



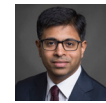
Planning for Unexpected Health Care Costs in Retirement

Most retirees won't experience an expense shock, but everyone should plan for it.

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KEY INSIGHTS

- The fear of a health care shock is pervasive, but data show that very few retirees experience a catastrophic increase in health care expenses.
- While the likelihood of experiencing health care shocks increases with age, particularly for those 80 years and older, these increases are usually not permanent.
- Retirees can take proactive steps to prepare for out-of-pocket health care expenses, because planning for the unexpected shouldn't be left to chance.



Sudipto Banerjee, Ph.D.

*Vice President,
Retirement Thought Leadership*

One of the unpleasant certainties of life is that everyone's health will decline in old age. While some retirees might enjoy a long and healthy life and have a slow and natural decline in health, others may get diagnosed with a sudden terminal illness or have one or more chronic conditions, like diabetes or dementia, that require prolonged care. In addition to these possibilities, there are the risks of injuries from accidents and falls.

No matter what path a retiree's health takes, one certainty is that everyone will experience some level of health care costs during retirement. While the routine costs of health care can be burdensome—some costs such as health insurance premiums and recurring prescriptions are easier to plan

for—retirees are more concerned about an unexpected large medical bill.

A number of studies (Banerjee, 2018¹; Poterba, Venti, and Wise, 2018²) have shown that retirees are not spending down their assets as one might expect. Retirees may be hesitant to spend their hard-earned money in fear of or in preparation for these unexpected health care expenses.

In order to help retirees create a successful retirement income strategy that balances the need for current spending and future health care expenses, we need to better understand the likelihood and the magnitude of these uncertain health care costs. This paper will explore the probability that a retiree will experience a health care-related financial shock as he or

¹ Sudipto Banerjee, "Asset Decumulation or Asset Preservation? What Guides Retirement Spending?" EBRI Issue Brief, no. 447 (Employee Benefit Research Institute, April 3, 2018).

² James Poterba, Steven Venti, and David A. Wise, "Longitudinal determinants of end-of-life wealth inequality," May 2018, <https://economics.mit.edu/sites/default/files/publications/1-s2.0-S0047272718300690-main.pdf>.

she ages and the chances of the higher expense becoming a new normal, resulting in higher future expense.

What Is a Health Care Shock?

There is no settled definition of what amount constitutes a health care expense “shock.” While shock is all relative to one’s financial situation, for our purposes, we focused on out-of-pocket health care cost increases of \$2,000 or more during a two-year period.

What’s Included in These Health Care Costs?

Sudden large increases in health care costs are usually associated with out-of-pocket costs. These include costs associated with:

- Hospital stays
- Nursing home stays
- Doctor visits
- Dental services
- Outpatient surgery
- Prescription drugs
- Home health care
- Use of special facilities (e.g., adult day care, physical therapy, social worker, transportation for elderly, etc.)
- A catchall “other” category

Incidence of Health Care Cost Shocks

While the fear of experiencing a health care financial shock is pervasive, only a very small share of retirees actually experience such catastrophic shocks. Figure 1 shows the percentage of Americans age 65 and older who experienced a health care shock. Over two years:

- 10.9% experienced an increase between \$2,000 and \$5,000,
- 9.1% experienced an increase between \$5,000 and \$25,000, and
- Only 2% experienced an increase of \$25,000 or more.

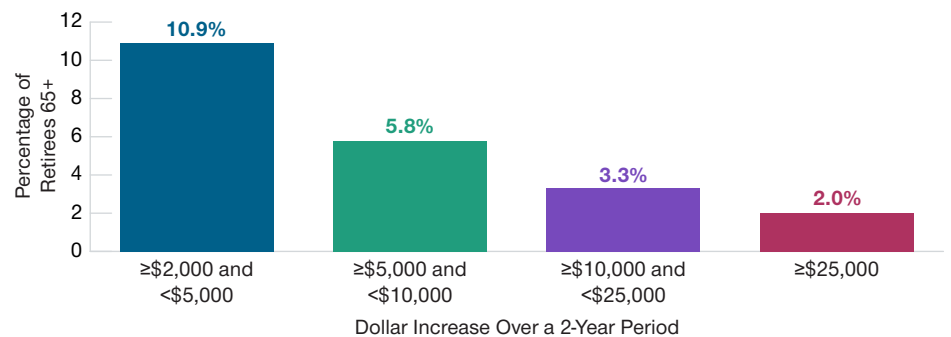
Incidence of Health Care Cost Shocks by Age

A deeper look at how the incidence of health care shocks varies across age cohorts shows that the really high health care cost increases (e.g., \$25,000+) that many people worry about typically don’t affect younger retirees (Figure 2). These significant increases were more prevalent among those who reach their 80s and 90s, and even then, a relatively small percentage of people were impacted.

