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Behavioral Finance: Why Do We Do the Things We Do

retirement-insight.com/behavioral-finance-why-do-we-do-the-things-we-do

By Michael Wilson, CFP®, CRC®, RICP®, Integrity Financial Planning

Michael Wilson, CFP®, CRC®, RICP®, Integrity Financial Planning

Editor's note: This article is an adaptation of the live webinar delivered by Michael Wilson in 2019. His comments have been edited for clarity and length.

You can read the summary article here as part of the 2nd Qtr 2019 Retirement InSight and Trends Newsletter, worth 1.0 CE when read in its entirety (after passing the online quiz.)

You may also choose to take the full length course "Behavioral Finance: Why Do We Do the Things We Do for 1.0 hour continuing education (CE) credit.

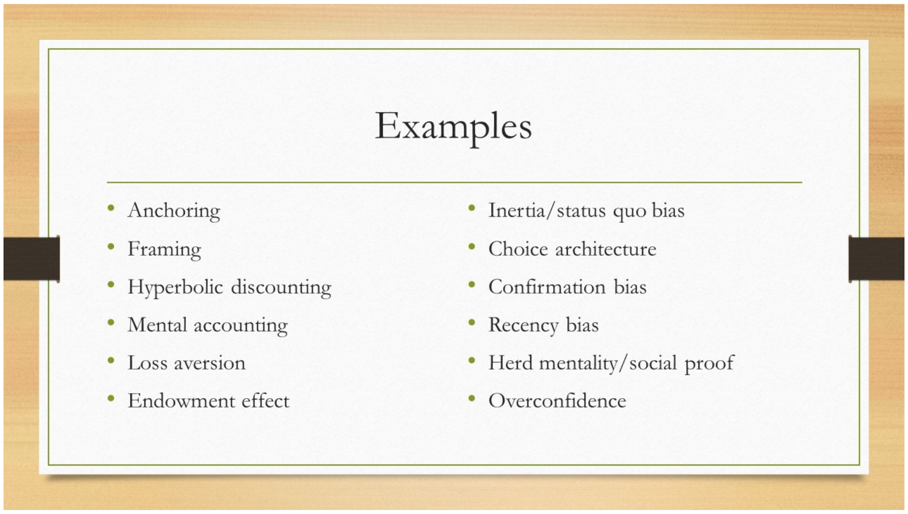
We all know there are certain things we should do, like eat right, exercise, get plenty of sleep, etc. The same is true for retirement saving: we all know we should be saving now for an unknown period of time in retirement.

Multiple studies and surveys have indicated how woefully inadequate average retirement savings are. But head knowledge doesn't always translate into action, into current behavior. What's the disconnect? Why aren't knowledge and education enough to move us to do the "right thing" now?

This article will examine several behavioral mental traps, or biases, that can help (or hinder) our ability to save for retirement, as well as suggest ideas for putting these biases to work in a positive way.

Behavioral finance is a relatively new field that has become more popular in the five years or so that combines behavioral cognitive psychological theory with conventional economics and finance, to explain why we do irrational things with money.

Examples of mental biases include:



Some of these you may have heard or been familiar with already. Unfortunately, merely being aware of them doesn't mean we don't still get tricked by them occasionally or don't fall into some of these mental traps. We'll review key biases.

How Does Designing in Friction Affect Behavior Change?

Imagine watching a favorite Redbox movie at home. Of which snack will you eat more?

Twenty-nine percent of webinar attendees went for the big 12oz bag of chips, 36 percent said "No difference. No one can eat just one chip," and 21 percent wanted to know why veggies weren't an option.

What's going on with this? Friction. In this particular experiment, you have the option to open a bag one time, where it's pretty easy to blaze through that bag of chips. Or, you have three small bags with the overall equivalent amount of chips, where the act of say opening that second bag might cause you to stop and think, "Am I going to open the second bag? Do I need another bag of chips?" By the time you hit that third bag, again there's that pause where you have to say, "Am I going to open the third bag of chips? I've already had two bags of chips. Do I really want a third bag or not?" Just those pauses, that friction, and that extra effort can cause you to pause and possibly change your behavior.

It's the same idea when it comes to retailers saving your credit card data. Think about Amazon, for instance. They have that one-click purchase option. Are they doing that because it's great customer service? You could probably spin it that way, but Amazon also knows if they can make it as easy as possible for you to buy, especially if it's kind of an impulse purchase, you're more likely to go through and make a purchase. If they can make the friction as little as possible or as small as possible, you're more likely to engage in a particular behavior.

If you want to encourage behavior, you want low friction. That's why things like auto-enrollment, auto-escalation, and auto re-enrollment, or maybe just one-click deferral changes if you're in your retirement savings plan, can help people to save more. The easier you can make these changes and the lower the friction, the more likely people are to engage in a particular behavior. On the flip side, if you don't want them doing a specific behavior, then you want to put in lots of friction. Maybe you have distribution forms that have a lot of information on them, or if you're tracking moving money from your firm to another firm, you say, "You know what? You also have to give us the other company's rollover form." Put in things like signature guarantees. If you work for a retirement provider that offers loans from their 401(k)s or 457s, maybe you do things to make the loans harder to obtain – more fees or more paperwork – instead of allowing those things to be completed online.

What is the Endowed Progress Effect?

Which of the following cards is more likely to be used? A blank card requiring eight punches or a ten-punch card with two free punches? Or is there no difference; it's eight punches either way?

It's better to have two free punches on the 10-punch card. This is an example of the "endowed progress effect." It's this idea that because a task has kind of already been started for us, it's easier to follow through than one where we have to start from scratch. Endowed progress is if you provide folks with a sense of artificial advancement towards a particular goal, they're going to exhibit greater persistence toward actually reaching the goal. In this specific example, if I have to start from scratch and I'm looking at the eight-punch card, the task hasn't started. If I get that first punch done, I'm one-eighth of the way there. That doesn't sound so great to me mentally, but if I have the 10-punch card and two of the punches are already done, I'm already 20 percent of the way there. When I get punch number three, I'm 30 percent of the way there, etc. I'm more likely to then actually follow through or to continue to use the 10-punch card.

If an employer offers a five percent contribution or a five percent match, one way to frame this or one way to present this to folks who are saving for retirement is to say, "Hey, good news. You're a third of the way there already. Let's get you the rest of the way," and again they're more likely to say, "I'll kick in one percent" or "five percent" or whatever the case may be.

How Can We Use Anchoring?

When is it better to start Social Security? Later, because you get larger monthly checks? Or it depends? Part of this decision can be related to anchoring, which is this idea of the first number I see is going to influence any other amounts that are going to be displayed to me.

Earlier in my career when I would explain to folks the pros and cons of starting Social Security early versus late, I used to mention the age 62 number first just thinking, that 62 is the earliest you can begin. Maybe their full retirement age was 67, and then 70 would be the latest they can claim. Age 62 then becomes the anchor, and any other numbers that I would throw at them they would relate to 62. Depending on how I framed it, if I said, for instance, “At age 62, you’re going to get $700 a month; at 67, you’re getting $1,000 a month, and at age 70, you’re getting $1,300 a month.” If age 62 was the first number that mentioned, that’s the one to which everybody related.

