Insured Retirement Institute

Health Care Expenses and Retirement Income

How Escalating Costs Impact Retirement Savings

January 2012

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Overview

When planning for retirement income needs, it is imperative that Boomers and their advisors incorporate the costs of health care into the calculation. Rising medical expenses, projected to be in the hundreds of thousands of dollars for retirees over their lifetimes—including premiums and out-of-pocket costs, bring another uncertain element to retirement income planning. This is compounded by the Social Security cost-of-living adjustment (COLA) that has not kept pace with today's health care costs and increases in Medicare Part B premiums which are deducted from Social Security checks.

Several strategies may be implemented to save for retiree health expenses, and those that involve insured retirement solutions can help mitigate future costs.

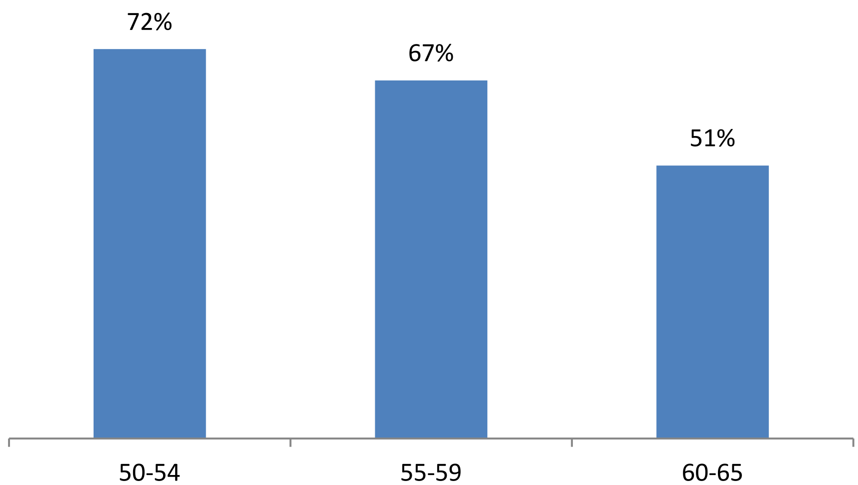
Key Findings and Analysis

- Future medical expenses are of great concern to Baby Boomers.
    - Nearly two-thirds (63%) of Baby Boomers lack full confidence that they will have enough money to cover their medical expenses during retirement.
    - The average person covered by Medicare will have out-of-pocket medical expenses totaling more than $4,300 per year (or $8,600 for a couple).
    - A healthy 65-year-old male can expect cumulative health care expenses, including premiums, to top $369,000 though the remainder of his lifetime. The corresponding figure for women is at least $417,000, a difference of 13%.
- Social Security, while providing a base income for retirement, will be insufficient on its own to fund retiree medical expenses.
    - The 2012 Social Security cost-of-living adjustment (COLA) of 3.6% represents an increase, on average, of $42 per month, or approximately $500 for the year.
    - The Social Security COLA has exceeded 3% in just five of the past 20 years.
    - Per capita health care expenses increased by 5.75% in the twelve-month period ending September 2011.
- Premiums for Medicare Part B are taking a growing bite out of Social Security checks.
    - For 2012, Medicare Part B premiums will account for 8.2% of the average Social Security benefit, up from 5.1% in 2000.
    - While the average Social Security check is 31% higher than it was in 2001, premiums for Medicare Part B have doubled.
    - Although there is no decline in the COLA net of Part B premiums (net COLA) for 2012, Part B premiums have negatively impacted the COLA for 12 of the past 20 years.
- Using an annuity in conjunction with a low-risk side investment to fund future medical expenses can reduce the investment required in a low-risk investment alone. A 55-year-old male can reduce the total investment needed to fund future health expenses by more than 70% by adding an annuity.

