Australia needs a new approach to capital financing of residential aged care

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1 Principles to underpin a new approach to capital financing

Australia's approach to paying for residential aged care land and buildings – 'capital financing' – is not fit for purpose. The capital financing settings need to be re-designed to uphold older Australians' rights and community interests.

This submission identifies the key problems with the current model and proposes a principles-based solution.

1.1 The aged care system should be designed according to clear guiding principles

A new capital financing system should be based on clear guiding principles to ensure that the model meets community expectations, rather than merely the interests of providers. The current system has developed over time, with each new problem addressed by making a tweak and adding complexity. The upshot is an opaque, inefficient, incoherent system. The new system should sweep away the current model, starting again with a coherent and logical approach.

Two sets of principles should inform the new capital financing model.

1.1.1 Rights-based principles

The first are consumer-oriented, rights-based principles to ensure the system upholds older Australians' rights in aged care. These rights are detailed in Grattan's recent report *Rethinking aged care: emphasising the rights of older Australians*.[1] In the context of capital financing, the following principles are relevant:

- Universal access: All older Australians in need of care and support should have access to residential aged care, regardless of geography, financial position, or other factors, and the services should be at an adequate standard.
- Informed choice and control: All older Australians should have genuine choice among residential aged care accommodation and payment options. Individual circumstances should not artificially constrain choices or force older Australians into a particular decision.
- Equity: Older Australians should pay for their accommodation and everyday living costs where possible; just as other Australians do. But older Australians without the means to pay must be looked after, and a minimum level of service should be guaranteed through government support.

1.1.2 System-level design principles

The second set of principles reflect broader community interests and should underpin system design. These include:

- Accountability: Transparency and accountability are necessary to ensure that taxpayer and consumer funds given to providers are used effectively and in the interest of the community.
- Efficiency: The capital financing model must make efficient use of residents' and taxpayers' funds to ensure quality and service standards.
- Feasibility: The model for capital financing in aged care must be sustainable, commercially viable, and politically feasible to ensure that it is implemented effectively and for the long term.

1. Duckett et al (2020).

2 Three concerns with the current capital financing model

The current model has three major problems that undermine access and choice for aged care residents.

2.1 Limited choice

Older Australians are in a vulnerable position when entering residential aged care and negotiating the terms of payment. Incoming residents are often frail and dealing with major health issues or impairments. The decision to enter residential care may have been made quickly as a result of a health event, leaving little time to plan and choose a facility.

There is a power imbalance during payment negotiations between providers and incoming residents. The current financing model encourages providers to seek a Refundable Accommodation Deposit (RAD) from the new resident. However, the provider receives a greater financial benefit from the RAD than residents (see next section).

Although incoming residents ostensibly have a choice between paying a RAD, a daily accommodation payment (DAP), or a combination of both, providers may pressure incoming residents to select the RAD payment method.

The financial status of some residents may leave them no option but to pay the RAD. This group of incoming residents have low income but high assets. They do not have the cash available to pay the DAP, but their high assets mean they do not qualify for government support. These incoming residents then unavoidably face the often-stressful process of selling their home quickly to pay the RAD.

The RADs represent an implicit subsidy from residents to providers, yet the extent of the subsidy is neither transparent nor equitable.

2.2 Interest-free RADs are not fair for all residents

The RAD is, as its name implies, refundable to the resident or their estate. However, what is refunded is what was deposited. Unlike any other use of capital, there is no capital growth and no interest payment. In return for this interest-free deposit, the resident gets an implicit discount on their rental charge equivalent to the DAP, but the discount is calculated at the 'Maximum Permissible Interest Rate' (MPIR), which is currently set at 4.1 per cent,[2] significantly below what the resident would have earned on their deposit if they had maintained it in their superannuation fund or as a private investment.

Access to interest-free financing is an outsized benefit to residential aged care providers, who would otherwise have to pay borrowing costs at the market rate, estimated by Frontier Economics as 5.9 per cent.[3]

For the average RAD of $318,000,[4] providers save $18,762 per year in interest.[5] Residents forgo the benefits of investing this money themselves when they enter into a RAD, but get a partial off-setting rental saving of $13,038.[6] The considerable saving that providers enjoy through this unique, off-market financing facility is inequitable.

In the past, this subsidy to investors may have been necessary to ensure access to capital – and it may still be the case that small or not-for-profit providers don't have a balance sheet which would support borrowing. But these capital market imperfections should be tackled

2. Royal Commission into Aged Care Quality and Safety (2020, p. 11).
3. Frontier Economics (2020, p. 34).
4. Royal Commission into Aged Care Quality and Safety (2020, p. 11).
5. Calculated as the interest cost on an average RAD of $318 000 at an interest rate of 5.9 per cent.
6. Calculated as the annual rental payment on $318,000 at an MPIR of 4.1 per cent.

directly rather than through opaque, complex, and inequitable subsidies from some residents to all providers.

