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How pensions can help meet consumer needs under the new Social Care regime

An Overview

By the Products Research Group of the
Pensions and Long Term Care Working Party

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1 Executive summary

1.1 Purpose of paper

Long term care (LTC) has long been a topic of political debate in England. The Commission on Funding of Care and Support (widely known as The Dilnot Commission) was established in July 2010 and tasked by Government with reviewing the funding system for care and support in England. The recommendations made by The Dilnot Commission in July 2011 have since been updated to form the current Care Bill (2013-14) progressing through Parliament.

The Government has recently been consulting with various stakeholders, including the financial services industry, on the anticipated changes to LTC that could result from the Care Bill (2013-14) becoming law. In particular, the Government has been seeking input from the financial services industry on what financial products may be developed to enable individuals to provide for their LTC needs in later life under the new regime.

The Institute and Faculty of Actuaries (IFoA) Royal Charter states that the objects of the IFoA shall be, in the public interest, to advance all matters relevant to actuarial science and its application to regulate and promote the actuarial profession. The IFoA, as an independent professional body, has sought to inform the debate by providing Government with an independent expert view, formed from its members who are specialists in both pensions and LTC.

This paper has been written by the IFoA's Pensions and Long Term Care Working Party's Products Research Group and considers how pensions might be used to help fund LTC needs at older ages. In particular, how pension wealth and uses of pension or pension based products could fund LTC needs in the new regime from 2016. This paper also considers the financial impact of the proposed cost cap for individuals in England.

Other IFoA members are providing views on how non-pension products could be used (e.g. equity release) and other groups within the IFoA are considering the impact of care costs on individuals and on building an understanding of the distribution of pension wealth.

1.2 Information on research group and authors

The Pensions & Long Term Care Working Party was formed in May 2013. The Products Research Group is a sub-group of the Working Party and is tasked with developing thinking on how pension products could provide part of the financial solution to meet LTC needs under the anticipated new social care regime due to come into effect in April 2016.

The terms of reference of the group are available from the IFoA.

The members of the research group and authors of this paper are: Thomas Kenny (Chair), Jerry Barnfield, David Curtis, Linda Daly, Ailsa Dunn, David Passey, Ben Rickayzen and Audrey Teow.

Thank you to Helena Dumycz and Rebecca Deegan of the IFoA for their invaluable support to the group in producing this paper. Thank you to our peer reviewers: Alison O'Connell, Sue Elliott, the Steering Group of the Pension & LTC working party and other IFoA Board members.

1.3 Key conclusions

People need to be encouraged to save more for their retirement and potential LTC needs.

1. Currently, the average level of pension savings is unlikely to be sufficient on its own to enable someone to meet their LTC needs in addition to their retirement income needs. However, pension savings could play a part in meeting care costs and the introduction of new products, together with a well thought out communications strategy, might encourage additional savings provision towards these needs.

Pensions provide a framework for meeting LTC cost needs.

2. Pensions provide an existing framework that could be developed further to help individuals make provisions to fund their LTC needs. There are a number of benefits discussed in more detail in Section 2.2 of this paper and summarised below:
    - Established framework – there is an existing level of awareness and understanding of the framework.
    - Speed of introduction – it would be quicker to develop and implement new products within an existing framework.
    - Flexibility – saving for LTC within the wider pension system, particularly in light of the Budget 2014 announcements, which give greater freedom to fund utilisation, will enable the money to be used for other purposes. This can help address the concern that LTC savings may not be needed and it could help to encourage greater saving for retirement in the future.

2014 Budget pension reform should facilitate product innovation, but may reduce the pension funds available to spend on LTC

3. The proposed simplification of the pension tax rules (announced in March 2014) and the removal of most pension income restrictions should facilitate product innovation. The products discussed in Section 5 have become more attractive under the proposed changes. However, there is a risk that individuals will choose to spend their pension savings earlier in retirement rather than making provision for their late retirement or potential LTC needs.

While most people will not need LTC in retirement, a significant proportion of retirees will.

4. It has been estimated that there is a 35% chance of a 65 year old female needing eligible care at some point in their life (25% for males) (Rickayzen, 2007).

Most people who enter LTC will not reach the Government's cost cap and all will have additional costs outside the cap.

5. There are three types of care costs; daily living costs, local authority set care costs and top-up care costs. The cap only applies in relation to local authority set care costs. For the majority of individuals entering care, there is a low chance of the cap being reached. We estimate that for individuals aged 85 (typical age) when entering care there is less than a 8% / 16% (male/female) chance that they will reach the cap. Those who hit the cap will have spent around £140,000 (average across England) on LTC costs before reaching the cap and this can increase to around £250,000 if an individual is in care for 10 years; only around 1% of individuals are expected to live this long whilst needing LTC (Laing and Buisson, 2013). These figures are based on a care home without nursing and include daily living costs and top-up care costs. This demonstrates the need for insurance for LTC needs. This is discussed in more detail in Section 4.

The personal costs of care and the chance of reaching the cap vary significantly by region.

6. There is a wide variation in the local authority care costs across the country and this has a significant impact on the time taken to reach the cap and the personal costs incurred by that point. For example, an individual entering a care home at age 85 in the West Midlands is expected to incur a personal cost of around £170,000 before reaching the cap after 7 years. This compares to £117,000 with the cap reached after 4 years for someone entering a care home in London. The cost of care in London is higher than in the West Midlands, but the time taken to reach the cap is shorter, so it has a dampening effect on the personal costs incurred. This is discussed in more detail in Section 4.

There is a range of new and existing products that could support LTC needs in retirement.

7. Pension products can be created and adapted to provide extra income to cover the costs of care on a savings or an insurance basis. An individual's financial and personal circumstances will determine which products are most appropriate – there is no unique product that is suitable for all consumer needs. The individuals most likely to make additional provision for their LTC needs through their pension are those with assets above the means test upper limits, but with expected retirement income below the cost of LTC. This is discussed further in Section 5.

The new adult social care system is simplified, but still complex as it stands against the backdrop of a relatively complex social care system and a wide range of products available. It is vital that consumers are given detailed information and advice so that the most appropriate product for the consumer is chosen. The information and advice needs to be provided when saving for retirement, at retirement itself and also at the point of needing care. Trigger points could be developed at these life stages to achieve better communication. The communication should be integrated across all parties involved, including the NHS and local authorities. This is discussed in more detail in Section 8.

1.4 Recommendations

Communication

1. The likely impact of the cap on consumer finances needs to be made clear as part of a communication strategy. The cap provides welcome protection from catastrophic care costs; however, the messaging to the public does need to be balanced as to its expected impact for the majority of individuals.

Because needs are diverse and cost structures complex, good information and advice is needed.

2. The suitability of the different products, for individuals in different financial situations and at different life stages, will depend on the level of income and assets an individual has and the time at which they are making provision for their LTC needs. There are two main types of pension-style products: those that start well in advance of needing LTC and those that are invested in at or near the time of needing LTC. Both avenues of funding should be explored by government and industry. The suitability of different products is discussed in more detail in Sections 5 and 6.

3. Central government could consider changing the regulations on product disclosure for pensions so that information on typical income needs in retirement (including illustrations) are disclosed and a clearer picture of the retirement income gap allowing for potential LTC costs can be seen. This is discussed further in Section 8.

Some regulatory and tax changes would help development of existing and new pension/LTC products.

4. In Section 8, we discuss potential regulatory and tax changes that may help to encourage greater use of pensions for LTC provision including the following:

    - Amend means testing rules to create a level playing field with other life assurance products that allow individuals to exclude assets from the means test (such as investment bonds).
    - Confirm that a Disability-Linked Annuity (DLA) can be treated as a pension annuity under the proposed pension tax rules in the 2014 Budget.
    - Allow payments to be made directly to registered care homes/providers from a pension for the benefit of an individual or their partner.
    - Consider establishing a Pension Care Fund (PCF) framework i.e. a separate pension pot which could only be used for funding LTC costs and would receive pensions (taxation) treatment without becoming part of the lifetime allowance. A PCF should allow individuals to designate part of a pension that can be transferred, exempt of inheritance tax (IHT), to their estate, as long as it remains only accessible for LTC provision to avoid disincentives to save.

2 Introduction

2.1 Background to social care changes for the elderly in England

The new Care Bill (2013-14) currently before Parliament is expected to receive Royal Assent in 2014. This legislation will replace numerous pieces of existing legislation and introduce a new legal framework that is intended to be simpler and fairer. Reforms are being phased in with implementation of the key reforms for individuals, such as personal budgets, care and support plans and the deferred payments agreements in 2015 and the remainder, such as the capped charging system, scheduled for 2016.

2.1.1 New cap on social care costs

One of the key elements of the Care Bill is the proposed introduction of a £72,000 cap (in 2016 prices) on the cost of care for people of State Pension Age and over. The cap, which is due to be effective from April 2016, aims to provide greater certainty to individuals of their total cost of care. An individual will initially face up to three types of cost: daily living costs; local authority set care costs; and top-up care costs. The cap only applies in relation to local authority set care costs. Individuals will pay all costs before the cap is reached (subject to means-testing and any benefits payable) and will pay daily living costs and top-up care costs once they have reached the cap.

2.1.2 Care costs not included in the cap

A person in a care home or a care home with nursing will be expected to make a contribution of around £12,000 a year towards their daily living costs (often referred to as 'hotel costs'). These costs do not count towards the cap. Any care costs incurred before an individual is assessed as having 'eligible needs' (as defined under 2.1.3) and the cost of provision in excess of what the local authority would pay for eligible care (the local authority set care cost) also do not count towards the cap. If NHS funded nursing care is being received then this element of the care costs does not count towards the cap.

2.1.3 New national minimum eligibility criteria

The Care Bill proposes a new national minimum eligibility criteria (expected to be set at what is referred to as 'substantial needs'), whereas currently eligibility criteria can vary by local authority. It is only when an individual is assessed as having needs that meet these criteria that they are deemed to have 'eligible needs'. From this point their care costs will count towards the cap.

2.1.4 New scheme to allow deferred payments

Another key feature of the Care Bill is the introduction of deferred payment agreements that will enable people who qualify to use the value of their home to pay for care, without the need to sell the property in their lifetime. The proposed qualification criteria would allow anyone needing residential care who has less than £23,250 in assets (excluding their home) and whose home is not occupied by a partner or dependent relative to access the scheme.

2.1.5 New means test limits

Under the Care Bill the means testing upper limits are expected to increase to £27,000 (property not included) and £118,000 (property included) from the current limit of £23,250. The lower limit is also expected to increase to £17,000 from the current limit of £14,250. If a person's assets are less than £17,000 they will only be required to contribute to their care costs from their available income. A tariff exists to compare the value of capital assets with income and for every £250 of capital assets above

the lower limit an additional £1 per week will need to be contributed from their assets towards the cost of care. Further details of how means testing interacts with the cap are given in Appendix 1.

2.2 Background to proposed pension changes

In the 2014 Budget major changes were announced to the way members of defined contribution plans (DC) will be able to access their pension savings. From 6 April 2015, the following changes are anticipated to come into effect (assuming they pass through the legislative process as announced):

- No withdrawal limits and so members of DC plans will be free to withdraw as much or as little of their accumulated savings as they wish (subject to 75% of the total savings being taxed at their marginal rate).
- Free and impartial guidance on the range of financial options at retirement to all DC retirees. This could create a need for regulatory advice, which the retiree will have to pay for.
- Minimum pension age to increase from 55 to 57 by 2028 and to maintain a 10 year gap with State Pension Age in the future.
- Consultation on allowing tax relief on contributions after age 75.

The Government has said that DC members can determine how they use the money from their DC pension pot. This could include a range of options such as:

- investing the money outside of the pensions regime in ISAs, property or other investments that may or may not be accessible in the pension scheme
- gifting money to children or relatives
- spending the money on holidays, cars, other luxury items
- supporting care costs for elderly parents or other medical care needs; and
- anything else that the retiree wishes to invest in or spend money on.

2.2.1 Impact on pension savings

Three immediate possible responses to these changes can be identified:

- Increased levels of pension savings at younger ages prompted by the easier access to such savings at retirement.
- A significant reduction in the number of retirees purchasing an annuity and the much greater use of drawdown or other more innovative products.
- As a result of the greater flexibility for accessing pension savings, lower volumes of savings held in pensions products at older ages, with the withdrawn assets being invested in alternative savings/investment vehicles or being spent.

2.2.2 Consequences for funding LTC costs from pension savings

A number of potential consequences of these changes can be identified:

- If more money is attracted into pension savings at earlier ages this should increase the overall wealth of people reaching retirement. This gives greater opportunity for retirees to invest in products aimed at meeting their potential LTC costs.
- The provision of free, impartial, face-to-face guidance at retirement should ideally allow the potential costs of LTC to be identified and the products available to help meet such costs to be fully explained. However this would require those providing this guidance to have sufficient understanding of the new social care regime and knowledge of the products available for funding LTC (there may be a role for the IFoA and other industry groups in helping develop best practice for such guidance).

- The increased flexibility available to retirees will strengthen the need for improved clarity and communication in many areas including the expected costs of LTC.
- In order to compete with the attractiveness of flexible drawdown or immediate access, the incentive for retaining funds in a pension product committed to meeting LTC costs may need to be increased. The proposed extension of tax-relief for contributions after age 75 will support this provided such contributions can be drawn from savings as well as earned income. We have identified in Section 8 some potential additional incentives that would encourage greater saving for LTC costs and these will become increasingly important in the liberated drawdown environment which the Government proposals will create.
- There will be some, and possibly many, who will withdraw and spend all their pension savings and thus find themselves in a position of being unable to meet their share of their LTC costs. In the event of these individuals needing care the State would then need to fund their care needs. There has been some discussion as to whether spent pension assets will be accounted for when assessing care provision, the outcome of this is yet to be confirmed.