For example, Figure 2 shows that only 0.9% of those ages 65–69 and 1.1% of those ages 70–79 experienced a health care shock of \$25,000 or

Large Health Care Shocks* Were Less Prevalent

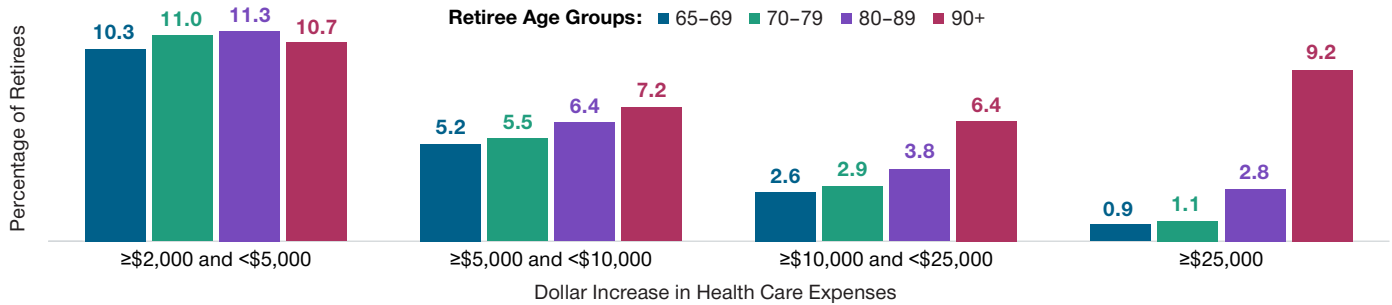
(Fig. 1) Percent of retirees who experienced a health care shock, by dollar ranges



*Health care shocks are defined as out-of-pocket increases of \$2,000 or more in a 2-year period. Source: T. Rowe Price estimates from Health and Retirement Study (2012–2018). Expenses are measured in 2022 dollars.

Health Care Shocks Increased With Age

(Fig. 2) Increase in out-of-pocket health care expenses over a two-year period



Source: T. Rowe Price estimates from Health and Retirement Study (2012–2018). Expenses are measured in 2022 dollars.

more. In contrast, a similar shock was experienced by 2.8% of those ages 80–89. The incidence drastically jumped to 9.2% for those 90 years and older. Overall, even for those over 90 years old, only about one-third experienced an increase of more than \$2,000. Stated otherwise, two-thirds of this age group did not experience any significant increases in health care expenses.

Persistence of Higher Health Care Expenses

A sudden large increase in health care costs can be both stressful in the short term as well as devastating for a retiree’s long-term finances, especially if the increase becomes permanent. According to our research, the average health care shock—a term that suggests

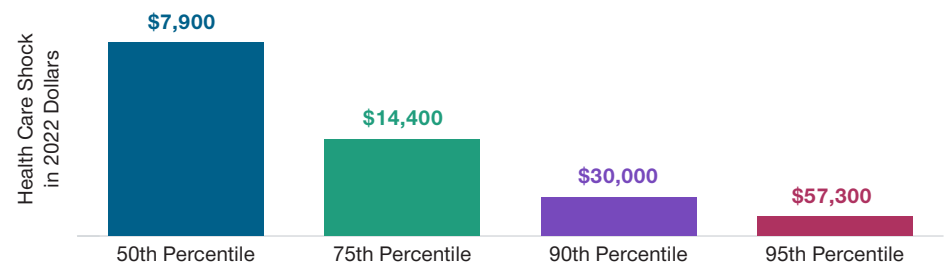
a temporary episode—usually cost retirees \$8,000 over a period of two years (Figure 3).

So, how often does a health care shock become a new financial reality? Figure 4 examines the persistence of shocks, showing after two and four years of experiencing a shock what percentage of individuals were still spending at that level or higher.³ We might consider these changes to be permanent after two years without substantial relief, and even more so after four years.

