Managing Prudential Risk in Residential Aged Care

Discussion Paper

Attachment A: Additional supporting technical information

Part 2 of the Managing Prudential Risk in Residential Aged Care discussion paper contains further technical information on a number of the EY options including;

- Option A1
- Options B1 and B2
- Options C1 and C2
- Option D3

EY option A1:

Require Approved Providers (providers) to report their corporate structures including the identity of ultimate shareholders and any significant changes to their ownership.

'Investments in Associates and Joint Ventures' is an accounting standard developed by the Australian Accounting Standards Board (Standard 128). The Standard addresses the matter of 'significant influence' in sections 5-9 as follows.

Significant influence:

5. If an entity holds, directly or indirectly (e.g. through subsidiaries), 20 per cent or more of the voting power of the investee, it is presumed that the entity has significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the entity holds, directly or indirectly (e.g. through subsidiaries), less than 20 per cent of the voting power of the investee, it is presumed that the entity does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an entity from having significant influence.
6. The existence of significant influence by an entity is usually evidenced in one or more of the following ways: (a) representation on the board of directors or equivalent governing body of the investee; (b) participation in policy-making processes, including participation in decisions about dividends or other distributions; (c) material transactions between the entity and its investee; (d) interchange of managerial personnel; or (e) provision of essential technical information.
7. An entity may own share warrants, share call options, debt or equity instruments that are convertible into ordinary shares, or other similar instruments that have the potential, if exercised or converted, to give the entity additional voting power or to reduce another party's voting power over the financial and operating policies of

another entity (i.e. potential voting rights). The existence and effect of potential voting rights that are currently exercisable or convertible, including potential voting rights held by other entities, are considered when assessing whether an entity has significant influence. Potential voting rights are not currently exercisable or convertible when, for example, they cannot be exercised or converted until a future date or until the occurrence of a future event.

8. In assessing whether potential voting rights contribute to significant influence, the entity examines all facts and circumstances (including the terms of exercise of the potential voting rights and any other contractual arrangements whether considered individually or in combination) that affect potential rights, except the intentions of management and the financial ability to exercise or convert those potential rights.
9. An entity loses significant influence over an investee when it loses the power to participate in the financial and operating policy decisions of that investee. The loss of significant influence can occur with or without a change in absolute or relative ownership levels. It could occur, for example, when an associate becomes subject to the control of a government, court, administrator or regulator. It could also occur as a result of a contractual arrangement.

https://www.aasb.gov.au/admin/file/content105/c9/AASB128_08-11.pdf

EY Option B1:

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

Current legislation

Section 43 of *Fees and Payments Principles 2014 (No.2)* (Principles) require providers to have sufficient liquidity in order to refund refundable deposit balances, accommodation bond balances or entry contribution balances, which can be expected to fall due in the following 12 months.

This is intended to ensure that providers maintain ready access to funds to allow them to repay lump sum balances, as, and when, they fall due. The *Explanatory Statement* to the Principles sets out that;

- ‘for example, as at any specified dated of the year (e.g. 5 June), a provider would need to have enough liquidity for the next 12 months, not just until the end of the current financial year’.

Section 44 of the Principles requires providers to implement, maintain and comply with a written liquidity management strategy (LMS), which must set out;

- the minimum level amount, expressed in whole dollars, that ensures that the approved provider has sufficient liquidity for the purposes of section 43 (the minimum level of liquidity);
- the factors that the provider had regard to in determining the minimum level of liquidity; and
- the form in which the provider will maintain the minimum level of liquidity.

The *Explanatory Statement* also sets out that;

- ‘providers are expected to determine (and assess) relevant factors based on their own individual circumstances and experiences.

  Examples of the types of factors that providers may wish to consider include, their historical pattern of refunds, the characteristics of the care recipients for whom they care that may influence the timing of refunds, the average value of lump sums held and the likely timing and value of any incoming lump sum payments’; and

- ‘in order to ensure that a provider is able to meet its obligation to refund lump sum balances as they fall due, it is important that the minimum level of liquidity for an provider is maintained in a form(s) that can be readily accessed. There is a wide range of financial instruments that have a high level of liquidity including, for example, cash, bank deposits, bank bills, stand-by lines of credit and guarantees’.

In addition, a provider should keep their LMS up to be to date and that it continues to comply with the requirements described above. It should be modified or replaced if or where the current liquidity management strategy no longer complies with the requirements described above.

Analysis of data - Information on the Annual Prudential Compliance Statement Guide (APCS guide)

Current guidance available to providers on what the Department considers to be ‘sufficient liquidity’ mirrors what is outlined in the *Explanatory Statement*. The Department makes available the APCS guide which sets out that providers are expected to maintain liquidity in a readily accessible form to refund accommodation payment as they fall due, including in the form of;

- cash,
- bank bills,
- stand-by lines of credit, and
- guarantees.

