Australian Government

Aged Care Financing Authority

Review of the Current and Future Role of Refundable Accommodation Deposits in Aged Care.

Introduction

Refundable Accommodation Deposits (RAD) paid by residents to residential aged care providers for their accommodation act as interest free loans and have been a significant source of capital for investing in the expansion and renewal of residential aged care infrastructure. This is particularly the case since the 2012 Living Longer Living Better (LLLB) reforms which, from 2014, extended lump sum accommodation payments to high care residents, replacing the previous system where non-supported high care residents could only be charged a daily payment set by government, known as an accommodation charge.

In its 2020 annual report, ACFA estimated that capital expenditure of around $51 billion was required over the next decade to meet demand. This represents more than 2.5 times the residential aged care sector's investment from 2010 to 2019. ACFA noted, however, that this estimate was based on the current target provision ratio for residential aged care places and does not take into account the impact of increased home care. Regardless, the required investment over the next decade will be substantial.

At 30 June 2020, a total of $32 billion of RADs was held by providers, about a doubling in nominal value since RADs were extended to high care residents.

As an alternative to RADs, residents can choose to pay a Daily Accommodation Payment (DAP), or a combination of a part RAD and part DAP. To facilitate the choice of payment method, an equivalence formula was introduced for converting a RAD into a DAP. The equivalence formula uses the Maximum Permissible Interest Rate[1] (MPIR), which remains fixed for the duration of a person's stay in that room within the aged care home.

Residents who, as a result of their means test, are assessed as eligible for some Government assistance towards their accommodation costs are known as low means residents. These residents are assessed as either not being able to pay any part of their accommodation costs (fully supported) or being able to pay a contribution towards their costs (partially supported).

A partially supported resident can choose to pay through a Refundable Accommodation Contribution (RAC) or a Daily Accommodation Contribution (DAC), or a combination of the two. In this report, references to lump sum payments generally include both RADs and RACs and references to daily payments includes both DAPs and DACs.

In recent years there has been a gradual shift towards new residents choosing to make daily payments over lump sum deposits. There have also been instances over the years of approved providers of residential care being in financial difficulty, with the Government having to step in to refund the lump sum payments to families of residents through the Accommodation Payment Guarantee Scheme (see page 9).

More recently, Counsel Assisting the Royal Commission into Aged Care Quality and Safety has proposed that consideration be given in due course to a phased transition away from RADs towards a rental model with capital funding derived from equity and debt. Counsel Assisting noted there were increased solvency risks from RADs, inequitable access to finance

[1] The MPIR is based on the general interest charge (GIC) published quarterly by the Australian Taxation Office, discounted by three percentage points as specified under aged care legislation.

for providers in regional, rural, and remote regions, and some consumers were not given their legislated accommodation payment choice.

Minister's request

In February 2020 the Minister for Aged Care requested ACFA to undertake an analysis of the current role of RADs in the market and their impact on the sector, and to consider what their role and settings should be into the future. The report is to include consideration of what the impact would be if there was a significant reduction in RADs, as well as the positives and negatives associated with potentially moving away from RADs.

This request pre-dated any known effects of COVID-19 on the sector and signalled the Government's intention to review RADs, including the impact of a reduction in RADs, before COVID-19 emerged. The problems and concerns associated with RADs were an issue prior to 2020, and the risks posed by COVID-19 on occupancy have amplified some of these concerns.

ACFA's analysis focuses on the current and future role of RADs as a source of capital for accredited residential aged care services providing 24-hour care and support, as legislated and regulated under the *Aged Care Act 1997*. ACFA notes that aged care accommodation payments by older Australians and by Government through accommodation subsidies can be conceived of more broadly, including their role in facilitating the development of new aged care service and accommodation payment models to support greater choice of accommodation settings for older people. Looking to a future of greater consumer choice, including allowing older people to 'age in place' while receiving care and support, there is a case for considering policy options that span residential and home-based care that provide flexibility for innovation in accommodation and care solutions for older Australians.

In undertaking this project, ACFA sought input from the Centre for the Health Economy at the Macquarie University.

Origins of RADs

The predecessors of the current RADs can be traced back to the not-for-profit sector and the enactment of the Commonwealth's *Aged Persons Homes Act 1954,* which made available capital grants on a matching basis to religious and charitable organisations to build more homes for the aged. The policy behind the *Act* was Government support for voluntary effort and self-help.

The methods religious and charitable organisations had been using to raise funding to build homes for the aged were unregulated. In a series of steps, the Government gradually placed conditions on the provision of capital assistance e.g. requiring a proportion of residents to be financially disadvantaged and exempt from 'donations' and entry contributions, ensuring hostel residents were able to retain a set level of assets before being asked to make an entry

contribution, and requiring that entry contributions in most cases had to be partially refunded when the resident left.

While Commonwealth assistance was initially focussed on providing capital, from 1969 the Government introduced a Personal Care Subsidy and homes for the aged became increasingly known as hostels.

Nursing homes evolved separately from hostels. Initially they were mainly privately owned and funded, and some were public facilities run by state governments. There was no Commonwealth funding for nursing homes until 1963 when the Government introduced a Nursing Home Benefit for non-government nursing homes.

The rapid growth in nursing home beds which followed prompted concerns that aged care was becoming dominated by expensive nursing home beds inappropriately accommodating older people with low care needs whose needs would be better provided in hostels or in their own home.

Responding to the growing cost of nursing home subsidies and concerns that a Deficit Funding Model which had been introduced to encourage not-for profit hostel providers to expand into nursing homes lacked an efficiency incentive, the Government in 1987 introduced new subsidy arrangements for nursing homes. The new arrangements comprised three elements – a Standard Aggregated Module to cover costs such as transport, laundry, food and also a return on investment; a Care Aggregated Module for nursing and personal care costs; and the Other Cost Reimbursement Expenditure module which reimbursed expenditure on long service leave, superannuation and workers compensation insurance. There was no explicit Commonwealth accommodation funding stream for nursing homes.

In 1997 the *Aged Care Act 1997* was enacted in order to achieve greater integration of aged care services by combining the hostel and nursing home systems under a single funding and regulatory framework and introducing accommodation bonds across all residential aged care. The latter, which effectively extended the entry contribution arrangements (accommodation bonds) that had developed for hostels to nursing homes, followed criticism in Professor Bob Gregory's 1994 review that nursing home funding was providing neither the funding nor the incentive for nursing home providers to maintain their buildings or to expand.

As well as accommodation bonds, the *Aged Care Act 1997* replaced capital grants with daily accommodation payments for low means residents (the Concessional Resident Supplement, which in 2007 became known as the Accommodation Supplement); maintained a residual targeted capital program; and legislated for retention amounts and minimum building standards.

However, the extension of bonds to high care residents was quickly reversed in response to community pressure. Instead, a maximum means tested daily Accommodation Charge set by government was introduced for high care residents.

The 2012 *Living Longer Living Better* (LLLB) package reversed, from 2014, the 1997 decision to limit accommodation bonds to low care residents by extending accommodation bonds to all new residents. This was mainly in response to a prolonged slowdown in investment in new and rebuilt aged care homes.

The LLLB package also made the accommodation deposit fully refundable, significantly increased the value of the daily Accommodation Supplement for low means residents moving into new or significantly refurbished homes, renamed accommodation bonds as Refundable Accommodation Deposits, and regulated to give consumers choice to pay by a RAD, an equivalent daily accommodation payment (DAP) or a combination of both.

The extension of RADs to all new residents and the increased Accommodation Supplement for new and refurbished aged care homes underpinned a significant increase in investment in new and rebuilt aged care homes.

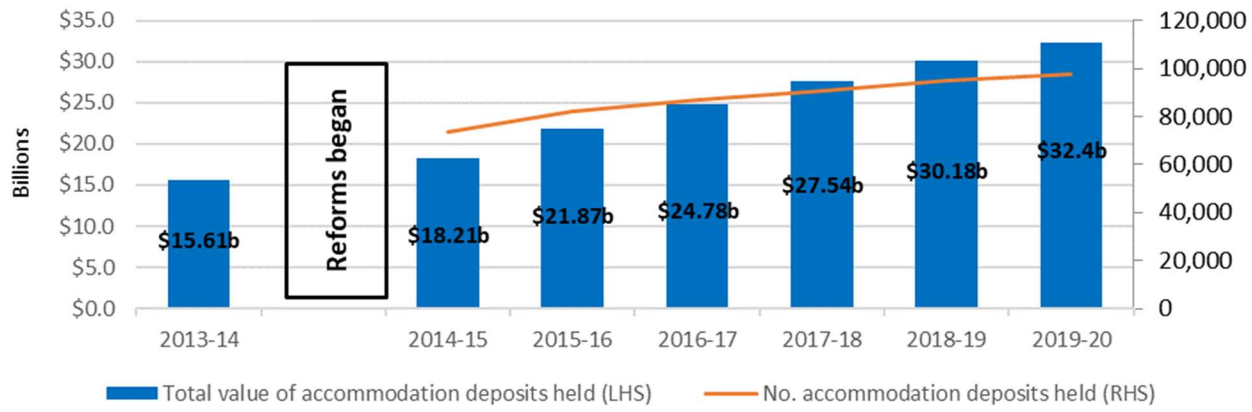
A more detailed history of accommodation payment arrangements in aged care is at Appendix A.