In the retirement savings world for instance, if you influence your enrollment forms whether they’re on paper online, do you want to start with a high or a low suggested savings percentage?

Anchoring suggests you probably ought to start with something high. If your suggested percentages are eight, six, four, or two, then list them in that order. Don’t display them in order of lowest to highest – because if you start with two, if that’s the first number they see at the top, that’s the one folks most likely are going to click on just simply because it’s first.

On Social Security statements, age 67 is the first number you now see, not age 62. Why is Social Security doing that? They understand the concept of anchoring and other behavioral finance concepts. Age 67 is now the anchor. That’s the one they are subtly trying to convince or to encourage taxpayers to shoot for when it comes to taking their Social Security benefit. Next, they show the age of 70. Well, then you could frame that as saying, “Hey, at 67, you get this amount. At age 70, look, your benefit goes up. You have a gain at that point if you are willing to wait an additional three years to take your money,” but now look at age 62. In this example, if I start at age 62 – again depending on how I frame it – I’m losing about $500 a month compared to age 67.

How I explain it can certainly influence their behavior. I could pitch age 70 as, “Look, you’re getting an extra $500 a month,” and age 62 as, “Oh, you’re losing $500 a month, and this is what the current statement looks like.” How it’s framed and how it’s presented can certainly have an impact on the decision people make about whether to start Social Security early versus late. I’m not trying to say one is better than the other; that’s something for you to think through with the clients you work with and the members of your retirement systems as to how you present this information. The idea is that we have to be aware that the way we present things certainly can have an impact on how it’s going to influence someone’s decision to do things like start Social Security.

The bottom line in all of this is the order in which we present things really does matter.

What is Framing?

Another example of framing is Dr. Shlomo Benartzi. He wrote a book called *Start Saving More Tomorrow*. It was this idea of making pre-commitments, and why pre-commitments work.

He did a study where he asked half of the users if they could start saving $150 a month towards a particular goal. About seven percent of those surveyed enrolled via an app to save $150 a month. For another group, he suggested that they save five bucks a day. Five bucks a day for 30 days a month is essentially the equivalent to the first savings option, but because of the difference in how the dollar amounts were presented, four times as many people signed up for the five-dollar-a-day option. Because five bucks a day was presented as "hey, that's a latte," more people chose that rather than thinking, "Oh, $150. Well, that's more like a car payment."

Framing makes a big, big difference. When you're talking to clients or members who are saving for retirement, think through when you give folks target amounts, are you expressing them maybe as annual amounts, as monthly amounts, or maybe even per-paycheck amounts? Probably the smaller you can make those target amounts, the more likely people are to buy into going with your particular recommendation. Framing again through all of this can certainly have a significant impact in terms of how we behave.

How Can We Help Prevent Fear of Regret?

Who's going to feel worse after running an Olympic marathon? The Gold, Silver, or Bronze runner? Some of you are crazy enough probably to have run marathons. When asked, half of the respondents said the silver medalist probably feels worse, and roughly a third said the bronze medalist. The silver medalist is thinking, "Man, if I'd only been a tenth of a second faster, I could've had the gold medal." The bronze medalist is looking down at the fourth-place person saying, "Man, good thing I was just a few tenths faster; otherwise, I wouldn't be up here on the podium at all." It's relation-perspective. In some cases, this is classified as this fear of regret.

In the financial world, we hear, "Hey, the market is too high. I'm afraid if I get in, it's going to go down," or "The market's too low. It's too scary right now because if I do get in, it's going to go down even further. I'm going to regret deciding to invest and get into the markets." So, what's the solution? Just maybe a nudge or a toe in the water instead of all at once. Maybe make one smaller decision: "Let's start doing dollar cost averaging;" rather than one big decision: "Let's throw all of the money into my Roth IRA all at once." Maybe it makes more sense to say, "You know what? I'm just going to put $100 a month into the Roth throughout the year" rather than say "Throw in all $1,200 at once." The idea is that doing the nudge and that one small decision, I'm less likely to have that sense of regret if the market misbehaves and does something different than what I expected.

Which Country Do You Suppose Has the Highest Organ Donation Rate?

Ninety-nine percent of Austrians are organ donors, and 12 percent of Germans are organ donors. Austria has this incredibly high rate. Well, why is that? In the Austrian system, you have to opt-out if you don't want to be an organ donor. On their driver's license form, in essence, the box that says, "Would you like to be an organ donor?" is pre-checked. Now, you can get out of it; you just have to take some action. You have to check the box. Germany, on the other hand, is very similar to the U.S. There, you have to opt-in. Again, you have to make some effort and say, "Yes, I would like to be an organ donor." Germany and Austria are two countries right next to each other with some cultural differences certainly, but again why the big difference? It's the choice architecture. The Austrian Motor Vehicle System has essentially said, "We're going to assume people want to be organ donors," and that's their default assumption. People can opt-out, but they're going to have to take some action if they want to do so.

This is an example of **status quo bias or inertia**. You want to think through the defaults that you want your participants, your customers, and your clients to take. Think about the default settings on your computer, your browser, or your phone. Those things aren't just there haphazardly. The companies who put those products together have a lot of intentional choice architecture put in place with a lot of thought behind the defaults that are listed there for you. They have particular reasons why they want you to use those things. In your retirement system or employer plans then, think about auto-enrollment. Auto-enrollment is an opt-in default. You can use inertia, this idea that people most likely aren't going to change; they're just going to go with whatever the default option is. If you are do something like auto-enrollment, do you want to set it at say three percent or six percent? There's research out there that folks are perfectly comfortable with six to seven percent their pay. You go above seven percent, and then you start seeing people opting out, but you can go anywhere between three and six percent and most folks will just kind of accept that as "That's just normal. That's just kind of what I expect."

What is Hyperbolic Discounting in Behavioral Finance?

When folks were presented just with the choice of "Do I want a chocolate bar or a piece of fruit today?" the majority went for the chocolate bar. When they were presented with a choice of receiving a chocolate bar or a piece of fruit in a week, more people chose the piece of fruit. The difference is an example of hyperbolic discounting, which means when we're receiving something far off into the future in sometimes as short as a week, we're more likely to be kind of more rational and make better choices if it's further down the road. If it's the chocolate bar or piece of fruit today, it's just too tempting and because this hyperbolic discounting says, "Well, I don't even know what's going to happen down the road. I want to maximize my pleasure today."

When we do make choices regarding the future, we tend to be a little bit more rational or a little bit wiser about it. That's just part of the function of the way our brains work. When we have immediate choices, our "reptilian" or "animal" brain goes for anything that's right in front of us at the time in the heat-of-the-moment. Studies show that when we make more of our decisions in the heat of the moment with this more instinctive or emotional reaction, we tend to generate higher credit card debt, higher default rates, and lower credit scores. Letting that reptilian brain rule isn't always in our best interest; in fact, a lot of times it isn't.

In Dr. Shlomo Benartzi's *Save More Tomorrow* book, he developed a campaign to test a sense of pre-commitment that asked participants to choose to increase their retirement savings by one or two percent in six months to one year. He found that people would then follow through because it didn't cost them anything today – there was no pain associated with today – so they were making more rational choices, thinking "I know in the long run I should be saving for retirement."

