

Long Term Care Insurance Decisions: An Alternative Strategy

This analysis demonstrates a viable alternative for middle-income, moderate-asset consumers who are considering purchasing LTCI. Seldom is the option of self-insuring against the need for long-term care assistance suggested in the financial press. In light of the evidence of the 75% lapse rate on policies, self-insurance is an option that should be considered by consumers who have recently purchased LTCI policies. Because of the uncertainty of future income, likelihood of letting a policy lapse, and the negative ramifications of dropping a policy after paying premiums for years, we urge educators to suggest the self-insurance option to consumers. While long term care may be required by younger persons, the focus of this analysis is on the elderly. This alternative approach to financing LTC adds a new dimension to the discussion. The resources can be passed onto heirs in the event that no or little long term care is required. The bottom line for most retirees is that they will likely need to draw upon the assets to finance routine living expenses.

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Deciding whether to buy long term care insurance presents a conundrum. Will you need it? Can you afford it? Can you afford not to purchase the insurance? Long term care insurance (LTCI) is being aggressively marketed by sales people anxious to motivate potential buyers by citing high nursing home costs and statistics on likely need for care. Much like life insurance, LTCI is “sold and not bought.”

The decision on LTCI is often presented by consumer educators and mass media writers (Franklin, 1999) as a two stage decision making framework: first, can I afford it, and second, to buy or not to buy. Low income, low asset consumers simply cannot afford insurance and must rely on Medicaid to pay their bills if they need nursing home care. High income, high asset consumers have sufficient resources to self insure for the costs of long term care but still have the option to purchase insurance to preserve their assets for a bequest. For those in the middle, the fear of an extended nursing home stay depleting one’s retirement resources, as well as the resources of their spouse, presents the question of whether to purchase LTCI.

To buy or not to buy, is that really the question? This paper presents an alternative consumer decision making framework for funding long term care. There are problems with the one-dimensional emphasis on either buying insurance or depleting assets to pay for care. Insurance is only one strategy for dealing with the risk of long term care expenses. Although LTCI is marketed primarily as a means of covering nursing home expenses, policies generally cover assisted living facilities and home health care, but at a percentage of payments for nursing home care. For example, some policies pay 50% of the nursing home benefit for home health care expenses. What is left out of the discussion in virtually all articles, web sites and resources on long term care is the third option: to self insure by investing the annual premium. This paper presents an alternative approach to financing long term care expenses through self-insurance using the basic principles of time value of money analysis.

Background and Review of Literature

Long term care insurance is being aggressively marketed to baby boomers and retirees who are concerned about the potential expenses of nursing home care. The number of companies selling LTCI grew dramatically from 30 insurers in 1986 who sold about 200,000 policies, to 125 insurers in 1995 selling 4 million policies (McNamara & Lee, 2003). With nursing home costs averaging \$50,000/year (HIAA, 2002), a lengthy nursing home stay for one spouse could

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deplete a couple's retirement assets. Many midlife boomers are experiencing the costs incurred by their elderly parents. Numerous mass media articles play heavily on the scare tactics of escalating costs. Most of these sales pitches present a dichotomy: "buy insurance" or "go bare" and risk depleting one's assets.

Low income and asset consumers cannot afford LTCI and will have to depend on Medicaid to cover their expenses. The financial status and security of Medicaid funding is a separate issue not addressed in this paper. The wealthy have sufficient assets to self insure as well as the resources to purchase insurance if they choose. The extensive middle income and asset group faces the decision of whether to purchase LTCI. If they delay purchasing, the premiums will be substantially higher at an older age. However, insurance actuaries have calculated costs so that those persons who purchase early for lower premiums pay for a longer period, on average, and those who delay purchase pay higher premiums but for a shorter time period. Taking into consideration the time value of money, each consumer pays a similar amount, but the earlier purchaser buys more years of protection and peace of mind as long as they continue to pay premiums.

A number of guidelines have been developed as to who should consider purchasing LTCI, at what age one should consider the purchase, and comparison shopping suggestions. The United Seniors Health Cooperative web site <<http://www.ushc-online.org>> offers the following guidelines on whether to buy LTCI. Buy LTCI only if:

1. you have assets of at least \$75,000 (excluding home and auto)
2. you have retirement income of at least \$25,000/person/year
3. paying the premium will not adversely affect your lifestyle (pay no more than 7% of your income on premiums)
4. you have the ability to absorb increases in premiums during your lifetime.