Ultimately, it is the responsibility of the provider to determine the appropriate form(s) in which their minimum level of liquidity will be maintained.

Letters of comfort do not provide a form of liquidity suitable to meet the Liquidity Standard. In considering the form(s) in which they hold their minimum level of liquidity, providers may also wish to consider cost issues. The cost to providers could be considered in terms of both the actual cost of accessing the funds (that is, the actual cost of the transaction) and the economic cost (the difference between the purchase price and the price realised on disposal).

For example, liquid instruments such as cash and financial products like term deposits have relatively low costs as the fee for accessing them is not significant and they can be redeemed at their face value. Given this, if the provider is following the guidelines set out by the Department, then current information on liquidity is accurate.

EY option B2.

Phase in the [proposed] liquidity threshold over a 5-10 year period. For example, require 5% within 5 years; 7.5% within 7.5 years and 10% within 10 years.

Calculation of prudential and financial information submitted by providers

First method of calculation – based on the existing APCS guide

Providers reporting on the level of liquidity that they maintain could use the information within the APCS guide as a basis for determining what is considered by them to be 'sufficient liquidity'.

Based on the above assumption an analysis of 869 residential providers who reported holding RADs in 2016-17 showed:

- 669 had a minimum liquidity level greater than 10% of their RADS; and
- 200 had a minimum liquidity level of less than 10% of their RADS.

(Table B2.1 reproduced from the discussion paper)

Liquidity ranges: less than 10% liquidity	**Amount of providers currently in that range**	**Period of time (recommended phase in - years)**	**Period of time (alternative phase in - years)**
7.5-10%	6.7%	5	2
5.7.5%	8.2%	7.5	4
0-5%	8.2%	10	6

A total of 669 or 77 per cent of all providers were assessed as having adequate liquid assets to achieve a minimum 10 per cent liquidity threshold in 2016-17. On that basis, and where maintained, they would not be adversely impacted by the implementation of EY's option.

Of 200 providers assessed as holding less than 10 per cent liquidity (at the time of reporting);

- 58 (6.7% of 200) reported holding a minimum level of liquidity between 7.5 and 9.99 per cent;
- 71 (8.2%) reported holding a minimum level of liquidity between 7.5 and 5 per cent; and
- 71 (8.2%) reported holding less than 5 per cent.

Second method of calculation

Using the sum of the GPFR fields Cash Assets and Liquid Financial Assets as a reasonable approximation of Liquid Assets, a check of the 200 Providers who reported holding a level of liquidity below 10 per cent through their APCS, shows:

- 131 have liquid assets **above** 10 per cent of RADS;
- 6 reported holding a minimum level of liquidity between 7.5 and 9.99 per cent;

- 10 reported holding a minimum level of liquidity between 7.5 and 5 per cent; and
- 53 reported holding less than 5 per cent.

This means that of the overall 869 Providers only 69 (8 per cent) would be impacted through the implementation of a minimum 10 per cent liquidity threshold.

Note: the APRAs liquidity guidelines for Banks could be used to inform the development of an LMS.

http://apra.gov.au/adi/Documents/cfdocs/Liquidity-Management-April-1998.PDF

EY Option C1:

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

Possible options for implementation: ***Option 1 - Tangible Common Equity Ratio***

This ratio measures an organisation's tangible equity as a proportion of its tangible asset value[1]. The result produced approximates the value of an organisation in the event of insolvency. The chance of recovering the value of intangible assets and goodwill is extremely low when a business becomes insolvent and hence their value is excluded from the calculation.

Based on the 2016-17 GPFR data received at approved provider level, the whole of sector tangible common equity ratio was estimated to be 41 per cent. ACFA notes that the sector held more than $3.4 billion in intangible assets as at 30 June 2016[2]. If this metric was adopted, approximately one third of providers would be impacted as they have a tangible common equity ratio of less than 20 per cent.

Option 2 – APRA's Prudential Standard for Capital Adequacy APS 110

APRA's prudential standard outlines capitalisation requirements for Authorised Deposit Taking Institutions (ADI's)[3] including the minimum level and quality of capital that ADI's are required to maintain to mitigate against the type, amount and concentration of risks to which the ADI is exposed.

ADI's hold both Tier 1 capital consisting of funding sources which can be paid out without the need to trigger a bankruptcy (e.g. from retained earnings), and Tier 2 capital which is lower in quality and utilised only when the Tier 1 capital has been exhausted[4] (e.g. subordinated debt). Tier 1 and Tier 2 capital are valued after all deductions such as goodwill and other intangible assets that lose value in the event of a bankruptcy.