If you have for instance an employer or maybe you're the retirement system or the agency, or you have clients who have matching contributions offered by an employer, the big key is to emphasize what's in it for me now. Don't stress, "Man, down the road, your retirement account's going to be worth hundreds of thousands of dollars." Emphasize what it's doing for them now. "It's doubling your money now" or "It's adding an extra 50 percent return to your money today." That's where you want to have the focus.

How Can We Apply Behavioral Finance Concepts in Retirement Plans?

Studies tell us that the old stand-and-deliver approach, "if I dump a lot of information on people, they'll get it and they'll change their behavior," by itself is not working so well. We have particularly in our industry a sort of this curse of knowledge and jargon. We may say things like "asset allocation" and "Monte Carlo analysis" and all of these wonderful terms. This just flies over people's heads. Many times, they don't get it. Any jargon word can cause a 10 to 15-second delay as the listener processes that word. When you say, "asset allocation," and you continue to speak for the next 10 seconds or whatever, they're still stuck on, "Asset allocation? What the heck is that?" If we can avoid some of those words and use words instead that people can relate to, they're more likely to continue to listen to us. As it turns out, language really matters.

Words to avoid include percentages, match, budget, and Monte Carlo. Don't say, "Monte Carlo." Why not? With Monte Carlo, most people think of gambling. What words could you use instead? Instead of aggressive, use volatility. You'll still probably have to explain that one. Instead of showing people percentages, show them dollars. Don't call it a match; call it free money. Don't call it deferrals; call it contributions. Don't call it a defined contribution plan, which is probably the worst name ever invented; instead, call it a retirement savings plan. It's not a budget; it's a spending plan. It's not "we have low fees;" it's "we're cost-efficient." I'm sure there are others you've heard of as well.

When you're explaining things like compound interest – that's a bit of a jargon word – it helps to express ideas graphically. Show them the difference. When most people think of compound interest, they're thinking of things just incrementally increasing along, not the exponential curve that we see with compound interest. Show it to them pictorially. "Your money is doubling over time."

In any particular interaction – presentations, sitting down, or one-on-one – 20 percent of the folks are already disposed to making changes. Things like auto-enrollment and auto-escalation are ways we can take advantage of status quo bias. We can use technology and things like apps and texts to remind us. You may have to decide, "If we go this behavioral finance route, are we manipulating things without our members or our customers realizing it?" That's something for you to decide, but I think when you're trying to do something good for them in the long run, folks will support that.

About Michael Wilson, CFP®, CRC®, RICP®, Integrity Financial Planning

Mike Wilson is the owner and founder of Integrity Financial Planning, which specializes in personal retirement planning. In one form or another, Mike has been in the training and financial services industry for 30 years. He earned his MBA in Finance from Baylor University and is a Certified Financial Planer®, Certified Retirement Counselor® and a Retirement Income Certified Professional®.

Mike and his wife Nancy reside in Salt Lake City, where he enjoys hiking and mountain biking whenever possible.

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Behavioral Finance: Why Do We Do the Things We Do – Michael Wilson

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The Value of Safe Home Care

By Phil Bongiorno, Executive Director at Home Care Association of America

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Editor's note: This article is an adaptation of the live webinar delivered by Phil Bongiorno in 2019. His comments have been edited for clarity and length.

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The number of families utilizing home care services continues to grow in the United States. A higher number of family caregivers who are caring for a loved one with a chronic or debilitating health condition are turning to home care, rather than institutional care, for their long-term care needs. Many cite the desire for a higher quality of life and independence as the reasons for the choice of care at home. Most of this care is paid for using available disposable income.

Faced with a bewildering number of choices, family caregivers more and more are turning to companies that offer them the least expensive price for care without understanding the implications of their choice. Many are hiring workers from entities that do not employ or supervise their workers but merely "place" them in home care settings.

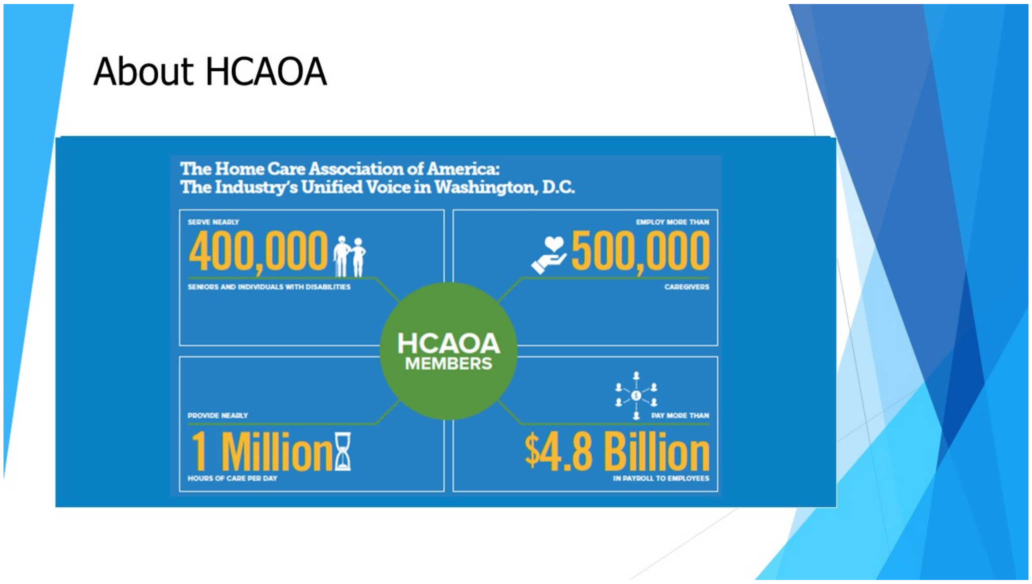
This article will provide ways to help you understand the differences in home care service models, reinforce the value of quality home care with your respective clients and assist in determining quality and value of home care providers.

Who is the Home Care Association of America?

The Home Care Association of America represents homecare providers. We mostly provide what's considered in-home personal care services supporting activities of daily living. Traditionally this has been called private duty care. Our organization started as the National Private Duty Association. We changed our name about six years ago to the Homecare Association of America.

Homecare is different from home health, and there are distinctions from home health depending on how it's paid. Our association serves nearly 400,000 seniors and people with disabilities. We employ about half a million caregivers around the country. We have about

3,000 member providers that are providing close to a million hours of care per day, and we have a footprint of about $4.8 billion in the economy.



We believe that people should be able to age safely in place at home and remain active in their community to the extent possible according to their desires. We champion advocacy measures at both the federal and state levels that promote home care quality and cost-effective, affordable care. We advocate that appropriateness of care and client protection is best provided in an employee-based model.

A couple of years ago, we published the report, "Caring for America's Seniors: The Value of Homecare." We are not home health – there's a distinction – so we decided to develop this industry report to establish the concept of homecare, what we do, and what our industry does.

