White Paper: The Coming HSA Investment Wave

While investing inside HSAs is now just a ripple, Health Savings Account owners are increasingly discovering the most powerful feature of their HSA accounts and investment professionals are waking up to the opportunities and risks that HSAs represent.

Developed in conjunction with Avidia Bank HSA

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Executive Summary

Health Savings Accounts have been around more than ten years, but are just now beginning to be used to their full advantage. Currently, nearly 20 million Americans are covered by an HSA-qualified plan that enables them to fund their healthcare with an HSA. However, very few HSA Owners currently invest and therefore miss the most powerful feature of their HSA.

Health insurance brokers are not always equipped with the knowledge to offer a full and comprehensive overview of the HSA or in some cases, do not even discuss it at all. Until now, most people have been introduced to the HSA concept by their employer's health plan, HR representative or broker. In the early days of HSAs, the concept was so new, that many employers went with the default option of facilitating the opening HSA accounts with the HSA Trustee linked to the health plan offering, or letting their employees decide if they need an account at all. Usually, the focus was on what the employees were losing and not necessarily the long-term, positive advantages of the HSA.

HSA Investments:

Yet to Emerge

The ability to invest funds for long-term tax free growth is a very powerful feature of the HSA account - and many HSA owners do not even know it exists.

Impending Growth Surge

We project that HSA investments are likely to quadruple every 3 years on their way from $3B now to $12B in 2017 and $40B in 2020.

Industries Converge

Thus far, HSAs have been introduced by health plan brokers and used for health spending in bank accounts, but the focus will shift to investing.

Individuals who have discovered the investment power of the HSA on their own, could be described as rare, happy, and profitable group. According to research by Devenir Group, only about 3% of all HSA accountholders invest. This small group, however, represents 19% of total HSA assets, up from 12.8% in 2011. No other investment vehicle offers the "triple tax savings" combo of immediate tax relief from income and FICA taxes, tax-free growth, and tax-free withdrawals, along with the ability to pass it on to your spouse as a functioning HSA or to any other heir as part of your estate when you die. HSA owners get the best of long-term tax-free growth to pay for health expenses in retirement and maintain full access to the money if needed sooner. Experience shows that HSA owners' satisfaction with the account increases dramatically when they save enough to reach milestones such as carrying money into the next health plan year or covering all potential deductible or annual out-of-pocket costs.

HSA investment growth is bound to accelerate due to account demographics alone and focused education could throw gas on the fire. We have analyzed the Devenir HSA Research Report and project even faster growth, predicting that HSA investments could grow to $11.5 billion by 2017 and to $40 billion by 2020, averaging just north of 50% per year compound annual growth. The reason is three-fold: First, demographics of account growth will bring millions of newly opened accounts into the prime investment range in the next several years. Second, market growth inside accounts helps assets grow faster than bank assets earning historically low interest rates. Third, HSA investment education is much better than in the past and may strongly accelerate as more investment firms and advisors enter the space.

HSAs offer investment professionals the opportunity to help clients with trusted expertise in the increasingly critical arena of health care planning and spending. By studying the concept and creating partnerships to offer a top notch program to your clients, you can set yourself apart in your firm and show others how to create a valuable extension to the retirement savings plans of your firm. Many advisors bill themselves as retirement experts, but few offer insights into this powerful investment tool tied to a pressing need for most in our society: how to address health costs and plan for a healthy future.

Setting the Stage – Why HSA accountholders have been slow to embrace investing

Health Savings Accounts were introduced in 2004 and have experienced rapid growth. America's Health Insurance Plans HSA Census in 2014 estimates that more than 17.5 million Americans, in my estimation at least 20 million, are covered by HSA plans and therefore eligible to contribute to an HSA. The focus on the high cost of health care, the emergence of Public and Private Exchanges associated with the Affordable Care Act (ACA) or as a reaction to it, and companies seeking to avoid the looming Cadillac Tax in 2018, have all lead to a new wave of growth in HSA plans and accounts. Many feel that HSAs are on the verge of becoming a mainstream product.

The basic concept behind the Health Savings Account is that the government allows the best tax treatment available to people who agree to obtain health insurance with a high deductible of at least $1,300 for individuals and $2,600 for families in 2015, but with out of pocket limits to reduce exposure for those with chronic and critical cases. In exchange, individuals with HSA-qualified plans are allowed to deposit up to $3,350 tax-free into an HSA in 2015; those with family coverage up to $6,650. Individuals that are 55 or older can add another $1,000 as a catch-up contribution. The tax break is earned when the money is deposited, either as a pre-tax salary reduction through an employer's payroll or a deduction for direct after-tax contributions to the HSA Trustee.

Once the money is deposited, it not only earns an initial tax-break, but it also grows tax-free for the life of the accountholder and can be used to reimburse qualified medical expenses for the accountholder, his or her spouse and any current tax-dependents (usually children) for the rest of the accountholder's life, regardless of insurance coverage. Like an IRA, the money is not locked away, but can be used for other purposes, but the accountholder would need to recognize the income they initially avoided and pay a 20% penalty. In fact, in the unlikely event that someone has too much money in their HSA and not enough health expenses in retirement, you can take withdrawals form the HSA at age 65 without penalty – the same tax treatment applies as a 401(k) or IRA withdrawal in retirement.

