Evaluating the Investment Potential of HSAs in Benefit Programs

Despite its complexities, the health savings account (HSA) is a powerful and growing element of the U.S. financial landscape. In the future, employers will likely be expected to provide tax-advantaged savings programs for employees’ current and future medical expenses. This article discusses investment lineup issues that must be addressed in order to optimize HSAs to help participants achieve successful outcomes. Plan sponsors at the forefront of addressing these issues (and perhaps others) will be in a better position to help their employees maximize both the health benefits and the wealth benefits provided for a secure retirement.

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Although there’s no guarantee about what the future may be for health savings account (HSA) investments, the U.S. Department of Labor has incorporated HSAs into its recent guidance regarding the definition of a fiduciary. It’s possible that as the assets in these accounts grow, regulatory scrutiny over the investments offered to employees through such accounts will increase. Given the potential shift in regulatory oversight, plan sponsors should consider whether it’s appropriate to start monitoring HSA investment options on behalf of their employees/participants.

In the past, HSAs (often viewed similarly to flexible spending accounts) have been used as “checking accounts” by many account holders. Historically, the majority of participants spent the balances in a short or intermediate time period to pay for medical costs. (See the sidebar.) However, a growing number of participants are now using the accounts as an additional form of long-term savings, allowing more meaningful account balances to roll over from year to year. According to the Employee Benefit Research Institute (EBRI), the average HSA balance increased by approximately 33% in 2014, suggesting that larger account balances will be rolled over year to year.

Despite the increasing popularity of HSAs, the investment component of these long-term savings requires some development. Since their introduction in 2003, HSAs have provided investment choices (mutual funds) to participants, but usually only after a minimum was kept in the “cash account.” According to EBRI, only about 6% of HSAs had investment assets at the end of 2014, posing a significant opportunity for investment accounts to grow and participants to take advantage of this benefit.
Indeed, a number of recent studies have documented the cost of health care as one of the biggest concerns faced by employees as they approach retirement. According to Mercer’s 2015 Survey of Employer-Sponsored Health Plans, 32% of respondents described employee saving for health care expenses in retirement as a major savings obstacle, up from 24% in 2014. To address this concern, the cost of living should be combined with the cost of health care in retirement, leading to the inclusion of HSAs as one of the pillars of retirement savings.

Even so, HSAs differ from other types of retirement savings programs, as future expenses may be hard to anticipate. It’s nearly impossible to predict medical costs and life events such as marriage, children or job changes that might cause a participant to switch from an HSA-compatible high-deductible health care plan to a non-HSA-compatible traditional plan, such as a preferred provider organization (PPO) or health maintenance organization (HMO).

But the potential value of HSA investments to participants can be significant.

**A Brief History and Background of HSAs**

Health savings accounts (HSAs) came into existence with the signing of the Medicare Prescription Drug, Improvement, and Modernization Act (enacted in 2003). HSAs allow taxpayers enrolled in high-deductible health care plans to set aside pretax funds to pay for or reimburse a multitude of incurred medical expenses, whereas IRS sets a maximum limit on annual out-of-pocket expenses within the associated high-deductible plan.

Although HSAs (federally tax-free) cannot be used to pay for health insurance premiums, distributions from the accounts are tax-free if used to pay qualified long-term care insurance premiums, Medicare premiums (for those 65 or older) and Consolidated Omnibus Budget Reconciliation Act (COBRA) premiums for those receiving unemployment benefits.

Supporters of the HSA system claim they are an efficient way to address rising health care costs and allow patients to access the care they need while reducing the hurdles of seeking reimbursement through an insurance company.

HSAs have similar structures and contribution limits to those of Roth individual retirement accounts (IRAs), although with different taxation rules. Like IRAs, HSAs are portable and feature annual contribution limits. For 2016, participants under the age of 55 years can contribute up to $3,350 for an individual and up to $6,750 for a family. Once HSA holders turn aged 55, they may begin to save an additional $1,000 per year (catch-up provision).

HSAs offer a triple tax effect, making these assets a powerful investment:

- Pretax contributions (in the year made) result in a reduction of taxable income.
- Earnings on the account compound tax-free (similar to IRAs/401(k) assets).
- Distributions used for qualified medical expenses from the account are not subject to taxation.
- And as a bonus, any distributions after aged 65 can be made for nonmedical expenses and are taxed as ordinary income (similar to IRAs/defined contribution assets) with no penalties.

Note: HSAs are federally triple-tax-advantaged, but several states do still apply state taxes for contributions, earnings and/or distributions.