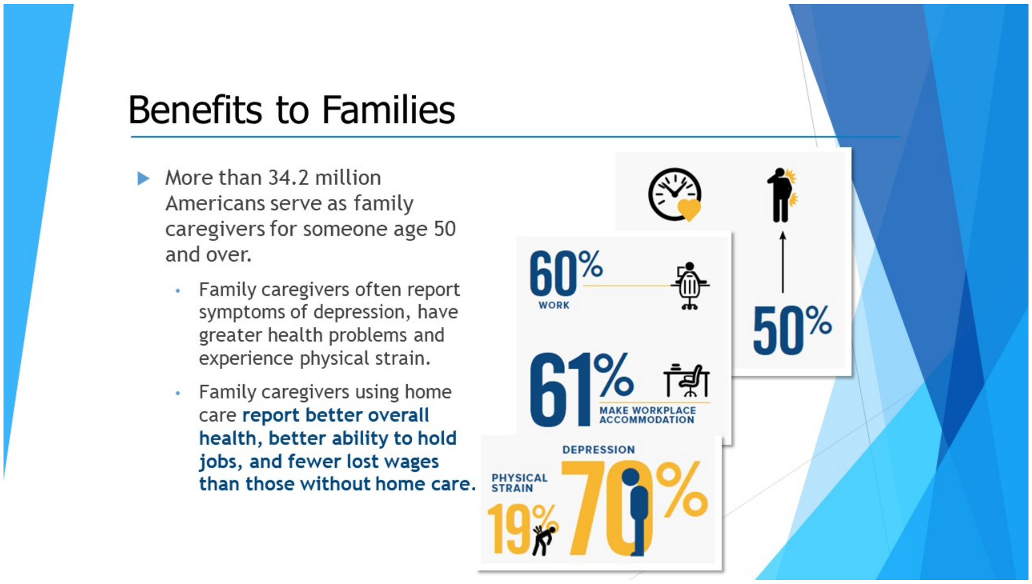
This report is a meta-analysis of existing data; it's not original research. It was a partnership between our organization and a group called the Global Coalition on Aging, which is made up of high-level corporations that have an interest in aging, both for their customers and for their employees, and it clearly defines our industry and demonstrates the benefits of homecare.

For seniors in the home, we're helping prevent falls. Falls are one of the leading causes of injury and death to seniors. We're helping keep seniors healthy and helping them keep their medication regiment on track for reminders. We're providing companionship to them. Many people don't know that senior isolation is one of the leading causes of mortality in this country. We're in the home with the seniors helping them with activities of daily living to make sure they're healthy and living a quality life in the home.

Over 34 million Americans serve as family caregivers for someone over age 50, and that statistic has certainly gone up in the last couple of years.

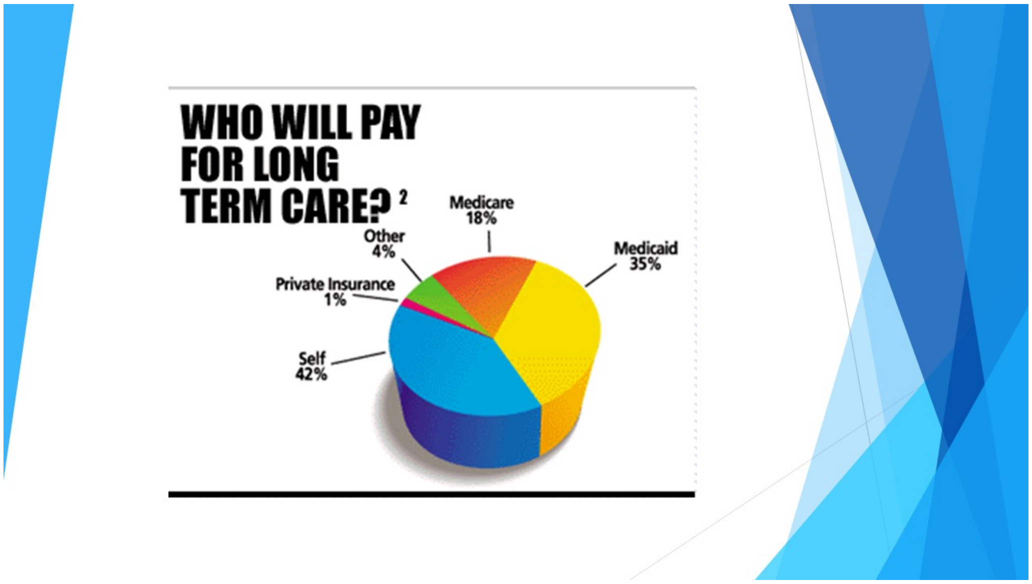
How can we pay for caregiving today?

Right now, most of our care is paid for out of pocket. As you can see, government-financed care is primarily going to nursing homes, to home health services, and only a small percentage to home care services, and that's primarily for veterans and the Medicaid program.



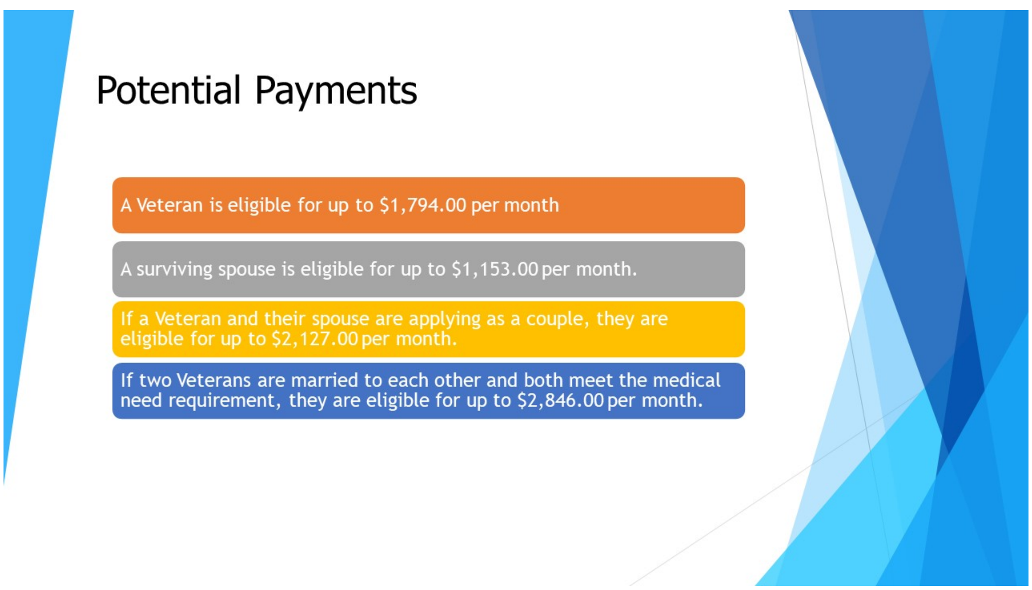
Data shows that by having someone in the home taking care of a senior, we help reduce healthcare costs in the form of readmissions, in the form of fewer doctor visits, and to relieve government health programs from some of the strain they have when it comes to the projected cost to those systems.

What is the plan to pay for healthcare? Right now, a lot of what we do is considered private pay or out of pocket, and in this statistic, you'll see that long-term care services are mostly coming out of individuals. There is some coverage from Medicaid and Medicare, and I'll talk about some of the government programs, but it's something that is very important for all of you to understand how you can help your clients with this question.