Trends and Statistics on the use of RADs

At 30 June 2020, residential aged care providers held a total of $32.4 billion in refundable deposits, made up of RADs (and a few remaining pre 2014 Bonds).

There was a total of 97,480 refundable accommodation deposits held by providers with an average value of $332,000. As shown in Figure 1 and Table 1, the total lump sum pool of accommodation deposits, the number of accommodation deposits held and their average value, have steadily increased over the last six years since the LLLB reforms began.

Figure 1. Total pool of accommodation deposits held, 2013-14 to 2019-20[2]



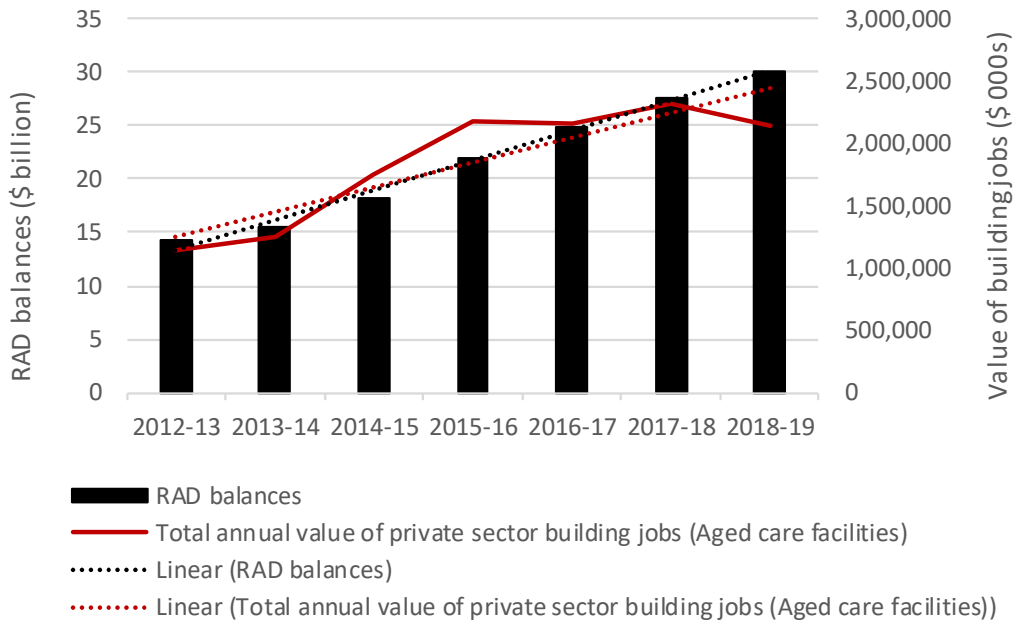
[2] Unless otherwise indicated, dollar amounts are presented at nominal value.

Table 1. Total number and average value of refundable accommodation deposits held by providers

	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Total number	68,182	73,324	82,006	87,160	90,899	94,870	97,480
Average value	$229,000	$248,000	$267,000	$283,000	$303,000	$318,000	$332,000

Figure 2 shows how the RAD balances and the annual value of private sector building jobs for residential care have increased together since 2012-13.

Figure 2: RAD balances and annual value of private sector building jobs for aged care facilities



Source: Chart 1.2 - *The role of refundable accommodation deposits.* February 2021. Centre for the Health Economy. Macquarie University.

At 30 June 2020 the residential care sector had $56.4 billion in assets, $44.7 billion in liabilities and $11.6 billion in net assets. When reported by ownership:

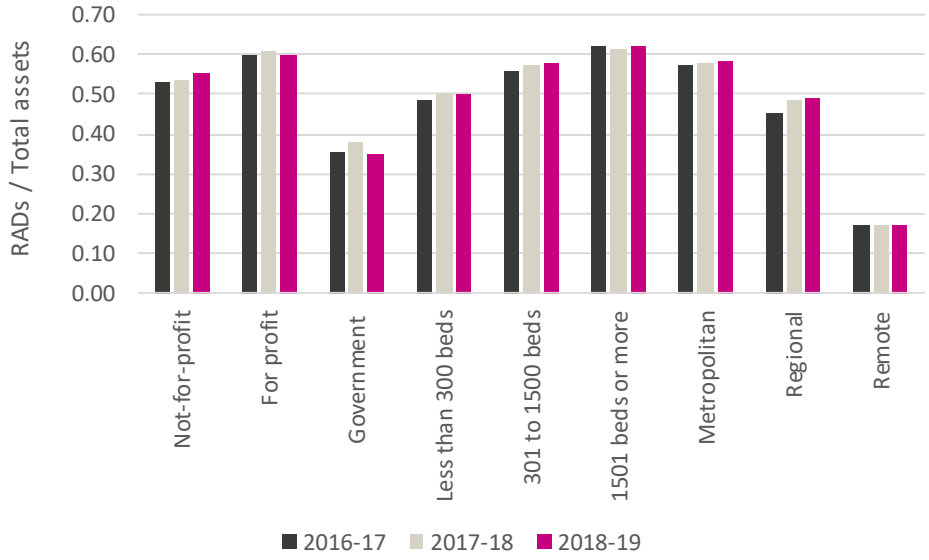
- Not-for-profit providers had $29.2 billion in assets, $20.4 billion in liabilities and $8.8 billion in net assets;
- For-profit providers had $25.2 billion in assets, $23.5 billion in liabilities and $1.7 billion in net assets; and
- Government providers had $2 billion in assets, $0.9 billion in liabilities and $1.1 billion in net assets.

For the whole sector, at 30 June 2020, the $32.3 billion in RADs represent 57 per cent of the total sector assets (48 per cent in 2014-15) and 72 per cent of liabilities (71 per cent in 2014-15). When reported by ownership:

- Not-for-profit providers had $16.6 billion in RADs, which represent 57 per cent of their total assets and 82 per cent of total liabilities;
- For-profit providers had $15 billion in RADs, which represent 60 per cent of total assets and 64 per cent of total liabilities; and
- Government providers had $0.7 billion in RADs, which represent 35 per cent of total assets and 78 per cent of total liabilities.

Reliance on RADs varies across the sector. This is illustrated in Figure 3 which shows capital expenditure over the last three years by ownership, scale and location.

Figure 3 Reliance on RADs for capital expenditure

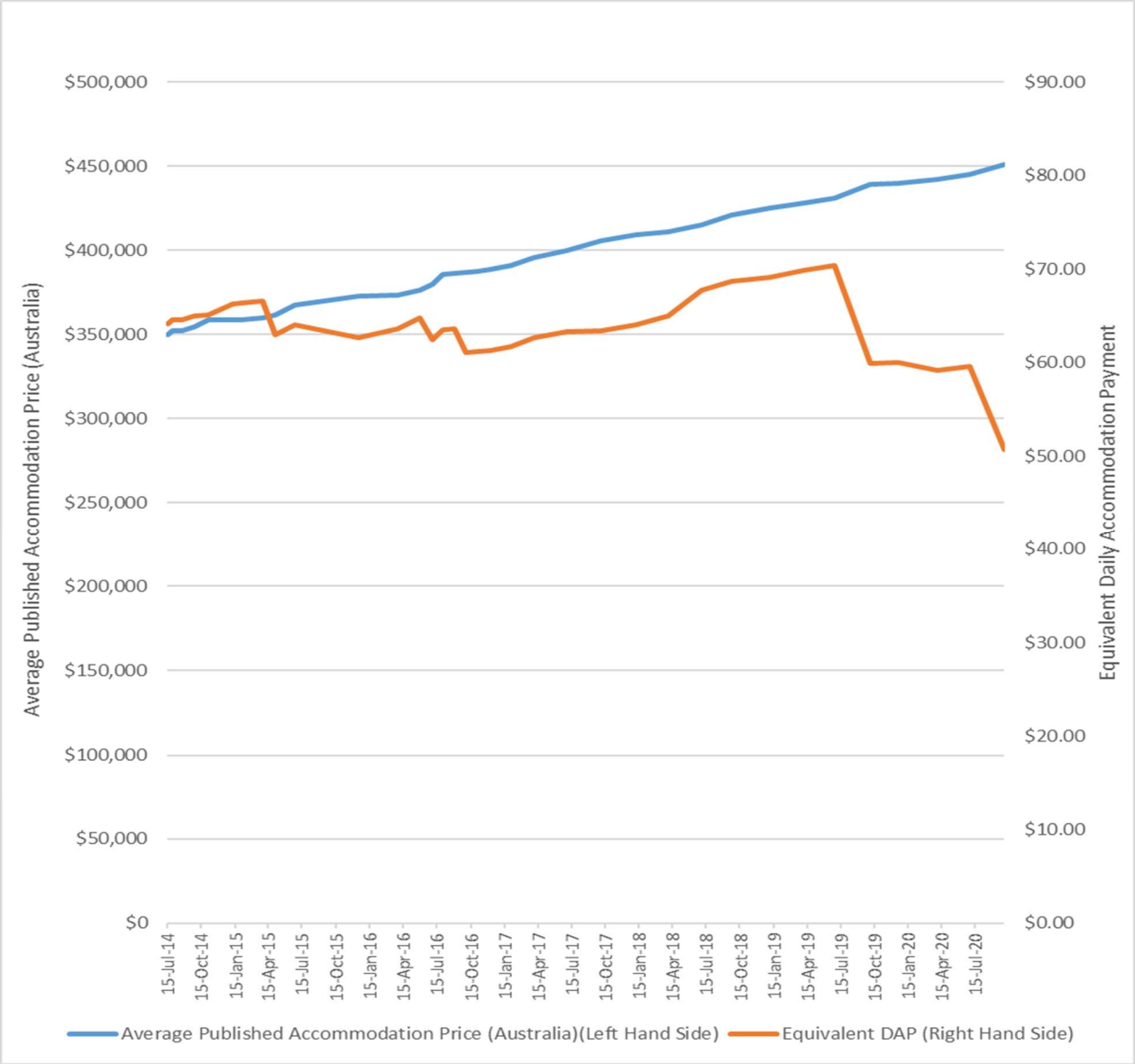


Source: Chart 2.5 - *The role of refundable accommodation deposits.* February 2021. Centre for the Health Economy. Macquarie University.