2.3 Why pensions could be used to support long term care needs?

Whilst the proposals set out in the new Care Bill are designed to provide some significant improvements over the existing arrangements, they do not remove the need for individuals to fund a substantial element of their LTC costs. To facilitate and encourage the necessary long term savings for this potential liability, suitable products need to be available. These products are likely to share many of the characteristics required for long term pension savings and so it is natural to consider whether the necessary products could be developed within the existing pensions environment.

With the majority of the UK population contributing to private pensions (over 80% of men and 60% of women in 2010-11 were actively contributing to private pensions, receiving income from private pensions or had contributed at some time in the past (International Longevity Centre, 2013)) there are opportunities to develop pension savings to incorporate elements of the potential costs of LTC. In fact such an approach does offer a number of advantages which we detail further below.

2.3.1 An established framework

The advantages of building on an established regulatory, fiscal and distribution framework are considerable. At a minimum there is an existing level of awareness of individuals' pension savings, particularly with the auto-enrolment initiative underway. In a growing sector of the population there will also be a good level of knowledge and understanding around how pension saving operates under both a defined benefit (DB) and a defined contribution model. This awareness and understanding could provide a valuable platform for launching LTC savings products. Developing a new product regime from scratch would require a significant resource commitment from providers and government, a significant educational commitment and may also need to overcome the concerns left in the public psyche from past mis-selling issues.

2.3.2 Speed of introduction

Using the existing tax, contribution and investment frameworks would offer opportunities to introduce suitable products much more quickly than would otherwise be possible and should provide economies of scale through the expanded use of the existing infrastructure. Integration with the pensions environment could also address the need to provide a solution for those who are already in receipt of pension income.

2.3.3 Flexibility

Saving for LTC costs may well be resisted because of the perception that 'it will never happen to me' and the misconception of 'I do not need to save as the government will pay'. It will be necessary to

overcome these two key areas of resistance. A comprehensive communication strategy will help to enable the breakdown of these barriers to engagement. Additionally, the concern attached to any pre-funding for an uncertain need, such as LTC, that the money saved will be lost if the need does not arise could be reduced by integrating the additional savings into the pensions environment. This could allow the flexibility for savings to be switched from LTC to pensions, or vice versa as individual circumstances require, avoiding the perceived risk to the individual of not being able to benefit from the savings made.

Indeed, the likely complementary nature of the two risks – either "I remain fit and need my pension for longer" or "I suffer illness and so need a higher income over a potentially shorter period" – make the pairing even more appropriate. This may be better received and, therefore, utilised than an alternative pure insurance based product which could continue to face resistance from those who have concerns that no benefit might be drawn despite the payment of a substantial premium and may, therefore, be unsuccessful at product launch.

2.3.4 Common asset

After an individual's property, his or her pension is likely to be the most substantial asset available to meet the personal contribution to LTC costs. Given the general lack of any other material savings by the general public and the continuing resistance to releasing value from the "family home" the use of pension assets may become more of a necessity than an option. Many individuals are not currently making full use of their tax-relieved savings opportunities so this approach could also reduce the need to create a new savings tax relief to incentivise LTC pre-funding.

2.3.5 Employer engagement

One of the ways that saving for LTC could be encouraged is if employers participate in, or support, the process. It is generally accepted that employees trust their employer more than they trust many other participants in the savings market and so employer support could help overcome nervousness and inertia. Provision on a bulk scale would also offer additional economies of scale. Indeed, if employers could be further incentivised to build such savings into their benefit offering the level of participation could be much higher than would otherwise be the case.

2.4 Areas considered within the paper

This paper will focus on considering pension wealth and the potential uses of pension or pension-based products to fund LTC needs in the new regime from 2016.

Section 3 considers the profile of potential consumers of care and illustrates care needs and current care costs. Section 4 builds upon this understanding of care use and cost through modelling of the financial impact of the capped regime in practice for individuals around the country.

Section 5 considers a number of potential product designs, some already in existence and others which have the potential to be developed in the short to medium term. This section describes the basic features of these products, how they could be funded and summarises the main advantages and disadvantages of them in practice. Section 6 then maps these product solutions against consumer profiles to indicate their appropriateness as a practical solution.

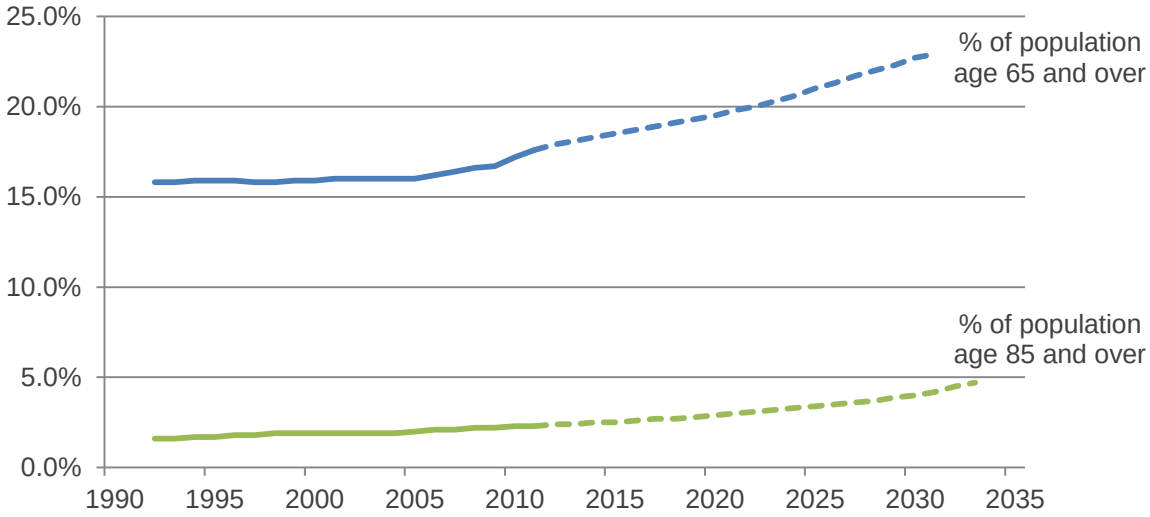
Sections 7 and 8 consider how, in practice, these products could be brought to fruition and be more widely utilised (where they already exist): section 7 through the adoption of a comprehensive and integrated communication plan and section 8 through legislative and technical changes that would allow such products to exist.

3 Consumer profile in retirement

3.1 Impact of ageing population on care needs

Overall life expectancy has been increasing, but there is considerable debate over whether healthy or disability-free life expectancy has increased at the same rate (Oxford Institute of Ageing and Club Vita, 2011). Analysis based on historical data for the UK suggests that for both men and women the increases in healthy and disability-free life expectancy have not kept pace with total gains in life expectancy (*ibid*). This implies not only more people reaching retirement but a growing need for LTC provision.

Figure 1: Proportion of the population that is in retirement and age 85+ is projected to rise considerably (Office for National Statistics, 2012a)



The number of people in the UK aged 65 or over is expected to increase by more than 50% in the next 20 years (Office for National Statistics, 2013a). Even more relevant to LTC is the number of over 85s, which is expected to more than double in the next 20 years (*ibid*). As shown in Figure 1 the older population is projected to make up a larger and larger proportion of the total UK population.

The total number of centenarians is also projected to rise from 14,000 in 2013 to 111,000 in 2037 (Office for National Statistics], 2013b).

3.1.1 Variation by Gender

Females have longer life expectancy than males (cohort life expectancies for women at age 65 in England and Wales reached 23.9 years in 2012 compared with 21.2 years for males (*ibid*)) and this, along with higher morbidity rates drives a greater need for LTC for females. The need for care and costs of care is also impacted by female partners outliving their male counterparts, as they are therefore less likely to have a partner to help with care at home towards the end of their lives.

The risk at age 65 of needing eligible care during their future lifetime is approximately 1 in 3 for women but only 1 in 4 for men (Rickayzen, 2007). This is also reflected in the expected lifetime costs of care, which at age 65, are estimated to be 75% higher for females than males (Commission on Funding of Care and Support, 2011b).

3.1.2 Variation by Geographical Region

The divide in England between North-South life expectancy and disability free life expectancy is often cited, with people in local areas in the North generally living shorter lives than those in the South (Office for National Statistics, 2012b). At birth, males in the least deprived areas in 2007-10 could expect to live around 15 more years disability-free than males born in the most deprived areas, for females it is almost 13.5 years (Office for National Statistics, 2013c). For the wealthier areas across the country, morbidity is similar regardless of geographical region, but for the least wealthy areas morbidity does vary by region. In the most materially disadvantaged areas in the north of England, morbidity is much higher than similarly disadvantaged wards in the southern regions, with disability-free life expectancy 4.9 years lower in the north for this group (Office for National Statistics, 2012c).

3.1.3 Dementia

Incidences of dementia are rising, and this could also drive up the number of people requiring LTC in retirement. It is forecast that the number of people in England and Wales aged 65 and over with dementia (moderate or severe cognitive impairment) will increase by over 80% between 2010 and 2030, to 1.96 million (Lords Select Committee on Public Service and Demographic Change, 2013).

These trends highlight that more people will be living to older ages with increasing degrees of LTC needs and yet these needs (and the need for funding) will not be borne uniformly across the genders or regionally across England.

3.2 Income distribution of current retired population

Pensioner incomes have grown faster than average earnings in the UK as a whole over the last 30 years and unlike wages, have historically not stagnated in times of economic pressure (Office for National Statistics, 2012c).

3.2.1 Sources of Income

The average disposable income for retired households was £18,700 in 2011/12, constituting a range of income sources, including, £8,800 from private pension and annuity income and £8,100 from the State Pension (Office for National Statistics, 2013d).

Benefit income (including State Pension) serves as the main source of income for pensioners as a whole. However, the importance of benefit income varies between pensioners depending on their wealth levels and other income sources.

Only a small number of pensioners rely solely on State benefits and the majority have some level of private income to top-up their retirement income (in 2010/11, 70% were receiving a private pension and 88% were receiving some sort of private income to top-up their State benefits[1]).

As a consequence of the proposed changes to the pensions tax framework in the 2014 Budget, the level of private pension income of future retirees will change in the future, however it is not yet clear what the full impact will be. The increased flexibility in accessing DC pots could encourage greater levels of pension savings overall, but this may be offset by an increase in the rate at which pension savings are depleted in retirement.

[1] The Pensioners' Incomes Series analysis is for pensioner units, which are defined as either single pensioners (people over State Pension Age) or pensioner couples (married or cohabiting pensioners where one or more are over State Pension Age).

3.2.2 Impact of gender

On average, male pensioners have higher incomes than female pensioners across all age groups (20% higher on average based on net income after housing costs (DWP, 2013)). The main difference between the genders exists for occupational pension income, which was 60% higher for single males than single females in 2010-11.

This contrasts directly with the expected cost of care in retirement, which is much higher for females than males.

3.2.3 Geographical differences

There are large variations in both income and care costs across England. Pensioners in London, the East, the South East and the South West have on average higher income than pensioners in other areas of England. Average gross income is 40% higher in the South East (the highest income region) compared with the North East (the lowest income region) (Laing & Buisson, 2013).

The average weekly private care home with nursing fee is 47% higher in the South East compared to the North East and the average weekly private care home fee 28% higher (*ibid*).

3.3 Wealth distribution of current retired population

3.3.1 Property

For current pensioners property is a significant component of wealth. In May 2013, 79% of over-55s in the UK owned their own home (Aviva, 2013) with the average value of the equity in the homes of those aged over 55 being £158,000.

3.3.2 Savings

The average savings pot of over-55s in the UK was around £11.7k in May 2013 (Aviva, 2013); however, there has been a lot of pressure on savings over the last few years which have seen pensioners drawing on their savings. The average savings of those aged 65-74 dropped by 50% in the 12 months to May 2013 (*ibid*).

3.4 Wealth distribution of future retirees

While it is possible to gather some information on the income and wealth distribution of the current retired population, current and future economic challenges together with changes in consumer attitudes to debt and savings (potentially as a result of the Budget 2014) mean the future market could be quite different from the one seen now. Additionally if the proposals initially announced in Budget 2014 are enacted, with effect from 2015 there will be no withdrawal limits on defined contribution arrangements so members of such schemes will be free to withdraw (subject to their marginal rate of tax) as much or as little of their accumulated pension savings as they wish. Consequently, this is likely to mean the income/wealth distribution of future retirees will reflect a very different picture to the one seen today.

The above, combined with other factors considered below, will impact consumer behaviour and the ability to fund potential LTC costs in future. In particular:

- Financial strain on the young population due to employment stagnation.
- Impact of baby boomers coming to retirement:
    - With a large number of people approaching retirement there could be a surge in people needing care in future.
    - High proportions have DB pension schemes at a material level.

