OCTOBER 2020 | WWW.DCIIA.ORG

Defined Contribution Institutional Investment Association

10 YEARS 2010-2020

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

Part II

Contributors

Steve Christenson, Ascensus

Barb Yearout, Ascensus

Rennie Worsfold, Custodia Financial, LLC

Tim Kohn, Dimensional Fund Advisors

Carol Waddell, Empower Retirement

Sasha Franger, Empower Retirement

Kevin Murphy, Franklin Templeton

Denise Faggella, General Electric Company

Robin Rueter, Income Research + Management

Stephen Popper, SageView Advisory Group

EXECUTIVE SUMMARY

In *The HSA: The "S" is for Savings (not Spending)!, Part I*, we explained that a health savings account (HSA) is not a "use it or lose it" type of account—that individuals can use their HSA to accumulate savings, and can invest their HSA balances over the long term. In this paper, we explore how HSAs can be more than a checking account to pay for current medical expenses—they can in fact be part of a comprehensive retirement savings and investment strategy. Through this lens, we explore some best practices for utilization and long-term investment design, which we hope will result in the expanded use of the HSA in just this way.

FOR FURTHER READING

Be sure to read Part I in this series, *The HSA: The "S" is for Savings (not Spending)!*, which provides an overview of the HSA and explores the benefits and current challenges of offering HSAs to employees.

OPTIMIZING AN HSA'S USE

HSAs are designed to allow individuals to save for current and future medical expenses on a tax-efficient basis. Three factors can help maximize the benefits of an HSA:

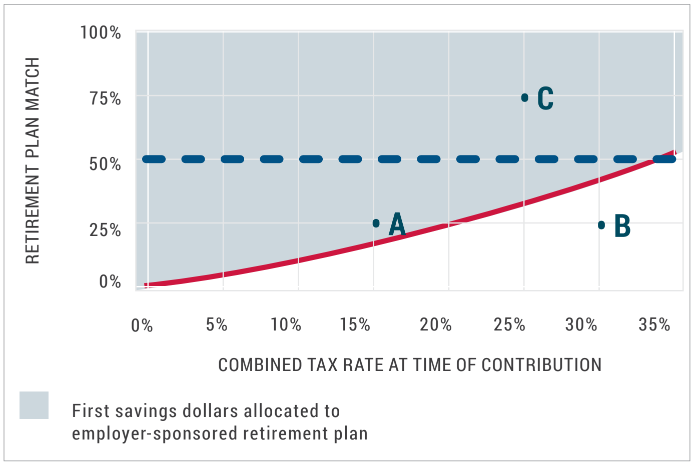
- **Optimize savings**: Consider how to balance savings and how much to save across different account types, including retirement accounts.
- **Invest appropriately**: Assess when and how money in the HSA should be invested to achieve targeted outcomes.
- **Spend wisely**: Think about the HSA as part of a comprehensive health and retirement strategy instead of as a present-day spending account.

OPTIMIZE SAVINGS

When developing long-term savings plans, individuals must first understand how much they can afford to save. Second, they should consider savings options available in terms of tax efficiency, purpose, expense and access to accumulated capital. For example, pre-tax savings accounts often include: 401(k)s/403(b)s or similar employer-sponsored retirement accounts; IRAs; deferred annuities; college savings plans; and HSAs. With so many choices, employees don't often think about where to put their next "savings" dollar so that it will function most efficiently.

To help with this, a simple optimization analysis can be done. The optimization model[1] in **Exhibit 1** shows the relative advantages of allocating savings first to a workplace retirement plan and then to an HSA, or vice versa. The model provides a helpful "rule of thumb" for HSA savers.

Exhibit 1
Savings Optimization Model



Source: Empower Institute, "The New Rx for Retirement: Solving the equation to maximize retirement and health savings," June 2018.

