DCIIA
Defined Contribution
Institutional Investment Association
10 YEARS
2010-2020

The HSA: The "S" is for Savings (not Spending!)

Part I

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EXECUTIVE SUMMARY

This paper sets the facts straight on health savings accounts (HSAs) and explains how educating employees will be a key factor in the continued growth of these tax-efficient vehicles. As more and more employers move to high-deductible health plans (HDHPs) to reduce insurance premiums for themselves and their employees, education will be crucial in helping employees understand the HSA's long-term savings benefits versus those of the more transaction-oriented flexible spending account (FSA). There is an opportunity now to engage with employees to spark an increase in HSA use as people become engaged in managing their long-term healthcare savings strategies. A second paper, Part II of this HSA series, will explore best practices for utilizing an HSA as part of a robust retirement strategy.

FOR FURTHER READING

Please read *The HSA: The "S" is for Savings (not Spending)! Part II*, our second paper in this series, which explores best practices for utilization of the HSA as part of a robust retirement strategy.

BACKGROUND

Rising health care costs are a top concern for many Americans. The HSA is one of the most powerful tools available to assist in saving and paying for healthcare expenses; however, it is often misunderstood and under-utilized. The HSA—available only in combination with an HDHP—facilitates savings and investment to grow financial resources to cover retiree healthcare spending. HSAs have three tax benefits, namely:

- Contributions are made on a pre-tax basis through payroll, reducing one's taxable income.
- Contributions can be invested and the earnings grow on a tax-deferred basis.
- Withdrawals used for qualified medical expenses are not taxed at the federal level.

An HDHP is a health insurance plan with lower premiums and higher deductibles than a traditional health plan. It is intended to incentivize consumer driven healthcare.

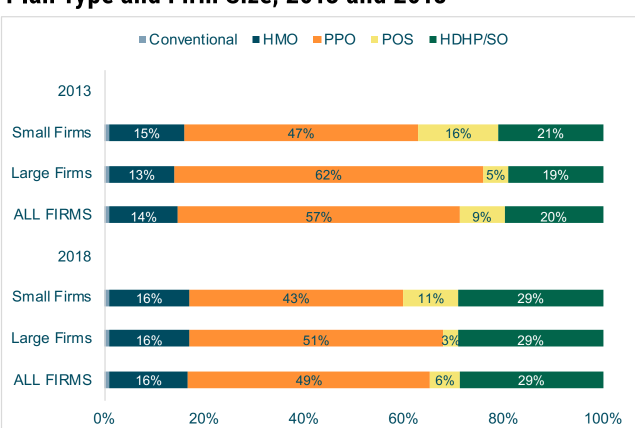
HDHP/HSA EVOLUTION AND DEVELOPMENT

Growth of the HDHP

Increasingly, employers have focused on containing medical benefit costs, while also trying to retain and attract employees. HDHPs have allowed employers and employees to purchase health insurance at lower premiums.

In **Exhibit 1**, findings from the Kaiser Family Foundation[1] illustrate the different types of coverage offered over a five-year period and show that firms of all sizes have increased the percentage of HDHP offerings.

Exhibit 1
Distribution of Health Plan Enrollment for Covered Workers, by Plan Type and Firm Size, 2013 and 2018



Source: Kaiser Family Foundation, "2018 Employer Health Benefits Survey", October 3, 2018.

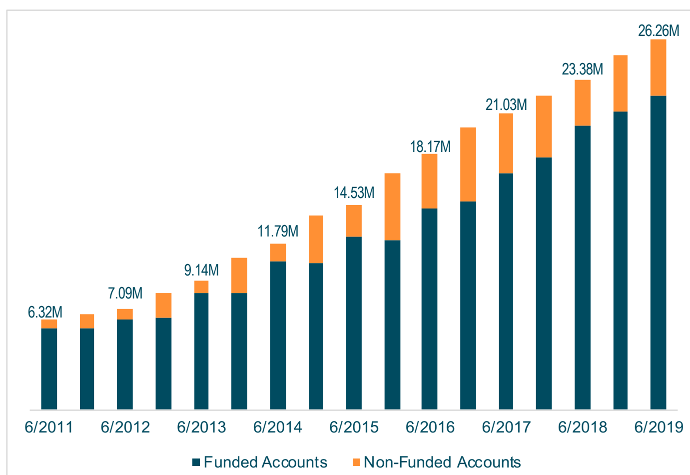
Growth of the HSA

Initial consumer concerns about the difficulty of paying higher deductibles and copays associated with HDHPs brought about legislative change in 2003, when Congress passed the Medicare Prescription Drug, Improvement, and Modernization Act, which created the HSA. The Tax Relief and Health Care Act of 2006 and the Patient Protection and Affordable Care Act (ACA) of 2010 later refined the HSA rules.