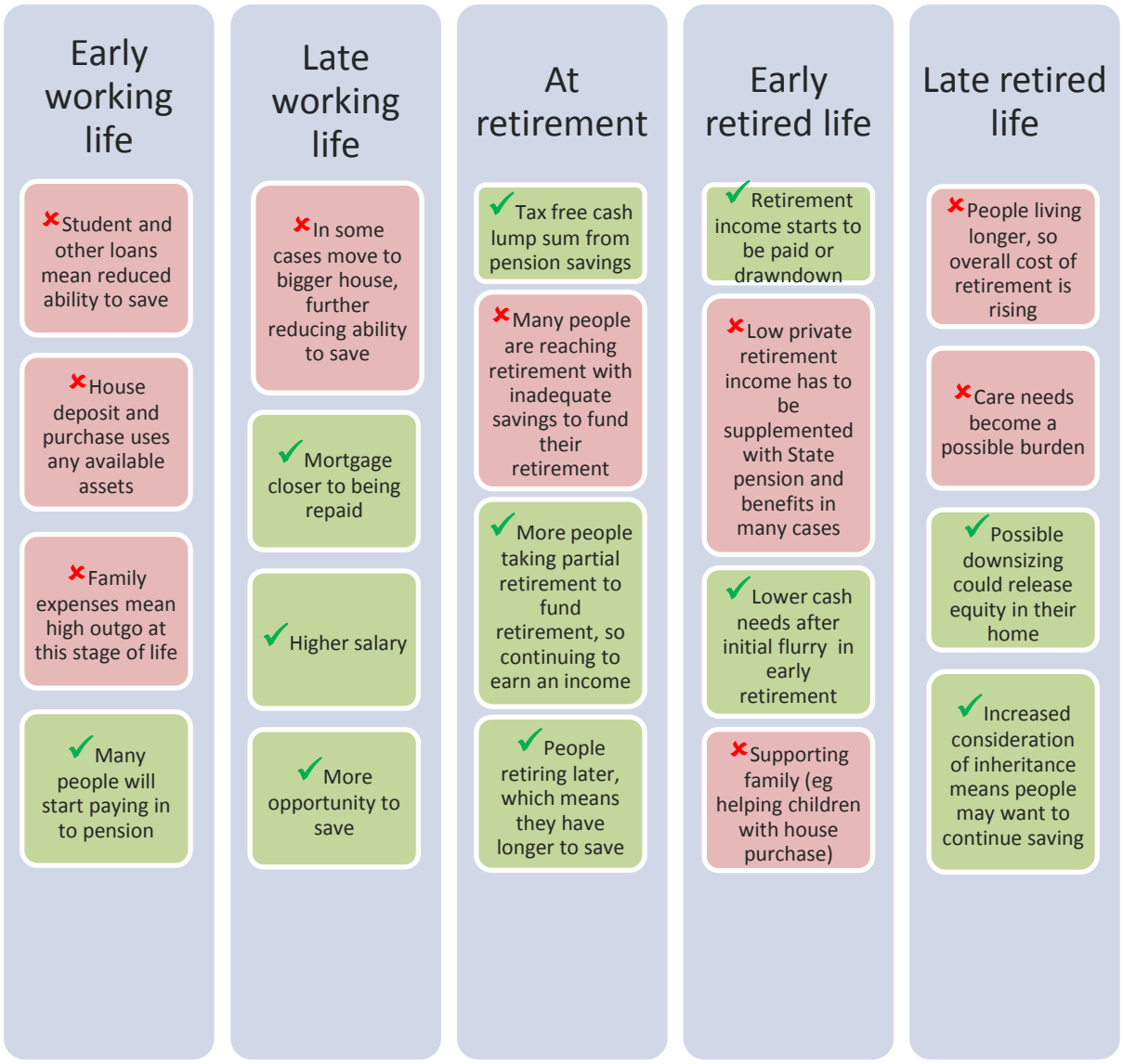
- Fall in DB pension provision – pension incomes from private pensions are likely to reduce in future as significantly more individuals reach retirement with only a DC pot.
- Generation of homeowners:
    - Around three quarters of those aged 65 and over are homeowners with no outstanding mortgage (Office for National Statistics, 2013e).
    - Given the housing bubble, future retirees may be less likely to have such high levels of property wealth and may be more likely to have interest-only mortgages.

3.5 Affordability and timing of funding

We have considered the income and wealth distribution of current and future retirees and will now look at opportunities to fund care in the period before retirement.

Figure 2 describes the high-level income and expenditure needs of individuals over the course of their lifetime and provides an idea of when there may be capacity for people to start saving for LTC needs.

Figure 2: How individuals' ability to save varies over different stages of their lifetime.



There may be some opportunity for people to start saving for LTC costs before retirement, although to specifically fund for care needs in advance is currently rare in the UK.

Even among the retired population only 6% are starting to save to pay for LTC (Aviva, 2013).

3.6 Will people pay for care in advance?

Being able to plan and fund ahead would help individuals to more effectively manage care needs that may develop in later life. Planning ahead could also drive product innovations and create a more efficient care market.

For those without sufficient assets, there may not be an incentive to consider saving to pay for their LTC needs with means-testing in place.

In reality, even for those who have the financial means to fund for care in advance, the general lack of understanding and public misconceptions on care funding are likely to mean that few individuals will pre-fund for care without State direction or guidance.

3.7 Potential care requirements

For any retiree, there are a range of care needs that might arise in future. Products designed to facilitate the customer's saving for LTC costs will need to be appropriate for the care needs likely to be encountered.

There are four main categories of care need that a person may fall into:

1. **Healthy individuals**

   Some people will never require LTC. Healthy and active in early retirement, health may deteriorate with ageing and they may become less active but they are able to support themselves at home, perhaps with the help of their family.

2. **Assisted living**

   Some people will require some assistance, but still want to live independently. Healthy and active in early retirement, their health may deteriorate with ageing and they may become less active. In order to keep living independently, they enter assisted living, in the form of short term rental with care services. This is not a 24 hour care service, and care services are still provided separately but it would provide optional 'hotel' services such as cleaning and meals.

3. **Care at home**

   Some individuals will require some help at home, but will not require care home or nursing home support. Healthy and active in early retirement, their health may deteriorate with ageing and they may become less active and eventually require assistance at home. Their health may, however, never deteriorate to the point where they need to enter a care home.

   This group may also include individuals who do have the level of care needs that could be met by a care home; however, their personal circumstances and levels of support mean they do not need to make that move.

4. **Receives care at home followed by entering a care home or care home with nursing**

   Some people's health may deteriorate with ageing and they become less active to the point that they require assistance at home. Further deterioration will mean that they may require, or

choose, full time assistance that will be provided in a care home or care home with nursing. Depending on the care home selected and the local authority set care cost rate, the individual may incur additional top-up costs that may not count towards the cap on top of the daily living costs.

Home care accounted for around two-thirds of local authority expenses (£1.69b) in 2006/07 (Comas-Herrera & Wittenberg, 2010). This, combined with the expected ageing and increasing morbidity of the population, may mean the criteria for eligibility will need to be tightened, as councils target resources to those in greatest need.

Some people who are receiving care at home may rely on the support of their partner or family, and will not always accrue the costs of care against a cap allowance even when they are classed as having substantial needs. For those who do receive formal care, whether at home or particularly those in care homes, the costs for LTC can seriously deplete the assets of individuals who require care for several years. Most individuals are over the age of 80 when they enter a care home or care home with nursing. People in care homes are likely to have substantial needs and this would typically count towards the cap.

Records show that the length of stay is shorter for people in care homes with nursing (compared to care homes without nursing) and for local authority supported residents (compared to self-funders, who it is believed are admitted to care homes at earlier stages). Based on a study of BUPA care homes, the average length of stay in a care home is 32 months and 25 months in a care home with nursing (Forder & Fernandez, 2011).

3.8 How much will LTC cost?

Care home costs depend on whether care is received in a care home with or without nursing, whether it is privately run or local authority managed and also in which region it is based. The differences are illustrated in Figure 3.

Figure 3: Average regional annual care home fees around the UK for 2011/2012 (Laing & Buisson, 2013).

Region/Cost per annum	Care Home with Nursing	Care Home
East Midlands	£32,136	£26,312
East of England	£41,600	£29,328
London	£42,692	£31,096
North East	£31,044	£24,492
North West	£34,476	£24,336
South East	£45,188	£30,888
South West	£39,728	£28,652
West Midlands	£36,816	£25,740
Yorkshire & Humber	£32,448	£24,076

4 Probability of individuals 'reaching' the cap

For someone qualifying as having eligible care needs under the new regime we have sought to estimate the probability of them reaching the cap if they become eligible at different ages and within different regions of England.

This section explains how under the new capped cost regime, individuals will still need to self-fund significant levels of their care costs, albeit at a lower level than before the changes introduced by the Care Bill. These costs will continue after reaching the cap and will vary significantly by region. This point highlights the potential need for a variety of product options to give flexibility to support individual circumstances. We consider solutions in the next section of this paper.

It has been estimated that there is a 25% chance of a 65 year old male needing eligible care at some point in their life (35% for females) (Rickayzen, 2007). We have developed a model which estimates the probability that an individual with eligible care needs reaches the cap and therefore receives some support from local authorities in meeting their care costs.

This probability will depend on:

- age,
- gender,
- health status,
- type of care home and rates,
- regional local authority set rates,
- state benefits received; and
- the survival rates used.

The model allows for the means test as set out in Department of Health's (2013) consultation 'Caring for our future: reforming what and how people pay for their care and support'.

In this section we illustrate a central scenario where the individual is a single homeowner with assets (including the value of their property) of £150,000 and has an income of £12,000 pa. The model has flexibility to allow for all of the above variations, but in this paper we have focused on highlighting the variations in:

- the probability of reaching the cap depending on both the gender of the individual and the age at which the individual is admitted to the care home – see Figure 4.
- the cost of care and the probability of reaching the cap based on the region in England and the type of care home (with or without nursing) – see Figures 5 and 6.

The figures are based on a 10-year projection of costs allowing for the probability of survival for each year. A 10-year projection was used as the data for individuals surviving in a care home for over 10 years is relatively sparse – the probability of surviving for 10 years is very low, around 1%.

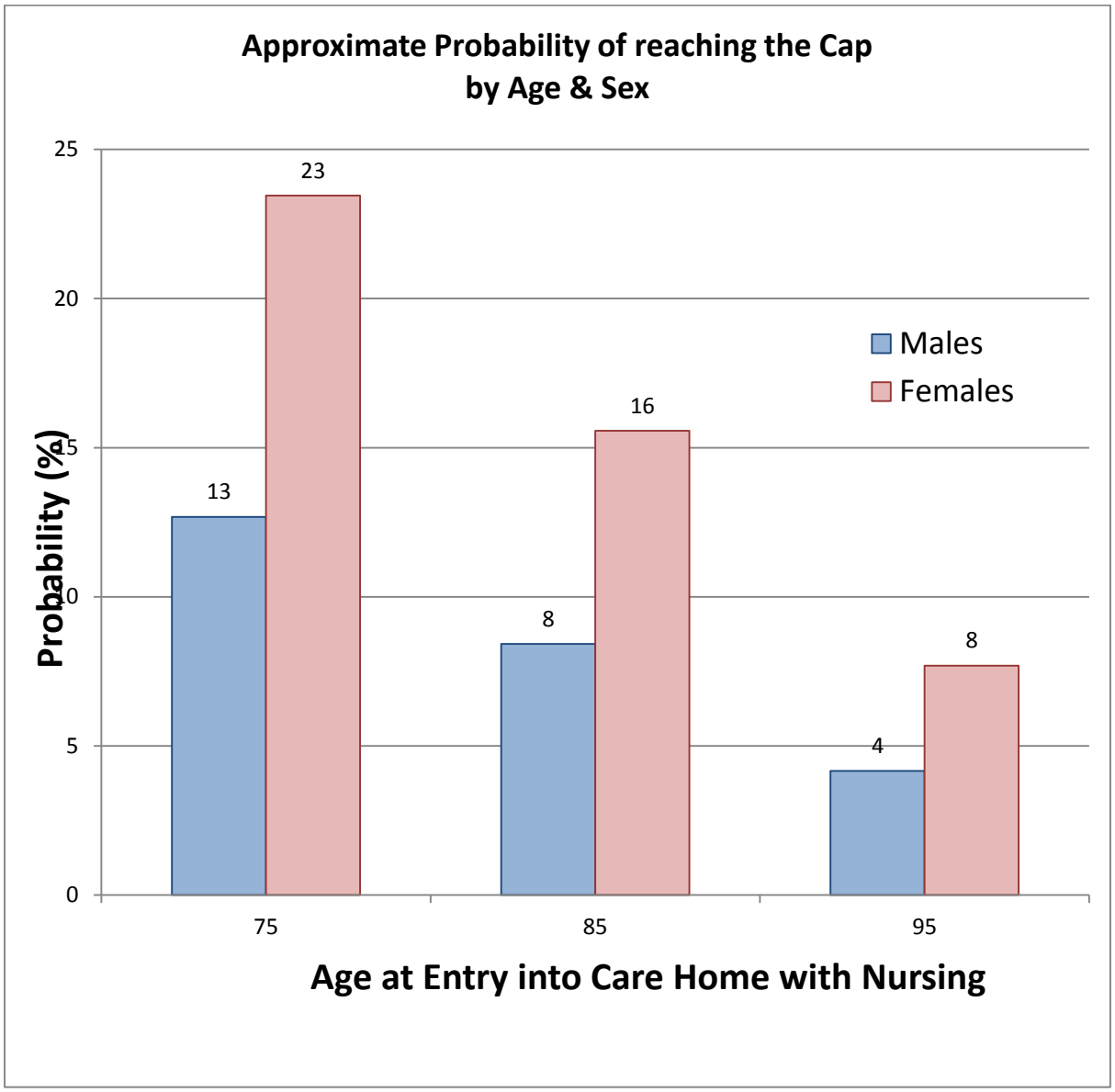
The survival rates are based on a comprehensive survey carried out by the Personal Social Services Research Unit (PSSRU) of care home residents in England that died from November 2008 to May 2010. The mean age at entry to the care home was 85 and around two-thirds of the residents were female (Forder and Fernandez, 2011).

Appendix 2 provides a summary of the key assumptions used.

4.1 Probability of reaching the cap by age and gender

Figure 4 shows the approximate probability of reaching the cap depending on the gender of the individual and the age at which they are admitted to the care home.

Figure 4: Approximate probability of reaching the cap by age and gender



4.2 Care costs and probability of reaching cap by region

Figures 5 and 6 are based on an individual entering a care home at age 85 and the potential costs incurred over the 10 year 'lifetime' period. These particular results are not gender specific.