Other liabilities, including bank borrowings and related party loans, are 8 per cent of assets for the sector as a whole but are mainly held by the for-profit providers.

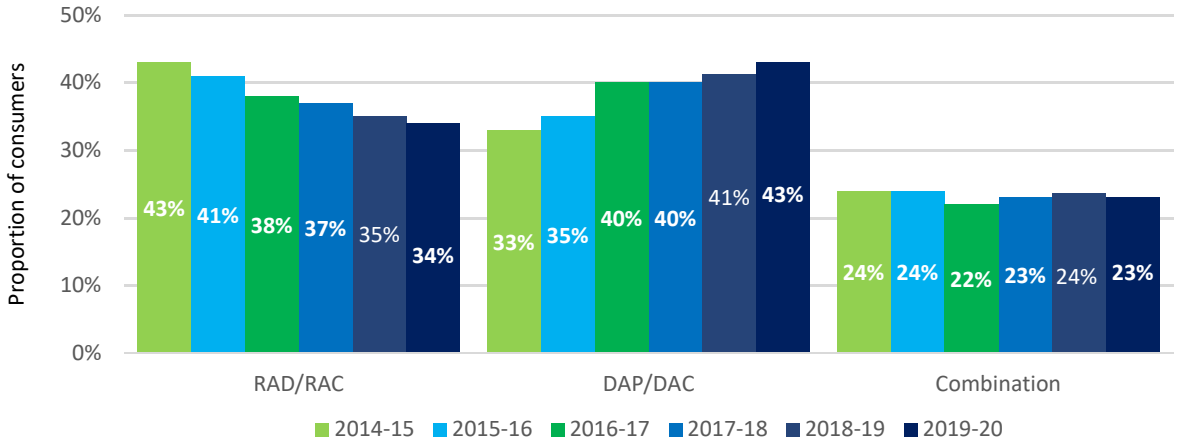
Non-supported residents agree a room price with their provider. The agreed price cannot be more than the advertised price but can be less. During 2019-20, the average accommodation price agreed by new non-supported residents was a RAD of $450,000, which at 30 June 2020 was the equivalent DAP of $60.10. While the average agreed room price has continued to increase each year, the equivalent DAP has decreased in recent years due to a reduction in the MPIR as a result of the general decline in interest rates. The MPIR was 4.89 per cent at 30 June 2020, down from 5.96 per cent at 30 June 2019. Figure 4 shows the average published accommodation price and equivalent DAP since July 2014.

Figure 4. Average published accommodation price and equivalent DAP amount



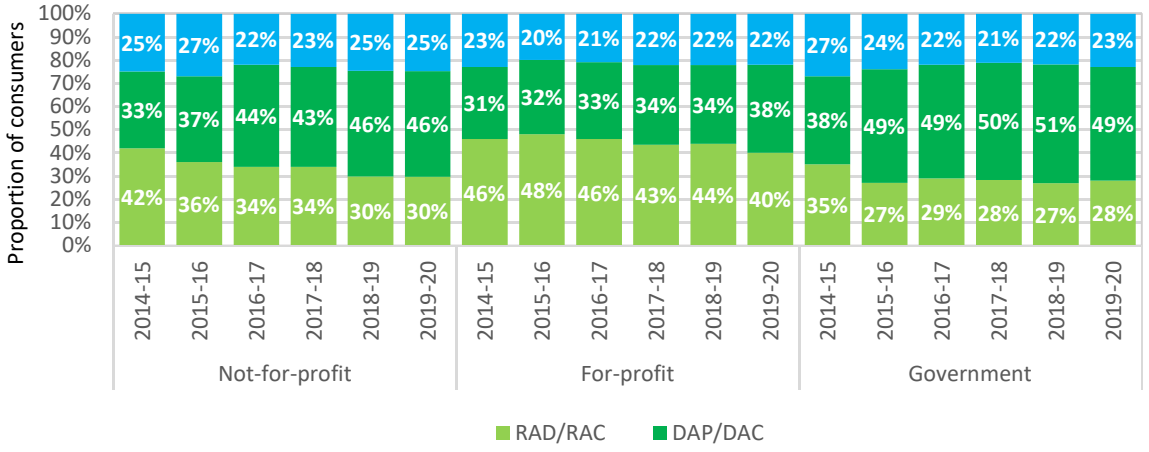
During 2019-20 the proportion of new non-supported residents paying a RAD only was 34 per cent. This is a gradual decline from 43 per cent in 2014-15 when the LLLB reforms legislated the right for residents to choose their preferred payment method (Figure 5). Commensurately, the proportion of non-supported residents paying a DAP only has risen from 33 per cent in 2014-15 to 43 per cent in 2019-20. Those paying by way of a combination has been steady at around 22-24 per cent since 2014-15.

Figure 5. Resident choice of payment method, 2014-15 to 2019-20



Residents entering homes of different ownership structures made different RAD/DAP choices (Figure 6). The proportion of residents who entered not-for-profit homes in 2019-20 who paid by RAD only was 30 per cent. As shown, this has steadily decreased since 2014-15 when it was 42 per cent. Those paying a RAD only entering for-profit homes has fallen from 46 per cent to 40 per cent in the same period.

Figure 6. Resident choice of payment method, by ownership, 2014-15 to 2019-20

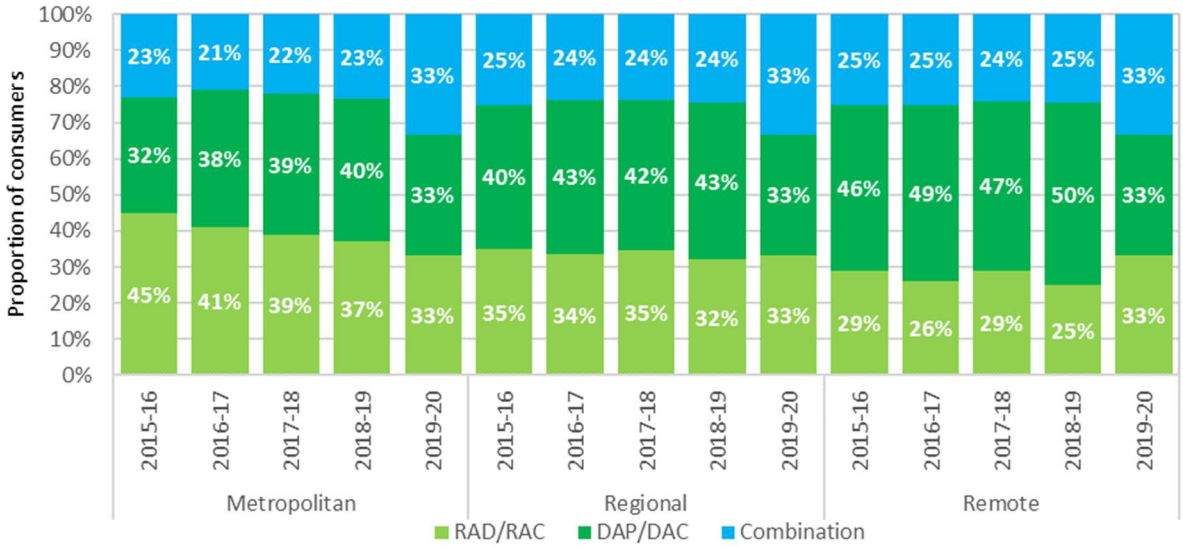


When analysed by location (Figure 7), it is evident that those paying by RAD only has decreased more significantly in metropolitan areas since 2014-15 than in regional and remote areas, although noting significant decreases in the latter locations also.

In metropolitan areas (MMM1), those paying by RAD only has fallen from 45 per cent in 2014-15 to 36 per cent in 2019-20. In regional areas (MMM 2-5) and remote areas (MMM 6-7), those paying a RAD only have dropped 6 and 4 per cent respectively (noting, as

per Figure 3, that providers in remote areas place very little reliance on RADs for capital expenditure). ACFA notes that rural and remote providers can also access the Commonwealth's Rural, Regional and Other Special Needs Building Fund (the Fund), which supports capital works projects in regional/rural locations. Grants under the Fund are targeted to providers that cannot accumulate sufficient reserves, or service the debt required, to meet some, or all, of capital works costs[3].

Figure 7. Resident choice of payment method, by location, 2014-15 to 2019-20



The Accommodation Payment Guarantee Scheme

The Accommodation Payment Guarantee Scheme (previously the Bond Guarantee Scheme) commenced in 2006. To date it has been triggered 13 times. On all but one occasion it was a for-profit provider that was unable to refund RADs to former residents or their families. In total, 334 RADs with a total value of $101 million have been repaid to residents or their families through the scheme.