Exhibit 1 displays the optimization results for saving when considering the combined tax rate (represented by the solid line) and workplace retirement plan match (represented by the dashed line):

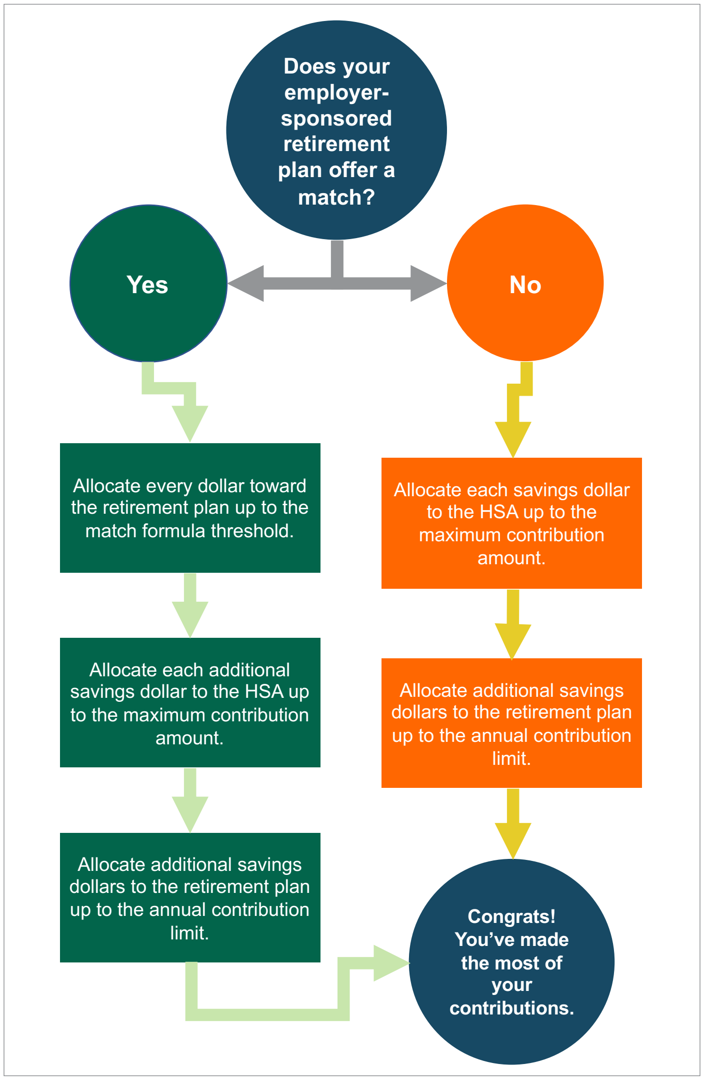
A. If a person falls in the shaded region, they should contribute up to their retirement plan match first, then contribute up to the HSA maximum. This way, the participant takes advantage of the "free" match and then the triple tax benefits of the HSA contribution. Once the maximum HSA contribution is reached, the participant should continue to save more in the retirement plan, up to the maximum allowed.

B. If the person falls in the white region (under the solid line), the opposite is true. This population can optimize long-term savings by maxing out their HSA first and then contributing to their workplace retirement plan.

C. If an employer offers a match of 50% or more, then almost everyone can follow the same rule of thumb, with the benefits noted in the first bullet.

The savings optimization model is revealing, but sometimes employers struggle to communicate these facts to employees. The visual in **Exhibit 2**[2] depicts an easy-to-follow flowchart that can be helpful in educating employees about where to most efficiently save their next dollar.

Exhibit 2
Making the Most of Your Savings Dollars



Source: Empower Institute, "The New Rx for Retirement: Solving the equation to maximize retirement and health savings," June 2018.

INVEST APPROPRIATELY

The Plan Sponsor Council of America (PSCA)'s "2019 Health Savings Accounts Survey Report"[3] found that over 85% of employees who have access to an HSA contribute to it, and that many employees do not spend their full balance over the course of a year. Once employees begin contributing to their HSAs, they usually have an option to invest those dollars. Investing is an important way to grow their balance. HSAs then become more than just a checking account for medical expenses; they are part of a comprehensive retirement savings and investment strategy. Through this lens, we can explore these elements as they relate to some best practices in investment HSA design.

