"We need a step-change in the way people plan for social care..."

UNLOCKING THE POTENTIAL

Les Mayhew
Duncan O'Leary

DEMOS

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As ever, all errors and omissions remain our own.

Les Mayhew[1]
Duncan O'Leary
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Foreword

Developed nations around the world are today grappling with public policy challenges created by dramatic improvements in life expectancy. Quite simply, people are living much longer than previous generations and in greater numbers than ever before – bringing the challenge of how we pay for these extra years to individuals and governments.

With the number of UK citizens aged 85 and over forecast to double between now and 2030 and 1.3 million people already receiving social care services in England alone, social care funding is a key public policy challenge. Against this backdrop the Government has set in train a set of reforms designed to get social care funding onto a sustainable footing, by establishing a new level for what individuals and the state will pay. The reforms are designed to encourage individuals to explore how best to use their available wealth and assets to meet care costs through a mixed economy of local authority and private sector care-funding options.

The litmus test for the reform package will be the extent to which it delivers a framework that prompts, encourages and enables people to plan ahead. This was among the issues identified by the House of Lords Public Service and Demography Committee, which warned that government and society are 'woefully underprepared' for the numbers of people requiring social care in later life. Addressing this lack of awareness so that people understand they have a responsibility to pay for some or all of their social care services, how much these services cost, and how the Government cap on these costs works in practice will be crucial to the reforms' success.

In writing *Unlocking the Potential* Demos, in collaboration with Cass Business School, has engaged a wide range of consumer, financial services, regulatory and policy experts to

seek fresh insights to inform the development of new options to address obstacles individuals face when making financial provisions for the costs in later life. The analysis draws on the framework set out in the Care Bill and known consumer behavioural traits, and develops recommendations to motivate individuals to plan for their care funding well before the point of need. The report also leverages one of the other key recommendations made by the Lords Committee – utilising housing wealth, and exploring how to enable people to pledge housing equity towards their potential care costs in later life.

Just Retirement is delighted to have contributed to the development of this report, making good the insurance industry's commitment to helping create new policy and financial product options to address people's needs in later life. With the Care Bill expected to create a new framework by 2016 this is a timely and hugely important contribution to the debate.

Stephen Lowe, Group External Affairs Director
Just Retirement Group

Executive summary

The passage through parliament of the Care and Support Bill marks a watershed moment in the history of social care funding in England. For the first time the costs of social care will be capped for each individual, albeit with various exceptions and caveats about which specific costs the cap includes.

This report explores what happens next. It argues that the reforms are necessary, but not sufficient, to create a new culture in which citizens forward plan for the costs of care in later life. It examines what further steps policy makers might take to encourage and enable people to plan ahead for care costs, and considers the kind of private sector products that might contribute to this.

The expectation among policy makers is that by capping the lifetime costs of care, a new market will open up for long-term care products, which enable people to meet their obligations up to the level of the cap. As the Prime Minister has put it, 'It's right to try and put in place a cap which will then open up an enormous insurance market, so people can insure against that sort of catastrophic loss.'[2]

However, there remain considerable demand-side barriers to such a market emerging in the near future. The most important of these is strikingly low public awareness of the likelihood of needing care, of the potential costs of that care, and of the division of responsibility for meeting those costs between the state and the individual. The evidence suggests that people tend to underestimate the chances of needing care and the cost of it – and only a small minority understand how the care funding system works. The danger, therefore, is that despite all the efforts of policy makers to cap and clarify care costs, lack of good information may prevent many people from planning ahead any more than they did in the past.

In addition to this lack of public awareness, there may also be strong behavioural barriers to people acting on the information that they have. People tend to suffer from 'optimism bias' – the tendency to overestimate the probability of desirable things – and underestimate the probability of undesirable things. Social care costs are likely to fall into this second category. Furthermore, recent pensions policy provides a warning about the risk that inertia will prevent people from acting even when they have good information and the intention to put money aside. The Government has decided the best strategy is to capitalise on inertia, rather than seek to overcome it. Since 2013 employees at the largest UK companies have been automatically enrolled into occupational pensions by law, with the ability to opt out rather than being expected to opt in themselves.

The passing of the Care and Support Bill therefore represents an opportunity for the Government to tell people what they will be entitled to and expected to pay through a concerted awareness-raising effort. Given the expectation that the financial services industry will innovate in response to the reforms and offer new long-term care products, it is also likely that the industry will play some part in raising awareness in order to demonstrate the value of its products. However, the lesson from policy areas such as pensions is that government information is not always enough to spur action on its own.

The Government should take a further step to encourage people to at least consider how well prepared they are for care costs in later life. We recommend that it institutes a financial health check for everyone reaching the state pension age. Each individual's first withdrawal from the state pension should be conditional on going through the health check, to ensure universal participation in it. The health check would be advisory and no more – people would still be left to make their own choices – but it would be a useful 'nudge' to encourage people to consider their assets, liabilities, planned future income and possible future care needs. This health check would take the form of an online tool, providing tailored feedback to individuals based on their responses to a relatively small number of basic questions, as well as offering prompts for next steps. This kind of

tool should also provide easily digestible facts, covering the likelihood of the individual requiring social care, the probable costs, the division of responsibility between government and the individual, and some broad-brush options for people to consider.

The Government should also explore the potential of introducing a more personalised and extensive face-to-face consultation with a financial expert, at an earlier age, when they are still preparing for later life. People could be invited to go through such a check at age 50.

The point here is to ensure that people understand – and stop to consider – the likely costs of social care in later life. This would be a major step forward in encouraging a culture of forward planning so that, having understood their liability for care costs, people can begin to assess their options in a straightforward way. One significant barrier to engagement in this respect is the complexity of the means test proposed in the Government's reforms. This complexity makes the system difficult for people to understand, let alone use as a basis for forward planning.

We propose that the Government should adopt a simpler means test, which would eradicate the complicated formula for 'equivalising' assets and income, as well as the thresholds and 'cliff edges' that make it hard for people to predict what support they can expect from the state. Our proposed, simplified system works through establishing how many years in residential care an individual could afford, based on a combined assessment of their assets and income. If implemented, those who can afford to shoulder a greater amount of their care costs would receive less support from the Government. Under this proposal, people would be reassessed annually so that as their assets deplete over time – and they can afford fewer years of care in the future – they receive more help from the state. The intention of this simplified approach is to make forward planning easier for people.

If more people are to plan ahead for the costs of social care they must first understand their liabilities and then be in a position to assess their options. The risk is that, equipped with a proper understanding of the liabilities they face, people may choose to do nothing at all – or, worse, to deliberately run down

their assets – because the state offers a safety net as a funder of last resort through the means test.

The Government should therefore seek ways in which to encourage and reward self-funding, and planning ahead for self-funding. If enough extra people can be encouraged to self-fund, or the same number can be encouraged to self-fund to a greater degree, then it may be possible to make savings and to reward those willing to take responsibility for their own care. This would have a double benefit: first, it would bring new money into the care system and improve care quality; second, it would reduce the burden on the Government and taxpayers who will face the material costs of meeting care services for a rapidly ageing population.

We recommend two options for further exploration. The first of these options is a savings model, with some similarities to pensions. Under this model the Government would create 'care accounts' in which individuals would store wealth in the form of savings or housing equity. The funds in care accounts would be reserved specifically for covering care costs and could not be withdrawn without a financial penalty after a set age in people's lives, such as age 70.

The incentive for people to ring-fence, or store, funds in these care accounts in this way would be that a proportion of the funds in the account would be disregarded in calculations for the Government's means test for care costs. This policy would be designed to reduce the moral hazard created by the means test, in that it would reward people for setting money or housing equity aside, rather than treating this as a reason for the Government to offer less support.

The second option that we present for further exploration is an insurance model. Under this model, the state would lower the social care cap for anyone able to demonstrate, in advance, that they will not require financial support through the means test for social care. In this model the Government would reward all those willing to make commitments in advance by reducing the level of the care cap for those individuals. This reduction would take the form of a percentage discount against the care cap. In practice, to qualify for this 'early-bird discount' people

would have to register the purchase of a long-term care product such as insurance or a disability-linked annuity with HM Revenue & Customs. Registered products would be kite-marked, to confirm their status.

These two options could coexist, or be implemented independently of one another, but both aim to reduce the moral hazard currently created by the means test by rewarding individuals willing to commit funds in advance to cover the future costs of social care. Both also rely on encouraging a greater degree of self-funding to cover the costs of the incentives involved. We recommend that the Government should explore the viability of these two options.

Finally, we explore the new types of products likely to enable people to draw on their assets – housing wealth in particular – and plan ahead for the costs of social care. We argue that the Government's Universal Deferred Payment Scheme will help people to draw on their assets, but not to plan ahead for care, especially if that care is provided in a domiciliary setting. On this point, we also argue that the opportunity exists for innovation by the financial services industry – to look at options that enable planning ahead and the use of housing wealth to cover care costs, including while homeowners still live in their homes.

We present one model for this concept, based on an equity-for-insurance deal. Under this model, individuals would be able to insure against care costs up to the cap in exchange for a fixed proportion of their housing equity. By allowing people to pay for insurance through housing equity rather than cash, such products would allow individuals to hedge against the risk of high care costs, without having to sacrifice their disposable income.

Any products engineered along these lines would need certain safeguards built in, which we discuss. Government and industry, meanwhile should continue to work together to remove any supply-side barriers to insurance products based on the concept of individuals insuring against costs up to the level of the cap. Industry stakeholders are clear that some significant obstacles remain in place. However, the Government's ambition

to enable products like this, offering individuals security and peace of mind, will bring good results.

Introduction

Social care funding has long been the problem that governments refused to confront. The last government produced a royal commission and three major reports on the subject but no significant policy changes. Cross-party talks have frequently been sought and always broken down.

In particular, governments have been unwilling to address the role of housing wealth in care funding. An ageing population has placed growing strains on public funding for care, while those aged 65 or over now hold an estimated £750 billion of unmortgaged housing equity.[3] Yet the cultural attachment to housing in the UK and the desire of people to pass something on to their children has made linking these two things politically toxic. A row over the so-called 'death tax', New Labour's final policy offering on the subject, dominated the airwaves for much of the 2010 election campaign before the proposal was withdrawn.[4]

In this context the Care and Support Bill making its way through parliament at the time of writing represents a substantial achievement. The reforms contained in the bill mark the most significant changes to social care in a generation, through capping lifetime costs for care (though not accommodation) for the first time in England and paving the way for an interest-bearing deferred payment scheme to be made available by local authorities across the country, to prevent the need for people to sell their homes against their wishes to meet care costs.

This report seeks to build on those reforms. It examines how likely the Government is to succeed in fostering a new market in long-term care products; it explores additional policy measures to facilitate more forward planning; and it considers the new kinds of products that industry could create, to allow people to tap into housing wealth in more

sophisticated ways than the Government's deferred payment scheme allows for.

The report draws on seven months of research and engagement with key stakeholders involved in the shaping of the Care Bill reforms. This work has included six policy seminars, including one at each of the three 2013 party conferences with relevant ministers and shadow ministers, as well as in-depth interviews with experts in the field, and desk-based modelling and research at Demos and Cass Business School, part of City University, London.

Our fundamental argument is that the Care and Support Bill will not be enough, on its own, to produce a step change in the way people plan for social care and that the care cap established through the current reforms is a necessary but insufficient step. Policy must go beyond these measures to draw on behavioural economics to spur people into action, particularly to overcome the known lack of public awareness of the realities of care funding costs. Government should sharpen incentives to ensure that people have good reason to plan ahead and new long-term care products will be needed, including products that draw on housing equity but also enable people to plan ahead for care.

Chapter 1 focuses on demand-side barriers to encouraging much greater forward planning for social care costs. It argues that people lack good information about care costs and their likelihood of facing them, noting further 'behavioural' barriers, such as a tendency towards inertia and a natural bias towards optimism, which may stop people from acting even when well informed. We recommend that the Government addresses these barriers by requiring individuals to go through an online financial health check as a condition of receiving their first payment from the state pension. Such a move could 'nudge' people to take steps to prepare for care costs in later life.

Chapter 2 examines the means test proposed by the Government, which builds on the recommendations made in the Dilnot report on social care funding.[5] We argue that the design of the means test makes it overly complex to understand, making planning ahead more difficult than it should be. This complexity

risks exacerbating people's natural tendency towards disengagement and inertia and in this chapter we set out an alternative, simpler means test to address this.

Chapter 3 explores the incentives that arise from the means test. We suggest that there is a risk of 'moral hazard' when government is willing to cover the costs of those who cannot afford to pay for their own care. We argue that the Government should examine ways to encourage and reward those willing to take steps to cover their own care, and explore two ways in which it could reward those willing to make commitments in advance to funding social care.

Chapter 4 identifies how people are likely to find the resources to fund care up to the level of the care cap. We note that pension savings will be inadequate for the vast majority, leaving housing wealth as a key part of the equation for many. We recognise that this will mean different things for different people, with some choosing to downsize and others turning to equity release options. We argue that the Government's deferred payment scheme will be suitable for some, but will not facilitate forward planning in the way that private sector products could.

Chapter 5 sets out some broad parameters for new financial products in this area, which would do the things that deferred payment schemes cannot – facilitate forward planning and help fund domiciliary care – while offering value for money, as part of a deal that consumers will be able to understand more easily. We demonstrate a product that could fulfil these criteria, based on a model that would see providers agreeing to cover future care costs up to the level of the cap in exchange for an agreed percentage of a consumer's housing equity. Anyone could buy it but it would be particularly suitable for homeowners who are unable to self-fund and without enough disposable income to purchase a conventional insurance product. We offers some stylised modelling on how such a product could work in practice.