Under existing legislation (*Aged Care (Accommodation Payment Security) Act 2006),* the Minister for Aged Care may make a costs recoupment determination for:

- One or more refund declarations (a refund costs recoupment determination); and
- Administrative costs relating to one or more event declarations (administrative costs recoupment determination).

To date, no Minister has made a costs recoupment determination.

[3] Around $400 million in capital grants has been allocated through the Fund to 131 projects since 2011.

In the 2018-19 Budget, following recommendations in both the 2017 Legislated Review of Aged Care and an Ernst and Young review, the Government announced its intention to introduce a mandatory levy on providers to recover default costs under the Scheme when default costs exceed $3m in a financial year. This measure was delayed due to the commencement of the Royal Commission into Aged Care Quality and Safety and the COVID-19 outbreaks.

The role of refundable accommodation deposits: a summary of key findings by Macquarie University

Between July and December 2020, the Centre for the Health Economy at Macquarie University undertook the following work in support of this report:

- analysis of financial and consumer choice of payment data for the period 2016-17 to 2018-19 held by the Department of Health;
- conducted an online survey of over 300 residential care providers;
- conducted discussion groups with 23 providers who were selected based on their significant RAD balances; and
- conducted interviews with 14 aged care stakeholders that represented banks, aged care peak bodies, consumer peak bodies, and valuers.

Macquarie University's full report is at Appendix B. The key findings from that report are summarised below:

Trends in RADs

- The number of RADs held by providers has increased in the period 2016-17 to 2018-19 for all types of providers. Not-for-profit providers held the largest number of RADs due to their dominant market share. Large providers (more than 1,500 beds) held proportionally more RADs than the mid-sized or small providers, even though there are many more small providers. Metropolitan based providers held the most RADs despite only accounting for around 50 per cent of the market. The relationship between provider characteristics and the number of RADs was similar for total RAD balances.
- The average value of RADs held by providers increased from 2016-17 to 2018-19. For-profit providers had the largest average RAD values across ownership type, although the average RAD values for not-for-profit providers grew more. Mid-sized providers had the highest average RAD values across provider size, followed by small providers and large providers. While metropolitan providers had the highest average RAD values by region, the growth in value from 2016-17 to 2018-19 was consistent across all provider regions.

Factors driving RAD choice

An analysis of consumers who entered residential aged care between 1 July 2016 and 30 June 2019 identified the following factors as likely to influence the choice to pay a RAD:

- A consumer that stayed for a relatively short period in residential aged care was more likely to choose a DAP. This may be due to a resident's inability to sell their former home in a short period, or they may have expected a shorter duration of stay, preferring not to cash out their assets.
- The more frail consumers are when entering residential aged care, the less likely they will choose a RAD as a shorter length of stay is likely anticipated.
- The more assets a consumer had, the more likely they were to choose a RAD, whereas the more income a consumer receives, the more likely they will choose a DAP.
- Consumers are more likely to choose a combination payment when faced with a high accommodation price.
- Consumers are more likely to choose a RAD as the maximum permissible interest rate (MPIR) increases.
- Older residents, or married residents, are more likely to choose a RAD. They are also more likely to choose a greater proportion of RAD within a combination payment.

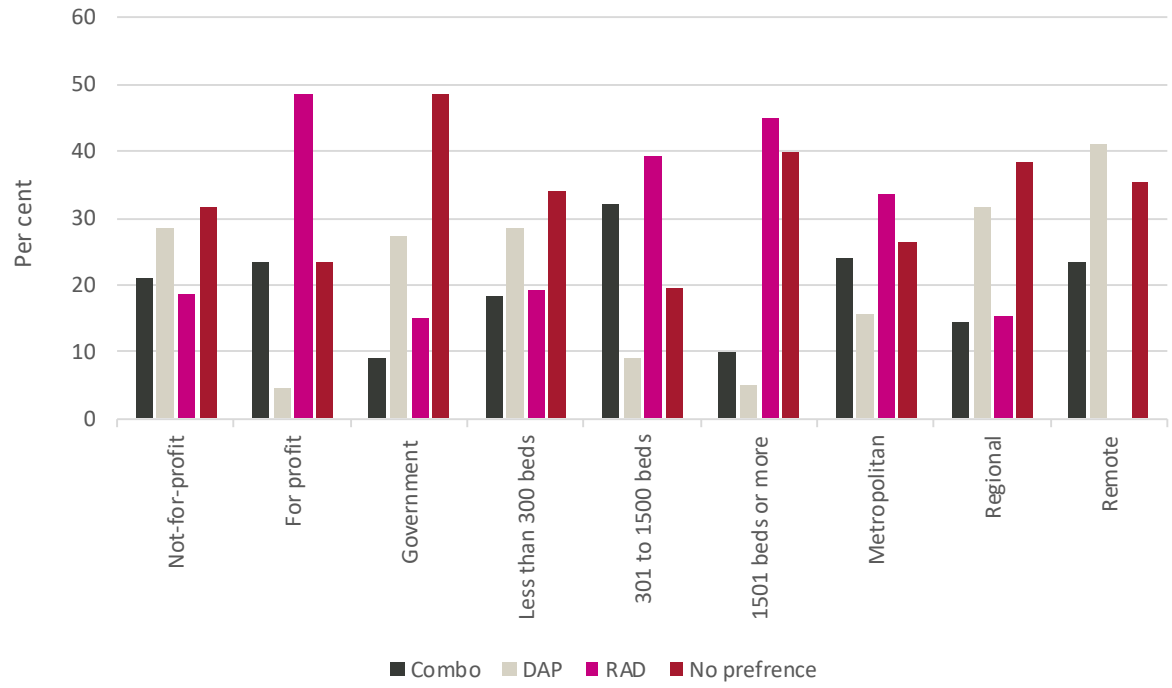
Provider feedback

In October 2020 Macquarie University surveyed 300 residential aged care providers, accounting for 36 per cent of all residential aged care providers.

- Provider preferences for RADs vary considerably. Twenty-five per cent of providers prefer to receive a RAD, 23 per cent prefer a DAP, and 20 per cent prefer a combination payment. Around 32 per cent of providers had no preference between receiving a RAD or DAP.

  Figure 8 below shows that provider preferences for accommodation payment method differed across provider characteristics. Around 48 per cent of for-profit providers stated they preferred RADs whereas only 23 per cent stated they had no preference. Conversely, only around 19 per cent of not-for-profit providers preferred RADs and a higher 31 per cent had no preference for accommodation payment type. Larger providers and those with facilities mostly located in metropolitan regions preferred a RAD.

Figure 8: Provider preference for accommodation payment type by provider characteristic

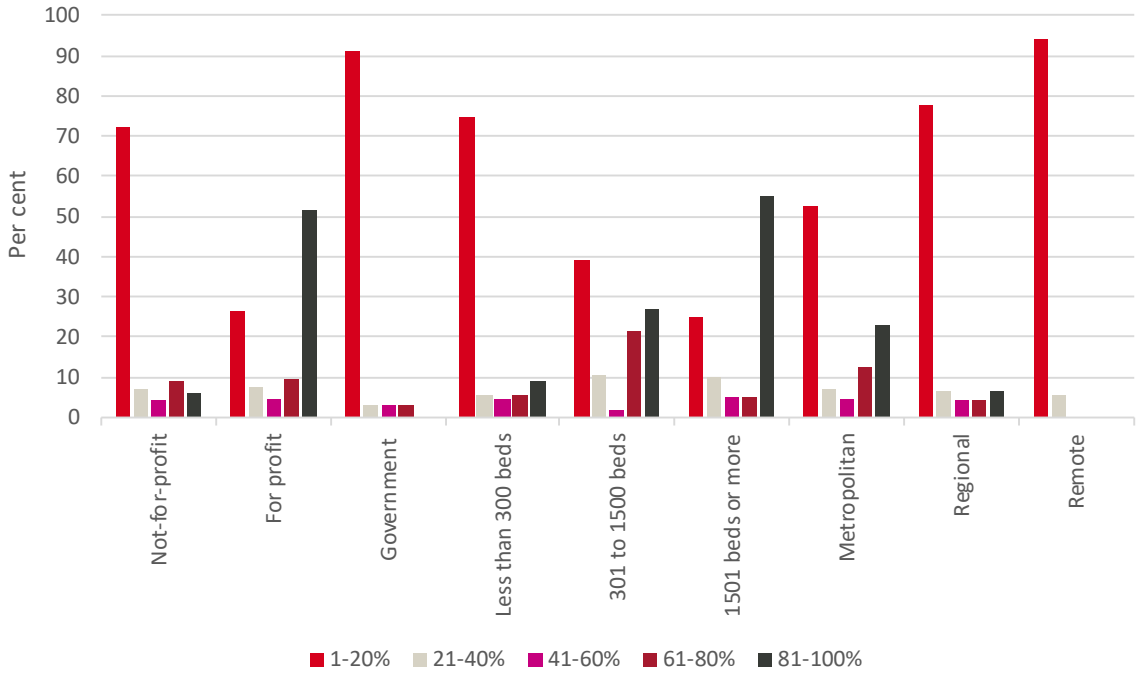


Source: Chart 4.2 - *The role of refundable accommodation deposits.* February 2021. Centre for the Health Economy. Macquarie University.

- The reliance on RADs for capital expenditure was also substantially divergent (Figure 9). For-profit and larger providers generally invested a considerable proportion of their RADs in capital expenditure, while RADs were used less for capital expenditure by smaller, more remote providers. Most RAD balances not used for capital expenditure are held as cash in a deposit account.

