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Does HSA Participation Help or Hinder DC Savings?

Employers face the dual challenge of managing ever-rising health care costs and equipping employees for a solvent retirement. Meeting both is essential to the long-term success of the organization and its ability to manage its human capital effectively.

High-deductible health plans (HDHPs) have been gaining popularity in recent years due to their ability to help manage the growth of health plan costs, while empowering employees to be wise purchasers of health care services. Today, new evidence is emerging that health savings accounts (HSAs), a critical component of HDHPs, can have a symbiotic and mutually beneficial relationship with 401(k) and similar defined contribution plans. Employers that embrace HSAs and nurture a "culture of savings" within their workforce can address their benefit cost challenges as well as help safeguard the long-term well-being of their employees.

HSAs, only offered in conjunction with an HDHP, came into existence in 2004, about three years after the birth of the HDHP. Today, approximately half of employees in large companies, and about 16% of employees of smaller organizations, have access to an HDHP. An estimated 21 million individuals were covered by such plans (whether they feature an HSA or Health Reimbursement Account) in 2010[1]. In addition to employee contributions, nearly two-thirds of employers provide employer contributions to their employees' HSA accounts[2].

Key Takeaways for Employers:

- HSA participation positively impacts defined contribution savings[3]
  - 1 in 5 (20%) employees actually *increased* their 401(k) deferral amount within a year of establishing an HSA.[3]
  - HSA participants across all income levels defer more in their 401(k) plans than the average DC participant at the same income levels.[3]
  - HSA participants of all ages and incomes have significantly higher average DC account balances than the average DC participant at the same age and incomes.[3]
- Fidelity's analysis of 50,000 HSA accounts[4] reveals key behavioral distinctions between three primary groups of HSA account holders: spenders, savers, and hybrids.
- Many organizations are building a "culture of savings." The more employees become engaged in saving for current and future health care expenses, the more they take action with regard to retirement readiness.

Shift towards Defined Contribution Health Care Plans

As complexity in health care continues to intensify, some employers are beginning to take a defined contribution approach to health care plans. This means employers may move away from a "defined health care benefit" and employees may be asked to shoulder more responsibility for their health care expenses. Employer expenditures may become more predictable and employees may be better motivated to take more personal responsibility for their overall health and wellness which could potentially help reduce their health care-related expenses.

The ongoing growth of HDHP and HSAs can be attributed to several factors:

- Steadily rising health plan premiums continue to motivate employers to seek ways to bend the stubborn cost curve.
- HDHPs with an HSA component provide a tax-advantaged savings vehicle for employees who may not tap into their health care benefit very often. In many cases employees may overpay when they participate in traditional health benefit arrangements. (In other words, they may be over-insured or overpay for the coverage they actually need. Over-insuring ties up dollars that could be used for savings or health care expenses when needed in the future.)
- HDHPs typically provide first-dollar coverage for prevention and wellness-oriented health services. This supports growing employer efforts to nip preventable costly medical conditions in the bud. When health promotion programs are incorporated into the HDHP framework, employers can better leverage their investments in wellness programs to increase employee engagement.
- As an effective use of health improvement incentives, some employers are connecting health and wealth savings initiatives by depositing earned wellness incentives into employee HSAs.

Three tax advantages to consider

HSAs are tax-advantaged savings accounts that are paired with HDHPs. For calendar year 2012, the annual contribution limit for joint filers is $6,250 ($3,100 for a single-person plan) a year, including pretax contributions from your employer, plus $1,000 in "catch-up" for those 55 and over. Consider the tax benefits of an HSA:

- The money you put into an HSA is tax deductible
- Investment gains are tax deferred
- Withdrawals from the account are tax free[5] when used to pay for qualified medical expenses[6]

Beyond the tax considerations, HSAs offer a distinct advantage over Flexible Spending Accounts (FSAs): Unused HSA funds remain available indefinitely, versus the FSA annual "use it or lose it" limitation.