APRA has set bank equity targets at 10.5 per cent, up from Tier 1 equity capital of around 9.5 per cent[5] of their risk weighted assets. If this metric was adopted, it may help to

[1] Defined as total assets less tangible assets before liabilities.
[2] ACFA's 'Fifth Report on the Funding and Financing of the Aged Care Sector' p109
[3] Including banks.
[4] Australian Bank Capital and the Regulatory Framework, Bulletin Sept Quarter 2010
[5] "APRA lifts bank equity target to 10.5pc for 'unquestionably strong' benchmark", AFR, 19/7/2017

improve the quality of capital that supports the RAD balances, provide a financial buffer and reduce the risks of financial distress.

Timeframe for adoption:

The capital adequacy requirement for either option could be phased as follows:

Equity levels	Timeframe for achievement
2.5%	3 years
5%	5 years
12.5%	10 years
20%	15 years

Special consideration will need to be given as to whether a longer timeframe should be given for not-for-profit, CALD and community based providers to achieve the proposed capital adequacy requirements. Such providers can hold low levels of cash and equity. Their main asset is the land and buildings, and this is often equalled or exceeded in value by the liability for RAD balances with any profits derived being generally returned into the business. It will be especially challenging for these providers to generate adequate capital reserves.

Consideration could also be given for whether different capital adequacy thresholds should be set for different sizes of providers. An example could be:

RAD holdings	Capital adequacy threshold
<$3 million	15%
$3-$15 million	17.5%
>$15 million	20%

Risks and benefits of proposed approach

Proposal	Risks	Benefits
Introduce capital adequacy requirements.	Some providers will have difficulty in improving their level of capital adequacy within the timeframes allowed. Capital adequacy levels of 20 per cent may not be sufficient (banks operate as secured creditors to businesses and use 20%). Alternative capitalisation levels for different sections of the sector may be seen as	Improves the quality of capital supporting the RAD balances and the financial strength of the sector. Improves provider awareness and focus on the balance sheet results. Reduces the risk of the Guarantee Scheme being triggered.

Proposal	Risks	Benefits
	being unfair to the for-profit sector.	
Development of a capital management plan and strategy.	Providers may not have the skills to develop a capital management plan. Providers may not adopt and follow the capital management plan.	Improves provider focus on the balance sheet results.
Reporting of compliance levels with capital adequacy requirements – we receive the annual data to check at year end so reporting may just relate to whether the level was maintained all year	Will providers self-report matters of non-compliance? There may be legitimate business reasons where capital adequacy requirements are not maintained – e.g. purchase of new facilities. Additional compliance costs.	Self-reporting of non-compliance with capital adequacy levels may provide an early indication of future financial distress.

EY Option D3:

Require Approved Providers to adopt an industry standard such as APS330. 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)**
- **Compliance with the capital adequacy metric (including any period of noncompliance and how it was rectified)**

Summary: Public Disclosure – Prudential Standard APS 330

- Prudential Standard APS330 is made under s11AF of the *Banking Act 1959* and applies to all locally incorporated approved deposit taking institutions (ADIs) other than purchased payment facility providers.

Key principles

- The key principles of APS 330 include, that the ADI must make accurate, high quality and timely public disclosures of information on aspects (and metrics) of its

operations so as to contribute to the transparency of financial markets and market discipline (s7).

Disclosures must be consistent with the scope and complexity of operations and sophistication of its risk systems and processes (s8). Examples of information to be disclosed include risk profile, capital adequacy, leverage ratio and liquidity coverage ratio (LCR). For some matters e.g. LCR, the ADI must also include qualitative discussion to facilitate the user's understanding including discussion of the drivers of the LCR results.

In addition, depending upon the circumstances, including where results or processes have changed materially, APRA may require more information from the ADI and/or more frequent reporting.

Authorisation/governance

- ADIs are required to have a formal policy relating to their prudential disclosures approved by their boards. Policies should ensure that disclosures are appropriate and verified for accuracy.

Power to require verification

- In instances where APRA has reason to believe the disclosure is inaccurate of misleading, APRA may require the ADI to commission an independent audit of its prudential disclosures.

Medium of disclosure

- ADIs' must publish disclosures on their own web sites or seek permission from APRA for alternative arrangements.

Frequency and timing of disclosures

- APRA requires some disclosures at the time of Balance Sheet reporting (annual) and others on a 'continuous' basis e.g. capital instruments and their features (within 7 days); risk exposures and assessment e.g. capital adequacy (quarterly)

Materiality

- In making a disclosure, ADIs must decide which prudential disclosures are material (immaterial disclosures are not required). Information is regarded as material if its omission or misstatement could change or influence the assessment or decision of a user relying on that information for making economic decisions.

Note: Refer to 'Excerpts from key legislation including Prudential Standards and Permitted Uses', for the full text of the Disclosure Standard.