KANAWHA CAPITAL MANAGEMENT

Second Quarter 2015

This Quarter's Highlights

- Rising Long-Term Care Costs Present Challenges
- Activities of Daily Living
- Policy Features of Long-Term Care Insurance
- Hybrid Policies
- Buy Insurance or Self-Insure

Kanawha Currents

Prepare for Long-Term Care

Rising long-term care costs present a challenge for those individuals and couples who have saved diligently for retirement but are still vulnerable to the financial impact of an unexpected need for care. Many retirees and pre-retirees face the difficult decision of how to best mitigate the risk of increasing costs for long-term care. Many seniors are protected from the rapid increases in most health care costs because of Medicare. There is still, however, considerable exposure to the high costs of caring for chronic physical illness, cognitive impairment, and disability. Long-term care insurance is designed to fill this void and protect a family from spending significant portions of their savings and investments on custodial care. This form of insurance may be suitable for those who expect to have sufficient levels of financial resources to meet their current or future retirement needs but are not comfortable with bearing the risk of financial loss that may come from a protracted period of care.

The responsibility for paying for most long-term care expenses falls on the individual or their family. Medicare, "Medigap" policies, and most individual health plans are designed to cover skilled, short-term medical treatment due to illness or injury. Medicare does not cover most costs associated with long-term care, but it may pay for some skilled nursing care for a limited time if certain conditions are met. If you have spent at least three days in a hospital and then are admitted to a Medicare-certified skilled nursing facility, Medicare may pay for certain services for up to 100 days. The first 20 days of qualified expenses may be covered at 100%, although the individual will be responsible for paying a daily coinsurance fee of $157.50 for days 21 through 100 (some Medigap policies cover this daily cost). After 100 days, the individual must bear the entire cost. Note that Medicaid may pay for long-term care costs, but only after an individual's resources have largely been exhausted, and only for approved facilities.

Most long-term care insurance policies provide for protection in the event you are no longer able to perform certain activities of daily living such as bathing, dressing, and eating. The nature of conditions associated with long-term care needs are often non-rehabilitative and contrast with more acute medical conditions, which are typically covered under Medicare.

Activities of Daily Living		
Bathing	Dressing	Continence
Eating	Toileting	Transferring

Long-term care services are available for a range of settings, including nursing homes, assisted-living facilities, hospice facilities, and a person's home. It is important to know what types of facilities used for administering care are covered under your policy. If you find out that a certain type of facility is not covered, your insurance company can refuse to pay for otherwise eligible services. Also, states define certain facilities differently. Policies that cover a type of assisted-living facility in one state may not cover services from that same type of facility in another state. If you are retiring to another state, check your policy to determine if there will be any benefit changes. As the market for in-home custodial care continues to grow, most long-term care policies now provide benefits for care delivered in a policyholder's home. The level of benefits, however, may be lower for home care than for nursing-home care. Since many people prefer in-home care to nursing homes, it makes sense to learn about any differences in benefits.

Long-term care insurance policies come with many features and benefits that affect pricing. It is important to be aware of the financial health of the underlying insurers. After a policy is purchased, you will be relying on the full faith and credit of that insurance company to keep their financial promise of satisfying any future claims.

Most policies are triggered when the individual loses at least two activities of daily living or develops a cognitive impairment such as Alzheimer's disease. While other forms of insurance define a deductible as a certain dollar amount, most long-term care policies have an *elimination period* that must be satisfied before any benefits are paid by the insurer. Elimination periods normally last between zero days and one year. Similar to deductibles, the shorter the elimination period is, the more expensive the policy will be. Also, some policies require that you meet the elimination period only once during your lifetime, whereas other policies require you to meet the elimination period for each occurrence. Additionally, policies may separate elimination periods for home health care from nursing-home care. Consequently, policies with a single elimination period are more attractive, since many individuals and families like to begin with in-home care before turning to nursing home care. Lastly, be sure to understand if the elimination period is satisfied using the calendar-day approach or actual days of service. Under the calendar-day approach, each day counts toward your elimination period after you begin care, whether or not you receive care every day of the week.

The amount of the dollar benefit for a policy is typically determined by a *daily* or *monthly benefit limit* and a *maximum lifetime benefit*. The insurer is obligated to pay a benefit up to a certain number of dollars a day or month for some amount of years. For example, an individual may purchase a policy that has a $150 daily benefit limit with a three-year maximum benefit. For this policy, the total lifetime benefit would be $164,250 ($150/day X 365 days X 3 years). Many of these policies use a pooled fund approach, which allows you to extend the benefit period if your daily costs incurred fall below your daily limit. As mentioned earlier, there may be cases where the benefit levels are reduced for in-home care. Also, since the cost of care varies by region, it is important to have an understanding for your local market. Finding out the average costs for home health care as well as nursing and assisted-living facilities in your area can help you gain a sense for what level of benefit would be most appropriate for you.