The average age at which Americans enter nursing homes is in their mid-80s (Metlife, 2002). No data were found on the age at which Americans enter assisted living facilities or start paying for in-home care. Due to steep increases in initial premiums with age, policies often appear to be most affordable for persons in their mid 50s to early 60s. Because this age group is often in its peak earning years, the annual premiums are affordable at this stage. However, a combination of factors make premiums less affordable once one retires: lower income, less income security, and higher premiums at an older age.

Retirement Funding Needs

Especially since the stock market bust of 2000, most baby boomers and pre-retirees need to put their financial resources toward building up their retirement accounts rather than buying an insurance policy that they may never use. Extensive research on retirement savings adequacy of Americans indicates that most boomers and pre-retirees are woefully behind in preparing for the general expenses of a lengthy retirement (Weller, n.d.; Wolff, 2002). Recent studies of residents of Massachusetts, Kansas, and Oregon (EBRI, 2003) reveal that most single women and many single men will have insufficient financial resources to fund even basic living expenses. Although married couples are less at risk of not being able to support themselves in retirement, many married women will eventually become widows at risk. Thus, before considering LTCI the prospective consumer needs to conduct a thorough analysis of their retirement resources, beginning with a longevity analysis. The Planning for a Secure Retirement web site <<http://www.ces.purdue.edu/retirement/>> includes two calculators to project life span based on one's current health and family history. Most Americans need to devote more money and planning time to improving their overall financial security in retirement.

Likelihood of Needing LTC

Some widely cited statistics by LTCI marketers are that for persons age 65, the lifetime risk of nursing home use is 43%, the average nursing home stay is 2.3 years (Liang, Liu, Tu, Whitelaw, 1996), and at \$50,000 per year this stay would cost \$115,000. However, analysis by a CPA of National Center for Health Statistics data for 1999 for persons age 45 and older indicates that data on the length of stay of current residents (2.5 years) is most useful to the industry, while individual consumers planning for nursing home costs should pay more attention to the length of stay for discharged patients which is just over one year (How long will you stay?). Fully 74% of female and 79% of male nursing home patients stay one year or less. Liu, McBride, and Coughlin, (1994) report that one-third of nursing home stays are for 90 days or less.

Cohen, Tell, and Wallack, (1986) calculated that 13% of the elderly account for 90% of nursing home expenditures. While 9% of nursing home residents stay five years or more, 68% reside in a nursing home for less than three months (Kemper, Spillman, and Murtaugh, 1991). However, statistics on nursing home use from a quarter century ago may not accurately predict use 20-25 years in the future, the time line for many people considering purchasing LTCI.

By analyzing data from the National Long-Term Care Survey and the National Nursing Home Survey, Manton and Gu, (2001) concluded that the disability rate is declining at an accelerating rate and that institutional residence

declined from 1982 to 1999 despite a 30% increase in the population age 65 and older. More elderly are being accommodated in assisted living facilities and at home with relatively fewer elderly living in nursing homes. This trend toward at home care and in less expensive residential facilities should be considered by consumers contemplating purchase of LTCI. A recent study of the eight largest insurance companies selling LTCI revealed that 47% of policy beneficiaries were receiving benefits while being cared for at home (Cohen, Weinrobe, and Miller, 2000). Home care costs less than a nursing home so benefits are often half of the nursing home rate.

The projected cumulative need for long term care for the elderly is growing steadily from 7 million persons today to 9 million elderly by 2005 and 12 million by 2020; persons age 65 and older face a lifetime risk of 40% of needing nursing home care (HIAA, 2002). Along with increasing longevity comes a higher risk of needing long term care. While most of us think of LTC as being provided by nursing homes, most care is provided in the person's home by an unpaid family member (U.S. Department of Labor, 2000). It is not clear what part affordability plays in the decision to care for an elderly person in their home versus placing them in a nursing home.