1 Making a market

'These reforms bring reassurance to millions of people by ending the existing unfair system so no one need face unlimited care costs or the prospect of selling their home in their lifetime,' argued care minister Norman Lamb, as the Government announced its plans for the reform of social care funding in 2013.[6] The measures the minister was referring to have since been developed, consulted on and inserted into the Care and Support Bill. This chapter argues that:

- the reforms represent a welcome move towards a 'social insurance model', through which the state helps individuals to pool risks of high care costs
- while a key goal of the reforms is to create a vibrant market for long-term care products, there remain supply-side and demand-side barriers
- in particular, government must anticipate the 'behavioural' obstacles to forward planning, in the same way it applies 'behavioural insights' to other areas of policy
- the Government should 'nudge' people to prepare for future care costs through an online financial health check at retirement age
- participation in this health check should be a condition of people making their first withdrawal from the state pension
- the Government should explore the potential for a face-to-face financial health check, which would be more personalised and extensive than the health check people would have when they reach retirement age, and would occur earlier in people's lives

The Dilnot reforms

The Care and Support Bill is based on the framework provide by the Dilnot Commission on social care funding. It contains

provisions to cap the lifetime costs of social care at £72,000, while also limiting annual accommodation or 'hotel costs' (which are not included in the cap). The bill increases the means test for residential care as well as the capital threshold for the residential care means test, which will rise to £118,000.[7]

The proposed reforms have not been immune from criticism. The Centre for Social Justice has described the provisions contained in the bill as 'the wrong priority at the wrong time', objecting to what it regards as middle class welfare and arguing that 'helping the most disadvantaged must be the starting point for any reforms'.[8] However, the 'care cap' is best understood as a move towards social insurance, designed to protect people against risks beyond their control, and it is this feature that has helped gather a relatively broad coalition of support for the changes.

Under the old means test anyone with assets over £23,250 received no financial state support and was therefore required to fund their own care. This left some individuals and families open to catastrophic costs and many having to sell their homes to pay for care. The Dilnot report found that under the current, unreformed system half of over-65s could expect to pay care bills of up to £20,000, with one in ten facing costs of £100,000 or more.[9] Some could spend hundreds of thousands of pounds on care in later life. Dilnot himself described this as 'a bit like being in a shop with no prices', arguing that 'we are moving to a world where people are effectively insured by the state which should make them feel much more comfortable'.[10]

In practice, the cap will provide financial support to only a few people. It is estimated that around 30 per cent will need long-term care at some point in their lives[11] and of these 16 per cent are projected to reach the cap.[12] Our own research suggests that it will take several years for many to reach the cap – something we return to in chapter 3. However, this element of risk-sharing is implicit in any insurance policy. Risks are pooled, so those who turn out to face higher costs are subsidised by others – but everyone's liabilities are limited. It is what Winston Churchill once described as 'bringing the magic of averages to the rescue of millions'. Furthermore, as Dilnot himself noted, even those who do not benefit financially should enjoy greater

peace of mind as a result of having an upper limit put on lifetime care costs.

Creating a market

Beyond risk pooling, the social care cap has another explicit purpose. With government having capped the liabilities that people will face, it is expected that people will be in a better position to take steps to prepare for the costs of care up to the level of the cap. The idea is that the cap will open up space for industry to step into, with new financial products designed to help people to plan ahead. The government statement on funding reform, issued in February 2013, put it this way:

the limit on people's care costs will provide greater incentives to provide relevant products that people see the benefit of purchasing.

The government expects the financial services industry to work creatively to amend existing products and develop new products that support people in making choices about how to plan for their care costs.[13]

The Prime Minister has been more bullish still about the development of a market for risk pooling, asserting that 'it's right to try and put in place a cap which will then open up an enormous insurance market, so people can insure against that sort of catastrophic loss'.[14]

The development of such a market would be a considerable achievement, given recent history and some scepticism over the capacity for such a market to grow in the near future.[15] As the Government's impact assessment on the new funding arrangements acknowledges, care liabilities have proven difficult to insure against, with providers citing difficulties establishing sustainable products and withdrawing from the market in the 2000s.[16] Even with the establishment of a cap, some doubt the likelihood of a new market developing either quickly or easily.

During interviews that formed part of this project, representatives from the insurance industry echoed concerns that the £72,000 liability could prove difficult to insure against. In

order to price risk effectively, insurance companies need to find a way to predict care costs over an individual's lifetime – and this risk is difficult to quantify. While companies have data to draw on for some of the variables determining care *needs*, such as life expectancy and the probability of people facing disability at some point in their lives, care *costs* are much more unpredictable. This is because some people will draw on informal forms of care support, such as that of family members, while others will rely more on formal care. It will therefore be complicated to predict when the care 'meter' will start, in the run up to reaching the possible £72,000 cap. One insurance industry representative told us: 'Care needs don't necessarily lead to care costs – and if you're pricing a product that is what you have to be able to predict.'

These supply-side issues pose problems but are likely to be surmountable, as a clearer picture emerges over time about average care costs under the new system and how the meter will work. However, there are further demand-side barriers to be overcome before a new market for long-term care products will emerge. The first is that at present people have very little sense of where and how the costs of social care will be divided between themselves and the Government.

Information and awareness

One policy expert from Age UK pointed out: 'Most older people and their families know very little about social care before they first encounter the system, typically at a time of crisis such as a fall leading to an unplanned hospital admission.'[17] This lack of awareness is reflected in government figures showing that around four people in ten are unaware that they might need to pay for their care and support later in life.[18] In large part this is because many people simply have not stopped to consider it or have assumed that the state is responsible for paying for this sort of care. More than six in ten (63 per cent of) people say they have hardly thought about how to pay for social care needs in the future, while over seven in ten (72 per cent) say they have not started to prepare.[19]

When people do consider potential care costs, other studies have found that people tend to underestimate the probability of needing care themselves in the future. More than half believed the probability was lower than 40 per cent, when in fact 65-year-old men have a 68 per cent chance of needing care before they die, and women an 85 per cent chance.[20] (Note the chances of needing institutional care are much less – perhaps 30 per cent. Institutional care is usually described as long-term care. Social care generally subsumes all forms of care – domiciliary, informal, nursing home and so on.)

There is little awareness among the public of the precise or even rough cost of paying for care. Surveys find that nearly half of the public say they do now know the average weekly cost of a place in a residential care home. The mean figure suggested by those who think they know the cost is around £140 – far below the actual average weekly fee of £531.[21]

Given that so few people have an accurate picture of the key funding aspects of the existing system, it is unsurprising that awareness of the details of the proposed reforms is low. A high proportion (82 per cent) of those who are 50 and over are aware of the cap on care costs, but less than one in ten (9 per cent) say they know what limit it has been set at – a crucial factor. Moreover, researchers found there was little understanding of how the care cap would be calculated among the general public.[22]

Without clear information about how the social care system works, the real chances of needing some form of social care in later life, and their liability to pay for it, people are unlikely to take steps to prepare for the future in the way that policy makers hope they might. All this has obvious implications for the likelihood that people will take steps, ahead of time, to plan for the costs of social care, through either saving or the purchase of long-term care products. As the Association of British Insurers has put it: 'Where people do not understand the risks and costs of care, the perceived value of planning ahead and paying premiums is low.'[23]

To date, this lack of understanding has not been addressed in a systematic way by either local or national government. 'We have a new system on the way, but it is not going to change

behaviour if people don't know about it,' argued one financial services representative in our discussions. The passing of the Care and Support Bill therefore represents an opportunity for government to communicate what people will be entitled to and expected to pay. Given the expectation that financial service companies will bring new long-term care propositions to market it is also likely that industry will play some part in raising awareness, as part of a bid to demonstrate the value of its products.

However, the lesson from other policy areas is that information provision is not always enough to spur action or even engagement by consumers, even when it might appear to be in people's own interests. The UK Government and others throughout the world are seeking to understand better the behavioural quirks and biases that can confound the most rational of policy incentives. The Government's Behavioural Insights Unit, dubbed the 'Nudge Unit' after the best-selling book *Nudge*,[24] is an expression of this. The Unit 'applies insights from academic research in behavioural economics and psychology to public policy and services'[25] and we set out some options for how these insights could be usefully applied to encourage forward planning below.

Behavioural barriers

Deep behavioural insights and bold policy measures are almost certainly likely to be needed in order to address the awareness challenge and encourage people to engage with long-term care planning. One such challenge is 'optimism bias'. Evidence in this area suggests that people systematically underestimate the chances of unwelcome things happening to them, such as getting divorced, losing a job or being diagnosed with cancer, but overestimate the likelihood of positive life events, such as having gifted children, successful careers or long lives. Thus, even when confronted with the odds, many expect to beat them.[26]

Box 1 **Optimism bias**

Optimism bias refers to specific beliefs about whether positive or negative events or outcomes are more likely to occur for oneself than for others. For example, studies have found that, on average, smokers regard their own risk of suffering from a smoking related disease to be lower than that of other smokers. Similarly, newlyweds underestimate the likelihood of going through a divorce themselves, despite awareness of the divorce rate. One study found that when asked the likelihood that they would divorce in the future, the median response of newlyweds was 0 per cent. The same study found that in a survey while male respondents estimated that 20 per cent of children live with their fathers following divorce, double that amount (40 per cent) estimated that this would be the case should they go through a divorce themselves.[27]

Optimism bias can be a problem for organisations. The UK government issues guidance on overcoming the problem, finding that the costs of publicly funded projects tends to be underestimated by between 10 per cent and 23 per cent.[28]

Inertia is another behavioural trait that suggests that good information is unlikely to be enough on its own to stimulate engagement – a lesson well learned from other policy areas. Stakeholders in a range of positions, from ageing charities to consumer groups and financial services, all repeatedly drew the parallel with pensions in our discussions. Following years of information campaigns to encourage more saving the Government has decided the best strategy is to capitalise on inertia, rather than seek to overcome it. Since 2013 employees at the largest UK companies have been automatically enrolled into occupational pensions by law, with the ability to opt out rather than being expected to opt in themselves. Rather than try to overcome inertia, policy makers have decided to work with the grain of it instead. 'Persuading people that they need to save is one thing, getting them to actually do it is something else altogether. That's the lesson from pensions', is how one financial services provider put it. 'People need the right encouragement,

not just the right information,' argued a stakeholder from one ageing charity.

Box 2

Inertia

Inertia is 'lack of movement or activity especially when movement or activity is wanted or needed'29 and occurs when there is a gap between people's intentions and their actions. For example, around 65 per cent of British people say they are prepared to donate an organ after their death, yet only 27 per cent of the adult population are registered donors.30 Policy is increasingly based on not just changing attitudes, but linking positive attitudes with action. The Office of Fair Trading has produced its own work on inertia, recognising that it can undermine traditional competition policy if not properly accounted for.31 For example, there is evidence that people tend to switch banks on average once every 26 years.

Awareness of these biases as significant obstacles for the reforms suggests that while the provision of information is necessary and important, it will be insufficient without people being prompted in a more overt and deliberate way to consider how they prepare for the potential costs of social care. While there is no equivalent social care policy to equal the auto-enrolment approach taken to encourage pension savings, there is a strong case for interventions that provoke people to pause and consider their options for care in later life.

The Government should learn lessons from its health policy, which has introduced regular health checks in England for those between 40 and 74, following an announcement in 2009.[32] Under the new model, people will be invited in for a health check over a five-year rolling cycle. The purpose is not just to screen patients for problems, but also to equip them with better information about how their lifestyle choices are affecting their health. Meanwhile, the Welsh NHS is in the process of establishing online self-assessment checks for those 50 and over,

which will provide people with tailored health advice after they fill in a questionnaire.[33]

Financial health checks

Online or face-to-face interventions are appropriate for financial as well as physical health. We recommend that the Government institutes a financial health check for everyone reaching the state pension age. Each individual's first withdrawal from the state pension should be conditional on going through the health check, to ensure universal participation in it. The health check would be advisory and no more – people would still be left to make their own choices – but it would be a useful 'nudge' to encourage people to consider their assets, liabilities, planned future income and possible future care needs.

There are different ways in which his financial health check could be instituted. We recommend that the Government should begin at the light-touch end of the spectrum. People should simply be required to go through an online health check, such as that already provided by the Money Advice Service,[34] which contains around 30 questions and takes around five minutes to complete. The Money Advice Service 'money health check' provides tailored feedback based on the questions, and offers prompts for immediate action and tools such as reminder emails to encourage people to follow up on plans in the future.

Recommendation 1

The Government should make each individual's first withdrawal from the state pension conditional on going through an online financial health check. The health check would be advisory only, but would provide people with clear information and broad-brush advice about social care costs.

This online tool should be coupled with easily digestible facts, covering the likelihood of requiring social care, the probable costs, the division of responsibility between government and the individual and some broad-brush options

for individuals to consider. This would be a powerful prompt for people to consider in relation to their future, involving only a very minimal imposition on each individual and a very low cost to the taxpayer.

In the medium term, the Government should explore the potential for something more personalised and extensive, involving a face-to-face consultation and expert advice at the point at which people are preparing for retirement. This would be more likely to drive behaviour change, but would have far greater cost implications. The Government should begin by instituting the light-touch model and then consult on whether there is public and industry support for a more extensive advice system – and if so how the costs might be shared between government, industry and individuals themselves.

