Self Insuring

Particularly in the financial press, I find a strong bias towards self insuring rather than buying insurance to pay all or part of the cost of long-term care services. This is certainly not completely unreasonable. After all, you might never need care. Why pay premiums for years for something you might not use?

The answer is that the risk is too high that you will use it and the cost when you do need care is too high to ignore.

Let's look at a few of the recommendations I've seen over the years for self insuring and consider not only where you'd be if you don't need care, but also whether self insuring has been a good solution if you do need care.

One prestigious financial magazine (the names have been omitted to protect the innocent) noted that at that author's age (about 55) insurance would cost about $900 per year (for a four year benefit period and compound inflation option). He noted that if he didn't waste the money on insurance and his money grew at 8% per year, in 25 years when he was likely to need care, he'd have saved up over $69,000. His conclusion was he'd rather self-insure. What he failed to consider was that over that same 25-year period, the cost of care would have grown from $110. a day to $370. a day and his $69,000 would only pay for just over 5 months of care. If he's purchased the insurance, he'd have had enough benefits to pay $370 per day for four years.

The article came out only a short time before the market tanked. I'm not sure if he'd still assume an 8% return today. Even so, let's assume 8% is reasonable. To have enough money to pay for 4 years of care, 25 years from now, at a cost of $370 per day, he would have to invest $7400 per year, every year, for the next 25 years, with no guarantee he wouldn't need care sooner than that. By buying the insurance today, he would have been able to pay for 4 years of care even if it was needed tomorrow.

Which is the better choice?

Self Insurance "Premium"	$7,400 per year
	Or
Insurance Premium	$ 900 per year.

I've looked at a lot of different approaches that suggest self insuring is a better choice because "If you don't use it, you don't lose it". This includes several ways of using life insurance to cover long-term care costs. With all of them I've seen, if you don't ever need care, you were better off not buying insurance (big surprise), but if you need more than just a few months of care, paying for it with your own money (self-insuring) makes no sense at all. You are better off buying the insurance.

Another major consumer publication suggested a few years ago that if you had $160,000 in savings and could afford to reinvest all of the interest that money earned (or at least 5% per year) you could afford to self insure LTC expenses. It appears this was based on a then national average cost of $40,000 per year. Essentially they were saying 4 years is enough. It was also reasonably clear that the recommendation was for $160,000 for each spouse.

First, I give them credit for recognizing the importance of inflation. The need to reinvest at a rate of 5% per year is crucial to still having enough money to pay for 4 years of care in the future. With no reinvestment, what was enough money today to pay for 4 years of care would only pay for 2 years of care 15 years from now and 1 year of care 30 years from now (assuming the cost of care continues to increase at 5% per year).

The biggest question I have is "How do we know 4 years is enough?" The NAIC Shoppers' Guide to Long-Term Care tells us that about 9% of the population will spend 5 years or more in a nursing home. If we include home care and consider 4 years rather than 5 years, there are no specific numbers available, but it seems reasonable to assume 15% to 20% of the population would use up all of their "self insurance account" and still need care. While everything worked out fine for perhaps 80% of the population, the result was a lot less attractive for the 20% who still needed care after all the money was gone.

What objective are you trying to accomplish in following this advice? Fundamentally, it appears to me that it is just a way to find an excuse for a preference not to pay premiums for insurance. What are you losing by following this advice? You are losing the use of 5% interest on 160,000. That's $8000 per year. Most of you will find that a long-term care policy with a $40,000 per year benefit ($110 per day), a 4 year benefit period, and a 5% compound inflation option would cost a fair bit less than $8000 per year.

A healthy individual at age 55 could buy that policy from a good quality company for about $900 per year. (Significantly less per person for a couple). One way of looking at this is that you would have $7100 less per year to support your standard of living if you self insure, than you would by buying insurance. From that point of view, self insuring costs almost nine times as much as insurance in real terms, that is in what you have left to spend.

Self Insurance "premium":	$8000
Insurance Premium :	$ 900

Which would you choose?

In reality, this seriously understates the cost of self insuring. In 15 years your "self insurance account" would have grown to $320,000 (so would your benefit in your LTC Insurance policy). You still need to reinvest 5% per year to keep your account growing, so you are now paying $16,000 per year for the privilege of doing without insurance. Since the LTC Insurance premium does not increase as the inflation rider increases your policy benefits (except in a few policies I don't recommend buying) you are now paying over $15,000 more for self insurance.