Retiree Health Costs

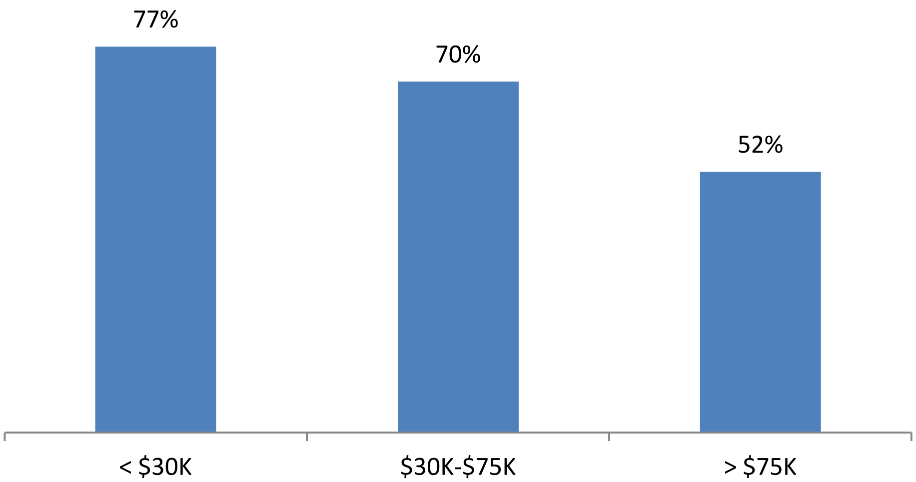
The cost of health care during retirement remains of great concern to Boomers. Research conducted by IRI earlier this year showed that 63% of Boomers lack full confidence in their ability to cover their medical expenses during retirement. This concern is most pronounced among younger boomers, yet still significant among those in their early 60s (51%) or late 50s (67%). Confidence also varies in proportion to annual income (52% for Boomers earning more than $75,000 per year, 70% for middle-income Boomers). The level of concern is consistent between men and women (63% of each group expressed concern), as well as by marital status (also 63%).

Percentage of Boomers Concerned About Medical Expenses in Retirement, by Age



Responses reflect those who indicated they were somewhat or not confident about their expectations about having enough money to take care of their medical expenses during retirement. Medical expenses include payment for doctor visits, prescription drugs, or hospital stays, and excludes costs related to long-term care.

Source: Insured Retirement Institute



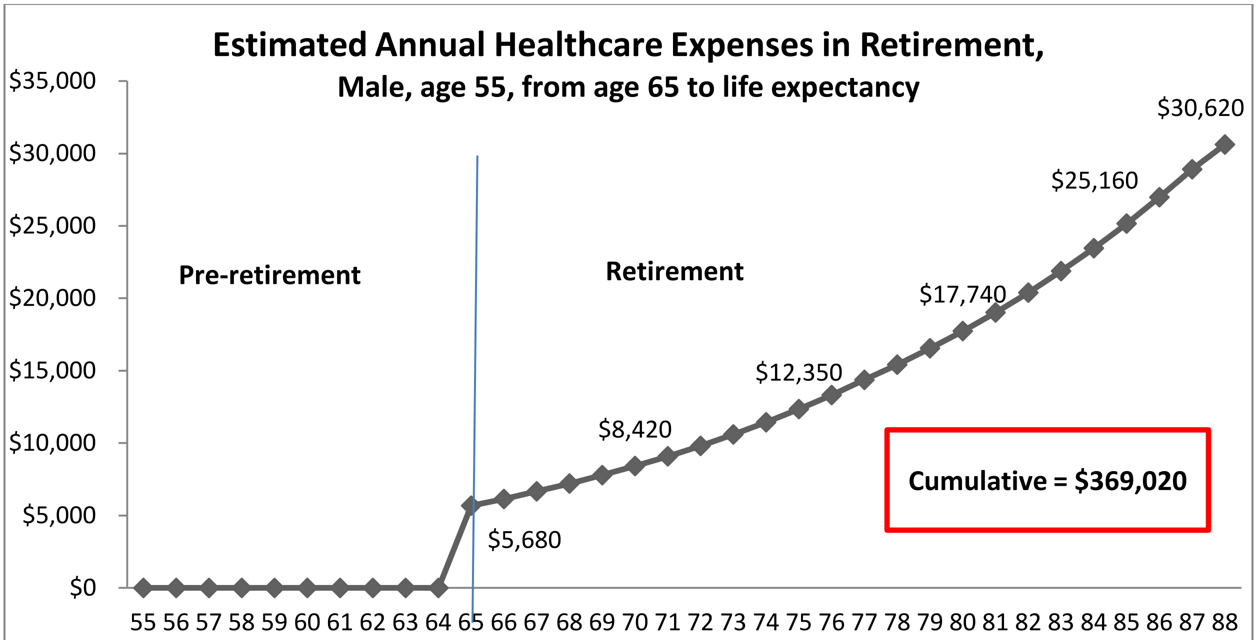
Percentage of Boomers Concerned About Medical Expenses in Retirement, by Household Income

Responses reflect those who indicated they were somewhat or not confident about their expectations about having enough money to take care of their medical expenses during retirement. Medical expenses include payment for doctor visits, prescription drugs, or hospital stays, and excludes costs related to long-term care.