Initially, only banks and credit unions offered HSAs. While these accounts gained some traction immediately, they did not reach their full potential until benefit service providers, such as third-party administrators (TPAs), insurance brokers, and investment and insurance companies began to make employer payroll deferral HSA options available. This motivated benefits technology platforms to provide a better HSA solution, including ease of access through debit-card usage. HSA growth accelerated in the number of accounts and asset accumulation.

According to Devenir,[2] HSAs surpassed 26 million accounts as of June 30, 2019, and Devenir predicts that they will exceed 30 million by the end of 2021 (**Exhibit 2**).

Exhibit 2
Total HSA Accounts



Source: Devenir

Note: Bars above represent six month increments. Non-funded accounts are accounts that are open but have no current year contributions.

HSA CONTRIBUTIONS AND BENEFITS

For an HDHP participant to be eligible to contribute to an HSA, the individual must meet four unique requirements:

1. Must be enrolled in an HSA-eligible health plan (like an HDHP)
2. Must not be enrolled in Medicare
3. Must not be claimed as a dependent on someone else's tax return
4. May not be covered under another, non-HSA health plan.

If a spouse is covered by the HDHP and meets all of the requirements above, then additional contributions for the spouse can be made to the employee's HSA.

Once an individual contributes to an HSA, they realize the following benefits:

> An individual cannot contribute to an HSA if enrolled in Medicare, but they can use any saved funds for qualified medical expenses, including Medicare premiums.

- Individuals can deduct contributions made to the HSA on their federal tax return (as they do with their contributions to traditional IRAs), if they were not taken via payroll deductions, which reduces their federal income tax liability.
- Earnings in the HSA grow tax-deferred.
- HSA distributions used for qualified medical expenses are tax-free; this includes both contributions and earnings.
- HSA owners control their assets—both when and how to invest them, and when to use them.
- HSA contributions can accumulate and grow year after year.
- HSA owners keep their HSA assets even if they change employers or health plans.
- HSA owners can reimburse themselves for out-of-pocket expenses that occur after the first HSA is established and still receive tax-exempt benefits. This is known as the Day 1 Rule.

As more data, consumer experience, and success stories become available, we believe HSA usage will continue to grow, as will the benefits HSAs bring to consumers and savers.

HSA CHALLENGES

The HSA faces several growth challenges, the largest of which is overcoming consumers' misconceptions, which include:

- HSA balances must be depleted each year because the HSA is a "use it or lose it" type of spending account.
- HSAs can only be established and contributed to through a payroll deduction.
- HSA assets cannot be invested.

An HSA is not an FSA

For many years, employers offered FSAs as a tax-efficient way for employees to pay for current-year deductibles and copays. According to a 2019 Bank of America report,[3] employers and employees often confuse HSAs with FSAs, which is one reason why employers and employees are not using HSAs.

HSAs and FSAs differ in important ways. While both types of accounts allow workers to set aside money before taxes, thereby providing a tax benefit, the FSA money must be used each year. Funds in an HSA, on the other hand, can accrue over many years through contributions and investment earnings. The contributions and earnings can then be used to pay past, current or future qualified medical expenses, including those incurred in retirement.

Consequently, an HSA's relative benefit over a FSA is the ability to compound tax-deferred dollars saved in years when the employee's medical expenses are not as great as in other years. Those funds can then be carried forward to be used for future expenses or to help meet needs when expenses are higher.