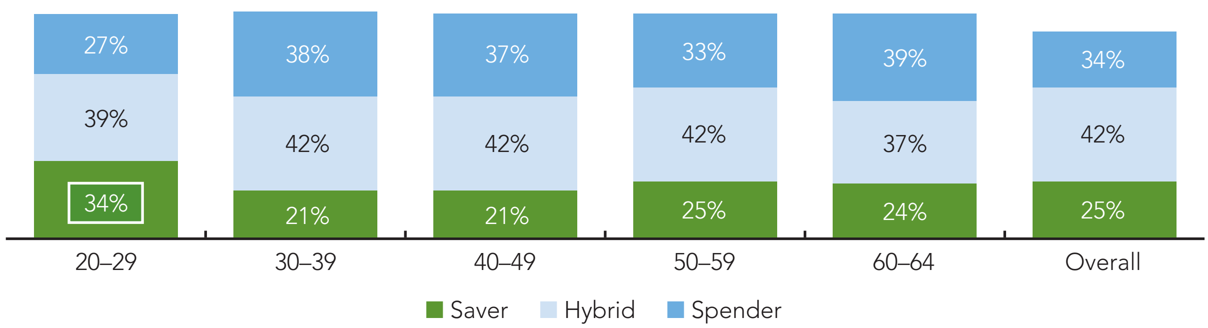
How Are HSA Participants Using Their Funds?

As HSAs emerge from their infancy, certain demographic patterns of HSA account holders are coming into focus. One particularly significant finding pertains to how employees use their funds on a year-to-year basis. Fidelity's analysis of HSA utilization patterns, based on reviewing nearly 50,000 HSA accounts[4] reveals key behavioral distinctions between three basic groups:

- savers, who spend less than 10% of their HSA funds each year
- spenders, who tap at least 90% of their contribution each year, and
- hybrids, who fall somewhere in the middle

1 in 4 (25%) HSA participants are savers; spenders comprise about one-third (34%) of the total, and the balance (41%) fall into the hybrid group. But the employee age patterns vary within each group, as Figure 1 below reveals. With one exception, hybrids are the most common group within each age bracket.

Figure 1: HSA Participants by Age and Profile — 2010



Source: The data is based on analysis of nearly 50,000 Fidelity HSA accounts, from January 1, 2009 to December 31, 2010.

A more notable pattern is that savers tend to be younger employees and spenders tend to fall into the higher age brackets. The high-water mark for savers occurs in the 20–29 age grouping, where they represent 34% of the total. Higher HSA balances for younger workers may reflect both a lower-than-average health care utilization, as well as recognition of the financial and tax-efficient benefits of long-term saving via an HSA.

That conclusion may be supported by another slicing of the data:

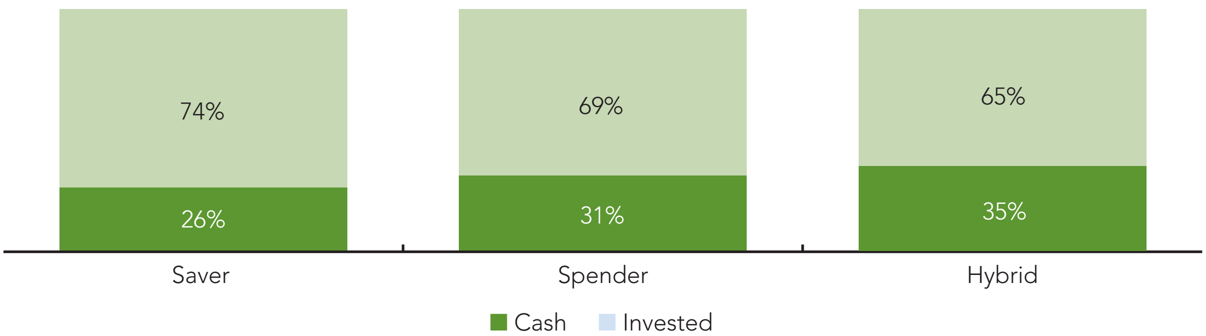
- Savers contribute 17% more, on average, to their HSAs than spenders ($2,896 vs. $2,466 annually).
- The large hybrid group, on average, contributes the most ($3,443), possibly due to the fact that they tend to dominate the middle age brackets and may be most likely to buy family coverage, which offers higher contribution limits. In addition they realize they may need to spend some to pay for medical bills today, but also want to save some for health care expenses in retirement — therefore they tend to contribute more than the savers and spenders to help ensure they have enough for both the bills and savings.
- The overall average HSA balance is $2,994.

Savers Are Planning Now for the Long Haul

Employers should consider encouraging HSA participation at all ages, perhaps with particular emphasis on younger workers. It may be easier to get younger workers enrolled, given their typically lower health expenses. Employee communication efforts need to emphasize that their health and financial circumstances will change throughout their careers, so taking advantage of the opportunity to save over the entire course of their career is critical. Employees must also understand the prospect that health care costs will continue to rise well into the future. Employers and employees alike should view the HSA opportunity not merely as an annual enrollment decision, but a long-term commitment.