2.3 RADs encourage undesirable investment

The vast majority of older Australians want to receive care at home, rather than in a residential care facility. Yet the current financing model encourages a growing residential aged care sector. The interest-free financing for residential care providers encourages reinvestment of these funds into yet more residential care infrastructure.

As home-based care increases, demand for residential care will fall. The upshot is more investment in residential aged care than the community needs. Some of this will be wasteful investment in underutilised facilities. The over-investment in residential care, driven by low-interest RADs, is thus an economically inefficient use of resources.

3 Grattan Institute's proposed new capital financing model

Australia needs a new capital financing model that increases transparency, ensures efficiency, and realises the rights of older Australians in aged care. The RADs cannot meet these criteria and should be phased out. A new system should be transparent, equitable, and ensure adequate capital financing, but avoid the waste of over-investment.

3.1 Residents should pay rent

A new capital financing model should assume that residents pay for capital through rental-like payments.[7]

People on low incomes should be supported with government means-tested payments which should cover, in part or in full, the cost of a residential aged care room at a defined, 'acceptable quality' level.

People with low incomes but with high assets should have the option to pay rent on an on-going basis or to have an equivalent value deducted from their estate after death (in which case the required payment would grow at the government's financing rate).[8]

Rental payments would vary according to the specific room and facility chosen. Rental costs for residents should be regulated so they meet the reasonable costs of capital financing as outlined in Section 3.2.

7. It may be appropriate to bundle rental and other 'lodging' payments, such as meals.
8. This follows Paul Keating's recently proposed 'HECS' model for aged care payments. Under his proposal, payments for aged care would be deducted from the resident's estate after departure from aged care. Payments would be paid up-front by the government to providers, and the balance would become a concessional loan made by the government to the resident. See Pagone and Briggs (2020, P-9102).

3.2 Residential aged care is a social benefit, so government should support its capital financing

Phasing out RADs will require an alternative source of financing. Requiring providers to source their own financing at market rates would impose a significant interest burden on providers and compromise the viability of many, leading to a reduction in quality of care and accommodation across the sector. Some providers may be unable to refinance; the market has proved reluctant to finance residential aged care providers, especially smaller ones, who are often perceived as high-risk debtors.[9]

In the absence of RADs, the financing problem may become too little capital rather than too much. Government should recognise this market failure with capital support through loan guarantees. The new capital financing model should recognise that residential aged care is part of the social infrastructure, and so government funding should be available to facilitate capital developments of both for-profit and not-for-profit providers.

Government should create a financing facility to fund capital investment in residential aged care – including land and buildings – through concessional loans, where the facility's funds are raised through government bonds. Providers should be able to apply to the facility for capital grants, which would finance new facilities, facility upgrades, and repayment of RADs (to enable a smooth transition to the new model).[10]

9. Royal Commission into Aged Care Quality and Safety (2020, p. 9).
10. A similar model is in place with the National Housing Finance and Investment Corporation (NHFIC), which serves as an instructive precedent. See the *National Housing Finance and Investment Corporation Investment Mandate Direction 2018, Part 3*.

Government financing should be based on normal prudential requirements and business cases — ideally assessed locally -— to ensure the government's risk is minimised and the investment meets community needs and aged care policy goals.

To ensure viability, business cases should include realistic estimates of local demand for residential care. Government guarantees should be contingent on the proposed development meeting social obligations, including a specified minimum threshold of places being available for pension-eligible residents.

Residents' rental payments (as per Section 3.1) should be linked to the government's cost of financing, enabling the government to recover principal and interest costs of any financing facility grants over the course of the asset's life.

3.3 How to move to the new model

RADs should be phased out as residents die or move to a different facility.[11] The government financing pool should be made immediately available so that providers can begin making applications for financing where needed as RADs are phased out.

At the same time, all new residents to residential care facilities should make rental payments.

The financing pool must be large enough to retire existing RADs as residents leave residential aged care. This sets the minimum size of the fund at $30.2 billion (the current stock of RADs). This figure does not represent an increase in risk for the government, since RADs are already guaranteed by the Commonwealth. Nor does it represent an increased interest or long-term debt burden, because residents' rental payments will fully cover the government's costs.

Grattan's proposed new arrangements are fair to both providers and consumers because capital costs are covered. However, they are not as generous to providers as the current arrangements, because the providers will no longer accrue all the benefits of the interest-free RADs.

If other policy initiatives are implemented – especially expanded homecare – there will be reduced demand for residential care, and so market pressure will reduce the ability of providers to pass on to consumers increased charges in an attempt to restore their previous position.

11. It may be appropriate to set a maximum phase-out, say five years, to simplify system covenants. At the end of this period existing RADs would be bought out.

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