MarketWatch

How to plan for health care in retirement without going broke

By Robert Powell
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Fidelity's latest estimate is a wake-up call

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Act now to protect your future.

How's this for putting a dent in your retirement savings plan? A 65-year-old couple retiring today will need an estimated $275,000 in today's dollars to cover anticipated health care expenses, according to Fidelity.

And if that wasn't shocking enough, consider this:

• The 2017 estimate is 6% greater than last year's figure of $260,000 (general inflation in 2016 was just 2% and health care inflation was 3.7%). That means next year's estimate — all things being equal — would be $291,500 and the year after that would be $308,990. It also means that health care costs for retirees are rising faster than for population at large.

•The Fidelity estimate is a 70% increase since Fidelity's initial retiree health care cost estimate in 2002 of about $161,000. That works out to an average increase of $7,600 a year.

And three, some firms estimate the amount a 65-year-old couple would need earmarked for health care expenses in retirement to be even greater than $275,000.

Read the 2017 retirement health care data costs report

By way of background, Fidelity's 2017 estimate represents the present value of month expenses for Medicare premiums, Medicare copayments and deductibles and prescription drug out-of-pocket expenses. It assumes enrollment in Medicare health coverage but didn't include the added expenses of nursing home or long-term care, which could make the $275,000 number even higher.

So, what should preretirees make of Fidelity's estimate?

Most pay for health care as they go

Most retirees today don't have a pile of money socked earmarked specifically for health care expenses. Instead, they tend to pay for such expenses as incurred from a mix of income, including Social Security, personal assets, and earned income.

Recurring health care costs remain stable throughout retirement

Usage and expenses of recurring health care services remain stable throughout retirement, while usage of nonrecurring ones increase with age and tend to be more expensive, according to a report published by the Employee Benefit Research Institute (EBRI), a nonpartisan research institute based in Washington, D.C.

For instance, in 2011, average annual out-of-pocket health care cost for a household between 65–74 years old was $4,383, which accounted for 11% of total household expenses. But that shoots up for households ages 85 and above to $6,603 a year, or 19% of total household expenses.

And it's those nonrecurring unpredictable expenses — such as surgery, hospitalizations and nursing home care — that, in the absence of a plan to manage those costs, can wreak havoc on a household's finances, according to EBRI.

By way of comparison, the EBRI report also suggests that a person with a life expectancy of 90 would require $40,798 — not including expenses for any insurance premiums or over-the-counter medications — at age 65 to fund his or her recurring health care expenses. And that number, call it $82,000 for a couple.

In another report, one that lumped all premiums for Medicare Parts B and D, premiums for Medigap Plan F, and out-of-pocket spending for outpatient prescription drugs, EBRI suggested that a couple with median prescription drug expenses would need $165,000 if they had a goal of having a 50% chance of having enough savings to cover health care expenses in retirement. And, if they wanted a 90% chance of having enough savings, they would need $265,000, according to an EBRI report.

Earmark Social Security to pay for health care

For some, it might make sense to use your entire Social Security benefit to pay for health care expenses, and use other assets and income to pay for all other living expenses in retirement. Consider, for instance, a report published by Michael Kitces, publisher of the Nerd's Eye View in 2015 estimated the lump sum value of Social Security. And what he found was this: "Given an average Social Security retirement benefit of $1,294/month (in 2014), a 10-year Treasury rate hovering somewhere around 2% (at the time of Kitces' writing), assumed inflation of 3%, and a life expectancy (according to Social Security's own 2010 Period Life Table) for someone who's already reached age 66 (full retirement age (FRA) for today's retirees) of approximately 17 years for a male and 20 years for a female, the average 'lump sum' value of Social Security is about $280,000 for males and $335,000 for females. At a maximum Social Security benefit of $2,642/month (for those who maxxed out the Social Security wage base for 35 years), the value of Social Security amounts to about $572,000 for men and $683,000 for women."

In other words, the lump sum value of Social Security for a couple retiring at FRA would be $615,000, which is more than enough to cover the $275,000 Fidelity estimates that couple needs to pay for health care in retirement.

Of course, the trouble with this plan is that couples would need to make sure they have enough assets and income to cover all other expenditures in retirement, such as housing, food, transportation and the like. And that might be a push given that many — even those who have been saving 30 years — don't have enough saved to fund their desired standard of living.