Chapter summary

The care cap is an important step forward in the creation of a more equitable system of social care funding, and a welcome move towards a model of social insurance in which the state protects people against catastrophic costs through pooling risk. There is also the potential for it to help create a market for long-term insurance products or related products, assuming measures can be taken to address known supply-side barriers including the inability to predict movements in care costs accurately. However, there are demand-side problems too. The first of these is a lack of public awareness about who is expected to pay for care and how much it really costs. The second problem is that even when people have good information, behavioural barriers such as 'optimism bias' and inertia greatly undermine forward planning.

Increasingly, government policy draws on behavioural economics to ensure policy measures go with the grain of known public behaviour. Harnessing approaches to pay for the costs of care in later life will be crucial to encouraging a culture of forward planning in relation to social care costs.

Alongside better public information policy makers should 'nudge' people to consider their options at an earlier stage. We recommend making the withdrawal of people's first state pension

payment conditional on going through a financial assessment. This would be one way of encouraging people actively to consider the costs of care. However, even with these changes making decisions will be hard. Part of this is caused by the complexity of the means test for social care, which we turn to in the next chapter.

2 Simplifying the system

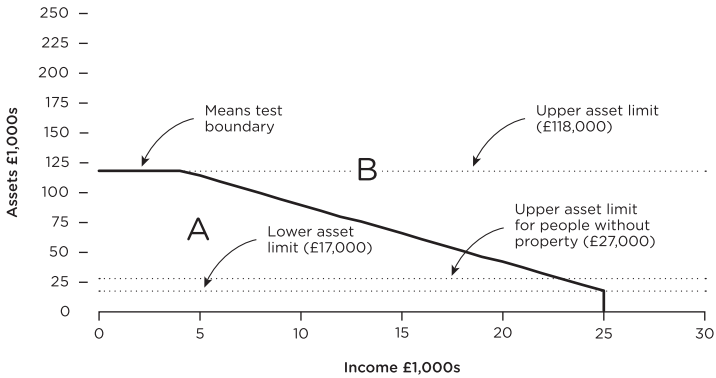
Ensuring that people understand – and stop to consider – the likely costs of social care in old age would be a major step forward in encouraging a culture of forward planning. However, having understood their liability for care costs, people must then be able to assess their options in a straightforward way. This chapter argues that:

- a significant barrier to forward planning is the complexity of the means test proposed as part of the Care Bill
- the multiple thresholds and 'cliff edges' contained in the means test make calculating entitlements for state support much more difficult than it should be
- the formula for 'equivalising' assets and income makes this problem even worse
- a simplified model is required, which eliminates the cliff edges and is based on a straightforward test of how many years of care an individual can afford
- the Government should adopt the means test we propose, which works on this basis

Complexity in the means test

In principle means tests are not difficult to understand: those who have less receive more support. In practice, the Government's proposed model is far less straightforward. Not only must people make ongoing calculations based on a formula combining assets and income,[35] there are various additional complications to contend with, which make planning ahead more complicated than it should be. At one of our seminars, attended by a group of experts in the area, few people were willing to say with any confidence that they understood the

Figure 1 **The means test proposed by the Government in the Care and Support Bill**



means test in its entirety. One Age UK representative commented that 'working out the overall impact on a person's income and assets of the Dilnot reforms is complex and challenging'.[36]

Figure 1 illustrates the proposed means test boundary at the heart of the Care and Support Bill. Those people with insufficient assets or income falling inside the solid line (region a) qualify for means tested support and those outside it do not (region B). In this example, we base our calculation on an assumed care home tariff of £25,000 per year. The graph demonstrates that there are three thresholds and two 'cliff edges' in this system, where state support either begins or falls away sharply. This makes the system difficult for people to understand and respond to. For example, the upper limit of £118,000 gives an impression that people should receive some state support if their wealth is less than this. However, after taking their typical retirement income into account a person will need assets of less than £89,000 before they receive any state support.

Similarly, the 'cliff edges' make the system less intuitive than it should be: support from the state can increase or decrease very suddenly in certain circumstances but not in others. This makes it difficult for people to adopt rules of thumb about the

kind of support they can expect from the state as their circumstances change. Instead, planning ahead requires people to make a series of calculations if they are to benefit, rather than lose out, from sharp changes in state support.

These kinds of complications make planning ahead an extremely complex endeavour, with the risk that people are overwhelmed and simply disengage altogether. As the last chapter showed, inertia is likely to be a barrier in any case – but disengagement becomes more and more likely the more complex the system becomes.

In seminar discussions, financial services sector representatives stressed that the complexity of proposals is likely to undermine efforts to develop a market for long-term care products. One representative commented:

The more complex the system, the harder it is to understand whether a given product will produce value for money. Not only do you have to understand the product itself, but you also have to get to grips with all the different ways the means test will affect the product in different situations. As the consumer you have to start working through all sorts of scenarios – what if this product tips me over this threshold or that cliff-edge and so on. It's a nightmare. Most consumers just aren't going to do that… they are just going to switch off all together.

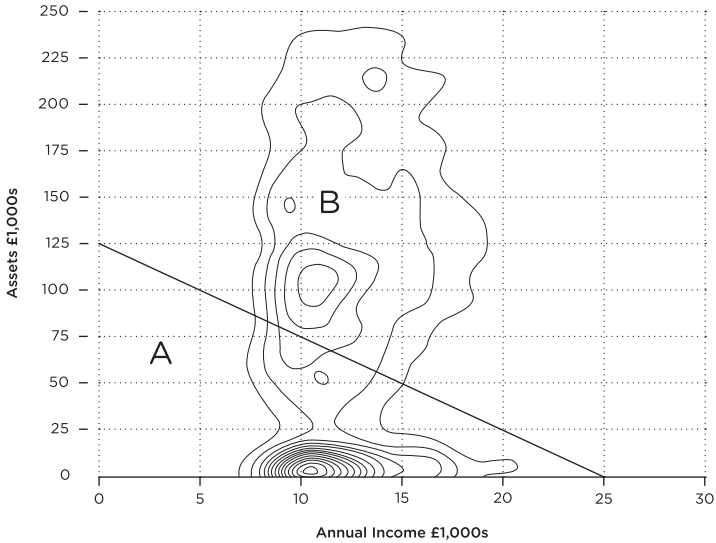
The consensus among those in the industry is that a consistent taper, without the cliff edges and thresholds in the Government's proposed system, would go a long way to addressing this problem.

A simplified means test

In our discussions with consumer groups, ageing charities and financial services providers, representatives from these bodies were unanimous that a simpler means test, with a consistent taper, is required to encourage forward planning.

Figure 2 sets out how such a test could work. It eradicates the boundaries and cliff edges in the Government's proposed means test, simplifying the test significantly by providing a

Figure 2 **Simplified means test with contours showing concentrations of wealth in the 65+ population**



consistent taper. The formula for our simplified means test is set out in appendix 1 but, at its most basic, it works through establishing how many years in residential care an individual could afford through a combination of their assets and income. Those who can afford more years of care receive less support from government. Each year, people are reassessed, so that as people's assets deplete over time – meaning they can afford fewer years of care in the future – they receive more help from the state.

Figure 2 illustrates how our proposed, simplified means test would work by showing the distribution of people affected in proportion to those individuals' income and assets. As with figure 1, this assumes an annual care home tariff of £25,000 per year. People falling inside the solid line (region A) qualify for means tested support and those outside do not (region B). The graph also demonstrates how different groups would be affected

by our proposed means test, with contours showing concentrations of people aged over 65 in different parts of the income–asset spectrum.

The concentration at the foot of the chart between the £8,000 and £15,000 income brackets represents people with assets of less than £25,000 and income of about £10,000. This group mostly comprises non-home owners. A second concentration includes people with assets of over £100,000 and an income of around £10,000. This group consists mostly of home owners. In total, there are about 3.4 million individuals age over 65 in region A, who would be eligible for some state support from the outset, and 8.3 million in region B – some of whom may need support at a later stage in their care cycle.[37]

The simplified means test in practice

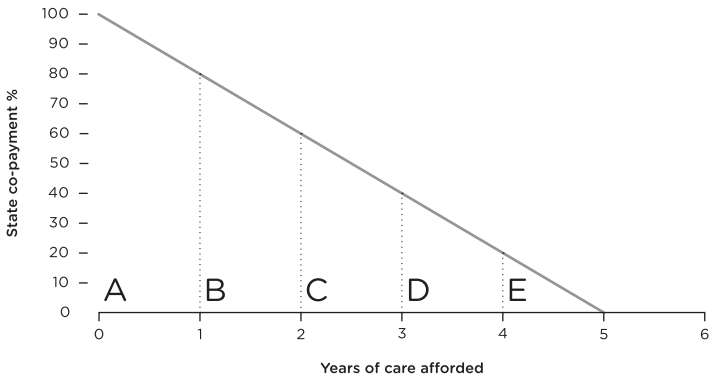
Figure 3 illustrates how our simplified means test would work in practice. This shows the percentage of costs that would be met by the state based on the number of years of care afforded.[38] Those who are able to afford care for a higher number of years – through a combination of their assets and income – receive less support, while those who can afford care for fewer years receive more support.

For example, people who could afford up to one year of care are in band A. This group receives between 80 per cent and 100 per cent of their care costs. Those who could afford to pay for care for between one and two years are in band B. This group receives 60 per cent to 80 per cent of their care costs. Those who can afford to pay for care for between two and three years are in band C and receive between 40 per cent and 50 per cent of care costs – and so on. Anyone who can afford five years of support or more receives no support with their care costs until their income and assets are depleted such that they fall into one of the bands on the graph.

Recommendation 2

The Government should implement a simplified means test, to facilitate easier forward planning. This means test would be

Figure 3 **Simplified means test showing the levels of support for different years of care afforded**



based on establishing how many years of care individuals could afford, through a combination of their assets and income.

Under the Government's proposed means test, entitlements are set to be recalibrated each year as people's financial circumstances change. We do not propose changing this. Therefore, under our proposed means test it is likely that from one year to the next, people may move from one band of support into another, gaining more support over time as their wealth diminishes.

Box 3 **Example: Recalibrating support under our simplified system**

Through a combination of her income and assets, an individual can afford between two and three years of care. This means that she is placed in band C and receives between 40 per cent and 50 per cent of care costs that year.

The following year her entitlements are recalibrated, to take account of the fact that she has been paying for care costs over the course of that year. Because her combined income and assets are now lower

than a year ago, she can now afford between one and two years of care, rather than between two and three, so she is placed in band B and has 60 per cent to 80 per cent of her care costs covered by the state during that year.

After a year her entitlements are recalibrated again to reflect her financial position.

Overall, we anticipate that under our reformed system the costs to the taxpayer would be roughly equivalent to those arising from the Government's proposed means test. Any variation could also be adjusted by using different tapers. However, within this spending envelope, our simplified formula would provide less state support in the early years of care and more support in later years as a consequence of eliminating the cliff edges in the Government's proposed system. This would fit with the overall principles of the Dilnot review and the Care and Support Bill, which are to continue to support those who have little, but to provide greater protection for those who end up facing higher costs.

How our simplified means test would work over time

Table 1 provides an example of how our simplified means test would work over time. It is designed to show the financial costs to an individual and the state of a typical person who enters a care home and is initially self-funding. We assume a tariff made up of £12,000 care costs and £13,000 living costs. The individual begins with £100,000 of savings and £10,000 income, so can afford 6.7 years of care and is not entitled to any support.

As the individual's assets are depleted over time as a result of paying for care costs each year, state support begins to kick in. By the time the cap is reached in year 6 the cost to the state will be £27,901 and to the individual £121,099. The out of pocket contribution during year 6 is £13,951 of which £10,000 is met from income, leaving £3,951 to be met from savings. The assets remaining at the end of year 6 is then

Table 1 **Care cost progression over a six-year cycle up to the cap including the depletion of assets, state support and out-of-pocket costs**

Year in care	Cumulative care payments (£)	Assessable capital at start of care year (£)	State support (£)	Cost to individual (£)	Contribution to cap (£)
1	25,000	100,000	-	25,000	12,000
2	50,000	85,000	-	25,000	24,000
3	75,000	70,000	1,667	23,333	36,000
4	100,000	56,667	6,111	18,889	48,000
5	125,000	47,778	9,074	15,926	60,000
6	150,000	41,852	11,049	13,951	72,000
		Total	27,901	122,099	

£41,852 – assets at the start of the year less £3,951 leaving £37,901 in this example.

The table illustrates three important points:

- Because accommodation costs are not included in the Government's £72,000 care cap, costs to the individual can mount up considerably even with a cap in place. The individual in this example pays more than £122,000 in total – including accommodation costs – before the cap kicks in, leaving them liable for ongoing accommodation costs.
- It is likely to take several years for many people to reach the cap in practice – six years in the case of this individual.
- The pace of depletion of assets – though high in the early years – gradually tails off.

A final and crucial point to note in light of these features of the means test is that the average life expectancy in residential care is around two and a quarter years.[39] This explains why only a small proportion of people could be expected to reach the cap, either under the Government's proposed means test or our simplified version.

Table 2 **The amount of state support delivered by the simplified and proposed means test for three people of equal wealth**

Person	Category	Amount (£)	Years of care afforded	Simplified support (£)	Proposed support (£)
A	Income Savings	10,000 50,000	3.33	8,333	6,603
B	Income Savings	15,000 33,333	3.33	8,333	8,136
C	Income Savings	5,000 66,667	3.33	8,333	9,669

Fair treatment of assets and income

A further positive feature of our simplified means test is that it would neither favour income nor savings. This contrasts with the Government's proposed means test, which favours assets over income. Table 2 demonstrates this through three hypothetical examples – persons A, B and C – and assumes care costs of £25,000 a year.

