



61

Insurance Economics

Information for Risk and Insurance Economics

website: www.genevaassociation.org

email: secretariat@genevaassociation.org

Insuring Long-Term Care Risk

by Christophe Courbage

This article was published in Insurance Economics No. 61, December 2010

Introduction

Population ageing in most industrialised countries is accompanied by an increase in the need for long-term care (LTC). LTC can be defined as a mix of social and health care provided on a daily basis, formally or informally, at home or in institutions, to people suffering from a loss of mobility and autonomy in their activities of daily living. In 2011, the first baby-boom generation will turn 65, and it is forecast that the size of the old-age population in state of dependency will double in the next 50 years (OECD, 2005).

At the same time, the decrease in the number of informal caregivers (due essentially to the increase in women's employment rate) and the low public long-term care coverage suggest that the financial consequences of dependency could be catastrophic, even resulting in ruin, for a number of elderly people and their families. A solution to this lack of public coverage is to develop the market for long-term care insurance. That is why, for some decades now, insurance companies have been offering contracts to cover the financial consequences of dependency and the use of long-term care.

Several theoretical arguments and empirical works have been proposed to explain the decisions on whether to purchase long-term care insurance, and the relative success of this small market. It remains that solutions exist that allow easier access to LTC insurance. Besides tax incentives, insurance may be combined with life insurance, individual savings or reverse mortgages. This short text outlines some ideas on the problem of covering the risk of dependency and pays special attention to insurance.

Financing LTC

LTC financing varies from one country to the other. The organisation of LTC coverage is in general a function of the health systems already in place. LTC is often provided by both health and social services, which are not necessarily disconnected. It may be difficult to differentiate the health insurance system from other systems specific to LTC risk.

Conscious of the need to create solid foundations for the financing of LTC, some countries offer comprehensive programmes funded through either social insurance or tax. In the face of LTC expenditure that represents an increasing share in health budgets, these countries have often decided to consider the risk of dependency as a new risk and to separate it from the health risk. These countries have established LTC insurance as a new branch of their social insurance system (e.g. Austria, Germany, Luxemburg, Japan). For budgetary reasons, these systems support only the most dependent and, unlike conventional health system, limit their benefits. According to a recent report by the European Commission (2008), most countries recognise the importance of finding an appropriate balance between public and private sources of funding. The logic of mixed funding based on public-private partnership in the coverage of LTC risk seems to be the way chosen by the largest number of countries.

The decision to purchase LTC insurance

Several theoretical arguments have been put forward to explain the decision on whether or not to purchase LTC insurance.

A common explanation for the lack of LTC insurance purchasing is that individuals are inadequately informed about the products available and that they ignore low-frequency high-severity events that have not occurred recently (Kunreuther, 1978). Another explanation for the limited development of LTC insurance markets includes the phenomena of moral hazard (over-consumption of care encouraged by insurance) and of adverse selection (over-representation of bad risks in the insured population), and the fact that the interaction of public insurance programmes arguably crowds out private insurance.

Since LTC is largely provided informally, mainly through family members, intergenerational factors have also been put forward to explain the rationale for taking out demand for LTC insurance (Pauly, 1990). The desire to leave a bequest seems to be a major motive for LTC insurance. However, elderly individuals with children may decide to forego the purchase of LTC insurance due to intrafamily moral hazard. Indeed, parents who prefer to receive care from their children may decline the offer to purchase insurance, as this may create a disincentive for children to provide care. Intra-family moral hazard differs from classic moral hazard in the sense that it is not the policyholder behaviour that is modified by the presence of insurance, but is the caregiver's behaviour. Nevertheless, it happens that bequests can be structured so as to provide an incentive for children to care for their elderly parents. If long-term care insurance were purchased, parents could increase the sensitivity of the bequest to caregiving in order to elicit attention from children (Zweifel and Strüwe, 1996).

