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HSAs: A Misunderstood and Underutilized Investment

Since their introduction in 2004, health savings accounts (HSAs) have become an important vehicle through which Americans can save for medical expenses. HSAs can be a valuable investment vehicle for many Americans given that there is more than $45 billion now being held in HSAs and that the money can be invested according to the saver's discretion.

But they remain underused in many ways, thanks to common misperceptions of what HSAs are and how they can be utilized. In this *Issue Brief*, we'll look at some of the most common misunderstandings surrounding HSAs, some of the reasons investors are not taking full advantage of them, and what the future might hold for this valuable tool. The following are some of the key insights:

- A recent survey by LIMRA found that 51% of Americans consider themselves to be knowledgeable about HSAs, yet 41% of those who say they are knowledgeable still mistakenly believe that the balance in an HSA must be spent by the end of the year or forfeited.
- Although many people consider HSAs to be in roughly the same category as flexible spending accounts, HSAs are actually more similar to IRAs. For people over age 65, the assets in an HSA are not limited to medical expenses.
- The number of HSA accounts reached 22 million by the end of 2017, holding a total of about $45.2 billion in assets. Devenir projects that the HSA market will exceed $60 billion in assets by the end of 2019, including roughly 27.5 million accounts.
- Account holders are not taking full advantage of the investment possibilities. Just 18% of all HSA assets were in investments as of December 31, 2017.
- Based on a LIMRA survey, nearly all of the surveyed advisors (96%) say they would like to learn more about HSAs.
- Enrollment is stronger among younger people than many advisors may realize; 32% of all enrollees are under age 24.

Background Snapshot

Health savings accounts replaced the old system of Medical Savings Accounts (MSAs), which had been established in 1996. MSAs had been restricted to those without health insurance, self-employed individuals, and small employers with 2 to 50 employees. As part of his presidential platform, George W. Bush promised to expand the MSA program, making them much more widely available. The legislation establishing HSAs was included in the Medicare Prescription Drug Improvement and Modernization Act of 2003, and they officially became available to Americans in January 2004.

The primary restriction, then as now, was that HSAs were limited to those in high-deductible health plans. Currently, the IRS defines a high-deductible health plan as any plan with a deductible of at least $1,350 for an individual or $2,700 for a family.

In 2004, the first year HSAs were available, the contribution limit was $2,600 for an individual and $5,150 for a family. That's now at $2,450 for an individual and $6,900 for a family, plus an additional $1,000 for any HSA saver who is age 55 or older.

Misperceptions Abound…

A recent survey by LIMRA found that 51% of Americans consider themselves to be knowledgeable about HSAs. That would leave roughly half the American populace lacking sufficient information about HSAs to make optimal use of them.

But the survey also establishes that the public's general knowledge of HSAs is not quite as strong as that topline figure might indicate. A sizable number of those who responded that they were knowledgeable about HSAs (41%) still mistakenly believe that the balance in an HSA must be spent by the end of the year or forfeited. Indeed, most of the respondents in the survey said they expected to use the money in their HSA for current health care expenses.

Many of these people are likely confusing HSAs with the similar flexible spending accounts, which are generally "use it or lose it" plans that must be spent each calendar year. While FSAs are intended to cover normal recurring medical expenses, HSA plans are designed to encourage people to save for long-term health care needs. Although they are both savings plans for health care purposes, the differences between them are vitally important for savers to understand.

That mistaken sense on the part of many that the money in an HSA must be spent in the near future may also help explain why many savers do not see them as an investment vehicle. If people are not aware that they may be able to hold on to this money for the long term, in some cases for decades, they are not likely to maximize its value as an investment. Since HSAs can be used to pay for health care and long-term care expenses even into retirement, they are in reality a viable option for long-term investing strategies.

Many savers may also be unaware that for people over age 65, the assets in an HSA are not limited to medical expenses. For those of retirement age, HSAs become more like IRAs, with distributions that are taxable at ordinary income rates.

There is also some misapprehension regarding eligibility. As many as 16% of all Americans believe that their income must be below median levels in order to qualify for an HSA, according to a 2014 survey conducted by Princeton Survey Research Associates. The limits on HSAs in reality have nothing to do with income, although they do require that the account holder be enrolled in a high-deductible health insurance plan. The same Princeton survey indicated that only 14% of respondents knew that a high-deductible insurance plan was a requirement to open an HSA.

The LIMRA study showed that financial advisors are attempting to address this lack of knowledge on their clients' part. Seven in 10 advisors surveyed have specifically addressed the use of an HSA for the clients as a means of funding health care or long-term care. But even those advisors concede that they don't have as much knowledge of HSAs as they would like to have. Nearly all of the surveyed advisors—a whopping 96%—say they would like to learn more about HSAs.

…Despite the Strengths of an HSA

Although, as we have seen, many people consider HSAs to be in roughly the same category as flexible spending accounts, it makes more sense to analogize HSAs to IRAs. Like IRAs, HSA balances can be invested in mutual funds, stocks, and bonds. These choices are limited to the options offered by the plan sponsor, and are often fewer than those offered by IRAs or 401(k)s. But they are in most cases broad enough to satisfy the needs of individual investors, particularly since HSAs serve as a supplement to a retirement plan rather than the primary account.