  Around 52 per cent of for-profit providers and 55 per cent of large providers used between 81-100 per cent of their RAD balances for either capital expenditure or to repay a debt incurred for capital expenditure. In contrast, 72 per cent of not-for-profit providers, used between 1-20 per cent of their RAD balances for either capital expenditure or to repay a debt incurred for capital expenditure. Small providers and providers operating in regional and remote regions also used a lower proportion of their RADs for these purposes.

Figure 9: Proportion of RADs used for capital expenditure, by provider characteristic



Source: Chart 4.3 - *The role of refundable accommodation deposits.* February 2021. Centre for the Health Economy. Macquarie University.

- Only a small number of providers noted they had experienced a decline in RADs balances. They associated the decrease mainly with consumer payment preference shifting to DAPs, lower occupancy rates, and an increased number of supported residents, (although ACFA notes that at a national level the proportion of supported residents has remained stable in recent years).
- Nearly half of providers noted their RAD balances were exposed to a reduction in housing prices. Providers were less concerned with other external events impacting their RAD balances. A decrease in occupancy rates was noted as a potential risk to RAD balances by 21 per cent of providers. So too was a reduction in the MPIR.
- Most providers expected a shift in consumer preferences from RADs to DAPs in the next five years. However, around 68 per cent of providers noted that a 10 per cent reduction in RAD balances would not impact their capital investment decisions. Some providers stated that they could cover this reduction in RADs by obtaining additional equity or commercial debt. Some providers noted they were considering entering into a real estate investment trust (REIT) agreement.
- Some providers noted they had a strategy to maintain or increase RADs balances e.g. marketing activities to increase occupancy and offering discounts on fees to incentivise residents to choose a RAD.

<u>Views from RAD reliant providers</u>

In September 2020 Macquarie University conducted discussion groups with 23 providers who were selected based on their significant RAD balances, reflecting primarily large for-profit and not-for-profit organisations that owned facilities located across Australia.

- These providers shared the view that RADs have encouraged and facilitated capital expenditure in residential aged care. However, they also held the view that while larger providers, for-profit providers, and providers with most facilities located in metropolitan areas could attract RADs for capital expenditure, the ability of other providers to attract substantial RAD balances was limited.
- Providers noted they have little control over a residents' accommodation payment choice.
- Providers also noted that a drop in occupancy rates and shorter length of stays threatened their RAD balances. However, most providers experienced an increase in their overall RADs balances due to increasing accommodation prices and increased bed capacity.
- Providers generally expressed the view that they would be unable to obtain enough debt or equity to replace a significant reduction in RADs, if it were to occur.
- Most providers stated that the MPIR did not reflect the cost of providing accommodation and suggested that the weighted average cost of capital (WACC) should replace the MPIR. They believed any alternative financing system that replaced a significant reduction in RADs must be facilitated by better investment returns to attract debt and equity.

Views from other stakeholders

In September 2020 Macquarie University also conducted interviews with 14 aged care stakeholders that represented banks, aged care peak bodies, consumer peak bodies, and valuers.

- These stakeholders recognised that RADs had played an essential role in allowing providers to increase capital expenditure, however some noted that RADs had created a more volatile capital structure than commercial debt. It was noted that a rapid and sustained outflow of RADs could cause liquidity issues for many providers.
- Some questioned whether some smaller providers had a full understanding of their prudential requirements regarding the treatment and usage of RADs.
- Banks noted that lending to providers for capital expenditure requires a provider with good access to RADs, as this indicates the capacity of the provider to repay debt. They also take into account management quality, including governance structure and integrity and experience of the entire management team, and a strong emphasis on financial viability.
- Banks also noted they are generally more willing to lend to large, multi-site providers given their economies of scale and ability to spread the investment over several sites. There was also a view from lenders that preference would be given to providers who have a demonstrated ability to attract RADs. Many providers with less than three facilities would have limited debt access to cover any RAD outflow due to their increased business risk.

- Occupancy rates, the remoteness of providers' facilities, and general demographics of the areas where facilities are located (including the proportion of supported residents) are also considered by the banks when lending.
- Several banks noted that a significant reduction in RADs would reduce their lending capacity.
- Some stakeholders noted there are no current viable alternatives to RADs. Several banks stated that if RADs were significantly reduced or removed altogether, they would not have the capacity to cover the outflow. There was a view from some that RADs could only be replaced if a stable alternative was available, along with a detailed transition plan developed in consultation with all stakeholders and implemented over a long period. A role for the Australian Government within the transition plan, and potentially providing a loan facility, was also supported by some providers.

RADs and provider financial performance

A detailed analysis of provider financial data for 2016-17 to 2018-19, sourced from the Department of Health, was undertaken to assess the relationship between RADs and provider financial metrics. The initial sample consisted of data from 941 providers. A total of 16 financial metrics was used across four domains, including profitability, capital expenditure, liquidity, and solvency.

Univariate analysis found a statistically significant relationship between provider RAD balances and profitability, capital expenditure, liquidity, and solvency. An increase in RAD balances was estimated to increase profitability and capital expenditure but reduce liquidity and solvency. The impact of RADs on financial metrics varied across the ownership type and provider size.

A multivariate analysis was undertaken to account for other factors that may also impact financial metrics. This was to reduce potential bias in relationships found within the univariate analysis. While the relationships between RADs and capital expenditure, liquidity, and solvency remain in the same direction and statistically significant, the positive relationship between RADs and profitability reversed, although the relationship became statistically insignificant.

International financial arrangements

A review of accommodation financing in other countries found that residents of long term care homes mostly pay accommodation fees. No other country uses a financing mechanism like RADs, although Japanese providers use a lump sum forward payment of rent until an expiration period as determined by the nursing home.

Private for-profit operators are the dominant players in several countries, such as the US and UK. These providers rely on a mix of debt and equity to fund capital expenditure. Government support for capital expenditure is available in some countries, such as mortgage insurance provided by the US Department of Housing and Urban Development. It can be used to finance the purchase, refinance, new construction, or substantial refurbishment of nursing home facilities. This encourages private lenders into the nursing home market.

European countries use a mix of long term care insurance to fund private operators and a greater proportion of government nursing homes, which receive funding for capital expenditure directly from the government.

Government intervention

- The Government would need to consider the benefits and costs of a sector shifting towards DAPs in deciding whether to intervene if there were a significant reduction in RADs. The primary argument for Government intervention is the need to ensure continuity of access to care.
- There are many ways Government could intervene:
    - increasing capital grants to providers;
    - guaranteeing commercial debt borrowed by providers to cover their RAD shortfall;
    - developing a loan facility for providers (potentially using either market debt or RADs from other providers that are not tied up in capital);
    - allowing providers to restrict the accommodation payment choices of their residents;
    - attracting REITs into residential aged care (although this would require a substantial increase in provider returns). This could be achieved if the Australian Government were to increase prices for daily living activities and care services, or allow providers to retain some component of the RAD again. An alternative is to provide tax advantages to REITs to encourage investment in the residential aged care sector.
    - attracting more capital to the residential aged care sector by increasing returns, and replacing the MPIR with a WACC.
- However, applying a WACC to the MPIR has several problems. The MPIR was not introduced to cover the cost of capital. It was designed to create an equivalent income to providers between a RAD and DAP. Providers have different WACCs so an MPIR based on an average WACC would provide a competitive advantage to providers with a lower WACC. The MPIR is also applied to the accommodation price, which is typically greater than the cost of building a room. Applying a WACC to the margin between the accommodation price and cost of the room may seem unfair by consumers.

Macquarie University's conclusions

1. Providing good quality residential aged care crucially relies on a financially healthy sector.
2. RADs are unique to the Australian residential aged care sector. Other countries rely on commercial debt and equity to finance capital expenditure. Real estate investment trusts have invested significant amounts into residential aged care stock in many other countries.

3. RADs have allowed providers to refurbish old facilities and build new facilities to better meet consumer preferences.
4. Providers that require RADs the most are those that have invested their RADs in capital expenditure, and those looking to undertake further significant capital expenditure.
5. Providers will need to undertake capital expenditure at some point, even if just to refurbish existing facilities. Therefore, the value of RADs to a provider is contingent on where they sit within their long-term capital expenditure cycle.
6. Total RAD balances within the residential aged care sector have grown by approximately 93 per cent between 2014 and 2019 despite a shift from RADs to DAPs.
7. There is little to suggest that a significant reduction in total RAD balances will occur soon. One key factor in the trend towards DAPs over RADs has likely been the reduction in the MPIR, which has very limited scope to decline much further. An increase in the frailty of new residents entering residential care would likely bias consumer choice to DAPs over RADs.
8. A significant reduction in RAD balances would impact residential aged care providers differently, depending on their reliance on RADs. Providers that would be most negatively affected are those where most of their RADs are invested in capital. A significant reduction in RAD balances would reduce capital expenditure for all provider types. In general, the sector could most likely absorb a small reduction in RAD balances over a long period.
9. A reduction in RADs may actually benefit those providers not looking to undertake significant capital expenditure. Given the low returns on permitted uses for RADs, a shift to DAPs would increase these providers' income.

Ultimately, greater return on investment, and reduced uncertainty within the residential aged care sector, is required to attract more equity and debt into the market. Without these, the residential aged care sector will continue to rely on RADs, and many providers will continue to be exposed to the financial risk from a significant reduction in RADs. Government will also continue to be exposed to risk through the Accommodation Payment Guarantee Scheme.

