LEADING AGE SERVICES AUSTRALIA

*The voice of aged care*

# MANAGING PRUDENTIAL RISK IN RESIDENTIAL AGED CARE

18 March 2019

***A strong voice and a helping hand for all providers of age services***

## Leading Age Services Australia

Leading Age Services Australia (LASA) is the national peak body representing and supporting providers of age services across residential care, home care and retirement living. Our purpose is to enable a high performing, respected and sustainable age services industry delivering affordable, accessible, quality care and services for older Australians. We represent our Members by advocating their views on issues of importance and we support our Members by providing information, services, training and events that enhance performance and sustainability.

LASA's membership base is made up of organisations providing care, support and services to older Australians. Our Members include private, not-for-profit, faith-based and government operated organisations providing age services across residential aged care, home care and retirement living. 55% of our Members are not-for-profit, 37% are for-profit providers and 8% of our Members are government providers. Our diverse membership base provides LASA with the ability to speak with credibility and authority on issues of importance to older Australians and the age services industry.

## Introductory statement

LASA has consulted with Members in response to the Government's discussion paper *Managing Prudential Risk in Residential Aged Care.*

LASA notes that our Members' capacity to provide feedback has been limited by other calls on resources including the Royal Commission and implementation of the new Aged Care Quality Standards. This is an issue that has been raised with the Department's Executive and the Minister's Office.

LASA's submission to this consultation provides insight into the matters our Members identified as the most important in the suite of proposed changes to the prudential regulation of residential aged care. For this reason, this submission does not provide a response to all options.



## General observations

### *Competition for investment funds*

The aged care sector competes for the investment dollar. LASA Members are concerned that prudential regulation that is too prescriptive will repel operators and investors from entering the aged care sector. Members believe that this issue can be addressed by regulation emphasizing prudential transparency rather than inflexible rules. This would give operators more room to move to design effective strategies that will sustain and grow their businesses.

### *Introduction of levy*

LASA has considered the implications of the Government introducing a levy to recover from the sector RAD refund costs exceeding $3 million. LASA has two main concerns about the introduction of this scheme:

1. Placing a 3 year levy on providers of aged care, many of whom are already under considerable financial stress, may result in further pressures on financial viability and further increase the risk of failures.. The people most affected by a provider failing would be the elderly and vulnerable residents of the Residential Care Facilities that are now no longer viable.
2. Providers paying the levy to the Government would to a large degree result in monies paid by the Government churning back to the Government. This is not a productive use of taxpayers' funds.
3. In October 2017, LASA Members reviewed the Aged Care Financing Authority's (ACFA) study *The protection of residential aged care lump sum accommodation payments.* Members were unanimous in their view that the Bond Guarantee Scheme should remain as is. They consider that the current Scheme works well and drew attention to ACFA's remark on page 8 of the report which says: 'Continuing the existing scheme is a viable option'. Members considered that government underwriting of the Scheme enables prospective residents to make lump sum payments with confidence.
4. Finally, the envisaged levy would result in an inequitable situation where all providers being financially penalised for the failure of one provider.

### *Rising costs of compliance*

Members observed that compliance with the reporting burden requires more and more data to be collected which is very resource intensive. How to pay for increases in compliance costs needs to be considered by government.

## Responses to Specific Proposed Options

### 1.Insufficient transparency in reporting

**A1**. Require Approved Providers to report their corporate structures including identity of ultimate (beneficial) shareholders and any significant changes to their ownership or control.



**To A1:** Members who responded to LASA's request for feedback supported A1.

They expressed concern that currently there is no requirement to report to the Department of Health (the Department) changes in ownership or the company structures of approved providers. Such changes may affect approved providers' financial and regulatory performance and therefore should be monitored by the Department.

However, views on this issue are likely to be conditioned by the complexity of an organisation's legal structure. Members noted that some providers may find this requirement more burdensome to comply with, including some private groups, public companies and even some faith based institutions that make use of property trusts.

**A2.** Allow Approved Providers to report on a single entity or consolidated group basis

**To A2:** The Department needs to clearly articulate the level of reporting required to achieve the transparency the strengthening of the prudential framework seeks to achieve.

**A3.** Where an Approved Provider wishes to transfer assets outside the Approved provider:

- The loan to value ratio of the asset to the liabilities should not exceed 80% of the value of the underlying asset; and
- The use must be secured by appropriate security, such as a mortgage (ranking below bank secured debt)

**To A3:** LASA Members that responded supported an 80% limit of the Loan to Value Ratio.

### 2.Providers not complying with the Liquidity and Capital Adequacy requirements

**B1.** Set a liquidity threshold as a defined percentage of Accommodation Payment money held by the Approved Provider Group, such as the higher 10%, where an Approved provider is a single site, single facility operation with a smaller Accommodation Payment pool and low resident turnover, a higher threshold.