Consider someone in their 60s who had participated in a 401(k) plan for 30 years had, at year-end 2015, an average account balance of more than $280,000 among participants in their 60s with more than 30 years of tenure, an amount that could be earmarked entirely for a couple's health care costs. And the average 401(k) balance for someone in their 60s was $123,000, which is roughly what one person would need set aside to pay for health care costs in retirement.

Consider using an HSA

Some workers might have the luxury of using their health savings account (HSA) to fund health care expenses in retirement. HSAs are paired with high-deductible health plans (HDHP), which often have lower monthly insurance premiums than traditional health plan offerings, and, according to Fidelity's release, include these key tax benefits: contributions go in tax-free, balances and savings can be withdrawn tax-free for medical costs.

Read: Health care costs in retirement are only going up — here's how to save

What else is worth knowing about Fidelity's study?

Most workers forget how much health care costs

Corporate employees are largely unaware of the costs they and their employers are paying for health care, said Michael Lonier, a retirement-income planner with Lonier Financial Advisory.

"Much of the cost is hidden in their payroll deductions," he said.

Indeed, in 2015, the average company-provided health insurance policy totaled $6,251 a year for single coverage, according to ZaneBenefits. On average, employers paid 83% of the premium, or $5,179 a year. Employees paid the remaining 17%, or $1,071 a year.

For family coverage, the average policy totaled $17,545 a year with employers contributing, on average, 72% or $12,591. Employees paid the remaining 28% or $4,955 a year.

"The first inkling some may get that health care is far more expensive than they were aware of is the COBRA notice they receive if they are laid off and now have to pay the full cost for their health insurance premiums," said Lonier. "The period after corporate coverage but before Medicare eligibility for those who suffer a job loss can be a budget killer."

Medicare Part B can be expensive

Although Medicare part B premiums are a magnitude smaller than other insurance premiums, costs can still be high for those enrolled in Medicare who use health care services frequently, said Lonier.

For instance, you generally have to pay your deductible, coinsurance, and copayments. Plus, some of the items and services that Medicare doesn't cover include: long-term care (also called custodial care); most dental care; eye examinations related to prescribing glasses; dentures; cosmetic surgery; acupuncture; hearing aids and exams for fitting them; and routine foot care.

Read more about what Medicare doesn't cover

What's more, even with a $0 premium Medicare Advantage policy, which, not surprisingly, are increasingly popular, the policy deductible/out-of-pocket limit plus part B premiums can be more than $8,000 a year per spouse, or over $16,000 a year for the household, said Lonier.

"Over 20 years, even without the high inflation that has been persistent in health care for decades, that can reach a $320,000 lifetime total for those who spend the max out-of-pocket every year," said Lonier. "With typical higher than CPI health care inflation, the number could easily double over the next 20 years."

Adopt a healthy lifestyle

No one gets to choose their DNA, and so for some, poor health comes with a high cost they can't avoid, said Lonier.

"For everyone, it clearly pays to adopt a healthy lifestyle — don't smoke, drink moderately, exercise, eat a very healthy diet, and actively manage stress," he said. "Cut your out-of-pocket costs in half, and a $16,000 a year per household expenses becomes $8,000 a year or less. Just as mom always said, your health is your most valuable asset — never truer."

One planner's approach

So, how does one financial planner who has to build retirement plans for his clients, incorporate Fidelity's estimate into his practice, in real life?

"The Fidelity estimate is a good reminder that there is a lot that we do not know about our future expenses," says Steven Schwartz, president of Wealth Design Services. "I have tried to incorporate a published number — such has the Fidelity estimate — in my planning models, but I always end up feeling that I am imposing a spending constraint that is too artificial. The reason is that we really have no way of knowing whether those expenses will materialize for any particular individual or when those expenses will materialize."

Ultimately, the way Schwartz has come to think about health care costs is to frame the problem around the structure of insurance.

"Most insurance policies create a choice around how we share expenses," he said. "We can choose to pay a higher premium, higher copays, deductibles or co-insurances or higher maximum out-of-pocket costs. We do cash flow planning in our firm rather than goals-based planning and build these short-term known costs into our plans rather than trying to think about the overall long-term costs that are possible. We probably get to the same place because I think that those costs are what make up the Fidelity number. However, at least for me, this is a more concrete way to approach the problem."

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