Principles for evaluating the future of RADs

In order to analyse options for the future of RADs in residential aged care, ACFA considered the roles and objectives of accommodation payments within the context of residents making a fair contribution towards their accommodation costs, ensuring an adequate return on capital for providers and managing fiscal risk to Government. ACFA therefore developed the following principles to support its analysis:

1. Consumers with the means to pay should contribute to, or pay for all the costs of their accommodation.
2. Consumers should have the choice of payment method for their accommodation.
3. All accommodation options, including pricing, should fully inform consumers and be transparent.
4. Consumer protections must be in place, including regulation to ensure that consumer choice of payment method can be exercised without provider interference or influence.
5. The Government's contingent liability arising from potential RAD repayment defaults needs to be managed through effective prudential regulation, noting also the potential for consequential recovery of default costs incurred by government from providers holding RADs.
6. The funding and financing arrangements must ensure that the non-government sector can secure the capital required to finance the renewal and expansion of residential aged care services that meet regulated standards.

Options

In this section ACFA discusses the following four options regarding a future role for RADs.

- Retain the current system of RADs and DAPs
- Retain RADs and DAPs but introduce changes to encourage greater use of DAPs
- Retain RADs and DAPs but introduce changes to create economic equivalence between the two
- Prohibit RADs with effect from a fixed date

There is some overlap across the options, and it is also acknowledged that these options do not represent the full extent of the options that could be considered by Government. They more serve as a way of outlining the range of potential future roles available and for assessing the positives and negatives of a range of options.

Option 1: Retain the current system.

This option would see no major change to current policy settings regarding RADs/DAPs, although there is scope to make changes that would have the intention of improving the functioning of the current system, particularly in the area of prudential regulation and the operation of the Accommodation Payment Guarantee Scheme.
Providers would continue to offer a price for a room in their facility and this could be paid by either a RAD or a DAP or a combination of the two. This would mean that the current choice of payment type specified in the *Aged Care Act 1997* would remain, and the MPIR would continue to be used to calculate the value of the DAP, although noting there is scope for both of these to be modified.

Advantages:

- Consumers would continue to have the legal right to choose how they pay for their accommodation (RAD, DAP or combination), with a clear method for converting RADs into daily prices.
- For providers (both for-profit and not-for-profit) who meet commercial lending criteria, RADs would remain a low cost and relatively easily accessible form of capital to assist with investment (although the recent gradual trend towards DAPs indicates it may be becoming less accessible).
    - Banks and other lending institutions can continue to lend for new builds on the assumption that the inflow of RADs on completion allows early repayment of debt and reduced financial risk.
- For the not-for-profit sector, RADs would remain a source of capital, noting that introducing private equity is not an option under their formation and mission principles.
- For many smaller providers who are not well placed to obtain financing from commercial sources, RADs would remain a source of capital.
- There would be ongoing certainty for RAD paying consumers regarding the repayment of the RAD through the availability of a Government guarantee, at no cost to them.
    - The RAD option facilitates estate planning certainty for consumers as it is known how much is to be returned to the estate.
- Retaining the MPIR would be consistent with ACFA's input to the 2017 Legislated Review of Aged Care Reforms where it concluded the MPIR was the fairest way of determining daily payments, providing a balanced option that recognises the differing perspective of consumers and providers.

Disadvantages:

- The potential remains for pressure to be placed on consumers by some providers to choose a RAD (or in some cases a DAP), or preference is given by providers to residents who indicate a willingness to choose a payment method that suits their business model (including a discount in fees).
- When providers do advocate the payment of a RAD, it can put additional pressure on a consumer/family, tied in with emotional issues such as selling of the family home and moving into aged care. It can also be a difficult financial decision, particularly when the incoming resident's expected length of stay may be short or at least uncertain.
    - While recognising these disadvantages, the exercise of free choice could be strengthened under the current system.
- If the recent gradual trend towards DAPs continues, providers with a business model built around RADs may come under increasing financial pressure or have difficulty in obtaining alternative finance to support ongoing capital investment. This is particularly the case if the trend were to accelerate. However if the trend continues, but in a gradual way, the risk is far less as the sector will gradually adjust in most instances.
- The risk to Government and to non-defaulting providers under the Accommodation Payment Guarantee Scheme would remain and potentially increase. While the proportion of new residents choosing RADs has recently declined, the value of individual RADs is

increasing in line with market trends and the total number of residents is likely to continue to increase as Australia's population structure ages (notwithstanding the increased availability of home care packages).
    - Strengthening of prudential regulations would help minimise this risk.
- The MPIR is often the subject of criticism by both consumers and providers. Consumers say it is too high, whereas providers say it is too low as it does not provide economic equivalence. So while ACFA has previously concluded that the current formula based on the MPIR is the fairest way of determining daily payments for both consumers and providers, there remains some debate.
    - One of the issues is whether the formula should be anchored in the RAD or the DAP. Anchoring the formula in the RAD provides greater certainty for providers and lenders as the RAD amount remains fixed.
    - On the other hand, anchoring the formula in the RAD makes the DAP, through the MPIR, sensitive to movements and volatility in interest rates, much more so than the wider housing rental market. However, the DAP amount remains fixed for the duration of each resident's stay – unless a resident voluntarily moves rooms (and is fully informed of the DAP consequences) or changes provider.
- The 'no change' option would not address concerns expressed by some that a continuation of the trend away from RADs will constrain the ability of some providers to invest in the sector to meet future demand. However, it is noted that an option to deliberately move away from RADs would raise the same concerns.

Potential Improvements to the Current Arrangements

ACFA has identified the following issues associated with the current arrangements where changes could be made to improve the operation of the current system.

1. Strengthening consumer choice of payment method

   One of the problems often encountered by consumers is the difference between the choice they are allowed under legislation and the practicalities of what providers tell them their choices are or the influence the providers apply. There is currently little scrutiny of the pressure that may be being placed on consumers regarding payment method and choice. Consumers' rights to exercise choice could be given greater publicity along with avenues for consumers to seek assistance or redress.

   Where consumer choice is the objective, this needs to be underpinned with access to and availability of qualified, appropriate and adequate independent advice to facilitate fully informed decision-making. Legislative reform or guidance may be needed to ensure this advice remains appropriate and is conducted within an appropriate regulatory framework to ensure the full implications are considered and conflicts are removed.

2. Stronger prudential requirements for uses of RADs

If the current system is retained, ACFA strongly supports implementation of more rigorous prudential standards, including liquidity and capital adequacy standards, as recommended in EY's *'Review of Aged Care legislation which provides for the regulation and protection of Refundable Accommodation Payments in Residential Aged Care - May 2017'* and as recommended by Counsel Assisting the Royal Commission into Aged Care Quality and Safety.

There is also a case for making the recovery of RAD repayment defaults under the Accommodation Payment Guarantee Scheme from RAD holding providers mandatory, noting however that legally providers cannot refuse to accept a RAD if offered by a resident and may wish to make some provision for the contingent liability in the RAD price.

3. Operation of the MPIR for partially supported low means residents

Under current arrangements and at the current low interest rates, a partially supported person who is paying the maximum accommodation supplement as an accommodation contribution (new/refurbished facility rate meeting the supported resident ratio) would have an equivalent RAC of $518,032. This is often more than the published price.

One option to address this perverse outcome would be to cap the RAC at the facility's published room price in order to provide a level of consumer protection and mitigate some of the exposure to increases as a result of lower rates of MPIR. This would not adversely affect providers who would have received the published room price from the person if they had not been assessed as low means. Capping the RAC at the published room price for each low means resident should not result in a significant shift in the proportion of low means residents paying their accommodation contribution as a full RAC due to the limited income and assets of this group.

Another option could be to have two separate MPIRs – one for partially supported residents and one for non-supported residents. While this would not create complete equity, it would serve to ensure that partially supported residents are not paying a disproportionate amount. For example, setting the partially supported MPIR at around 5 per cent would convert a daily payment of $58.19 into a lump sum of $424,787 (which approximates the national average for a new RAD though not necessarily the average RAD in the local area) might be effective.

4. Technical changes to the legislation

If RADs are maintained, there are some technical changes to legislation that could be considered by Government to address issues and problems currently faced by consumers. These include:

- While an interest rate penalty was introduced as an incentive for providers to repay RADs quickly once probate has been shown, there is no mechanism to force the repayment.

- The ability to have a RAD repaid directly to a third party if that party used their own funds to pay the RAD on behalf of the resident (e.g. where a child pays the parent's RAD) – this would avoid the estate planning complexity that currently exists.
- For a couple, administration could be simplified if it was possible to transfer a RAD from one person to the other, without it needing to be refunded to the estate and then paid back to the surviving spouse.

Option 2: Retain both RADs and DAPs but introduce changes to make DAPs more attractive so that the use of RADs as a source of capital is reduced over time.

This option would see the retention of DAPs and RADs, including the Accommodation Payment Guarantee Scheme. However, changes would be made to make the use of DAPs by in-coming residents more attractive, thereby reinforcing the current trend toward consumer preference for DAPs over RADs and reducing RAD holdings by providers.

Policy changes could allow Government to influence a gradual shift away from RADs, noting the assessment of the Counsel Assisting the Royal Commission that consideration be given to phasing out RADs in the longer term in favour of rental payments, with appropriate modifications to enable providers to access higher levels of debt and equity.