The figures show how the costs vary by the region in which the care home is located and the:

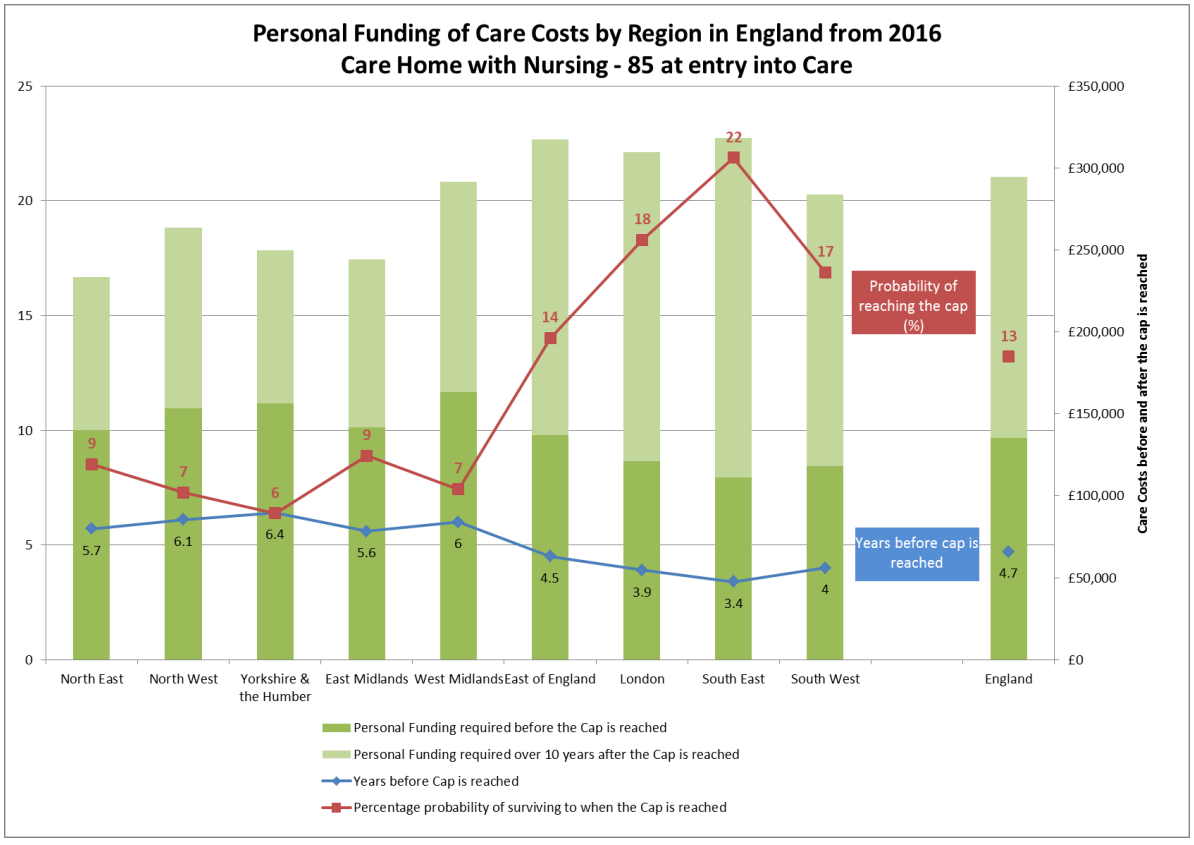
- probability of reaching the cap.
- number of years before the cap is reached.
- cost incurred before and after the cap is reached.

Figures 5 and 6 show the results for care homes with and without nursing respectively.

For example, Figure 5 shows that an individual entering a care home with nursing at age 85 in London is expected to reach the cap after about 4 years, incur a personal cost of around £121,000 before reaching the cap and a further £188,500 if the individual lives for 10 years. The probability that the individual lives long enough to trigger the cap is about 18%.

The total cost of around £310,000 only applies if the individual lives for 10 years. However, since we estimate that only around 1% of care home residents will live for that period of time, it is also worth considering the total costs for shorter durations. Based on the survival rates used in the model, we estimate that 75% of those entering a care home with nursing in London will at least live for 6 months and incur costs of £22,000, 50% will at least live for 15 months and will incur costs of at least £48,000 and 25% will at least live for 36 months and incur costs of at least £98,500. The 'expected'[2] personal costs are around £70,500.

Figure 5: Variation in probability of reaching the cap and care costs by region for those entering a care home with nursing at age 85

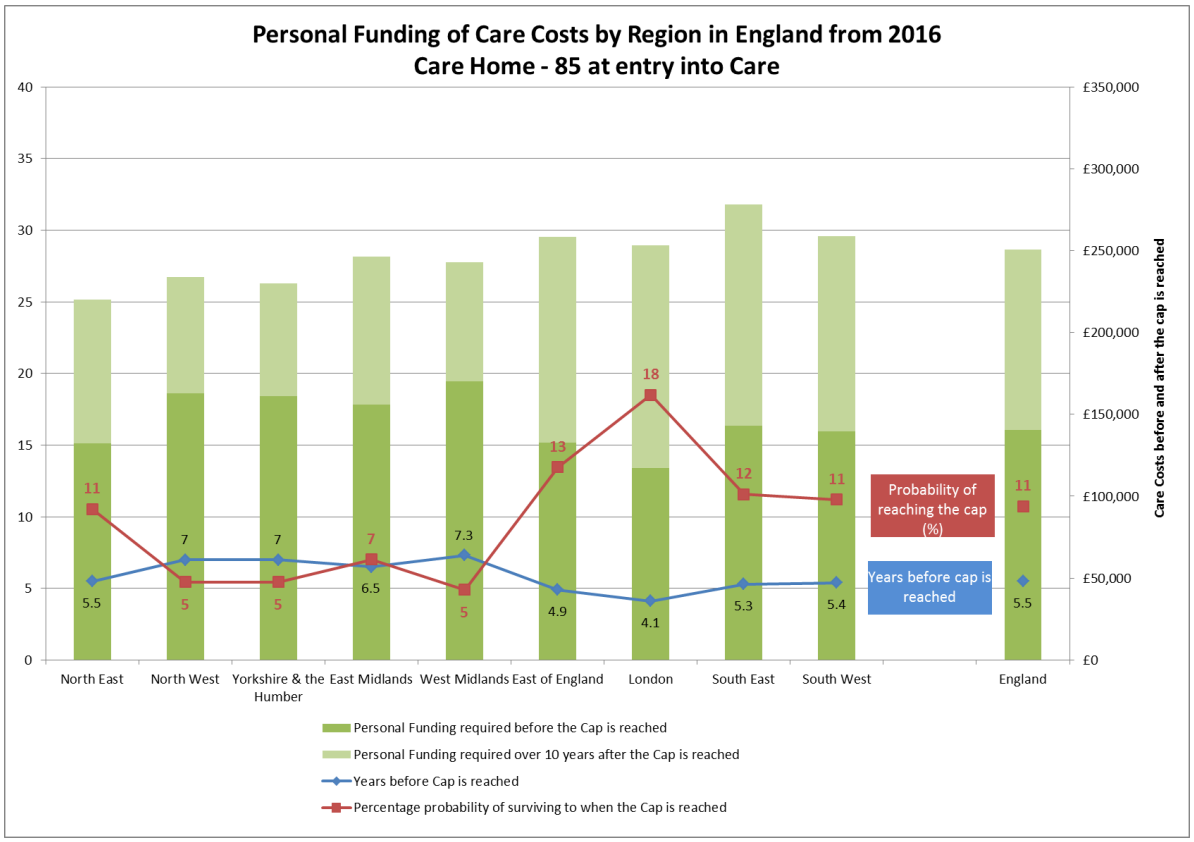


[2] The 'expected' personal cost takes into account the probability that the individual lives to the ages at when the costs are incurred. The survival probabilities are taken from the model.

As a further example, Figure 6 shows that an individual entering a care home at age 85 in the West Midlands is expected to reach the cap after around 7.3 years, incur a personal cost of £170,000 before reaching the cap and a further £73,000 if the individual lives for 10 years. The probability that the individual lives long enough to trigger the cap is around 5%.

The total cost of around £240,000 only applies if the individual lives 10 years. Based on the survival rates used in the model, we estimate that 75% of those entering a care home in West Midlands will at least live for 7 months and incur costs of around £16,000, 50% will live for around 18 months and will incur costs of around £38,500 and 25% will at least live for around 3.5 years and incur costs of £90,000. The 'expected' personal costs are around £58,500.

Figure 6: Variation in probability of reaching the cap and care costs by region for those entering a care home at age 85



4.3 'Percentile costs' of care based on survival rates

The care costs set out in the previous section gave some examples of the likely personal costs depending upon how long 75%, 50% and 25% of those entering a care home would live, and applying the survival rates used in the model.

Figure 7 show the 'percentile costs' and the 'expected' costs' for all regions based on individuals entering a care home with and without nursing respectively:

Figure 7: 'Percentile costs' and 'expected costs' by region for individuals entering care homes with and without nursing

Personal costs for 85 year old entering Care Home with Nursing				
Region	**75% survival**	**50% survival**	**25% survival**	**'Expected costs'**
North East	£14,500	£33,000	£80,500	£54,000
North West	£17,000	£38,000	£90,000	£59,500
Yorkshire & the Humber	£15,500	£35,000	£85,500	£56,500
East Midlands	£15,500	£35,000	£85,000	£56,000
West Midlands	£18,500	£42,000	£94,500	£64,500
East of England	£21,500	£47,000	£97,500	£70,000
London	£22,000	£48,000	£98,500	£69,500
South East	£24,000	£51,000	£100,500	£73,000
South West	£20,500	£45,000	£96,500	£66,500
England	**£20,000**	**£44,000**	**£96,000**	**£65,500**

Personal costs for 85 year old entering Care Home				
Region	**75% survival**	**50% survival**	**25% survival**	**'Expected' costs**
North East	£15,000	£36,000	£85,000	£55,500
North West	£15,000	£36,000	£85,000	£55,500
Yorkshire & the Humber	£14,500	£35,500	£83,500	£54,500
East Midlands	£16,500	£39,500	£92,000	£59,000
West Midlands	£16,000	£38,500	£90,000	£58,000
East of England	£18,500	£44,500	£98,500	£64,000
London	£19,500	£47,000	£101,000	£66,000
South East	£19,500	£47,000	£101,000	£67,500
South West	£18,000	£43,500	£97,500	£63,500
England	**£17,000**	**£41,500**	**£95,500**	**£62,000**

5 Product designs in a pensions framework

This section describes a number of product designs within a pensions framework that could potentially support the funding of LTC needs, some of which exist in some form already and others which are more innovative in the current pensions space. The products considered are:

Product	UK Market size (2012)
Protection Insurance	New product*
Income Drawdown	£1.2bn (ex Self Invested Personal Pensions)
Ring-fenced pension pot (Pension Care Fund)	New product
Disability-linked annuity	New product
Immediate and deferred needs annuities	£0.2bn (as a Purchase Life Annuity (PLA))
Variable annuities	£1.4bn

**this product is not currently marketed in the UK. However, there are over 30,000 policies in-force in the UK*

There are a range of investment-linked annuities, variable annuities being one of them. We have not covered the full range of investment-linked annuities, such as with-profits annuities, investment backed annuities and fixed term annuities, but recognise that they could also be used to provide income to cover LTC needs. .

This paper focuses on how pension products can be used to help fund LTC needs. However, it is likely that consumers will need to provide for their LTC needs through multiple sources given that the average level of DC savings is only £30,000 (NAPF, 2013). The main non-pensions products where LTC needs could be met in addition to pension savings are:

- Equity release
- Other savings vehicles (bank accounts, ISAs)

We have not considered these alternative financial solutions in any further detail in this paper.

5.1 Long term care costs met by protection insurance

5.1.1 Background

Insurance protection products are designed to cover an event that is uncertain and in some cases unlikely to occur, but where the financial consequences may be challenging without insurance. LTC insurance is not a new product, but is not currently marketed in the UK.

The likelihood that someone will need funding for LTC needs in their life time is somewhat higher than many events for which protection insurance is commonly purchased (e.g. term policies covering death, critical illness or income protection. As such, the cost of cover may seem like a high proportion of the eventual maximum benefit paid upon incidence, a factor which may seem to negate the value of such protection.

However, LTC protection markets do exist in other parts of the world. In particular in the USA, where there is no requirement for such insurance cover, but nonetheless a moderate market exists.

This section explores how a LTC protection insurance policy might be incorporated into the pensions environment and used as a way to fund for LTC needs.

5.1.2 Basic features

A policy would be purchased by an individual, most likely prior to retirement to allow time for premium costs to be financed and also to provide cover for a benefit paid prior to retirement if needed. Joint life policies can also offer cover for couples. Regular premiums would be paid for life, or until a claim is made, in return for a predetermined contribution towards LTC costs if LTC is needed. This could enhance the importance for individuals to start saving earlier for LTC needs. It is likely that the benefit paid would be based upon some Activities of Daily Living (ADL) measurement/cognitive impairment or an indemnity of needs up to a certain amount per week, and for a predetermined period. To use the US as an example, a '5 year, $200 per week' policy equivalent might be purchased which will have a fixed premium amount depending on the policy starting age. The payment period could be extended if amounts lower than the maximum weekly benefit is taken.

Such a policy could be integrated into the pension environment in an administrative fashion, even if not for financing and investment. For example, premium payments prior to retirement could form part of an older worker's retirement benefits package, with post retirement payments taken directly from their pension should they continue with their policy, or capitalised and paid as a single premium from their retirement lump sum.