Gender and Long Term Care

Women are twice as likely as men to need nursing home care. "Long-term care is overwhelmingly a woman's issue. Women live longer than men. They become primary caregivers for LTC service and in the end they are the primary recipients of LTC. Women also have more financial barriers to LTC than men" (DOL, 2000). Many Caucasian, middle and upper-income, well-educated women can expect to live well into their nineties. The Extension web course "Planning for a Secure Retirement" <<http://www.ces.purdue.edu/retirement/Module1/module1b.html>> offers two life expectancy calculators to help clients assess their longevity and, thus, the likelihood of needing long term care. The longer the expected life span, the more likely the need for care.

LTCI Costs and Purchasing Behavior

The cost of a year in a nursing home averages \$50,000 (HIAA, 2000). Assisted living facilities cost \$35,000-\$40,000 per year. As a result, LTCI is costly. Premiums vary considerably, based on age at the time of purchase and the policy options. The Health Insurance Association of America provided premium estimates (in 1999) for a policy that provides \$100 a day for nursing home care, \$50 a day for home care, a 29-day elimination period (deductible), four years of coverage, and five percent inflation protection. The premium estimates for this coverage were: \$409/year at age 50, \$1,002/year at age 65, and \$5,895/year at age 75.

Using the Health and Retirement Study (HRS) data from 1996, 1998, and 2000 (6,220 cases) McNamara and Lee (2003) reported a substantial policy lapse rate from 1996 to 2000. Of the 700 subjects reporting LTCI in 1996, only 23% maintained their policies through 2000. The researchers attribute this high drop rate to a lack of information on the risks of LTC and lack of knowledge about affordable policy options. In addition to recommending a designated structure for LTC policies, they recommend research on the reasons and dynamics for purchasing LTCI.

Consumer Problems with LTCI

The main problem facing LTCI purchasers is whether they will be able to continue to afford rising premium payments for the decades between initial purchase and potential need. The problem is particularly acute for persons who make the purchase when they are in their prime wage earning years and enjoy employee health and retirement benefits. A premium that is affordable while employed on a steady and predictable income may quickly become unaffordable once retired.

Risk Assessment and Management

A severity and frequency assessment provides a decision making framework for deciding whether to buy insurance or self-insure. Consumer educators recommend that insurance be purchased for high severity exposure, whether low or high frequency. Garman and Fogue (2002) provide a detailed framework for deciding among the following options for managing risk: avoidance, retention, loss control, transfer and reduction. The only viable options for managing the cost of LTC are transfer (buy insurance) or retention (self insure). Individual consumers need to estimate their likelihood of needing LTC based using a longevity calculator and family medical history and then determine whether they can afford to buy LTCI or if they would prefer to self-insure. While persons who have a spouse to protect have a different decision framework than singles, in most married couples it is the wife who will most likely outlast her husband and thus, one could approach the decision as if one were single. Married couples should consider survivor waiver of premium and shared care options if they purchase insurance.

Analysis

Since most consumer-oriented sources on LTCI recommend waiting until one is 50 to purchase, and the average age of entry into a nursing home is 83 years old, we calculated the future value of the monthly premiums if they were invested rather than used to purchase insurance. We used three alternative rates of return on hypothetical mutual fund portfolios: a conservative fund yielding 6% average annual total return, a moderate risk portfolio with an 8% average annual total return, and an aggressive portfolio invested primarily in stocks with an average annual return of 10%. Of course, as recent history illustrates, investment markets do not provide steady, predictable rates of return over time. However, for simplification and because a long time horizon is involved, allowing for smoothing out erratic investment return cycles, constant annual returns are assumed in this analysis.

Premiums for TIAA-CREF LTCI from their website (<http://ttaa-cref.org>) were used in this analysis because the company is highly rated for stability and security, expenses are low relative to many other companies, and many consumer educators are familiar with the largest investment and insurance company in the world. The following assumptions were made for this analysis. Since single persons are more likely to need care with no spouse available, and women, whether previously married or not, are twice as likely as men to need nursing home care, premiums were calculated for a single woman at ages 55, 60 and 65, living in a western state. Information in parentheses indicates the range of options available on TIAA-CREF policies.