While theoretical literature on the subject is rather abundant, relatively little empirical research has been done on the factors affecting the decision to purchase coverage, and it relates almost exclusively to the situation in the United States. Sloan and Norton (1997) examine the relationship existing between the demand for LTC insurance and, respectively, the bequest motive and expectations of future nursing home use. Although they find phenomena of adverse selection, the bequest motive does not seem to influence the demand for LTC insurance. Mellor (2001) shows that education, income and wealth positively impact LTC insurance, whilst availability of informal care has no statistically significant effect on LTC insurance. Doeringhaus and Gustavson (2002) show that nursing home expenditure levels, the relative size of the elderly population and the nursing home population are significant explanatory factors of LTC insurance purchase in some states of the United States. The intuition is that these variables raise awareness among the elderly about cost and quality issues in LTC, which should reinforce the utility of LTC insurance for such individuals. Recently, Brown and Finkelstein (2007) have presented evidence of supply-side market failures in the United States LTC insurance market, such failures being explained by the characteristics and pricing of the products on offer. Finally, using French data, Courbage and Roudaut (2008) have shown that insurance for formal long-term care is purchased to preserve bequests and to protect families in the event of disability. Risk behaviour, as well as experience of disability, also plays a significant role in explaining the demand for insurance covering LTC in France.

How to increase access to LTC insurance?

To address the relatively low development of the market for LTC insurance, a number of proposals have been discussed to develop and make this market more accessible. Here are a few suggestions.¹

Combining LTC insurance and life insurance

In recent years, new products have been developed to cover the risk of dependency, and in particular a combination of LTC insurance and life insurance into a single product. The longevity risk is usually covered through life insurance, while the risk of using LTC is covered by LTC insurance. The strategy of combining these two products in one is that risks compensate each other: healthy people with high life expectancy attracted by life insurance offset those in poor health with a short life expectancy attracted by

¹ For a comprehensive proposal related to the U.S. market, see Feder, Komisar and Friedland (2007).

LTC insurance. Moreover, combining these two risks in one product has two advantages. First, it reduces the phenomenon of adverse selection in the market for life insurance, since dependent people should not live long enough to qualify for long-term annuities. Second, the selection of risk is minimised because it only consists of filtering out individuals who can immediately benefit from insurance payments.

In a recent study, Murtaugh *et al.* (2001) have shown that combining life insurance with LTC coverage was likely to reduce the cost of both products as well as to make them more accessible to potential buyers. In particular, their model shows that under a minimum risk selection, excluding those who would be eligible to receive payments on the date of purchase, 98 per cent of 65 year-old applicants would be accepted compared with 77 per cent under current LTC insurance underwriting conditions.

Combining LTC insurance with reverse mortgages

For some time, financial institutions have been offering a product known as “reverse mortgage”, which approximates to the notion of “viager” in France. A reverse mortgage is a loan secured on the value of a property. This type of loan enables to make liquid, or to monetize, real estate assets, without any transfer of ownership. If necessary, the sale of the property at a later date enables the reimbursement of the loan. As few elderly seem to use reverse mortgages to supplement income during retirement, this tool could be used to finance LTC. This concept seems to appeal primarily when it is directly linked to LTC expenses. For instance, the recent report of the French authorities on the creation of the fifth risk for social security suggests that, to receive the full rate of public help in case of dependency, people whose wealth exceeds a certain threshold will have to pledge part of their inheritance.

Chen (2001) suggests going further by linking the reverse mortgage, not to LTC spending, but to either life or LTC insurance. The idea is that the reverse mortgage would be used to pay insurance premiums and not LTC. One solution would be to link the annuity to be received to the value of the house and to the level of dependency. The property would act as a safety net and would be used as financing of last resort. Of course, a limit to this solution is that this source of income is available only to property owners.

Combining insurance and private savings

Another way that would make insurance coverage more accessible would be to allow and/or to force individuals to save during their work-time period in order to pay for either their LTC expenses later in life or their LTC insurance premium so as to spread the cost of insurance over time. This would allow for one generation to accumulate sufficient resources to take care (partially) of its own needs in LTC through individual savings accounts. These savings accounts could take the form of health savings accounts that already exist in Singapore, China or the U.S., where savings are invested in a special account to cover only health care spending. These accounts are generally offered in combination with a high deductible insurance. Various possibilities exist, whether in the form of voluntary participation with financial incentives, or of mandatory contribution with additional contribution from the employer. These savings accounts could also take the form of the Swiss second pillar, the mandatory occupational pensions system. The funds of the second pillar are already being used to expand home ownership. They could also be used to expand access to insurance. Such a system, based on inter-temporal distribution mechanisms, enables building up reserves for old age and makes it possible to fight against moral hazard. However, such accounts do not enable risk sharing between individuals and depend on the performance of financial markets. Additionally, they can segment the pool of insureds further and make LTC risks more difficult to insure.