Person A has £50,000 of savings and £10,000 income per annum. He can notionally afford 3.33 years of care, based on total care costs including care itself and 'hotel costs' of £25,000. Person B has £33,333 of savings and £15,000 income per annum. He can also notionally afford 3.33 years of care out of pocket. Person C has £66,667 of savings and £5,000 income per annum. She can also notionally afford 3.33 years of care out of pocket.

Table 2 shows that the Government's proposed system unfairly favours people with large savings above people with higher incomes because it delivers more state support to person C than to person A, even though the two can afford the same number of years of care. Our simplified means test would eradicate this problem, delivering the same level of support to persons A, B and C because money gained from assets and income is treated equally. There is no formula to 'translate' a

Table 3 **The Government's proposed means test compared with our simplified system**

Proposed government means test	Our simplified system
Cliff edges and thresholds	Consistent taper
Formula to convert income into assets	Income and assets added together to establish years of care afforded
Favours assets over income	Assets and income treated equally
Delivers more support in initial stages, less in later stages	Delivers less support in initial stages, more in later stages

given amount of income per annum into a given amount of assets; instead our simplified system simply calculates how many years people could notionally afford, by adding together assets and income.

In our system state support gradually increases as the total figure – based on a combined figure for assets and income – declines as people run down their assets to pay for their own care. Table 3 summarises the differences between the Government's proposed means test and our simplified system.

Chapter summary

The means test proposed by the Government in response to the Dilnot recommendations risks discouraging forward planning because of the in-built complexity that arises from the combination of various thresholds, cliff edges and the formula to convert assets into income for the purposes of assessing eligibility. There is a risk that this level of complexity will lead to fatalism and inertia, rather than forward planning.

We propose a simplified means test, which would go a long way to making it easier for people to plan ahead. Our simplified system, which we believe would be no more costly to the taxpayer than the Government's proposed system, would be based on the number of years an individual could afford through

a combination of their assets and income. Each individual's financial position would then be reassessed each year, and this approach would be adaptable for domiciliary and institutional care purposes with certain important differences such as the treatment of housing assets.

We recognise that simplifying the system would not resolve all the problems with the Government's proposed approach. A further risk, as with any means test, is that of moral hazard: that people able to self-fund would instead choose to rely on government funding. We turn to this problem in the next chapter.

3 Rewarding contribution

If more people are to plan ahead for the costs of social care then they must first understand their liabilities so they are in a position to assess their options. However, there is a risk that equipped with this information people will simply choose to do nothing at all – or, worse, to deliberately run down their assets. This is because, through the means test, the state offers a safety net as a funder of last resort. This chapter argues that:

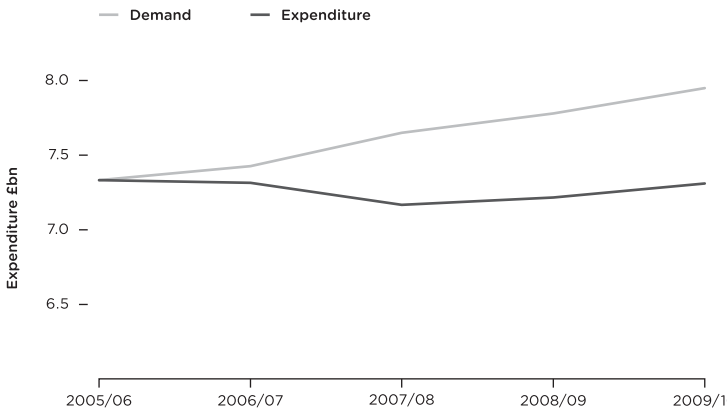
- the means test creates the risk of 'moral hazard': people may choose to let the state cover the costs of their care rather than provide for themselves
- there should be stronger incentives for self-funding
- encouraging a new generation of self-funders would produce a saving for the taxpayer
- the Government should perform a cost-benefit analysis of the two policy options set out in the chapter, which are designed to encourage more self-funding

Care funding shortages

One of the problems that the Dilnot review was set up to address was the shortfall in funding for social care, illustrated in figure 4, which shows demand for care growing at a faster rate than funding. Between 2005/06 and 2009/10 demand for social care outstripped funding by 9 per cent. This funding gap goes some way to explaining the problems with standards in the care sector. When the same resources are spread over a larger number of people, it is always likely that standards will drop.

There is evidence that these fears are being borne out in practice. In 2013 a record number of care homes were issued with official warnings by the Care Quality Commission (CQC), which

Figure 4 **Expenditure and demand in social care for the elderly in the UK, 2005/06–2009/10**



Source: Dilnot[40]

identified failings judged to put the vulnerable at risk.[41] More than 900 notices were issued by the CQC over the course of a year, an increase of 43 per cent from the year before.[42] Such figures, alongside some high profile cases of abuse and neglect, have filtered through into the public consciousness. Demos research has revealed overwhelmingly negative perceptions of residential care, with only a quarter of adults saying they would consider moving into a care home if they became frail in old age.[43]

Experts in the sector warn against attempting to 'provide care on the cheap', and in 2013 the director general of Saga Group observed, 'We have a crisis in the care home sector, with staff on minimum wage pay delivering minimal care, rather than the decent and dignified care that people deserve.'[44] These sentiments were echoed by various stakeholders in the research for this report. Local authority officers expressed concerns about

the growing proportion of local authority funding being taken up by social care provision and the difficulty of achieving quality standards when faced with such demand. One senior politician summarised the problem by suggesting that people would not be willing to see their own parents treated in many care homes.

Dilnot's answer to the problem of underfunding was to create a system with a higher proportion of self-funders and a smaller proportion of people reliant on state funding:

It is our expectation that our reforms will be an important step in delivering higher quality services overall. Our proposals should lead to a better resourced system, in which people are less fearful of the future, feel able to spend their money more effectively and can manage their care as best suits them.[45]

The mechanism to create a better resourced system is the care cap, which Dilnot believed would enable and encourage people to plan ahead by clarifying their responsibilities. The Dilnot report describes the proposal for a care cap as 'a type of social insurance policy, with a significant "excess" that people will need to cover themselves'.[46] In some ways this is a fair description, in that the cap does pool risk, in an attempt to protect people from contingencies outside their control.

However, unlike most insurance policies, the post-Dilnot system contains no formal incentives for people to contribute because those who have nothing or relatively little in the way of assets or income will receive state support under the means test. Under the proposed reforms state support will be available for those entering residential care with assets of £118,000 or less, while anyone with less than £17,000 in assets will have their care paid for entirely.[47]

Moral hazard

Given the fall-back option of the means test, there is a risk that people will choose not to make provision for their own care costs, leaving the taxpayer to foot the bill. The Association of British Insurers puts it bluntly:

There is no benefit to the individual of planning ahead unless they have income or assets well above the means test threshold, because saving or insuring for care costs means that the individual does not benefit from state support.[48]

In practice, people could choose to run down their assets in order to ensure qualification for the means test, or fewer people might take active steps to ensure that they have the means to cover care costs in old age. One local authority official argued, 'It is our job to look after the most vulnerable, but we have to get better at persuading the rest to put money aside. That's the difficulty with the means test.'

The Government recognises this problem in the current system. As the official statement on funding reform, issued in February 2013 put it, 'There are large incentives in the current system for people who would otherwise not receive financial support to hide their assets to gain access to government support.'[49] The document sounds a note of optimism that the care cap will 'make it more likely that people would pay their fair share' but the reality is that the care cap does little to change the situation of those close to the means test threshold. In discussions for this project, a representative from a charity for social care users warned that 'a market has sprung up in terms of companies peddling trusts to avoid long-term care fees'.

The social care system already contains measures designed to prevent people from intentionally running down their assets in order to qualify for the means test. The rules stipulate that if someone is judged to have done this deliberately to avoid care costs councils are permitted to treat that person as if they still owned the assets. However, financial advisers engaged in this project described this as a 'grey area'. Equally, Age UK guidance published in April 2013 on the deprivation of assets and the means test explains that the organisation 'continues to work to clarify the rules'[50] – suggesting the rules are hardly watertight. Other stakeholders involved in discussions for this project warned that local authorities are not yet implementing the rules as rigorously as might be expected.

Where the rules are clearer it is evident that low-level spending, planned in advance, would not constitute a breach of the rules. For example, the Department of Health guidance states that in regard to capital

it would be unreasonable to decide that a resident had disposed of an asset in order to reduce his charge for accommodation when the disposal took place at a time when he was fit and healthy and could not have foreseen the need for a move to residential accommodation.[51]

In interviews for this project, government officials expressed greater concern about inaction than the deliberate deprivation of assets. As one put it:

The rules we have should be enough to stop people playing the system. The bigger worry is that people won't do anything at all… they will drift along and end up relying more on the Government than they should do.

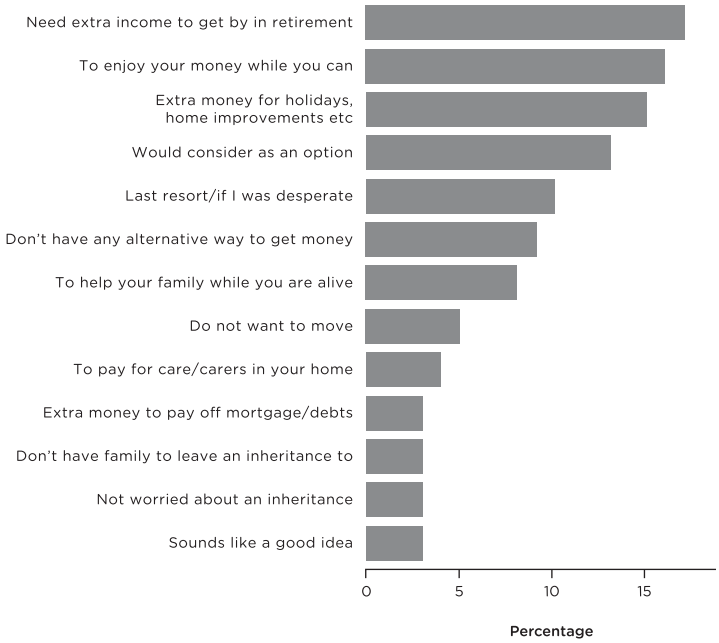
Clearly it is likely that large numbers of people will simply be less inclined to make sacrifices over a long and indeterminate period of time when they know that local authorities will fund their care if necessary. Low-level awareness that the government is the funder of last resort will add to the risk of inertia described in previous chapters.

This attitude is demonstrated in the responses given to a survey in 2012 by Just Retirement (figure 5). Of those who said that they are interested in equity release products, just 4 per cent said that the purpose of releasing equity would be to pay for care in old age. Under the current system, at least, there is little expectation that people will draw on their assets to cover care costs.

Incentives for forward planning

All of this has important implications for taxpayers, who must foot the bill for those unable to afford to cover their own social care costs. It is also likely to diminish the standard of care received by those relying on state support, with resources spread

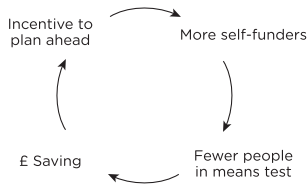
Figure 5 **Reasons for expressing an interest in equity release**



Source: Just Retirement[52]

more thinly than need be the case. The challenge, then, is to find the best way to offset the risk of moral hazard with a stronger incentive for people to make provision to pay for their own care. To meet this risk of moral hazard, the Government should explore ways to encourage and reward those willing to take steps to guard against the costs of care in later life. The aim should be to create a virtuous circle, in which more people are encouraged to self-fund, reducing the number of people falling into the means test, and thereby freeing up resources to reward thrifty and responsible forward planners (figure 6).

Figure 6 **Virtuous circle in forward planning**



In our interviews for this report industry figures, third sector groups and government officials all recognised the potential for such incentives. There was a consensus that incentives should fulfil two essential criteria. First, any new incentive should encourage an *outcome* – self-reliance – rather than a *method* of paying for care. A representative of one consumer group warned, 'Government should avoid favouring particular products individuals and their families are best placed to make those decisions. People need the right information, not someone telling them which route to go down.

Second, new policies should work to minimise 'dead-weight' costs. One Whitehall official commented: 'You don't want to be throwing money at people to reward them for things they are likely to do anyway. If there's going to be an incentives for people to self-fund, you want it to actually change behaviour.' An incentive for forward planning should reward those who are thrifty and responsible – but also encourage more people to demonstrate those virtues.

We propose that the Government explore two options for doing this, both of which have the same basic idea at their heart: people should be encouraged to ring-fence, or set aside in advance, portions of their wealth to pay for the costs of social care later in life. In doing so people would provide reassurance to government they will be in a position to cover the costs of some or all of their care in old age, rather than fall back on state support through the means test. To reward and encourage more of this behaviour, government would offer an incentive

for people to make commitments ahead of time. The aim would be to use the mechanism of ring-fencing alongside the offer of an incentive, in order to produce a higher number of self-funders.

Option 1 The savings model

The first of the two options that government should explore is a savings model. This would involve the Government creating a new legal mechanism, 'care accounts', through which people could put funds aside specifically to cover the costs of care in later life. People would be given the option of committing portions of their current wealth – in the form of savings, housing equity or a combination of both – into care accounts. Savings could be transferred to care accounts through a simple bank transfer; housing equity would be stored in the accounts through a legal charge on their home.

The funds stored in these care accounts would be reserved specifically for covering care costs, in such a way that access to the amount pledged would then be triggered following a care assessment. In this way, government would know that people were setting money aside for their part of the bargain up to the level of the care cap, reducing the risk of people relying instead on support through the means test. The incentive for people to ring-fence funds in these care accounts would be that a proportion of the funds in the account would be disregarded in calculations for the Government means test for care costs.