Mechanisms to encourage a shift towards DAPs over RADs could include:

- Lowering the MPIR or using another interest rate method that was relatively lower which would benefit DAP payers over RAD payers. By applying a lower interest rate, the DAP would decrease, reducing the amount consumers would need to pay through a DAP for the same RAD value.
- Making equity release more attractive, e.g. through lower interest rates under the Pension Loans Scheme. This would need to have controls such as the drawdowns only being able to be used for aged care (with lump sum drawdowns excluded from this arrangement). Timely equity release approvals would be needed by consumers wishing to pay by DAPs. ACFA notes that approval for loans under the Pension Loans Scheme can often be protracted. If this is to be a viable option for those seeking residential care, the timeframe needs to be relatively short.
- Treating the MPIR-derived DAP as a price cap, rather than a fixed price, together with introducing more competition between providers by the removal of rationing and introducing 'funding following the consumer' by abolishing the ACAR, which may result in the market setting lower DAPs. It would allow providers who were currently not favouring RADs because of their position in their capital expenditure cycle to attract more DAPs.
- Increasing Government funding for capital grants, providing more zero real interest loans or increasing the maximum accommodation supplement. The Royal Commission has proposed that the Rural, Regional and Other Special Needs Building Fund be increased and expanded. However, these options come at increased

Government expense and the formulation and administration of eligibility criteria.

Advantages:

- An increased focus on DAPs may better match the anticipated trend towards shorter lengths of stay in residential aged care, while still providing consumers the option of using RADs.
- In the long term the Government's RAD guarantee liability would be reduced, as would the risk of RAD default costs incurred by Government being recovered from providers (noting that in the short-term both of these factors could actually have a higher chance of occurring due to the financial risk to some providers in the transition to DAPs).
- Applied in conjunction with other reforms, such as independent pricing based on the efficient provider and funding following the consumer, this would operate as a structural adjustment mechanism, noting that some providers would have difficulty accessing RAD capital.

Disadvantages:

- Providers would need to source more expensive debt or equity to fund future growth and renewal. It is unclear if this would be possible given the lower financial returns being achieved by many providers.
    - RADs were introduced for all new residents as part of the LLLB reforms in response to a marked slowdown in new capital investments in order to improve provider access to capital for infrastructure renewal and expansion .
- Greater use of and/or lower DAP prices would further reduce provider revenue, which is already being reduced by the current lower MPIR.
- There would need to be greater pre-debt levels of return for providers in order to support more expensive capital raising.
    - While there may be equity investors seeking investment opportunities in aged care, it is doubtful whether the returns for many for-profit providers are adequate to attract them.
    - Debt providers would lose the certainty of a RAD inflow on completion of a new build which currently allows early repayment and reduces their risk. Lenders are likely to charge a higher premium to compensate for longer term debt and increased risk. Debt availability would be impacted with terms less likely to meet usual lending criteria for banks.
- This option would reduce access to the major source of external capital for the not-for-profit providers who would need to rely on retained earnings to support commercial financing of growth and refurbishment. Private equity is not an option under their formation and mission principles.
- If the transition to more DAPs occurred too quickly, the consequential reduction in RADs might trigger the collapse of some providers, resulting in disruption for

consumers and costs for Government and potentially providers under the Accommodation Payment Guarantee scheme. Consideration may need to be given by Government to introducing transition arrangements to ensure that providers were not left unable to access funding to repay RADs.

- Consumers who do not have access to liquid assets to pay a DAP (or timely access to equity release arrangements such as the Pension Loans Scheme) would likely still need to sell their home or other assets to provide liquidity to meet DAP payments. For some, equity release may be more complicated than paying a RAD, including navigating the potential effects on the age pension of retaining surplus funds from which they would pay their DAPs.
- A system where a significantly greater proportion of accommodation is paid through daily payments, and if alternative capital funding cannot be readily obtained at a reasonable cost, may result in insufficient capital investment in new and refurbished facilities to the detriment of future residents.

Option 3: Retain both RADs and DAPs but introduce changes to create economic equivalence between the two.

This option would see the retention of DAPs and RADs, including the Accommodation Payment Guarantee Scheme. However, changes would be made to the current formula for converting RADs to daily payments so that daily payments reflect the economic cost of capital to providers. Providers would also be permitted to stipulate a preferred payment method (DAP, RAD or combination) that supports their business model.

Under this option, the market and provider business strategies would play a greater role in determining payment methods and prices for non-supported residents.

Advantages:

- RADs would remain a low cost and relatively easily accessible source of capital to fund infrastructure renewal and expansion.
- Banks and other lending institutions can continue to lend for new builds knowing that the inflow of RADs on completion allows early repayment of debt and reduced financial risk.
- Reflecting the economic cost of capital in the DAP may strengthen the viability of providers and reduce the potential for RAD repayment defaults.
- Certainty for consumers of the availability of the Government guarantee would be maintained, at no cost to them.
- The RAD option allows for estate planning certainty for consumers as it is known how much is returned to the estate.
- Providers could determine the payment method that best suits their business needs and strategies, such as their position in the capital expenditure cycle.

Disadvantages:

- Using economic equivalence for converting RADs to DAPs would likely result in higher DAP prices to be paid by consumers.
- Economic equivalence would likely lead to further increases in the value of RAD deposits held by providers.
- The risk to Government of providers defaulting on RAD repayments would still exist, with the potential under the Accommodation Payment Guarantee Scheme for flow-on costs to other RAD accepting providers.
- Choice of payment method would not be open to consumers (contrary to Principle 2) unless the provision of residential aged care services became highly competitive and was reflected in increased consumer power;
    - There would need to be certainty that an efficient market would operate in accommodation pricing and in framing business models. This would not be the case in many outer regional and remote locations.
- If the trend to DAPs over RADs was to accelerate as a result of market forces, it places RAD reliant providers under pressure in a similar way that the removal of RADs would have, and the issues discussed in that option would apply in the same way.
- If changes as part of this option do result in RADs becoming less attractive in comparison to DAPs, the industry needs confidence that capital could be sourced from elsewhere to ensure the required investment in the sector would continue, as set out in Principle 6.
- It is not apparent what the conversion factor for achieving economic equivalence should be. Use of the Weighted Average Cost of Capital (WACC) poses several problems, including providing a competitive advantage to providers with a lower WACC.
- In ACFA's advice to the Minister in May 2013, ACFA concluded that as a "conversion factor", the WACC was inferior to the MPIR.

Option 4: Prohibit new RADs with effect from a fixed date

This option would see RADs being removed from the sector entirely by setting a fixed date after which no new RADs would be allowed. Existing RADs would remain, but after the implementation date all new residents would pay a DAP (a rental payment). This would over time bring Australia into line with many other countries whose residential aged care providers largely rely on equity and debt to fund capital expenditure.

Given that RAD deposits currently total $32 billion, and are expected to increase further, their removal as a source of capital would be a major change to current financing arrangements for many providers and lenders.

The timing and mechanism for such a change would need to be carefully managed to prevent having too disruptive an impact on the sector. This could be achieved, for example, by setting a notice period after which RADs would be prohibited, or by gradually capping the percentage of the accommodation payment that could be taken as a RAD until it reaches zero.

These options would allow RAD exposed providers to transition to rental payments in a managed way, but within a fixed timeline.

Advantages:

- A simplified arrangement for consumers – everyone with means would pay a rental style payment, the calculation of which would be easy to understand.
    - A rental style payment would also be consistent with the rental style payment (daily accommodation supplements) that government makes to providers on behalf of low means residents.
- Consumers would not be exposed to pressure from some providers to make RAD payments, thereby avoiding the need for regulation to support consumer choice between RAD, DAP and combination payment methods.
- Concerns over the need to instigate and the stress of a rushed sale of the resident's former home would be reduced, but not entirely removed as many in-coming residents will not have ready access to liquid assets to make rental payments.
    - This could be addressed by improving timely consumer access to equity release schemes, such as the Pension Loans Scheme, though this could add complexity if access is not streamlined and affordable.
    - A variation on the Pension Loans Scheme which may reduce complexity for consumers is for the Government to recover resident accommodation payments that accrue from the person's estate.
- A focus on rental payments would better match the anticipated trend towards shorter lengths of stay in residential aged care.
- The Government's RAD guarantee liability would be gradually reduced over time and eventually removed completely, eliminating the need for the Accommodation Payment Guarantee Scheme and extensive and costly prudential regulatory arrangements; the risk of RAD default costs incurred under the Scheme being recovered from non-defaulting providers would also be eventually completely removed.
- Applied in conjunction with other reforms such as removal of rationing and 'funding following the consumer' through abolition of the ACAR, this would operate as a structural adjustment mechanism. Some providers would have difficulty accessing capital for the current form of aged care homes but some (existing or new) providers may diversify the form and funding of residential care to respond to changing consumer preferences for a more 'home-like' care experience.

Disadvantages:

- The change would remove an element of choice for consumers (contrary to Principle 2) – noting that despite the recent trend towards DAPs, 30 per cent of residents currently entering residential care are using RADs and 23 per cent use combination payments.