Among those who experience a \$2,000 to \$10,000 health care shock, roughly 1 in 4 can expect it to be a permanent increase. Meanwhile, increases above \$10,000 are more likely to become

Average Health Care Shock Costs ~\$8,000

(Fig. 3) Distribution of health care costs by average amount over a period of two years

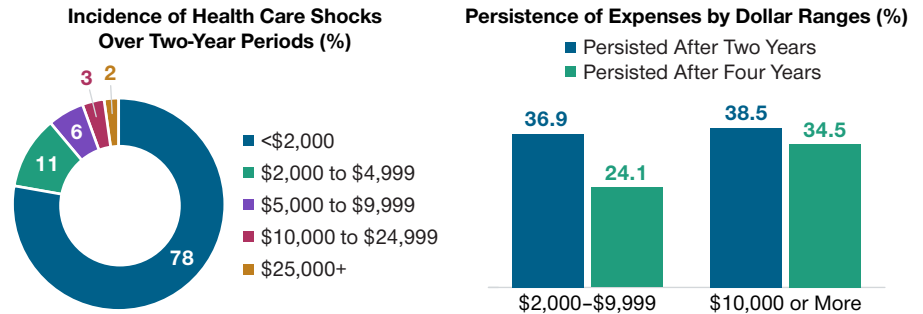


Source: T. Rowe Price estimates from Health and Retirement Study 2012–2018.

³ For shocks between \$2,000 and \$5,000, the persistence numbers measure the percentage of individuals whose spending either went up (after 2 or 4 years) or did not go down more than \$500. In case of shocks above \$5,000, the numbers show the percentage of individuals whose spending either went up (after 2 or 4 years) or did not go down more than \$500.

Persistence of Health Care Shocks

(Fig. 4) Likelihood that cost increases become permanent



Source: T. Rowe Price estimates from Health and Retirement Study 2012–2018.

permanent. This is because the likelihood and persistence of critical and/or chronic health risks increase with age. Notably, individuals who died within two or four years following the health care shock would not be tracked, which limits our ability to track permanence of these shocks over time.

How to Prepare for Future Health Care Expenses

What does this mean for current or future retirees? On the positive side, only a relatively small percentage are likely to experience large health care cost shocks. Among those impacted, only a minority of that small group are expected to see a permanent increase in health care costs.

These risks are limited. While almost 1 in 10 individuals over 90 years old experienced a health care shock of \$25,000 or more, a low percentage of individuals who are currently 65 years old (men and women) are expected to live into their 90s.⁴ Planning for individual circumstances requires a different perspective. Based on their own health status and family history, individual retirees must try to answer several tough questions:

- Will I live into my 90s?

- Can I financially sustain a health care shock of a modest size?
- Will I have enough money if the increase becomes permanent?

To help better plan for these expenses, Figure 5 provides the age-based distribution of out-of-pocket health care expenses (not including health insurance premiums) based on Health and Retirement Study⁵ data. Rather than a simple age-based average, we provide a detailed picture of the distribution of these costs because health care costs are rightly skewed (i.e., a small share of people incur very large costs), and simple averages tend to overstate these costs.

We provide three different points in the distribution of out-of-pocket health care expenses:

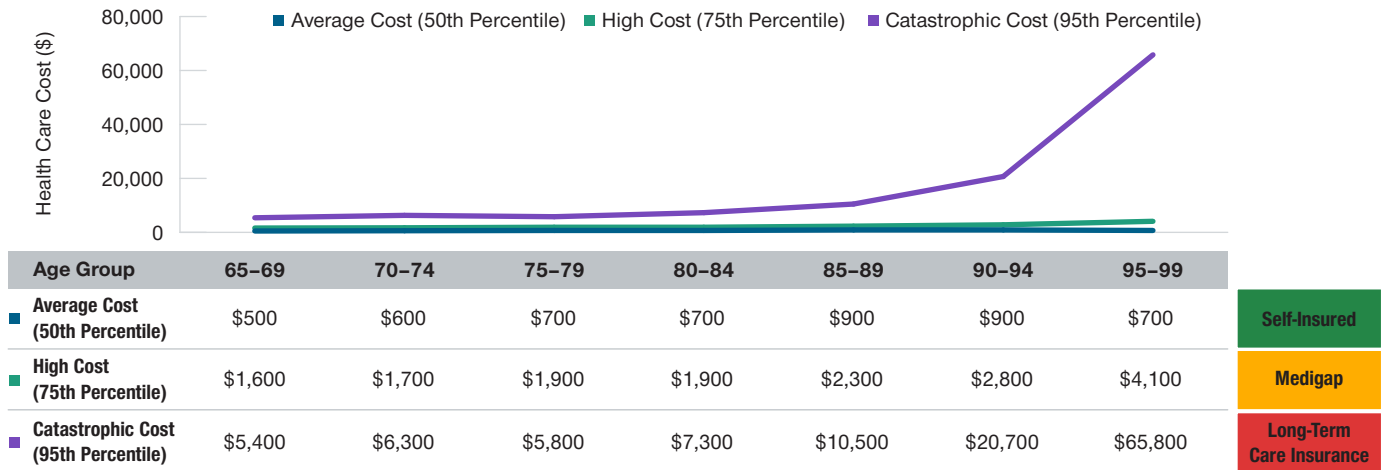
- Average Cost (50th percentile)**—50% of retirees spent more than this amount
- High Cost (75th percentile)**—25% of retirees (1 in 4) spent more than this amount
- Catastrophic Cost (95th percentile)**—5% of retirees (1 in 20) spent more than this amount

