operate, what they might cost, and what some of the key policy considerations might be. Some results of modelling for specific options are discussed in the chapters about those options.

1.3.5. Analysing the options: stakeholder engagement

To obtain the views of the aged care sector and wider public on the existing Scheme and alternative approaches, ACFA undertook two stages of consultation:

1. Initial targeted discussions with consumer and provider peak bodies as well as aged care financiers and insurers; and
2. Invitation to the broader industry and public to provide written submissions.

ACFA met with consumer and provider organisations in late 2016, to discuss possible options and policy questions. These consultations ensured ACFA was presenting options and issues that were consistent with those recognised by key stakeholders in aged care. The input from stakeholders in this first phase informed the development of the public discussion paper, and the decision to maintain a focus on a limited number of likely options, rather than extensively considering every possible configuration of an accommodation payment guarantee scheme.

On 3 February 2017 ACFA published a call for submissions on its website, seeking responses by 3 March 2017. Stakeholders including aged and flexible care providers and peak bodies were notified of ACFA's call for submissions via the Department's Bulk Information Distribution System. ACFA wrote to the Aged Care Sector Committee and National Aged Care Alliance, asking them to distribute the call for submissions notification, with accompanying links to the ACFA website. Key peak consumer and provider organisations who had been involved in previous discussions were also notified.

ACFA received 26 submissions, including 18 from providers and provider peaks, 3 from consumer peaks and 5 from others, such as insurance companies and consultants. These were complemented by 50 published submissions received by the Aged Care Legislated Review (ACLR) currently being undertaken by Mr David Tune, that also commented on the Guarantee Scheme, and to which ACFA was able to refer. In this report, submissions to ACFA are referred to simply as submissions, while those made to the Legislated Review are referred to as ACLR Submissions.

ACFA is also grateful to officials from Commonwealth, State and Territory agencies who took time to provide explanations and advice about how they undertook their work, and their experience administering diverse schemes with the common goal of providing guarantees in the public interest.

1.4. Policy issues

In the course of its inquiries, ACFA identified several policy issues for consideration where an accommodation payment guarantee is being provided. These policy issues are not limited to any single option, but they do influence how options should be designed if the options are to meet Government policy objectives, as well as to make them as efficient and effective as possible. These issues influenced how ACFA approached the evaluation of its options, and are briefly summarised here. More detail about many of the options is found in Appendix 2.

The key policy issues that cut across some or all of the options for providing an accommodation payment guarantee were:

- Recovery of guarantee costs;
- Reinsurance;
- Management of residual liability;
- Opting out; and
- Attribution of costs, including risk rating.

1.4.1. Provider recovery of guarantee levies from consumers

The existing Scheme and other options envisage that providers may be charged a levy to fund the cost of the Scheme. Providers may then wish to consider whether and how much of that cost they would pass on to consumers. Currently there are two factors that would impact on that decision. First, the law restricts the nature and uses of consumer fees that providers are allowed to charge. This position was highlighted in the Department of Health's advice to residential care providers in 2016, that fees for other care or services are capped, must be agreed with the resident beforehand and cannot be charged unless the resident receives a direct benefit from them.[3]

Second, the law also requires equivalence between a lump sum accommodation payment and a daily payment,[4] to ensure consumers have full discretion to choose which mode of payment they prefer, without incurring a financial penalty.

These current constraints on provider fees may prevent or limit a providers' ability to charge levy costs associated with the accommodation payment guarantee. This would be particularly relevant if such charges were on-charged only to consumers that have made lump sum payments and not those making daily payment, as it could impair the currently required equivalency. On the other hand, it may be difficult on equity grounds to justify on-charging the levy to all consumers, unless the levies are viewed as general financing costs of the business.

Policy reform would need to make explicit and resolve three issues:

- Whether or not providers have the discretion to pass on to consumers the cost of a levy;
- How any differential in on-charging between lump sum and daily payment consumers would affect the current nexus between lump sum and daily payments; and
- Consistency with the policy on Additional Services.

1.4.2. Reinsurance

During consultation with experts and other scheme operators, it became apparent that it would be challenging, and potentially inefficient, to try to create a scheme without a mechanism to manage the impacts of low probability events with very large costs. All models of guarantee scheme have to confront this problem.

ACFA responded by examining the inclusion of reinsurance as part of the design of various options. Reinsurance is a method for an insurer to spread their risk of payment, by providing protection against the risk of a large claim occurring. The insurer will purchase reinsurance from other insurance companies in exchange for agreeing to pay part of the payment required if a large claim arises. Reinsurance provides an insurer with a way to manage the financial impacts of a large claim occurring.

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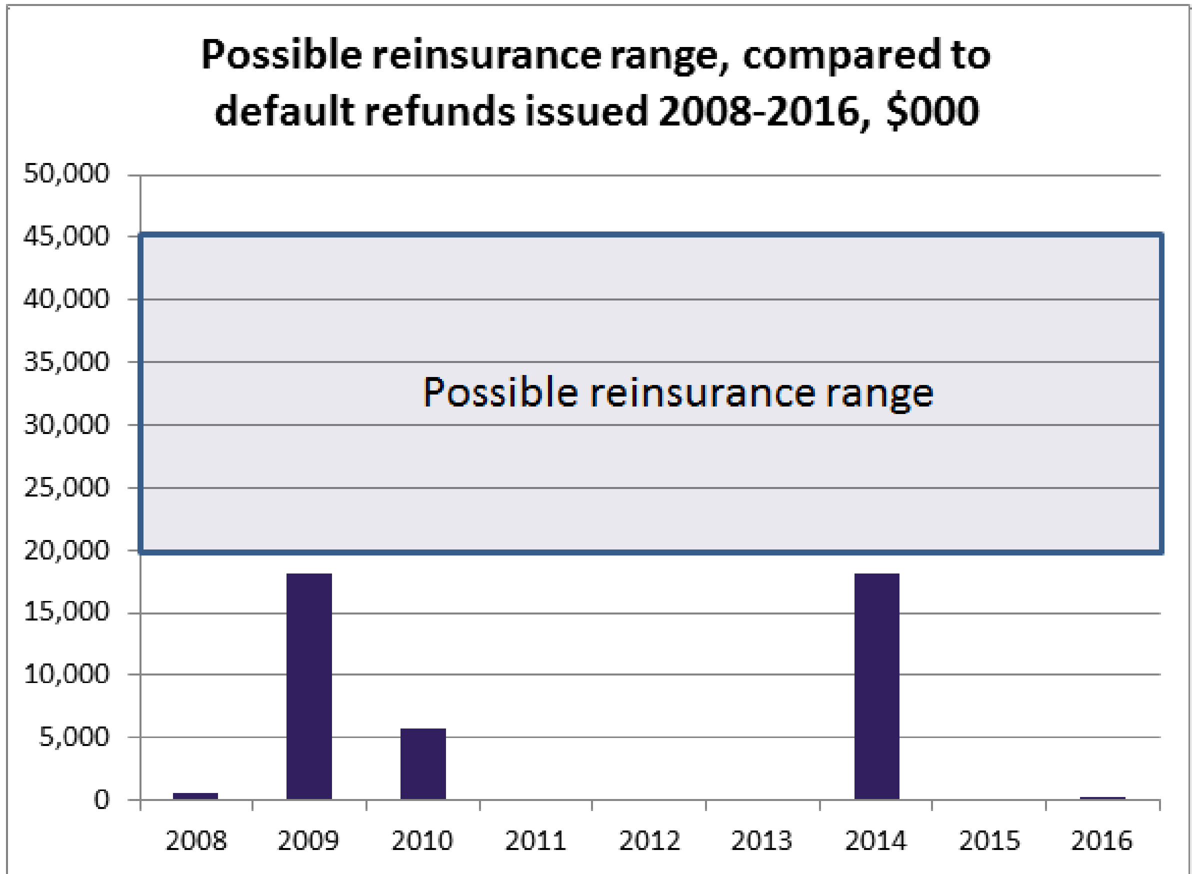
[3] Department of Health, Charging fees for additional care and services in residential aged care, including 'capital refurbishment' type fees, September 2016, https://agedcare.health.gov.au/programs/residential-care/charging-fees-for-additional-care-and-services-in-residential-aged-care-including-capital-refurbishment-type-fees

[4] Section 20 of the *Fees and Payments Principles 2014 (No. 2)*.

ACFA considered how either the existing Scheme, or an alternative, could operate with a reinsurance component. It focussed on a layer of reinsurance designed to cover a default event of a scale exceeding the default events experienced to date, as shown in the chart below.

Chart 1: Possible reinsurance range



Following consultation with experts with experience in insurance, it was considered that a layer of reinsurance from $20 million to $45 million could be relatively effective. Reinsurance was included in the modelling for options 1B and 2 (chapters 5 and 6).

1.4.3. Residual liability

Under the existing Scheme, the Commonwealth is liable for all outstanding lump sum accommodation payments, in the event of the collapse of an approved provider. This constitutes a *contingent liability* for the Commonwealth.

Some of the options considered by ACFA have the capacity to reduce the Commonwealth's contingent liability. However, there are circumstances in which an alternative scheme would not completely eliminate it. Under many alternative schemes, it is possible that costs could arise that would exceed the limit of coverage provided. *Residual liability* refers to the gap between a scheme's cover, and the total costs that might arise from the largest insolvencies.

The Government will need to decide how to manage this residual liability. The existing Scheme provides full coverage to all consumers in the event of a provider failure, and an alternative scheme

would need to provide the same level of consumer protection. In this report ACFA has assumed that any scheme design would ensure there was no residual liability that could affect investor confidence.

1.4.4. Opt out

The most important feature of an accommodation payment guarantee scheme is that it protects all lump sums, without gaps that might leave some consumers' assets vulnerable. Ensuring every lump sum is protected may not mean, however, that every provider would be subject to the same method for providing that protection.

Some providers advised ACFA that it should be possible for them to opt out of a guarantee scheme because of the adequacy of their significant reserves and asset bases. Others argued there should not be opt-out for reasons focussed on equity and consumer confidence. For a range of reasons explained in Appendix 2, ACFA considers that it is unlikely to be effective to have a scheme from which some providers are able to opt out, and the evaluations of the options assume there is no opt-out.

1.4.5. Attribution of costs, including risk rating

In all options where a levy is applied, or insurance or a guarantee is obtained, there will be a question of whether to charge everyone the same flat rate applied to the level of lump sums they hold, or whether the price should be differentiated based on an assessment of different provider risks. Risk rating is a concept routinely applied in insurance, and involves an assessment of what risk there is that the event being guaranteed against will actually occur. In this case, it would be the likelihood of providers defaulting.

Risk rating can be applied to providers individually, or to particular types of groups. The advantages of risk rating are that:

- It ensures that the costs to individual providers of funding the guarantee attempt to fairly reflect their risk of default;
- It recognises the stability and high prudential standards of some providers;
- It can give providers information about their level of risk, and allow them to make choices about how to administer their businesses, to change that level of risk; and
- If made available to consumers, it can provide them with information to support their decisions in choosing a provider.

The disadvantages of risk rating are that:

- It may increase the compliance burden, where additional information has to be provided on which to base the risk assessment;
- It may involve additional costs in administration, for collecting and analysing information to determine ratings; and
- In some circumstances, providers may have a limited capacity to act to alter their risk rating, meaning its ability to encourage the right behaviour may be undermined. For these providers, risk rating could adversely affect their brand, market share, occupancy, or staffing levels.

Risk rating can make some options more effective, but it can have disadvantages. It also requires transparency and careful regulatory design. It would necessitate establishment of a process of review and appeal of risk rating assessments, so that providers have opportunities to dispute a rating with which they do not agree.

The modelling of risk rating is outlined in Appendix 2, and discussed in the Chapter on option 2, however detailed consultation with aged care providers and the Department would be essential in the event that the Government decides to implement a scheme that includes risk rating.

1.5. Relationship to other inquiries

Aged care is a dynamic policy environment, in which significant change is occurring, with further reforms envisaged. ACFA's study has taken place against this background of change. In the eighteen months over which ACFA has had responsibility for this review of the Guarantee Scheme, there have been two default events under the Scheme, and the pool of accommodation payments that the Scheme protects has grown by more than $2 billion to over $21.7 billion.

There are two significant reviews taking place in parallel with ACFA's work.

The first is the Aged Care Legislated Review, being undertaken by independent reviewer Mr David Tune, and scheduled to report by 1 August 2017. The scope of the review is set by the *Aged Care (Living Longer Living Better) Act 2013*, and includes examination of the effectiveness of arrangements for protecting refundable accommodation payments. When the Minister, the Hon Sussan Ley, directed ACFA to undertake the present review, she wrote that it was her intention that the current analysis and report by ACFA would contribute significantly to the Legislated Review. ACFA invites Mr Tune to use and quote this report as he finds appropriate.

The second review is of the prudential regulation of aged care providers and lump sum payments. The Department has engaged Ernst and Young to conduct this review, which will evaluate the adequacy of existing legislation and prudential standards in the context of protecting the interests of care recipients and ensuring prudent management of lump sums held by providers. The review will consider the role and effectiveness of the Prudential Standards. Ernst and Young are expected to report on their review to the Department of Health in the first half of 2017. Their report is also expected to be considered in the context of the Aged Care Legislated Review.

The second review is critical, because effective prudential oversight and regulation are important to improving industry sustainability, the security of consumer funds, and continuity of care where a provider is exiting the industry. The effectiveness of prudential oversight and regulation in turn influences the design and scale of claims on the Scheme for protecting consumers' lump sum accommodation payments.

1.6. Structure of this report

The remainder of this report comprises:

- A history of accommodation payments and their guarantee (Chapter 2);
- A description of the protection of consumer contributions, including the Scheme (Chapter 3);

- Evaluation of the existing Scheme (Chapter 4);
- Evaluation of the variant on the existing Scheme, comprising an automatic retrospective levy (Chapter 5);
- Evaluation of the alternative approach of a guarantee fund pool, financed by a prospective levy (Chapter 6);
- Brief evaluations of three less preferred options, being a bank guarantee, private insurance, and pooled insurance (Chapter 7); and
- ACFA's conclusions (Chapter 8).

The first Appendix explains the design and assumptions that were used in modelling the accommodation payment pool. The second Appendix provides a detailed discussion of the policy issues outlined in Chapter 1. The final Appendix lists organisations that made submissions to ACFA's study of the Guarantee Scheme.

CHAPTER 2

THE HISTORY OF ACCOMMODATION PAYMENTS AND THEIR GUARANTEE

2.1. Introduction

Residential aged care is an important and unique setting for the provision of aged care. Significant funds are required to construct and operate an aged care facility, so there needs to be a reliable supply of sufficient capital. Ensuring ready access to capital to deliver aged care of the kind, and to the standard, that the community expects has long been a concern of governments and providers.

2.2. The history of capital financing in aged care

Throughout the nineteenth century, it was common for family members to provide care for their elderly relatives, and those requiring higher levels of care were managed in the same way as the indigent, with care being provided in asylums.[5] Care for the elderly was also provided at this time through state based institutions including hospitals. Religious and charitable institutions also raised significant capital, building and operating services that provided assistance to the needy, indigent, sick, aged and infirm.

By the beginning of the twentieth century, the States provided the main source of support for social security, welfare, health and housing needs for the aged.[6] The Commonwealth's involvement was limited to indirect support through charitable organisations, but the Government became more involved in the provision of funding for accommodation from the early 1950s.

At this time, the shortage of supported care accommodation had been placing significant pressure on the operation of the hospital systems.[7] In addition, the return of servicemen following the end of the Second World War had placed pressure on the supply of housing for individuals with low income levels.[8] In 1954, the Commonwealth first started providing funding for homes for the aged under the *Aged Persons Homes Act 1954*, through a subsidy for their capital costs. The payment was made through a 'dollar for dollar' grant to eligible organisations (not-for-profit organisations including religious, charitable, benevolent organisations, and organisations for defence ex-servicemen). The legislation encouraged alternative forms of accommodation to institutional care and promoted the provision of suitable homes:

> *at which aged persons may reside in conditions approaching as nearly as possible normal domestic life, and, in the case of married people, with proper regard to the companionship of husband and wife.*[9]

The grant payment to eligible organisations initially did not exceed more than one half of the capital costs of the home or the amount contributed by the organisation from its own funds, though the level of funding was later doubled in 1957.[10] The payment of grants resulted in a growth of cottage / hostel style self-contained accommodation. This form of accommodation enabled the elderly to be more independent and look after themselves, with access to accommodation and meals, and other services, whilst receiving a lower level of nursing support than the amount provided in a nursing

[5] Department of Health and Ageing, 2003, *A Review of Pricing Arrangements in Residential Aged Care*, p. 5
[6] Ibid, pp. 2, 27
[7] Ibid, p. 27
[8] Dickey, B., *Developments in Aged Care in South Australia, 1952-2002*, p. 12
[9] *Aged Care Persons Act 1954*, subsection 3(1)
[10] *Aged Care Persons Act 1954*, subsection 9(1)

home environment. The provision of cottage and hostel accommodation at this time helped to ease the housing shortage and resultant pressure on hospital beds. During that period, consumers also made significant capital contributions to the cost of their accommodation through the payment of donations.

Supporting capital financing has been important to ensuring the growth of aged care services. The number of nursing home beds available in the 1950s remained static as they were not eligible for the capital funding subsidy. However, reforms in 1962 provided an increased recurrent nursing home benefit for residents in nursing homes. This payment resulted in a 20 percent increase in the number of nursing homes built between 1963 and 1968.[11] This was also bolstered by the Commonwealth providing a capital subsidy towards the cost of beds for the first time in 1966.

In that same year, nursing home beds within hostels were made available to frail residents enabling them to age in place. State government run nursing homes were ineligible for the capital subsidy. However, an incentive existed to approve the building of new private nursing homes that would be funded by the Commonwealth.

Three years later, the increase in nursing home accommodation continued through the introduction of a subsidy in 1969 to fund the provision of one nursing bed for every two residential beds.[12] At the time, a shortage of suitable low cost nursing home accommodation still existed. Within the States, the *States Grants (Nursing Home) Act 1969* was enacted, providing matched Commonwealth funding for nursing homes in each State to supplement supply.

During the early 1970s, rapid growth occurred in the nursing home sector and by 1972, Commonwealth expenditure on nursing home benefits had increased to almost three times the expenditure on Commonwealth hospital benefits for insured patients.[13] In that year, a capital subsidy was provided for hostels under the *Aged Persons Hostel Act 1972* with a view to increasing the number of hostels in operation as they provided alternative accommodation for the aged which was cheaper than nursing homes.

In 1973, capital subsidies became available to voluntary organisations to purchase private nursing homes or to fund the construction of new ones. However, even with capital financing support, many voluntary organisations were already operating at a loss and were unable to consider venturing into new projects. In response, the Commonwealth supported new financing models, and covered operating losses, to help ensure the sector continued to develop. New measures were introduced through the *Nursing Homes Assistance Act 1974* establishing 'deficit financing' arrangements, enabling not-for-profit organisations to establish new projects to operate nursing homes.[14] This arrangement led to an increase in the number of beds operated by the voluntary sector. Substantial increases in the number of nursing home beds occurred over the next decade.

A change in the direction of funding occurred in the 1980s. At this time, 90 percent of Commonwealth funding for aged care was being spent on the residential care sector, with 90

[11] Le Guen, R., 1993, *Residential care for the aged – an overview of government policy from 1962 – 1993*, p. 2
[12] Department of Health and Ageing, 2003, *A Review of Pricing Arrangements in Residential Aged Care*
[13] Le Guen, R., 1993, *Residential care for the aged – an overview of government policy from 1962 – 1993*
[14] ibid

percent of these funds being spent on nursing homes.[15] Following the release of the Nursing Homes and Hostel Review in 1986, the capital financing of nursing homes was changed to contain expenditure and achieve a better balance of nursing homes beds across the States whilst at the same time increasing the capital financing of hostels so expansion would occur.

In the Government's 1986-87 Budget, greater focus was given to the use of hostels over nursing homes and significant capital funding was provided for hostel development. The deficit funding for nursing homes was replaced with recurrent capital grant funding arrangements commencing from 1 July 1987.

In 1987, hostel funding arrangements were amended to increase hostel provider's access to capital funds through borrowings and the ability to charge an incoming resident a refundable entry contribution. Incoming residents were able to keep a certain asset level before they were asked to make an entry contribution. When the resident left the hostel permanently, the entry contribution had to be partially refunded, less retained amounts for each six month period the resident lived in the hostel, for a maximum of five years.[16] Entry contributions for which capital subsidies had been paid to the provider had to be used to meet capital and/or recurrent costs of the hostel.[17] Entry contributions formed an interest free loan to provider and this provided a valuable source of capital funds in addition to the capital grants provided by the Commonwealth.

The 1980s saw increasing attention on the capital and funding requirements for specific areas of aged care that faced fiscal challenges. Between 1988 and 1992, the Commonwealth provided smaller sized nursing homes and hostels with additional capital funds to assist with redevelopment.[18] Additional capital funds were provided on a more permanent basis for small homes in remote locations and small homes catering to groups with special needs. The additional recurrent funding program was introduced in 1992-93 for non-government nursing homes if providers built new nursing homes that resulted from a demand for additional beds, built new homes that catered for residents with special needs, or attended to the rebuilding of older nursing homes in poor condition so the required care standards could be achieved.

Ensuring sufficient capital funding for aged care remained an ongoing policy challenge. In 1993, Professor Robert Gregory was asked to review the capital funding systems for nursing homes and his review was conducted in two parts. The first part considered the structure of nursing home funding arrangements. Professor Gregory found that entry contributions from residents entering hostels provided an additional source of capital funding to the hostels, and this funding was the key reason that building standards in hostels were noticeably higher than the building standards observed in nursing home facilities.[19] Funding inequities also became apparent when comparing residents in hostel environments to residents in nursing home environments that had similar care level requirements. Whilst the care needs of both residents were the same, the funding arrangements differed significantly based solely on the mode of care that had been provided.[20]

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[15] ibid
[16] Gregory, R., 1993, *A Review of the Structure of Nursing Home Funding Arrangements*, p. 50
[17] *Aged or Disabled Persons Care Act 1954*, Determination ADPCA 10F 3/1995
[18] Department of Health and Ageing, 2003, *A Review of Pricing Arrangements in Residential Aged Care*
[19] Department of Health and Ageing, 2003, *A Review of Pricing Arrangements in Residential Aged Care*
[20] Department of Health and Ageing, *Report on the Operation of the Aged Care Act, 1997-98*, p. 11

In the second part of his review, Professor Gregory considered the capital funding needs of nursing homes and hostels as well as the quality of the stock. He found that the capital funding system was contributing to the poor quality of nursing home buildings as there was insufficient capital funding arrangements and incentives for nursing home providers to maintain or improve the quality of their facilities.

A substantial decline in annual capital funding for nursing homes occurred between 1992-93 and 1996-97.[21] To assist providers in addressing the reported deficiencies, structural incentives were introduced in 1996 for nursing home improvements through a tiered funding system with the greatest funding attributed to new and rebuilt homes. Funding was also increased for voluntary sector homes and hostels. Nursing homes and hostels had previously operated as separate programs, with separate guidelines and funding arrangements. Residential care programs in nursing homes and hostels were brought together in a single program at this time. There were now standard funding arrangements for accommodation and related services, and varying care costs depending on the needs of each resident.