Right now, some programs like Medicaid – you have to qualify, of course – will provide programs under what's called the home- and community-based services waiver. Many of the Medicaid programs have this service in place, where it pays for home care services, but you have to qualify in the Medicaid program.

There are veterans' programs as well that will provide veterans services, and what's called the aid and attendance benefit, where you would have to qualify as a veteran and meet other requirements from the Veteran's Administration (VA) to receive these services and have homecare reimbursed under this program.



Some changes are happening with the VA right now. We've had delays in payments from the VA to our members of three to six months, so it's a challenge for some of our members to participate in this program because of the VA's administration of this. We're working with the VA to make some changes on how we can cut some of the red tape so that veterans can receive these services.

Other financing options include reverse mortgages, hybrid life insurance plans, annuities We look at other options as well – for example, the Medicare Advantage program. Many may not know this, but that program is growing. You have the traditional Medicare program where beneficiaries participate. You also have Medicare Advantage (MA), which is the managed care program of Medicare, and right now under the Chronic Care Act that passed a few years ago, the Centers for Medicare and Medicaid Services, or CMS.

The Center for Medicare and Medicaid Services allows for the Medicare Advantage or MA Plans to cover home care services. This is a new development in what was considered health-related services. Home care is still not considered a health service, but CMS is looking at what we're calling social determinants of health, so in addition to home care, they're looking at other services like meal delivery, home modifications, and that sort of thing. We're working with these MA plans to establish appropriate reimbursement, so stay tuned for that. You'll probably see more of that be promoted by the MA plans out there.

Another exciting opportunity is with health savings accounts (HSAs). We are working with Congress on the potential of allowing home care services to be an allowable expense. Unlike the flexible spending accounts, as you probably know, HSAs can be rolled over from year to year, so this is an excellent opportunity for folks that are investing and saving in HSAs to use that to cover home care services potentially.

Home Care Association of America (HCAOA) Public Policy Objectives

Another way to pay for home care services in the future is with tax credits. We've supported a bill called the Credit for Caring Bill, and it's bipartisan. It's interesting – we have everyone from a very conservative Republican from Iowa to Elizabeth Warren from Massachusetts – you can't be further apart on the spectrum than these two individuals – that are supporting this bill to look at tax credits and how they can be used for home care services.

Tax credits for home modification are also in legislation that's is proposed in Congress that will help offset home modification costs for families that are making changes like ramps and other accessibility modifications in the home to help seniors age in place.

CAPABLE is a program developed at the Johns Hopkins School of Nursing for low-income seniors to safely age in place. The approach teams a nurse, an occupational therapist, and a handyman to address both the home environment and uses the strengths of the older adults themselves to improve safety and independence. Recently the grant program at Johns Hopkins Baltimore hospital invested anywhere from $1,000 to $2,000 in home modifications for their Medicaid population, and they found that by combining home modifications with homecare, they saved a lot of money in readmissions and other healthcare costs.

At the state level, we support state licensure for homecare providers. Unfortunately, not every state has licensure for the services we provide. It's interesting – you need a license in every state to catch a trout, but you don't need a license in every state to take care of a senior or bath a senior. It's interesting that we still have many states that have not licensed this service.

We support hospital discharge and referral legislation. This is legislation that points to hospitals to make sure they are referring properly to home care providers that are licensed.

We also support consumer protection disclosure legislation for placement registries. This legislation requires placement agencies to make sure families understand the type of model and relationship that they have with the caregiver, and that they often have responsibilities.

The Affordability of Home Care

One of the other things we're working on is the affordability of care. Fifty-three percent said that affordability of care was a significant factor in why employees left their jobs, an others mentioned the inability to find trustworthy help and the inability for them to meet their work responsibilities as a result.

The National Academies of Sciences published a report, "Families Caring for an Aging America," which examined the state of family caregiving and looked at the impact on caregivers' health, their economic security, and overall wellbeing. It identified ways we can design interventions to support family caregivers. This report concluded that there are recommendations for developing a national strategy to help family caregivers.

The RAISE Act is a bill that directs the Department of Health and Human Services – HHS – to develop a national family caregiving strategy. They've already begun the process of convening a family caregiving advisory council to advise on this issue, so that's happening right now. There's a recognition by industry, government, and academia to look at how we can support family caregivers.

When you need to pay for home care, it creates an environment with no formal standards, no oversight, and in some cases, no criterion for business ethics, and that's a concern we have, particularly in states where there's no licensure.

As a result, there's a variety of home care providers that deliver their services in various models when they provide those services, and the consumer has been and continues to be vulnerable, and it impacts our industry representing homecare providers.

What are some of the homecare regulation standards? This takes the form of no licensing requirements governing home care providers in some states, no regulations governing essential matters such as practices for the hiring and training of caregivers, and no regulations regarding care supervision or quality control practices of homecare services. This is all in states where there is no currently existing licensure.

Accountable homecare does things a little differently. HCOA sets and defines industry standards in the absence of a formal regulatory environment, so even in states where we do not have licensure, we have members who are operating under our standards.

There are two different models of homecare services delivery. The first is where the home care provider has an employer/employee model, and the second is what we call domestic referral agencies or independent contracting, which is often called the “domestic registry model.”

Under our first model, the employer model, you have a provider that is generally bonded and insured, offers comprehensive orientation with in-depth caregiver training, takes care of any legal issues that occur should the caregiver or client be injured in the job, and provides ongoing supervision. This is a significant distinction, and I’ll get into some of the Department of Labor requirements when it comes to determining who is an employee versus an independent contractor because there was recent guidance specific to home care.

The employer-model provider has a staff pool to call upon to quickly find a replacement for backup care. They always do an employment reference check, a background check for abuse and neglect, criminal background checks, and in some states, we’re supporting doing fingerprinting as well. They have pre-employment testing, like drug testing, in most states, and the employer also does skills assessment testing.

In addition to that, there’s requiring proof of certain certifications that would include things like whether the caregiver is TB-tested, whether they’re certified in CPR or first aid, any license – in our case, we have what’s called a CNA or Certified Nursing Assistant, which many of our caregivers carry as a credential.

Our members also have proof of whether the caregivers have a sound driver’s license. Driving services are often required, and many homecare companies allow their caregivers to drive the client to doctor’s appointments and other social activities.

Many of our members are embracing technology. They are investing in and working with companies for fall detection, medication reminders. Siri and Alexa have a lot of that kind of smart technology happening in the home already, so some of our members are taking advantage of that to assist in their caregiving needs. EVV – electronic visit verification – is also a technology that helps our companies make sure that the caregiver is reporting in when they said they were going to report, and that they’re where they should be when it comes to the client.

Wearables are a technology that are often embedded into clothing, whether it’s anything that goes around the neck like neckwear that allows for individuals to make sure we know where the client is, especially for someone who might be experiencing dementia who might wander. If they go out of a certain room or catchment area, there would be an alarm that makes sure individuals know where they are.

The other home care business model is a “Registered and Independent Contracting Model.” These are generally agencies or organizations that help families locate a caregiver and place one in a client’s home on an independent-contractor basis. Registries do not serve as an employer, nor can they take responsibility for supervision. If they did that, they would lose their designation as an independent contracting placement agency.