Retirement Value Added by HSAs

Using very simplified assumptions, it’s possible to calculate the value added by HSAs for today’s employee during the accumulation phase, beginning at the age of 22. Based on a return of 6%, if a participant rolls over about half of the annual HSA contributions maximum of $3,350 for 2016 ($1,750) from year to year (not spent on health care), his or her HSA could grow to $350,000 at retirement.

However, using slightly different assumptions—a major chronic illness with the high cost of prescription drugs (assuming $2,000 per year, starting at the age of 45), a reduction in DC contributions from $18,000 to $10,000 because of the additional health-related expenses and a stoppage of HSA contributions after 20 years—a new value of approximately $200,000 results.

With either example, the savings potential is powerful if participants start
contributing early. HSAs also provide a tax-advantaged vehicle to cover medical expenses throughout retirement or can be used as ordinary income for other spending needs in retirement.

As mentioned, HSAs are not yet subject to fiduciary oversight by plan sponsors/employers and, therefore, fee structures do not have the same transparency requirements as those placed on defined contribution (DC) retirement plans today. Although many DC plans are seeking to provide enhanced transparency to participants, the fees associated with a particular HSA account remain opaque.

HSA fee structures for investments offered to employees often include both an account fee and some type of revenue sharing within the investment products offered. As a result, the investment fees associated with HSA accounts are often significantly higher than similar investments offered through the DC plan. Considering the negative impact fees can have on returns, plan sponsors should look to how the HSA providers are being paid on participant account balances.

After reviewing several HSA lineups, we find that most programs include higher priced mutual funds than their DC counterparts. For instance, HSAs may be invested in “A” share classes, which could be ten to 30 basis points higher in cost than the institutional share classes often found in DC plans, which again undercuts investment returns. This is true of both active and passive options. For example, one HSA we reviewed owned a Barclays U.S. Aggregate Bond Index fund at 22 basis points and an S&P 500 Index fund at nine basis points. Both are roughly two to four times the fees of DC plans based on their size and scale of assets. However, there are some lower cost HSA providers in the marketplace.

As it stands today, aligning the investment options of a DC plan with a firm’s HSA would be very burdensome. Since HSA providers usually are not DC recordkeepers, getting access to the same funds in both places might be difficult. More important, if plan sponsors start to select investment options, regulators may deem them fiduciaries. Sponsors should be aware of this added responsibility.

**Structuring the Investment Lineup**

Until recently, HSA providers typically determined the HSA investment fund lineups offered to employees. It ap-
It appears there is relatively little analysis conducted to determine whether the investment structure within a plan will best meet the needs of participants, such as expected health care costs or the “checking account” versus “long-term investment account” mentioned above.

Thus, plan sponsors should consider the following when becoming actively involved in structuring the investment lineup within the HSA offering:

- Although not commonly used today, target-date funds and income-based funds may be appropriate for participants, as they serve two different purposes for long-term savings in premixed options:
  - Target-date funds are appropriate for a majority of healthy individuals who are using HSAs as a long-term savings vehicle. The glidepath provides participants with a professionally managed asset allocation that becomes more conservative as the employee nears retirement, essentially moving in line with the individual’s health profile.
  - Income-based funds (including both fixed income and some equities) are appropriate for those individuals who would like to reduce their risk exposure with a more conservative option, as they may have a better indication of their health care costs.
- The cash portfolio within the HSA could be a fitting place for some of the new innovations coming to DC plans for principal protection and inflation sensitivity, as these assets are commonly used for the “checking account” portion of the portfolio.
- Finally, the current investment lineups look like DC plans of the past—too many funds, with considerable overlap, potentially resulting in participants making poor investment decisions due to anxiety and confusion.

To date, managed account providers have been able to do little to incorporate an HSA into their investment analyses. An HSA used to save for retirement would benefit from the same tools and guidance managed account providers use for more common retirement accounts. As the popularity of these accounts continues to grow, there is significant unrealized opportunity for managed account providers to combine health and wealth savings when guiding investors toward their retirement savings goals.

Despite the complexities discussed here, the HSA is a powerful and growing element of the U.S. financial landscape. In the future, employers will likely be expected to provide tax-advantaged savings programs for employees’ current and future medical expenses. But in order to optimize this benefit so that participants achieve successful outcomes, the above issues need to be addressed. Plan sponsors at the forefront of addressing these issues (and perhaps others) will be in a better position to help their employees maximize both the health benefits and the wealth benefits provided for a secure retirement.