HSA holders can invest their HSA dollars in mutual funds, as well as ETFs and other securities, keep them in a cash position, or allocate HSA dollars to a combination of investment options. In general, the smaller the HSA account balance, the higher the likelihood the account is held in cash. The majority of HSA accounts with less than $2,500 in assets, for example, are held in cash. Figure 2 below, however, reveals an important distinction between the investment patterns of savers and spenders. Specifically, of HSA holders who have a portion of their accounts invested — savers are the most highly invested (74% invested/26% cash, on average).

Figure 2: Invested Accounts Split Between Cash and Investment by Profile



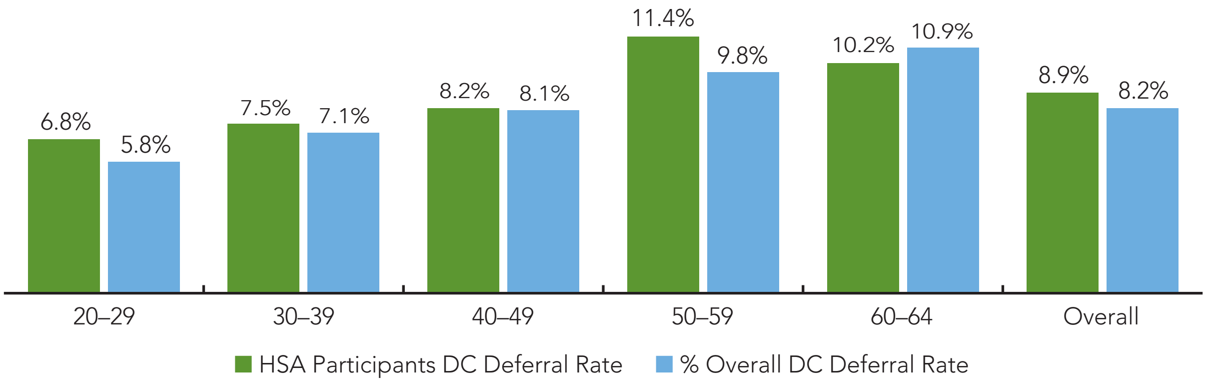
Source: Based on analysis of nearly 50,000 Fidelity HSA accounts, from January 1, 2009 to December 31, 2010.

HSA Savings Help, Not Hinder DC Savings

A logical question for employers considering adopting a new HDHP with an HSA (or stepping up the promotion of an existing plan) is whether employee saving for health expenditures in an HSA comes at the expense of their retirement saving through a 401(k) plan. It is an important question, because if the answer were "yes," the wisdom of promoting 401(k)s and HSAs with equal dedication might be counterproductive. However, Fidelity's analysis of plan participant data shows that it is not a zero sum game. In fact, the opposite is true.

Figure 3 on page 5 shows that the average 401(k) salary deferral rate of employees was 8.2%, but the average deferral rate for employees who also contributed to an HSA was a significant 70 basis points higher — 8.9%. When the data is segmented by age bracket, only one age group of HSA participants — the oldest — deferred less (on average) in their 401(k) plans than the average DC participants.

Figure 3: Average 401(k) Deferral Rates for HSA Participants by Age



Source: Fidelity Investments analysis of 50,000 HSA accounts as of 12/31/2010 and 11 million DC participant accounts as of 12/31/2010.

Equally significant, during the two-year period studied, 1 in 5 participating employees actually *increased* their 401(k) deferral amount, by an average of 4.2 percentage points, within a year establishing an HSA. That pattern was most prevalent among younger employees. In addition, 15% of employees decreased their 401(k) deferral rates after beginning to take advantage of an HSA.

"Even in these cases, many such employees have increased their overall savings rates when the HSA and 401(k) savings amounts are combined," observes William Applegate, vice president, HSA business development for Fidelity Investments. And of employees who reduced their DC deferral rate within the first year following HSA enrollment and 1 in 4 (25%) actually went back and increased their DC deferral rate in the second year following HSA enrollment.

The conclusion that HSA participants do not "cannibalize" an existing 401(k) plan overall is bolstered by a review of HSA participant data segmented by income. "We find that HSA participants across all income levels save more in their 401(k) plans than the average 401(k) plan participant," Applegate says. This suggests that the presence of an effective HSA program, featuring annual employer contributions and aggressive employee communications efforts, can contribute to a "culture of savings" within the workforce.