Self Insurance "premium" (in 15 years)	$16,000
Insurance premium (in 15 years)	$ 900

Since a typical age for requiring care is between ages 80 and 85, and our example was for someone age 55, we really should project the numbers out for another 15 years.

Self Insurance "premium" (in 30 years)	$32,000
Insurance premium (in 30 years)	$ 900

You might well object that in 30 years your $160,000 has grown to $640,000 and if you don't need it your kids will get it, not the insurance company. With the insurance premium you've spent $900 per year and it's gone forever. You're right. But what were you trying to accomplish? If your objective was to make your kids rich, you may have succeeded. You have if you never need care. If your objective was to make sure you had enough money to pay for care if you needed it and to be able to use any other money you had to be able to have a comfortable retirement, then choosing self insurance was an extremely expensive way to do it.

One other thing to consider is that buying insurance doesn't mean you've spent the entire $160,000. It just hasn't grown as quickly as it would have if you weren't paying an insurance premium. Over 30 years, at 5%, instead of growing to $640,000, by withdrawing $900 per year to pay for LTC insurance, it has only grown to $580,000, $60,000 less than it would have if you weren't paying for insurance.

What happens if you do need care? You are paying for the care with your own money when you self insure. In 30 years, your cost of care has grown from $40,000 per year to $160,000 per year. You would spend the extra $60,000 in 4.5 months of paying for your own care.. If you need care any longer than that, you actually have less money in your self insurance account than you would have had paying for insurance. This is a fair comparison because if you buy insurance, you are using the insurance company's money to pay for your care.

Whose money would you rather give to the long-term care provider, your money or the insurance company's money?

Do not infer from this that I am totally opposed to any form of self insurance. Let's consider an individual who does not have an informal network of caregivers to help provide their care (as I discussed in my article on "Comprehensive, Facility Only, or Home Care Only Policies" and in my article on "Informal Caregivers"). If that person recognizes there is little or no chance of remaining at home, they might choose to buy a facility only policy because it has a cheaper premium. Let's also suppose they have a $3000 per month income. To further reduce the premium, they might decide to buy a policy with a benefit large enough to pay only that portion of their care their income could not cover. How much policy benefit should they buy? If they needed care today and the cost of care in their area was currently $150 per day, their $3000 per month ($100 per day) income would cover all but $50 per day of care. Of course, if they needed care today, they would be uninsurable, so they'd have to pay the full cost of care themselves. If you are going to take this approach, you need to project what the cost of care is likely to be when you actually need care and what your income will be at that time. In our example, if you are currently 65, it is likely to be 15 years before you need care. During that time, the cost of care is likely to double. For most of us, our income will not be increasing. If you buy a policy with a 5% compound inflation option, during that 15 years the policy benefit will also double. In that case, the cost of care at age 80 is projected to be $300 per day and your income is still $100 per day. You will need a policy that pays $200 per day. A policy with a $100 per day benefit and a 5% compound inflation option would grow to $200 per day in 15 years. To be conservative, since you might not need care until you are 85 or 90, or you might need care at age 80 but still be alive and needing care at 85 or 90, it might make more sense to buy perhaps $120 per day now.

This approach can also work for couples, but any mistakes will be paid out of the standard of living of the healthy spouse, so I recommend being very cautious. Any competent agent can help you do these calculations and weigh the risks and costs involved.

One other thought in self insuring is to buy enough insurance to pay the full cost of assisted living facilities in your area. They usually cost less than care in a nursing home. If you are fortunate, the policy should be enough to pay for all of your care outside of a nursing home and you are only self insuring the extra cost if nursing home care is needed. In that case, as I discuss in my article on independent caregivers, it would probably make sense to buy a policy that pays for informal home caregivers since this could stretch the purchasing power of your home care benefits.

Conclusion

Don't use self insurance as an excuse to ignore the need for long term care insurance. Think it all through very carefully. When you take all of the costs of self insuring into account, particularly the impact it has on your current standard of living, it rarely makes sense.

The real cost of self insuring is the money you have to reinvest to protect against the rising cost of care, to make sure your self insurance fund is still adequate when you actually need care. This cost, when carefully assessed, is likely to be much higher than the cost of insurance. Which is more important to you, "making the kids rich" or having enough money available to live a comfortable retirement? If it is the latter, insurance is likely to be the smarter choice.