2.2.1. The expansion of accommodation payments

There were major changes in aged care in 1997, in part as a response to the issues identified in Gregory's review. These included removing the distinction between hostels and nursing homes, in favour of having a more integrated system of residential aged care. In response to the urgent need for a significant increase in capital funding in the nursing home environment, legislative changes provided the ability for nursing homes to charge lump sum accommodation bonds from October 1997 – previously, these had only been able to be charged by hostels.[22] The payment of the lump sum accommodation bond formed an interest free loan to the aged care service provider. The lump sum was partially repayable upon the resident departing the facility.

The nature of the contributions made toward capital funding depended on the kind of care people received. Residents requiring "low" levels of care services and extra service high care residents could be asked to pay a lump sum payment in the form of an accommodation bond, as a contribution towards the capital costs of the facility. Residents were also able to pay a combination payment, being part bond payment and part periodic payment. Residents requiring "high" levels of care could not be asked to pay lump sums, but could be asked to pay an accommodation charge, which provided a regular flow of capital[23] funds that could be used by the provider. The amount of the accommodation bond was agreed between the incoming resident and the service provider.

Many people could not afford to pay a bond. Access to accommodation for residents who depended on the aged pension (known as concessional residents) was protected through the introduction of Government funded accommodation supplements and the supported resident ratio.[24] Facilities that provided accommodation to concessional residents were able to receive the accommodation supplement income for these residents.

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[21] Accommodation Bonds for Residential Aged Care: Will We Need to Sell Our Homes
[22] *Aged Care Act 1997*
[23] Parliamentary Library, Bills Digest No.159 1997-98, Aged Care Amendment Bill 1998
[24] Department of Health and Ageing, *Report on the Operation of the Aged Care Act, 1997-98*, p. 36

With the capacity for providers to receive capital contributions from incoming residents' bonds, the Government reduced the provision of capital funding on a sector wide basis. Instead, the Government provided more targeted support through the payment of capital contributions to providers where other sources of capital funds were limited.[25] This targeted capital contribution recognised the fact that some providers were unable to attract enough bond paying residents, or had limited access to bonds, as the provider specialised in providing services to financially disadvantaged or high care need residents. In addition, funds were provided for restructuring purposes for providers that were unable to raise adequate capital funds, especially in rural and remote locations.[26]

The 1997 reforms had also introduced the User Rights Principles, which set out requirements relating to the content and process for the making of agreements with residents, and set out the rights and responsibilities of residents in care. The User Rights Principles included some prudential requirements.[27]

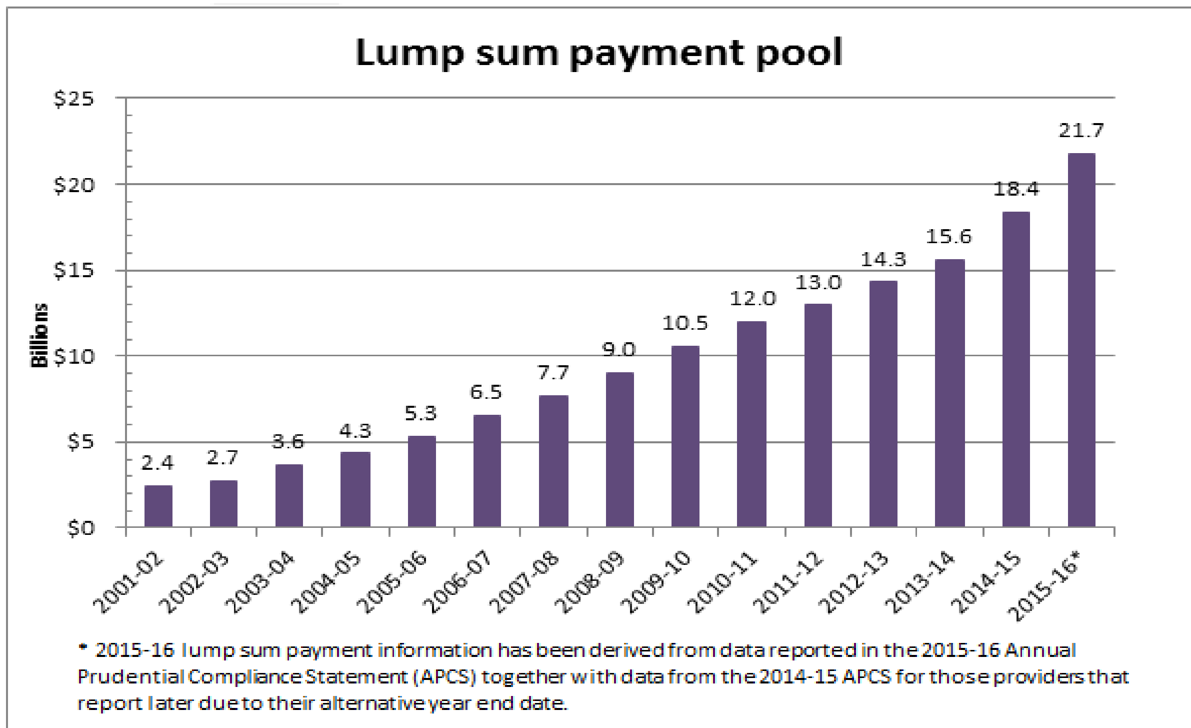
2.2.2. Accommodation payments in a growing aged care sector

The payment of entry contributions from 1987 in the hostel environment, and the introduction of accommodation bonds (for low care residents) and accommodation charges from 1997 across all residential aged care, provided a significant source of capital funds to the residential accommodation sector to maintain, expand and upgrade facilities.

Growth across the sector has continued to occur over time, from just under 140,000 residential care places in 1997, to more than 192,000 residential care places today. Lump sum accommodation payments are significant sources of capital for providers. They are unsecured no-interest debt that has financed 50 per cent of assets in the sector.[28] The lump sum pool has grown rapidly over that time, increasing from just over $2 billion in the year 2000, to more than $21 billion today, as shown in the chart below.

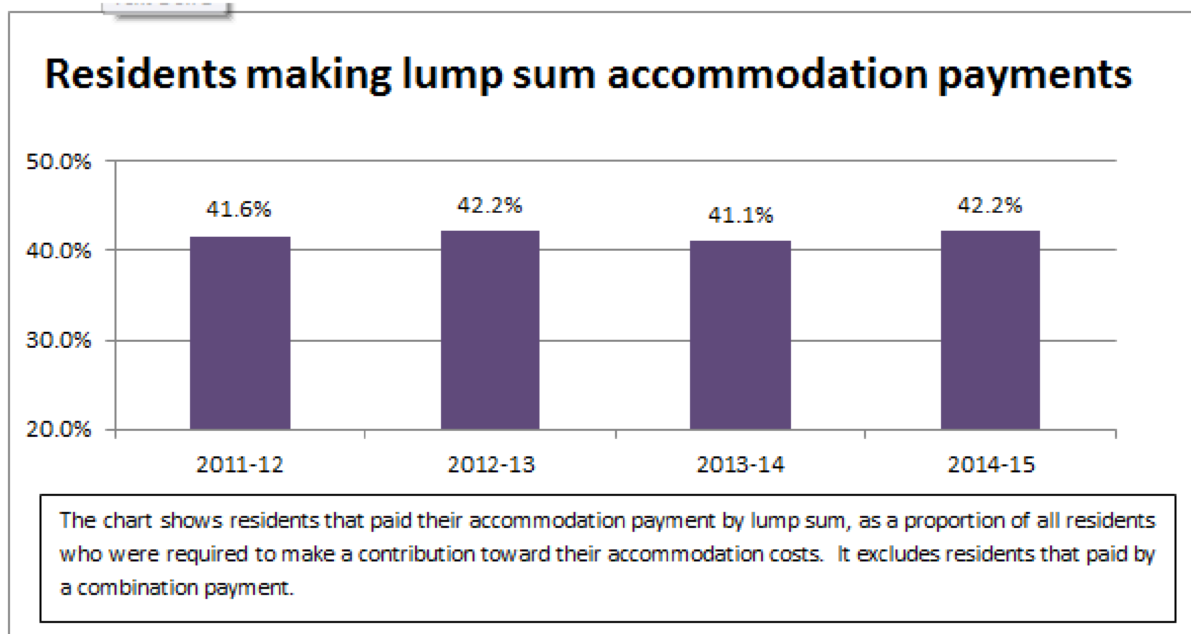
[25] Hogan, W.P., 2004, *Review of Pricing Arrangements in Residential Aged Care*, pp. 192-193
[26] Department of Health and Ageing, 2003, *A Review of Pricing Arrangements in Residential Aged Care*, pp. 40-41
[27] See the *User Rights Principles 1997*, Part 4.
[28] Aged Care Financing Authority, 2016, *Fourth Report on The Funding and Financing of the Aged Care Sector*

Chart 2: The lump sum payment pool



The number of operational residential places has increased over time and the proportion of lump sum-paying residents remained relatively constant up to 2014-15, as noted in the chart below; more recent data is not yet available. These two factors, coupled with an increase in the average lump sum paid by residents, have contributed to the increase in the total pool of lump sum accommodation payments.

Chart 3: Proportion of residents making lump sum accommodation payments



At the balance sheet level, the value of accommodation payments for the sector has increased over time. The net worth of providers and their total asset position has also increased, as noted in the table below. At 30 June 2016, a total of $21.7 billion of lump sum accommodation payments were held by providers and this amount is expected to continue to grow.

Table 3: Provider sector net worth and asset position

	2011-12 $m	2012-13 $m	2013-14 $m	2014-15 $m
Cash and equivalents	3,239	3,942	3,558	5,170
Fixed assets	8,046	9,372	10,238	10,674
Other assets	16,767	17,539	19,866	20,742
Total assets	28,052	30,853	33,662	36,586
Accommodation bonds	12,966	14,295	15,611	18,213
Other liabilities	5,474	6,369	6,883	7,472
Total liabilities	18,440	20,664	22,494	25,685
Total equity / net worth	9,612	10,189	11,168	10,901
Bonds as a % of total assets	46.22%	46.33%	46.38%	49.78%
Bonds as a % of total liabilities	70.31%	69.18%	69.40%	70.91%
Bonds as a % of total equity	134.89%	140.30%	139.78%	167.08%

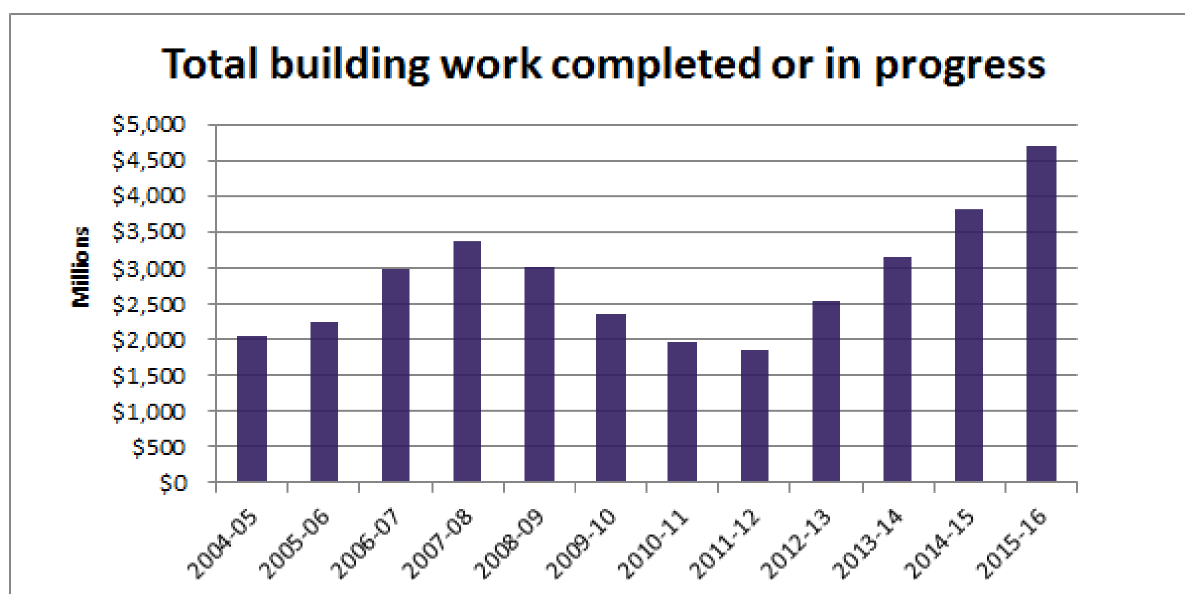
Prospective lenders and financiers take into account the accumulated lump sum payment amounts for the purposes of lending additional funds, as the lump sum payments may be viewed as short term debt which is not formally secured by mortgage or other charges. Cash and other liquid assets retained from lump sums also attract interest which adds to the cash flow available to cover debt repayments.[29]

Deloitte Access Economics noted in their 2011 report that lump sum payments were typically used to repay bridging finance for bank loans that fund the construction of new facilities. Lump sum payments from incoming residents were also used for capital expenditure, reducing the cost of capital to the facility. The use of lump sum payments provided a number of advantages including a shorter debt repayment period and a lower rate of return that needed to be paid on the debt.[30]

Building activity in the sector has varied over time, with the highest spending occurring in 2015-16 where it exceeded $4.5 billion, and the lowest spending levels occurring in 2011-12 at $1.95 billion as shown in the chart below. Capital funding, provided through these lump sum payments, has assisted the sector to expand through significantly reducing the cost of capital to aged care service providers.

[29] Hogan, W.P., 2004, *Review of Pricing Arrangements in Residential Aged Care*, p. 192
[30] Deloitte Access Economics, June 2011, *The Viability of Residential Aged Care Providers*, p. 46

Chart 4: Building activity in the sector



The way capital is raised and administered in aged care is evolving, as is the structure of the sector. The proportion of residential care services delivered by for-profit providers is slowly growing, from 34 per cent in 2009 to 38 per cent in 2015, and this growth is expected to continue. For-profit providers have a different approach to capital financing to not-for-profit providers. This is reflected in the different net financial positions of the two segments of aged care. At 30 June 2015, not-for-profit providers mainly used equity to fund 50 per cent of total assets with liabilities other than their accommodation lump sum liabilities financing only 13 per cent of total assets. At 30 June 2015, not-for-profit providers held a higher level of total assets and lump sum liabilities in comparison to for-profit providers. For-profit providers held other liability balances which represented 31 per cent of their total assets, indicating that for-profit providers were more highly leveraged than the not-for-profit providers, reflecting their greater use of debt to finance investment.[31]

As well as evolution in the structure of the sector, business models are also evolving. Elsewhere, ACFA has noted continuing consolidation in aged care.[32] Alliances between for-profit and not-for-profit providers are emerging, such as sale-and-leaseback arrangements. 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, creating implications for how accommodation lump sum payments are held and guaranteed within this business model.

2.3. Guaranteeing lump sum accommodation payments

The previous section has shown the long history of government and sector involvement in trying to ensure sufficient investment in aged care. As the history shows, securing adequate capital to ensure

[31] Aged Care Financing Authority, 2016, *Fourth report on the Funding and Financing of the Aged Care Sector*, chapter 8 – Table 8.3 and Chart 8.4

[32] Aged Care Financing Authority, 2016, *Fourth report on the Funding and Financing of the Aged Care Sector*

sufficient investment has been a constant challenge for the sector. Underinvestment, with both quality and growth in bed numbers lagging behind demand, has been a recurring issue.

In these circumstances, it has been particularly important for governments to identify and implement policies that help attract capital, and ensure that that capital is secure. As lump sum accommodation payments increased in significance, ensuring their security became an increasing focus.

Policies intended to protect lump sum accommodation payments have their origins in new aged care legislation in the late 1990s. In January 1997, the initial report of the Funding and Other Implementation Issues Working Group (a committee established by the then Department of Health and Family Services to implement the legislation) discussed options for the protection of resident accommodation bonds under the new legislation. The Committee discussed a range of options including: the use of trust funds or bank guarantees, development of a universal insurance scheme, or provider self-insurance.

Key issues that the committee identified to be addressed included:

- The desirability of avoiding duplication or conflict with State retirement village legislation;
- The extent of access to capital sums and interest provided by the arrangement;
- The adequacy of security for residents;
- The cost to government and providers;
- The ease of administration;
- The impact of the arrangements on the willingness of financial institutions to lend funds for capital improvements;
- The capacity to apply the arrangements to leasehold or other situations where providers have limited equity in the property; and
- The implication for current funds held by hostels.[33]

The Senate Standing Committee on Community Affairs was asked to consider the proposed aged care reforms. The Committee made a range of recommendations about appropriate legislative protections for accommodation bond funds.[34] The recommendations emphasised that there should be “an unconditional assurance that the balance of the accommodation bond is able to be refunded”. The recommendations also noted that the cost of the guarantee scheme needed to be kept down; and that although generally it should be mandatory for providers to be covered, exemptions could be granted for some church-run facilities, if the accommodation bonds were backed by the church.

The Government’s 1997 aged care changes did include the establishment of a “contributory fund” for holding accommodation bond funds.[35] This independent fund (administered as a trust) was intended to receive the bond payments from all residents entering care and would refund their bond on their departure from care. The trust was established in October 1997, but policy changes the next month led to it being closed. Over the coming years, funds were returned to those residents whose

[33] Funding and Other Implementation Issues Working Group: Report to Minister for Family Services.
[34] Entry contributions (accommodation bonds) had been operating in hostels since 1987.
[35] See the original *Aged Care Act 1997*, S.57-4.

bonds had been lodged with the trust during that brief one month window for which it had operated. The funds totalled approximately $7.5 million. This first attempt to create an independent, non-provider administered bond pool and refund system was short lived.[36]

In 2004, the Review of Pricing Arrangements in Residential Aged Care (the Hogan Report) acknowledged that the volume of aged care accommodation payments was growing and argued that the Government had a moral obligation to ensure that bonds held by providers were not at risk of loss. It recommended that:

The Government should establish a guarantee fund:

- *managed by an Authority established for the purpose;*
- *funded by an industry levy, the amount of which is determined on actuarial advice; and*
- *in the event of a defined 'default event', people with entitlements are able to recover accommodation bond amounts from the fund.*

As well as management of the fund, the review recommended that the Fund Authority "…have prudential oversighting authority of approved providers".

As part of its response to the Hogan Review in the 2004-05 Budget,[37] the Government announced that it would support the establishment, in consultation with the community and aged care approved providers, of a provider-funded guarantee fund. However, the Government indicated it did not consider that the high degree of regulation recommended by the Review could be justified, and that a guarantee fund offered a similar degree of security without the high cost of additional regulation to approved providers.

The Conditional Adjustment Payment and Prudential Reference Group (the Reference Group) was set up to provide advice to the Department, including the establishment of a provider-funded guarantee fund. The Reference Group recommended that a fund be established using a "pre-payment" model, where providers would contribute a percentage of their bond balance to the fund. The pooled funds would be used to repay consumers, should a provider become bankrupt or insolvent.

The Government responded by bringing a scheme forward in legislation, through the 2005 Aged Care (Bond Security) Bill. The Government explained that the scheme was needed, given the increased growth in bonds held by providers; and the risk that, in the event of insolvency, bonds would not be refunded as they were classed as an unsecured debt.[38]

However, a significant departure from the Reference Group's recommendation was adoption of a mechanism to levy providers to recover any refunds made to consumers. The Government stated that it preferred the "post–payment" approach over the "pre-payment" approach that had been recommended by the Reference Group as it required less administration and did not reduce the provider's capacity to access their scarce capital reserves. The government's argument highlighted

[36] That trust was finally wound up in 2006.
[37] The Investing in Australia's Aged Care: More Places, Better Care package.
[38] Aged Care (Bond Security) Bill 2005, Explanatory Memorandum

the concern, always present in the sector, that capital was scarce, and a policy priority remained ensuring there were no impediments to capital being used as effectively as possible.

There was industry support for the model proposed. Catholic Health Australia observed at the time:

> *It has been Government policy since the Federal Budget of 2004 that there be a prudential guarantee scheme to protect resident bonds funded by the industry. The outcome that the Government intends to legislate into existence is by far the lowest cost guarantee scheme that the industry, including the Church based sector, could possibly hope for and should be supported in the interests of resident confidence in continuing to pay increasingly larger bonds.*[39]

One of the options that was rejected at this time was the trust option, that had been adopted briefly in 1996-97. Having evaluated the range of options, the Department explained to the Senate Community Affairs Legislation Committee that there were several reasons that such a trust fund would not provide a workable and comprehensive solution, including "the impact on the usefulness and worth of accommodation bonds to providers as capital debt offset".[40]

With the new legislation in place, the Department commissioned Pricewaterhouse Coopers (PwC) to undertake some work on the preferred option of an industry levy.[41] They asked PwC:

> *to analyse the financial risk profile of the residential aged care industry, with particular emphasis on the ability of approved providers to repay accommodations bonds in accordance with the Aged Care Act 1997 and evaluate, by actuarial calculations, the amounts approved providers would need to pay to fund such an arrangement.*

Based on the analysis, the Department concluded:

> *that in any given financial year the average value of accommodation bonds that may need to be repaid by the Guarantee arrangements, and consequently recovered from providers would be in the order of 0.2% of the value of the industry's accommodation bond holdings. The amount of the levy that a given approved provider could be asked to pay would therefore also be 0.2% of their accommodation bond holding.*

The levy option was considered cheaper than alternative mechanisms, as well as overcoming other issues relating to scope and administrative ease. The levy option also had the advantage of being able to be charged according to whether default events occurred, whereas other options would require providers to pay or contribute, regardless of whether or not there was a default claim:

> *These costs are very low compared to other mechanisms that approved providers could employ to ensure that all residents were guaranteed the repayment of their accommodation bond. For example, it is estimated that the purchase of an Irrevocable Guarantee from a (prudentially regulated) financial institution would cost the provider one to two per cent of the value of bonds held (each year), regardless of whether a default event occurred.*

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[39] Catholic Health Australia, September 2005, *Aged Care Bulletin*, Issue A88/05

[40] Department of Health and Ageing, Submission to Senate Community Affairs Legislation Committee inquiry into the bond security bills (the Aged Care (Bond Security) Bill 2005, Aged Care (Bond Security) Levy Bill 2005 and Aged Care Amendment (2005 Measures No. 1) Bill 2005).

[41] Australian Parliament, *Senate Hansard*, Monday 27 March 2006, p. 134

From this time, a Commonwealth Government guarantee was provided on accommodation deposits, but at this point no levy was being charged to providers to recover the (comparatively small) costs the Scheme was incurring.

In 2011, the Productivity Commission in their report 'Caring for Older Australians' noted that:

> *…in the Commission's view the cost of the Australian Government guarantee of accommodation bonds should be borne by the providers through the setting of a fee (recommendation 7.4). Arguably, the cost of prudential regulation should also be borne through the setting of a fee arrangement. Conceptually, both these fees could vary according to the risk of the provider. In practice, however, such an arrangement is likely to be too complicated. Nonetheless both a charge on the prudential regulation and the Government guarantee would more fully reflect the cost of bonds.*[42]

The need to strengthen earlier regulatory arrangements surrounding the management of refundable accommodation bonds by approved providers was highlighted within several significant and broad ranging reports on the aged care sector. The issues raised were also the subject of discussion and consultation with the sector during 2010-2011.[43]

As a result, the *Aged Care Act 1997* (the Act) and the *User Rights Principles 1997* (the Principles) were amended on 1 October 2011 to strengthen governance and reform the use of bonds (discussed further in Chapter 3).