Source: Insured Retirement Institute

Consumers have every reason to be concerned. According to the U.S. Bureau of Labor Statistics, expenses for health care per household averaged approximately $3,100 during 2009, up 5% from the prior year. For individuals between 55 and 64 years of age, the average amount was nearly $3,900, and was $4,900 for those between 65 and 74. The Center for Retirement Research at Boston College estimates out-of-pocket medical expenses—including Medicare premiums—for retirees at $4,300 per year for an individual and $8,600 for a couple.

The estimation of future health care expenses has a considerable number of moving parts, including interest rates, inflation, current health, state of residence, and income. Using a proprietary software program that enables advisors to input these variables, HealthView Services estimates that a healthy 65-year-old male earning less than $85,000 annually will, on average, have projected medical costs during retirement of roughly $369,000. It is key to note that costs will be higher for those who have pre-existing conditions, those in higher income brackets (whose premiums for Medicare are higher), as well as for women. Additionally, inflation and future interest rates remain unknowns. Even so, the amount needed at retirement to fund future health care costs is in the hundreds of thousands of dollars. HealthView Services estimates that funding this expense starting at age 55 would necessitate an investment of more than $180,000.



Expressed in future dollars based on a 55-year old healthy male, retiring at 65, and living to 88; includes Medicare A, B, D, and Gap coverage. Assumes earnings of less than $85,000 annually, and expenses close to national averages.

Source: HealthView Services

Social Security: COLA Can Fall Flat

Looking back at pre-retiree sentiment, the two age groups that are most concerned about meeting health care expenses in retirement—those in their early 60s or late 50s—are also likely to consider Social Security a major source of their retirement income (51%, and 41%, respectively). Looking ahead, this presents a potentially serious conflict as increases in Social Security payments are not keeping pace with the projected cost of health care.

For the first time since 2009, Social Security recipients will see a cost-of-living adjustment (COLA) in their retirement checks, effective calendar year 2012. The raise is modest—3.6%—which, on average, represents an increase of $42 per month, or approximately $500 per year.

Meanwhile, according to the S&P Healthcare Economic Index, per capita health care expenses increased by 5.75% in the twelve-month period ending September 2011.

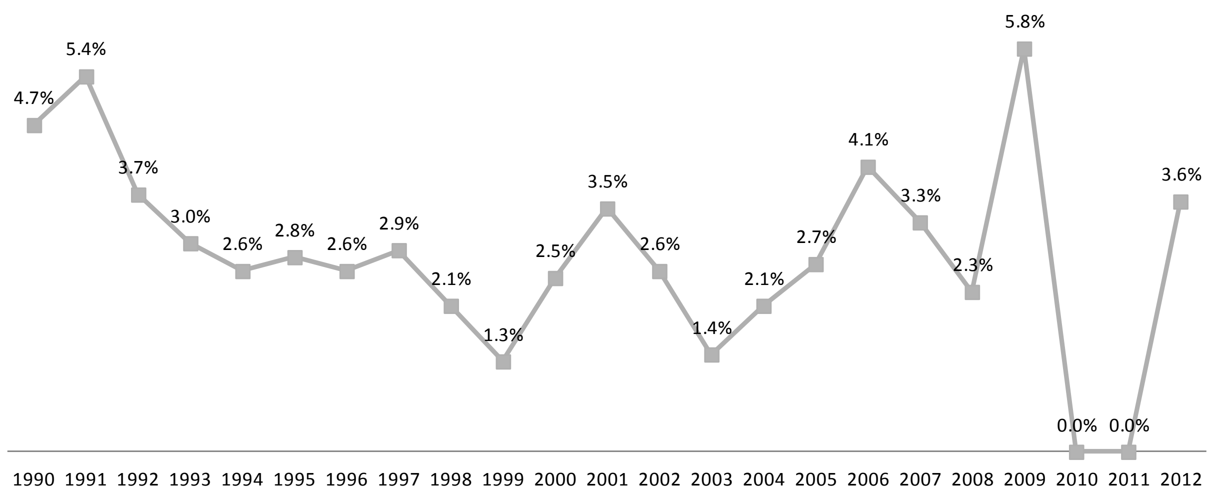
The annual COLA is determined by a formula that is based on the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W). The CPI-W is developed monthly by the Bureau of Labor Statistics (BLS). It reflects expenditures of urban households who derive more than half its income from clerical or wage occupations and in which at least one earner was employed for a minimum of 37 of the previous 52 weeks. (This represents approximately one-third of the U.S. population, per BLS.) Among the expenditures included in the calculation are housing, food and beverages, and medical care. The CPI-W does not include investments.

