

Optimizing retirement financial strategies: Integrating annuities, defined contribution plans, and long-term care costs

Executive summary

Older individuals face an enormous financial risk in later life, namely the need to pay the costs of nursing home stays. In the United States, long-term care (LTC) costs represent one of the most significant financial risks in later life, as 70% of Americans age 65+ need some form of LTC. On average, users need 3.2 years of coverage but 20% require care for 5+ years. Financing these costs is a key challenge.

Three principal financing mechanisms for LTC exist. Medicaid operates as the payer of last resort, intervening only after substantial asset depletion and imposing constraints on amenities. Private LTC insurance suffers from adverse selection and high premiums resulting in persistently low uptake. Consequently, most households self-insure, maintaining assets throughout old age to cover potential LTC costs. Besides other liquid assets, employer-sponsored defined contribution (DC) plans and individual retirement accounts constitute funding sources, which retirees may either draw down directly or annuitize. Recent regulatory reforms, notably the SECURE Acts of 2019 and 2022, have facilitated the inclusion of qualified longevity annuity contracts (QLACs) in DC plans. These deferred annuities commence payouts late in life—often after age 80—providing late-life income at relatively low cost.

Our analysis employs a life cycle economic model to determine both the optimal amount and deferral age for purchasing longevity income annuities with accumulated DC assets, explicitly accounting for the risk of late-life LTC expenses. Our framework integrates health shocks, mortality, Medicare and Medicaid rules, taxes, and retiree heterogeneity. By combining life cycle modeling with realistic institutional features, we assess when and how much to annuitize and compare fixed versus variable annuity payouts. This approach bridges the literature on health risk and annuitization, offering policy and plan design insights for more secure late-life financing.

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