



Comparing Long-Term Care Alternatives

By Joe Tomlinson

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Should clients buy expensive long-term care insurance they might never need, or go without insurance and risk a big hit to their life savings? For advisors whose clients face this critical dilemma, there's now a third option: life insurance and annuity products that also incorporate long-term care insurance.

I'll compare these alternatives, using financial modeling to develop a more precise understanding of the financial implications of the choices advisors and clients face. But first, let's review the financial products that address long-term care needs in more detail.

The traditional insurance model

Traditional long-term care (LTC) insurance is a straightforward insurance product with a menu of options. The purchaser pays annual or monthly premiums and is reimbursed if and when they require long-term care services such as professional care at home, or in assisted living, or in a nursing home. In order to qualify for payment, the insured must satisfy certain criteria – typically being unable to perform two or more Activities of Daily Living (ADLs) – such as dressing or eating – or suffering from significant cognitive impairment. A menu of options affects pricing, including:

- Waiting or elimination period – the time from becoming eligible until claim payments begin
- Monthly maximum benefit – a cap on how much will be paid per month for benefits
- Benefit period – the maximum number of years that payments will be made (which may be extended if less than the maximum monthly benefit is used)
- Inflation protection – the annual rate of increase, from date of issue, in the monthly maximum benefit

Despite meeting an important need, long-term care insurance has never been very popular – only about 10% of retirees carry this insurance. Annual premiums of \$1,500 to \$3,000, or even more, are a significant deterrent. The past few years have been particularly difficult for long-term care insurers for various reasons. The interest rates they earn on policy reserves have been falling, and claims have gotten more expensive at the same time as claimants have required care for longer durations. Meanwhile, “lapse rates” have declined – a higher percentage of policyholders are keeping their policies well into old age, when claims are most prevalent. To protect the solvency of their business, insurers have gotten permission from state insurance departments to significantly increase premiums on both existing and new business, which has alarmed consumers. Some major insurers, including Prudential and MetLife, are so concerned about the viability of the business that they have stopped selling new policies altogether.



The most-cited reason for not buying long-term care insurance is concern about future premium increases. But some members of the advisory community feel that most, if not all, the bad news for the industry has already been factored into current prices, in which case future premium increases should be less of a risk. Michael Kitces laid out this case in an October 24, 2012 post on his [blog](#), and I agree with his reasoning. There is always some chance of further premium increases, but I believe that risk is low, and that long-term care insurance is worth careful consideration.

Hybrid products

These days, with the traditional insurance model under so much strain, advisors and their clients have an increasingly popular alternative: hybrid approaches. These products involve setting aside funds in a life insurance or annuity policy (often as a single-premium deposit) and then having these funds available for long-term care if needed – or passed on to heirs if not. For those willing to pay higher premiums than for standard hybrid policies, there are enhanced hybrids that provide LTC benefit maximums greater than annuity account values or life insurance face amounts. Hybrid policies do set maximums for monthly benefit payments, but, similar to regular LTC insurance, they can include inflation protection if desired.

An attractive feature of hybrids is that payouts are guaranteed, and there is no worry about future premium increases. Also, there is the comfort factor of knowing that the products will pay out even if long-term care is not needed. Hybrids have received a lot of mention in the popular financial press recently, and sales have increased rapidly in the past few years. Media coverage, however, often discusses product alternatives in general terms without providing meaningful financial comparisons. In the next section, I'll describe a simple modeling approach that will help fill in the financial details.

Modeling the long-term care risk

A proper analysis must begin with estimating the probability of needing long-term care and the range of possible durations over which care may be needed. Good numbers are not readily available, so I developed my own rough estimates using the Society of Actuaries claim data and other sources. The table below shows the likelihood of needing a few representative durations of care, from never filing a claim up to requiring five years of care. It takes the full range of durations of possible care needs (from zero to 20 years or more) and slots them into four discrete scenario paths.

Care Need	Probability
Less than 90 days (or none)	60%
One year (plus 90 days)	20%
Three years (plus 90 days)	10%
Five years (plus 90 days)	10%



Source: Author's estimates

I lump the first 90 days in with not needing care at all because I assume that any care that lasts less than 90 days will be paid by Medicare if following a hospital stay, or paid from the client's health care budget if not.

I develop the remaining analysis using the following example:

- A single individual age 55 (I base this analysis on unisex data, although a more sophisticated approach would estimate experience separately for men and women.)
- Life expectancy of 30 years (to 85) and any long-term care needs in the final years of life
- Annual nursing home costs of \$80,000, home care costs of \$40,000, and care split equally between home and nursing home
- Long-term care costs increasing at 3.5% annually, 1% faster than assumed general inflation
- Offsets in living expenses of \$25,000 per year for food, shelter, and transportation if in a nursing home

These estimates came from various sources. For example, the nursing home and home care costs are roughly equal to the national averages published by the MetLife Mature Market Institute in its annual [Market Survey of Long-Term Care Costs](#). The above costs and savings, when combined, produce an annual cost for long-term care (in today's dollars) of \$47,500.