1. Single woman, resident of a western state (Premiums are the same for all western states, including Hawaii and Alaska)
2. Daily nursing home benefit = \$200 (\$100, \$200 or \$300)
3. Daily maximum for home or community care = \$100 (50% or 100% of nursing home benefit)
4. Benefit period = 3 years (3, 5, 7, unlimited)
5. Waiting period = 90 days (30, 90, 365)
6. Inflation period = periodic (periodic or 5%/year)
7. Nonforfeiture option (reduced benefits if premiums are no longer paid after paying for at least 3 years) = No
8. Survivor waiver of premium = No
9. Shared Care option = No

Explanation of choices:

The benefit choice of \$100/day amounts to \$36,500/year, below the average nursing home cost of \$50,000; \$200/day = \$73,000 which is well above the current average. There is no need to choose the \$300/day benefit unless you expect to use a very expensive nursing home.

Table 1
LTCI Premiums at Various Ages

Age	\$100/day benefit/ periodic inflation adjustment	\$100/day benefit/5% inflation adjustment	\$200/day benefit/ periodic inflation adjustment	\$200/day benefit/5% inflation adjustment
55	\$340	\$970	\$680	\$1940
60	\$470	\$1160	\$1140	\$2320
65	\$690	\$1440	\$1660	\$2880

As shown in Table 1, the premium for a \$100/day benefit with 5% inflation is very similar to the cost of \$200/day benefit with a periodic inflation adjustment. The \$200 benefit with periodic adjustment was deemed the preferred option of the two. The \$100 benefit would not cover average costs today nor would it likely cover costs in the future. The \$200 benefit would more than cover expenses in the average cost nursing home today and periodic inflation adjustments should help cover average costs in the future.

Since home care is considerably less than nursing home care a 50% benefit was deemed appropriate for home or community care. The average stay in a nursing home for current residents is 2.5 years and three-quarters of residents stay for less than one year so the shortest stay of three years was selected. A mid-range waiting period of 90 was chosen since one should have sufficient reserves to cover the cost of three months care. TIAA-CREF offers the option of a

“periodic” increase in costs or a 5% increase. Since the 5% inflation rider resulted in a doubling of the premium (see Table 1), a “periodic” increase was selected. Our example is a single woman so neither of the last two options are needed.

The average cost of a year in a nursing home is currently \$50,000. To estimate “periodic” increases we use the 3% average increase in the Consumer Price Index. So, at 3% annual inflation, in 15 years the average annual nursing home bill would be \$77,898; at 5% inflation, the cost would be \$103,946.

If the annual premiums of \$680, \$1,140, and \$1,660 at age 55, 60, and 65, respectively, are invested at 6%, 8% or 10% till the individual is 80 years old, then the individual would have the amounts shown on table 2 available for nursing home care needs at age 80.

Table 2

Projected Investment Returns.

Rate of Return	Age 65	Age 60	Age 55
6%	\$38,638	\$41,936	\$37,308
8%	\$45,073	\$52,169	\$49,712
10%	\$52,742	\$65,293	\$66,876

The above analysis is based on fixed annual premiums reflecting the age at which a policy is purchased; however, the premium is likely to increase periodically in the future. No information was found to help project the rate of increase. Current average annual costs are \$50,000; future costs are shown in Table 3 for three future time periods at 3% and 5% inflation.

Table 3

Projected Nursing Home Costs.

	15 years	20 years	25 years
3%	\$77,898	\$90,306	\$104,689
5%	\$103,946	\$132,665	\$169,318

Because the individual’s living expenses will be significantly, if not entirely offset by entrance into a nursing home facility, their income should also be factored in and the marginal cost of entering a nursing home facility is the key indicator of whether self insurance is viable.

To examine the marginal costs of nursing home care and the viability of self insurance analysis three annual incomes were used and inflated over the respective periods. The estimated future marginal cost of nursing home care was then calculated by subtracting the future income from the future cost of nursing home care. The future value of the income was calculated using a 3% growth rate.

Tables 4 and 5 show the results of the analysis. The present value of income is shown followed by the future value of the marginal costs of nursing home care. The final figure is the number of years of nursing home care that could be covered using the invested premiums. An 8% annual rate of return is assumed for the analysis. The time of withdrawal is again assumed to be at age 80, and is treated as a lump-sum withdrawal for simplicity. Table 4 is based on the cost of nursing home care increasing at the same rate as inflation, 3%. Table 5 uses a 5% inflation rate.