The calculation of the Social Security COLA for the upcoming year is generated automatically, and compares the CPI-W for the third calendar quarter of the current year (in this case, 2011) with that of the third calendar quarter of the most recent COLA (in this case, 2008). Therefore, future COLAs cannot be projected with any accuracy. A provision in the law requires that if the percentage difference between these two figures is less than 0.05%, or is negative, there will be no COLA, meaning the Social Security benefit level will remain unchanged from the prior year. This was the case at year-end 2008 and 2009; therefore there was no increase for the next calendar years.

The exhibit below shows the Social Security COLAs for calendar years 1990 through 2012, inclusive. An examination of this exhibit yields two key observations.

- Although the COLA cannot be negative, the level can fluctuate from year to year and is difficult to predict more than a few months in advance.
- The COLA has exceeded 3% in only five of the last 20 years. During this period, annual COLAs ranged from 0% to 5.8%, and averaged 2.6%.

Social Security Cost-of-Living Adjustments, 1990-2012



Reflects the year in which COLA takes effect.
Source: Social Security Administration

Additionally, the Social Security COLA is just the starting point for the increases that most retirees will see in the coming year. This is because premiums for Medicare Part B—which covers doctors' services in an outpatient setting—are deducted from beneficiaries' Social Security checks. This can therefore reduce the effective COLA.

Medicare Impact

Although they are deducted from Social Security payments, premiums for Medicare Part B are calculated in a very different manner—one that does not account for changes in the CPI. Rather, premiums are calculated with the goal of covering 25% of projected costs for the coming year. Still, the final Medicare Part B premium is influenced by the Social Security COLA. Under a hold-harmless provision, increases in Part B premiums are capped, dollar-for-dollar, to the corresponding COLA increase for Social Security. The Social Security Administration (SSA) estimates that three-quarters of Part B participants are subject to this provision. (The remainder includes new enrollees, those with high incomes, and dual Medicare-Medicaid recipients.)

Therefore, it is possible to run into the situation—as experienced for 2010 and 2011—in which the final Part B premium is less than the calculated premium. This is illustrated in the table below.