Because caregivers are independent contractors, they’re lower in cost, as there’s little or no overhead in the way of training, benefits, workers’ comp, and that sort of thing. The client is liable for payroll taxes and possible work-related injuries of the caregiver as part of this model, so basically, the family is directly responsible as the employer of the caregiver in this case, and often they’re not made aware of that.

Many of you might be aware of the distinctions between employees and independent contractors. The Department of Labor published a field assistance bulletin in late 2018 that specifically addresses Registries in homecare. The DOL’s guidance said that is a Registry is one that does not plan and provide care for the client, but might seek information concerning the type of care the client needs for matching purposes and looks at how the work is controlled. The caregiver may not receive any instruction from the Registry about how to care for clients. They can’t instruct caregivers how to provide caregiving services, monitor or supervise caregivers in clients’ homes, or even do a simple performance evaluation.

If they do any of these services, which we see as a quality standard in home care, they will trigger themselves as an employer, and they do not want to have that designation. They want to maintain their placement agency or independent contracting status. The Department of Labor has recognized that the absence of such control indicates that the Registry is not an employer of the caregiver. To maintain that status, they’re not providing a quality service to their families, which is why we see a distinction in this care as a standard for our industry.

You’ll see that with the Registry, the cost is generally 10-20 percent lower. However, you should be aware that there are hidden costs that are not reflected in this percentage that clients don’t often consider. It’s the fact that they have responsibility for tax liability, they usually have to look at they’ll need to pay workers’ compensation insurance costs to go along with that. Homeowner’s insurance will generally not cover a worker’s injury in the home, and they will likely need to get a rider. Looking at it in total, it’s not much less expensive when you include these other costs.

What Should Your Clients Be Asking Prospective Homecare Providers?

We recommend that families question prospective home care providers with the following questions:

- **How do you recruit your caregivers?**
- **Should a scheduling conflict occur, are there trained backup caregivers that are available?** Frequently, when you have a Registry model, the family is placed with just one caregiver, and that's the only one. If that individual is sick and cannot come to the home, what happens then? If that Registry is then directing another caregiver to the home, then they may not be a Registry. They potentially trigger an employment relationship.
- **Are the caregivers bonded and insured?** Many times, we don't necessarily have that reliability with certain placement agencies.
- **Are the caregivers employees of the provider?** Again, it goes to whether there's oversight.
- **Does the provider handle the payroll and required taxes of the caregiver?**
- **Is there a criminal background check and a check for references for each of the direct care staff?**
- **Does the provider follow and/or execute a plan of care?** That's another distinction of our members. As part of our intake with clients, we're making sure that we're part of a plan of care from a healthcare provider or help to develop a plan of care when it comes to what the specific needs are of the client.
- **If they're experiencing a specific medical condition, what are some of the homecare needs that they will specifically have as part of their service?**
- **Does the provider perform periodic visits for each of their clients?** Again, as an employer, that's a standard. We would certainly do oversight and supervision. As a placement agency, if they begin doing that, they would have the potential of losing their distinction as an independent contracting agency versus an employer, so you're not likely to see that happening with those agencies.
- Does the provider conduct caregiver training and supervision? Supervision of care is a clear distinction between what employers do and what independent contracting agencies do.

What Are Key Takeaways for Advisors?

Look at and take care to advise your clients on the distinctions and the quality and convenience reflected in the different home care service delivery models that we've covered here. Incorporate the checklist above to screen prospective homecare providers as a resource for your clients and their families.

Become more knowledgeable on the policy developments. I mentioned the tax credit bills and the opportunities we have in both the health savings account and the Medicare advantage programs. Be aware of what's happening that could help you advise your clients on what their financial planning would look like if they were to take advantage of some of these programs if they become law.

We welcome you to network with the home care providers in your community as a resource to you and your clients, and also take advantage of the resources that we have from HCOA in promoting safe, quality home care services.

Visit our "Safe Home Care Initiative" website. Some of the things that I've addressed here are encapsulated on this website so that it can be a resource not only to families that are considering home care, but also professionals like you who are servicing seniors and their families.

We also have an individual professional associate membership category that financial planners can utilize. If you have an interest in home care and want to keep tabs on what's happening in home care, we welcome you to be part of that.

About Phil Bongiorno, Executive Director at Home Care Association of America

The Value of Safe Home Care – Phil Bongiorno

With more than 25 years of extensive health care and public health policy experience, Phil has represented numerous associations focused on health care and disability issues over the years.

He began his role in January 2014 as Executive Director for the Home Care Association of America (HCAOA), a trade association representing nearly 3,000 home care providers across the United States. Phil is responsible for the Association's overall operations, including strategic planning, financial management, membership development, education, advocacy and public affairs.

In his spare time, Phil is a long distance runner and has completed the Marine Corps Marathon 17 times.

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Which Annuities Offer the Best Inflation Protection?

By Joe Tomlinson, FSA, MAAA

Joe Tomlinson, FSA, MAAA

Joe Tomlinson is an actuary and financial planner, and his work mostly focuses on research related to retirement planning. He previously ran Tomlinson Financial Planning, LLC in Greenville, Maine, and now resides in West Yorkshire, England.

Recent articles in *Advisor Perspectives* by David Blanchett and by Zvi Bodie and Dirk Cotton have dealt with single-premium immediate annuities (SPIAs) used to generate lifetime income in retirement. The focus of those articles was the pricing and the risks of going without inflation protection. In addition to SPIAs, insurers also offer variable annuities (VAs) and fixed-indexed annuities (FIAs) with optional riders known as guaranteed lifetime withdrawal benefits (GLWBs). I'll expand on the recent articles by comparing the income-generating properties of SPIAs versus VAs and FIAs, and place particular emphasis on how inflation risk impacts inflation-adjusted income.

Example

This analysis is based on a 65-year-old female making a $100,000 purchase of an annuity product. She has the following purchase options:

- An inflation-indexed SPIA (also called a "real annuity") with lifetime payments that adjust annually based on actual inflation (CPI-U) – Principal Financial;
- A "COLA" SPIA with lifetime payments that increase by fixed percentage each year – Penn Mutual;
- A VA/GLWB providing lifetime withdrawals that may ratchet up based on underlying investment performance – Vanguard/Transamerica; or
- A FIA/GLWB – providing lifetime withdrawals that increase each year based on the credited returns in the contract – Allianz.

In projecting retirement income, I assume this individual lives to age 90, which is the expected average for a female annuitant based on the latest Society of Actuaries annuity mortality table.

Inflation and investment modeling

The modeling for this analysis involves Monte Carlo projections of variable future inflation and investment performance. The inflation-indexed SPIA has the unique property that real, inflation- adjusted income will remain level regardless of inflation. Real income generated by the COLA SPIA will vary with inflation, and both inflation and investment performance will impact real withdrawals for the VA and FIA.

For investment modeling, stocks are assumed to earn an arithmetic average nominal return of 7% and bonds 3%, with standard deviations of 20% and 7% respectively.