5.1.3 How funded?

Potential sources of funding could include:

- Policyholder premiums could be facilitated by their existing pension scheme, for example, a group care cost scheme that runs alongside a DC or DB pension scheme. This may make pricing easier than would be the case if individual underwriting was required.
- The employer could also contribute towards this in the manner of an age-related contribution scale beginning at age 50 for example. The 'step-up' in employer pension contributions at older ages is, therefore, instead directed towards the LTC product.
- A deduction from their pension would be used to pay premium costs post retirement.
- The lump sum upon retirement would be an alternative/additional method of meeting the premium for cover post retirement.

5.1.4 Structuring of the product

The policy could be insured by the same firm providing the policyholder's income in retirement or be a separate firm specialising in such cover.

The ability to place a maximum benefit on the policy helps to limit the maximum loss that an insurer could incur, which will help to manage capital requirements and therefore keep premium payments more reasonable for policyholders. Policy limits could be dovetailed with the cap to provide a fairly extensive cover against LTC needs or simply taken at a lower level to help finance some of the costs upon needing care.

It is envisaged that such a product would be taken to cover LTC costs in excess of 'hotel costs', which might be met from normal pension payments, for example, State benefits. However, to the extent that these are higher than normal living costs, additional protection could be purchased e.g. £300 per week for 5 years.

Medical underwriting may be limited due to the long period between underwriting and an expected claim event.

It might be sufficient to accept all policies if they are part of a group employment scheme, but exclude claims arising from pre-existing conditions or claims arising in the first few years. Underwriting standards will certainly need to be scrutinised carefully and there exists some room for industry innovation in this area.

Claims management would be fairly intensive. Claim payments are likely to be based on ADLs or a cognitive impairment and/or some indemnity of actual needs, so audit and management of these claims will need to be conducted by specialists.

However, such measures have anecdotally been found to 'pay for themselves' to some extent and at the same time can raise the quality of life for the policy holder. For example, payments and advice that lead to the installation of facilities that allow a claimant to remain at home and receive home care are likely to be in both the insurer and the claimant's interests in terms of lower costs and, potentially, a better experience for the policy holder. This type of advice and the initial capital to cover the cost of making such home changes may not otherwise be available, increasing the product's relevance to policyholders.

5.1.5 Taxation

Although not strictly necessary for the product concept, some level of tax relief or at least deferral would be advantageous in encouraging take-up of this product as for any LTC funding solution.

Ideally, there would be some level of tax exemption for such a product to at least put it on a par with pension contributions. Currently pre-funded care products are taxed like income protection products, whereby premiums are paid from post- tax income, but benefits are paid tax-free.

More thorough integration into the pensions environment might allow premiums to be paid from existing pension funds (even prior to retirement); for example, if an individual wants to finance a policy but is in lower paid or part time work in the immediate run up to retirement. Access to such funds would require a change in tax regulation to take before the age pensions funds can be taken without tax penalty.

If such products are integrated into the pensions environment there may be no need to change the mechanism by which the lifetime allowance (LTA) and annual allowance (AA) are calculated to incorporate LTC policies. Either, such products are simply excluded from the calculation or a way of incorporating their value into the LTA and AA calculation would be established (potentially increasing the limits to make some allowance for these policies).

5.1.6 Summary of advantages

- Protection insurance is already integrated into the pensions environment in the form of death benefits before retirement, so this product does not require large scale amendments to the legislative environment.
- Protection cover may suit some consumers as a way to cover all or just some part of LTC costs to obtain the certainty of insurance cover. Whilst this may start as a niche need, as in the US, it may well establish itself as a viable product and one that grows in popularity as awareness of LTC needs and costs improves through the generations.
- The pensions system provides some of the platform for collecting premiums and access to the likely users of such a product.
- Integration with pensions presents a 'holistic' post-retirement benefit platform.

- If tax rules can be made flexible enough to cater for a number of solutions then private enterprise may fill this need. It is conceivable that a few simple tax changes could facilitate this product in some form.

5.1.7 Summary of disadvantages

- Experience from the US indicates this is likely to be a niche product. Although some consumers do choose to buy this protection, it is not the market norm.
- Therefore, there may not be enough demand for a private market to develop in the UK. Industry and consumer consultation would be important to ascertain the appetite here.
- Premiums may be quite a large proportion of income for many savers (depending, for example, on the starting age and level of coverage sought).
- If the tax changes needed to facilitate the successful launch of the product are too demanding, it may not be deemed worthwhile for a potentially niche group of individuals.

5.1.8 Past experience of product in the UK

There have been similar products launched in the UK in the past. These have mainly been dropped due to a lack of demand. It is possible that they may be more viable in the new regime since:

- The existence of some level of capping on the amount of funding required by the individual may make a capped insurance product more attractive, as otherwise a customer would still see a potentially unlimited cost.
- The ability to cap product pay-outs helps remove the tail-risk otherwise held by an insurer, which may reduce the cost of the product. This could make it more attractive to customers to purchase and the insurers to provide.
- The increased publicity surrounding the social care changes may also lead to increased awareness, increasing the potential customer base.

5.1.9 Consumer profiles

This is a niche product and may be attractive to consumers with some means but who have insufficient income or savings to cover the cost of care in the long term. It is likely that a typical consumer who purchases this product will be a middle income individual, with income below the cost of care level, but with sufficient means to afford the additional protection.

This is a protection type product so it may appeal to consumers who have little family support and are concerned about the future long term cost of care. This may also appeal to consumers with limited housing wealth or those who are reluctant to sell their home to fund the cost of LTC. Given the nature of the benefits (a predetermined amount for a fixed period only) it is unlikely to be applied as a pure wealth protection tool.

5.2 Long term care costs met by Income Drawdown

5.2.1 Background

When a member of a pension scheme is considering how to take their retirement benefits (often referred to as crystallising their benefits), they currently have a choice as to whether they want:

- a secure pension payable for the rest of their life (such as a lifetime annuity); or
- to drawdown their pension fund during their retirement on a regular or ad-hoc basis; or
- to buy a temporary annuity and reassess their retirement options at the end of the annuity period; or
- a combination of any of the above three options; or

- to defer crystallising any of their pension benefits.

In all cases, when a member crystallises benefits they can choose to take a tax free lump sum at that time up to the equivalent of 25% of the value of their pension benefits being crystallised. Moreover, members can often choose to crystallise only part of their benefits at a particular point in time and leave the rest of their pension fund 'uncrystallised'. Each time benefits are crystallised the member has the same choice of the type of pension benefits they want and has the option of taking a tax-free lump sum.

There is, therefore, a fair amount of flexibility in the way that DC pensions that can be paid to members, however, awareness and availability of some of the options is limited and the vast majority of members (75% according to HM Treasury (2014)), purchase a lifetime annuity. It is sill not clear what impact the recent 2014 Budget changes will have on the retirement market although we expect this proportion to fall.

For members of DC schemes the pension scheme may allow members to opt for 'Income Drawdown' (the second option in the bulleted list above) otherwise, they can transfer their pension fund into an Income Drawdown product with another provider. Members of DB schemes who want more flexibility in their retirement options may be able to take a full or partial transfer value to another scheme to take income drawdown. However, transferring all benefits to a DC arrangement from a DB scheme is not usually recommended and partial transfers are currently not often available.

5.2.2 Capped and Flexible Income Drawdown

From April 2014, members who already have a secure retirement income of at least £12,000 per annum qualify for 'Flexible Drawdown' and have no restrictions on the amount they drawdown each year. It is proposed that from April 2015 'Flexible Drawdown' will be extended to all, with no minimum income requirement imposed. This means that there will be no limits on the amount that an individual can withdraw from their DC pension savings in any year, however, from a tax perspective only 25% can be taken as tax-free cash before marginal tax rates apply.

Any Income Drawdown benefits not yet drawn from the pension pot at death can be used to provide survivor benefits or a lump sum can be passed on through the member's estate. A 55% tax charge is payable on the lump sum; however, the payment is outside of IHT.

5.2.3 Using Income Drawdown to help fund care costs

The flexibility provided by Income Drawdown lends itself to meeting care costs and the new relaxation of restrictions in the current Income Drawdown regime will increase how Income Drawdown could be used to fund care costs. Flexibility of income to meet future care costs is important because the timing and the cost of care is uncertain.

If an individual has eligible care needs then it may be appropriate for them to drawdown their pension fund rapidly to meet the costs of care.

We would suggest that Income Drawdown payments made directly to registered care home providers from pension schemes are not treated as income for tax purposes. This would require such payments to be treated as 'authorised payments' by the pension schemes to meet HM Revenue and Customs requirements.

This tax treatment would be consistent with immediate needs annuities (INAs).

5.2.4 Consumer profiles

Income Drawdown is likely to be aimed at people who have large DC pension pots with sufficient assets to fund or partially fund their care needs.

This may be most appropriate for those who enter care close to retirement where a larger proportion of their pension pot remains available. It may also be popular for people who want to avoid having to sell their homes to fund their care.

While the number of people contributing to DC pension provision is substantially on the rise (National Association of Pension Funds (2013)), the average 2012 UK DC pension pot upon retirement is just £30,000. Workplace pension reforms will push this figure up over time, but it is unlikely this will reach the level required to meet LTC costs in addition to an individual's other post-retirement needs. Therefore, it is unlikely an 'average' retiree will have a sufficient pension pot at the point of entering the care system to be able to afford to cover all of their care costs.

However, the additional flexibility introduced by the Government will enable Income Drawdown to be a more effective element of some of an individual's LTC funding.

5.3 Long term care costs met by Pension Care Fund, a flexible long term care savings fund

5.3.1 Background

The structure of pension benefits, and the option to convert part of an individual's pension savings into a cash sum, has traditionally been fixed at retirement with no subsequent alteration to the benefit form. Some additional flexibility is now available through segmented personal pension policies and the use of income drawdown. However, with the significant increases in life expectancy and the prospect of an extended period of reduced capacity or ill health, it is perhaps no longer appropriate to consider retirement as a single homogeneous period. Adopting a more flexible approach to the build up and draw down of long term savings could be a very attractive way of enabling individuals to prepare for and fund their LTC costs.

In this section we look at how the introduction of greater flexibility into the existing regulatory structure for pension saving could provide a simple and cost effective approach to funding the LTC costs for both current and future retirees. We describe below a potential structure for the Pension Care Fund (PCF) and explore its possible operational aspects.

5.3.2 Basic features of the PCF

The PCF would be established within the pensions environment as a DC savings fund. The PCF would be administered, invested and regulated under the existing pension fund framework, but would be separately identified and ring-fenced. In order to encourage the establishment and maintenance of such a fund, greater flexibility would need to be available for the use of the PCF and it would need to attract tax incentives at a similar (or greater) level to pensions. The PCF could be drawn on to meet regular care costs as they emerge or could be used to fund the purchase of an insurance product (presuming they exist). The PCF could be used for both the individual's and their partner's LTC needs and any unused balance could be passed over to the next generation exempt of IHT, but still ring-fenced for meeting their LTC costs.

5.3.3 How funded

The PCF would be financed through regular individual contributions both before and after retirement. The ability to continue to contribute post retirement would be helpful as there is evidence that, following an initial period (possibly of many years) of active retirement, many pensioners move into a phase during which, although still healthy, they are less willing or able to undertake extensive travel or social activities. During this phase pensioners may therefore find that they are net savers again and so would have the opportunity to increase their PCF.

The possibility of including employer contributions on a similar incentivised basis as currently applies to pension provision could encourage employers to promote and facilitate the establishment of PCFs, thereby supporting the increase in participation levels amongst the employed workforce.

Further flexibility in funding could be provided through the ability to make lump sum payments and to transfer funds from existing DB or DC pension savings to the PCF. In addition, transfers from the previous generation's PCFs would also be allowed.

It seems unlikely that significant saving for LTC costs will be initiated unless suitable financial incentives are built into the system. As a minimum, it will be necessary to offer consistent tax treatment on both contributions and invested funds to that currently available on pension savings since the PCF could be designed to operate in that system. One of the challenges of the existing pension environment is the difficulty or inability to pass pension assets on to the next generation. Given the uncertainty as to whether an individual will need LTC, the ability to pass any unused funds onto the next generation without incurring IHT could be a key point in the promotion of saving for LTC costs.

5.3.4 Structuring the product

It is envisaged that the PCF would form a ring-fenced DC savings fund within an existing occupational pension fund or personal pension account. Monies paid to or transferred into the PCF could only be used for LTC costs (including both hotel and nursing costs) for the individual or their partner or transferred to the next generation.

An appropriate limit could be set on the maximum tax-relieved new money which could be added to the PCF. This limit could be a fixed percentage of the LTA or age dependent. Unlimited transfers from the previous generation should be allowed.

The PCF would be invested with the same tax treatment as pension fund assets but may adopt a different investment strategy given the different expected date of maturity. Funds would not need to be drawn down at retirement but, typically, would remain invested and could continue to receive contributions throughout retirement. Funds could be drawn down to provide annual payments or used to purchase an insurance product at the point of LTC need and would also be split on divorce.

Accumulated DC funds could be transferred to a PCF and the amount of any transfer would be deemed to be a contribution for the purposes of the contribution limit. Transfers from DB pension assets could occur using the same approach as for divorce calculations i.e. a cash equivalent transfer value calculated on factors set by the trustee to represent the expected cost of providing the member's benefits within the scheme. Such transfers can be made pre or post retirement but the residual pension income would need to be sufficient to cover on-going living costs excluding medical costs.

5.3.5 Taxation

In order to create the necessary incentive the PCF would be outside both AA and LTA rules and employee and employer contributions would receive the same tax relief as pension contributions but, in order to limit tax relief available, a maximum tax relievable direct contribution could be set, perhaps expressed as a percentage of the Standard LTA. This approach would also encourage earlier funding.

Transfers from PCFs built up by the previous generation would be made tax free and investment returns would be taxed in same way as pensions savings.

Payments out of the PCF must be used for LTC costs, including hotel costs. Residual funds on death could be transferred to the next generation exempt from IHT but must be retained as a PCF.