For example, if the Government offered a 10 per cent disregard, then an individual with £50,000 in their care account would only have £45,000 counted by the Government in calculations for the means test. If the Government offered a 20 per cent disregard then the same person would have only £40,000 counted in the means test. If the Government offered a 30 per cent disregard then only £35,000 would be counted – and so on. This policy would be designed to reduce the moral hazard created by the means test, in that it would reward people for setting money or housing equity aside, rather than treating this as a reason for the Government to offer less support.

An important feature of care accounts would be a set a deadlines in people's lives. For example, there could be a deadline that people could no longer add funds to the care account once they have reached age 70. The purpose of preventing people from adding money or equity to the account after the deadline would be to provide a spur to action, rather than allowing people to drift along and inertia to take hold. The deadline would also serve to reduce deadweight costs, by preventing people from sheltering assets in care accounts immediately prior to care needs. The aim is to encourage forward commitments and therefore increase self-funding, not simply to subsidise everyone. Should care costs never arise, the Government would have no claim on the money stored in the care accounts. The accumulated value of the person's care account would go into their estate.

The deadline would also have implications for people withdrawing money from care accounts, for example in the case of a financial emergency. Until the deadline, people would be able to withdraw money or equity from care accounts at any point, without any consequences. After the deadline the funds contained in the account would be committed to meeting social care costs. Anyone seeking to withdraw funds from the account would be subject to a financial charge or penalty. The purpose of this arrangement would be to encourage people to leave funds in the accounts to cover care costs, having made a commitment to do so, but still leave them with enough flexibility to cope with crises. In setting the level of the penalty, the Government would need to ensure that the flexibility built in for personal financial emergencies would not undermine the need for the ring-fence to be a meaningful commitment for the vast majority of people taking up the option.

One reason to think that people would be unlikely to want to withdraw money is the phenomenon of 'mental accounting' – people's tendency to apportion money for particular categories of spending and demonstrate a real reluctance to 'cross subsidise' spending from one category to another. If people put money aside for a particular purpose, such as care costs, evidence suggests they would become more reluctant to spend that money

on other things. This implies that simply getting people to place money or housing equity into care accounts should be half the battle. The financial incentives associated with the account would matter, but so too would the effect on the way people would come to think about their savings.

Box 4 **Mental accounting**

The term mental accounting describes the way in which people mentally apportion money for different sorts of spending in their lives. For example, people create budgets for different categories of spending, such as food, travel and entertainment. Academics at Princeton University have identified that when people spend over their assigned budget in one area of spending, they tend to claw back savings in that area rather than make up the ground through lower expenditure in a different category.[53]

Policy makers in the UK are now beginning to explore what this insight means for policies dealing with welfare and saving. For example, the Department for Work & Pensions (DWP) has been exploring the potential for 'jam jar' accounts, which enable people to place either wages or welfare payments into different accounts for different purposes. Such accounts could encourage people to account mentally for portions of their income as being 'rent money', even if in practice they are free to spend it as they choose to.[54]

Another reason to believe that people would be reluctant to withdraw money from care accounts is our natural tendency towards loss aversion – the widely identified tendency for people to strongly prefer avoiding losses to acquiring gains. Some studies suggest that losses are twice as powerful, psychologically, as gains. Therefore, loss aversion would be likely to have a strong effect in discouraging people from withdrawing money from the accounts and incurring penalties in the process. Loss aversion would make people reluctant to give up a discount they felt they had already earned.

Box 5 **Loss aversion**

Loss aversion occurs when people experience more pain from losses than they experience pleasure from equivalent gains. For example, studies have shown that people typically ask for higher prices when selling a good than they are willing to pay when buying it.[55] *Similarly, people demonstrate reluctance to enter into 50/50 bets, suggesting that the risk of the pain outweighs the equally likely prospect of gain.*

Policy makers are increasingly interested in how to apply this idea. For example, in the US researchers found that school results improved when teachers were paid bonuses in advance – with schools asking for them back only when results were not achieved. This type of incentive had a greater effect than traditional performance bonuses, which were paid only after goals had been achieved.[56]

An important feature of care accounts is the potential to ring-fence savings, housing equity, or a combination of both, up to the level of the cap. At any point, people would have the option of switching housing equity for savings in the account, or vice versa. This would be a major step forward in encouraging people to start to think through how to use all of their assets and income, as a package, to cover the costs of care in later life.

Should people move house they would be able to reassign portions of housing equity in their new homes, making the care accounts 'portable' from one home to the next. For example, should an individual owning a house worth £200,000 decide to ring-fence £25,000 of housing equity and subsequently downsize to a house worth £150,000 they would have two options: to exchange the ring-fenced housing equity worth £25,000 for ring-fenced cash to the same value, or to continue to ring-fence £25,000 worth of equity in their new home.

When social care costs arose, people would be able to spend the funds stored in their care accounts directly on care costs – or on kite-marked long-term care products tied specifically to cover those costs. Those people who had ring-

fenced portions of housing equity, rather than cash savings, would be required to release equity to pay for care, or to find the equivalent amount of money from somewhere else. The Government would not specify *how* people should release equity – some might turn to financial products such as equity release, others would choose to downsize – but merely that people should do so, in order to meet their commitments.

One analogy for care accounts is pensions. With a pension, people set aside money to provide an income in later life and the Government provides tax incentives to persuade them to do so. In setting money aside, people are not pre-committing to any particular product, they are simply partitioning funds to cover costs later in life. There is also a cap on how much can be set aside in total to be able to qualify for tax relief and rules about how much money can be withdrawn and from which age.

The analogy with pensions should not be taken too far but clearly they share several common features with care accounts. The key point is that government should attempt to encourage and reward thrifty behaviour for care funding as it does for pensions saving, using a mechanism flexible enough for people to set aside either savings or portions of housing equity. Care accounts would be designed to achieve this.

Option 2 The insurance model

The second model that we believe the Government should explore is based on insurance rather than savings, although it also rewards people who set money aside, in advance, for their social care costs. Under this model, the state would lower the social care cap for anyone able to demonstrate in advance through the means test that they will not require financial support for social care. A key difference with conventional insurance products is that the model would allow for the possibility of using housing equity as payment rather than a cash lump sum or regular payments, which may be too expensive for most.

In practice, to qualify for this 'early-bird discount' people would have to register the purchase of a long-term care insurance product, with HM Revenue & Customs. Registered products would be kite-marked, to confirm their status. Taking out insurance against social care costs up to the level of the cap would be one way of doing this.

The Government would reward all those willing to make commitments in advance by reducing the level of the care cap for those individuals. This reduction would take the form of a percentage discount against the care cap. For example, if the Government offered a 10 per cent 'early-bird discount' and the national care cap was £100,000, then individuals who had made advanced commitments would benefit from a lower cap of £90,000. A 20 per cent 'early-bird discount' would produce a lower cap of £80,000, and so on. This discounted cap would limit individuals' liability further, making it cheaper to insure against care costs.

A final element of this policy would be a deadline, again a set age in people's lives, after which the 'early-bird discount' would expire. As with the savings option discussed earlier in this chapter, the deadline would be a spur to action for individuals, helping overcome inertia, and a means for government to reduce deadweight costs. By setting the deadline relatively early, the Government would help avoid offering a reduced cap to people who might have bought such products anyway later in life.

Comparison of the two models

This second option – the insurance model – has potential advantages and disadvantages in comparison with the savings model, described earlier in the chapter. In theory, the insurance model offers a level of simplicity that might appeal to people. A reduced cap offers an incentive that would be straightforward to understand, while insurance against care costs would provide people with peace of mind that lifetime care costs (though not 'hotel' costs) would be covered. However, this route also has some comparative disadvantages:

Table 4 **Differences between the savings model and the insurance model**

Savings model	Insurance model
Method: store funding in care accounts to cover care costs up to the level of the cap	*Method*: insure against care costs up to the level of the care cap
Deadline: after set age, individuals can no longer deposit into care accounts; suffer penalties for withdrawal	*Deadline*: after set age, individuals can no longer benefit from early-bird discount
Not locked in: Consumer can change mind before deadline with no consequences, after the deadline with a charge	*Locked in*: Consumer cannot change mind, must make binding commitment
Incentive: agreed percentage of funds in care account disregarded from the Government means test	*Incentive*: care cap reduced by an agreed percentage
'Nudge': taps into mental accounting and loss aversion	*'Nudge'*: N/A
Financial benefit: rewarded for pre-committing funding for care	*Financial benefit*: rewarded for pre-committing funding for care
Financial risk: charge for withdrawing funds from care account after deadline	*Financial risk*: individuals may never need insurance policy they buy
Other benefits: none	*Other benefits*: peace of mind with costs up to the care cap covered
Means testing: still required to assess eligibility for top up state support	*Means testing*: greatly reduced or avoided as all care costs covered

- It depends on the ability of the private sector to find ways to insure against care costs, something that we return to in chapter 5.
- It would offer less flexibility than the savings model, both in the nature and level of the commitment required to qualify.

The key differences between the two options are set out in table 4.

Further analysis

A full cost-benefit analysis of both incentives would need to be performed before implementation. Both of these policies are premised on the idea that encouraging more people to pre-commit to making financial arrangement for their potential care needs will reduce the extent to which people rely on government support through the means test. For either policy to work, the fiscal benefits from fewer people drawing on the means test, or the same number of people drawing to a lesser extent, would need to be higher than the fiscal costs of providing the incentive to ring-fence money for care costs in advance.

There are reasons to be optimistic about the potential of both these models. The savings model would benefit from the fact that it would not subsidise those wealthy enough to be self-funders, unaffected by the means test. Only those likely to be affected by the means test would have any incentive to store money in the care accounts, in order to benefit from the disregard. This suggests that the policy would be targeted specifically at the group who would need to be encouraged to put more money aside for the taxpayer to generate any saving. We recommend that the Government models these two options to explore their viability.

Meanwhile, the insurance model would benefit from the fact that just 16 per cent of the entire population is expected to reach the cap at its current level, so even the discounted cap would apply to only a minority in practice, making likely costs to the taxpayer relatively low. By contrast, all of those insuring against care costs would be guaranteed not to draw at all on the means test, suggesting that savings to the taxpayer could be significant, even after deadweight costs.

Recommendation 3

The Government should undertake a cost-benefit analysis of the two policy options discussed in this chapter – the insurance

model and the savings model – both of which are designed to encourage and reward those willing to make provisions, in advance, to pay for their own care.

One objection to these policy options might be made on distributional grounds – that any new incentive for people to purchase long-term care products would not benefit the least well-off in society, for whom such products would be likely to be out of reach. However, this would be to misunderstand the nature of the incentive and the consequences of the policy proving successful in practice. The nature of the incentives suggested above is not to switch money from one *group* to another but from one *activity* to another. Both the insurance model and the savings model would subsidise forward planning, rather than compensate for the lack of it through means testing. The aim of the policy would be to save the taxpayer money overall, leaving more resources available for the least well-off.

Chapter summary

The value of means tests is that they provide an eligibility test to protect those who have nothing. But the problem is that they produce moral hazard: people may choose to run down their assets – or choose not to buy financial products covering the costs of care – because they know that the state will be there as the funder of last resort.

The Government should take steps to counterbalance the incentives created by the means test in the post-Dilnot system. One way of doing this would be to create savings accounts, allowing people to put money aside for care in the form of either savings or housing equity. The value in the care account would accrue over time with access to the fund being triggered following a care assessment. In determining eligibility for state support a proportion of the care account balance would be disregarded in the Government means test. This would be the reward for people for setting money aside.

A second option would be to reward those who insure against future care costs with a reduced care cap. This would

make forward planning more attractive and should reduce the number of people falling into the means test and thus potentially lead to significant savings in administrative costs. The idea behind both of these two options is that encouraging people to self-fund to a greater degree could reduce costs for the taxpayer. This still leaves the question of how people will find the money to do this – and what the response from industry itself might be. We turn to these questions in the next chapter.

4 Unlocking housing wealth

The post-Dilnot settlement has two elements at its core: protection from catastrophic costs and a safety net for those who have very little. Chapter 3 recommended that the Government should explore a third component: encouragement and reward for those who plan ahead to cover the costs of their care. Even with this third strand, however, there remains the question as to how and whether people will find the money either to cover costs directly or to pay for long-term care products. This chapter argues that:

- pension savings will be insufficient to provide the funding necessary for a good standard of care for most people
- housing wealth will be an essential part of the solution to the problem of funding care in later life, reflecting sustained and significant growth in house prices
- some will choose to downsize in order to release equity as a means of covering care costs
- many will wish to remain in their homes but will still need to draw on the wealth stored in their homes
- this group is likely to consider equity release products when considering how to cover care costs

Pension shortfalls and house price growth

It is clear that pension savings and other pre-funded options are unlikely to provide the answer to social care funding on their own. The value of the state pension has gradually been eroded over a sustained period, such that replacement rates for earnings are among the lowest in Europe.[57] The Government's 'triple lock' on future increases to the state pension and the introduction of the new, flat rate state pension from 2015 will help

boost the value of the state pension for many, but the days of generous state pensions and defined benefit provision are unlikely to return.