Anticipating the risk of dependence early enough—the Eldershield experience

Insurance products covering the risk of dependency have a relatively low penetration rate compared with other insurance products. One reason is that relatively few people are aware of this risk and the existence of such insurance products. Another reason is that insurance becomes an expensive solution when it is contracted at a later age. Indeed, since it is important to provision this risk (transfer of risk over time rather than between individuals), insurance is more interesting when it is contracted early. With this in mind, the Singapore authorities have introduced a new public financing system of dependency risk,

entitled Eldershield. From the age of 40, all individuals are automatically enrolled in this system, and randomly allocated to an insurer. Anyone is free to choose another insurer among the insurers authorised to participate in the system. It is also possible to refuse membership to the system in the first three months. In this case, it is not possible to take advantage of the benefits of the system (no public subsidies and preferential underwriting conditions). The product and its pricing are to be borne by insurers. The premium is paid until the age of 65 and compensation in case of dependency is for life. Possibility of surplus redistribution and premium discounts is also included. The plan was launched in 2002. The government funded a portion of the premium in order to smooth age segmentation. It also provided mean-tested benefits for those already dependent. A large information campaign was conducted to promote the plan and its products. The opt-out rate of the plan decreased from 38 per cent in 2002 to 14 per cent in 2006, reflecting the importance of guiding people and of raising awareness of the risk of dependency.

References

- Brown, J. and Finkelstein, A. (2007) "Why is the market for long-term care insurance so small", *Journal of Public Economics*, 91, pp. 1967–1991.
- Chen Y.P. (2001) "Funding long-term care in the United States: the role of private insurance", *The Geneva Papers on Risk and Insurance—Issues and Practice* 26, pp. 656-666.
- Courbage, C., Roudaut, N. (2008) "Empirical evidence on long-term care insurance purchase in France", *The Geneva Papers on Risk and Insurance—Issues and Practice*, 33(4), pp. 645-658.
- Doeringhaus, H.I., Gustavson, G.G. (2002) "Long-term care insurance purchase patterns", *Risk Management and Insurance Review*, 5(1), pp. 31-43.
- European Commission (2008) *Long-Term Care in the European Union*, EC: Brussels.
- Feder, J., Komisar, H., Friedland, R., (2007) "Long-term care financing: policy options for the future", *Georgetown University Long-Term Care Financing Project*, Washington DC.
- Kunreuther, H. (1978) *Disaster Insurance Protection: Public Policy Lessons*. Wiley: New York.
- Mellor, J.M. (2001) "Long-term care and nursing home coverage: Are adult children substitutes for Insurance Policies?" *Journal of Health Economics*, 20(4), pp. 527-547.
- Murtaugh, C., Spillman, B., Warshawsky, M., (2001) "In sickness and in health: an annuity approach to financing long-term care and retirement income", *Journal of Risk and Insurance*, 68(2), pp. 225-254.
- OECD (2005) *Long-term Care for Older People*. OECD: Paris.
- Pauly, M.V. (1990) "The rational nonpurchase of long-term care insurance", *Journal of Political Economy*, 98, pp. 153-168.
- Sloan, F.A., Norton E.C. (1997) "Adverse selection, bequests, crowding out, and private demand for insurance: evidence from the long-term care insurance market", *Journal of Risk and Uncertainty*, 15, pp. 201-219.
- Zweifel, P. and Strüwe, W. (1996) "Long-term care insurance and bequests as instruments for shaping intergenerational relationships", *Journal of Risk and Uncertainty*, 12, pp. 65-76.

Author: Christophe Courbage is Research Director at The Geneva Association.

This article was published by The International Association for the Study of Insurance Economics (The Geneva Association). Articles, documents and recent publications of the Association can be found on its website, at www.genevaassociation.org