Table 4

Marginal Cost of Nursing Home Care and Number of Years Covered by Portfolio, 3% Inflation.

Annual Income	Age 65		Age 60		Age 55	
	Marginal Cost	Years Covered	Marginal Cost	Years Covered	Marginal Cost	Years Covered
\$20,000	\$46,739	0.96	\$54,183	0.96	\$62,813	0.79
\$30,000	\$31,159	1.45	\$36,122	1.44	\$41,876	1.19
\$40,000	\$15,580	2.89	\$18,061	2.89	\$20,938	2.37

Table 5

Marginal Cost of Nursing Home Care and Number of Years Covered by Portfolio, 5% Inflation.

Annual Income	Age 65		Age 60		Age 55	
	Marginal Cost	Years Covered	Marginal Cost	Years Covered	Marginal Cost	Years Covered
\$20,000	\$72,787	0.62	\$96,543	0.54	\$127,442	0.39
\$30,000	\$57,207	0.79	\$78,482	0.66	\$106,504	0.47
\$40,000	\$41,628	1.08	\$60,420	0.86	\$85,567	0.58

If the cost of nursing home care increases at the same rate as inflation (3%), then the option of self-insuring appears to be quite feasible, especially for the older two cohorts anticipating annual inflation adjusted income during retirement of at least \$30,000. If the cost of nursing home care increases at 5% then self-insuring becomes less attractive. The only sub group that would be able to finance at least one year in a nursing home would be those age 65 with a \$40,000 inflation adjusted income.

Clearly, buying a policy from a highly rated company and paying the premiums diligently each year will ensure that the protection is available when needed. The main argument against the “invest the premium yourself” approach is that most people would not invest the money every year because other expenses might interfere. However, it is very easy to set up an automatic monthly investment into a low-cost, tax-efficient mutual fund, thus taking care of the discipline “problem.” A second concern arises if care is needed much sooner than anticipated so that investment returns are insufficient to cover costs. Further, investment returns are not guaranteed.

In addition to “peace of mind,” another argument in favor of buying LTCI is the income tax break for the premiums paid and benefits received. Taxpayers must itemize deductions to take advantage of the deduction for premiums; whereas only about one-third of taxpayers itemize. Another potential tax advantage of LTCI is that benefits (up to \$210/day in 2002) are not taxable income; they are treated in the same way as health insurance benefits (IRS Pub. 525 Taxable and Nontaxable Income).

Advantages of the “invest the premium yourself” approach include:

- more flexibility in use of financial resources
- no worries about not being able to (or forgetting to) pay the premium and having a policy lapse
- no problems with policy restrictions; the money can be used to pay for needed expenses not covered by the policy (i.e., paying a relative to provide care)
- no concerns about insurance company insolvency
- if you never need long term care, your heirs will inherit the money.

However, based on the low level of preparedness for lengthy and expensive retirements, most retirees will need the money simply to pay living and medical expenses in retirement.

Summary and Discussion

This analysis demonstrates a viable alternative for middle-income, moderate-asset consumers who are considering purchasing LTCI. Further, in light of the evidence of the 75% lapse rate on policies, self-insurance is an option that should be considered by consumers who have recently purchased LTCI policies. Because of the uncertainty of future income, likelihood of letting a policy lapse, and the negative ramifications of dropping a policy after paying premiums for years, we urge educators to suggest the self-insurance option to consumers who are considering purchasing LTCI. While long term care may be required by younger persons due to disability caused by accident or medical condition, the majority of policies are designed to cover the costs of care for the dependent elderly, the focus of this analysis.

This alternative approach to financing LTC adds a new and original dimension to the discussion. Self-insurance through an automatic monthly investment in a balanced (stock and bond) or conservative stock mutual fund is the best option for most consumers because it offers more flexibility in care and payment options than insurance. Further, the resources can be passed onto heirs in the event that no or little long term care is required. However, the bottom line for most retirees is that they will likely need to draw upon the assets to finance routine living expenses.

In summary, most Americans cannot afford LTCI for the lengthy period during retirement in which they would need to pay premiums. Most boomers and pre-retirees need to invest more money more aggressively in order to finance a long retirement and pay for routine medical expenses. They may have to rely on Medicaid to pay for nursing home care.

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