5.3.6 Summary of advantages

- Adopts an approach to infrastructure which is already known and understood by potential users as the pensions framework.
- Uses existing legislative framework so minimal new legislation should be required.
- Offers the potential to engage employers which will increase the probability of success.
- Tax incentives are important to incentivise participation but must be limited overall to avoid abuse.
- Provides a structure that will work for both existing pensioners and those still in the accumulation phase.

5.3.7 Summary of disadvantages

- A limited infrastructure would still need to be developed for establishment of the PCF.
- Communication needs to be driven and participation encouraged.
- Additional tax concessions will need to be funded.
- There is a general resistance to long term saving for any purpose across the public due to the behavioural preference for funds in the short term.
- There is some potential for the PCF to distract from pension funding.
- Concern that saving in this way could reduce an individual's eligibility for State benefits through means testing.

5.3.8 Consumer profiles

For consumers pre-retirement, it is likely to appeal to those who have larger disposable incomes and those that want to take advantage of un-used tax incentives. The take-up rate could be incentivised further if there were some 'matching' arrangement between employer and employee contributions. This product is unlikely to be affordable for consumers on lower income levels who have little disposable income.

There may also be some opportunity within an employer sponsored arrangement to increase take-up by capitalising on the inertia of individuals i.e. if the setup of the PCF is (to some extent) automatic within a group scheme and/or well communicated so as to generate awareness, then some individuals will be attracted to the ease of building up such a pot in that existing arrangement.

For consumers post retirement, given the PCF can remain invested and receive contributions post retirement; it is likely to appeal to consumers on larger pensions and who want to make use of the advantageous tax treatment.

5.4 Long term care costs met by Disability-Linked Annuity (DLA)

5.4.1 Basic features

The disability-linked annuity (DLA) is a combination of a lifetime annuity and a LTC product. It provides standard lifetime annuity payments whilst the policyholder is in reasonable health. However, the annuity payments increase to a much higher level (or levels) if and when the policyholder subsequently requires LTC. The trigger for the enhanced level of annuity being paid could be the policyholder failing a certain number of ADLs.

For example, the initial level of the lifetime annuity could be £10,000 per annum. If the policyholder subsequently fails 2 ADLs then the annuity could be increased to £15,000 per annum, and increased to £25,000 per annum upon failing 3 or more ADLs. This would be described as a '1/1.5/2.5 level DLA'. As a variation on this example, the policyholder could choose to purchase a '1/1.5/2.5

increasing DLA' where the three annuity amounts increase from date of purchase in the same way that standard lifetime annuities do, for example, by 3% per annum.

The idea behind the DLA is that the annuity enhancements should, to some extent, offset the extra costs incurred when increasing levels of LTC needs are required.

In theory, the annuity payments would reduce if the policyholder subsequently recovers. However, this is unlikely to happen in practice, given how incapacitated the individual would be at the increased benefit levels.

From the insurer's perspective, an interesting feature of a DLA is that, in general, the mortality and morbidity risks act in opposite directions to one another (e.g. the earlier the policyholder triggers the annuity enhancement, the lower the likely overall life expectancy). This means that adverse selection risks to the insurer are reduced compared to separate lifetime annuities and long term products. It should be noted that one possible exception to the theory that morbidity and mortality risks oppose one another is the case of the cognitive claim (e.g. Alzheimer's) where the onset of the mental impairment does not necessarily reduce the life expectancy of the individual.

To give an idea of the cost of purchasing a DLA, it is estimated that a 65 year old female would need to sacrifice approximately 9% of her initial annuity income for her standard lifetime annuity to be converted to a '1/1.5/2.5 level' DLA (Rickayzen, 2007).

5.4.2 How funded

The policyholder could purchase a DLA by a single premium paid at retirement. This could come from a DC pension fund or the tax free lump sum available at retirement within a DB / DC framework.

For DB pension schemes, subject to scheme rule amendments being authorised and made, then one idea would be for scheme members to be able to sacrifice some initial pension to convert their benefits into a DLA. There is also no obvious reason why this flexibility of benefit conversion could not be introduced for both private sector and public sector schemes.

5.4.3 Taxation issues

For insurers to be interested in launching DLAs, they would need to be certain of the tax treatment of DLAs which does require some further clarification. It may be, for example, that DLA's could be treated as 'pension' and therefore receive favourable tax treatment for contributions and investment, with the annuity payments taxed as income.

Alternatively, the DLA could be treated as a combination of a Purchase Life Annuity and Income Protection (IP) benefit. This means that the premium would need to come from post-tax savings. However, both the capital element of the PLA component of each annuity payment and the whole of the IP benefit would be payable tax-free whilst the interest element (i.e. non-capital element) of the PLA component would be subject to income tax.

It should be noted that, in the event that the DLA is treated as 'pension', HM Revenue and Customs may not deem it appropriate for the annuity to be reduced if the individual ever recovers to a lower level of incapacity.

5.4.4 Advantages of DLAs

- Should be attractive to consumers since its two components can be presented in a positive fashion: life annuity is payable whilst the individual is healthy and an enhancement to this annuity exists should the individual suffer very poor health. Standalone LTC policies have tended not to sell well in the past because, by definition, they force prospective purchasers to dwell on the somewhat unsavoury prospect of requiring LTC at some point in the future.

- The amount of initial pension which needs to be sacrificed for the annuity enhancements is relatively low. This is because the enhancement is not expected to commence payment for several years, and so is only expected to be paid for a short period.
- As mentioned in section 5.4.1, from the insurer's perspective, there is a pooling of the longevity risk (associated with the life annuity) with the morbidity risk (associated with the LTC insurance component). These risks tend to pull in opposite directions, thereby creating a natural hedge, and the risks might not be easily diversifiable in other ways.
- More flexible than a standard annuity since the DLA increases to help meet LTC costs as and when required (to a maximum).
- The annuity enhancement would help to meet the additional care costs associated with severe disability and thereby support any bequest motive.
- The DLA could enable the purchaser to fund care in their own home rather than having to move into an institution such as a care home. This helps resolve the problem of individuals being "capital rich but income poor".
- Individuals could use income drawdown to withdraw funds from a DC fund from time to time in order to meet LTC needs when they arise. However, it is quite possible that, at that point, the person will not be in the right mental state to make decisions required to manage income drawdown appropriately if they have not appointed a Power of Attorney (or an adviser with limited powers) to manage this process on their behalf. The advantage of buying a DLA at retirement is that the decision to provide for future LTC is made while the individual is relatively healthy (both physically and cognitively).

5.4.5 Disadvantages of DLAs

- The individual needs to be willing to give up some amount of initial pension for the DLA. This will not be feasible for the less wealthy. As it is, the vast majority of annuitants choose level lifetime annuities rather than increasing ones in order to maximise the amount of initial pension so could be unlikely (absent of greater understanding and / or encouragement) to opt for a reduced level initially.
- It could take several years before funds in DC pension schemes are at a sufficient level to purchase a DLA and fairly substantial legislative amendments are required for direct DB pension access, although the tax-free cash lump sum is available to be utilised.
- As mentioned in 5.4.3, clarification on the taxation position would be required before insurers could decide to introduce DLAs.

5.4.6 Consumer profile

The DLA is most suited to an individual at retirement that has access to a large lump sum which can be used as the single premium to purchase such an annuity. The lump sum is most likely to be from the proceeds of a DC pension scheme or the tax free lump sum from a defined benefit arrangement. Given that the individual must be willing to sacrifice some initial pension for the DLA, the level of pension must be relatively high initially so that the individual can afford to forgo such income. Therefore, the DLA will be most suited to relatively wealthy individuals who view the annuity enhancements of the DLA as being helpful in providing for the additional costs imposed by requiring LTC. The DLA should help in personal financial risk management and give greater certainty in later life.

5.5 Long term care costs met by an immediate and deferred needs annuity

5.5.1 Basic features

An enhanced INA is a medically underwritten annuity calculated based on the life expectancy of the insured life at the time of purchasing the annuity. In return for the payment of a single premium a guaranteed income is paid for life.

The annuity is normally purchased at or around the time of receiving care at home or going into a care home or a care home with nursing. The income provided by an annuity is fixed at outset but can increase on a pre-determined escalation basis such as RPI or 5% per annum. The annuity cannot be surrendered and does not offer any investment choice. A death benefit offering a partial return of premium during the first few months of buying the annuity can also be offered.

A lower cost deferred option is available enabling an element of self- insurance for the duration of deferral. Deferred periods are typically between 1 to 5 years. During the deferred period the insured life funds their care needs from other sources. At the end of the deferred period the annuity commences and operates just like an immediate needs annuity.

5.5.2 How funded

The single premium could be funded directly from uncrystallised pension savings. However, currently they are usually funded from funds outside of the pensions framework given the average age of purchase is by individuals in their early 80's.

5.5.3 Taxation

Payments made directly to registered care homes/providers from an INA are tax exempt (HM Revenue and Customs b). However, it is expected that care annuity payments from a pension would be taxed as income in a similar way to other pension income (with the tax relief having been granted on contributions and investment income).

5.5.4 Summary of advantages

- Providing sufficient funds are available, income can match needs accurately since the annuity is purchased at the point of need.
- For individuals in drawdown or with funds in a PCF the annuity can provide certainty on the total cost of care. For example, costs not covered by the cap such as hotel costs can be met.
- Income may be higher than other options that involve annuitising earlier in retirement if funds can be invested in higher growth/riskier assets for longer prior to purchase of the INA. Since underwriting occurs at the point of need it is likely that the annuity rate calculated more accurately reflects the health of the insured life (poor health and hence reduced life expectancy) and offers a higher level of income as compared to a retirement in normal health.
- Deferred needs cover can be used as a stop loss type of cover and appears cheaper than the immediate needs version, although there is the need to self-fund for the deferral period.

5.5.5 Summary of disadvantages

- Large premiums are required to fund care in full, typically in the range of £100k to £200k for immediate needs cover, which would need to be funded by some mechanism. A lower premium would be required to fund only part of care for example: to fund hotel or top up costs.
- There is limited flexibility (e.g. escalation option to allow for potentially increasing care costs) once the contract is purchased and no surrender value exists.

- A limited death benefit exists which limits the ability to pass across funds to future generations through the estate. Additionally, should the individual die in any deferral period then the funds would be lost to future generations.

5.5.6 Consumer profiles

This product is aimed at consumers on or after entering LTC, and is therefore likely to be suitable for a large number of consumer segments. The product is likely to appeal to those who have significant pension savings at the time of needing care (£100k to £200k) or those able to use their pension savings in combination with other options such as other non-pension savings, equity release or the sale of their property.

This product can be used to ensure the individual should not run out of money while in LTC or as a wealth protection tool to ensure a legacy can be passed to future generations if they remain in LTC for an extended period.

5.6 Long term care costs met by a variable annuity

5.6.1 Basic features

A variable annuity is an existing pension product available in the UK market. A variable annuity is a unit-linked guaranteed product that can provide a guaranteed minimum level of pension income within an income drawdown framework. The guaranteed income varies according to age at income commencement and increases periodically if fund performance leads to a growing account balance. Similar to income drawdown, the consumer has the choice of investment funds and they can vary the level of income received, subject to GAD limits (until April 2015). It is possible that the guaranteed minimum income could increase on going into care, although this feature is not currently offered.

In addition to the product charges made for non-guaranteed drawdown products, a guarantee charge is deducted. The guarantee charge varies according to the level of investment risk within a fund; higher equity exposure funds have higher charges for example.

A guaranteed death benefit is offered based on the premiums invested. A surrender value is available based on the value of the underlying investments.

5.6.2 How funded

The product is funded in a similar way to income drawdown by creating a pot of funds to make regular withdrawals from. Regular contributions can be made into the product to establish the pot or transfers in from other pension savings can be made.

5.6.3 Taxation

Any benefits received are taxed in the same way as income drawdown.

5.6.4 Summary of advantages

- In addition to the advantages seen from an income drawdown product such as flexibility of income and investment choice a variable annuity provides additional security by guaranteeing a minimum level of pension income and offering a guaranteed death benefit.
- Asset depletion risk, a feature of income drawdown, is minimised due to the guarantee.

5.6.5 Summary of disadvantages

- The initial pension is usually lower than conventional annuities due to the extra flexibility offered, such as the ability to surrender the policy and receive a benefit on death.

- Charges are higher than non-guaranteed income drawdown to pay for the guaranteed minimum level of pension income.

5.6.6 Consumer profiles

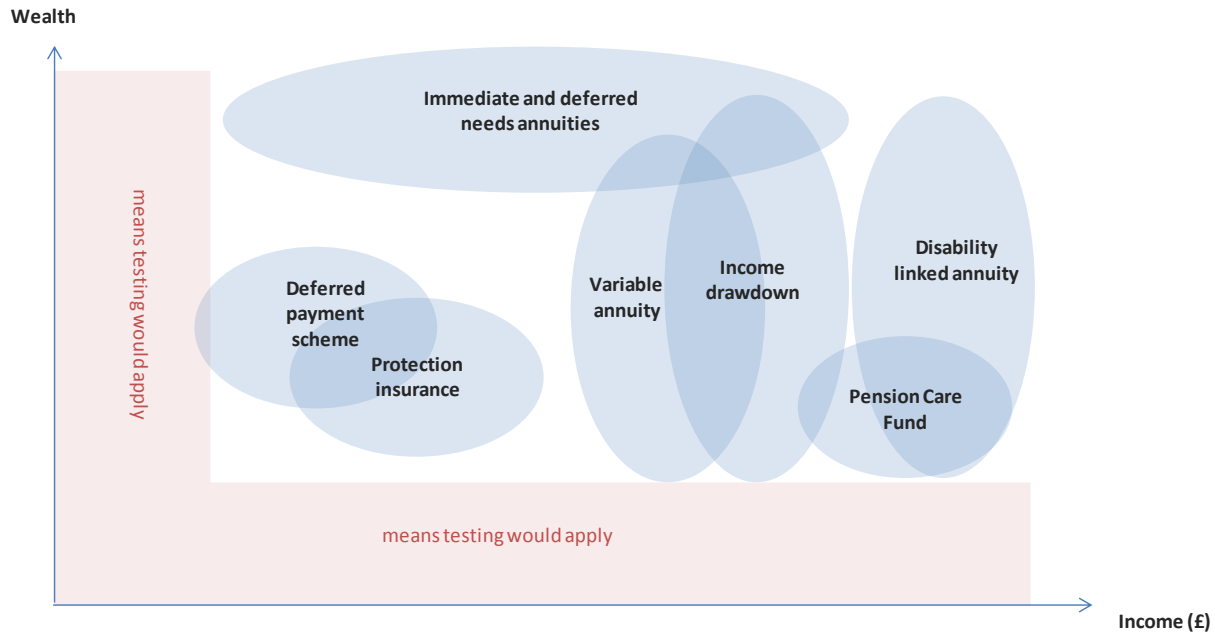
Variable annuities are likely to appeal to a similar consumer profile as Income Drawdown (See section 5.2.4). However, with the additional benefit of the guarantee it would be more appropriate for consumers with lower income and assets than typical for Income Drawdown since they may have more need for a guarantee.