**B2.** Phase in the threshold over a 5-10 year period. For example, require 5% within 5 years, 7.5% within 7.5years and 10% within 10 years.
**B3.** Define the form of liquidity as real liquid or accessible funds being a combination of unpledged/unencumbered cash in the bank; a bank facility (such as overdraft or line of credit) or money that can otherwise be accessed immediately.

**To B1.** Members supported the importance of maintaining adequate liquidity, but noted prudential regulation must avoid unnecessarily restricting operators' decisions about how to manage their capital and cash.



The appropriate minimum liquidity ratio will depend on a providers' circumstances, including the sophistication of their investment and risk management processes. This means that any overarching rule will necessarily be too conservative for some providers and too aggressive for others.

Members that responded to LASA did not generally express a concern with a 10% ratio.

However, rather than setting strict liquidity ratios it may be more appropriate to have an 'if not, why not' approach where any movement outside of the standard minimum ratio would require explanation.

**To B2.** Members supported the phasing-in of any liquidity threshold over a 5-10 year period. There may need to be some compromise on the phase in ratios – the Government needs some data in relation to how many providers are in each bracket now and what they will need to do to move to the required thresholds.

**To B3.** Members supported the definition of the form of liquidity.

## 3.Introduce a capital adequacy requirement

**C1.** Introduce a capital adequacy metric, such as 20% equity on the balance sheet.

**To C1:** LASA Members considered that the introduction of a 20% capital adequacy requirement may be problematic for some providers. Therefore, a period of introduction of 15 years was thought desirable.

A key concern for LASA Members is having a clear definition of capital adequacy to work with. Members consider that the Department should provide a formula for calculating capital adequacy that is accompanied by unambiguous rules.

Capital adequacy is likely to be a greater concern for providers expanding their services and concern was expressed that this rule may result in a reduction of new builds. Members suggested that a capital adequacy ratio may not be needed if a liquidity ratio is also introduced.

**C2.** Define quality of capital to include tangible assets such as land, buildings and intangible assets which are able to be valued, such as, bed licenses.

**To C2:** The term 'quality of capital' should be clearly articulated. Also, the basis on which these assets will be valued needs to be clearly defined, is it at the original or revalued cost? If revaluing is required, who will bear the cost of this being done?

## 4.Enhance disclosure to the Department

**D1.** Amend section 9(1) of the Act to require notification "as soon as it happens and in no event more than 14 days after it happens".

**D2.** Require the prior consent of the Department to be given to material changes in the legal ownership or control of an Approved Provider.

**D3.** Require Approved Providers to adopt an industry standard such as APS330 or Direct2APRA (D2A) reporting. Approved Providers would be obligated to disclose the following to the Department;

- changes in corporate structure;
- significant related party transactions, which are required to be reported in the GPFR;
- cash flow in accordance with the Accounting Standards to show the financial position of the Approved Provider;
- compliance with the liquidity standard (including any period of non- compliance and how it was rectified); and
- compliance with the capital adequacy metric (including any period of noncompliance and how it was rectified).



**LASA comment to D1:** This is taking on continuous disclosure regime. Under such an approach there must be significantly greater clarity regarding what must be reported. The current provision is very broad and subjective, particularly for a strict liability offence attracting 30 penalty units.

There must be a clear distinction between what is required for sign-off by the Department to obtain Approved Provider status and requirements under a continuous disclosure regime.

(The Option in the Ernst-Young Report **E1.** *Independent Auditor* has already been implemented)

## 6.Strengthen governance requirements

**F1.**Develop the Governance Standard to adopt generally accepted corporate governance principles (such as those adopted by ASIC, APRA, ASX and the ACNC). This includes (leveraging ASX corporate principles 3rd ed.) to:

- Lay foundations for the management and oversight of the organization;
- To act ethically and responsibly;
- Safe guard reporting; and
- Prepare a code of conduct for 'key personnel' to improve industry practices to operate in accordance with recipients' of care best interests.

Impose an obligation for Approved providers to produce a corporate governance statement which describes the extent to which they have complied with the code of practice and principles.

G1. Incorporate a financial risk management standard into the Governance Standard.

**To F1:** Members observed that there is a great deal of concern in the aged care sector about the quality of governance. While management and the executive are well informed on prudential issues, the Boards of Directors (frequently volunteer boards) may be lacking in detailed understanding of prudential obligations. This results in a lack of informed oversight and for this reason risk frameworks and risk strategies, such as a liquidity management strategy, may not be in place. This situation is compounded by the difficulties encountered with the recruitment of board members, particularly in regional, rural and remote areas.



LASA Members felt that some Boards may require ongoing education to prepare them for discharging their responsibilities and to enable them to maintain independence and objectivity in the conduct of their duties.