The Australian Government's response[44] to the Productivity Commission's recommendations in May 2012, indicated in-principle support but suggested that the issue be addressed through obtaining insurance. The Government foreshadowed that:

> *From 1 July 2014, all aged care providers will be required to insure any new accommodation bonds that they are paid by residents for entry to care. This approach is more efficient and involves lower administration costs than the Commission's approach.*

However, the Government's suggestion did not come to fruition. During the major aged care reform process culminating in the Living Longer Living Better package of bills, the sector expressed concerns, both to government and to a Senate inquiry into the bills. After consulting with industry and consumers, the Government decided not to introduce private insurance arrangements for accommodation payments proposed from 1 July 2014. This decision was based on the lack of availability of a developed private market to insure accommodation payments, which the Government believed could create significant uncertainty relating to costs for providers and potential flow-on costs to consumers.[45] The Government instead decided to extend the existing government-backed bond guarantee scheme to cover new lump sum accommodation payments and contributions.

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[42] Productivity Commission, 2011, *Caring for Older Australians*, pp. 407-408

[43] Department of Health and Ageing, 2011, *Consultation Paper: Enhanced Prudential Regulation of Accommodation Bonds*

[44] Australian Government Response [to] Productivity Commission, *Caring for Older Australians*

[45] Australian Government, 2013, Response to Senate Community Affairs Legislation Committee Report on the Living Longer Living Better legislation

The issue has however remained firmly on the policy agenda. The legislated review of the Aged Care Reform package that is required by Section 4 of the *Aged Care (Living Longer Living Better) Act 2013*, needs to consider "the effectiveness of arrangements for protecting lump sum accommodation payments and accommodation bonds".

In 2014, the National Commission of Audit reiterated the recommendation of the Productivity Commission for the "introduction of a fee for aged care providers to access the accommodation bond guarantee or, alternatively, requiring providers to take out appropriate private insurance to cover the risk of default".

2.4. Conclusion

Several themes emerge from the twin histories of capital financing in aged care, and the protection of lump sum accommodation payments. These are:

- Persistent concerns about capital scarcity in aged care have prompted ongoing government policy interventions designed to try to ensure capital flows are sufficient;
- That same perceived scarcity of capital has been a major influence on the design of prudential controls and guarantees of resident contributions, sometimes preventing implementation of proposals to tighten or implement cost recovery that have been made by a range of reviews and by government;
- A shift in the policy approach to capital funding for residential aged care services, so that those who can contribute to the cost of their accommodation are required to do so;
- A commitment to protection of resident contributions. This has meant that, although there remain policy issues associated with the security of lump sum accommodation payments, there have been, and remain, strong protections for these sums;
- The distinctive nature of capital investment in the aged care sector, and significant differences between the business models of providers within that sector, create challenges to the development or reform of any scheme to protect lump sum accommodation payments.

CHAPTER 3

THE PROTECTION OF ACCOMMODATION PAYMENTS

3.1. The protection of accommodation payments

There are many layers of protection afforded to consumers when they pay providers an accommodation payment to support their residential aged care accommodation. They are protected by:

- Australian consumer law;
- Contract law;
- The *Corporations Act 2001*;
- Aged care law including the *User Rights Principles 1997* and *Fees and Payment Principles (No 2) 2014*. These are monitored and enforced through Prudential Standards and monitoring; and
- The Guarantee Scheme.

The Guarantee Scheme, which is the subject of this review and report, is not the primary protection of consumers' funds, but stands as a safety net when a provider has become insolvent.

One of the cornerstones of aged care is the Resident Agreement, which is the legal foundation of a consumer's use of aged care, and is an enforceable contract. The Resident Agreement will for most aged care consumers include provisions around accommodation (sometimes formally referred to as an Accommodation Agreement), including any accommodation payment. These agreements are required by aged care law to cover what consumers will be provided as part of their care; to be in plain English; and to be negotiated and agreed with the consumer. Aged care law specifies many elements that must be addressed in the Resident Agreements, but they are not a 'take it or leave it' proposition. They are contracts in which consumers have an important say, to ensure they are obtaining the services they need on appropriate and acceptable terms.

The process by which accommodation payments are managed is set out in the box below, outlining the place of the protections available to consumers.

How do lump sum accommodation payments work?

When someone decides they need to enter residential aged care, they will search for a facility that provides a room to best meet their needs. An approved provider is an individual or entity approved to provide residential aged care under the *Aged Care Act 1997* and the provider will have to meet the aged care sector's Prudential Standards in managing the funds of its residents. The person requiring care will make a contribution to their costs of care, and may also be asked to pay some or all of the costs of accommodation, if they are assessed to have the assets and income to do so. If not, the government fully or partially subsidises their accommodation at a specified rental level.

The person will be offered a written Resident Agreement to cover their accommodation, including a choice whether to pay by a lump sum, now called a Refundable Accommodation Deposit (RAD), a rental-type payment called a Daily Accommodation Payment (DAP), or some combination of the two (hybrid or combination RAD/DAP). This agreement between the resident and the provider is a contract, and consumers are protected by consumer law governing fair contracts, as well as the Charter of Care Recipients' Rights and Responsibilities, which is specific to aged care.

Once the resident moves in, they then have 28 days to decide by which of the three modes of payment, (RAD/DAP/Combination) they will pay for their accommodation, and a further period in which to organise payment of any lump sum accommodation payment they have decided to make.

The Department conducts prudential monitoring of the aged care sector through assessment of each provider's financial performance and compliance activities for risk indicators.

At some point, a resident will leave care, often when they die. The lump sum accommodation payment then needs to be returned to them or to their estate, within 14 days from the date of their departure, or evidence of probate being tabled with the aged care provider.

When the consumer or their estate approaches the aged care provider to secure the return of the lump sum accommodation payment, the provider has obligations, not only under aged care law, but also under consumer and contract law, to ensure the funds are returned. If there are delays or other problems getting the money back, then in addition to exercising these legal rights, the consumer could approach the Aged Care Complaints Commissioner about the issue, and may be referred to the Department's Prudential Branch.

Very rarely, it may become clear to the consumer or their estate, or to the Department, that the provider is unable to make the repayment. This may be because the provider is already insolvent or under administration and lacks the assets, or it may be that the inability to repay the debt causes the consumer to seek an order for the provider's business be wound up, under the Corporations Act. On the rare occasions that formal insolvency occurs, the Guarantee Scheme, which is the subject of this report, is then triggered. Where insolvency occurs while a consumer is living in an affected facility, the Scheme is also triggered.

This chapter summarises the different protections, before outlining the Guarantee Scheme and its operation.

3.2. Consumer, contract and corporation law

Aged care consumers have the rights shared by all consumers of goods and services under the Australian Consumer Law through the *Competition and Consumer Act 2010*. Likewise, providers have the same obligations as other businesses under that law.

When the consumer or their estate approaches the aged care provider to secure the return of a lump sum accommodation payment, the provider has obligations under consumer and contract law, to ensure funds are returned. In cases where the provider is a corporation, there are additional requirements and avenues for redress under the *Corporations Act 2001*.

The legal protections afforded by consumer law and contract law are important in guiding the expectations and good practice of providers. The hope is that they will seldom have to be exercised in court. However, 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 independent of the rights conferred under aged care law, and which do not rely on invoking the Guarantee Scheme. The options available to a consumer may include bringing an action against the provider under contract law, for a debt due and payable under an accommodation payment agreement.

Where the provider is a corporation, and is currently operating (not in cases where it may be insolvent), under the Corporations Act, the consumer could issue a statutory demand to the provider for the amount as a debt due and payable. The possibility of such a demand being issued will generally ensure that a provider does everything possible to honour the consumers' rights.

Exercising this kind of recourse may impose a cost on the consumer in terms of legal advice and fees. However, providing transparency in Residence Agreements as to these legal options for consumers helps ensure clarity in the relationship between providers and consumers, so that everyone knows their rights and responsibilities.

In addition to the general protections that consumers can expect under consumer and contract law as well as the Corporations Act, there is a set of consumer protections specific to aged care, set out in the *User Rights Principles 2014* and *Fees and Payments Principles 2014* (in particular the Disclosure Standard at 3.3.1). Under the User Rights Principles, there are provisions to ensure that rights and protections are understood, such as the legal onus placed on providers to assist the care recipient to understand the information they are given (S.11), and for the information to be expressed in plain language and be readily understandable by the care recipient (s.15).

Aged care can be complex. It is important that the expectations in the User Rights Principles are clearly reflected in the documentation provided to consumers by aged care services. While it is outside the scope of the current project, ACFA support scrutiny by the Department and the Aged Care Legislated Review as to whether the User Rights Principles are being well communicated in plain language in contracts and agreements, and that new residents are being effectively supported to understand the information.

3.3. Aged care law and regulation

The legal and regulatory framework of the aged care sector includes the following:

- The *Aged Care Act 1997* (the Act);
- The *Aged Care (Transitional Provisions) Act 1997*;
- The *Fees and Payment Principles 2014 (No. 2)*;
- The *Aged Care (Transitional Provisions) Principles 2014*; and
- The *User Rights Principles 2014*.

This section sets out how prudential standards and monitoring operate within this framework to protect consumers' funds.

3.3.1. Prudential Standards

Important consumer protections are contained in aged care law, including the Prudential Standards (the Standards) and the *Fees and Payments Principles 2014 (No. 2)* to which aged care providers are required to adhere.

Section 52M-1 of the Act requires providers to comply with the Prudential Standards. In addition, the Fees and Payments Principles, made by the Minister through legislative instrument, give effect to the matters dealt with in section 52M-1 relating to residential and home care fees.

The Prudential Standards set out four requirements for liquidity, records, governance and disclosure.

1. The *Liquidity Standard* aims to ensure that approved providers have access to sufficient, readily available funds so that they can refund lump sum accommodation payment balances.

2. The *Records Standard* requires all approved providers holding refundable deposits to establish and maintain a register that includes: [46]
   - The resident's name and ID number;
   - Refundable deposit details;
   - The date the resident entered the service;
   - If a resident is transferring from another service, the date the resident entered the original aged care service;
   - The amount and date on which the whole or each part of a refundable deposit paid as a lump sum was paid;
   - The date and amount of, and reason for, any deduction made from the refundable deposit;
   - The refundable deposit balance at the end of each month; and
   - The amount and date of any refund paid (and the date due to be repaid) including interest (if any), due to death, transfer, any other reason the provider ceases to provide care.

[46] Slight differences only apply depending on whether the refundable deposit is a RAD, bond or entry contribution.

3. The *Governance Standard* ensures that there is an appropriate governance system in place to ensure compliance with prudential responsibilities in relation to refundable deposits held by a provider. This includes ensuring that each refundable deposit:
   - Is only used for permitted uses; and
   - Balance is refunded to the resident in accordance with the timeframes required by the Act.

   To support effective governance of funds, the Act and Fees and Payments Principles set out a range of requirements for how residents' funds are managed, with providers required to implement and maintain a written investment management strategy (IMS) broadly when investing the funds outside the provider itself. The IMS is intended to ensure that providers have a risk management strategy for their investments as well as the expertise to ensure the funds are managed appropriately.

4. Finally, there is a *Disclosure Standard*. This requires approved providers holding refundable deposits to give the Secretary of the Department of Health, residents,[47] prospective residents and their representatives, information on their compliance with the Liquidity and Records Standards; and information on their financial standing.

Together these four standards provide a range of prudential controls on the holders of the funds, transparency and protection for consumers and prudential oversight by government.

Some of these standards have been strengthened as a result of scrutiny by the Auditor General in 2009, which followed several triggers of the Scheme, and rapid growth in the lump sum accommodation payment pool. The ANAO had at that time concluded that:

> *the administrative framework established by the then Department of Health and Ageing to manage prudential arrangements for the protection of residential aged care accommodation bonds does not sufficiently support effective regulatory oversight.*[48]

The Auditor General made seven recommendations (all agreed by the Department) to strengthen prudential processes. There was discussion and consultation with the sector during 2010-2011,[49] after which the Act and the *User Rights Principles 1997*, which outline the responsibilities of providers, were amended to:

- Clarify the permitted uses of accommodation bonds;
- Introduce a two-year transition period for approved providers to adjust and fully comply with the permitted uses;
- Introduce a Governance Standard for approved providers holding bonds;
- Improve reporting and disclosure for greater transparency and consumer confidence;
- Introduce additional information gathering powers for monitoring compliance;

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[47] Section 57 of the FPP requires each provider, within 4 months of the end of the financial year, to furnish each care recipient who has paid an accommodation bond with a copy of their refundable deposit register and a written statement saying they will provide information listed in this section within 7 days of a request.

[48] Australian National Audit Office, 2009, *Protection of Residential Aged Care Accommodation Bonds*; Productivity Commission, 2011, *Caring for Older Australians*

[49] Department of Health and Ageing, 2011, *Consultation Paper: Enhanced Prudential Regulation of Accommodation Bonds*

- Remove restrictions on the use of income from bonds, retention amounts and accommodation charges; and
- Introduce criminal penalties for the misuse of bonds (refundable accommodation deposits).

The changes included the introduction of prudential standards, including one that required:

> *Whenever an approved provider holds bond balances, the approved provider must maintain sufficient liquidity to ensure that the approved provider can refund, in accordance with the Act and these Principles, any bond balances that can be expected to fall due in the following 12 months.*[50]

The Standards set a benchmark for the performance of all Approved Providers of aged care, and also form a foundation to support monitoring of the sector.

3.3.2. Prudential monitoring

The Department's Prudential and Approved Provider Regulation Branch (PAPRB) has been undertaking financial risk assessments of approved providers since September 2010 and uses a range of analyses to evaluate risk.

PAPRB undertakes data analysis annually. It uses General Purpose Financial Report (GPFR) data to identify providers that are at highest risk of financial failure or potentially under financial distress and prioritise its risk management and compliance investigation activity.

The first pass assessment provides a preliminary financial risk rating of the providers based on a range of indicators including losses in the past two years, cash flow, net tangible assets per place, current ratio, late accommodation payment refunds, late GPFR and Annual Prudential Compliance Statement (APCS) reporting, and qualified audit opinion. The highest rating given during that preliminary assessment is 'severe', with the second tier being rated as 'high'.

PAPRB conducts detailed risk assessment of all approved providers that present as severe in the first pass analysis. As part of the strategy for managing risk of approved providers that present as high in the first pass, those that have other risk indicators raising concerns are also assessed.

The detailed assessment results in a matrix based on financial and compliance data, to create a risk rating for providers. Indicators used include:

1. Profit Margin – assesses the profit level of a business after all costs have been taken into account;
2. Equity Per Place – assesses the resources underpinning each allocated place and is a measure of the financial margin of safety;
3. Current Ratio – assesses the provider's liquidity, and ability to pay back its short-term liabilities from its short-term assets;

[50] *User Rights Principles 1997* (F2011C00792) Reg.23.36. The equivalent is now in *Fees and Payments Principles 2014 (No. 2)* (F2015C00623) Reg.43.

4. Shareholder Assets to Refundable Deposit Liability Ratio – assesses the provider's realisable assets (cash and property, plant and equipment) less borrowings in comparison to its refundable deposit liability; and
5. Longitudinal tracking of approved provider's performance year-to-year.

Scoring providers against these indicators allows the Department to create a risk rating, which has helped the Government to understand the characteristics of the industry and to motivate better prudential management in the industry.

The Department works with both its central and State offices in managing this risk. This can include further detailed assessment and analysis in conjunction with regular meetings with the approved provider to address and remedy the situation. The Department's monitoring and engagement with approved providers at risk plays an important role in minimising the incidence of insolvency and the flow on impact on aged care consumers, and is described in more detail below.

The Department provided de-identified risk rating data to ACFA, to assist in understanding the characteristics of the existing lump sum accommodation payment pool.

3.4. The Guarantee Scheme

Established in 2006, the existing Guarantee Scheme was created as part of a suite of legislated changes to strengthen prudential controls of residential aged care providers. The Scheme gives effect to the policy aim of protecting refundable deposits paid by care recipients to approved providers of residential aged care and flexible care. It ensures the refund of accommodation payments by the Government to residents in the event that a provider is unable to refund payments because they are insolvent.[51]

3.4.1. Establishment

The Scheme was implemented through two acts. At that time, they were titled the *Aged Care (Bond Security) Act 2006* and the *Aged Care (Bond Security) Levy Act 2006*, though the titles were changed in 2013 as part of the Living Longer Living Better reform package.[52] They are now:

- The *Aged Care (Accommodation Payment Security) Act 2006* (Payment Security Act), which enables the Australian Government to pay a resident an amount equal to the accommodation balance owed to them by the approved provider. In exchange for the payment, any rights the resident had to recover the amount from an approved provider are then transferred to the Commonwealth.
- The *Aged Care (Accommodation Payment Security) Levy Act 2006* (the Payment Levy Act), which operates in conjunction with the Payment Security Act and enables levies to be imposed on approved providers to recover any costs to the Commonwealth, including administrative costs, from repaying lump sum accommodation payment balances to residents. To date the levy has not been applied by successive governments.

[51] Department of Health, 2015, *Accommodation Payment Guarantee Scheme Manual*
[52] The change was made by the *Aged Care (Bond Security) Amendment Act 2013*

Activation of the Scheme is approved by the Secretary of the Department of Health. Activation of the levy is a decision of the Minister.

The aged care reforms implemented in July 2014 made a number of changes affecting the accommodation payments that the Scheme protects. These include:

- Removal of the distinction between high and low care places, allowing providers to accept lump sum accommodation deposits from all residents, regardless of the level of care they receive. Consistent with this change, the largest annual increase in the size of the accommodation payment pool was after the changes, when it grew by 18 per cent in 2014-15;
- Consumers can choose how they pay for their accommodation, using a refundable deposit, a daily payment, or a combination of both. This makes the number and value of lump sums less predictable;
- The values of the lump sum accommodation payment and the daily accommodation payment offered by a provider are linked according to a formula fixed by legislation, so cannot move independently; and
- Providers must advertise a maximum price for their accommodation. This has improved a consumer's ability to compare services and more clearly understand the value of their accommodation.

3.4.2. Scope of Scheme

The scope of the Scheme has three key attributes: to whom it applies; what moneys it covers; and what event triggers it.

To whom does the Scheme apply?

The Scheme applies to approved providers, as defined in the *Aged Care Act 1997*.[53]

What moneys are covered by the Scheme?

The Scheme applies to what are referred to as accommodation payment balances. The Payment Security Act defines these as:

(a) a refundable deposit balance; or

(b) an accommodation bond balance; or

(c) an entry contribution balance; or

(d) an unregulated lump sum balance.[54]

The first three terms are defined in Schedule 1 of the Act, while the last is defined in the Payment Security Act. In general terms, refundable deposit balances are those contributed since July 2014, accommodation bond balances are those contributed between 1997 and 2014, and entry

[53] Payment Security Act, S.6
[54] Payment Security Act, S.6

contribution balances are those from before 1997, while unregulated lump sums were paid to some providers prior to 2009, with the provider subsequently becoming an approved provider under the Act. The Payment Security Act refers to “balances” because what has to be recovered is not the whole payment (typically a refundable accommodation deposit, or RAD), but the RAD less any amounts allowed to be deducted from it.

Not every lump sum of money received by an aged care provider is necessarily an outstanding accommodation payment within the meaning of the Payment Security Act. As retirement village accommodation is not residential care under the Aged Care Act, accommodation deposits paid to retirement villages are not covered by the Scheme.

What triggers the Scheme?

Under the Payment Security Act, the Scheme can be triggered by a number of types of event, collectively referred to as insolvency events. For the Scheme to be triggered there must be at least one accommodation payment balance overdue to be refunded by the approved provider, together with one of the events listed in the Payment Security Act, set out in table 3.1.[55]

Table 4: Scheme triggers

Definition of event from the Payment Security Act	Meaning and definitions
(a) a CGT event G3 (within the meaning of the *Income Tax Assessment Act 1997*) in respect of shares or financial instruments of the approved provider or former approved provider;	The ATO has declared that the shares of a company have no value even though the company is not yet wound-up / de-registered
(b) the making of an order: (i) under section 459A or 459B of the *Corporations Act 2001*; or (ii) under a provision of the law of a State, or Territory, which deals with the incorporation of associations; that the approved provider or former approved provider be wound up in insolvency;	Court ordered wind-ups where there has been an application by the company, creditors, a director, liquidator, ASIC to wind-up (liquidate) in insolvency and the Court decides that the company cannot pay its debts as they fall due.

[55] Table based on *Accommodation Payment Guarantee Scheme Manual*, 2015, p. 7

Definition of event from the Payment Security Act	Meaning and definitions
(c) the passing of a special resolution: (i) under section 491 of the Corporations Act 2001; or (ii) under a provision of the law of a State, or Territory, which deals with the incorporation of associations; that the approved provider or former approved provider be wound up voluntarily;	Voluntary wind-up following a resolution of shareholders. Requires a declaration of solvency and therefore should not result in Guarantee Scheme refunds.
(d) the passing of a resolution under paragraph 439C(c) of the *Corporations Act 2001* by the creditors of the approved provider that the approved provider be wound up;	A decision by the creditors of a company that is under administration that the company should be liquidated.
(e) the making of a sequestration order against the estate of the approved provider;	A Court order separating a bankrupt person from control of their assets.
(f) the acceptance of a debtor's petition (within the meaning of the *Bankruptcy Act 1966*) against the approved provider by an Official Receiver (within the meaning of that Act);	Acceptance of a person's self-identification as a bankrupt by the Government Official in charge of bankruptcies.
(g) the making of an insolvency event declaration in relation to the approved provider (see section 7). (a) either: (i) the person is an externally-administered body corporate (within the meaning of the *Corporations Act 2001*); or (ii) a personal insolvency agreement under Part X of the *Bankruptcy Act 1966* is in effect in relation to the person or the person's property; and (b) there is at least one outstanding accommodation payment balance of the person.	Externally administered means a body corporate: (a) that is being wound up (liquidated); or (b) in respect of property of which a receiver, or a receiver and manager, has been appointed (whether or not by a court) and is acting; or (c) that is under administration; or (ca) that has executed a deed of company arrangement (DoCA) that has not yet terminated; or (d) that has entered into a compromise or arrangement with another person of the administration of which has not been concluded.

The last of these categories is included

> *because there may be circumstances where a provider is insolvent but wind up action has not commenced (as provided for in the Accommodation Security Act's definition of insolvency event) and the approved provider is highly unlikely to be able to trade out of difficulty.*[56]

This provision in the Act allows the Minister to make a declaration in such cases, ensuring that there is a safety net for residents in all circumstances. The Department works with the provider or the appointed administrator to process refunds to residents.

What actions might mitigate against triggering the Scheme?

At a point in time the Department of Health may become aware that while an insolvency event has not occurred, a provider has an elevated risk of insolvency. This may happen either through the provider's own notification to the Department of a recent and significant event, or where the Department's internal monitoring of financial performance or compliance with the Prudential Standards has flagged that elevated risk.

In either case the Department would review its risk assessment and compliance investigation processes, leading to a series of coordinated actions involving both its central and State office-based teams. Those actions involve a mix of formal notices such as the Notice of Non Compliance (NNC),[57] and meetings to fully appraise a provider of their responsibilities including their obligations to refund all outstanding lump sum accommodation deposits and to provide continuity of care for residents.