6 Comparison of product designs against consumer profiles

In the previous section we considered a detailed range of product options that could potentially be used within a pensions framework to support LTC costs. Our work has clarified that it is highly unlikely a single product will meet the needs of all, and each product is likely to be suitable for people in certain income or wealth groups.

Figure 7 considers the income and wealth groups that could benefit most from the products we have explored. However, it is important to note that as these products develop and their structure becomes more well-defined, their potential market could change. If the proposals initially announced in Budget 2014 are enacted, with effect from 2015 there will be no withdrawal limits on Defined Contribution pension pots so members' of such schemes will be free to draw (subject to their marginal tax rate) as much or as little of their accumulated pension savings as they wish. Consequently this means the income/wealth distribution of future retirees could be a very different picture to the one seen now.

Figure 7: Potential beneficiaries of products in relation to their income-wealth profile



We consider income as income from private or employer pensions or from state benefits, and wealth as an indicator of other savings and housing assets that sit outside the pensions framework.

We expect that LTC products will appeal to those in higher income and wealth bands who expect to be outside of means testing should they have LTC needs. These individuals may want to protect their wealth to maximise the amount they are able pass on as inheritance and/or may want to (and be able to afford to) top-up their care costs and increase their choice of care provision.

6.1 Low wealth, low income

Those with limited wealth and income are likely to rely on the State pension to top-up their retirement income and could also be granted additional State support under the means test if they are unable to pay for LTC without assistance.

Because they are able to fall back on the Government for support, they are unlikely to consider products to fund their LTC needs without any State compulsion to do so. At the moment there is a disincentive for anyone falling close to the means test threshold to save for their LTC since this may mean they miss out on Government support.

6.2 High wealth, low income

For those with high wealth but limited income, they may need to fund their LTC costs from their assets.

For those whose wealth is tied up in housing assets, they may benefit from making use of the Government Deferred Payment Agreement should their income be sufficiently low, which would allow them to release wealth from their home rather than forcing them to sell it upfront to fund care. This is available to those with assets excluding their house of below £23,500.
Immediate and deferred needs annuities could also be an option for those with assets significantly above the means test. These products can be used to ensure the individual doesn't run out of money while in care or to protect wealth for those with a very large amount of assets, to ensure it can be passed on in inheritance.

6.3 Low wealth, high income

For those with high income but lower levels of wealth, their income may cover some costs of ongoing care but limited assets mean that depending on their income level, they may not be able to afford to top-up care costs in a home of their choice.

Disability-linked annuities could be attractive to this high income group, as they can afford to give up some of their initial income in return for a step-up of income on going in to care. This could meet hotel costs, or top-up costs of their chosen care home.

Income drawdown and variable annuities could offer flexibility for those with high levels of income, especially for those who want a choice of investments.

A PCF could also be an option to those with high level of incomes in retirement and also to those with high levels of disposable income before retirement and, therefore, able to pre-fund.

Protection insurance is likely to appeal to those with a moderate level of income and savings that are likely to be insufficient to cover the cost of care in the long run, but high enough to afford the insurance premium.

6.4 High wealth, high income

For those with high levels of wealth and income, if their level of income is sufficient to cover care costs, then products such as the DLA, PCF, immediate and deferred needs annuities may be less attractive. However, they could provide them with comfort and peace of mind to ensure their care fees are covered and be used to protect wealth by reducing the risk of material asset depletion.

To summarise, with regards to product innovation the biggest opportunities appear to exist in the low wealth – high income sector and the high wealth – low income sector. With the new freedom to access pension assets more readily, there will be appetite for more efficient products that can offer consumers the peace of mind and greater clarity in planning for their long term care costs.

7 Communication plan – before and beyond retirement

For any solution to individual/private funding of LTC, i.e. care that is not fully funded by the State, to be commercially viable on a material scale will require widespread public engagement. This would need to promote the necessity for individuals to ensure appropriate financial provisions are made for any future care needs. Industry and governmental bodies have a joint role to play in making information available and raising awareness of the funding need and the potential range of product solutions that exist.

This educational role should be targeted to different segments of the population to achieve maximum engagement with those segments through relevant information, for example, people at different ages, different life stages and with different levels and types of wealth. We have described earlier in this paper potential market segments and the next step would be to define these more clearly as well as the trigger points, for example, reaching retirement, starting a family, that could give rise to engagement with and action by individuals.

As announced in the 2014 Budget, everyone with a DC plan will be offered free and impartial face to face guidance on the range of options available to them at retirement. Pension providers and pension schemes will have to deliver this guidance guarantee by April 2015. This change should lead to greater awareness amongst retirees of the potential costs of LTC, providing the guidance includes information about retirement income needs, including LTC.

7.1 Long term care communication plan

Once a suitable regulatory regime is in place and industry players are engaged with suitable products, a combined effort should highlight steps people can take to prepare for their LTC needs.

The following describes how a multi-party communication plan between the Government and the industry might fit together to encourage appropriate decision making by users of LTC products.

The communication plan will be required to provide three messages:

1. Ensure the needs and magnitudes of LTC costs are understood by the general population.
2. Counter misunderstandings regarding what the NHS and local authorities will provide.
3. Promote general understanding of the potential products available to help meet costs and when they might be considered.

These messages follow a sensible structure with awareness and understanding generated first (which is likely to be most appropriate for Government) and communication of solutions to the funding gap following (likely to be most appropriate for industry).

Parties likely to have a direct responsibility or incentive to communicate this message are:

- Central government
- Local authorities
- NHS
- Insurers (or other savings/product providers such as pension providers)
- Industry bodies and regulators

- Financial advisers
- Employers
- Charities

With the Care Bill, the Government has developed a framework which may present a much clearer picture of how high the costs of care in old age could be. However, it was clear when the Bill was announced that certain misconceptions existed as to what was previously covered. In particular, some public commentators implied that the introduction of this regime was generally placing additional costs on individuals, rather than capping costs that already existed. It may be useful for the size and nature of these misconceptions to be understood further so that they can be addressed fully. A communications plan might usefully address these misconceptions whilst highlighting the now capped costs and how this helps the individuals to plan their finances before and after retirement.

A clear understanding of the current regime to reassure people that the changes are sustainable and to reduce the fear of catastrophic care cost and material erosion of assets is important. This has the potential to benefit the care and support system in the long term and allow people to make informed and responsible choices. The subsequent increase in consumer confidence will support the purchase of suitable financial products to supplement their needs and/or better understanding and management of their resources.

The timing of a communications plan could focus around the implementation of the Dilnot proposal, in which care costs will accrue in Care Accounts from 1 April 2016.

A Government led awareness campaign is currently planned to begin in December 2014.

7.2 Government

Central government has a responsibility to provide information about the changes that will be implemented from Dilnot's proposals and to counter misunderstandings about what is and is not provided. The Joint Statement of Intent (between the Department of Health and the Association of British Insurers), announced in January 2014, in this area of awareness is a welcome coordination to communicate the services and options available to individuals.

While it may be difficult to encourage individuals to make adequate provision for funding uncertain LTC needs, as has been observed in the promotion of adequate levels of pensions saving, we would recommend that the use of targeted communications aimed at educating the public on the potential magnitude of care costs and clarifying what is and is not covered by local authorities and the NHS would be effective. Local authorities might also consider, as part of their provision of information duty, providing some degree of referral to financial advice and advocacy services for self-funders as more than half of older people are self-funding in full or part (Carr-West, J. & Thraves, T., 2013).

Government communications can be a catalyst for wider media coverage and therefore, increased public awareness and lessons can be learned from overseas. For example, in France there has been a considerable growth in uptake in private provision of LTC with a 15% per annum growth rate observed, leading to France becoming the second largest market globally for LTC (Kessler, 2008). The OECD report 'Providing and Paying for Long-Term Care' (2011) stated that in 2010 15% of the population aged over 40 had a LTC policy in 2010. This growth has been mostly attributed to the wide discussions that took place in the French media on how to fund LTC, making the public more aware of the risks and costs involved in funding LTC and the gaps in public provision. The national solidarity day introduced in 2005, where a public holiday was given up and workers' pay was donated to charities helping the aged, is also cited as facilitating an increase in awareness.

Communication of a funding need by the insurance industry may simply be perceived as selling an unnecessary product if this originates from the private insurance industry. The Government may well be perceived as more trustworthy by the public when describing a 'gap' in individual's social security provision and how this can be managed.

Methods could include:

- Proposal that everyone has free, impartial guidance at retirement from April 2015 onwards
- TV advertising.
- Availability of information and access to advisory services through local authorities' offices.
- Extension of existing e-marketplace solutions.
- Encouraging employer support.

It is important that the Government is able to present a regulatory regime that is for the long term. Funding for LTC requires a long term plan and all stakeholders will need to be confident of the stability of the regime in order to feel confident in planning for the future.

7.3 Product providers

We would anticipate that advertising of products and engagement by product providers with employers and financial advisers might also encourage understanding of the issue at large.

Commercial advertising is a visible and existing awareness raising communication method. Provided private insurers and/or other product providers have viable product solutions to offer, it might be expected that the market will fill this gap.

7.4 Industry bodies and Regulators

There is likely a need for an industry association to promote the understanding and take-up of products. A key factor of this will be to develop an understanding of the potential market and identify the drivers that can be actioned to facilitate this market establishment. For example, understanding of the demand for products, affordability of products and consumer responses, will all be important in this developing area. The industry body might seek engagement of the press and help interested journalists to write about the products and the wider need for them.

A regulator would need to oversee that the products offer protection that meets the public's needs and expectations. It would also have a role in shaping products and the communication of products to ensure ease of public understanding (whilst ensuring competition is not adversely impacted). Precedents exist that support public understanding, for example the development of standard quotation request forms, whilst still maintaining scope for price and product innovation and competition. Product illustrations could be required to include information on typical income needs in retirement including LTC costs to help highlight the long-term retirement income gap which individuals could be facing.

7.5 Financial Advisers

Financial Advisers have a responsibility to understand the products in order to be able to advise their clients on suitability and will likely be keen to explore this opportunity. Depending on the product, this is likely to be a large distribution channel, so engagement with Financial Advisers is critical. Education of advisers is likely to be carried out by their own associations as well as by individual product providers who may wish to use this distribution channel to access the market. There are

specialist advisory groups for care and old age groups who might be expected to be especially active here.

7.6 Employers

Depending on the range of emerging products that are aimed at the working population, there may need to be a large involvement of employers. Engagement of a few large employers may help to encourage and initiate general take-up of a benefit provided to staff (if appropriate, depending on the product). Large corporations and commercial banks may be a good place to begin engagement as they have a large pool of potential and existing pension savers.

7.7 Charities and online websites

For the older population, generic advice may be sought from charitable organisations. Involving charities offers the opportunity of an additional avenue for enabling people to access information on LTC generally and on the LTC products available in the market. A robust market of comparison websites and e-calculators might help people to understand the need for adequate provision to support them in the long-term. As part of the new guidance provision, the government will set up a development fund to assist the charitable advice sector in developing guidance materials, training and capacity building.

7.8 Integration

Our thinking highlights the clear need for integration, not just of governments, regulators and local authorities but also of industry and the relevant distribution channel facilitators. This integration needs to extend not just to the education and awareness raising campaign but also to the communication of product ideas. What we have described in this paper is a range of pension-based solutions for funding LTC; however, many of the concepts apply equally to other financial solutions, for example, utilising housing wealth for funding LTC. Engagement with the public at various trigger points in life, such as retirement, should encompass an integrated approach, particularly in terms of the products available to people.

8 Technical changes to help long term care product development

As already noted, the UK pensions infrastructure is well placed to accommodate its use for the provision of savings vehicles such as the products described in section 5. We have identified some areas where relatively small changes in HM Revenue and Customs rules and regulation would facilitate the use of pensions related products to help provide the funding of care costs where needed.

8.1 Facilitating greater flexibility

The Government has made significant changes to provide more flexibility and choice for DC members taking their benefits which will potentially help such members use their pension pots to support the funding of care costs where necessary.

The following changes would facilitate greater flexibility to some of the existing products we have identified:

- The opportunity to restructure existing pension benefits post retirement to release funds for social care costs i.e. for DB schemes.
- The ability to pay the benefit directly to a registered care provider as an 'authorised payment as set out in the Finance Act (2004). The current rules preclude payment to such third parties.
- The opportunity to contribute from unearned income or from pension income beyond the current £3,600 p.a. limit and beyond the age 75 limit
- A significant reduction in the 55% tax on funds within the income drawdown framework when the member dies.