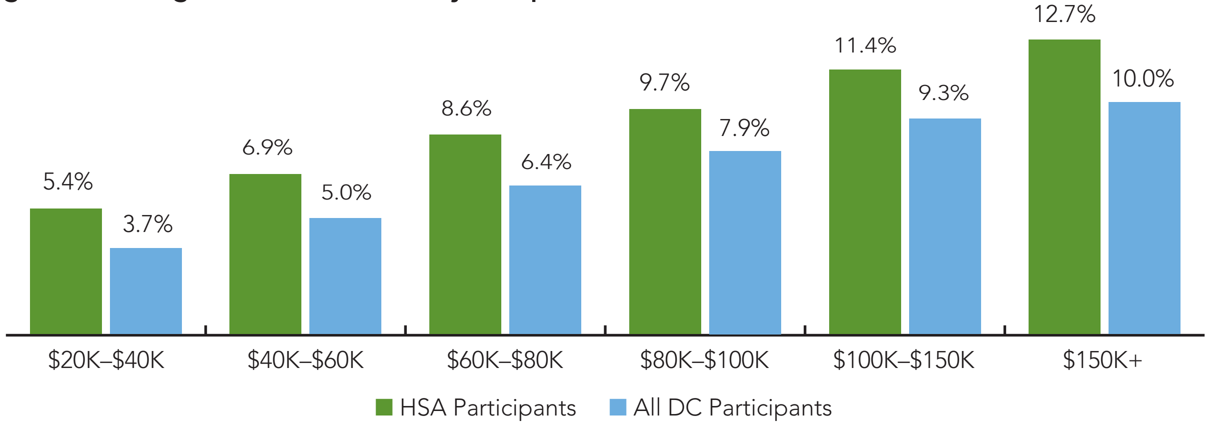
HSA Participants Save More and Have Higher DC Savings vs. Average DC Participants

A comparison of the 401(k) account balances for HSA participants to the average DC account balance reveals that the average 401(k) balance is $71,500 versus for those with HSAs: their average DC balance is $170,500[3,4]. HSA participants have nearly $100,000 more saved in their DC plan. While the actual differences in 401(k) balances between employees with or without HSAs vary by income bracket, the higher 401(k) balance pattern is consistent. For example, for those making $20,000–$40,000, the average 401(k) balance is $19,074 versus $30,342 for HSA participants.

A possible explanation for the higher 401(k) account balances for HSA participants is that participants with both 401(k) and HSA accounts may work for employers that promote "culture of savings," providing the tools and resources to help employees take ownership of their retirement and health care savings.

Across all employee income levels HSA participants save more in their DC plan than the average DC participant[3,4]. This is especially true for lower compensated employees — those earning $20,000–$40,000. As Figure 4 depicts, HSA participants in the lowest income bracket defer almost 2% more in their DC plan than the average DC participant.

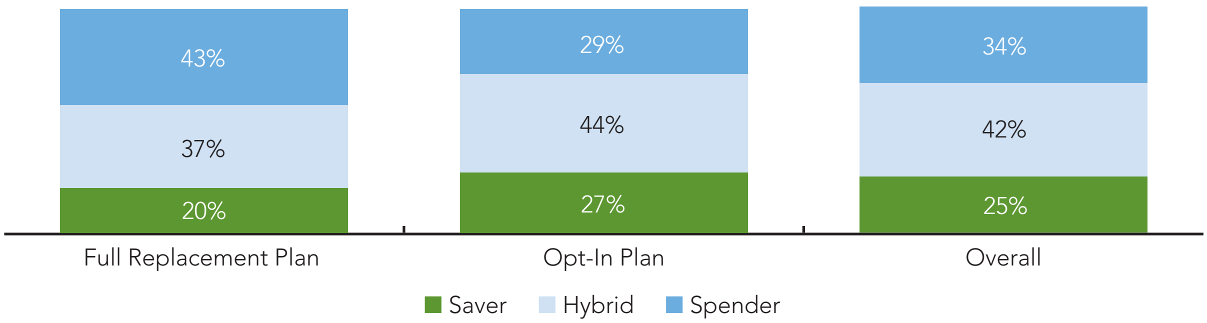
Figure 4: Average DC Deferral Rate by Compensation — 2010



Source: Fidelity Investments analysis of 50,000 HSA accounts as of 12/31/2010 and 11 million DC participant accounts as of 12/31/2010.

Many employers that offer HDHPs/HSAs present that plan as an option for employees, on an "opt-in" basis, while also allowing them to choose a traditional lower-deductible health plan such as an HMO. However, there is a growing trend among employers to go the "full replacement" route — shifting all employees to an HDHP en masse. Fidelity reviewed HSA behavior for employees covered by full replacement plans and those who instead chose the HDHP on their own. As revealed in the Figure 5 on page 7 — not surprisingly, full replacement plans have more spenders and fewer savers than opt-in plans; however, even in full replacement plans, 1 in 5 saves more than 90% of their HSA contribution.