The Department would also ensure the provider understands the potential consequences of triggering the Scheme, including the revocation of approved provider status, exit from the industry and potentially legal action if lump sum accommodation deposits have been wilfully misused.

Depending upon the specific circumstances, including the Department's assessment of the likelihood of progressing to insolvency and the level of co-operation of the approved provider, both parties may discuss and establish the provider's options for implementing either exit or recovery strategies and activities.

The Department may also require the provider to submit regular reporting to allow monitoring of behaviour and progress on agreed actions to either exit aged care provision or return to compliance.

In working with an at-risk provider, the Department may need to manage a range of administrative issues including:

[56] *Accommodation Payment Guarantee Scheme Manual*, 2015, p. 26.

[57] The Notice of Non Compliance (NNC) sets out the details of a provider's non-compliance with responsibilities under Parts 4.1-4.3 of the *Aged Care Act 1997*. The NNC also sets out the actions required to remedy the non-compliance and what sanctions can be imposed for failing to remedy, including prohibiting the charging of lump sum accommodation payments for one, more than one or possibly all of the providers' residential care services.

- issuing NNC, assessing responses and possibly imposing sanctions[58] on the provider and monitoring undertakings by the provider to remedy non-compliance; and
- assessing the regular reports by providers as they move towards either recovery or a shut-down and the repayment of lump sum accommodation deposits.

Where necessary, the Department will assist the provider to source alternate care for residents, which may or may not be with related entities. The Department may also identify other providers that may be interested in acquisition and facilitate discussions between the parties.

If the feasibility of recovery from a potential insolvency is assessed as low and the implementation of a plan to exit aged care service provision is deemed the most appropriate course of action for the provider, a trigger event may still be avoided where either:

- the provider or related entity can demonstrate their ability to meet outstanding lump sum accommodation payment liabilities; or
- a potential buyer of the business agrees to accept those liabilities, or the liabilities remaining after a period of Administration.

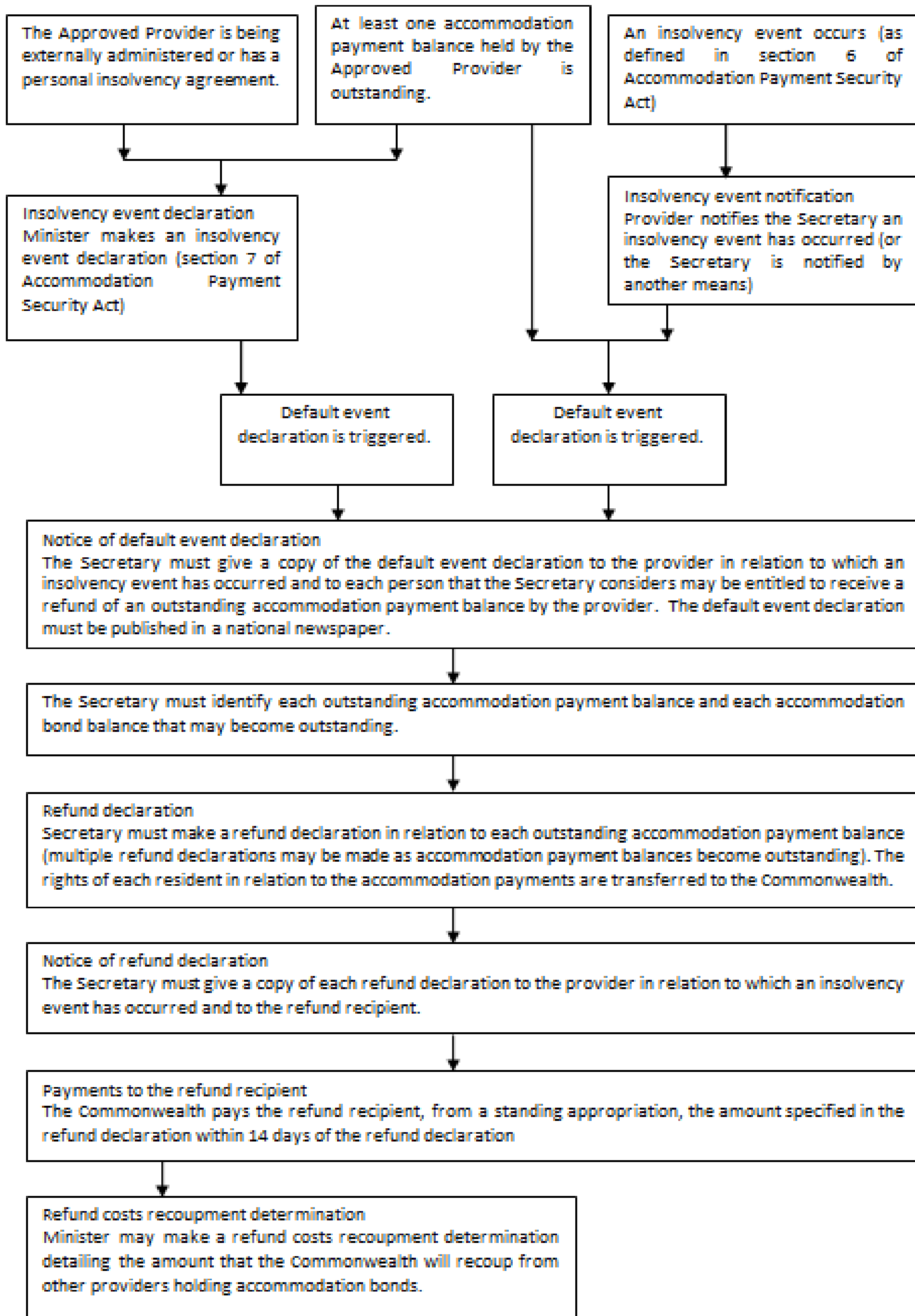
Process of implementing the Scheme

Once a trigger has occurred, "the Secretary must make a 'default event declaration'",[59] by writing to the provider that has experienced the insolvency event, as well as to each resident, former resident or estate potentially eligible for an accommodation deposit refund, as well as publishing a notice in a newspaper.

The process of scheme operation is set out in the flowchart below:[60]

[58] The timelines associated with issuing and responding to the Department's formal notices means that it may take several months before the Department is able to sanction a provider for non-compliance with their responsibilities.
[59] *Accommodation Payment Guarantee Scheme Manual*, 2015, p. 13.
[60] Accommodation Payment Guarantee Scheme Manual, 2015, p. 12.

Diagram 1: Process of implementing the Scheme



3.4.3. Recovery of costs

There are two types of cost involved in the Scheme: the refund of the accommodation deposits; and the administration costs of the Scheme.

Both the costs of refunds and the costs of administration are initially met by the Commonwealth, and section 17 of the Payment Security Act appropriates revenue for this purpose.

The Levy Act allows the Commonwealth to impose a levy on approved providers in the residential aged care sector to recover both types of cost. Following the payment by the Commonwealth of outstanding refunds to residents, the Department writes to the Minister and seeks advice of whether the Minister wishes to make a costs recoupment determination. This decision must be made by the Minister, and is not mandatory.

The Levy Act states that the method of working out the levy would be determined in regulations, but sets two main parameters:

- the levy cannot raise more money than it cost to implement the Scheme and make payments of outstanding accommodation balances;[61] and
- the levy can be set at different levels for different classes of providers, but “must not otherwise discriminate between different approved providers”.[62]

Allowing the creation of classes of providers has several implications. It means a levy cannot be set according to individual provider, but must involve applying some formulas or rules to provider groupings. It also means that some providers could be exempted from a levy, by setting the level for a class of provider at zero. The Levy Act also states that a class of provider cannot be defined “in such a way that the levy would discriminate between States or parts of States”. This is giving effect to Section 99 of the Constitution, which says that the “Commonwealth shall not, by any law or regulation of trade, commerce, or revenue, give preference to one State or any part thereof over another State or any part thereof”.

To date, there has not been a decision to impose a levy under the Levy Act.

If an approved provider becomes insolvent and defaults on its refund obligations, the Commonwealth guarantees the repayment of the resident’s refundable accommodation payment balance. Upon payment of these funds to the resident, the rights of residents to recover these amounts transfer to the Commonwealth. To date, the Commonwealth has not been able to recover any of these debts.

3.5. Conclusion

It is important that all mechanisms to ensure protection of consumers in aged care are known and accessible to consumers, starting with their rights and obligations being easily understood and communicated when they enter into Resident Agreements. Consumers are protected in several ways:

[61] Levy Act, Section 8
[62] Levy Act, Section 9

- Consumer protection provided under consumer law, contract law and the *Corporations Act 2001*, which ensure that a consumer who is facing difficulty in recovering their lump sum accommodation payment can bring legal proceedings against the provider;
- Prudential standards and monitoring, which provide for monitoring of providers to ensure sound financial management; and
- The Guarantee Scheme providing an overarching guarantee to consumers where a provider has become insolvent.

Prudential standards and monitoring in particular are critical protections for aged care consumers, to which this report returns in its conclusion. The Scheme, which is the subject of this review and report, is not the primary protection of consumers' funds, but stands as a safeguard against insolvency.

This chapter has outlined several key features of the existing Scheme, including that it provides coverage to every approved provider of aged care. It also explained that the Commonwealth carries liability for all lump sum accommodation payments in the event of provider default. This guarantee which supports the existing Scheme is reported as a contingent liability of the Commonwealth. At 30 June 2016, the maximum contingent liability, in the unlikely event that all providers defaulted, was approximately $21.7 billion. The following chapters evaluate the existing Scheme and its alternatives.

CHAPTER 4

EFFECTIVENESS OF THE EXISTING SCHEME

4.1. Introduction

Chapter 3 described the existing Scheme. This chapter outlines its use to date, and assesses its effectiveness against the set of principles and criteria set out in Chapter 1.

Both the Aged Care Legislated Review and the Aged Care Financing Authority called for public submissions that related to the Guarantee Scheme. The Legislated Review sought views only about the existing Scheme. ACFA, while also seeking evidence around the current Scheme, placed more emphasis on obtaining feedback around the strengths and weaknesses of alternative options. Submissions and stakeholder views from both inquiry processes have been used by ACFA in its assessment of the Scheme to date, and is providing this study to the Independent Reviewer, Mr David Tune, to use in developing his report.

4.2. The operation of the Scheme to date

Between its inception in 2006 and the time of this review, the Scheme had played a small but significant role in ensuring that aged care residents' accommodation payments were protected. To March 2017, the Scheme had been triggered ten times, in relation to eleven aged care facilities. Refunds under the Scheme finalised to that date totalled approximately $43 million, comprising of refunds on 258 accommodation payment balances totalling $41.2 million, with additional interest payable to the resident or their estate totalling $1.7 million. The largest single trigger event to date was in 2014, and comprised $10.8 million for 59 accommodation payment balances. Table 4.1 below summarises trigger events for which action has been finalised in the period to March 2017. To date, there is one refund of an accommodation balance that is pending payment.

Table 5: Trigger events under the *Aged Care (Accommodation Payment Security) Act 2006*

Former Provider	Entered liquidation	Service	Number refunded	Lump sum balances	Interest payable	Total amount refunded
Lifestyle Care Providers Pty Ltd	14/01/2008	Lifestyle Carrara, *38 places	5	$528,793	$5,438	$555,985
Vitality Care Commissioning Pty Ltd	05/11/2008	Bridgewater Aged Care Facility, *102 places	50	$8,164,871	$249,432	$8,414,304
Kendalle Pty Ltd	11/06/2009	Gracedale Manor, *62 places	54	$9,624,445	$181,549	$9,805,994
Drysdale Aged Care Hostel Pty Ltd	25/11/2009	Palmerston Court Hostel, *50 places	20	$2,715,611	$64,579	$2,780,190
Hirange Management Pty Ltd	24/12/2009	Berwick Village Supportive Care Home, *38 places	20	$2,868,938	$69,203	$2,938,142

Former Provider	Entered liquidation	Service	Number refunded	Lump sum balances	Interest payable	Total amount refunded
Viva Care Pty Ltd	27/11/2013	Viva Care at Albion, *120 places	30	$4,788,801	$290,475	$5,079,277
De' Ryan Pty Ltd	14/11/2013	Brunswick Manor, *60 places	16	$2,185,377	$90,917	$2,276,294
Nepean Hospital Pty Ltd	11/04/2014	Alexander House, *46 places	24	$3,381,144	$153,110	$3,534,254
		Mount Martha Valley Lodge, *125 places	35	$6,680,932	$602,103	$7,283,086
Kalinda Craft Pty Ltd[63]	03/02/2016	Rosewood Mews, *60 places	1	$106,304	$18,902	$125,206
D&R Community	07/06/2016	Hillside Haven, *12 places	3	$178,746	$2,313	$181,059
Total			258	$41,224,015	$1,728,021	$42,952,036

There were ten separate trigger events, with claims being made by residents of three providers that operated as part of the Cambridge Aged Care Group.[64] Of the ten events, eight of them, comprising 250 of the 258 refunded deposits, occurred in Victoria. All ten were from the for-profit sector.

ACFA reviewed the administration of the Scheme by examining the timeliness of response to default events. Default events are usually complex situations, and can be occasionally compounded by a lack of cooperation by the former provider. The priority for the Department is ensuring the safety and welfare of residents in cases where a facility is not only bankrupt, but also closing down. A declaration of a default event can only be made when one of the legal criteria in the Payment Security Act has been met, so it is necessary for the Department to obtain appropriate evidence to determine whether that has occurred.

Once a default event has been declared, the Department has to then determine through the records that are available whether each resident is owed money, and how much. If current or past residents are found to be entitled to refunds then the processes of the Scheme are set in motion. The individuals legally entitled to the refund have to be located, which can be challenging in those cases where a resident is deceased and the refund needs to be directed to an estate.

[63] To date, the return of one lump sum payment totalling approximately $530,000 is owed to an estate, pending evidence of probate being provided.

[64] Trigger events occurred for the three providers operating four services under the Cambridge Aged Care Group - Viva Care Pty Ltd, Nepean Hospital Pty Ltd and Kalinda Craft Pty Ltd. See also Grant Thornton, 3 April 2014. Nepean Hospitals Pty Ltd (Administrators Appointed), Section 439A Second Report to Creditors, http://www.grantthornton.com.au/globalassets/1.-member-firms/australian-website/creditors-documents/gtal_2014_nepean_hospitals_pty_ltd_s439a_report.pdf

Despite these potential complexities, the Scheme appears to be administered in an efficient manner. Analysis of data from the default events to date shows that on average it took 19 calendar days from a provider being insolvent to the official declaration made under the Payment Security Act, and 36 days from that declaration to the first refunds being made to residents (or their estates). The fastest official declaration was just six days after bankruptcy, while the fastest repayment after declaration was 22 days.[65]

Given the number of steps and potential complications involved in what are always unplanned and difficult situations, ACFA concludes that the Scheme has been implemented in a timely manner, as well as being effective in ensuring every eligible person receives the return of their lump sum contribution.

While the Scheme's administration is timely, the periods reported above may not reflect the total delay in receipt of the refund, from the time the estate or resident becomes entitled to refund of the lump sum.

There may be a considerable interval during which the resident, estate or government seek retrieval of the funds before the formal insolvency event, using the processes and legal recourse outlined in Chapter 3. While not related to the performance of the Scheme, ACFA recognises that in some cases there may be protracted delay in the refund of an accommodation payment. In these instances, more rigorous oversight of compliance with legislative and regulatory provisions that already require plain language Resident Agreements, regular reporting and communication of lump sum status to residents may reduce the amount of time residents are waiting to receive refunds.

4.3. Assessment against the principles

As was outlined in Chapter 1, ACFA developed a list of principles against which to assess both the existing Scheme and its alternatives.

This section reviews the existing Scheme against these principles, beginning with the question of whether the Scheme is **effective**.

Consumers and providers both considered that the current Scheme delivered appropriate protection for accommodation payments. Leading Aged Services Association (LASA), one of the provider representative associations, said:

> *LASA believes the current Scheme is already effective, demonstrates efficiencies, is simple and well understood by Providers and consumers alike.*

Table 6: Existing Scheme[66]

Principle	Assessment
Effectiveness	
Efficiency	
Simplicity	
Sustainability / flexibility	
Equity	
Operability	
Right behaviour	
Certainty	

[65] It should be noted that these periods are those applicable to the Guarantee Scheme. It is acknowledged that considerable time may have eventuated from the time the lump sum became legally refundable, if a provider was still operating but had failed to return the accommodation payment balance. Chapter four outlines other avenues of recourse that are not reliant on the declaration of insolvency.

[66] Colour bars indicate the principle is assessed as met (green), partially met (amber) or not met (red).

The aged care sector has always been aware of the Government's ability to call on the levy and has accepted, and continues to accept, that obligation.

Individual providers and provider groups had similar comments. One provider stated:

IRT believes the current Guarantee Scheme to be in the best interest of providers and consumers. IRT does not support changes to the current scheme. If providers were to bear the costs of such changes, this would be money that otherwise could have been spent on care delivery.[67]

Others did not directly express a view about the current Scheme's effectiveness, but wanted to ensure some of its attributes remain unchanged as a result of any reforms. Consumer organisation Council of the Ageing (COTA) said:

COTA Australia believes that consumers need guaranteed outcomes in relation to the return of their accommodation lump sum payments if they are to be asked to make refundable deposits as payment for their accommodation costs.

Any changes to arrangements for protecting lump sum deposits must maintain the absolute confidence in the return of Refundable Accommodation Deposits, and must not impose any significant additional costs on consumers, who already make these funds available at no interest, which constitutes a forgoing of income.[68]

The current Scheme is **cost effective** from the point of view of consumers and providers, who make no financial contribution. Many stakeholders considered the 'free' protection of accommodation payments to indicate that the Scheme was cost effective. The current Scheme is less cost effective for the Commonwealth, which carries all risk and all costs. However, to a significant extent, this is because the Commonwealth has chosen not to trigger its existing levy powers. As one provider peak commented, the Scheme was cost effective for the Commonwealth with the existing capacity to levy the industry if needed, saying there is:

no real risk to the Commonwealth in providing this guarantee [because the] Commonwealth has the statutory capacity to levy the industry to recover any losses incurred by failures within the industry scheme.[69]

It would appear that the current Scheme is **efficient**.

Alzheimer's Australia observed:

this option represents the most minimal impact on consumers, who should not be adversely impacted by the inability of a provider to meet their prudential requirements. The rare triggering of the Scheme, combined with the comparatively small proportion of providers who default on lump sum accommodation payments (0.13%) means that the current impact on consumers is dispersed.

As some stakeholders (e.g. Catholic Health Australia) noted, the existing Scheme does not require a separate body to run it, with both prudential monitoring and administering claims being undertaken

[67] IRT Group, ACLR Submission, p.10
[68] COTA, ACLR Submission, p.24
[69] Aged Care Guild, ALCR Submission, p.12

by the Department of Health. Many of the alternative options would require separate administration arrangements, or new responsibilities for other regulators such as Australian Prudential Regulation Authority (APRA). Establishment of a separate agency, or the requirement to establish additional functions in an existing one, would increase the cost of delivering the same protection as the current Scheme does, and therefore is unlikely in itself to be more efficient. As Catholic Health Australia noted:

> *Keeping the current Scheme avoids the cost of establishing and administering a guarantee fund based on a prospective levy, while at the same time protecting consumers and ensuring access to an economic source of capital which results in lower cost aged services for the community than might otherwise be the case.*

For an alternative scheme to be more efficient than the current one, it would need to include initiatives that reduced provider risk of default. This possibility, particularly by risk-rating providers, is discussed further in Chapter 5.

The current Scheme is relatively **simple**.

There are no separate registration requirements or eligibility tests for a provider to be covered, as Scheme coverage is based on providers being approved to offer residential aged care. The Scheme does not necessitate fees to be charged or separate monitoring of compliance with eligibility requirements each year. While providers are required to comply with and report on prudential standards that contribute to the protection of accommodation payment lump sums, these requirements are not part of the Scheme itself.

In cases where a provider becomes insolvent while owing residents lump sums, particularly if a provider's record-keeping has been deficient, it can be a complex task for the Department to determine exactly how much is owed, and to whom. It should be noted that, while the regular written reporting to each resident of the status of their lump sum is mandated under the Fees and Payment Principles and required to be provided for in Resident Agreements, some providers also fail this obligation. This issue would arise regardless of how a scheme operated, so is the same for all options.

The current Scheme would be potentially complex in the event that the Minister decides to implement the levy. This is because the Levy Act requires the levy to be calculated according to regulation, but no regulations have yet been made. In the event that the existing Scheme levy is implemented by the Minister, a number of decisions would need to be made, including how much to levy, who to levy, and how to calculate the levy imposed on each provider. The complex consultation requirements and associated policy issues likely to emerge during the process of levy design have not been required in the application of the Scheme to date.

One of the key questions regarding the existing Scheme is its **sustainability**.

To date, the Scheme has cost the Commonwealth $43 million over nearly a decade (or an average of around $5 Million per annum). Measured against the size of the sector's accommodation payment holdings (around $20 billion), or against the Commonwealth's annual expenditure on residential aged care (around $10 billion), the Scheme's cost has been modest. Payments under the Scheme have represented about 0.05 per cent of Commonwealth annual expenditure on residential care.

While this expense has been manageable for the Commonwealth, a different picture may emerge in terms of the predictability of sector responses to reform in the future. While payments have been modest, their pattern has been inconsistent. Annual costs for payments incurred by the Commonwealth have varied from zero in several years, to nearly $20 million in others. This volatility makes meaningful budget planning unrealistic.

The rising value of accommodation payments held by providers is continuing to increase the contingent liability to which the Commonwealth is exposed. In addition, the structure of the industry is changing. There is growth in the proportion of services that are provided by for-profit businesses that are more highly leveraged when compared to the large not-for-profits that historically dominated the sector. These trends mean there is a possibility that claims against the Scheme will rise in future.

As noted earlier, some stakeholders have argued that the existing Scheme's sustainability is assured because the Commonwealth can always levy the sector if required.

This raises two issues.

The fact that the Commonwealth has not implemented the levy at any point in the last decade may not be reflective of the amount that may be levied in the future. For the sustainability of the existing Scheme to be assured, it may need to be altered to address this issue.

The other issue is whether a discretionary levy raises sustainability issues for providers. Several providers raised concerns about the impact a levy would have on provider viability, particularly for small or non-metropolitan services. Buckland Aged Care for example said:

> *The cost of creating a pool fund by levying all providers would place a large financial burden on providers… many small providers currently struggle to make a surplus and would probably have to reduce staffing levels further to meet the cost of a new levy.*

Modelling undertaken suggests average levies of approximately $198 per resident per annum[70] if the levy was shared equally across all residents who had made lump sum accommodation payments. Based on the average length of stay of three years in a residential aged care facility, the levy would equate to approximately $600 per resident or around 0.2% of the average lump sum payment.

Providers generally raised the issue of the impact of the levy in the context of funding alternatives to the existing Scheme. However, it will arise if the Commonwealth exercises its existing levy power. The need to ensure sustainability of providers exists regardless of whether the Government retains the existing Scheme or an alternative. The modelling undertaken for ACFA and advice it has received suggests that the impact on providers of default events such as those that have occurred over the last decade would be very modest.

The **equity** implications of the operation of the existing scheme depend on how equity is defined.