For inflation modeling, there are strong indications pointing to a 2% future average. The current Treasury/TIPS spread is just under 2% and we also know that the Fed is targeting 2% inflation. However, my purely subjective view is that there is a somewhat greater risk of higher inflation, and I've modeled future average inflation based on the following probability distribution:

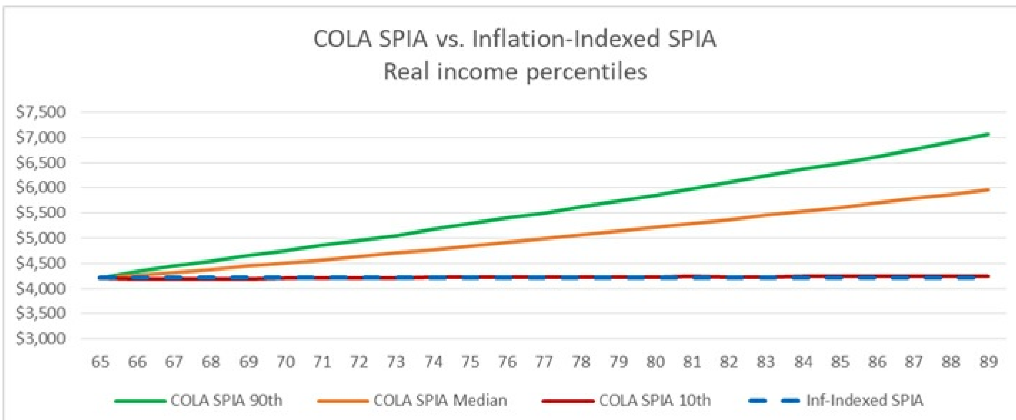
Average inflation	Probability
1%	10%
2%	60%
3%	20%
4%	10%
Overall average	2.30%

The modeling involves generating 10,000 25-year inflation scenarios. Each of the 10,000 scenarios involves random selection of average future inflation based on the above probability distribution. Then, based on inflation volatility since the early 1980s, I generate random year-by-year inflation assuming a 1.3% standard deviation.

Inflation-adjusted indexed SPIA versus COLA SPIA

The first analysis compares a COLA SPIA to an inflation-indexed SPIA, similar to the analysis in the Blanchett article. Principal Financial is the only insurer currently offering an inflation-indexed SPIA, and, as of early June 2019, $100,000 would purchase an annual lifetime income of an initial $4,211 increasing with inflation each year.

For the COLA SPIA, I determined what fixed annual percentage increase in payments this individual could obtain for $100,000 with the same initial $4,211 payment as for the inflation-indexed SPIA. The pricing service CANNEX provides pricing for 15 companies offering COLA SPIAs, and, for this 65- year-old female, the best rates are from Penn Mutual. By combining COLA SPIAs with 3% and 4% step-ups, we can construct a SPIA that will pay an initial $4,211 with payments increasing by 3.6% each year. These are nominal payments, so the real inflation-adjusted payments will vary depending on Monte Carlo generated inflation. The chart below provides a comparison of the inflation-indexed SPIA versus the COLA SPIA.



The projection for the inflation-indexed SPIA is depicted by a dashed blue line and it remains level over the full retirement at $4,211 in real dollars. For the COLA SPIA, nominal income will increase at a fixed 3.6% each year, but real income will vary depending on inflation. I show the 90th percentile (green), median (orange), and 10th percentile (red).

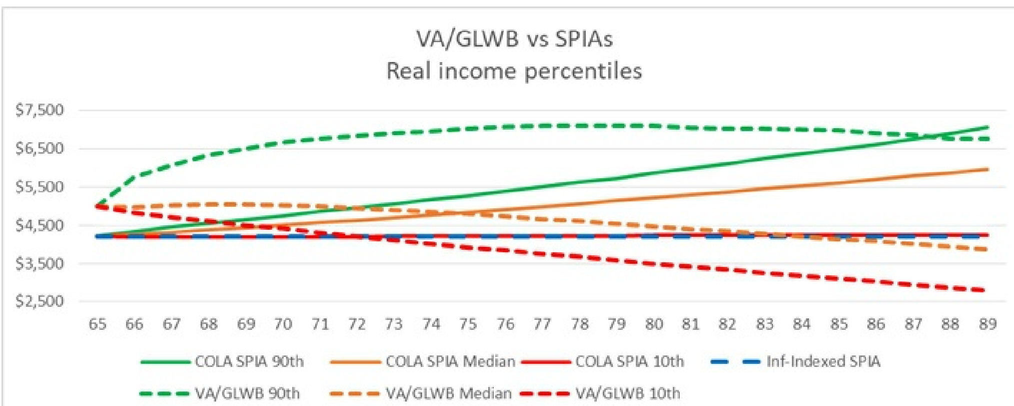
It turns out by pure coincidence that the 10th percentile for the COLA SPIA almost exactly matches the inflation-adjusted indexed SPIA. So there’s a 90% chance that purchasing the COLA SPIA will generate more real income than the inflation-indexed SPIA and a 10% chance it will do worse. This result is consistent with Blanchett’s findings. The upward-sloping median result for the COLA SPIA indicates that it beats inflation on average; this would be expected given its 3.6% annual increases in payments versus inflation averaging 2.3% overall. The 90th percentile beats inflation by a bigger margin.

These results look very favorable for the COLA SPIA, but it’s worth cautioning that they are a direct reflection of my particular inflation model, which was built with considerable subjectivity. Higher future average inflation would reduce the advantage of the COLA SPIA and higher inflation volatility would increase the spread between 10th and 90th percentile results. The inflation-indexed SPIA has the unique property of providing a pure hedge against very high inflation, which is a material risk that every retiree must acknowledge and consider.

SPIAs versus VA/GLWB

Next I'll use the previous SPIA chart as a base case and provide a comparison with the lifetime withdrawals generated by investing $100,000 in a variable annuity with a GLWB. The particular VA/GLWB I have chosen is a Vanguard product that has Transamerica as the insurer. In this example, the 65-year-old can withdraw 5% or $5,000 in the first year, and nominal withdrawals may ratchet up (i.e., increase without future decreases) depending on underlying investment performance. For investments, I assume the Vanguard balanced fund with 65% stocks. More details about the Vanguard product can be accessed via this link.

The ratcheting-up feature of GLWBs is prominent in how these products are promoted – "Your withdrawals can increase, but never decrease." But, in real terms, allowable withdrawals will vary and may indeed decrease. The chart below superimposes projections for the VA/GLWB over the previous projections for the SPIAs. For the VA/GLWB I use dashed lines and the same red, orange, and green colors for 10th, median, and 90th percentiles.