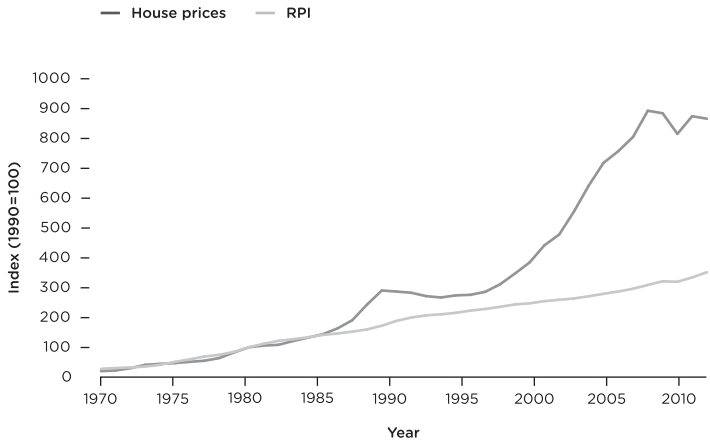
Defined contribution workplace schemes have not provided a large enough bank of private pension savings for people to fall back on. The average total employer and employee contribution into defined contribution schemes was just 8.9 per cent of salary in 2010, compared with 20.8 per cent for defined benefit schemes.[58] An estimated 6.25 million people aged 50 and over have no pension plan in place and are likely to end up relying solely on the state pension.[59] Many of the experts we spoke to as part of this project thought that in the long-term pensions savings and social care preparations need to be integrated with one another – but in the short term there is little prospect of pensions providing funding adequate care for those with anything more than minimal needs.

Many households may be able to plug the gap by tapping into housing equity. One reason for this is the British disposition towards storing personal wealth in bricks and mortar. As one interviewee with a background in mortgage lending put it,

There is something in the British psyche – something injected into us at birth in Britain – that drives the desire to own your own home. People see it as their goal, their achievement and then their nest-egg. I don't see that changing.

A second reason why housing wealth will be an essential route for funding social care is the extraordinary growth in house prices in recent years. Aggregate house prices began to grow at a faster rate than inflation from the mid-1980s onwards. Figure 7 plots the Retail Prices Index, the standard measure of inflation, against the houses prices – and shows a dramatic divergence between the two between the late 1990s and 2008. Though these changes in house prices are not uniform across the country, as a rule those who purchased their homes before 2000 will have seen their asset rise in value considerably. In 1986, the average home in a British city cost £35,209. Today the same property would cost around £170,000.[60]

Figure 7 **Average UK house prices compared with cost of living index (Retail Prices Index), 1970–2010**



House prices and care costs

The effect of this rapid growth in house prices is that home-owners will be able to draw on housing equity to fund social care to a greater degree than in the past. Table 5 shows changes in average house prices since 1980 and estimates of the change in institutional care costs based on inflation. It demonstrates that the ratio of house prices to care costs has increased from 3.8-fold to 10-fold during that period. Housing equity was always an important source of savings, and its importance has become more pronounced as house prices have rocketed.

Further analysis shows the difference that tapping into housing wealth can make in determining people's ability to meet care costs over time. Figures 8 and 9 provide a break-down of how many years of care different sections of the population aged 50 and over could afford, first through income and second through housing wealth. As with examples in previous chapter, this assumes total care costs of £25,000 per annum, made up of £12,000 going towards care itself and £13,000 towards 'hotel costs'.

Table 5 **Average house prices compared with the estimated cost of care**

Year	Average house price (A) (£)	Estimated average annual cost of care (B) (£)	Multiple (A/B)
1980	26,885	7,106	3.8
1985	38,657	10,056	3.8
1990	77,151	13,405	5.8
1995	74,201	15,849	4.7
2000	118,847	18,102	6.6
2005	203,736	20,406	10.0
2010	235,251	23,763	9.9

Source: ONS[61]

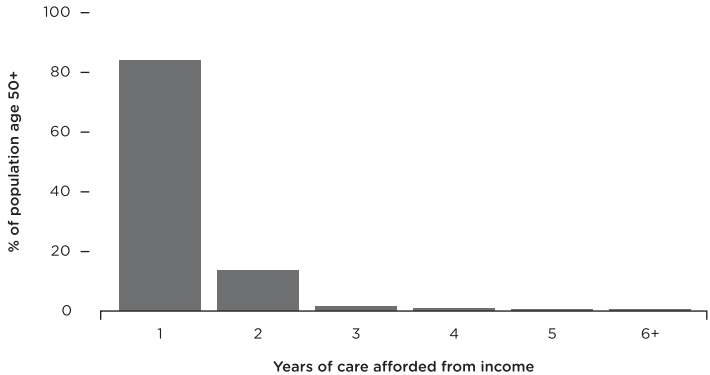
Figure 8 demonstrates that most people would struggle to pay for even one year of care if reliant only on income. By contrast, figure 9 shows that if all wealth is taken into account the picture changes dramatically and most people are able to afford six years of care. The key factor which makes the difference is the value of housing equity.

Options for self-funders

These examples demonstrate the importance of people finding ways to tap into housing wealth to cover care costs up the level of the care cap. Figure 10 shows the different ways in which people are likely to be able to pay for their care, based on their assets and income. It suggests that

- those with relatively low income and assets – group A – are likely to have to rely on the state or to turn to new types of products, such as personal care savings bonds, discussed by Mayhew and Smith[62]
- those with high assets but a low income – group B – are likely to need to release equity to cover the costs of care; the exception to this will be a minority of those within this group with large

Figure 8 **Years of care most people could afford if funding is based on their personal income only**

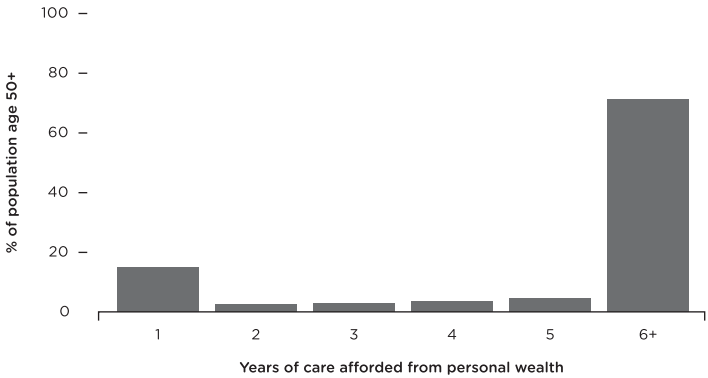


savings or housing assets, who might choose to buy a product such as an immediate needs annuity[63]

- those with a moderately high income – groups C and D – are likely to turn to either pension products such as disability-linked annuities or insurance products paid for through income or using a pension lump sum
- those with the highest incomes – group E – are likely simply to self-fund and have no need of financial products

Figure 10 gives an indication of the relative size of each of these groups. The contours in the chart suggest that there is a large collection of people within group A with very low income and assets – this group is most likely to rely on the Government's means test for state support and new product innovations such as personal care savings bonds. The contours also show that there is another collection of people on the boundary between groups A and B. This collection is likely to be amenable to using housing equity to cover care costs, given the right opportunities to do so.

Figure 9 **Years of care most people could afford if funding is based on their personal income and assets**

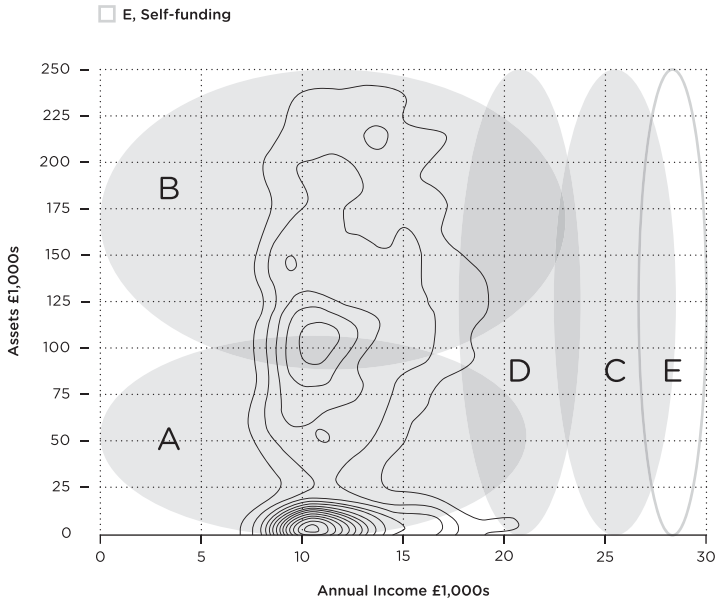


Releasing equity

Recent evidence suggests that people have some awareness of the likely role of housing equity if they are going to cover the costs of their own care, rather than rely on state support.[65] In a recent survey (under the current, pre-Dilnot care system) a majority said that they could only afford to pay for long-term care if they sold their house.[66] Just over one in six reported seeing either their parents or a close relative spend most of the equity in their home on paying for long-term care. This shows there is relatively high awareness among the population that housing equity may provide the answer to funding care.

There are different ways to release equity, including downsizing to a smaller house in order to release some of the money stored in the current residence. Previous Demos research has demonstrated there is an appetite for this, with more than half (58 per cent) of people aged over 60 saying that they were interested in moving – and a majority of that group interested in downsizing by at least one bedroom. Three-quarters (76 per cent) of older people currently occupying three-, four- and five-bedroom homes declare an interest in moving somewhere smaller. Overall a third of the over-60s are open to the idea of downsizing, equating to 4.6 million over-60s across the UK.[67]

Figure 10 **Product map showing how people are likely to be able to pay for their long term care, by assets and income**



Source: Mayhew et al[68]

These figures illustrate that some older people feel trapped in their homes, without the confidence, information or physical ability to move from one house to another.[68] However, even when this group is taken into account, this still leaves two-thirds of over-60s who say that they do not wish to downsize.[69] This is almost exactly this proportion of people (67 per cent) who say that they resent the idea of having to sell their home to pay for social care.[70]

If people do not wish to move, but have a large proportion of their overall wealth tied up in housing equity, the most appropriate solution to the problem of funding care in retirement is likely to be some form of equity release. This is the analysis at the heart of the Government's deferred payment

scheme, which is designed to tap into housing equity to cover care costs on a wider scale than any government scheme to date. Since 2001, local authorities have had discretionary powers to defer self-funders' residential care fees against a charge on property, but provision of this service has been patchy around the country, with local authorities setting their own eligibility criteria in each area.

The Care Bill contains provisions to make the deferred payment scheme available across the country. All authorities will have a duty to offer deferred payments, with consistent rules for eligibility, which fees can be deferred and for how long. At the time of writing (early 2014), the precise eligibility criteria for the scheme are still under consideration, but it is clear that the policy is not geared towards forward planning and early intervention because the deferred payment scheme is designed to meet the care costs of those on the point of entering residential care, to prevent the need to sell people's homes too hastily.

As the Government's impact assessment on the policy notes, having to sell a home in a rush can lead to people losing out on up to 25 per cent of the property's market value.[71] By allowing people to defer payment until after death, at which point homes must be sold, the Government hopes to protect people from stress and financial loss. Officials we spoke to in interviews for this project were clear on this point: the purpose of the deferred payment policy is to protect people from the worst consequences of entering residential care without having a clear plan for how they are to pay for it. It is a damage limitation policy, rather than one designed to encourage people to think ahead.

The Government's deferred payment scheme will be useful for those who enter residential care with assets to draw on, but will not help people to use housing wealth to pay for care while they are still in their own home. This is a potential problem for individuals and the Government as this form of 'early intervention' has been shown to minimise care costs in the long run. Small doses of care and support for people in their own homes can delay or prevent the need to enter costly residential care.

This gap in the deferred payment scheme creates an important opportunity for the private sector to step in and add value. There is an opportunity to provide equity release products, which allow people to draw on housing wealth to cover the costs of care while they remain in their homes. Such products could help people live at home for longer, as many wish to, while minimising care costs too. Policy makers and figures in the industry agree that this opportunity is worth pursuing. As one official close the deferred payment scheme put it,

The aim of the [deferred payment] policy is not to crowd out the private sector. There ought to be a lot of space for new products which cover the domiciliary care costs. That would be good for individuals because it would keep care costs low – and actually it ought to help the Government too if it means fewer people end up reaching the cap.

Chapter summary

Given the shortfall in pension savings and the rapid rise in house prices in recent years, housing wealth is an essential part of the solution to the problem of funding of care in later life. When people are able to use some of their housing wealth to pay for care, they can cover the costs of care for considerably longer. Some people want to downsize, but many wish to remain in their own homes, and these people are likely to be able to meet their domiciliary care needs by using equity release products.

The Care Bill will make the local authority deferred payment schemes available across the country, albeit with some caveats on eligibility. This should protect those entering residential care from having to sell their homes too quickly and suffering losses as a result. However, the deferred payment scheme is not designed to enable early intervention or encourage forward planning. This is where the opportunity lies for private sector products. The next chapter considers the parameters equity release products that might serve this purpose.

5 New products: drawing on housing wealth

By establishing a care cap, the Government has challenged industry to come forward with innovative financial products to help people cover the costs of care in later life. As the last chapter showed, many individuals are likely to find releasing equity is an essential way of doing this – and using equity release products the best route for those wishing to remain in their own homes.

This chapter argues that:

- traditional equity release products tend to be accessed by people at the point when they require income, rather than as a device for planning ahead
- this is especially the case with the Government's deferred payment scheme, which allows people to draw on housing equity to cover costs only when they enter residential care
- new private sector products should go beyond this, by enabling people to plan ahead, using housing wealth to cover care costs even while they still live in their homes
- such products would serve an important purpose for consumers – and may be of benefit to the taxpayer too
- the industry should explore the scope for new products along these lines, while government should work with industry to understand the ways in which policy can minimise supply-side barriers

Box 6 **What is equity release?**

Equity release allows individuals aged 55 and over to release money from the property they live in without having to make any monthly repayments. By using an equity release product, a home owner can draw a lump sum or regular smaller sums from the value of their home, while remaining in their home.