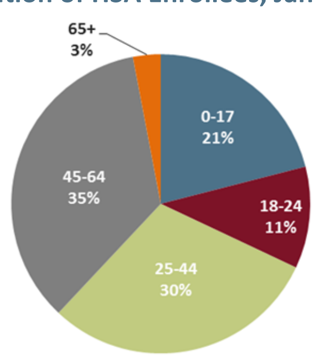
The tax advantages of HSAs are considerable. Contributions are tax-deductible, or if made through a payroll deduction, they are pretax. The interest accumulates in the account tax-free, and withdrawals for qualified medical expenses are tax-free as well.

Before age 65, distributions are limited to health care needs. On top of that, there is also a 20% penalty for withdrawals for nonqualified medical expenses, including such things as elective cosmetic surgery, hair transplants, and health club memberships.

Starting at age 65, though, account owners may take penalty-free distributions for any reason, not limited to medical needs. However, only withdrawals for qualified medical expenses are considered tax-free. The money can stay in the account for as long as the saver wishes; there are no required distributions as there are for such things as traditional IRAs.

Since the structure of HSAs makes them well-suited as a long-term investment vehicle, they are particularly useful for younger savers, who will benefit most from the long-term returns they can offer. Enrollment is actually stronger among young people than many advisors may realize, even though younger cohorts generally are less likely to incur sizable medical expenses. One reason for this is that younger people are more likely to enroll in a high-deductible health plan, knowing that they are unlikely to incur high out-of-pocket medical costs.

Age Distribution of HSA Enrollees, January 2017



Source: America's Health Insurance Plans (AHIP), April 2017

The younger than age 18 cohort would be those enrolled under a family plan. The tiny percentage of people aged 65 or older enrolled in an HSA may be explained by the fact that people on Medicare are not eligible to open an account. HSA enrollees who are over 65 would have almost certainly opened their account when they were younger.

HSA Plan Market Growth

The most recent comprehensive market sizing of the overall HSA plan market is the *2017 Year-End HSA Market Statistics & Trends* by Devenir Research, based on a survey conducted in January 2018 among the top 100 HSA providers.

The number of HSA accounts reached 22 million by the end of the year, holding a total of about $45.2 billion in assets. That represented a year-over-year increase of 11% in accounts and 22% for HSA assets for the year ended December 31, 2017. There was an average balance of $16,457 in each invested HSA, counting both deposits and investment accounts.

Although they don’t approach the total amount held in IRAs or 401(k), HSA investment assets are a significant and fast-growing class. There was an estimated $8.3 billion in HSA investment assets as of December 31, 2017, a 53% increase from the year-earlier figure. Devenir projects that the HSA market will exceed $60 billion in HSA assets by the end of 2019, held among roughly 27.5 million accounts.

Total HSA Assets ($ Billions)

Source: Devenir Research, “2017 Year-End HSA Market Statistics & Trends” February 2018

Yet account holders are not taking advantage of the investment possibilities. Just 18% of all HSA assets were in investments as of December 31, 2017.

At the same time, though, savers are not shortchanging their retirement accounts for the sake of funding an HSA. Fidelity looked at the accounts of its customers who had both an HSA and a defined contribution retirement plan, and found that those people saved on average 10.7% of their annual income in the retirement account. Those who had only a defined contribution plan actually put less of their money into it, an average of 8.2% in that account.

One key finding from the Devenir study was that direct employer relationships have become the leading driver of new account growth. They accounted for 41% new accounts opened in 2017. Source of funds in HSAs include:

- 21% of all HSA dollars contributed to an account came from an employer, with the average employer contribution at $604.
- 63% of all HSA dollars contributed to an account came from an employee, with the average employee contribution at $1,921.
- 14% of all HSA dollars contributed to an account came from an individual account not associated with an employer, with the average individual contribution at $1,475.

According to America’s Health Insurance Plans, the following are the top five states with the largest reported HSA enrollment levels:

1. Illinois (1,623,027 accounts)
2. Texas (1,534,513)
3. Minnesota (1,178,559)
4. Ohio (1,008,177)
5. California (1,001,308)

Positive Outlook for HSAs

Industry experts see a strong opportunity for continued growth in HSAs. Both researchers and financial advisors alike consider HSAs to be underutilized at this time.

“Today, only a quarter of Americans plan to use HSA assets to fund future health care costs in retirement,” said Judy Zaiken, corporate vice president and project director at LIMRA, upon the release of its HSA study. “The findings underscore a great opportunity for the industry to educate consumers and advisors on the value of using HSAs for tax-free asset growth and as a financial hedge against retirement health care costs, which is still an uncommon strategy.”

“As the onus of providing income during retirement is increasingly the responsibility of the individual, it is critical for the retirement income industry to drive consumer education on the value of participating in an HSA,” said Cathy Weatherford, president and CEO of the Insured Retirement Institute (IRI). “While the need for more education is clear, it is encouraging to see the continued growth of HSAs over the past decade and the increasing number of employers offering and seeking avenues to offer these accounts in their benefit packages.”

Many advisors are also beginning to see the investment opportunities in HSAs. This was a popular topic of conversation at the Schwab Impact conference in Chicago in November 2017. “It is one of the areas that will be the rocket booster in 2018,” said Peter Stahl, president of Bedrock Business Results, who spoke at the conference. “I want to be managing the HSAs as well as the 401(k)s. We're going to mirror what we're doing in the 401(k).”

FUSE expects HSA assets to exceed Devenir’s projection of $54.5 billion by the end of 2018. In addition to covering medical expenses, HSAs also reduce taxable income. We believe more people will embrace it as an additional retirement savings vehicle. However, they need to be made aware of HSA’s triple tax break (tax-deductible contributions, tax-deferred asset growth, and tax-free withdrawals for medical expenses), portability, and rollover flexibility.