Notwithstanding the above, given the wide variety of entity structures within the sector, developing uniform corporate governance standards may be difficult and existing governance standards are not likely to be fully applicable to all entities. One option would be to incorporate corporate governance principles into the industry code of practice that is currently under development.

It is also important to note that reporting against corporate governance standards can be expensive and these costs will need to be borne one way or another. The history of financial reporting shows that responses to excessive or poorly specified reporting standards is often the creation of boilerplate reports that provide little useful information or action.

LASA, in partnership with the Governance Institute of Australia, is providing a series of workshops nationally to support Age Care boards to understand their increased responsibilities within the new Age Care Quality Standards. Governance in Aged Care training sessions have occurred in all metropolitan cities and are due to commence a national regional rollout in the near future.

**To G1:** Members supported the idea of having a declaration of compliance by the directors with prudential requirements as part of the sign-off of their financial report.

## 7. Enhance disclosures to the resident/family

**H1.** Require Approved Providers to disclose to recipients of care and their families how Accommodation Payment money will be held, when it will be refunded and how recipients of care rank on a winding up of an Approved Provider.

**LASA comment to H1:** Paragraph 15(d) of *Fees and Payment Principles 2014 (No 2.)* covers this with respect to refunding arrangements.

Ranking upon winding up is problematic as recipients of care would currently rank as unsecured creditors. This could just be confusing for people and the main thing they need to know is that the Bonds are guaranteed by the Government (and the limits around this guarantee)

How the money would be held is also problematic as this can change on a daily basis and is counter-intuitive to the permitted use rules and how accommodation funds can be used. This implies that all deposits are ‘held’ in some liquid form which is not the case.

This could be modified to disclose in what form minimum liquidity amount is held.

## 8. Limit or phase out discretionary trusts

**I1 and I2**
Limit or phase out discretionary trusts.
**Alternative option 1**
Retain discretionary trusts but improve transparency of all trusts and transfer to/from them through additional reporting requirements.
**Alternative option2**
Retain discretionary trust but restrict the level of transfers to all related trusts (including discretionary) or other entities.



LASA first responded to this issue in 2017 in our submission to the Ernst and Young report when LASA wrote:

LASA opposes this proposal – we question whether there is any real evidence of actual problems regarding discretionary trusts, noting the low rate of call on the guarantee scheme. This will unfairly and unnecessarily affect some small private providers and may have tax implications for them and hence, for the viability of some residential aged care operations.

- A Member says: "*Operators will have to sell their businesses to themselves or others to get out of the trust arrangements. If he sold there would be transaction costs and taxes of the order of $20m. Trusts are a preferred vehicle in small business to protect assets and allow flexibility to distribute income. The 'no new trusts' provision may reduce new entrants to the industry*".

However, if this requirement were to be introduced then LASA is of the view that existing trusts must be grandfathered.

## 9. Compliance with new adequacy requirements

**J1.** If the approved provider's capital or liquidity falls below the liquidity or capital adequacy thresholds;

- Require the approved provider to make up the shortfall; such as by injecting additional capital or by entering into a subordinated loan with shareholders, and
- Restrict the charging of new Accommodation Payments until the capital metric liquidity threshold is achieved. This may also require an amendment to the Sanctions Principles accordingly.

**To J1:** Members felt strongly that providers who are only a small way off meeting the liquidity and capital adequacy requirements should be required to provide an explanation rather than have sanctions imposed.

A continuous disclosure regime for any breaches of the prudential standards (rather than the current annual regime) would be a better way of facilitating early intervention to address an issue where this is necessary.

The sanctions suggested above have the potential to increase risk by limiting providers' ability to trade their way out of their difficulties.

## Further Options (Department of Health)

### 10. Assessment of financial viability



**AA1.** Create legislative authority to support the assessment of the financial viability of Approved Providers:

- Allow independent review by the Commonwealth of provider's current financial information (audited and unaudited).
- Allow the Department to require the provision of current financial information where there are concerns of provider's financial viability when warranted.

Allow the Department to require the provision of relevant supporting information including current financial reports for the provider and / or related entities where there are concerns relating to a providers financial viability, prudential compliance and/or permitted use.

**AA2.** Require Approved Providers to inform the Secretary (under Section 9(1) of the Act) of concerns relating to financial viability.

**AA3.** Support the migration of all providers to Tier 1 financial reporting.

**To AA3:** LASA Members had different views of AA3.

There are significant additional costs associated with moving from Tier 2 to Tier 1 reporting. If this recommendation is adopted funding to cover these costs should be provided.

Members supported a targeted approach, requiring compliance with only:

- AASB 8 Operating Segments; and
- other Australian Accounting Standards where entities have transactions or activities that would otherwise have to be reported on under these.