There are two types of equity release – lifetime mortgages and home reversion plans. Lifetime mortgages involve taking out a type of mortgage, which typically does not require monthly repayments. Rather than these payments, the loan accrues compound interest over time. The customer retains ownership of the house and the loan is repaid when they either die or move into long-term care.

In home reversion plans providers purchase all or part of a customer's house, either through a lump sum payment or through regular payments. The customers remain in the home, rent-free, with a lifetime lease. Customers and providers retain the same proportions of housing equity, regardless of changes in house prices. At the end of the plan the property is sold and the sale proceeds are shared according to the remaining proportions of ownership.[72]

The SHIP standards

Equity release products are regulated by the Financial Conduct Authority, and the Equity Release Council's code of conduct, known as the safe home income plan (SHIP) standards, sets out a series of core principles that equity release products must meet. Only those that meet the principles carry the SHIP standards kite mark. The SHIP standards stipulate that:

- customers have the right to remain in their property for life provided the property remains their main residence
- customers will be provided with fair, simple and complete presentations of their plans
- the client's legal work will always be performed by the solicitor of his or her choice, who will be required to sign a certificate to the effect that the plan has been explained to the client fully and that they understand the risks and benefits of the plan
- customers have the right to move their plan to another suitable property without any financial penalty
- the Equity Release Council certificate will clearly state how the loan amount will change, or whether part or all of the property is being sold

- all Equity Release Council plans carry a 'no negative equity guarantee', whereby no customer will ever owe more that the value of their home[73]

We believe there is an opportunity for new products to be introduced that build on these standards, but go beyond both the traditional model and the Government's deferred payment scheme by facilitating forward planning for social care. There is an opportunity for products that allow consumers to cover the costs not just of residential care, as the Government's deferred payment scheme does, but also of domiciliary care. Such products would enable people not just to unlock value from their homes, but also to go on living in them for longer, as many wish to. As the last chapter demonstrated, such products would also have the advantage of releasing money for early intervention, helping stave off chronic care needs, rather than just providing a way of paying for residential care when it is needed.

New opportunities

In interviews, industry figures familiar with the equity release market were keen to stress the importance of simplicity in the design of such products. This view mirrors the discussion earlier in this report, about the risk that the complexity of products puts people off making decisions altogether: 'It's got to be simple and intuitive – if you need a maths degree to understand it then people probably aren't going to buy it,' was how one interviewee put it. New products ought to be straightforward from the perspective of the consumer, so that people can readily understand and make judgements about their appropriateness and usefulness.

This demand for simplicity is often linked to the need for products to provide value for money, beyond the SHIP requirement of protection against negative equity required by the code's no negative equity guarantee. Equity release advocates from within and outside the industry were often most insistent about this.

It is important to stress that our idea of a savings account, described in chapter 3, does not constitute a new product of

itself. Instead it is a mechanism for setting aside part of one's wealth to pay for future possible care costs. When care is triggered the value of the fund is released and only then would individuals choose from financial products available in the market-place. These include equity release draw down products or immediate needs annuities:

- Equity release products allow individuals to withdraw cash to pay for care at the point of need; the value of the loan plus interest is payable when the home is sold.
- An immediate needs annuity pays for some or all of a person's care costs until death or on sale of the home and the payment of a lump sum.

In the next section we explore a completely new type of product.

Recommendation 4

Providers in the equity release industry should explore the potential for new products that have the following characteristics:

- conform to the SHIP standards
- enable forward planning
- release money for domiciliary care
- offer a simple deal for consumers
- provide value for money

Outline of a new product

There will no doubt be many product variants able to build on the SHIP standards, enable forward planning, cover domiciliary care, offer a simple deal and provide value for money, but below we explore how a new ring-fenced product based on the insurance option described in chapter 3, using housing equity as payment, might work. This should be regarded not as a full product design, but rather a concept for providers to build on where they see fit.

The product complements the Government's deferred payment scheme, but has certain key differences. As with the policy proposals set out in chapter 3, the mechanism, again, would be for people to ring-fence part of the equity in their homes, without having to sell their house, in return for the provider covering the individual's care costs up to the level of the care cap. Any products built along these lines would seek to dovetail with the state system of support – something the Association of British Insurers believes would be attractive to consumers.

This form of ring-fencing would be an equity-for-insurance deal, which could work in conjunction with the 'early-bird' discount suggested in chapter 3. As with traditional equity release products, the product would be 'portable', allowing people to move house subject to an updated agreement being drawn up with the provider, ring-fencing a percentage of equity in the consumer's new home.

One of the advantages of a product structured along these lines is that it would overcome one traditional obstacle to pre-funded insurance schemes – that consumers have proven unwilling to make sacrifices to their current standard of living to cover against the possibility of care costs in the future. Faced with other demands, such as mortgage payments and pension contributions, alongside day-to-day living costs, people have tended to take their chances with care costs, rather than make sacrifices to pay into insurance schemes. Paying for insurance through equity would offer one way round this. People would not face additional day-to-day costs, hedging their risk against high care costs with housing equity rather than disposable income, for which they may have made other plans. Over the long term this would still come at a cost, but it would not require people to make short-term sacrifices in their standard of living to address long-term risks.

The individual and the provider would agree that the provider would recoup a percentage of housing equity from the individual, either at the moment when she or he enters residential care or at the end of that person's life.

Table 6 compares this proposed ring-fenced product with the Government's deferred payment scheme. As discussed in

previous chapters, individuals have a relatively low chance of reaching the cap so, simply through risk pooling, providers ought to be able to price the risk at less than the level of the cap itself. Therefore, through a risk pooling mechanism, providers may be able to offer insurance against care costs for less than the level of the cap itself.

Such a deal would need to have some safeguards built into it, protecting both consumers and providers from dramatic swings in house prices. Consumers would need to be protected against the risk that house prices would rise so fast that products would become more expensive than the risk they were insuring against. This could, theoretically, be the case with a product based on committing a percentage of equity, without safeguards built into it. To address this, providers could offer a guarantee that they would not recoup equity higher than the value of the care cap – or better still a fixed proportion of the care cap. This would ensure that any consumer entering into the deal was genuinely hedging against the risk of care costs up the level of the cap.

In exchange for this consumer safeguard, agreements could build in a corresponding protection for providers against dramatic falls in house prices. Just as products would be prevented from becoming too expensive, they could also be prevented from becoming too cheap. We recommend that the insurance industry, government and financial intermediaries work further on this idea by testing and simulating a range of scenarios to ensure that the design of the product is fair to both individuals and providers.

Such a product could work in conjunction with the policy incentives discussed in chapter 4, or in the absence of them. The key advantage to the consumer would be peace of mind because a known amount or percentage of their assets would be fully protected, and all means testing for eligibility to state support would be avoided. The advantage to the taxpayer is that more people would be taken out of state support altogether and personal inheritance planning would be simplified.

Figures 11 and 12 demonstrate how the idea could work, by addressing how the product would respond to different

Table 6 **A comparison of the Government deferred payment scheme with our outline product**

Government deferred payment scheme	Ring-fenced product parameters
Agreement made when individual enters residential care	Agreement made in advance of care needs and costs
Covers costs for residential care only	Covers costs of domiciliary or residential care
Costs recouped: actual care costs up to social care + interest	Costs recouped: agreed percentage of housing equity
Costs recouped by local authority on death	Costs recouped by provider either on death or on entering residential care

contingencies. Figure 11 shows what would be likely to be the more expensive option for the consumer, in which the provider recoups an agreed percentage or amount of housing equity when the individual dies. Figure 12 looks at what would be likely to be the cheaper option, under which the provider would recoup an agreed percentage or amount of housing equity at the moment the individual enters residential care. This second option would be likely to be cheaper than the first because the provider of the product could expect to recoup their money at an earlier stage.

As a rule, anything likely to delay the provider from recouping their fee – the agreed percentage of the consumer's housing equity – would be likely to make products drawing on this outline idea more expensive. This explains why such products would be likely to be more expensive for those living with a dependant, which would delay the sale of the house, than for those living alone. For example, if an individual dies without needing care and their house is empty, their house would be sold within 12 months and the agreed percentage recouped. By contrast, if a dependant is living in the house, it would not be sold until the dependant moved out.

Figure 11 **Equity recouped by the provider when the consumer dies**

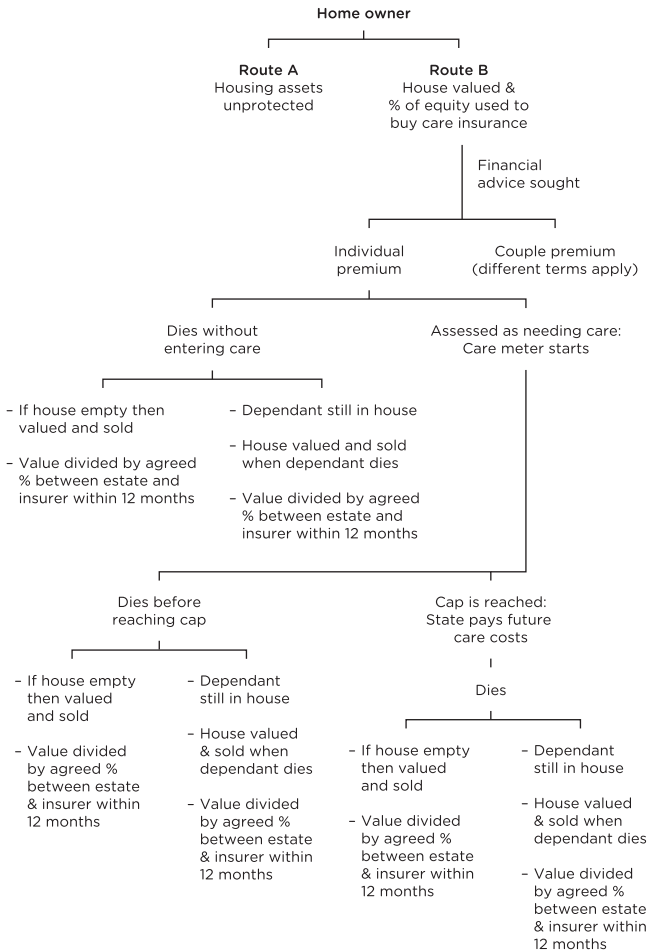
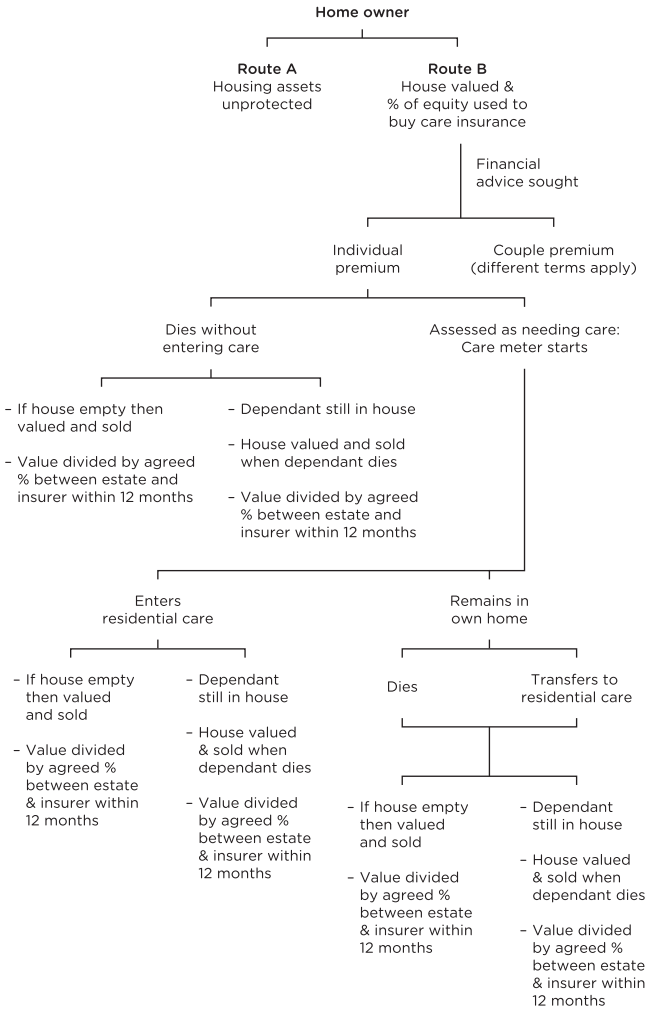


Figure 12 **Equity recouped by the provider when the consumer enters residential care**



Demand-side barriers

Any products that are ring-fenced, as discussed in the previous section, are likely to experience some demand-side barriers, one of which might be a tendency for people to consider that they will not experience care costs up to the level of the social care cap and therefore risk taking no financial precautions to meet their potential care needs. An inevitable feature of the proposed ring-fenced products is that some people may end up losing more in equity than they would have paid in care costs if they had not bought the product. This is in the nature of insurance. The danger is always that the protection will not be needed in practice, but this risk is traded off by the consumer for security and peace of mind.

A second demand-side barrier might be the fear that in ring-fencing a fixed percentage of housing equity, consumers would fear that products engineered along these lines might become too expensive should house prices rise quickly. This fear could be addressed through some of the safeguards described earlier in the chapter, for example, capping how expensive (or cheap) a product could become over time.