All providers and all lump sum accommodation payment-paying consumers are treated equally, in that they all have received protection of their investments and capital for no charge. Protection of lump sums is not affected by the location of a resident, their means, or the kind of provider they

[70] Based on the average lump sum of $340,000 in 2014-15.

choose. Providers receive equal protection, regardless of size, the market in which they operate, their ownership structure, or their profitability. As one provider put it:

> *IRT believes that the current Scheme is fair given that all providers are treated in a similar fashion [and that] the Commonwealth acts as guarantor and ensures residents receive a timely refund of their accommodation contribution.*

Conversely, it may be regarded as inequitable that taxpayers, through the Commonwealth, provide free security for the funds of residents with sufficient money to provide a lump sum accommodation payment and the providers who benefit from access to these funds. This is arguably a cross-subsidy for these residents and providers, at the expense of taxpayers.

The existing Scheme's **operability** is proven.

As noted above, the Scheme has successfully returned lump sum payments to individuals affected by provider insolvency, and has generally done so in a timely way. The Department advised that there can be cases where poor record keeping, or non-cooperation by an insolvent provider, can make implementation of refunds sometimes difficult or time-consuming, however this has not prevented the Scheme being effectively applied to ensuring consumers' accommodation payments were refunded. There are no implementation or administrative hurdles that prevent consumers and providers being covered effectively by the Scheme.

The one question, already noted, regarding the Scheme's practical implementation is that the levy provisions have never been used during the past decade after eleven insolvency events. A change in approach may be needed, if the Commonwealth wishes to recover costs in future.

The current system **encourages right behaviour** in some parts of the aged care system, particularly government.

The Commonwealth faces strong incentives to undertake prudential monitoring and to work with providers to avoid insolvency, because it carries the liability for defaults.

Conversely, the Scheme does not create incentives for consumers to scrutinise the prudential standards of providers or to choose providers based on the level of protection offered on their investment, as all accommodation payments are automatically provided with a guarantee that has no cost.

Some alternative options would result in providers being charged a risk-rated price for the guarantee, encouraging them to minimise insolvency risk. It could be argued however that providers do not need an insolvency insurance charge to motivate them to avoid bankruptcy, as that would be a fundamental objective of their activities in any case. It is therefore not clear whether scheme design plays a significant role in influencing provider behaviour around maintaining solvency.

A consumer organisation argued in support of the existing Scheme, suggesting that a shift from the current system could reduce the incentive for government to undertake prudential monitoring, weakening consumer safeguards:

> *If the changes envisaged under the Roadmap are seen to reduce government's financial responsibility for aged care, there may be less justification for prudential monitoring of care*

providers' financial operations. The incentive then would be for the Department of Health to reduce its administrative costs by winding down its monitoring operation, which would no longer be able to provide advice informing the targeting of providers presenting service quality or financial risk. Without this alert mechanism, aged care residents would in turn be placed at increased risk of poor quality service or the stress of a sudden need to relocate. (Health Care Consumers Association, ACLR Submission, p.15)

The current Scheme offers a high degree of **certainty** for consumers, through having an unqualified guarantee of funds enshrined in legislation.

The Payment Security Act requires that an insolvency event (listed in chapter 3), such as an order for a company to be wound up, must trigger the requirement that the Commonwealth step in and refund unpaid accommodation payment balances to consumers. In addition, the Minister can trigger refunds in circumstances where insolvency has not legally yet occurred but a consumer is owed an accommodation payment balance. These provisions mean that consumers can be certain their money will be secure.

Stakeholders are attracted by the certainty afforded by the existing Scheme, reflected in the emphasis that many placed on the confidence the Scheme provides, both in terms of ensuring funds are secure and in supporting investment in aged care.

The Scheme currently contains one significant uncertainty, noted during discussion with stakeholders. This is the Minister's discretionary decision as to whether to levy the aged care sector to recover the costs of past default events it has incurred. The legislation allows the Minister to recover the cost of default events, including the administrative costs.

There is no time limit on the Minister's decision.

A future Minister could legally levy providers for default events that occurred throughout the last decade, though this would be controversial.

The Minister can choose to recover any proportion, up to 100 per cent, of the cost – again, the proportion is discretionary.

Finally, the Minister can make regulations that set different rates of contribution to a levy from different "classes" of provider, and can set the contribution of a class of providers at zero. Thus it is possible that some providers could find they are subject to a levy, while others are exempt.

The discretionary nature of the levy and its design means providers are unable to plan to meet possible costs of a scheme.

ACFA understands that the largest provider, if the Government were to levy the full cost of all insolvency events since 2006, would face a bill in excess of a million dollars. While this would be a small proportion of their annual operating budget, it is a large amount to be unable to predict and budget.

Aged care providers do not believe that a government would implement the levy for all historical events, but some concern was expressed about the uncertainty caused by the discretionary nature of the decision whether to implement a levy.

4.4. ACFA's observations

ACFA noted that stakeholders often emphasised the importance of the guarantee to consumer confidence and investment. Attention was drawn to research by National Seniors Australia, surveying older Australians, that indicates the existence of a government guarantee could be a factor in people's decisions about how to pay for their aged care.[71]

ACFA emphasises that this report considers alternative ways of delivering a guarantee of accommodation payments.

It is not considering the possibility of removing the guarantee.

ACFA considers it important that the scheme is comprehensive, and that consumers and providers can be certain of the protection of lump sum payments. Whichever option is pursued – including maintenance of the existing Scheme – there should be a guarantee mechanism.

While acknowledging the Scheme, one consumer organisation had a different view about the use of lump sum accommodation payments themselves, and therefore the consequent need to guarantee them:

> *[the lump sum payment] was an unconventional and complicated solution to what should, with foresight, have been a simple problem resolved with an equitable long-term contribution scheme.*[72]

It is correct that accommodation payments are a financing mechanism unique to aged care. This reflects the complex nature of residential aged care as being both a service and a form of housing. Offering the choice between lump sum payments and daily payments creates flexibility for consumers to choose how to contribute to the accommodation cost of aged care.

Aged care providers, while supportive of the existing arrangements, recognised the pressures facing the Government.[73] Stakeholders made some suggestions around key features of the Scheme to be retained in the event of any change.

Prominent among the issues raised was the importance of prudential oversight and control. Some provider organisations that discussed the issue (such as the Aged Care Guild and the Aged Care Industry Association) favoured tightened prudential controls, regardless of any change to the Scheme, with a particular focus on leasehold operators.

ACFA agrees that ensuring strong prudential oversight is important to both consumer protection and investment in residential aged care. Whether the existing Scheme is continued, or a different guarantee mechanism is considered, prudential oversight will remain a central underpinning of aged care.

There is widespread support among providers for the existing Scheme, evident in the views expressed by five major provider peak organisations:

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[71] National Seniors Australia, July 2016, *Report on the importance of the Bond Guarantee Scheme*, p. 7

[72] Aged Care Crisis, ACLR Submission, p.8

[73] See, for example, Aged and Community Services Australia's submission to the Legislated Review.

- Aged and Community Services Australia (ACSA);
- The Aged Care Guild;
- Catholic Health Australia;
- Leading Aged Services Australia (LASA); and
- UnitingCare Australia.

Similarly, consumer organisations, while less concerned about how the Scheme should be designed, were just as committed to a strong guarantee, and that it not significantly impact on the costs incurred by a consumer entering care.

The existing Scheme has met provider and consumer expectations, but exposes the Commonwealth to an uncertain liability.

ACFA notes that the Scheme is unusual. In other areas where governments provide guarantees or insurance in the public interest, they do not do so without beneficiaries contributing to the cost. This is true in cases as diverse as medical indemnity and terrorism insurance.

ACFA agrees in principle with previous reviews, including by the Productivity Commission and the National Commission of Audit, which concluded that the Scheme's beneficiaries should contribute to the costs of the guarantee. This would bring the existing Scheme into line with other similar systems, such as building completion warranty, medical indemnity and student tuition fee protection. It would also limit the Commonwealth's liability. This should be the case whether the existing Scheme is retained, or another model is implemented. However, in practice, a levy or other cost sharing mechanism should only be implemented if the benefits of doing so outweigh the costs.

To minimise uncertainty, ACFA recommends that, if taking steps to implement cost recovery under the existing Scheme, the Government agree to:

- determine that the levy provisions will not be applied to recover historical default costs incurred by government to date;
- introduce a formal process for notifying the sector of defaults occurring during each financial year; and
- for each notified default event, formally advise the sector of the minister's decision whether to apply a levy.

CHAPTER 5

EXISTING SCHEME WITH LEVY

5.1. Description of the option

This option involves the continuation of the existing Scheme with the provision of coverage automatically to all approved providers in receipt of lump sum accommodation payments. It varies the existing Scheme by prescribing the automatic retrospective imposition of a levy to recoup future default event costs. This report will refer to it as the ***automatic retrospective levy*** option.

Following a default event, the Commonwealth would repay outstanding lump sum accommodation payment balances to residents. The Commonwealth would then recoup the costs incurred, including administrative and claims handling costs, through a levy imposed on all providers. The levy would be retrospectively imposed following a default event. A retrospective levy could be set to recoup any proportion of the incurred costs, however for this discussion ACFA assumed that the retrospective levy would be used to recover the full cost of default events.

Currently, under existing legislation the Commonwealth can adopt an instalment approach in applying the levy, which could assist providers to spread the financial impact of individual default event costs over a number of years.

ACFA considered that it would be desirable to adopt such an instalment approach and has used this approach in the modelling undertaken, with the automatic levy being calculated as a third of the costs of each default event that occurred in the preceding three years.

For example, if the costs of a default event occurring in 2018 were $10.2 million, then $3.4 million, being one third of this cost, would be recouped each year through an annual levy in 2019, 2020 and 2021. The table below provides a hypothetical illustration of how it would work over time, as different default events occur.

Table 7: Hypothetical instalment approach to applying a levy

Hypothetical defaults each year		Total levy on the sector in each year per event - $000					
Year	$000	2019	2020	2021	2022	2023	2024
2018	10,200	3,400	3,400	3,400			
2019	none		0	0	0		
2020	10,800			3,600	3,600	3,600	
2021	2,700				900	900	900
Total levy paid by sector		**3,400**	**3,400**	**7,000**	**4,500**	**4,500**	**900**
Total as $ per $1,000 of lump sums. *		$0.17	$0.17	$0.35	$0.23	$0.23	$0.05

* Assuming constant pool of $20 billion in lump sum payments is held by providers from 2019 through to 2024, and the levy is charged to providers at a flat rate spread over the three following years, based on the value of lump sum payments held.

Under this option, providers would be fully exposed to default event costs as there would be no ceiling on potential recovery of costs from providers. It is possible that providers could face no costs in some years.

There was support from some providers (for example, Catholic Health Australia) for taking an instalment approach to the calculation of the levy, to ensure smoother and more affordable payment requirements.

As noted in Chapter 1, ACFA considers that reinsurance could be used to effectively reduce the variability of costs faced by providers resulting from a large default event. Reinsurance would operate by creating a limit to the amount of exposure that is faced by the providers, transferring a layer of risk to the reinsurer in exchange for the premium paid.

ACFA modelled the inclusion of a layer of insurance protection. In the event that default costs exceeded the reinsurance limit, the Commonwealth could undertake to meet default costs in excess of the limit of reinsurance cover provided, and then recoup these through the imposition of the retrospective levy in subsequent years.

5.2. Assessment against the principles

The *automatic retrospective levy option* would not alter the scheme's **effectiveness** in protecting lump sum payments.

The option would remain certain to return lump sum accommodation payments to residents impacted by a default event. As outlined in the previous chapter, there have been some occasions where there has been a delay in the money being returned to residents (or their estates), but these reasons generally have been un-related to the design of the scheme.

Table 8: Retrospective levy option

Principle	**Assessment**
Effectiveness	
Efficiency	
Simplicity	
Sustainability / flexibility	
Equity	
Operability	
Right behaviour	
Certainty	

For the Government, the automatic retrospective levy option would ensure better sharing of costs, and provide a greater connection between gaining a benefit from the scheme and contributing to its costs, when compared to the current Scheme with its latent but un-used option to trigger the levy following a default event. When the levy is not triggered, the costs are shared inefficiently. The residents that have been impacted benefit from the operation of the Scheme, but the costs to date are all borne by the taxpayer.

The automatic retrospective levy option could be relatively **efficient.**

The automatic levy is an efficient way to recover costs as it avoids the establishment of new governance arrangements or institutions. Amongst providers however, the fact that the automatic levy would be applied retrospectively may be considered inefficient, as the defaulting provider does not contribute to the costs of the levy. The levies paid by solvent providers meet the cost of other providers' default events, never their own.

A number of providers also commented that a retrospective levy would create a cost and administrative burden for industry which would offset or outweigh the greater efficiency in the sharing of costs. One provider commented that:

> *This option is not fair to providers, and will add further costs to an industry in which a significant number of services already operate at a loss from their aged care operational business sector, or show an unsatisfactory level of return. This levy will put at risk the future viability of services, including their ability to refurbish facilities as required.*[74]

The automatic retrospective levy option would be relatively **simple** to operate, placing no administrative burden on consumers or providers. Following a default event however, the administrative role for government would increase with the need to determine the levy amount for each class or type of provider, and to oversee the collection process for the levy imposed.

One provider argued that this administrative requirement was unnecessary:

> *IRT believes that though the backdated levy is a simpler scheme than the other options, it still adds a level of unnecessary complexity and uncertainty.*

The automatic retrospective levy may be more **sustainable** than relying on the existing capacity to levy the sector that has not been used and for which no regulations explaining how it would work have been made.

As noted in section 4.2 of this report, whilst the size of the claims made under the Scheme over the last decade has been modest, their pattern is volatile. This fact coupled with anticipated changes in the sector and growth in the accommodation payment pool means there is a chance that claims against the Scheme will increase in the future.

In this environment, an automatic levy is likely to be more sustainable, because the automatic levy process creates a greater sharing of costs between all stakeholders. The Commonwealth would no longer carry all the risk and costs, and it would provide greater certainty to providers on whether or not the levy will be implemented.

One provider, Catholic Health Australia noted:

> *Keeping the current Scheme avoids the cost of establishing and administering a guarantee fund based on a prospective levy, while at the same time protecting consumers and ensuring access to an economic source of capital which results in lower cost aged services for the community than might otherwise be the case.*
>
> *Should the Commonwealth decide to implement a retrospective levy, we would support that recovery extend over three years, and that the levy be set as a proportion of lump sum deposits held by each approved provider.*

The Association of Aged Care Service Professionals foresaw both a benefit and risk associated with the introduction of an automatic levy:

[74] Sunnyside Lutheran Retirement Village submission

The bigger providers would see this as an opportunity to buy up the smaller providers. This is a benefit only where it can be assumed that the bigger groups are generally running their businesses well and are less of a risk of default, or perhaps as a bigger group it is easier to see financial issues arise earlier on than at time of default.

On the other hand, it was noted that:

Such a levy could result in smaller providers selling up to the bigger groups. This compounds the issue of default of a larger provider, which potentially holds hundreds of millions rather than tens of millions in lump sum funds.

As outlined in the previous chapter, the costs of a levy were modelled. In 2020 the actuarial modelled scenario of defaults would result in a levy of $68 per $100,000 of lump sum payments held, per annum. Based on the average length of stay for a resident in a residential aged care facility, the upfront levy costs would be approximately $600 per resident or 0.2% of the average lump sum payment.

The sector is currently adjusting to a number of other policy reforms and budgetary constraints. Introduction of the automatic levy option in the current environment would create an additional cost pressure, particularly if providers remained restricted in their ability to pass on a portion of the cost to consumers.

The existing Scheme levy is optional, thus providing the Government with **flexibility**. Whether flexibility would be retained with the automatic retrospective levy option would depend on its design.

The Government can determine on a case by case basis how and when the levy is imposed. In practice, however, this has never been done, leaving it unclear how it might be implemented. An automatic levy may appear less flexible because it could fix the level of costs recovered. However, this depends on the way the levy provisions are designed and implemented. They could provide a similar level of flexibility to the Government, by allowing the Minister (or a regulator) to set the levy at a rate less than that needed to recover 100 per cent of costs. Nevertheless, an automatic levy necessarily reduces the flexibility of Ministerial discretion to some extent.

The automatic retrospective levy option is **equitable** for all lump sum accommodation payment-paying consumers and providers as everyone is fully protected through the scheme.

The equitable treatment of consumers and providers is not impacted by whether the imposition of the levy is optionally or automatically applied. The greater difference between the two approaches to the levy lies in the outcome for taxpayers. If the levy is applied automatically, the cost for protection of the lump sum payments would be paid by providers, through a levy following a trigger event, and this is consistent with the fact that providers benefit from access to these funds. This arguably assists in stopping the cross-subsidy of these residents and of providers, by taxpayers and future residents.

There remains the concern that it is inequitable that failed providers have made no contribution to the cost of protecting their lump sum accommodation payment holdings. IRT noted that:

> *The only argument concerning equity is that a provider who fails won't be required to contribute to the shortfall to the Scheme. Though this appears to be inequitable for providers who have managed their businesses more effectively, there doesn't seem to be a simple solution to this issue. It's a reality that companies that fail have an impact on a range of other entities and individuals. There doesn't appear to be a clear reason to treat aged care any differently.*

The **operability** of the current Scheme is proven: adding an automatic retrospective levy to it would not present significant difficulties.

Implementing an automatic levy would not affect the scheme’s success in assuring the return of lump sum accommodation payments to residents (or their estates) that have been impacted by a default event.

Australian Governments, at a multijurisdictional level, already operate a number of levies, so the mechanisms to undertake these are well understood and could be used as models if an automatic levy were to be introduced to the Guarantee Scheme.

An automatic levy could be implemented with minimal administrative impact and within a reasonable time line for providers especially if the most recent information included in the APSC and GPFR was used by the Department to determine the levy to be applied to each provider. For government, an additional administrative burden would arise because of the need to calculate the levy, notify providers of the amount payable, and to oversee the payment process. This was noted by one provider that said:

> *Providers would be obliged to advise the Department about their RAD/Bond holdings every time there's a failure event that triggers the Scheme. This process could be simplified by adopting the RAD/Bond information given by the provider at the time of lodging annual accounts. But it hardly satisfies the objective of simplified administration processes and the removal of unnecessary red tape.*

The automatic retrospective levy option would continue to encourage **the right behaviour** from government.

The Commonwealth would continue to operate under strong incentives to continue prudential risk monitoring activities and to work with providers to mitigate the risks of insolvency. With the inclusion of the automatic retrospective levy, the Government would continue to have responsibility for the care of residents impacted through a collapse. Providers would share in the costs of a default event occurring, creating greater incentive across the sector to assist, where capacity exists, in mitigating default events. This could occur through the takeover of one provider by another.

In contrast, the automatic levy could be considered not to provide an incentive for risky providers to minimise their prudential risk of default. Risky providers will receive no price signal that would assist them to make different choices. This view was expressed by a number of providers. One provider noted that:

> *There's no clear evidence that a backdated levy will encourage the right behaviour. If it's assumed the intent is to improve performance by the failed provider, it's simply too late. If*

the intent is to drive the right behaviour amongst existing providers, IRT doesn't believe the Scheme is the correct mechanism. IRT is of the view that the prudential Scheme is the correct vehicle for driving right behaviour

The automatic retrospective levy option would continue to provide **confidence** for consumers who pay lump sum payment. Compared to the current Scheme, it will improve **certainty** for providers in many respects. At present providers have no idea *whether* the levy will be implemented, *when* it might be implemented, *how much* of the default costs they might be asked to pay, or *how the levy might be calculated* to share costs among providers. An automatic levy has the capacity to resolve all these sources of uncertainty.

At the same time, an automatic levy would impair certainty for providers in receipt of lump sum amounts in two ways. Whilst providers would know in advance the basis for the application of the levy, they would only be advised annually of the levy amount payable. The magnitude of the levy would be variable because it would depend on the cost of individual default events.

A number of issues would need to be resolved in calculating the levy. These include how to define each provider's lump sum payment holding. This presents a challenge for an automatic annual levy (compared to one that is implemented at the time of a default) because each provider's pool of lump sums varies over time, so may be different at the point in time the levy is calculated from the time at which defaults occurred.

The national provider organisation representing large private providers, the Aged Care Guild, stated that it:

views option 1B as a codification of the existing Scheme; effectively locking in arrangements by outlining how the Commonwealth would look to enact a levy if required. A levy effectively penalises providers that are compliant with prudential requirements. If the government does levy the sector into the future, more focus should be placed on prudential compliance and oversight. The Guild is broadly supportive of option 1B, on the condition that improvements are made to prudential regulation…

As was noted in Chapter 3, prudential monitoring is a very important part of the process of protecting accommodation lump sums, and is currently being separately reviewed by the Government.

5.3. ACFA's observations

The existing Scheme has been effective for consumers, however the decision not to implement the discretionary levy to date means that the Commonwealth's exposure as guarantor of all lump sum accommodation payments has not been offset.

In these circumstances, if the Commonwealth wishes for the beneficiaries of the Scheme to contribute to its cost, reform may be necessary. The simplest step for the Commonwealth to take would be to implement the option considered in this chapter, of an automatic retrospective levy, upon occurrence of a default event.

ACFA noted that that continuation of the existing arrangements was welcomed by providers. The introduction of an automatic retrospective levy was considered a cause for concern in the majority of submissions received. Concern related both to the size of any future levy, which is unknown until a default event occurs; and also related to the affordability of any levy that was imposed.

Currently, the Commonwealth can adopt an instalment approach in applying a levy that is imposed. The retrospective application enables some time for providers to plan for the costs of the levy, while the use of an instalment approach could be used to spread the financial impact of any levy over a number of years. Under this approach, however, there will always be uncertainty about the size of the levy because it is determined by the magnitude of whatever default events occurred in the preceding year.

The introduction of an automatic levy would provide a fairer sharing of costs, with a greater connection between the costs of the Scheme and the providers who benefit from its use, albeit without the defaulting providers contributing at any stage.

A greater sharing of costs between all stakeholders will provide a greater incentive both for the Government to monitor the sector through the prudential arrangements, and for providers to actively address the factors which give rise to risk which is present in the sector.

One drawback associated with the retrospective application of the levy is that when a default event occurs, the provider that defaulted does not contribute to the cost of the levy. This inequity can only be addressed through the application of a prospective levy. This forms part of the model considered in the next chapter.

CHAPTER 6

GUARANTEE FUND

6.1. Description of the option

Under this option, referred to here as the ***guarantee fund option***, approved providers in receipt of lump sum accommodation payments would be required to pay annual contributions into a guarantee fund pool. Whereas the previous option would involve a retrospective levy, this option involves *prospective* payments. The fund would hold and accumulate the contributions against possible future payouts. In case of a default event, it would repay the net outstanding lump sum accommodation payments to the care recipients from the balance of funds accumulated.

In the unlikely event that a large provider collapsed, this could trigger claims for the recovery of accommodation payments that exceeded the value of the guarantee fund pool. A layer of insurance protection could help to manage the risk of an event of this kind. This would be done either by the Commonwealth undertaking to meet that gap and obtaining its own insurance, or by the guarantee fund being liable, but obtaining insurance protection for events of a value that exceeded the accumulated fund.

6.2. Assessment against the principles

In many respects, the *guarantee fund option* with a prospective levy would be **effective**.