⁴ Social Security Administration Life Tables. <https://www.ssa.gov/oact/STATS/table4c6.html>

⁵ Health and Retirement Study, public use data set. Produced and distributed by the University of Michigan with funding from the National Institute on Aging (grant number NIA U01AG009740). Ann Arbor, MI.

Distribution of Individual Annual Out-of-Pocket Health Care Costs

(Fig. 5) Excludes insurance premiums



Source: T. Rowe Price estimates from Health and Retirement Study 2012-2018. Expenses are measured in 2022 dollars.

We interpret median as the average cost, while the 75th percentile may be considered as the high cost scenario and the 95th percentile as the catastrophic cost scenario. The top-heavy nature of the distribution of these costs is immediately clear. When we compare the two ends of the age distribution (60-69 and 95-99) we see that the median cost is \$500 and \$700, the 75th percentile more than doubles from \$1,600 to \$4,100, while the 95th percentile increases more than 12 times, from \$5,400 to \$65,800.

These numbers can be used as guidelines for how much a retiree might need for annual out-of-pocket expenses at different ages. Someone in excellent health might budget for the median, while someone with a chronic medical condition might use the 75th percentile as their guideline. Those in poor health might use the 95th percentile. At the end of the day, it comes down to a personal decision of how much is enough to stave off a sizable, unplanned expense.

Ultimately, these costs vary from individual to individual based on their health condition, the type of insurance they have, and the extent of care they need. As Figure 5 suggests, one

might think about self-funding the average costs, using Medigap policies to safeguard against high costs and purchasing long-term care insurance to protect themselves from catastrophic cost scenarios. While these numbers can provide broad planning guidelines, we suggest retirees consult with their financial and health care providers to better understand future health care expenses.

The data show a low probability that a retiree will face a large health care expense and an even lower probability that the increase will be permanent. Further, the ability to manage such expenses is largely dependent upon one's wealth.

Action Items for Preretirees and Retirees

Planning for the unexpected should not be left to chance. There are a few proactive steps that preretirees and retirees can take to prepare for out-of-pocket health care expenses.

Preretirees should:

1. Include realistic health care expense estimates in a retirement budget before terminating employment.

2. Thoroughly research ways to pay for potential long-term care expenses, including insurance and relying on a portion of assets for out-of-pocket costs. Remember that long-term care expenses such as nursing home stays and in-home custodial care are generally not covered by Medicare. Keep in mind that long-term care policies can be expensive, and premiums usually increase as people get older.
3. Choose between enrolling in Medicare Part C (Medicare Advantage) or traditional Medicare. Consider adding a supplemental drug plan (Part D) and Medigap policy to traditional Medicare. Options like these beyond traditional Medicare can increase premium costs, but they may reduce potential out-of-pocket expenses.
4. Be aware of deadlines to sign up for different types of Medicare plans. Missing these deadlines may

result in permanent increases to monthly premiums.

Retirees should:

1. Annually review existing health insurance coverage to ensure that it is appropriate, given the need and individual situation.
2. Consider earmarking assets that can be used to cover an unexpected health care expense, and revisit that amount annually.
3. Understand what insurance will and will not cover when it comes to long-term care.
4. Think about end-of-life health care. The decision to receive care at home or in a nursing facility can have very different cost implications. Also, skilled nursing home facilities are not always covered by Medicare, neither are nursing homes that provide custodial care.

ABOUT OUR STUDY

We used data from the Health and Retirement Study (HRS), which is a nationally representative survey of Americans ages 50 and older. The HRS has been conducted every year starting in 1992. We looked at people who were between 65 and 99 years old from 2012 to 2018. All costs are adjusted for medical inflation and expressed in 2022 dollars. Since the survey is conducted every two years, respondents report their out-of-pocket health care costs for the preceding two years. As a result, the increases reported are for two-year periods.

Given the vast size of the survey, data is released on a lagged basis and different sets of data are available at varying times.

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