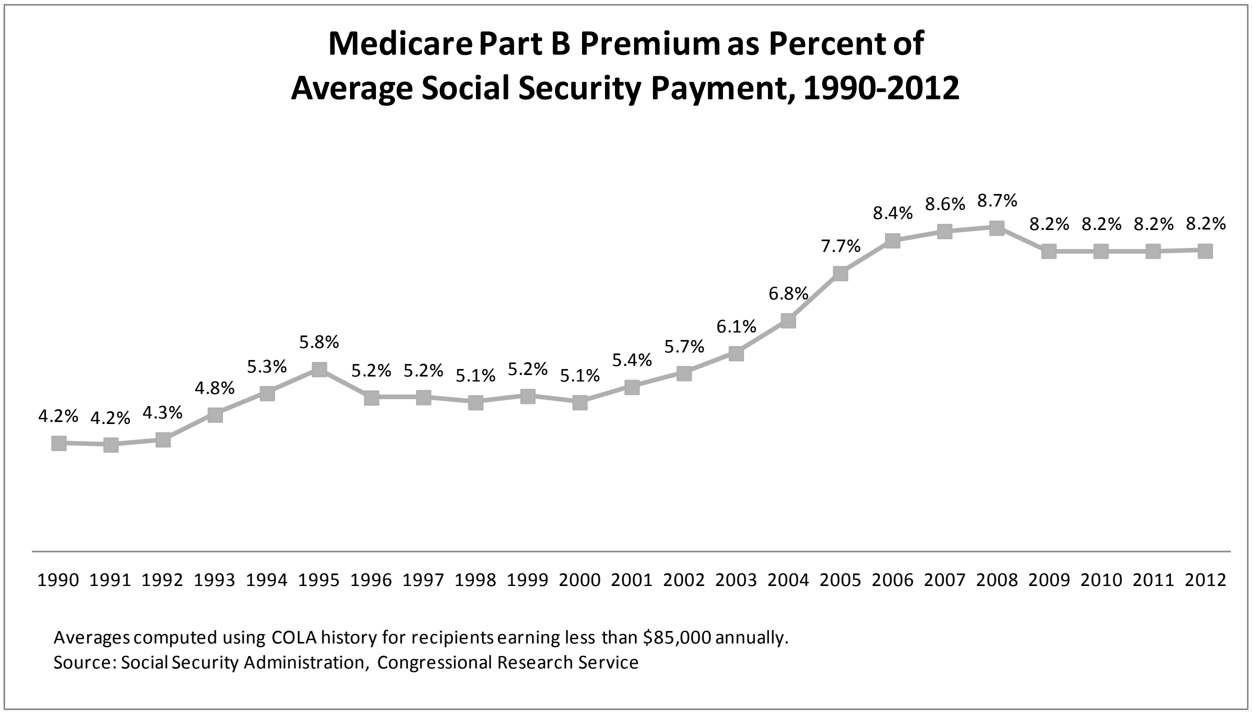
For 2012, the standard monthly rate is set at $99.90. (The standard premium decreased as they were somewhat inflated in earlier years for the higher-income retirees who are not impacted by the hold harmless provision.)

	2010	2011	2012
Standard Medicare Part B Premium Rate	$110.50	$115.40	$99.90
Total Monthly Medicare Part B Premium	$96.40	$96.40	$99.90
Annual Change ($) in Total Part B Premium	$0.00	$0.00	$3.50
Estimated Change ($) in Social Security Benefit	$0.00	$0.00	$42.37
Net Increase to Social Security Benefit after Medicare Part B Premium	$0.00	$0.00	$38.87

Note: The total premium rate reflects the impact of COLA for those eligible.
Sources: Congressional Research Service, Social Security Administration, IRI

Therefore, retirees enrolled in Medicare Part B will also see their first increase in premium since 2009. Although this is not as large as what was originally anticipated (early estimates were closer to $112, which would have consumed the entire COLA increase), premiums have increased significantly over the past decade. While the average Social Security check is 31% higher than it was in 2001, premiums for Medicare Part B have doubled.

Viewed another way, premiums for Medicare Part B have taken a growing bite out of Social Security checks. In 2011, the Medicare Part B premium represented 8.2% of the average Social Security benefit. This is up from 5.1% in 2000. Although this proportion has steadied in the past several years—largely due to freezes in Medicare premiums as a result of freezes in COLA—premiums climbed sharply in the past decade, eventually crossing the 8% mark in 2006.



One good bit of news, however, is that the annual deductible for Medicare Part B will decline in 2012, from $162 to $140. Still, this savings of $22 per month amounts to little when other costs are considered.

Health Care Funding for Retirement

The formulaic determination of Social Security COLAs leaves uncertainties as to future benefit amounts. While benefits, as they currently stand, will not decrease, it does signal the need for a complementary source of guaranteed income in retirement.

As discussed earlier, future health costs—and, therefore, the amount to invest to ensure they are covered—require various assumptions for inflation, health status, and other variables. Although there are various estimates for the present value of the costs of future health care for retirees, the dollar amounts are staggering.

According to a 2010 study by the Center for Retirement Research at Boston College, a healthy 65-year-old couple will need an outlay of nearly $200,000 to fund health care costs during the remainder of their lifetimes. Fidelity Investments, in 2011, estimated that a 65-year-old couple would need to invest $230,000 at age 65 to cover these expenses.