Table 9: Guarantee fund option

Principle	**Assessment**
Effectiveness	
Efficiency	
Simplicity	
Sustainability / flexibility	
Equity	
Operability	
Right behaviour	
Certainty	

Guarantee fund pools are an established and effective means of managing risks, including default risks, in a range of sectors both in Australia and internationally. Examples include the Tuition Protection Service (TPS), administered within the Commonwealth's Department of Education, which assists international students on student visas whose education providers are unable to complete the delivery of their course of study.

A guarantee fund pool assesses risk and accumulates sufficient capital to meet the likely cost of most default events. In the view of South Australian provider Resthaven:

The costs over the long term should be similar irrespective of which option is adopted; the benefits are that each ensures that the bond guarantee is retained.

[However], this option has a predictable cost to providers, reduces the exposure of Government, and has the benefit that the assessed risk is funded. All providers contribute to the fund.

Establishment of the entity holding the guarantee fund pool within the Australian financial services system would mean it is subject to regulatory supervision. The likelihood of the guarantee fund defaulting on its obligations would be low. Nevertheless, sector confidence may be reduced if the refundable amount was limited to the value of the accumulated fund. The relatively low risk, mentioned above, of claims exceeding the accumulated fund limit, could be addressed through adding a layer of re-insurance. As was outlined in Chapter 1 (and detailed further in Appendix 2), the

management of residual liability is an important aspect of any scheme; ACFA anticipates that it would be addressed in the case of the guarantee fund pool by the Commonwealth accepting liability for refunds that exceeded both the accumulated guarantee fund pool value and the reinsurance cover. If the Commonwealth did not legislate to accept this residual liability as part of implementing the option, its effectiveness would be substantially less than that of the existing Scheme or the automatic levy options, as consumer and investor confidence could be impaired.

All the tasks in the refund process, including making a default event declaration, determining the person entitled to a refund, and the amount of refund, could remain centrally managed by the Government. This would ensure that responsibility for and ownership of all tasks is clear.

The guarantee fund option with a prospective levy may be no more **efficient** than the automatic retrospective levy option, though it could produce lower premiums than the other options that ACFA concluded were less attractive (and are outlined briefly in the next chapter). The cost to providers of a guarantee fund pool is likely to be lower than options such as a bank guarantee or insurance, due to the simplicity of the arrangement, as well as the absence of a need to deliver a profit margin, which would be required by the private sector. However, the saving produced by not requiring profit margins may, during initial years, be offset by the additional costs of accumulating enough capital to form the basis of an ongoing fund, as well as costs associated with any new administrative reporting and other obligations imposed on providers. A provider outlined its concern about the costs of implementing the option:

> *Having had experience with Government guarantee funds in the past there is a substantial cost in the setting up and administration of the fund, which would be added onto the cost of the levy to all providers.*[75]

ACFA notes that in the case of the TPS, the Commonwealth provided $5 million in capital to establish the pool. Commonwealth seed funding of the guarantee fund option may be necessary to avoid providers facing larger set up costs in the initial years.

A significant number of respondents to ACFA's call for submissions argued that any levy on providers was an undesirable impost. One consumer organisation viewed the guarantee fund option as more likely to offer providers an opportunity to pass on that cost to residents:

> *The probability of providers passing on the cost of a prospective levy to consumers in a separate charge additional to the lump sum payment would be very high as the raising of an additional charge on Refundable Accommodation Deposits (RADs) illustrates. This additional daily fee has various names, depending on the provider, but is explicitly linked to a consumer's choice to pay for their accommodation in the form of a RAD.*[76]

While all provider peaks expressed a preference for no levy on providers, in the event that the Government took a different view, it was argued that providers should then be able to pass through the cost:

[75] Buckland Aged Care Services submission
[76] Combined Pensioners & Superannuants Association of NSW submission

> *If alternative options are advanced, ACSA would support prospective arrangements coupled with the ability to cover the levy cost through resident charges as ultimately, this guarantee is for the resident and they must pay for that guarantee.*[77]

The efficiency of the option also depends on which consumers contribute, and whether there is risk rating. Economic efficiency would suggest that only those receiving the benefit of the charge should pay its cost. On this basis, only the consumers paying a lump sum accommodation payment would be charged for the guarantee. However this would require a change to government aged care charging policy, removing the existing equivalence mechanism between lump sums and daily payments. Other considerations regarding the use of risk rating, outlined in Chapter 1 and explained further in Appendix 2, are discussed below.

One of the issues that would require resolution with a guarantee fund is how much money should be held by the fund. Uncertainty around the cost and timing of insolvencies leads to a range of model results on the appropriate size, and the timing of the accumulation, of the fund. Too large a fund would risk inefficient use of sector and residents' assets; too small a fund may not be able to cover the likely range of insolvency events. These uncertainties may reduce the economic efficiency of this option. The most efficient way to use funds may be to limit the scale of the guarantee fund pool through the use of a layer of reinsurance for claims beyond the upper limit of the fund. Australia's existing terrorism protection insurance scheme works using layers of protection of this kind.

The guarantee fund pool with a prospective levy has some advantages in terms of **simplicity**, but is less simple than the existing Scheme with a levy.

For a guarantee fund pool, avoiding complexity requires careful design of the fund structure and its governance.

A guarantee fund would be simple in that one body would hold all monies. Regulators, consumers and providers would not need to deal with multiple service providers, as would be the case with bank guarantees or private insurance.

As is the case with the other options, applying risk rating to providers to determine an amount of levy may run contrary to a preference for simplicity. As HammondCare have suggested:

> *A risk rating would be complicated to deliver in practice. For providers that operate multi-service businesses – such as that offer community care and independent living services in addition to residential care – may find themselves disadvantaged unless the business segments can be separately risk-rated.*

Some stakeholder feedback to ACFA emphasised that 'fairness' was at least as important as simplicity. While generally unsupportive of the guarantee pool option, IRT also said:

> *To be fair to all providers, there would have to be a risk rating built into this levy. There would have to be an allowance for a facility that holds a very high percentage of lump sum payments in cash accounts, with minimal debt, as opposed to one that holds a low percentage of cash with a higher level of debt.*

[77] Aged Community Services Australia submission

Simplicity would require attention to the structure of the fund. Previous research by the Commonwealth, and discussion with some stakeholders, indicated that a trust-based model for the fund could be complex to establish and maintain. Trusts can be complex because of the governance requirements, and difficulties in arranging the benefits of the trust to flow to consumers affected by bankruptcies. Consumers need to be established as beneficiaries of the trust in order to receive the repayment of funds, and this is not a simple process. Trusts can also be complicated to adapt in changing circumstances. Non-trust models may be simpler. They are also not uncommon. ACFA understands that in the United States guarantee funds (known there as pools, or risk pools) are common and routinely operate without difficulty. A number of fund pools operate in Australia, including the Tuition Protection Service and fund pools that provide services such as professional indemnity insurance to local councils.

A guarantee fund would be simple for the Government to supervise, given that it is a central account that covers all providers. However, it is less simple than the automatic levy, as new governance arrangements would have to be established, that the existing Scheme does not need. If the fund was operated by a sector-dominated entity, the existing prudential reporting requirements could be enhanced to inform the Government of the financial soundness and governance of the guarantee fund pool, and the progress of any refunds. The existing administrative refund process is likely to remain largely unchanged, although recovery actions and responsibility could be passed on to the guarantee fund, removing some administrative burden from the Government.

Transitioning to the guarantee fund option would take some time as it would require:

- Setting up the entity managing the fund including its operations such as governance, appointment of directors/administrators, and investment strategy;
- Establishing the regulatory arrangements such as the mechanism for recording lump sums paid by residents;
- Enforcing payment of the contribution; and
- Accumulating contributions to a level that is self-sustaining.

A guarantee fund option should be relatively **sustainable** and **adaptable**, though as for all options, it is hard to predict with certainty.

Any levy or fee will increase the costs to providers, and in turn may be passed on to some degree to consumers. The size of any levy or fee is therefore important to consideration of sustainability, from both the point of view of its impact on individual providers' business costs, and in terms of sustainability of the guarantee fund pool. Financial services provider La Trobe Financial observed that:

> *One of the key risks [to this option] is that the levy pool is too small for claims on the RAD refund.*

One of the providers that made a submission queried how a sustainable pool would be determined:

> *It is unclear as to what the total of the RAD/Bond pool needs to be to cover risk exposure of provider failure [under this option]. Is it the annual average failure amount of the last ten years? Is it the gross shortfall of the last ten years? Or is it something else not explored in the Discussion Paper? Should the pool be allowed to grow to the total of the bond holdings of the*

largest aged care provider? Should the pool be supported to grow to an arbitrary total of say $2 Billion?[78]

The modelling commissioned by ACFA indicated that the pool, funded through a prospective provider levy[79] was projected to be modest. In 2020, a likely scenario of defaults would result in a levy of $77 per $100,000 of lump sum payments held, or $261 for an average lump sum of $340,000 per annum. Based on the average length of stay for a resident in a residential aged care facility, the upfront levy costs would be approximately $780 per resident or 0.3% of the average lump sum payment.

This modelling suggests that the level of additional costs would have a modest impact on the affordability of an aged care lump sum accommodation payment. It is also likely that, once the fund has accumulated sufficient levy contributions to cover the likely scenarios of default, the required level of levy contributions could be reduced. This would however be influenced by the future pattern of defaults among residential aged care providers.

Stakeholders expressed concerned about the cost. One provider submitted:

The cost of creating a pool fund by levying all providers (Option 2) would place a large financial burden on providers, many smaller providers currently struggle to make a surplus and would probably have to reduce staffing levels even further to meet the cost of any new levy.[80]

The guarantee fund pool option should be readily adapted to changing market circumstances. The nature of the guarantee fund means that it is responsive to market size. If there are future policy changes, such as deregulation of the supply of beds, that affect market size or composition, a guarantee fund should adapt well to such changes.

Equity of access to a guarantee fund pool could be equivalent to the existing Scheme (depending on how the pool was governed), and better than for options that ACFA concluded were less viable.

The rules governing guarantee fund pool membership would determine whether it offers equity of access for aged care providers. For a guarantee fund pool to provide access as equitable as the existing Scheme, it would be required to admit all approved providers. This was the principle ACFA adopted when reviewing and modelling options.

For consumers, equity depends on all residents having equal protection of their funds. A guarantee fund pool that included all providers would provide such equity, but only if there was a Commonwealth guarantee that it would meet the costs of a low probability default event that exceeded the value of the fund pool. If it did not, then residents whose aged care providers have very large accommodation payment holdings would have less protection than those whose care was being provided by smaller services.

[78] IRT submission
[79] Based on the historic rate of provider default of 0.13% and inclusive both administration costs and a layer of reinsurance cost (for scheme losses exceeding $20 Million but less than $45 Million).
[80] Buckland Aged Care Services submission

Equitable access to refunds from the scheme is affected by the scheme's capacity to pay in all circumstances. ACFA's discussion with experts led it to propose a layer of reinsurance, and ultimate Commonwealth Government backing, to ensure that refunds would be available in all circumstances.

The **implementation** and **operability** of a guarantee fund pool with a prospective levy are more complex than for the existing Scheme, because it requires establishment of a vehicle such as an Advisory Board operated by either government or the sector to support management of the guarantee fund pool, and regulatory oversight that guarantees every provider has valid coverage with the fund. A fund director supported by a small team would be responsible for the operations of the fund and set key components of the levy to be paid, following the advice and recommendations of the Advisory Board. Comprehensive coverage would be achieved, for example, by requiring providers to be current financial members of the scheme in order to hold approved provider status.

The complexity of implementation would also be influenced by the systems used for calculating and collecting a levy. Potentially, this would involve providers advising the scheme of their receipt of each new lump sum payment. However, experience in other funds indicates that once established, a guarantee fund can be reasonably simple to administer.

The guarantee fund option would require attention to transition arrangements, to ensure protection of lump sums while the guarantee fund is in its establishment phase. Consumers will expect their lump sums to be protected at all times. There will be policy and regulatory issues that arise for those lump sum payments that were paid prior to the Scheme becoming based on the guarantee fund. It may be that government will have to provide 'grandfathering' protection arrangements for these accommodation payments during transition.

The guarantee fund pool with a prospective levy may be better able to **encourage 'right' behaviour** than the existing Scheme, but this depends to some extent on whether risk rating is adopted.

A guarantee fund pool has the advantage that all providers contribute, and therefore have an interest in keeping levy costs down, whereas a retrospective levy never applies to the provider that has defaulted. However, ACFA heard mixed views about whether this represents a significant influence on provider behaviour. The prevailing view was that other mechanisms, particularly prudential requirements, have a greater impact:

> *While this proposal would go some way to producing a price signal to providers about the cost of defaults, the existing prudential requirements for providers have proved largely successful in managing the risks related to lump sum accommodation payments.*[81]
>
> *If the Government does levy the sector into the future, more focus should be placed on prudential compliance and oversight.*[82]
>
> *IRT can't see any incentive created by Option 2 that will drive and or encourage the right behaviour by providers.*[83]

[81] Hammondcare submission
[82] Aged Care Guild submission
[83] IRT submission

Confidence and certainty under a guarantee fund could be undermined by the limited size of the fund. The possibility of a provider failure affecting accommodation payments greater in value than the guarantee fund pool is one that would have to be addressed. Otherwise, the guarantee fund option would not provide sufficient confidence to consumers.

Once an appropriate pool size had been reached, most or all likely defaults could be paid from the scheme. One financial services organisation suggested:

> *Creating a guarantee fund pool through a prospective levy is a probably the best outcome for all stakeholders in our view especially considering the reinsurance market cannot take on this RAD liability given its sheer size.*[84]

From a provider perspective, the guarantee fund pool with a prospective levy option creates certainly, because it allows relatively stable annual contributions to be budgeted for:

> *The benefits of this option include consistency for a provider on how much to pay each year. This is likely to be passed on to the resident and so at the very least needs to be transparent and advertised.*[85]

This increases certainty compared with an option based on recovery of costs of retrospective events, or one that is driven by changing private sector capital and profit requirements.

Certainty can be afforded by a guarantee fund in a way that a private insurance market cannot. ACFA consulted with other sectors in which insurance is required for public interest purposes. Those consultations highlighted how market volatility can cause insurers to exit a market, creating a crisis of coverage. This has happened in the medical indemnity market and the builders warranty market at different points in time. A guarantee fund avoids the risk that insurance will only be available some of the time.

6.3. ACFA's observations

The guarantee fund option would represent a significant change and therefore be more complex to implement than a levy attached to the existing Scheme.

Feedback received by ACFA from stakeholders was in the main resistant to having a prospective levy, on the basis that it would present an unnecessary additional cost for providers. This includes the additional administrative activity required by such a scheme, which contributes to the overall cost of a levy and is contrary to the "regulatory reform framework"[86] policy of the current Government. This feedback reflects provider comfort with the existing and the longstanding benefit received by providers through the Government's acceptance of all financial and administrative liabilities of the existing Scheme.

The guarantee fund pool option offers the Government, consumers and providers an approach to guaranteeing lump sum deposits in a relatively planned and cost effective manner. Conceptually, it is similar to purchasing an insurance product, in that the amount of premium and the extent of

[84] La Trobe Financial submission
[85] Association of Aged Care Professionals submission
[86] Previously 'Red Tape Reduction Framework'

coverage are known, with costs planned for and paid in advance. This provides a level of certainty and confidence. However unlike insurance, the guarantee fund's prospective levy does not contain an element of profit, which helps keep down the cost to providers.

The attractiveness of the guarantee fund pool option, compared to the existing Scheme with an automatic levy, depends on providers' desire for certainty.

The possible right for providers to differentially pass the levy to lump sum paying residents would need to be reconciled with the current principle of precise equivalence between lump sum and daily rental accommodation payments, assured by the application of the Maximum Permissible Interest Rate (MPIR) to provide certainty and transparency that residents are not differentially rewarded or penalised for their choice.

Modelling indicates that, in an average year, the automatic levy approach will be slightly cheaper than the guarantee pool. However, it will also be less predictable, while the guarantee fund pool would see the Commonwealth carry residual liability in the case of a large default event, which under the automatic levy could fall on providers. This trade-off is likely to be important for stakeholders to consider in the event that the Commonwealth opts to move away from the status quo.

The administration of the guarantee fund would require regular assessment of the amount needed to grow and sustain the amount of funds within the pool. The levies used to grow the guarantee fund pool could be reduced or paused if or when a target balance of funds was achieved. Since 2006 there have been several periods where there were no calls on the existing Scheme, including a period of 3 years (2011-2013). ACFA's modelling showed that in the absence of calls on the scheme over a period of three years, the pool could grow to a size ($55 Million) that exceeds the total of all refunds paid under the Scheme to date ($43 Million) and likely to be sufficient to cover all but the most severe failures. In such a scenario, the pool of funds would also generate positive returns that would further grow the pool. This is illustrated in the table below, which uses the same hypothetical claims scenario as used in Chapter 5 to illustrate the levy costs for an automatic levy.

Table 10: Hypothetical growth in pool funds

Year	Hypothetical sector levy, $M	Less hypothetical claims, $M	Less administration costs	Plus interest earned on pool funds	Net position of guarantee fund pool
2018	17.9	10.2	0.8	0.2	**7.1**
2019	19.0	0	0.8	0.8	**26.1**
2020	20.2	10.8	0.8	1.0	**35.7**
2021	21.5	2.7	0.8	1.6	**55.3**

As noted above, modelling based on the historic rate of provider failure showed that the annual cost to a provider of a flat rated levy would be in the order of $261 per year for an average

accommodation payment of $340,000[87] including administration and a layer of re-insurance coverage. ACFA considers this to be a relatively modest level of cost.

While initially more complex to set up, once established, a guarantee pool fund would be a relatively straightforward operation, with a level of government oversight retained, as is the case with the Tuition Protection Scheme.

[87] Modelling was undertaken on the 2014-15 lump sum payment pool and at this time, the average accommodation price was $340,000. See *2014-15 Report on the Operations of the Aged Care Act 1997*, p. 64

CHAPTER 7

OTHER OPTIONS

7.1. Introduction

As outlined in Chapter 1, ACFA explored a number of options in addition to those outlined in more depth in the previous chapters. They were discussed with agencies and organisations that operate other schemes; experts in insurance and finance; and banks and insurance companies. ACFA's assessment against the principles suggests that these options are either likely not to be viable, or not as effective as the options on which this report concentrated.

The other options are set out here, with an explanation of some of the key likely disadvantages.

7.2. Option 3: Industry arranged bank guarantee

The *bank guarantee option* is an alternative to approved providers paying amounts directly into a fund and assumes that the sector would arrange a bank guarantee for a fixed amount to cover the anticipated costs associated with repayment of the net outstanding lump sum accommodation payments. The bank guarantee is an unconditional promise from the bank to pay the recipient[88] of the guarantee the amount agreed and requires security in the form of cash held on deposit with the bank or other assets such as property. The deposit funds held as security would accumulate interest at the prevailing interest rate.

Table 11: Bank guarantee option

Principle	Assessment
Effectiveness	(red)
Efficiency	(red)
Simplicity	(red)
Sustainability / flexibility	(amber)
Equity	(red)
Operability	(red)
Right behaviour	(amber)
Certainty	(red)

Analysis of the *bank guarantee option* indicated that there would be limitations to its **effectiveness, simplicity** and its **operability**, because of the way bank guarantees work. Banks could be willing to provide guarantees to their own clients. However, creating bank guarantees across the whole sector, including many providers that do not have a complete banking relationship, would be difficult. It would be particularly challenging in the not-for-profit sector, where business models and organisational structures would make it hard for banks to understand the operations and structure a guarantee around the lump sum accommodation payment risk. This would be most acute for those not-for-profits that also operate services outside aged care.

In addition, the total pool of over $20 billion is likely to be too large to be fully covered. Because there are legal obstacles to operating a pooled bank guarantee, the end result would be a system that would be unlikely to cover all providers, making it **inequitable**.

The bank guarantee is unlikely to be **efficient**. The unfamiliarity of the banking sector with aged care, and the need to secure the guarantee with assets, are both factors likely to increase the cost to providers of the option. In addition, banks will require a profit margin from the arrangement that is not required by the existing Scheme or a guarantee fund.

[88] The recipient may be identified within the guarantee agreement as the specific beneficiary, that is, the resident or their estate or alternatively, a specified agent acting on behalf of the beneficiary including the Government or Department.

The **sustainability** of the bank guarantee option is questionable, and it may not be **flexible**. The decision of a bank or banks to refuse to take on the risks of a guarantee could cause the option to fail, because some providers might find themselves unable to secure cover. Costs could rise significantly if banks became concerned about stability in the sector. Bank guarantees are not very flexible instruments and may not work well across a diverse range of business models.

The bank guarantee option could have the capacity to **encourage right behaviour**, as the quality of a provider's financial situation would be subject to scrutiny by the bank. This should help ensure prudential rigour by providers, though not all will be operating in situations where it would be reasonable to expect them to improve their financial position (for example small providers in regional areas).

A bank guarantee could provide **certainty** for those providers able to secure it. However as noted above, it appears unlikely that it would be possible to ensure every provider was covered.

7.3. Option 4: Private insurance model

This option involves each approved provider separately purchasing an insurance policy covering the total value of all lump sum accommodation payments that each provider holds. It is referred to in this report as the private insurance option. When a default event occurs, a lump sum payment holder (or their estate) would make a claim against the approved provider's insurance policy. The insurer would assess and process the claim, and then arrange for the payment of the net outstanding lump sum accommodation payments to the care recipients from their funds. Insurers may impose their own administrative or reporting requirements.

Table 12: Private insurance option

Principle	**Assessment**
Effectiveness	
Efficiency	
Simplicity	
Sustainability / flexibility	
Equity	
Operability	
Right behaviour	
Certainty	

Insurance coverage would need to ensure that there is a safety net for residents in all circumstances, and this option would involve working with the insurance sector to create a 'without exception' insurance product that is suitable for this purpose.

The insurance policy would need to cover all factors that contribute to an approved provider being placed into liquidation, or becoming insolvent. This includes extending to situations where a provider is insolvent, but wind up action has not yet commenced and the approved provider has an extremely low probability of being able to trade out of difficulty.

Analysis of the *private insurance option* indicated that it would be unlikely to be **effective**, and would its **operability** would be a major challenge. The accommodation payment guarantee would represent a new kind of risk, so the insurance industry would be cautious, with premiums likely to be high as insurers assessed the sector and guarded against losses.

ACFA's assessment is that securing coverage for the entire sector would be so difficult as to be impossible. Insurers would risk-rate individual providers, and those with perceived higher risk may be declined insurance, or offered it at a price that would be prohibitive. Even if insurers were willing to offer coverage to individual providers, the pool of around $20 billion and growing may be too large for the insurance sector to fully cover.

Private insurance is unlikely to be **efficient** when compared with the options considered in previous chapters. ACFA understands there are some insurance schemes in other sectors that operate with modest premiums. However, initial estimates of the size of the premiums required to guarantee lump sum accommodation payments indicated it could be a relatively expensive option, and therefore unlikely to be attractive.

It will be difficult to achieve **equity** under a private insurance model. Providers without strong balance sheets, including small rural and remote providers, may be unable to secure insurance, and have little ability to modify their business structures to meet the requirements of an insurer.

A private insurance model will not meet requirements for **sustainability** or **certainty**. The history of mandatory insurance schemes elsewhere in the economy, such as in health or home building completion, indicates that insurance is vulnerable to the exit of insurers from the sector when costs are high, meaning stability could be hard to achieve. The Commonwealth could find itself having to step back into the field in an unplanned way following such an event. This is both an undesirable outcome for the Government and also likely to be accompanied by a period of significant uncertainty for consumers and providers.