Further, it should be noted that committing a percentage of equity could be advantageous for consumers as a useful way for individuals to hedge against fluctuations in house prices. This can be understood by considering two possible scenarios:

- Scenario 1: rising house prices would make the product more expensive overall, as the agreed percentage would be worth a higher amount than if they had remained level, but this would be in the context of the individual gaining overall from an appreciating asset. A more expensive product would be offset by the house itself being more valuable.
- Scenario 2: house prices fall, so consumers suffer from their asset declining in value. However, some of this decline in value is offset by a cheaper deal with the provider, because the percentage of ring-fenced equity is now worth less than in scenario 1. If house prices fall, the product becomes cheaper.

One demand-side barrier the product would not suffer from is too much complexity because it avoids the use of

compound interest, in favour of paying the provider through the ring-fence mechanism. People could be offered a deal in simple terms – for example,

If your house rises in value by A relative to care costs then the product would cost B. If your house falls in value by X relative to care costs then the product would cost Y.

This simplifies the product significantly and prevents the problem of interest gathering exponentially over a long period of time. Such features ought to help overcome some of the demand-side barriers that equity release products can suffer from.

Supply-side barriers

Any products engineered along these lines would need to overcome some significant supply-side barriers as well as the demand-side barriers. The most important of these would be the challenge of pricing insurance up to the level of the care cap because of uncertainty surrounding several of the variables involved in the calculation. These include the rate at which the cap would rise over time and the precise way in which the Government 'meter' would count care costs up to the cap. Unless providers have a straightforward way of predicting these things, it will always be difficult for a vibrant insurance market to emerge that includes products of this kind.

The Government has already taken some steps to address these sources of uncertainty. For example, the Care and Support Bill sets out the Government's intention to up-rate the care cap each year in line with the cost of inflation. This provides one benchmark for industry to work with, at least within the life of a parliament. It is not clear whether a degree of cross-party consensus can be reached that goes beyond this relatively short timeframe, which would allow individuals and consumers to make investments in the future with some certainty.

Another step taken by the Government to provide a greater degree of certainty on metered care costs is the move towards a national approach to determining what care costs are eligible for

state support and which are not. The Care Bill sets out how the current eligibility framework will be replaced by a single set of criteria to describe a minimum threshold for eligible needs of those requiring care, and a single set of criteria for carers.[74]

Further analysis

Our initial simulations of the proposed ring-fenced product using different assumptions about care cost and house price inflation (HPI) show that only relatively modest amounts of equity would need to be ring-fenced. For example, assuming care cap inflation of 3 per cent per annum and HPI of 4 per cent per annum, the amount of equity that would need to be ring-fenced on an average home worth £200,000 is 3 per cent (less with a percentage cap discount). Note that it is the difference between two inflation rates which is important and not the rates themselves.

Here is an example based on the over-simplified assumption that 30 per cent of people would need care for two years at the end of life and face care costs of £12,000 per annum before inflation. If the ring-fenced product is purchased at age 65 when the cap is £72,000 and care is triggered in 20 years time, the house would then be worth £432,000 and the care cap £131,000 at that point. The maximum exposure to the consumer (or to his estate) would therefore be £13,000 in this example (3 per cent of £432,000) to be set against a potential loss of up to the £131,000 cap if care is needed (all numbers rounded). Obviously there would be a responsibility on providers to make accurate forecasts of inflation rates and on government to ensure they do not diverge unduly, and this may or may not be viable in practice. In addition to the consumer safeguards discussed earlier in this chapter, limits could be put on the permissible drift in care cost and HPI compared with the date of the policy agreement to ensure the out-turn is not too detrimental to either party. More explanation is given in appendix 2.

We recommend that the Government continue to work with providers to explore whether these steps will be enough to

allow industry to offer consumers to insure themselves against care costs up to the level of the cap. A fundamental aspiration of the Dilnot report and subsequent reforms was that a care cap would provide a fee for people to insure against. Should this not yet be the case – as some providers have suggested – the answer should not be to give up on the idea but to explore ways in which remaining barriers can be overcome. Succeeding in this kind of work is technical in nature. but in fact holds the key to a system under which individuals might be able to secure peace of mind about care costs in the future

Recommendation 4

Government should continue to work with providers to address supply-side barriers to new products, which would allow industry to offer insurance against care costs up to the level of the cap.

Chapter summary

Ministers have challenged industry to come forward with new products. The SHIP standards already provide a set of guarantees that products should provide, beyond the regulatory rules set by the Financial Conduct Authority. Following engagement with various stakeholders in this debate, we have established further features of products, which we believe would contribute towards helping people plan for the costs of social care. These features are that the product would enable forward planning, covering domiciliary care, offering a simple deal and providing value for money.

We set out the parameters of a ring-fenced product above for illustration and further exploration by providers. The product would be like a private sector version of the Government's deferred payment scheme. Under the kind of product that we envisage individuals would ring-fence an agreed amount, or percentage, of housing equity in a deal with a provider, in exchange for that provider covering social care costs up to the care cap. This ring-fenced equity would then be

recouped either at the point the individual enters residential care, or on death. Providers may want to explore the viability of this product further, while government should ensure that policy does all it can to minimise supply-side barriers in the marketplace.

Conclusion

After the most significant reforms to social care funding in living memory, there is a temptation for policy makers to believe the mission accomplished. When the provisions in the Care and Support Bill become law, for the first time the Government will have succeeded in establishing a cap on the lifetime costs of care in Britain. Many hope that this will create the conditions for a new market in long-term care products to flourish. This report has sought to show that such a view would be too simplistic. The care cap is a necessary condition for such a market to emerge but almost certainly not a sufficient one. Not only are there supply-side problems to address, such as whether people's liability for up to £72,000 is an insurable risk, but there are considerable demand-side barriers to overcome.

Chapter 1 discusses the first barrier to creating the conditions for a new market in long-term care products to flourish: people know very little about the social care system, tend to underestimate both the risk and the costs of care, and are likely to have made very little preparation for them as result. For this reason, the Government should go further than implementing a traditional information campaign. To overcome people's lack of awareness, innate optimism and characteristic inertia, the Government should require all individuals to go through an online financial health check as a condition of their first withdrawal of the state pension. This health check would be a light-touch, cost-effective 'nudge' to encourage forward planning for the costs of social care. Should there be appetite for a more comprehensive and personalised assessment, the Government should consult on how best to cover its costs.

Prompting people to stop to consider the likely costs of social care is a first step towards achieving a culture of more responsible forward planning; the next hurdle to overcome is to

ensure that people are able to assess their options in a straightforward way. Chapter 2 demonstrates that the complexity of the proposed means test, based on the Dilnot model, militates against this. The different thresholds and 'cliff edges' in the system make decision-making much more complex than it needs to be and risks creating inertia rather than overcoming it. A simpler means test is needed: we propose a formula that does not give special treatment to either income or assets and eliminates the complexity in the Government's proposed model.

While forward planning ought to be a virtue, there is a risk that savvy individuals will decide that they are happy to let the Government pay for their care and deliberately run down their assets. This is the risk that the Government already acknowledges under the existing system, which includes a means test. This is likely to continue when the new arrangements come into force. Moral hazard is an almost inevitable consequence of means testing, but the Government should explore ways in which it might encourage and reward those willing to cover the costs of their own care, up to the level of the cap.

Chapter 3 presents two options for further exploration, both of which centre on rewarding people who are willing to pre-commit portions of their wealth to funding social care costs in later life either in the form of savings or as insurance. In return, people would receive financial benefits if they go into care or, as with insurance, peace of mind that their care costs will be covered.

The aspiration to encourage more self-funding raises the question of where people will find the money. Chapter 4 demonstrates that most people are unlikely to do so from pensions, given the decline in value of the state pension and the relatively low savings rates in defined contribution schemes. Many will need to turn to housing wealth, which is a decisive factor in determining how many years of care people are likely to be able to afford. Some of this group will choose to release equity through downsizing, though a majority say they would prefer not to move home. Equity release is likely to enable those wishing to remain in their houses to pay for their care. Local authority deferred payment schemes offer one means of doing

this, but they are restricted to funding residential care and not designed to facilitate forward planning, early intervention and the funding of domiciliary care. This presents an opportunity for the private sector to step in.

Traditionally, equity release products are designed to unlock housing wealth at times when people require extra money, but the creation of a social care cap presents the opportunity for new types of products to be introduced that are more geared to forward planning for social care costs. Such products should conform to the SHIP standards, established by the Equity Release Council, and fulfil a number of other criteria, including enabling forward planning, covering domiciliary care, offering a simple deal and providing value for money. Chapter 5 presents the parameters of one possible product that would fulfil these criteria. It would be a complementary alternative to the Government's deferred payment scheme, in which providers agree to cover care costs up to the level of the cap, in exchange for an agreed proportion of people's housing equity.

Taken together, these recommendations add up to what we believe to be a more complete agenda for social care funding, involving contributions from the Government, the private sector and individuals themselves. We believe they are based on a more accurate understanding of human behaviour, which recognises the behavioural quirks that can often confound policy makers and the importance of encouraging and rewarding personal responsibility. In this way our ideas are designed to build on a set of reforms that have been long awaited, but which hold out the potential for a fairer, more effective system in the future.

Appendix 1 Formula for the simplified means test

The number of years a person could notionally afford to pay for their care is given by:

years afforded = savings/(£25,000 income)

In which £25,000 is the assumed annual care tariff. Under the simplified means test the amount of support a person receives is given by:

(1 × 0.2 × years afforded) × £25,000

The factor 0.2 is called the taper, whose value is between 0 and 1. The lower the taper the more state support is provided.

So the amount a person must pay is £25,000 × 0.2 × years afforded.

It follows that anyone with income above £25,000 per annum is a 'self-funder'.

Appendix 2 Insurance-for-equity product

The example of a possible ring-fenced product given in chapter 5 is actuarially based but involves several important simplifying assumptions. These are that a fixed percentage of the population will spend a fixed amount of time in residential care at the end of their lives and that calculations of the required premium are underpinned by a joint male and female life table for England and Wales. A more sophisticated version of the model would include a range of actual probabilities for the time spent in care and include provision for care costs to change over time. The following example is therefore only by way of illustration.

The example quoted in chapter 5 assumes 30 per cent of people aged 65 will need care for two years at the end of their lives. Their house is initially valued at £200,000 at the time of the policy, the care cost cap is £72,000 and annual care costs are assumed to be £12,000. House price inflation (HPI) is assumed to be 4 per cent and care cost inflation as measured by the retail price inflation (RPI) is 3 per cent; care cover at the point of taking out a policy would be about 3 per cent of housing equity in this case. If the HPI and RPI are as predicted then the value of the home when it is sold will be £432,000 and the cap £131,000. The cost of the premium would then be 0.3 times the present house value in this case (0.3 × £432,000 = £13,000)

The percentage of equity released depends on the future expected difference in HPI and RPI. Table 7 gives examples and includes cases where care cost inflation is greater than HPI and vice versa. As is seen the percentage of equity required decreases the higher HPI is expected to be above care cost inflation.

These examples are based on the assumption that HPI and RPI are as predicted at the time when care is actually triggered, in this example in 20 years time. The amount by which the expected and actual premium diverges will determine how much

Table 7 Examples of the equity on expected future annual differences in HPI and RPI

Expected future annual difference in HPI and RPI (%)	Equity (%)
–1	4.3
–0.5	3.9
0	3.5
0.5	3.2
1	2.9
1.5	2.6
2	2.4
2.5	2.2
3	2.0

is due when the premium is actually paid. For example, if the actual rate of HPI rises quicker than expected and diverges by 2 per cent per annum the premium would be £19,000 but the home would be worth more; if they diverge 2 per cent per annum in the other direction the premium would be worth £9,000 but the home would be worth less. Exceptional losses in either direction could be limited by including a cap on the permissible divergence in rates between the start and end of the policy.

Appendix 3 Glossary of terms

Care cap A care cap is a limit on the amount that any individual is expected to pay towards their eligible care needs, before the state steps in to pay those costs. It includes the costs of care received either at home or living in a care home and is designed to protect people from catastrophic costs.

Care meter The means by which eligible care costs are monitored and counted towards the care cap.

Disregard A disregard is an amount of money that is ignored for the purposes of determining the level of state support in the means test. It has the effect of reducing out of pocket costs, limits the depletion of assets and potentially increases the level of state support. A disregard can apply to assets (eg a ring-fenced savings product, or the value of a home) or to income (eg exempted income from a kite-marked social care savings product such as a disability linked annuity, or certain welfare benefits).

Tariff A tariff is a reference sum of money based on the cost of providing care to an individual with eligible assessed care needs. It includes a care cost and a living cost component. In instances where assessed living costs are covered exactly by an individual's income the years of care afforded in the proposed means test formula is simplified to be a person's assets divided by the annual assessed cost of care.

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Social care funding has long been the problem that governments refused to confront. An ageing population has placed growing strains on the care system, without the means to pay for it. In this context, the Care and Support Bill, now making its way through Parliament, represents a substantial achievement. The reforms contained in the bill mark the most significant changes to social care in a generation, including the first ever cap on the lifetime cost of care.

Unlocking the Potential seeks to build on those reforms. It examines how likely the Government is to succeed in fostering a new market in long-term care products and explores additional policy measures to facilitate more forward planning. The fundamental argument is that the Care and Support Bill will not be enough on its own to produce a step change in the way people plan for social care. Policy must also draw on behavioural economics to spur people into action.

The report recommends various ways of achieving a more complete agenda for social care funding, based on a more accurate understanding of human behaviour. These include a financial 'health-check' for individuals before they first withdraw from the state pension; a simplified means test, to make it easier for people to determine their eligibility; and 'care accounts' to provide stronger incentives for planning ahead. In so doing, it holds out the potential for a fairer, more effective system in the future.

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