Estimating Out-of-Pocket Health Care Costs in Retirement

By Kerry Pechter *Tue, Nov 10, 2009*

Couples can expect to spend $200,000 or more on premiums, deductibles and co-pays in retirement. This article is the first in a series on retirement risks.

Even if President Obama signs a health care bill this year, retired and soon-to-retire Americans still face plenty of uncertainty regarding their own physical health and their ability to cover all their out-of-pocket medical expenses in retirement.

Indeed, the risk of "unexpected health care needs and costs" always ranks near the top when Americans are surveyed about which retirement risks—longevity risk, inflation risk, stock market risk, and so forth—concern them most.

Unpredictability is part of what makes health-related risk so troubling. "Health care costs are very skewed," said Anna Rappaport, a Chicago-based consulting actuary who studies retirement risks. "Each year, about 63% of all health care spending is accounted for by the 10% of the population that spends the most." But no one knows if he or she will be among that 10%.

The fact that health care costs continue to rise faster than the overall rate of inflation also makes them unpredictable and hard for retirees to budget for. According to the Urban Institute, by 2030 even high-income retired couples will be spending twice as big a share of their disposable income on health care as they did in 2000.

And there's the ever-present concern that a retiree might suffer a catastrophic illness or injury that overwhelms his or her health coverage. "Even if you have insurance, there might be maximum coverage limit of $1 million. Or the insurer might pay only $300,000 for cancer treatment that the hospital says costs $500,000," Rappaport said.

Over the months ahead, *Retirement Income Journal* will publish a series of articles on the financial and non-financial risks that retired Americans face. We'll examine the risks themselves, as well as the recommended ways to mitigate them. In light of last week's passage of the "Affordable Health Care for America Act," we're starting the series with a look at health care cost risk.

Expect to Pay $200,000 to $300,000
Several groups have tried to estimate what the typical retiree's out-of-pocket costs would be. If you limit costs to what a 65-year-old retired couple might pay for Medicare co-pays and deductibles and premiums for supplemental private insurance, the best estimates are between $200,000 and $300,000.

At the lower end, the Center of Retirement Research at Boston College has estimated that the average 65-year-old couple retiring today might spend $206,000 on health care in retirement. But for those retiring in 2020, the estimate jumps to $284,000. In 2008, Fidelity Investments suggested that health care costs could average $225,000 per couple. Richard Johnson, a researcher at the Urban Institute, told RIJ that the typical expenditure might be as low as $150,000 for many couples.

Estimates by the Employee Benefit Research Institute tend to be higher. Using Monte Carlo methodology, EBRI projected the amount of assets needed to cover health care costs in retirement 50%, 75%, and 90% of the time. The cost estimates varied between $194,000 and $635,000, on average, depending on the risk assumed and the level of prescription drug use.

These are averages, of course. The premiums for Medicare Advantage plans or for employer-sponsored retiree health benefits—which are increasingly rare—can vary widely from one part of the U.S. to another and from one company to another. Also, the costs of nursing home care or long-term care insurance do not figure in these estimates.

Practical steps

There are a number of preventive measures you and your clients can take to minimize or mitigate health care cost risks. They include:

- Make room in your retirement budget for health care. When projecting annual living expenses in retirement, it will help to anticipate spending about $10,000 per year per couple on health insurance premiums, co-pays, deductibles and medications, even when Medicare coverage is in place. Adjust your savings rate accordingly. In the years when you spend less, think about putting that money back into savings.

- Mind the gap between retirement and eligibility for Medicare. People who retire before age 65 but don't buy private medical insurance run the risk of incurring huge medical costs if they become seriously ill. To eliminate this risk, don't retire until age 65 or buy private insurance.

- Supplement Medicare with a layer of private insurance. Of the respondents to the Society of Actuaries 2007 Risks and Process of Retirement Survey, 61% of retirees said they purchased supplemental health insurance or participate in an employer's health plan and 14% planned to do so. The premiums will add to your out-of-pocket costs, but the coverage may save you money in the long run.

- Buy long-term care insurance. Although long-term care cost risk is a separate retirement risk that we'll discuss in a future story, it's worth mentioning here. Nursing home costs can dwarf all other health care costs in retirement. For wealthy families with large amounts of legacy assets to protect, the cost of long-term care insurance may be relatively trivial. Depending on their risk preference, they may prefer to buy insurance even if they can afford to self-insure.

- Become a smarter health care consumer. If medical costs continue to climb at their current rate, they will eventually claim an unsupportable share of retirement income. When that happens, retirees will need to economize. "You'll find that once individual spending gets too high, people will just cut back. They will become more savvy consumers. They won't get those extra tests. That will bring down spending to some extent," said Richard Johnson.

- Live a healthy lifestyle. You can minimize health costs by preventing illness through exercise and proper nutrition. But this is easier said than done. In a Society of Actuaries poll, 75% of retirees said they do this and 23% said they plan to, but the SOA pointed out that "these high percentages may be more indicative of wishful thinking than tangible action."

Bottom line

The research suggests that the average retired couple will need to spend at least $200,000 over the course of retirement—assuming both spouses live to their life expectancies or longer—to cover Medicare deductibles and co-pays and premiums for private or employer-sponsored supplemental coverage.

One's ability to handle these expenses depends on one's income, of course. A retiree with an income of $120,000 can afford to pay $10,000 a year on health insurance and prescription drugs. But the same $10,000 would represent a much larger burden for the millions of retirees with incomes of $40,000 to $50,000.

Out-of-pocket health care spending as a percentage of after-tax income is expected to grow in the years ahead. In 2030, according to the Urban Institute, the poorest retired couples could spend more than 50% of their income on health care. Even the highest earners are expected to spend about 16% of income on health care two decades from now, up from less than 10% in 2000.