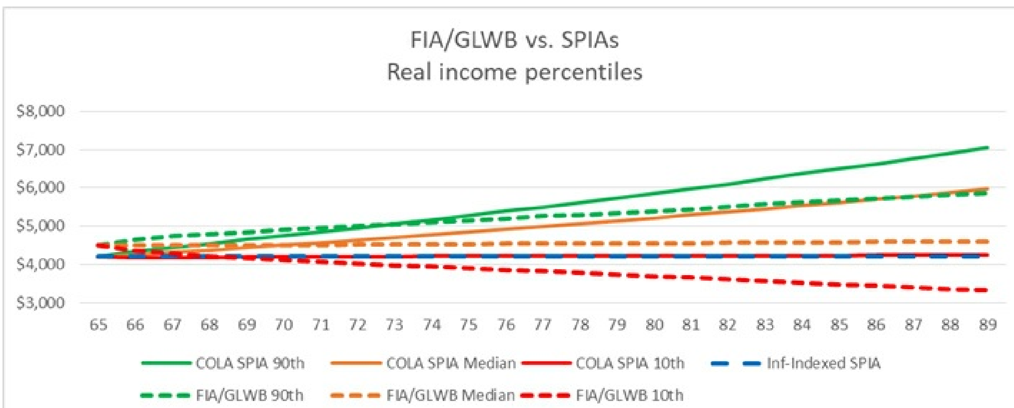
Withdrawals from the VA/GLWB start out at a higher level ($5,000) than the SPIA payouts ($4,211). They also follow more varied paths, depending on the variability of underlying investment performance and inflation. This chart brings home the important point that results in real dollars, reflecting actual spending power, can indeed decrease, even substantially – which is very different from the marketing message used to promote certain products.

Compared to the SPIAs, the VA/GLWB offers a wider range of potential outcomes, both upside and downside as might be expected when investment performance is brought into the picture. It's hard to determine which product offers the better median performance because the paths cross, but I'll address this later in the article with summary measures for all the products.

SPIAs versus FIA/-GLWB

Now we'll compare the SPIAs to an overlay of a fixed-indexed annuity (FIA) with a GLWB, in this case the Allianz Core Income 7 described in more detail here. FIAs are similar to VAs, but the range of potential outcomes is constrained by caps and floors on performance of an investment index or by crediting partial participation in index performance. For the FIA in this example, the index will be a performance of the S&P 500 without dividends (assumed 2% for modeling) with returns (referred to as "interest credits") constrained to a band between a 0% minimum and a 4.5% cap. Allowable FIA/GLWB withdrawals start at 4.5% or $4,500 for this example and their nominal value increases each year by the interest credit. Because of the 0% minimum, allowable withdrawals can never decrease in nominal terms, although there can be real decreases.

The chart below replaces the VA/GLWB projections from the previous chart with FIA/GLWB projections and again provides a comparison to the SPIA base case projections.



The results we see are less positive than in the previous chart for the VA/GLWB. Instead of a tradeoff of performance versus volatility, we now see projected performance (dashed lines) that is inferior to the COLA SPIA (solid lines) for all the percentiles shown. The median case does appear to match inflation (flat line), but from a lower base $4,500 than for the VA/GLWB ($5,000). Overall the COLA SPIA appears to be a superior to the FIA/GLWB as an income generator.

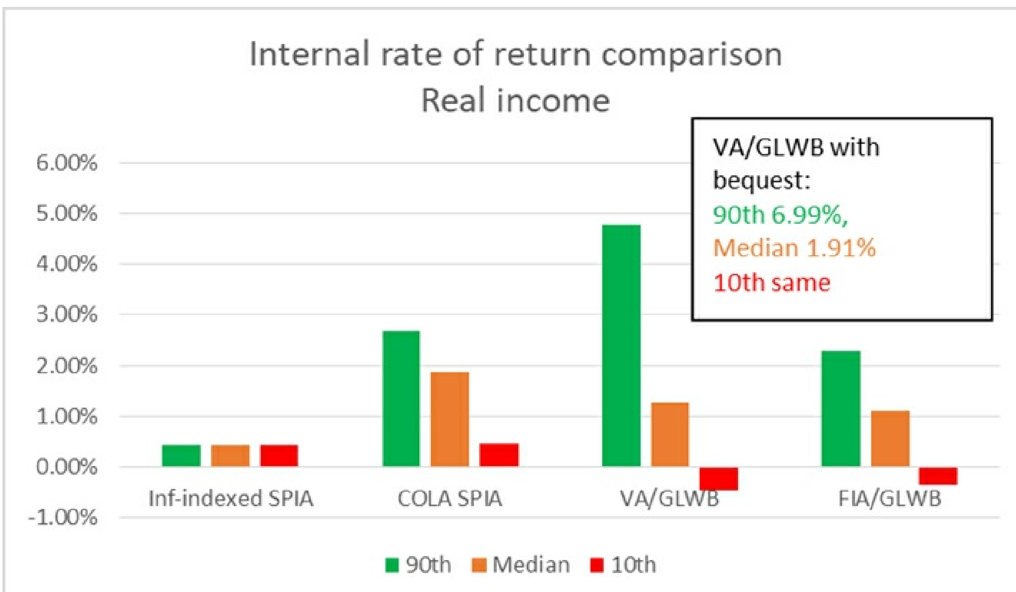
In fairness, I should point out that this result reflects one particular FIA and the way this particular product is structured. There are many different FIA products and different ways of structuring them – choices of index, return crediting method, timing of commencing withdrawals, and others. So it's hard to make blanket judgments. I view this particular analysis more as an example of how to evaluate FIA products rather than providing a verdict on the product line.

One very important negative about both FIAs and VAs is that insurers typically have flexibility to change terms, such as the fees and caps, after purchase. For example, the Vanguard VA/GLWB currently charges 1.20% per year for the GLWB, but has the flexibility to raise this to a maximum of 2%. The cap on the Allianz FIA is currently 4.5% but can be lowered to a minimum of 0.25% at the discretion of the insurer. Insurers have no such flexibility with SPIAs, so the payment structure is more certain.

Although there is only one issuer of inflation-indexed SPIAs, there is more competition among issuers of COLA SPIAs and especially among issuers of "vanilla" level-pay SPIAs. Given the simple structure of those products, issuers can compete only on price and the COLA rate. This creates a relatively efficient, consumer-friendly market. By contrast, issuers of VA/GLWBs and FIA/GLWBs can compete on any of the terms underlying the complex structure of those products. That creates a market where it is more difficult for consumers to know that they are paying a fair, competitive price.

Summarizing the results

The following chart compares the products by calculating internal rates of return, based on an upfront investment of $100,000 and 25 years of payments.



On this basis, the COLA SPIA and the VA/GLWB appear to be the most attractive of the four products. A footnote on the VA/GLWB is that it is the only product I project to leave a bequest at age 90. And the text box shows the projected IRRs with bequests projected for the median and 90th percentiles. With the bequest, the IRR median for the VA/GLWB is 1.91%, very close to the 1.87% for the COLA SPIA.

Final comments

It's unfortunate that projections for annuity products that clients see are typically done in nominal terms. Clients should be made aware of what can happen to real, inflation-adjusted spending power. Projections of steady, non-decreasing nominal income can mislead, when in fact real income will be variable and can potentially decrease.

It's also unfortunate that only one company offers an inflation-indexed SPIA and that the pricing is not as aggressive as for COLA SPIAs, where there is competition. A more attractively priced inflation- indexed SPIA would provide a better way to avoid what Bodie and Cotton properly refer to as betting on inflation. This is the sole source of variability in the COLA SPIA projections and contributes to the variability shown for the VA and FIA.

About Joe Tomlinson, FSA, MAAA

Joe Tomlinson is an actuary and financial planner, and his work mostly focuses on research related to retirement planning. He previously ran Tomlinson Financial Planning, LLC in Greenville, Maine, and now resides in West Yorkshire, England. He may be reached here.

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