Future medical expenses, whether incurred in the working years or during retirement, are a variable and unknowable annual expense stream that everyone should anticipate funding. Fidelity Investments' 16th annual "Retiree Health Care Cost Estimate" survey[4] shows the average couple who retired in 2018 can expect to spend $280,000 on total healthcare expenses during retirement, which will equal 15% of their total retirement expenditures. Investing in HSAs could help individuals fund these significant retirement medical expenses from money saved during their working years. Using HSA funds during retirement for certain recurring medical expenses—such as Medicare premiums and long-term care insurance—can help them ensure that their other retirement savings are used for the primary goal of maintaining their standard of living in retirement. To be in this financially secure position, an HSA saver must be an HSA investor.

Investment Platform Considerations

There are several considerations that employers should evaluate when selecting their HSA provider. According to Morningstar's "2019 Health Savings Account Landscape" report,[5] HSA providers should follow these general best practices when designing investment-focused HSAs:

- **Menu Design**: Offer investment strategies in all core asset classes while limiting overlap
- **Quality of Investments**: Provide strong investment strategies
- **Price**: Charge reasonable fees for both active and passive strategies.

Employers should evaluate a range of HSA providers by conducting a thorough review of current HSA offerings in the marketplace. HSA platforms have changed over the past several years, with many now offering features similar to those found in defined contribution (DC) plans.

What do HSA platforms currently offer?[6]

- 86% offer investment options for HSA savings
- 91% of employers say their HSA provider selected the investment options
- Minimum balance requirements vary:
  - No minimum: 15%
  - $0 to $1,000: 9%
  - $1,000: 33%
  - More than $1,000: 43%
- Types of investment options vary:
  - 97% offer mutual funds
  - 19% offer self-directed brokerage accounts
  - 4% offer CDs
- Less than 3% of employers offer similar investment lineups for both their HSA and their retirement plan

Top Tips for Evaluating HSA Providers

Gather insight into HSA usage and trends:

1. Request references from the HSA provider's current clients.
2. Review the HSA provider's integration with the employer health plan.
3. Review all associated expenses (e.g., integration, plan fees, participant fees).
4. Evaluate ease of consolidating HSAs.
5. Review participant communications.
6. Evaluate participant web and call center experiences.
7. Review the ease of participant transactions (e.g., enrollment, deposits, funding expenses).
8. Review the breadth of investment options, the requirements and ease of investing assets, and the HSA's ability to mirror the DC investment lineup.
9. Examine the depth of integration of the HSA into the retirement program (e.g., the ability to provide a consolidated view of all retirement accounts, and the ability to integrate HSA assets into retirement income projections).

THE CURRENT HSA LANDSCAPE

The PSCA 2019 HSA Survey Report[7] found that 86% of plans offered an investment platform as part of their HSA; of these, the HSA provider selected the fund lineup 91% of the time.

Only 3% of plans established the same investment lineup in the HSA platform as they did in their 401(k)/403(b) plan.

Investment Options

While employers may not want to assume the obligation of selecting the funds that will be in the HSA, they should understand the lineup being offered, and understand the process and due diligence that the HSA provider undertakes to determine which funds are offered. Some questions employers may ask:

- Does this lineup make sense?
- Do options include target date funds (TDFs) or balanced funds?
- Are the investment strategies robust offerings for my employees?
- Are the investment fees reasonable?
- Is there any flexibility to the provider's "standard lineup"?

To ensure that an HSA program is not treated as a qualified plan and hence subject to Employee Retirement Income Security Act of 1974 (ERISA) requirements, employers should follow certain US Department of Labor (DOL) guidelines.[8] In addition to ensuring that an HSA is completely voluntary, employers should not:

- Limit the ability of eligible individuals to move their funds to another HSA
- Impose conditions on utilization of HSA funds, beyond those permitted under the Internal Revenue Code (IRC)
- Make or influence the investment decisions with respect to funds contributed to an HSA
- Represent that the HSA is an employee welfare benefit plan established or maintained by the employer
- Receive any payment or compensation in connection with an HSA.

Alternatively, a plan sponsor can select an HSA provider that offers investment options that replicate those in their 401(k)/403(b) plan.[9] This type of "mirroring" can simplify the employees' investment decision-making by reducing the choices that they face when selecting where to invest their savings.