Modeling the insurance products

For a standard LTC insurance product, I assume a 90-day elimination period, a five-year benefit period, a monthly maximum benefit of \$4,570, and an inflation rider based on changes in the CPI. I've estimated the premium for this policy to be about \$3,000 per year. The monthly maximum was chosen to roughly cover the assumed nursing home costs, net of expense offsets. Because I have assumed care costs increase faster than the general inflation rate, this monthly maximum benefit will not provide full coverage in the later years of one's life.

The hybrid product I use in the example is based on Lincoln's MoneyGuard® Reserve Plus life insurance policy. I attempt a reasonably close match to the benefit structure under the standard LTC policy, in this case with a \$100,000 single premium that will provide an initial monthly maximum LTC benefit of \$4,800 for five years, with annual inflation adjustments of 3% (from time of purchase). These particular options yield a face value on the life insurance of \$172,700 payable at death. Under the hybrid structure, payments of LTC benefits are subtracted from the face amount, until reaching the minimum guaranteed death benefit, which is 10% of the original face amount (\$17,270 in this example). The five-



year benefit guarantee with inflation increases allows for the possibility of long-term care benefit payments well in excess of the face amount.

Results

This chart shows the projected impacts on bequest values under the two insurance approaches and for the option of no insurance ("No LTCI"). I show outcomes in current dollars, rather than future inflated dollars, to make the numbers meaningful in today's purchasing power. The impacts are shown for various LTC durations, with weighted averages (based on the likelihoods I estimated in the previous table) at the bottom. In calculating the figures, I assumed that invested savings earn 4.65% after taxes (based on my estimates for a 65/35 stock/bond portfolio and a 15% effective tax rate). For comparison's sake, I also show what the weighted averages would be with a 2% return, assuming a fixed income portfolio.

Projected Bequest Impacts (@ 4.65%, in current dollars)

LTC duration	No LTCI	LTCI	Hybrid
No LTC Claim (60% chance)	\$0	-\$93,667	-\$104,051
1 Year LTC (20%)	-\$64,267	-\$100,500	-\$165,462
3 Years LTC (10%)	-\$194,950	-\$112,561	-\$178,171
5 Years LTC (10%)	-\$328,554	-\$122,344	-\$178,171
Wtd Avg Impact @ 4.65%	-\$65,204	-\$99,791	-\$131,157

Wtd Avg Impact @ 2.00%	-\$61,474	-\$64,983	-\$31,106
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Source: Author's calculations

So what does this chart tell us? The "No LTCI" column shows how widely the potential impact varies if clients go without insurance. And it is important to note that the uninsured effects of needing LTC will be even greater in certain urban areas, where average cost for the various types of long-term care may run as much as double the national averages I used for this chart. Also, if a client uses more-aggressive investment strategies to generate more growth, he or she risks a doubly bad outcome if investment markets perform poorly and there is also a need for extensive care. (A useful extension of this modeling would be to incorporate both investment and LTC risks.)

On the "No LTC Claim" line, a surprising result is that the hybrid does worse than LTCI, even though the hybrid pays the life insurance face amount if there is no claim. The \$100,000 invested in the hybrid policy earns a much lower return than the 4.65% return assumed for savings. As a result, even if there is no LTC claim and the hybrid product pays the maximum possible death benefit, a client still would have been better off holding on to their money, paying the premiums over time, and investing the remaining money themselves.



Looking at the weighted averages for a 4.65% return reveals that going without insurance ("No LTCI") has the least-negative effect on average, which is reasonable because we would expect insurance companies to extract margins to cover expenses, risk, and profit. But clients clearly face a risk-reward tradeoff, given the volatility of outcomes with no insurance.

The most interesting insight comes from comparing the two different weighted averages, which show us that the choice of LTCI versus a hybrid must take into account the client's strategy for investing retirement savings. If the client wishes to invest for growth, it may not make sense to lock up a lot of funds in a hybrid policy. But the hybrid may make sense if the client is extremely conservative, shuns equity investing, and is okay with locking in today's low interest rates for a long time to come.

Conclusion

Based on the assumptions underlying this example, I'd be inclined to favor regular LTC insurance over either going without insurance or investing in a hybrid.

LTC insurance can reduce risk, at least according to this simplified example. Of course, my results are based on a complex combination of assumptions about client characteristics, product features, investment outcomes, LTC utilization, and LTC cost. Changing these inputs will yield different results. But this framework shows how advisors can develop a better understanding of how traditional long-term care insurance compares with hybrids.

Long-term care is the biggest uncertainty that many clients face in retirement. An increasingly important role for advisors will be helping clients decide among options to deal with this risk.



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