Exhibit 3

Fact vs. Fiction: Helping Employees Navigate HSA Myths

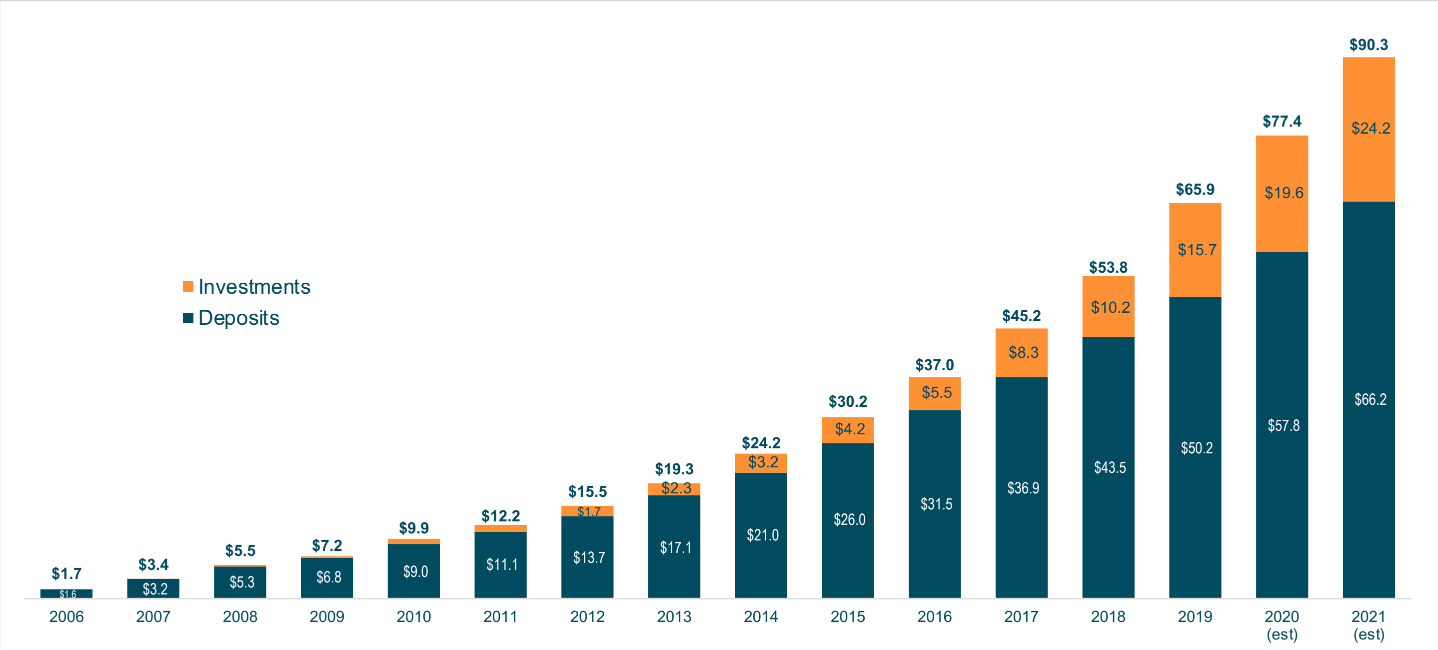
FICTION	FACT
You must use your HSA money by the end of the year or you lose it.	The funds roll over year after year and you can take the account with you to another job or into retirement. You can even save your current receipts to request reimbursement years from now.
Your spouse and children can only use HSA money if covered by your HDHP plan.	Whether you have individual or family insurance coverage, you can use HSA money tax-free for qualified medical expenses for your spouse and tax dependents, even if those family members are covered under a different plan.
You can only invest HSA money in a savings account.	Most HSA platforms offer a variety of mutual funds that you can invest in, similar to a 401(k) plan, once you reach a minimum balance required by the provider (usually $1,000–$2,500).
You can't use money in the HSA after you sign up for Medicare.	Although you cannot contribute to an HSA once you are enrolled in Medicare, you CAN use the funds that you've accumulated.

Highlighting consumers' lack of understanding about the potential to invest their accumulated HSA balances, WEX Health[4] asked survey respondents if they thought a person could invest within their HSA. A surprising 54% answered no, and an additional 6% were unsure.

Exhibit 4 illustrates how HSA assets nevertheless continue to grow, both in terms of cash and investments. Investments alone realized a 54% gain in 2019 and are becoming a standard component in many wealth management portfolios.