Investment Strategy

Employers can help their employees determine their investment strategy by encouraging them to think about their individual savings time horizon. This helps employees make more effective investment decisions.

- **Spend my account to $0 each year**: This is for the employee who uses all their HSA savings each year to meet their medical needs. They cannot risk losing principal and should invest their savings in low-risk, cash investments.
- **Saving for a big medical expense**: This is for the employee who builds up an account balance over a period of less than five years to meet large expenses for care, such as braces, elective surgery or ongoing therapy sessions. They could benefit from investing their assets in shorter-term, lower-volatility funds, ones that can earn some return over the period in which they are investing; they can then also gradually draw down their balance.
- **Packing it away for retirement**: These employees are probably further along in their career and saving as much as they can pre-tax to fund medical expenses in retirement. They will need a full range of investment solutions, much as they do with their retirement plan, to gain the full benefit of investing their HSA dollars to, and through, their retirement years.

By incorporating thoughtful investment design, a robust platform with quality funds, and a communications strategy, employers can confidently encourage employees to use HSAs as part of their retirement planning.

SPEND WISELY

The third way to optimize an HSA is for the account holder to spend efficiently. HSA users fall into four categories: spenders, super-spenders, savers and super-savers. The figures below from a ConnectYourCare 2018 report show the percentage of HSA owners in each category:[10]

- 23% of HSA users use 100% each year (Super-Spenders—spend all of their account)
- 33% of HSA users use 51-100% each year (Spenders—spend most of their account)
- 28% of HSA users use 0.1-50% each year (Savers—save most of their account)
- 16% of HSA users use 0% each year (Super-Savers—save all of their account)

According to this study, 55% of account owners spend most of their account each year, with nearly one-quarter of individuals spending their entire account balance every year. What about the other three-quarters? Are they maximizing their potential to grow their accounts? The data suggests that there are simple barriers to doing so, which employers can help participants overcome. Consider, for instance, that 44% of HSA participants reported they would benefit from investment education and awareness,[11] while another 40% reported that they either simply do not have the time to learn the full benefits, never considered having an HSA, or do not understand the details.[12]

It is important to ensure that employees understand that they can save their HSA funds to cover their healthcare expenditures in retirement—that although the account is available for present-day spending as needed, it does not need to be used up each year. A simple message is best, one that conveys: "The 'S' is for SAVINGS, not spending," and "The HSA is not a 'use it or lose it' type of account." Once this foundation is laid, plan sponsors can strive to further change employee behavior through personalized, interactive decision-making tools. These tools can show, among other things, the impact on take-home pay, as well as a streamlined way to compare medical services.

The critical message for employees is that HSA funds can be used to cover current qualified medical expenses, or they can be saved and used for expenses at some point in the future or some combination of the two. Covering current copays and minor medical expenses out of pocket or with a limited-use flexible savings account (FSA) will allow an HSA balance to grow over time so that it can cover medical expenses in retirement. Alternatively, if expenses in a single year exceed the HSA balance, educate employees that they can save those receipts for reimbursement to themselves using future years' savings.

For those "use it all this year" employees, promote the easy debit-card feature that many providers offer today, which enables account holders to conveniently pay for qualified medical expenses at the doctor's office or a pharmacy straight from their HSA account. Getting employees comfortable with the benefits and features will build long-term user habits.

TIPS FOR HSA EDUCATION

Employers are in an ideal position to help improve their employees' healthcare and retirement outcomes by educating them about HSAs. Here are a few tips to ensure employees know the full value of the HSA:

- **Encourage employee savings**. If employees are enrolled in an HDHP, consider automatically enrolling them in an HSA. Promote the HSA as a means for increasing savings available for retirement.
- **Communicate the HSA's benefits**. Ensure that employees understand the triple tax benefit, as explained in Part I of this series. Make certain that they comprehend the HSA's long-term nature and that HSAs do not have the "use it or lose it" rule of FSAs.
- **Educate employees**. Use the Exhibit 2 graphic to show them how to make the most of their HSA dollars. Help employees determine what type of saver they are and their savings time horizon to help them select the best investment strategy. Illustrate ways to pay out-of-pocket for today's medical expenses while letting their HSA account grow to be used for medical expenses in retirement.