7.4. Option 5: Pooled insurance model

This option involves all approved providers collectively purchasing coverage under a national insurance policy to cover the aggregate lump sum accommodation balance held by the sector. When a default event occurs, a claim would be made against the national insurance policy. The insurer would assess and process the claim, and then arrange for the payment of the net outstanding lump sum accommodation payments to the care recipients from their funds.

Table 13: Pooled insurance model

Principle	Assessment
Effectiveness	
Efficiency	
Simplicity	
Sustainability / flexibility	
Equity	
Operability	
Right behaviour	
Certainty	

The national insurance policy would cover all approved providers and would be developed based on the aggregate lump sum accommodation payment balance held by the sector, and the risk profile of the sector, as assessed by the insurer.

Analysis of this option indicated that there would be some similar problems as for private insurance. It was recognised that a pooled approach could resolve the issue of some individual providers not being able to obtain cover, but the costs of the risk would still have to be recovered through premiums across the industry.

However, the pooled risk is sufficiently large that, as government has experienced in some other insurance markets, there may not be enough capacity in the industry to cover the entire pool.

The option would be unlikely to satisfy the principles of **effectiveness**, **operability**, and **confidence** or **certainty**.

CHAPTER 8

CONCLUSION

8.1. Assessment of the Scheme and other options

ACFA's public consultations indicated widespread support from providers and consumer organisations for continuing the existing Scheme arrangements. On the other hand, while supportive of the existing arrangements, some aged care providers expressed concern about the uncertainty of a levy being applied to recoup the costs of past default events. Aged care providers also acknowledge the contingent liability faced by the Government in administering the Scheme.

As previously outlined, ACFA agrees in principle with previous reviews, including by the Productivity Commission and the National Commission of Audit, which concluded that the Scheme's beneficiaries should contribute to the costs of the guarantee. This would bring the existing Scheme into line with other similar systems, such as building completion warranty, medical indemnity and student tuition fee protection. It would also limit the Commonwealth's liability. This should be the case whether the existing Scheme is retained, or another model is implemented. However, in practice, a levy or other cost sharing mechanism should only be implemented if the benefits of doing so outweigh the costs.

This chapter summarises ACFA's assessment of the existing Scheme and other options and conclusions with respect to each principle. The final sections outline key policy and scheme issues that ACFA suggests the Government consider.

8.2. Assessment of the current Scheme

The existing Scheme provides coverage to consumers and providers, but the operation of the Scheme in its current form creates some uncertainty and inequity for providers.

For government, the existing Scheme is unusual in design when compared to other similar arrangements because the beneficiaries of the Scheme have not contributed to its cost. The Government remains fully exposed to an unknown future liability, the costs of which are impacted by factors generally outside its control. Providers also face uncertainty around whether and at what price a retrospective levy will be applied to recoup the costs of past default events, which hinders their ability to plan.

The imposition of a retrospective levy at the Minister's discretion continues to be possible under the existing Scheme. If charged, it would raise an equity issue. Whilst all providers and lump sum-paying consumers are fully covered by the Scheme, the design is inequitable, as a failed provider does not make any contribution to the costs of protecting their lump sum payment holdings.

ACFA's assessment of key advantages and disadvantages of the existing Scheme are shown in the table below.

Table 14: Current Scheme – advantages and disadvantages

Principle	Key advantages	Key disadvantages
Effectiveness		
Efficiency	Minimal administration costs	

Principle	Key advantages	Key disadvantages
Simplicity	Avoids the complexity associated with a prospective funding model	
Sustainability /flexibility	Flexibility for Government, with the ability to recoup costs in a one-off process or an instalment approach.	Sustainability questionable, especially in the event of a large provider default
Equity	Protection of lump sums is not affected by the location of a resident, their means, or the kind of provider they choose.	Risks and costs are not shared with the providers and consumers that benefit from the Scheme. Defaulting providers do not contribute to the levy which would be subsequently charged.
Operability	Clear and proven process already established.	
Right behaviour		Consumers are not encouraged to scrutinise the prudential compliance of providers, or providers to prudently manage their risks.
Certainty		Uncertainty whether, when and how the levy will be applied. Volatile and unpredictable levy costs for providers.

Uncertainty associated with the existing Scheme can be readily ameliorated. In the event that the existing Scheme is retained, ACFA recommends that the Government:

- determine that the levy provisions will not be applied to recover historical default costs incurred by government to date;
- introduce a formal process for notifying the sector of defaults occurring during each financial year; and
- for each notified default event, formally advise the sector of the Minister's decision whether to apply a levy.

While this would mitigate the uncertainty associated with the existing system, it would not address the inequity of defaulting providers not making any contribution toward Scheme costs.

8.3. Assessment of other options

ACFA's study also identified two viable alternative options to the existing Scheme. The options were:

- An *automatic retrospective levy option*: retain the existing Scheme and implement an automatic retrospective levy on providers following future default events; or
- A *guarantee fund option*: create a guarantee pool fund through a prospective provider levy.

Other options that ACFA has concluded are unlikely to be viable include a bank guarantee approach and the use of insurance, either as a pool or by individual providers.

8.3.1. Automatic retrospective levy option

ACFA's assessment of the *automatic retrospective levy option* was that it was likely be as effective as the existing arrangements. This alternative arrangement would continue to return lump sum accommodation payments to residents impacted through a default event. For government, the automatic levy would provide a greater sharing of costs and be more sustainable for it.

Under the automatic retrospective levy option, there will always be uncertainty about the size of the levy in any given year because it is determined by the magnitude of the actual default events, which are unknown. This uncertainty regarding the timing and amount of default event costs will limit providers' ability to plan.

The introduction of an automatic levy could provide a fairer sharing of costs for government, with a greater connection between the costs of the Scheme and its beneficiaries, although an inequity still exists for providers as a defaulting provider does not contribute to the default costs at any stage. This inequity can only be addressed through the application of a prospective levy (addressed in the next section).

ACFA's public consultations suggested that this was aged care providers' less preferred of the two alternate options. ACFA's assessment of key advantages and disadvantages of the automatic retrospective levy option are shown in the table below.

Table 15: Automatic retrospective levy option – advantages and disadvantages

Principle	Key advantages	Key disadvantages
Effectiveness		
Efficiency		
Simplicity		Requires establishment of a mechanism to underpin the automatic levy.

Principle	Key advantages	Key disadvantages
Sustainability /flexibility	Sharing of risks and costs between providers, consumers and Government. Levy mechanism still provides flexibility to government, with the ability to recoup costs in a single payment or through an instalment approach.	Additional administrative costs may be incurred by providers and government in determining and collecting the levy that is payable. Introduction in the current environment would create additional cost pressure on providers.
Equity	Protection of lump sums is not affected by the location of a resident, their means, or the kind of provider they choose.	Defaulting providers do not contribute to the levy which would be subsequently charged.
Operability	Uses a clear and proven process with minimal change from the existing arrangements.	
Right behaviour		Consumers are not encouraged to scrutinise the prudential compliance of providers, or providers to prudently manage their risks.
Certainty		Unpredictable levy costs for providers.

In the event that the automatic retrospective levy option is preferred by government, ACFA recommends the Government develop a formal process to notify the sector of defaults occurring during each financial year and announce the basis of calculation of the levy and resultant allocation across providers.

8.3.2. Guarantee fund option (with prospective levy)

ACFA's assessment of the *guarantee fund option* funded by a prospective levy indicated that the option could provide full protection to providers and consumers. This is only on the basis that the Commonwealth guaranteed refunds in the unlikely event that the costs of a default event exceeded the value of the funds accumulated in the guarantee fund pool.

The guarantee fund option could be more equitable than both the existing Scheme and the automatic retrospective levy option. This is due to the fact that all providers, including those that subsequently default, contribute to the costs of default. The guarantee fund option also provides greater certainty to providers about the size of the levy in any given year, facilitating their budgeting.

The guarantee fund pool and the prospective levy to fund it would represent a significant change from existing arrangements. This option would be initially more complex to implement than a levy attached to the existing Scheme. The fund would require significant actuarial modelling to define the

total pool required, the basis for annual levies and specification of number of pool collection years to achieve the target pool.

Once established, the ongoing operation of the fund would be straightforward, with a level of government oversight retained. The fund would require regular reviews of the quantum of the levy to be collected, to ensure that the levy is commensurate with the predicted quantum of defaults – not too low or too high.

If change from the existing Scheme was being contemplated by government, some stakeholders supported a guarantee fund as the preferred alternative. Most providers recognised that this option could present an additional cost, which was a concern, and it would be important to ensure that the Commonwealth provided sufficient guarantee of any residual risk to maintain provider and consumer confidence.

ACFA's assessment of the key advantages and disadvantages of the guarantee fund with a prospective levy are shown in the table below.

Table 16: Guarantee fund with prospective levy option – advantages and disadvantages

Principle	**Key advantages**	**Key disadvantages**
Effectiveness	Readily provides coverage to all providers. Effective provided the Commonwealth covers the residual liability in event of a default larger than the value of the fund.	
Efficiency	Does not need to deliver a profit margin to the pool operator.	Potentially less efficient than the existing Scheme, as it can be difficult to determine the optimal size of the fund pool.
Simplicity		Additional complexity for Government in determining the cost and timing of insolvencies and the correct rate of accumulation into the guarantee fund. Additional administrative costs and complexity in establishing the fund together with ongoing reporting requirements.
Sustainability /flexibility	Accumulates sufficient capital over time, reducing the need for additional contributions. More sustainable with the sharing of risks and costs between providers and Government.	May run out of funds in the event of a large provider default.

Principle	Key advantages	Key disadvantages
Equity	Greater equity exists as defaulting providers contribute to the levy that is charged.	
Operability	Proven process operating effectively in other sectors.	Some additional administrative costs will be incurred by providers and Government in determining and collecting the levy.
Right behaviour	Greater potential to be able to encourage the right behaviour if a risk rating approach is adopted to differentially reflect providers' viability.	
Certainty	The imposition and pattern of levy payments are more predictable.	

8.4. Conclusion

ACFA's study identified a number of different alternatives to the existing Scheme. From the five alternatives, two were noted as achieving a comparable level of effectiveness to the existing Scheme. Whilst the strengths and weaknesses of the existing Scheme and each alternative option have been analysed, the decision to make any change from the existing arrangements rests solely with the Government.

8.4.1. The existing Scheme and its alternatives

The most important consideration for consumers is not which approach is taken to guaranteeing their capital, but that their capital is guaranteed. Consumers also do not want to pay significantly more for what they already see as being an interest-free loan to providers. Continuing the existing Scheme is a viable option. If the Government chooses to retain the status quo, ACFA recommends that greater certainty is given to providers by quarantining defaults to date from future levy imposition, and by formalising the processes applying to the notification of default event costs and the Minister's decision as to whether a levy will be applied.

The *automatic retrospective levy option* was not a preferred alternative for provider organisations. The *automatic retrospective levy option* would be effective for government and consumers, but providers would continue to face issues of uncertainty and inequity.

The *guarantee pool fund* was the preferred alternative option for some providers, though it was recognised that the sector could incur additional costs. The *guarantee pool fund* has the potential to be effective for consumers, providers and government, providing a solution to both issues of uncertainty and inequity.

8.4.2. Policy considerations

Regardless of the option chosen, ACFA identified a number of policy issues that will require Commonwealth consideration.

Whether the existing Scheme is retained, or another option is chosen, the Commonwealth may wish to consider purchasing a layer of reinsurance to help manage risk, as currently occurs in several other schemes, including the Tuition Protection Service and the Australian Reinsurance Pool Corporation reinsurance scheme.

In any scheme, consideration will need to be given to how to manage any residual risk (for example if a default requires refunds greater than a scheme's coverage). The key factor in managing residual risk is that coverage be sufficient to ensure investor confidence.

Another issue worthy of careful consideration and analysis in the event the Commonwealth implements a levy, or moves to a different scheme model, is the use of risk rating in determining the levy payable by each provider. The use of risk rating can more fairly reflect each provider's risk of contributing to future defaults. This in turn can lead to changes in provider behaviour, encouraging higher risk providers to more effectively manage their risk. It may also provide consumers with transparency for provider solvency risks, if required to be notified by the provider.

ACFA concludes that a risk rating methodology is more complex to implement than a flat fee arrangement. It would add to the responsibilities of the prudential compliance area of the Department of Health or other agency, as it would require significantly more data and/or assessment effort than is currently required. ACFA notes that it can be introduced in stages, as in the Lawcover Professional Indemnity Insurance Scheme, which initially adopted broad categories for risk rating that were subsequently refined. Cost differentiation using risk rating can be effective in achieving an equitable distribution of costs. Risk rating would also necessitate establishment of a process of review and appeal of risk rating assessments. Given these complexities and added costs, ACFA suggests that risk rating would warrant detailed consultation with the sector prior to implementation.

Finally, ACFA advises against providers being able to opt-out from a scheme and provide their own guarantees, as it is likely to impair the sustainability of a scheme by necessitating a higher levy from fewer participants. It would also be complex to administer and manage.

8.4.3 The prudential review

ACFA's review of the existing Scheme and alternatives is taking place in parallel to two other significant reviews. Government consideration of the Scheme should take into account the perspectives of all three related reviews.

The Department is reviewing the role and effectiveness of the Prudential Standards, as well as current reporting and compliance processes through a project being undertaken by an external consultant. This project will evaluate the adequacy of existing arrangements, including prudential standards in the context of protecting the interests of all stakeholders, including care recipients and the Government, by ensuring prudent management of lump sums held by providers. ACFA draws particular attention to this review, as it is widely acknowledged that prudential standards and

monitoring are critical protections for aged care consumers, while the Guarantee Scheme is the safety net that protects consumers' investments when other measures have not.

The second review currently underway is the Aged Care Legislated Review, which is required by the *Living Longer Living Better Act 2013*, and which will consider the effectiveness of the Guarantee Scheme. This ACFA report and the report of the review of prudential standards are expected to be considered by the Government in the context of the Aged Care Legislated Review, which is scheduled to report by 1 August 2017.

APPENDIX 1: MODEL DESIGN AND ASSUMPTIONS

For ACFA to compare the existing Scheme with alternative approaches, it needed to develop a model of the aged care sector and its accommodation payment holdings. This model could then be used to evaluate different guarantee mechanisms, and to identify the issues that would arise in each case. The process underpinning the modelling was outlined in Chapter 1. This Appendix sets out the design features and assumptions made in the modelling, both for the model overall, and when modelling individual scheme options.

The design of the model

As stated in Chapter 1, the model built by PwC considered:

- the population of consumers and their aged care choices;
- the range of providers and their accommodation payment history; and
- government policy relating to accommodation payments and residential care.

The model's variables are built across:

- Provider characteristics, operations and behavioural variables;
- Consumer demographic and behavioural variables;
- Regulatory variables; and
- Economic variables.

The model was built in the latter half of 2016 and used de-identified accommodation payment data collected through the Approved Provider Compliance Statement for the year ended 30 June 2015. At that time, the lump sum payment pool totalled $18.2 billion. The most recent available average agreed accommodation price at that time was of $340,000 (for 2014-15), so this was used as the value of the accommodation payment received in 2016 when there was a turnover in a residential place. The lump sum payment pool at 30 June 2016 was $21.7 billion with an average agreed accommodation price of $370,000 during 2015-16.

To address the complexity of the modelling, data from individual providers was aggregated to form 15 categories of provider groupings which accounted for size, location, organisational ownership type and a calculated risk score. Modelling inputs included a range of provider-related data and information captured by the Department of Health including operational characteristics such as:

- the provider's location;
- the number of operational places managed;
- occupancy;
- the organisational type including whether the provider was for-profit or not-for-profit, government or private organisation;
- the number and total value of refundable accommodation deposits held across all of the provider's facilities; and
- internally calculated risk-related information.

Projections of future behaviour of specific groupings of providers were also factored into the modelling, including specific groups increasing market share (places); and the level of market consolidation through mergers and acquisitions.

Modelling variables which relate to consumer demographics include population projections over the next twenty years, as well as estimations of the average length of a consumer's stay in residential care. The variables related to consumer behaviour included the choice of payment method (RAD/DAP or combination) and the average rate of drawdown by a resident on their lump sum deposit.

The sole variable of a regulatory type used in the modelling is the projected number of approved residential places made available by the Department of Health. This is expressed as a ratio per 1,000 of population over 70 years of age.

The modelling used economic factors to calculate changes in the lump sum accommodation pool over time. Those variables included the anticipated growth in the price of lump sum accommodation payments across city, regional and remote locations. In addition, actuarial analysis was used to determine the potential losses (to the Scheme and selected alternatives) given provider default, expressed as a percentage of the value of a provider's total lump sums. The potential costs to each stakeholder of administering a scheme were also taken into account by the modelling.

Assumptions underpinning the modelling of scheme costs

For the model to produce meaningful and accurate numbers, a number of decisions had to be made to feed into the model's operation across all options. These were:

1. **Government providers.** Should accommodation payments held by government-owned aged care providers be included in the pool of payments that require protection?
2. **Opt out.** Should some providers be modelled as having opted out of the scheme?
3. **Reinsurance**. Should reinsurance be included in the design and costing of the option?
4. **Which costs to include**. What costs would the scheme cover?
5. **Rate of default**. How frequent should the modelling assume default by a provider should be?
6. **Cost recovery**. How much of the lump sum accommodation payments held by the provider that is in default will be able to be recovered, with the remainder to be funded by the scheme?
7. **Who pays?** How should it be assumed the costs of the levy would be distributed?

There are other variables that needed to be tailored to individual options, and are outlined below. The remainder of this section talks about the seven areas listed above.

1. **Government providers.** Should accommodation payments held by government-owned aged care providers be included in the pool of payments that require protection?

Around five per cent of residential aged care places are operated by providers owned by state and local governments. They hold around two per cent of all accommodation payment lump sums.

ACFA considered that it would not be necessary to include these providers in a guarantee scheme, as it is legally impossible for a government to become insolvent such that a state would not be responsible for any debt owed to a resident or their estate. There is therefore no realistic scenario under which a resident of a government-owned provider would need to call on the Scheme in order

to recover their lump sum. These lump sum payments, and the providers, were excluded from the modelling and could be excluded from an alternative scheme.

2. **Opt out**. Should some providers be modelled as having opted out of the scheme?

The scope and cost of a guarantee scheme would be affected by which providers are covered by the scheme. If some providers were allowed to opt-out, through alternative means of guaranteeing the lump sums that they hold, it would change the scope of the Scheme.

As was explained in Chapter 1, there are significant difficulties with permitting an opt-out mechanism from any guarantee scheme. ACFA views opting out as unlikely to be feasible, and therefore not appropriate to include in its modelling. Even if opt out were envisaged, there is no way to predict which providers might choose to do so if they were allowed. This makes it impossible to predict what effect on a scheme any opt-out provisions would have, again meaning it could not be included in modelling.

For these reasons, all modelling is based on the assumption that all non-government providers are included.

3. **Reinsurance**. Should reinsurance be included in the design and costing of the option?

As outlined in Chapter 1 and Appendix 2, reinsurance appeared to be potentially useful in managing the potential volatility of costs of a guarantee scheme. Based on expert advice, PwC modelled some of the scheme options to produce an estimate of the annual premium required by reinsurers to provide cover for losses up to $25 million in excess of $20 million incurred in a year (i.e. losses incurred between $20 million and $45 million). Using the historic default rate of 0.13%, that estimate was approximately $3 million.

A larger tranche of reinsurance cover could be provided, but would come at a higher premium cost if the initial scheme retention (the first $20 million of losses) was not increased.

4. **Which costs to include**. What costs would the scheme cover?

The main purpose of a scheme is to repay outstanding lump sum accommodation payments, and these represent the scheme’s main cost. However, there are other expenses as well, and it was decided that all should be included in the modelling, to give an accurate understanding of what each option would cost. In addition to the refunds of accommodation balances themselves, the other costs that were included were:

- Interest owed to residents on outstanding lump sum accommodation payments;
- Claims handling expenses, which were set at 2 per cent of the value of refunds;
- The cost of obtaining reinsurance (discussed above); and
- Administration expenses.

Administration expenses vary according to the option.

5. **Risk of default**. How frequent should the modelling assume default by a provider should be?

The risk of default is defined as the overall probability of a provider defaulting in a year. A historic annual rate of default over the period since the Living Longer Living Better aged care reforms were enacted, of 0.13 per cent, was modelled, as well as a moderately higher rate of 0.2 per cent.

6. **Cost recovery**. What proportion of the accommodation payments held by the provider that is in default will be able to be recovered?

When a provider goes bankrupt or is placed in administration, it may still hold assets. Residents, or those acting on their behalf (such as an estate, or an insurer), may recover some of the lost funds. Accordingly, modelling the cost of a scheme needs to take account of the possibility that the outstanding lump sum accommodation balances may not have to be paid entirely through a scheme.

Based on experience of past default events, it was assumed that 17 per cent of the accommodation payment holding would be recovered, and a scheme would need to pay out 83 per cent.

7. **Who pays?** How should it be assumed the costs of the levy would be distributed?

The question of who pays the levy does not affect the modelling of the options themselves, a scheme's total cost or how a scheme would work. However, determining who will pay is important to understanding how the costs of a guarantee scheme would be met by providers or consumers.

For the purpose of modelling, it was decided to express the costs in terms of the value of lump sum accommodation payments. The modelling therefore expresses costs based on the average lump sum accommodation payment and per one hundred thousand dollars of accommodation payment. Only providers who held lump sum accommodation payments were assumed to contribute to a scheme, and contribution would be according to the value of lump sum payments held (rather than numbers of lump sums, or numbers of residents).

The accommodation payment pool is not uniformly distributed across the industry, and not every consumer pays a lump sum payment. About five per cent of aged care providers do not hold them at all. Only some residents in aged care are paying lump sums. Some do not have the means to make any accommodation payment, and their accommodation needs are subsidised by government. Of residents who do contribute to the cost of accommodation, around a third choose to do so through daily payments and pay no lump sum. Thus, only 43 per cent of residents at 30 June 2015 had contributed a lump sum accommodation payment of any kind.

When estimating what a levy would cost per resident, it was assumed that providers would only be charged for residents who had a lump sum accommodation payment. Estimates were made excluding residents who were either fully supported, or who were meeting the cost of their accommodation using daily accommodation payments alone.

This should not be taken as meaning residents in aged care would necessarily pay the full cost of the levy. It will be up to government to determine how the scheme is designed, and under most of the options in this report, providers would need to make decisions about how those costs would be met, and what portion of those might be recovered from residents. To allow analysis and comparison of options, ACFA needed to make the calculations on a consistent basis, but this does not represent a recommendation on ACFA's part about how a levy should be charged or paid.

Assumptions for individual options

In addition to the above general assumptions, there were specific assumptions included in the modelling of individual options, in the case of the existing Scheme with a mandatory retrospective levy; and a guarantee fund pool with prospective levy.

The following were the assumptions made for the automatic retrospective levy.

Table 17: Assumptions for the automatic retrospective levy option

Properties	Assumptions
Levy charged	Retrospectively
Proportion of default costs recovered	100 per cent
Period over which costs are recovered	Instalment, applied over 3 years
Include reinsurance layer	Yes, for default costs between $20 million and up to $45 million
Recover administration expenses	Yes, estimate $500,000 p.a.
Recover claims handling expenses	Yes, estimate 2% of the total refund amounts paid

The following were the assumptions made for the guarantee fund pool with a prospective levy.