8.2 Facilitating a Pension Care Fund

The creation and operation of a PCF would require limited additional regulation as compared to establishing a new regime. However, some changes in regulations would be required to enable the introduction of PCFs as set out in section 5.3 in addition to the changes identified above in 8.1.

Important elements of the additional flexibility which might be required include the ability to:

- move historic pension savings into the PCF either before or after retirement
- direct PCF resources to support the care costs for a spouse or partner; and
- pass on any unused balance to the next generation.

8.3. Incentivising pre-funding

Accompanying the greater flexibility described so far there may also need to be some level of tax advantages in place to ensure consistency with existing products with similar features. Whilst these will add to the cost to the Government of providing social care support, they should help overcome some of the challenges to pre-funding potential social care costs including:

- The risk that the savings will not be required as a result of early death or only a short period of disability prior to death.
- The risk that the regulatory regime will change to the disadvantage of someone who has already saved to meet potential social care costs.
- The risk that the means testing rules act to disadvantage and disincentivise savers.

The changes to the tax regime envisaged would include:

- Contributions from both individuals and employers, whether to a 'qualifying' insured product or a PCF, being treated in the same way as existing pension contributions.
- Accumulated savings being treated in the same way as pension savings.
- Contributions to social care products such as PCFs being outside the AA restrictions.
- Accumulated savings to meet potential social care costs not being counted towards the LTA or changes made to the regime to accommodate social care products such as PCFs.
- Unused long term savings in PCFs and other social care products being able to be transferred to the next generation without the imposition of income tax, capital gains tax or IHT.

We are happy to discuss these ideas further with Government and assist in exploring the longer term impacts and overall viability of establishing product solutions that can meet the future needs of the public enabling them to protect themselves from the risks they face.

9 Next steps

9.1 Case studies

Once responses to this paper have been received the IFoA plans to explore the product designs described in this paper further including exploring case studies to demonstrate how the different product designs meet consumer needs as well as considering in more detail how these products could be activated.

The paper has focussed on the needs of an individual and we would look to expand the case studies to consider households/couples who will often want and need to plan for their combined needs.

9.2 Probability of reaching the Cap model

We plan to update the analysis in Section 4 to be based on survival rates from the Cass disability model which should enable a more refined analysis to be produced.

9.3 Pension reform (2014 Budget)

While the proposed additional flexibility is welcome, it is unclear if the changes will lead to an increase or decrease in the pension funds available to fund LTC needs. The guidance offered at retirement will need to be sufficiently easy to understand and robust enough so that individuals understand the longevity and morbidity risks they face. They will need to be in a position to determine the maximum level of income they can afford to take from their pension savings and even if they do understand the risks they may yet choose to maximise their current income.

We plan to analyse the expected impact of the proposed pension reforms in the pension and LTC environment in more detail.

Appendix 1
Overview of Social Care changes

Cap on care costs

From April 2016 a cap will be introduced on the costs that people will have to pay to meet their eligible care needs. The cap will, initially, be set at £72,000 in April 2016 for people of state pension age and over. People of working age who develop care needs before retirement age will benefit from a cap that is lower than £72,000. People who turn 18 with existing eligible needs will receive free care and support to meet those needs for the rest of their lives. The cap and associated financial limits are proposed to be increased each year with average earnings and the system, as a whole, will be reviewed every 5 years.

Local authorities will be responsible, amongst other things, for: raising awareness of how care and support works to enable better planning by individuals; providing access to the appropriate information at the point of need; providing the assessment that determines care needs; and ensuring care provision and assessment integrate with health provision and assessment. Eligible care costs will contribute towards the cap and the local authority will establish a personal budget for the individual and will keep this under review. Progress towards the cap will be captured in the individuals' care account and annual statements will be provided to communicate the rate of progress towards the cap.

Assessment – What counts towards the cap?

The local authority assessment is intended to be the first stage of the process which supports people in identification of their needs, understanding the options available to them and planning how their care and support needs can be met. The assessment will be focused on the health and wellbeing of individuals and will align to their needs and aspirations. From 2016, the assessment will also establish whether or not a person's needs are eligible and, therefore, whether their care costs will count towards the cap. To receive financial support from the local authority towards the costs of meeting their needs an individual will need to undergo a financial assessment of their income and assets.

If a local authority assesses someone as having eligible needs, they will work out how much it would cost to meet those needs, excluding their contribution to daily living costs, often through a resource allocation system. Only the cost of meeting eligible needs will count towards the cap.

People in care homes will remain responsible for their living costs if they can afford to pay for them. These reflect the types of costs that people would have to meet if they were living in their own home – such as food, energy bills and accommodation. The Government is expected to introduce a personal contribution to living costs of around £12,000 a year, approximately £230 per week, from April 2016 and this will not count towards the cap.

In summary, an individual will initially face up to three types of cost: daily living costs; local authority set care costs; and top-up care costs. The cap only applies in relation to local authority set care

costs. Individuals will pay all costs before the cap is reached (subject to means-testing) and will pay daily living costs and top-up care costs once they have reached the cap.

Means-testing

The total cost to a local authority of meeting a person's eligible needs will count towards the cap. This cost could, in practice, be paid by the individual, their local authority or through a combination of the two if the individual is eligible for some financial support. The cost of meeting eligible needs will still be recorded against the individual's cap even where financial support has been provided by their local authority.

The financial limit used to determine whether an adult may receive financial support will depend on whether the adult's home, where owned, is included in the financial assessment. The value of an individual's house is not counted for the first 12 weeks after a permanent move into a care home (or the first year of a temporary stay) or where it is occupied, in whole or part, by their partner, an incapacitated relative aged 60 or over or a child under age 16. The support provided financially by a local authority is summarised in Figure 8 (Department of Health, 2013).

Figure 8: Local Authority contribution to eligible needs

<table>
<tr><td colspan="3">Individual and local authority contribution towards costs of meeting eligible needs from 1 April 2016 where the local authority decides to charge for a type of care and support</td></tr>
<tr><td>Less than £17,000 in assets</td><td colspan="2">If a person's assets are below £17,000 then a person will only contribute their income towards the cost of meeting their eligible needs. People receiving residential care will remain responsible for their daily living costs if they can afford to pay them. This will be set at a standard amount of around £12,000 per annum. They will be left with a defined minimum amount to cover appropriate expenses relevant to each care setting (with annual adjustments applied), and any income they earn will be retained. The person's local authority contributes the remainder of costs up to the value of the personal budget.</td></tr>
<tr><td>Between £17,000 & £27,000 in assets</td><td>Where a person's property is excluded from the financial assessment, if a person has less than £27,000 in assets, they will qualify for financial support towards the costs of meeting their eligible needs.</td><td rowspan="2">The person will contribute all their income (except for the minimum amount) and a contribution from their assets above £17,000 towards the cost of meeting their eligible needs. People receiving residential care will remain responsible for their daily living costs if they can afford to pay them. This will be set at a standard amount of around £12,000 per annum. The contribution from the person's assets will be calculated using a fixed formula. The local authority contributes the remainder of costs up to the value of the personal budget.</td></tr>
<tr><td>Between £17,000 & £118,000 in assets</td><td>Where the person's property is included in the financial assessment if a person has less than £118,000 in assets they will qualify for financial support towards the costs of meeting their eligible needs.</td></tr>
<tr><td>Above £27,000 / £118,000 in assets</td><td colspan="2">The person contributes the full costs of meeting their needs in most cases if they have assets above £27,000 where property is excluded, and £118,000 when property is included in the financial assessment.</td></tr>
</table>

There will be help for people with their care home costs if they have assets of up to £118,000 (including the value of their home) and for people with assets of up to around £27,000 (where the value of their home is excluded). A tariff calculation will apply to determine the contribution that is required to be made from assets where an individual has assets of between £17,000 and £118,000 where their property is included and assets of between £17,000 and £27,000 where their property is excluded. The tariff is expected to mean that for every £250 in assets an individual has they contribute an additional £1 per week to their eligible care costs.

Deferred Payment Agreements

The Government intend to introduce deferred payment agreements from April 2015. This will mean that people meeting the criteria will not have to sell their homes in their lifetime to pay for LTC needs. The local authority would agree to pay an individual's care fees on their behalf and the individual/their estate would repay later, with repayment secured against their property. This is proposed to be open to those who would benefit from residential care (based upon a needs assessment), who have less than £23,250 (the financial limit excluding housing in April 2015) in non-housing assets and whose house is not occupied by a partner or dependant relative.

People will be able to defer the full costs of their residential care and accommodation, up to the value of the equity in their home (and other assets). Taking out a deferred payment agreement is not expected, all things being equal, to adversely affect entitlements to financial support or their progress towards the cap on care costs.

Local authorities will be able to charge an administration fee for the arrangement of the scheme and interest (the rate being nationally set) to cover lending costs and to mitigate against the risks of non-repayment.

Further technical definitions can be found in the Glossary to this report.

Appendix 2
Probability of reaching the Cap – Model

Key assumptions in the model

The current version of the model uses survival rates based on Table 15 in the PSSRU/BUPA Report on Length of Stay in Nursing Homes in England (Forder and Fernandez, 2011). The survey had a mean age of 85. The survival rates for varying gender, age and type of care home have been extrapolated linearly from the survival rates shown in Table 15 and Figure 1 in the PSSRU/BUPA Report. This enables us to give an indication of the impact of gender, age and type of care on the probability of reaching the cap.

It should be noted that the survival rates are based on residents in care homes across England. We have not at this stage tried to accommodate regional survival rates.

To provide more accuracy in the survival rates we are looking to update the model described in Rickayzen and Walsh (2002) in a later version of this work. This requires revised assumptions regarding morbidity, recovery and mortality which are being developed.

The care costs are based on Laing & Buisson (2013) average care home costs and Local Authority standard rates in 2012/13 values and have been inflated to 2016/17.

When Local Authority support reaches the maximum limit (the cap), it is assumed that individuals' assets are depleted. When no assets are left it is assumed a top-up is provided by a third party.

In the charts shown in this report, it is also assumed that:

- the Means Test is re-assessed each year based on updated asset and income values.
- care costs, the care cap, the means test limits, the Attendance Allowance and the NHS funded nursing care contribution all increase in line with inflation at a rate of 3.5% per annum.
- assets and income increase at a rate of 3.5% per annum.
- as the cap increases the percentage of the cap achieved remains constant.
- individuals continue to make top-up payments after the care cap is reached.

All these parameters can be configured in the model.

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Glossary

Term	Meaning
Activities of Daily Living (ADLs)	Basic personal tasks of everyday life such as bathing, dressing, using the toilet, eating etc.
Annual Allowance	The annual allowance is the maximum amount of 'pension input' to registered pension schemes in a year. For a DC scheme the pension input includes contributions made by anyone else into your pension such as your employer. For a DB scheme, the pension input is basically the increase in pension benefit accrued in the year. If your pension input exceeds the annual allowance you'll have to pay a tax charge and give details in your Self Assessment tax return. HM Revenue and Customs rules allow you to carry forward any unused annual allowance from the three previous tax years to offset this charge. From 6 April 2014 the annual allowance is £40,000.
Care Home	Residential Care home
Care Home with Nursing	Nursing home
Daily Living Cost	Those in care homes will pay a contribution of around £12,000 yearly towards general living expenses such as food and accommodation.
Defined benefit (DB) pension scheme	In a DB scheme the amount of pension you will get when you retire does not depend on the size of your pension pot. Under this arrangement you're promised a certain amount of pension at retirement. The amount of your pension is usually based on your pay and length of service. DB arrangements are normally only found under occupational pension schemes. Examples of a DB arrangement are: • final salary - where your pension is based on your final salary and your period of employment • a career average scheme where your pension is based on the average of your earnings over your period of employment • lump sum only schemes that do not provide a pension but only a lump sum - for example 3/80ths (3.75 per cent) of your final pay for each year of employment or scheme membership

Defined Contribution (DC) pension scheme	The employer and employee agree on a set amount (normally expressed as a percentage of salary) to be contributed to an individual pension fund. This may be monthly, annually or dependent on pay schedule. The contributions are invested to provide a fund which is used to buy an annuity (pension) on retirement. The employee contribution comes from their salary, before tax is applied. Unlike defined benefit pension schemes (sometimes referred to as final salary schemes), the level of retirement income for the member is not guaranteed.
Disability-free life expectancy	Measure of the number of years an individual can expect to live free from illnesses or impairments which restrict a person's ability to carry-out normal day to day activities. Disability is defined as a person having: • any health problems or disabilities that will last for more than a year, and/or • these health problems or disabilities, when taken singly or together, substantially limit the person's ability to carry out normal day to day activities
GAD limit	The maximum that you can withdraw from a drawdown pension plan based on relevant factors, like age, gender and 15-year gilt yield index – calculated by the Government Actuary's Department.
Lifetime Allowance (LTA)	The value of benefits within registered pension schemes of which will have no additional tax charges. From 6 April 2014 the Lifetime Allowance is £1.25m.
Local Authority Rate	The assessment by the local authority of the weekly cost of meeting the assessed LTC needs. This is the amount net of Daily Living Costs that accrues towards the cap once an individual has eligible needs.
Long Term Care (LTC)	References to long term care in this paper relates to the planning for long term care needs which might be experienced in later life (i.e. aged over 65).

Substantial Need	Substantial need arises when: • there is, or will be, only partial choice and control over the immediate environment; and/or • abuse or neglect has occurred or will occur; and/or • there is, or will be, an inability to carry out the majority of personal care or domestic routines; and/or • involvement in many aspects of work, education or learning cannot or will not be sustained; and/or • the majority of social support systems and relationships cannot or will not be sustained; and/or • the majority of family and other social roles and responsibilities cannot or will not be undertaken
Top-ups	An individual can choose to receive more expensive LTC than that provided by the local authority providing they "top-up" their care fees.