Figure 5: HSA Participant Profile by Plan Type



Source: Fidelity Investments analysis of 50,000 HSA accounts as of 12/31/2010.

Building a "Culture of Savings"

Employers must give careful consideration to plan design and communication strategies if their HDHPs and accompanying HSAs are to achieve their objectives. "Organizations need to build a 'culture of savings' that spans both employees' current and future health care needs, as well as retirement income," says Applegate. Such a culture can be fostered by a combination of educational efforts, online tools, and financial incentives.

On the education front, Fidelity has produced a helpful article found at https://guidance.fidelity.com/viewpoints/grow-your-nest-egg-hsa, outlining how, thanks to HSAs' triple-tax benefits, employees may come out ahead by using their HSAs as an integral part of their retirement savings strategy, versus relying on their 401(k) alone. Helpful resources employers can use to guide employees on taking full advantage of their 401(k) are also available on the Fidelity Forum, http://www.fidelity.com/forum.

Properly communicating some of the intrinsic features of HDHPs to employees nurtures a "culture of savings" and can help employees understand how HSAs can fit into a broader retirement strategy. For example, HDHPs typically cover preventive care (sometimes including maintenance prescriptions) at minimal or no cost to employees. Encouraging healthy behavior in this way may equate to promoting savings both for the short and longer term.

Similarly, the generally lower premium cost of HDHPs compared to traditional health plans can be seen by employees as offering an opportunity to "bank" these savings in the HSA either for near-term qualified medical expenses or those that can be anticipated in retirement. Employers can — and most do[7] — help employees focus on the HSA's potential by either providing an employer contribution to help fund HSA accounts, or by matching employees' own contributions to their HSAs.

Summary

In Fidelity's analysis of workplace savings plan data, participation in health savings accounts has been shown to positively impact defined contribution savings. Although once viewed as only designed for the affluent, HSAs have now found broad appeal to a wide range of demographics and income levels. As more organizations strive to build a "culture of savings," more employees are becoming engaged in saving for current and future health care expenses. The bottom line: Many employees are participating in both HSA and 401(k) workplace savings programs and taking positive action to improve their retirement readiness.

Key Considerations for Employers

- Investigate the option of adding an HDHP with an HSA to your health plan lineup in time for next year's annual enrollment. Read more on HDHPs on the Fidelity Forum, http://www.fidelity.com/forum, including the article "HDHPs: Healthy, Wealthy, Wise."
- Determine where your employees might fit in the spectrum of HSA savers, spenders, and hybrids and determine appropriate plan design changes that could help improve retirement readiness.
- Learn more at www.fidelity.com/viewpoints, about how tax efficiency can impact the retirement-readiness levels of your employees.
- Create programs to help employees become more engaged in their purchase of health services as consumers of health care.

Contact your Fidelity representative to learn how health savings accounts can play a role in your benefits design and delivery — while potentially improving 401(k) or defined contribution plan participation.

[1] Characteristics of the CDHP Population, 2005–2010, May 2011 Employee Benefit Research Institute "Notes," p. 15.

[2] Employer and Worker Contributions to Account-Based Health Plans, 2006–2010, March 2011 Employee Benefit Research Institute "Notes," p. 2.

[3] Fidelity Investments analysis of 50,000 HSA accounts as of 12/31/2010 and 11 million DC participant accounts as of 12/31/2010.

[4] Fidelity Investments analysis of nearly 50,000 HSA accounts, from January 1, 2009 to December 31, 2010.

[5] With respect to federal taxation, but may or may not apply to state taxation, see your tax advisor for more information on the state tax implications on HSAs.

[6] If money is taken out of the HSA before age 65 to pay for things other than qualified medical expenses, there is a 20% penalty. If money is taken out at or after age 65 to pay for nonqualified medical expenses, this amount is taxed, but incurs no penalty.

[7] A survey by the International Foundation of Employee Benefit Plans found that 66% of employers, which make an HDHP/HSA available, make contributions to their employees' HSAs.

Note: All charts in this document are based on Fidelity Investments analysis of 50,000 HSA accounts as of 12/31/2010 and 11 million DC participant accounts as of 12/31/2010 and/or Fidelity Investments analysis of nearly 50,000 HSA accounts, from January 1, 2009 to December 31, 2010.

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