Exhibit 4

Total HSA Assets (in billions)



Source: Devenir, "2019 Year-End HSA Research Report"

According to the "Bank of America Merrill Lynch 2019 Workplace Benefits Report," 57% of employees and 65% of employers believe they have a good understanding of HSAs, but actually only 11% and 7%, respectively, could name the four basic attributes of HSAs:

- Employee-owned
- Without expiration and portable
- Offer pre-tax savings, tax-deferred growth and tax-free withdrawals for medical expenses
- Can be invested for the long term

In addition, 16% of HSA accounts remain unfunded, meaning the account holders are not making tax-deferred contributions each year. And, while workers clearly understand that the HSAs are set up to pay for their healthcare copays and uncovered expenses—paying more than 80% of their expenses using debit cards issued to them for their distributions—they do not realize that if they covered smaller items out-of-pocket their HSA balances could be reserved for future healthcare expenses.

Employee Benefit Research Institute (EBRI) Trend Research

EBRI recently examined its HSA database, looking at trends over the 2011-2018 period with regard to account balances, contributions, distributions, invested assets and participant demographics.[5] EBRI's overall findings were that participants appear to be using HSA accounts primarily for current expenses (deductibles, coinsurance and copayments), rather than taking full advantage of potential tax benefits by maximizing savings and preserving HSA balances for healthcare expenses in retirement. Specifically, EBRI found that:

- While HSA balances increased, the increases were modest and balances remained low.
- Average total contributions (combined employer and employee) also increased modestly over the period, and remained at less than half of the allowable amounts for family coverage.
- 59% of participants withdrew funds.
- Very few participants invested their HSA balances in available investment options other than cash.

EBRI had some positive findings, as well. It found over the same time period that participant behaviors changed the longer a participant held their HSA account, reporting that:

- Annual contributions were three times as large for accounts open 10 years versus those that were only one year old.
- At the 10-year mark, 10% of accounts were invested in options beyond cash, compared to 2% of accounts after only one year.

EDUCATION IS KEY

How HSA Fluent Are Employees?

57% of **employees say they understand** how their HSA works

11% Could **actually correctly identify** the common attributes of an HSA

Source: Bank of America Merrill Lynch 2019 Workplace Benefits Report, September 2020.

CONCLUSION

As you have read throughout this paper, HSAs are not well understood, even 16 years after they became available to eligible savers. According to a Bank of America Merrill Lynch 2019 study, only 57% of employees say they understand how their HSA works. What is more alarming, however, is that only 11% of them can correctly identify the attributes of an HSA. It is critical that industry participants fully understand how HSAs function and how they can provide long-term benefits. Only then can we bring this knowledge to employers and participants alike, whether it is through content developed by financial services firms, open enrollment meetings, or benefit fairs.

[1] Kaiser Family Foundation, "2018 Employer Health Benefits Survey", October 3, 2018. https://www.kff.org/health-costs/report/2018-employer-health-benefits-survey

[2] Devenir Research, "2019 Midyear HSA Market Statistics & Trends Executive Summary," August 27, 2019. https://www.devenir.com/wp-content/uploads/2019-Midyear-Devenir-HSA-Research-Report-Executive-Summary.pdf

[3] "Retirement & Benefit Plan Services, Bank of America Merrill Lynch, "2019 Workplace Benefits Report: Expanding the financial wellness conversation," September 2019. https://www.benefitplans.baml.com/publish/content/application/pdf/GWMOL/2019WorkplaceBenefitsReport.pdf

[4] WEX Health, "2018 WEX Health Clear Insights Report: Easing Workers' Concerns About the Rising Cost of Healthcare," 2018.

[5] Paul Fronstin and Jake Spiegel, "Trends in Health Savings Account Balances, Contributions, Distributions, and Investments, 2011-2018: Estimates from the EBRI HSA Database," EBRI Issue Brief, EBRI, January 9, 2020. https://www.ebri.org/content/trends-in-health-savings-account-balances-contributions-distributions-and-investments-2011-2018-estimates-from-the-ebri-hsa

ABOUT DCIIA

The Defined Contribution Institutional Investment Association (DCIIA) is a nonprofit association dedicated to enhancing the retirement security of America's workers. To do this, DCIIA fosters a dialogue among the leaders of the defined contribution community who are passionate about improving defined contribution outcomes. DCIIA's diverse group of members include investment managers, consultants and advisors, law firms, record keepers, insurance companies, plan sponsors and other thought leaders who are collectively committed to the best interests of plan participants. For more information, visit: www.dciia.org.

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