Given the steady increases in the cost of long-term care in recent years, consumers are naturally drawn to inflation protection as an attractive policy benefit. Policyholders can usually choose between automatic increases or guaranteed purchase options. Automatic increases normally apply a simple or compound rate of inflation of 5% per annum. The younger the policyholder, the more beneficial it is to have inflation protection. The compound rate of inflation, albeit more expensive, will provide the best protection against escalating costs. Guaranteed purchase options allow the policyholder to increase their level of benefits in the future without having to go through medical underwriting again. The increased benefit will be priced according to their older age at the time the selection is made. This option may be more suitable for those who are buying policies at older ages. The older you are when buying a policy, the less need there may be for inflation protection.

One of the major drawbacks to purchasing long-term care insurance is cost. Individual policies can cost several thousands of dollars per year and, like other insurance products, there are no guarantees a policyholder will ever receive any benefits in return for the premiums paid. In addition to the elimination period, benefit limits, and inflation protection, the age and health of the applicant weigh heavily on the cost of a policy. The older the applicant is, the more expensive the premiums will be. Conversely, younger individuals will pay less in annual premiums, but they are more likely to be paying premiums over a longer period of time. Individual policies normally require some level of medical underwriting. The healthier the person, the lower the premium is likely to be.

Most policies are sold with a condition that premiums cannot rise in the future due to increases in age or deterioration in health of the policyholder. However, insurers may be able to increase these “level premiums” for an entire class of policyholders if granted state approval to do so. For this reason, it is wise to be skeptical of terminology that suggests premiums will not rise in the future. In fact, in recent years, the market has witnessed premium hikes due to the underlying cost of care rising faster than expected and policyholder lapse rates being lower than predicted. For those who experience price hikes and are thinking about terminating their policies, you may consider asking your insurer about reducing benefits to maintain your premiums.

The market for long-term care insurance has evolved considerably in recent years. Sales for traditional policies declined by 65% between 2000 and 2010, according to the National Association of Insurance Commissioners. The trend away from traditional standalone policies has coincided with a shift toward hybrid policies, which combine long-term care coverage with life insurance or annuities. Consumers now must evaluate many of the features of traditional coverage along with a slew of combination possibilities. Hybrid products often address one of the main emotional concerns among many consumers: the fear they might invest a significant amount of money in a product and never derive any benefit from it. Hybrid policies are generally constructed to give the policyholder and their family an opportunity to receive some benefit in the future, even if they never file a claim for long-term care. Recent studies have shown, however, that while hybrid policies may provide more flexibility with death benefits and/or liquidity, they are also likely to be more expensive per unit of long-term care coverage.

Long-term care insurance provides individuals with a means to reduce their exposure to significant financial loss from costs associated with chronic illness due to old age, disability, or cognitive impairment. The question really boils down to how much of the risk they are willing to absorb themselves versus how much, if any, of the risk they can transfer to an insurance company. It is impossible to have a definitive answer on whether a person should buy this insurance, but certain factors should be taken into account, such as the amount of resources an individual has, relative to an estimate of future costs. Individuals or couples who have a significant net worth and little risk of spending down their assets during their lifetimes may be comfortable absorbing this risk themselves (i.e., self-insuring). Others who feel they are marginally close to having sufficient resources and are worried a protracted period of care may wipe out their savings could be candidates for this type of insurance. Lastly, those with few financial assets and a modest level of income are not likely to be able to afford the relatively high cost of long-term care insurance. An individual's risk appetite should also be considered. Some families may have significant assets and income but are still drawn to the idea of paying an insurance company a relatively small amount of money each year in exchange for absorbing the increasingly expensive cost of care in the future due to the unfavorable economics of rising demand, limited supply, and longer life expectancies.

These are general examples. The question of whether long-term care insurance is suitable really should be determined on a case-by-case basis. It's important to point out that the answer to whether or not somebody needs coverage is not an all-or-nothing proposition. It may be reasonable for an individual to partially absorb some of the risk herself and transfer a portion of the risk to the insurance company. For couples, they may also be faced with the question of whether one or both of them should obtain coverage. The market for long-term care insurance is experiencing change. The best advice is to work with knowledgeable insurance professionals and financial planners who specialize in this field and can help you evaluate different strategies that are best suited to your needs.

Sources: National Association of Insurance Commissioners (NAIC). Christopher Finefrock, Suzanne Gradisher, and Caleb Nitz, "Long-Term Care Insurance: Comparisons for Determining the Best Options for Clients", Journal of Financial Planning, February, 2015. Karyn Neuhauser, "Long-Term Care: Helping Clients Make the Right Choices", Journal of Financial Planning, November, 2012.

This is intended to be for illustrative purposes only and should not be interpreted as advice. This is not intended to be a comprehensive discussion on long-term care insurance.