Table 18: Assumptions for guarantee fund with prospective levy option

Properties	Assumptions
Levy charged	Prospectively
Proportion of default costs recovered	100 per cent, based on actuarial estimates
Period over which costs are recovered	Not applicable
Include reinsurance layer	Yes, for default costs between $20 million and up to $45 million
Recover administration expenses	Yes, estimate $800,000* p.a.
Recover claims handling expenses	Yes, estimate 2% of the total refund amounts paid

*The guarantee pool fund was projected to have a higher level of administration costs reflecting the additional record keeping and audit requirements.

APPENDIX 2: POLICY ISSUES

Introduction

In the course of its inquiries, ACFA identified several policy issues for consideration where an accommodation payment guarantee is being provided. These policy issues are not limited to any single option, but they do influence how options should be designed if the options are to meet Government policy objectives, as well as to make them as efficient and effective as possible. Several such issues were outlined in Chapter 1 and are discussed further in this appendix.

Key policy issues that cut across some or all of the options for providing an accommodation payment guarantee included:

- Reinsurance;
- Management of residual liability;
- Opting out; and
- Attribution of costs, including risk rating.

Reinsurance

During consultation with experts and other scheme operators, it became apparent that it would be challenging, and potentially inefficient, to try to create a scheme without a mechanism to manage the impacts of low probability events with very large costs. All models of guarantee scheme have to confront this problem.

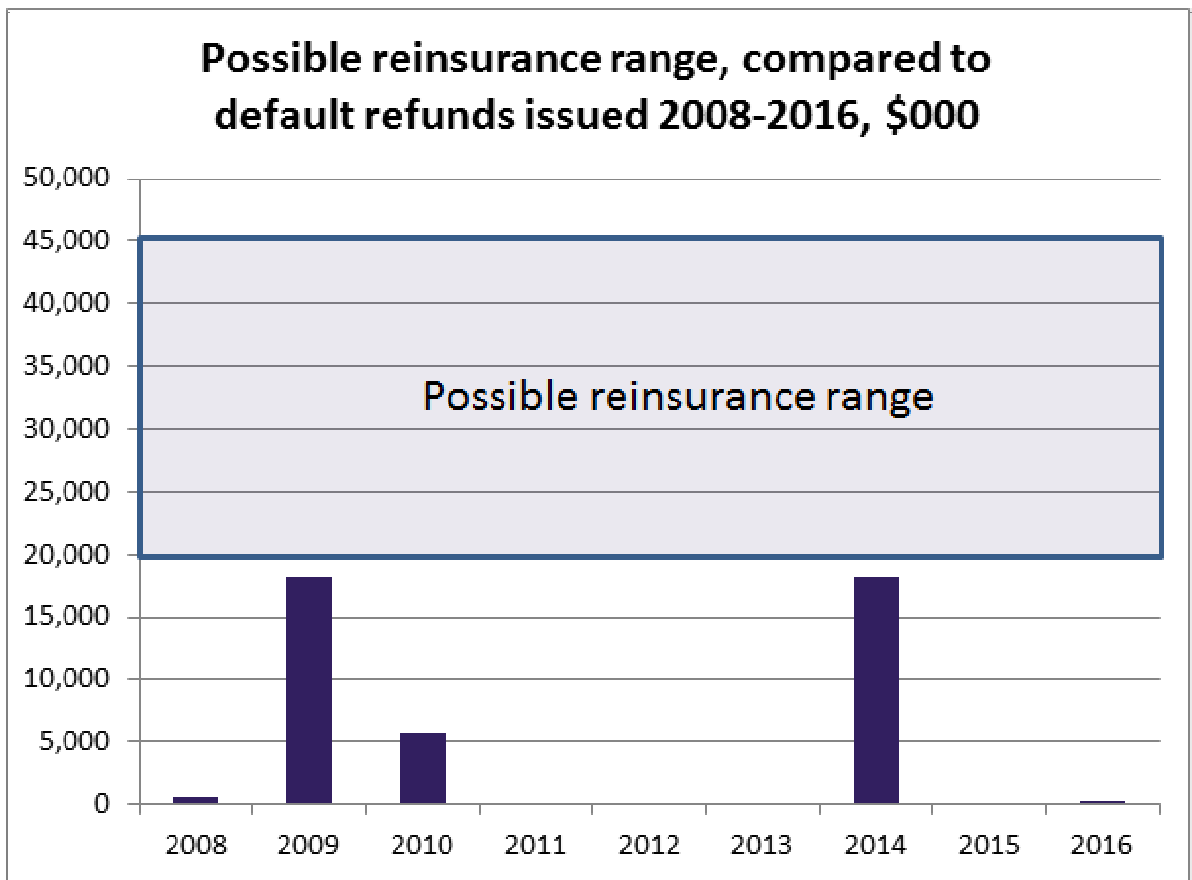
ACFA responded by examining the inclusion of reinsurance as part of the design of various options. Reinsurance is a method for an insurer to spread their risk of payment, by providing protection against the risk of a large claim occurring. The insurer will purchase reinsurance from other insurance companies in exchange for agreeing to pay part of the payment required if a large claim arises. Reinsurance provides an insurer with a way to manage the financial impacts of a large claim occurring.

Reinsurance can be an *effective* method of transferring some of the risk: it spreads the risk of low probability, high impact events across several parties, instead of one party (such as the Commonwealth or an individual insurer); and it can be *efficient*: reinsurance can be purchased at a relatively modest cost, compared to alternative ways of transferring some of the risk for low probability events.

Reinsurance could be obtained to supplement either the existing Scheme or other options, such as a guarantee fund pool or private insurance. A number of existing schemes, such as the Australian Reinsurance Pool, do this to create layers of protection. In the case of the Australian Reinsurance Pool, the Commonwealth is also the 'insurer of last resort', in the unlikely event of a high-cost claim that exceeds the cover provided by both private insurance and reinsurance cover.

ACFA considered how either the existing Scheme, or an alternative, could operate with a reinsurance component. It focussed on a layer of reinsurance designed to cover a default event of a scale exceeding the default events experienced to date (graph). Following consultation with experts with experience in insurance, it was considered that a layer of reinsurance from $20 million to $45 million could be relatively effective.

Chart 5: Possible reinsurance range



It is hard to predict how likely it is that the reinsurance would be called upon, as it would depend on several variables, including on how the industry develops. Modelling undertaken by PwC for ACFA on the reinsurance suggested the annual likelihood of the reinsurance being triggered may range from around 14 per cent to 24 per cent, depending on rates of default and the value of accommodation lump sums involved. While there have been no defaults of this magnitude since the Scheme commenced, the percentages estimated by the modelling reflect factors such as the increasing size of the lump sum accommodation payment pool, and consolidation of the sector – factors that would make larger defaults somewhat more likely in future.

Reinsurance creates greater stability at a modest price. Industry modelling indicated that the cost of reinsurance could add around 11 per cent to the cost of a scheme without reinsurance.[89] The benefit would be significantly less volatility in scheme costs over the long term. This would provide more certainty to government and providers about what their likely annual costs would be.

Residual liability

Under the existing Scheme, the Commonwealth is liable for all outstanding lump sum accommodation payments, in the event of the collapse of an approved provider. This creates a *contingent liability* for the Commonwealth, described in the Budget in these terms:

[89] The modelled costs of scheme options are discussed below, in the section on attribution of costs.

> *The Accommodation Payment Guarantee Scheme (the Guarantee Scheme) guarantees the repayment of aged care residents' accommodation bond, entry contribution balances and, from 1 July 2014, refundable accommodation deposits and contributions if the approved provider becomes insolvent or bankrupt and defaults on its refund obligations. In return for the payment, the rights that the resident had to recover the amount from their approved provider are transferred to the Australian Government so it can pursue the approved provider for the funds. In cases where the funds are unable to be recovered, the Australian Government may levy all approved providers holding bonds, entry contributions and refundable accommodation deposits to meet any shortfall. On 30 June 2015, the maximum contingent liability, in the unlikely event that all providers defaulted, was approximately $18.3 billion.*[90]

Some of the options considered by ACFA have the capacity to reduce the Commonwealth's contingent liability. However, there are circumstances in which an alternative scheme would not completely eliminate it. Under many alternative schemes, it is possible that costs could arise that would exceed the limit of coverage provided. The *residual liability* refers to the gap between a scheme's cover, and the total costs that might arise from insolvencies. The Government will need to decide how to manage this residual liability.

Residual liability has two components:

- Costs that are within the scope of a scheme, but which exceed that scheme's capacity. Examples include
    - In the case of private insurance, costs that exceeded the maximum value of the insurance cover held by an aged care provider that goes bankrupt; or
    - In the case of a guarantee fund pool, costs that exceeded the accumulated funds of the pool.
- Costs that fall outside the scheme's scope. Under some options examples include:
    - The cost of guaranteeing funds held by aged care providers that are unable to obtain cover from banks, insurers or financial institutions; or
    - The cost of guaranteeing funds held by aged care providers in the event of the failure of an entity (such as an insurance company or bank) that was providing the guarantee scheme cover.

Both kinds of residual liability have the potential to create circumstances in which the Commonwealth could still carry significant levels of risk of provider failure.

Under the existing Scheme, the Government can recover all of the costs from the sector through a levy. Currently, therefore, it could act to ensure it does not ultimately carry the cost for any provider failure, regardless of scale. Thus while the Commonwealth currently reports a significant contingent liability, it has the legal authority to charge a levy that would ensure that the costs incurred are fully reimbursed.

In implementing an option that does not rely on this levy mechanism (meaning all options other than the status quo and option 1B), there will need to be a decision about what to do to address defaults

[90] 2016-2017, Budget Paper 1, p. 8-30

that create a cost greater than those the scheme can meet. Reinsurance, discussed above, is one mechanism designed to limit the risk of extreme events. However, if there was a large provider bankruptcy that required payments in excess of the level of cover provided by the scheme, where would this cost ultimately fall?

The existing Scheme provides full coverage to all consumers in the event of a provider failure, and an alternative scheme would need to provide a comparable level of consumer protection. As a result, there are broadly three policy choices that could be adopted:

1. The Commonwealth retains residual liability, and meets any cost beyond that covered by a scheme. This is the case with the existing Scheme, as the Commonwealth reimburses consumers for the loss of lump sum payments when a provider is declared insolvent;
2. Require a scheme to be liable for the cost of lump sum accommodation payments regardless of whether an individual provider was in compliance with, or had valid cover with, the scheme. This would mean that the Commonwealth's residual liability would be limited to circumstances in which the scheme itself failed (not just an individual provider); or
3. Create a cap on the Commonwealth's residual liability, so that it is not unlimited. This is the approach in terrorism reinsurance policy. It would mean that, in the event of the failure of a provider or providers with lump sum accommodation payment liabilities greater than a fixed amount, neither the scheme nor the Commonwealth would be legally liable for the 'gap' between the scheme's coverage, and the value of those lump sum payment liabilities. This would mean the affected consumers could face some residual exposure if the payments required exceeded the liability coverage level.

All non-government stakeholders agreed that the current Scheme provided effective coverage, and that protection of lump sums was vital to the sector. ACFA believes option 3 would undermine confidence in the sector unless the cap on liability was set at a sufficiently high level that it addressed all feasible scenarios.

Opt out

The most important feature of a guarantee scheme is that it protects all lump sums, without gaps that might leave some consumers' assets vulnerable. Ensuring every lump sum is protected may not mean, however, that every provider would have to be subject to the same *method* for providing that protection.

Some providers advised ACFA that it should be possible for them to opt out of a changed guarantee scheme requirements because of the adequacy of their significant reserves and asset bases. This view was most commonly held by conservatively-managed not-for-profits, often with strong balance sheets. HammondCare for example reasoned:

> *HammondCare supports the opportunity for providers who are effectively self-insured to opt out of a national scheme, however, we understand that this could increase the cost for remaining scheme recipients. HammondCare has adopted a sound prudential approach to managing the risks associated with accommodation bond liabilities by establishing a financial reserve. The levels of this financial reserve are based on independent actuarial advice and are subject to external review at least every three years. HammondCare has also*

developed a number of liquidity performance measures to ensure it has the ability to meet its short, medium and long term financial obligations based on this same expert advice. Taken together, these measures serve as a form of self-insurance.

Catholic Health Australia held similar views. Their correspondence drew attention to the stewardship approach taken by Catholic aged care services:

which emphasises a prudent and conservative approach to capital financing and business operations - to the extent that no Catholic provider has ever been in a default situation…If there were to be changes to the current Scheme, Catholic providers would wish to keep open the option of making private insurance arrangements to secure the lump sum deposits they hold.[91]

In contrast, ACFA also received submissions from a number of providers who argued there should not be opt-out for reasons focussed on equity and consumer confidence.

Opt-out arrangements would require that those providers wishing not to be covered by the main guarantee scheme be able to demonstrate and satisfy the Commonwealth that the provider has a mechanism that ensures that the lump sum payments they hold could be repaid in the event that the provider became insolvent or ceased operation. This would most likely be through some form of private insurance (which was mentioned by both HammondCare and Catholic Health Australia) although other robust mechanisms such as legally binding deeds of cross guarantee could also be considered. It is noted that an opt-out option is likely to create an additional and significant administrative burden for government, require the extension of existing prudential monitoring activities as well as segmenting the aged care market.

Evidence suggests that opt-out arrangements are rare in similar schemes: ACFA did not identify cases in other industries or sectors that gave organisations the option to opt-out. The Australian Capital Territory's builders warranty scheme allows builders to obtain protection against insolvency through two different methods: "residential building work insurance or a Fidelity Fund certificate from an approved Fidelity Fund scheme".[92] However, opting out altogether is not permitted.

There are two key problems that must be solved if consideration is to be given to allowing some providers to opt out of a guarantee scheme:

- How will government and consumers satisfy themselves that a provider has absolutely certain arrangements in place to repay accommodation payments in any future circumstance, including insolvency?
- Will opting out cause the costs for the remaining pool of providers to increase unsustainably, or make it harder for the scheme to cover all remaining providers?

The first of these problems is likely to create additional administrative complexity for the Government, and risk reduced effectiveness for consumers. For an opt-out scheme still to provide certainty, the Government would require a regulatory framework that governed opt-out cases, in addition to that supporting the scheme itself. The monitoring and enforcement activity for each

[91] CHA, correspondence, 22 December 2016
[92] Master Builders ACT, https://www.mba.org.au/consumer-advice/home-warranty-insurance/

element would be likely to be different. For consumers seeking to recover money owing to them from a provider who opted out, they would have to locate the insurer or guarantor for their money, in circumstances where the provider itself may no longer exist. Because the provider would be outside the main scheme, it could be more difficult for the consumer to identify who to make their claim to, and they would not have the advantage of a centralised and standardised claim process.

The second issue is a risk that allowing opting out would increase the cost of the scheme for remaining providers. Those most likely to seek to opt out are:

- not-for-profits with strong balance sheets, which include some of the largest providers in the country; and
- large for-profits seeking insurance that might cost them less than a scheme arrangement.

Both these possibilities indicate that larger players might try to choose to opt out, leaving relatively large numbers of small providers in the pool. If those providers who remain present a greater default risk, the costs for the pool would be spread across fewer participants. Government would need to carefully consider the implications of this for the sustainability of any scheme and the protection it affords.

Having a smaller and unstable pool of providers in the scheme would also make design and maintenance of a scheme more difficult, particularly if there is a guarantee fund pool. This is because an accurate actuarial model, which can tell Government and industry what levy is required, relies on knowing the profile of the providers in the pool. Every time the pool profile changes through a provider opting out or opting in, it changes the inputs to the model, and creates potential strains on the stability and predictability of pool fund contributions.

ACFA considers that it is unlikely to be effective to have a scheme from which some providers are able to opt out.

Attribution of costs, including risk rating

In all options where a levy is applied, or insurance or a guarantee is obtained, there will be a question of whether to charge everyone the same flat rate based on the level of lump sums held, or whether the price should be differentiated based on an assessment of different provider risks. The use of a risk rating is a concept routinely applied in insurance, and involves an assessment of what risk there is that the event being guaranteed against will actually occur. In this case, it would be the likelihood of providers defaulting.

Risk rating can be applied to providers individually, or to groups. To explore some of the implications of risk rating for the guarantee scheme, ACFA tested both a flat rate of the levy across all providers, and examined one type of risk-rated levy that could be varied by organisation type and size and assessed contingency of default.

For some scheme options, the decision of whether to adopt a risk rating would be a matter for government; in others, ACFA expects that the use of risk ratings would be inherent to the scheme because private providers of guarantees (such as insurance companies or banks) would require it. If

the scheme were delivered using private insurance or a bank guarantee, ACFA expects that financial institutions would apply risk ratings in determining the premium they would charge each provider.

The use of risk ratings for providers can include a range of measures to give an indication of the vulnerability of providers to default. No single provider attribute is predictive of future financial performance or risk.

To support the exploration of different ways in which the Scheme or an alternative could operate in the future, ACFA modelled the inclusion of a risk rating using a tool based on several financial performance and compliance indicators, and analysis tracking of approved providers' performance and compliance activities year-to-year. If a risk rating approach were adopted, other approaches could also be considered.

With the use of a flat rate levy modelled using both the historical and slightly higher rates of default (see Appendix 1), ACFA's costing indicated a levy in the range of $75 to $125 per annum, per hundred thousand dollars of accommodation payment, reflecting a range of between 0.075 per cent and 0.125 per cent per annum of the lump sum payment. This translates to around $255 to $425 per annum on an average lump sum of $340,000. The total funds levied across an accommodation payment pool of $18.2 billion would range between $13.65 million and $22.75 million per annum to provide for the costs of future default events.

The use of risk ratings would result in different scheme costs for different providers. Risk ratings can spread the cost of the scheme in a way that may better reflect each provider's risk of contributing to future defaults, and send a price signal to providers, encouraging the right behaviour. In some settings, the use of risk ratings could raise issues of equity, affordability, and accuracy of ratings. It would require transparency and rights of recourse for providers to dispute their ascribed risk rating.

Using a different approach and adopting a risk based levy, ACFA's modelling suggested the widest likely range for a levy would be from around 0.02 per cent per annum (for the lowest risk rated group of providers, under the historical rate of default) and range up to 0.59 per cent per annum (for the highest risk rated group of providers, and using the higher assumed default rate). These rates represent a levy ranging from $20 to $590 per annum, per hundred thousand dollars of accommodation payment. This translates to around $70 for the lowest risk to $2,000 per annum for the highest risk on an average lump sum of $340,000.

Under either alternative, the levy would represent considerably less than one per cent of the value of the accommodation payments.

Risk rating has both potential advantages and disadvantages. These will need to be weighed up in the design of any scheme.

The advantages of risk rating are that:

- It ensures that the costs to individual providers of funding the guarantee attempt to fairly reflect their risk of default;
- It recognises the stability and high prudential standards of some providers;
- It can give providers information about their level of risk, and allow them to make choices about how to administer their business, to change that level of risk; and

- If made available to consumers, it can provide them with information to support their decisions in choosing a provider.

The disadvantages of risk rating are that:

- It may increase the compliance burden, where additional information has to be provided on which to base the risk assessment;
- It may involve additional costs in administration, for collecting and analysing information to determine ratings; and
- In some circumstances, providers may have a limited capacity to act to alter their risk rating, meaning its ability to encourage the right behaviour may be undermined. For these providers, risk rating could adversely affect their brand, market share, occupancy, or staffing levels.

For both providers and consumers, there will be circumstances in which risk rating may not be able to assist in encouraging the right behaviour. Some providers may be operating in an environment where they have limited choices available regarding business decisions. Particularly where there are older facilities, lower property values, sub-scale/smaller facilities or larger proportions of supported residents,[93] they are more likely to be operating with tighter margins and have fewer ways they can vary their operations in response to risk rating price signals.

In these circumstances, there are equity considerations in decisions about the methodology used to determine the amount of levy a provider should pay. As Aged Care Services Australia argued:

> *If risk is based on provider risk profile then the most disadvantaged services, rural and remote, may have difficulty in funding the levy.*

In these circumstances, determining levies on a flat rated basis using a low percentage of the total value of lump sums held by each provider may be a more equitable approach than risk rating, as the costs of the scheme are more equally shared across the sector with no relative disadvantage to smaller or more remote services.

For consumers to respond to the cost differentials that go with risk rating, they would need to have a choice of providers. In some cases, however, markets will be 'thin', meaning there won't be much actual choice available. This will often be true for consumers with special needs, including members of CALD communities, people experiencing homelessness, or consumers in rural areas. In these cases, any differentials between providers' risk ratings may not be particularly effective in supporting consumer choice.

Risk rating can only be effective if there are ways to determine the factors that contribute to the risk that is being guaranteed against. For example, home insurers know that houses in some suburbs are more likely to be burgled than in other suburbs. They also know that a house with window locks is a safer insurance prospect than one without locks. Because this information helps them predict the likelihood of having to pay a claim, they can use it to undertake risk rating.

[93] Such as reported in ACFA's report *Issues Affecting the Financial Performance of Rural and Remote Providers, both Residential and Home Care Providers*, May 2016.

For an accommodation payment guarantee scheme, risk rating would require the ability to make meaningful predictions of the likelihood of future default of an aged care provider. With a limited number of default cases over the last decade to analyse and learn from, it may be difficult for the administrator of a scheme (whether government, insurers, banks, or regulators) to determine what are the key predictive factors. However, the Department of Health has experience in assessing prudential risk that goes beyond actual defaults. Its analysis has for some years supported the identification of providers at risk of getting into financial difficulty, allowing it to provide support and advice. The significance of this for risk rating is that there is more evidence and analysis available than the number of actual defaults would suggest.

In addition, whilst understanding risk factors is ‘core business’ for insurers and regulators, they would need to potentially draw on the Department’s work to date, mandatory financial and prudential reporting by providers and industry analysis, to undertake risk rating. This is currently an integral part of the Prudential team’s accountability.

Risk rating may present a trade-off around administrative costs. A levy that is the same per dollar of lump sum held by each provider may be easier and cheaper to administer than one that risk rates providers. Risk rating in theory should be more economically efficient, as it produces a price signal that reflects the riskiness of the provider being covered. It may be unclear whether the gains from the efficiency and equity of risk rating would be sufficient to offset the greater administrative cost and complexity. This greater complexity would include the necessity of establishing review and appeal mechanisms that allowed a provider’s risk rating to be reconsidered.

Detailed consultation with aged care providers and the Department would be essential in the event that the government decides to implement a scheme that includes risk rating.

APPENDIX 3: LIST OF SUBMISSIONS RECEIVED

Table 19: Stakeholders that provided a submission to ACFA

Organisation
Advantaged Care
Aged Care Guild
Aged Care Industry Association
Aged Care Services Australia (ACSA)
Alzheimer's Australia
Association of Age Service Professionals
Australian Projections P/L
Brotherhood of St Laurence
Buckland Aged Care Services
Catholic Healthcare
Chinese Australian Services Society
Combined Pensioner and Superannuants
Complex and Tailored Underwriting Solutions
HammondCare
IRT
Java Dale
La Trobe Financial Asset Management Limited
Leading Aged Services Australia
Lockton Companies Australia P/L
Manor Court
Mayflower Group
National Seniors
Newcare
Pride Living Group
Resthaven
Sunnyside Lutheran Retirement Village