It is also essential to consider premium costs for Medicare and Medigap coverage—something incorporated in HealthView Services' calculations. According to HealthView Services, a healthy 65-year-old couple would need an investment of approximately $506,000 at age 65, assuming an interest rate of 3%. By making the investment ten years earlier, at age 55, the required investment would be approximately $377,000.

Additionally, gender plays a significant role. As stated earlier, HealthView services projects lifetime medical expenses of $369,020 for a middle-income male starting at age 65. The corresponding figure for females is $417,550, a difference of 13%.

The Role of Annuities

While there are a number of ways of funding future health care expenses, annuities can help cushion these costs, as follows:

- Immediate annuities or deferred annuities with a guaranteed minimum withdrawal benefit (GMWB) can provide a base level of guaranteed lifetime income, further supplementing income from Social Security.
- Purchasing an annuity several years prior to retirement and investing the GMWB amount into a separate account starting at retirement will reduce the investment that a pre-retiree will need to make today to fund future health care expenses.

The first scenario is fairly straightforward. Although experts at the SSA predict that the Social Security Trust Fund will remain solvent until at least 2036, the youngest Baby Boomers will still be in their 70s at that time. Even at today's low interest rates, a 65-year-old male can purchase an immediate annuity that will pay $1,000 per month for life with 10 years guaranteed for less than $175,000. A fixed-term annuity for 10 years would require a deposit of $110,000, and an annuity for 5 years would be available for less than $60,000, per ImmediateAnnuities.com.

Yet, a strategy that is likely to appeal to more Boomers is to use annuity income to supplement a separate investment. According to a recent study from IRI and Cogent Research, only 31% of investors age 65 or older are willing to give up control of some or all of their investment principal in exchange for lifetime, guaranteed regular income payments. Building up a side fund can help overcome this objection while keeping annuities in the mix.

According to HealthView Services, using an annuity in conjunction with a low-risk side investment can reduce the investment required in a low-risk investment alone to fund future health expenses. In the earlier example of the 55-year-old male, adding an annuity can reduce the total investment needed to fund future health expenses by more than 70%. By investing in the annuity at age 55, the income base used to determine the GMWB payment should be sufficient to fund the annual healthcare expenses at age 65, as well as to start a low-risk investment to help cover expenses in future years.

Scenario	Projected Medical Costs *	Out-of-Pocket Investment Required at age 55, no annuity, 3% return	Variable Annuity Investment Required at age 55 **
55-year-old male, <$85K annual earnings	$369,020	$180,525	$60,000
55-year-old female, <$85K annual earnings	$417,550	$196,536	$61,500
55-year-old couple, <$170K annual earnings	$786,570	$377,062	$114,000
55-year-old male, $200K annual earnings	$674,839	$330,799	$107,000
55-year-old female, $200K annual earnings	$779,514	$367,052	$113,500

* Includes Medicare premiums (Parts A, B, D, and Gap coverage)
** In years in which the value of the withdrawal exceeds healthcare expenses, the difference is invested in a low-risk account. Assumes savings begin at age 55, retirement at 65, 3% annual rate of return on low-risk investment, 3% rate of return for excess withdrawals, 4% withdrawal rate on annuity.
Source: HealthView Services

Conclusion

There are several key considerations when planning for retiree health care costs. First, traditional sources of income in retirement, specifically Social Security, will not be sufficient to cover these costs long-term, even with COLAs. Second, there are many variables inherent in the determination of the present value of future health care costs—including, but not limited to, types of Medicare coverage, household income, health status, interest rates, inflation, the age at which one can start investing for this rising expense, and gender. Therefore, it is wise to use conservative estimates when employing these calculations.

Boomers are already concerned about their ability to cover their lifelong medical expenses during retirement—therefore, they will likely be open to discussing ways in which to fund the large outlay that will be required. Among these is the use of annuities to help mitigate the costs of living in retirement. Aside from providing a stable, guaranteed source of lifetime income, annuities can also be used, in addition to other investments, to fund health care costs directly (through annuitization or guaranteed withdrawals) or by offsetting a side fund set aside for health care. The latter can play a significant role in reducing the up-front investment required to mitigate these lifelong expenses.