- Providers will need to source more expensive debt or equity to fund future growth and renewal. It is unlikely this would be possible given the current financial environment of lower returns being made by many providers.
    - RADs were introduced for all new residents as part of the LLLB reforms in order to improve provider access to capital for infrastructure renewal and expansion in response to a marked slowdown in new capital investments.
- There would need to be greater pre-debt levels of return for providers in order to support more expensive capital raising.
    - While there may be equity investors seeking investment opportunities in aged care, it is doubtful whether the current returns for residential aged care providers are adequate to attract them.
    - Debt providers would lose the certainty of a RAD inflow on completion of a new build, which currently allows early repayment and reduces risk. They are likely to charge a higher premium to compensate for longer term debt and increased risk. Debt availability would be impacted with terms less likely to meet usual lending criteria for banks.
    - This option would remove a major source of external capital for not-for-profit providers who would then need to rely on retained earnings to provide equity to support the commercial financing of growth. Private equity is not an option for not-for-profit providers under their formation and mission principles.
- If sufficient notice were not given, it could potentially trigger the collapse of some providers. Consideration may need to be given by government to introducing transition arrangements to ensure that providers were not left unable to access funding to repay RADs.
- Consumers who do not have access to liquid assets to pay a DAP (or timely access to equity release arrangements such as the Pension Loans Scheme) may still need to sell their home or other assets in any case to provide liquidity to meet DAP payments. For some this may be more complicated than paying the lump sum RAD, including navigating the issues of the effects this may have on the age pension of retaining surplus funds from which they would pay their DAPs.
- A system where all accommodation is paid through daily payments, and if alternative capital funding cannot be readily obtained at a reasonable cost, may result in insufficient capital investment in new and refurbished facilities, which would be to the detriment of residents in the longer term. This is contrary to ACFA's Principle 6.

Conclusion

RADs (and bonds prior to July 2014) have provided, and continue to provide, a valuable source of capital for many aged care providers. RADs offer interest-free access to capital for providers wishing to build new capacity or refurbish existing rooms that meet community standards, and allow providers to be less restricted by conventional lending requirements.

RADs are also favoured by banks as they allow early repayment of debt on commissioning of services and involve significantly reduced financial risk.

The extension of the availability of RADs to all new residents from July 2014, together with the increased Accommodation Supplement for low means residents living in new and refurbished homes, resulted in greater access to capital and underpinned substantial increased investment in the renewal and expansion of aged care homes following the LLLB reforms. Most of the building expansion and upgrading since 2014 has been by large for-profit and not-for-profit providers using RAD capital and short-term bank finance.

The need for continued investment remains, with over $50 billion projected to be required over the next decade, as is the need to replace RADs that are paid out when consumers are no longer resident in the aged care home.

Consumer choice of payment method was a foundation principle of the 2014 reforms to accommodation payment arrangements. Some consumers choose RADs, some choose DAPs and some choose a combination of the two, with varying proportion of RAD/DAP within those combinations. Overall, consumer preferences have shifted gradually towards DAPs over RADs since the accommodation payment reforms came into effect in 2014.

ACFA considers that this choice of payment method remains an important principle.

Provider preferences for RADs vary considerably. Twenty-five per cent of providers prefer to receive a RAD, 23 per cent prefer a DAP, and 20 per cent prefer a combination payment. Around 32 per cent of providers had no preference between receiving a RAD or DAP.

A significant reduction in RAD balances would impact residential aged care providers differently, depending on their reliance on RADs. Providers that would be most negatively affected are those where most of their RADs are invested in new and rebuilt homes. In general, these are large, mostly for-profit providers with most of their facilities located in metropolitan regions.

For providers who have existing high RAD balances, a significant reduction in consumer preferences for RADs would reduce their liquidity as they would need to cover their RAD outflow with alternative finance. Banks may well be reluctant to offer core debt in such circumstances.

A decline in new RAD inflow would also increase the cost of new investment in aged care homes as providers would need to access higher cost debt or equity.

A decline in occupancy can also reduce RAD numbers and balances. Occupancy decline is likely to be experienced most by older facilities, especially those with multi-bedded rooms. Small providers with such facilities would also have difficulty sourcing bank lending.

The impact of a reduction in RADs is dependent on the rate at which the reduction occurs, as well as the implications for the lending criteria of the banks and other debt providers and for investors.

The current trend of an increasing consumer preference for DAPs over RADs, while noticeable, is relatively gradual and the sector has been able to adjust and accommodate the

reduction in incoming RADs. However, some providers have expressed concern and favour the ability of providers to mandate RADs as a condition of entry.

As shown in the Macquarie University report, the reliance on RADs, and therefore the impact of this trend, varies greatly across the sector. In general, the value of RADs to a provider depends on their position relative to their long-term capital expenditure cycle and their growth strategies.

If the decline in RADs was to accelerate, either by a significant decrease in occupancy or by a change in Government policy to move away from RADs with a short implementation time, a significant number of providers could struggle to adjust. Providers who are more dependent on RADs could struggle to repay debt and may face liquidity pressure. Additionally, the finance market would be unlikely to be able to provide sufficient debt for providers given the higher cost of that debt and a greater reliance by financiers on conventional lending requirements.

ACFA notes that a significant number of providers are already excluded from accessing commercial debt despite holding RADs as they do not meet lending criteria such as size, management experience, and strong financial positions. Allied to this, historically there has been a broad spread in provider financial performance across the sector, which is still evident with the recent financial pressures being experienced across the sector.

The diversity of financial performance remains an issue for Government in that any additional funding to the sector designed to improve returns in order to access higher cost debt and equity in the absence of RADs would add to the returns of the top performing providers as well. Hence, simply increasing funding may reward inefficient providers and create disincentives for more efficient and effective providers.

ACFA's Position

In coming to a position on the future of RADs, ACFA notes the diversity of consumer preferences for DAPs, RADs and combinations, notwithstanding a gradual shift towards DAPs; current dependence of the sector generally on RADs to fund service renewal and expansion; the differing ownership types of providers and the consequence for accessing external equity; the issues related to the availability and cost of sourcing debt; and the very varied use of and reliance on existing and prospective RADs by providers.

The shift in consumer preference to DAPs over RADs, albeit gradual, may continue, and is dependent on a number of factors including the rate of the MPIR (which has limited scope to decline much further), the availability of additional home care packages and their impact on length of stay, changes in occupancy rates and increasing competition amongst providers.

The sector could most probably absorb a small gradual reduction in RAD balances. However, if a significant reduction were to occur in a shorter timeframe, it appears unlikely that banks and investors could provide sufficient funding to meet the future capital financing requirements of the residential aged care sector.

In the circumstances, ACFA concludes that there is no obvious and immediate alternative to RADs for non-government financing of capital expansion and renewal. Having a system that includes, in some way at least, both RADs and DAPs and consumer choice of payment method, continues to be appropriate.

Given how dependant the current system is on RADs, any significant policy move away from RADs would have to be transparent, gradual, involve sector consultation and occur alongside increased returns for the sector as a whole – noting the current diversity of financial performance across providers. Additionally if the trend away from DAPs was to accelerate, the sector would be placed under increasing pressure and may require targeted Government intervention.

There are, however, financial risks associated with RADs. The Government guarantees RAD repayments for consumers through the Accommodation Payment Guarantee Scheme. In the absence of other viable insurance arrangements, this provides the necessary protection for consumers. But the Government guarantee also provides comfort for providers in accepting RADs, and has led to risky financial management behaviour by some providers. There are also the ever present general insolvency risks associated with businesses operating in any sector of the economy.

ACFA considers, therefore, that there are changes required, as discussed under Option 1, to improve and strengthen the operation of the current system:

- Noting the size of RAD balances and the prospect of continued growth in RAD balances, there is an urgent need to strengthen prudential regulations, including liquidity and capital adequacy standards, and to improve financial reporting to support more effective monitoring of individual provider solvency and financial strength. Any changes to strengthen prudential arrangements would need to be phased in to allow providers who may need to adjust their financial arrangements time to adapt.

- Additionally, the Government could consider a form of risk premiums to be paid by providers for the guarantee. This cost would likely be passed on to the consumer. ACFA has not examined this option. While acknowledging that providers cannot refuse a RAD payment, mandatory recovery of default costs under the Accommodation Payment Guarantee Scheme from RAD holding providers might see the contingent liability involved reflected in RAD prices.

- More needs to be done to better enforce the consumer's ability to freely choose their form of accommodation payment. This requires both greater scrutiny of any pressure being placed on consumers by providers and access by consumers to appropriate information and appropriate and qualified financial advice.

With or without a system of RADs, there will be a continuing need for capital and other assistance to ensure the availability of aged care services in 'thin' markets such as rural and remote locations and for services targeting certain disadvantaged groups such as the aged homeless.

ACFA acknowledges that, under current policy parameters, the residential care sector's overall financial performance is unsustainable. It is also apparent that this is one of the factors that would make it difficult for providers to access capital from banks and equity investors should RADs continue to fall. However this issue is a broader and more complex policy issue than the focus of this report.

Policy on the future of RADs should therefore be considered in the context of prospective reforms arising from the final report of the Royal Commission, including policies to increase flexibility for older people living in their own home (rather than in an aged care home) and policies to increase consumer choice and greater competition in service provision. Together, such policies are likely to generate more market-driven innovation in accommodation models in response to consumer preferences, which still may involve a form of congregate living.

Flow-on implications for current policies regarding the quality regulatory framework, means testing, access by people with lesser means, subsidy entitlements and user contributions across accommodation and care would have to be taken into account. To the extent that alternative accommodation models emerge for older people, policy considerations would also have to interface with existing public housing policies for seniors.