Educating employees on the benefits of having an HSA should lead to an increase in adoption and savings rates, and eventually to increased investment of account balances. This will help to provide employees with enough savings in their HSAs to pay for healthcare expenses in retirement.

CONCLUSION

With proper education we hope to get employees to think of the "S" in HSAs as being for savings. Focusing employee education on the long-term impact of saving in an HSA, both from an investing and tax perspective, can help employees understand how to get the most from their HSAs. This understanding should lead them to make the HSA a key element of their overall retirement strategy.

[1] Empower Institute, "The New Rx for Retirement: Solving the equation to maximize retirement and health savings," June 2018. https://www.empower-retirement.com/empower-institute-the-new-rx-for-retirement
[2] Ibid.
[3] Plan Sponsor Council of America, "2019 Health Savings Accounts Survey Report," 2019. https://www.psca.org/2019HSASurvey
[4] Fidelity Investments, "2018 Fidelity Retiree Health Care Cost Estimate," 2018. https://www.fidelity.com/about-fidelity/employer-services/a-couple-retiring-in-2018-would-need-estimated-280000
[5] Morningstar, "2019 Health Savings Account Landscape," October 2019. https://www.morningstar.com/lp/hsa-landscape
[6] Empower Institute, "The New Rx for Retirement: Solving the equation to maximize retirement and health savings," June 2018.
[7] Plan Sponsor Council of America, "2019 Health Savings Accounts Survey Report," 2019.
[8] Employee Benefits Security Administration, "Health Savings Accounts – ERISA Qs &As," Field Assistance Bulletin No. 2006-02, US Department of Labor, October 27, 2006. https://www.dol.gov/sites/dolgov/files/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2006-02.pdf
[9] Ibid.
[10] ConnectYourCare, "CDH Account Trends: Tax-Advantaged Account Usage, Outlook and Perceptions – 2018 Report," 2018.
[11] Ibid.
[12] Franklin Templeton's 2019 "Retirement Income Strategies and Expectations (RISE) Survey" was conducted online among a sample of 2,002 adults, comprised of 1,000 men and 1,002 women, all 18 years of age or older.

APPENDIX

Case Study: Dimensional Fund Advisors

Dimensional Fund Advisors[1] recently undertook a redesign of its HSA to reframe the benefit as a part of its comprehensive retirement savings and investment strategy, instead of having employees view it simply as a mechanism to pay current medical expenses. Beyond that overall strategic objective, Dimensional wanted to accomplish two specific goals:

1. Expand the number of employees investing their HSA savings. (Dimensional's original program required a minimum $1,000 cash balance threshold before savings could be invested. At the time, only 14% of employees had sufficient balances to invest, and only 5% were actually doing so.)
2. Increase the percentage of account holders selecting an investment option instead of leaving the funds in the cash account.

Dimensional worked with the firm HealthSavings Administrators to offer a new HSA option. In doing so, it accomplished the following:

- Removed the minimum cash account threshold to allow for first-dollar investing. Also gave employees the option to either continue using their existing HSA or transfer their balance to the new account in the first year.
- Provided new initial and ongoing education through focused, hour-long informational meetings and a series of ongoing communications, which included infographics, educational content for those who didn't attend the initial meetings, and a short video.
- After a year, all HSA accounts were migrated to the new HSA by the employer.

Through these efforts, Dimensional was able to achieve:

- A six-fold increase in employees investing at least a portion of their HSA balance;
- A four-fold increase in the percentage of HSA funds invested; and
- A three-fold increase in the average HSA balance.

Further, Dimensional observed a shift in savings versus spending, with 50% of employees maxing out their HSA contributions, and 54% not making any health-related spending withdrawals.

[1] Dimensional Fund Advisors and HealthSavings, "Investing In A Healthier Future, April 2019.

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.

DCIIA Defined Contribution Institutional Investment Association 10 YEARS 2010-2020