In other words, the government offers people a deal: If you expose yourself to a higher threshold of day-to-day medical expenses through a higher deductible, we will give you a terrific tax-free vehicle with which to set aside and save money to pay those costs. What naturally happens when the reality of a high deductible is introduced is that consumers start behaving like consumers. When they see how much things cost and can keep the money they save, they start engaging with the health system differently. They ask more questions. They call the 24-hour nurse line for the first time. They switch to generic drugs. They get their free preventative care every year. They also start thinking about the long-term cost of health care and planning for how they will fund it.

Until now, most people have been introduced to the HSA concept by their employer's health plan, HR representative or broker. In the early days of HSAs, the concept was so new, that many employers went with the default option of facilitating the opening of accounts with the HSA Trustee linked to the health plan offering, or letting their employees decide if they needed an account at all. Usually, the focus was on what the employees were losing. A change to a high-deductible plan created uncertainty: "Why can't I just keep the Cadillac Plan you used to pay for?" The open enrollment meeting was all about the health plan change and usually only mentioned the HSA in the last minute or two of the meeting. The Health Broker is not an expert in interest rates, tax savings or investment options. Frankly, in many cases, it is viewed by the health broker as a small, complicated component of the plan with little or no revenue potential, so they don't bring it up at all and let people find an HSA option on their own if they so choose.

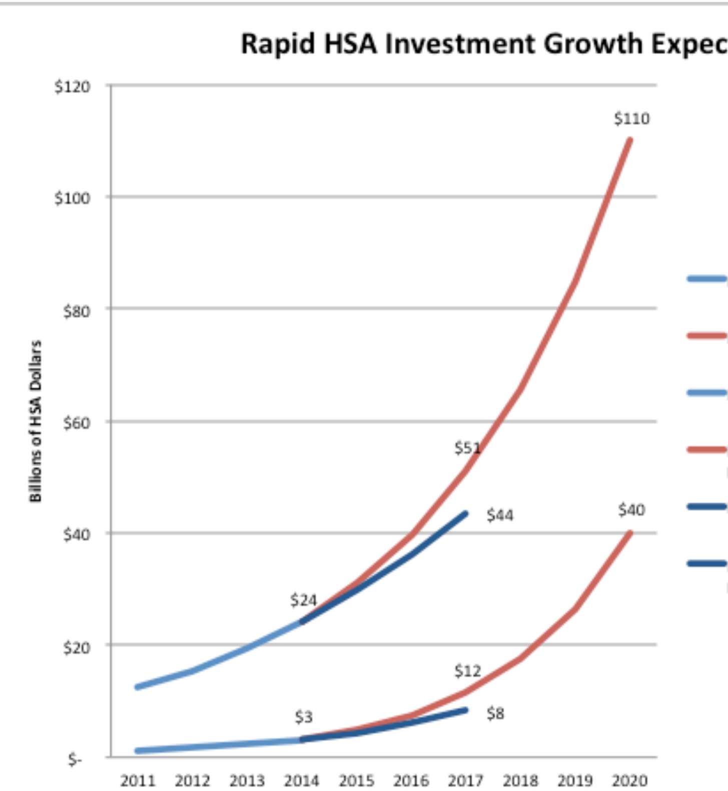
Even worse, for some reason the US health insurance industry has morphed into a "one year at a time" mentality. Your health is the most valuable long-term asset you have, but all health insurance decisions are made each year at open enrollment and seem very unpredictable to a consumer. Estimating how much to put into a Flexible Spending Arrangement (FSA) each year has always been a difficult exercise for most people. As a result, most people are too conservative with their FSA elections to avoid the last minute rush to spend those dollars. Recent changes have given some relief, but that mentality has strongly influenced how HSAs are introduced. While the HSA can replace the FSA as a simpler, more effective way to pay current out of pocket medical expenses, to describe it as such under sells its true benefits.

So if this is how the HSA account concept is explained to the consumer, it is no wonder that it often takes years to undo those misperceptions. It is hard to re-frame how people think about the HSA from "a better FSA for this years spending" to "a tax-efficient, long-term savings vehicle with short term utility". But this may be changing. Lynda Westbrook, Vice President of Avidia

Bank's Healthcare Solutions business says, "Over the past six months, every new group or broker that I encounter has inquired if Avidia offers investment options for our HSA program. They tell me that the group's President, CEO or HR Director wants it and that their employees are asking as well."

Using a Smart Phone as a Hammer? A good friend of mine is notorious for using what ever is available for whatever he needs at that moment. I have seen him hammer nails with screwdriver handles, scissors, rocks, anything short of his smart phone to avoid going in the next room to grab a hammer. In the same manner, many HSA owners own a powerful tool, but rarely use it for its highest and best use. No other investment vehicle offers the "triple tax savings" combo of immediate tax relief from income and FICA taxes, tax-free growth and tax-free withdrawals, along with the ability to pass it on to your spouse as a functioning HSA or to any other heir as part of your estate when you die. You get the best of long-term tax-free growth to pay for health expenses in retirement and maintain full access to the money if you need it sooner. Yet HSA Consulting Services estimates the median balance in an HSA in 2015 is still only around $500. Clearly, the vast majority of today's HSA owners do not understand how this tool could work for them. You might as well grab your smart phone and start whacking!

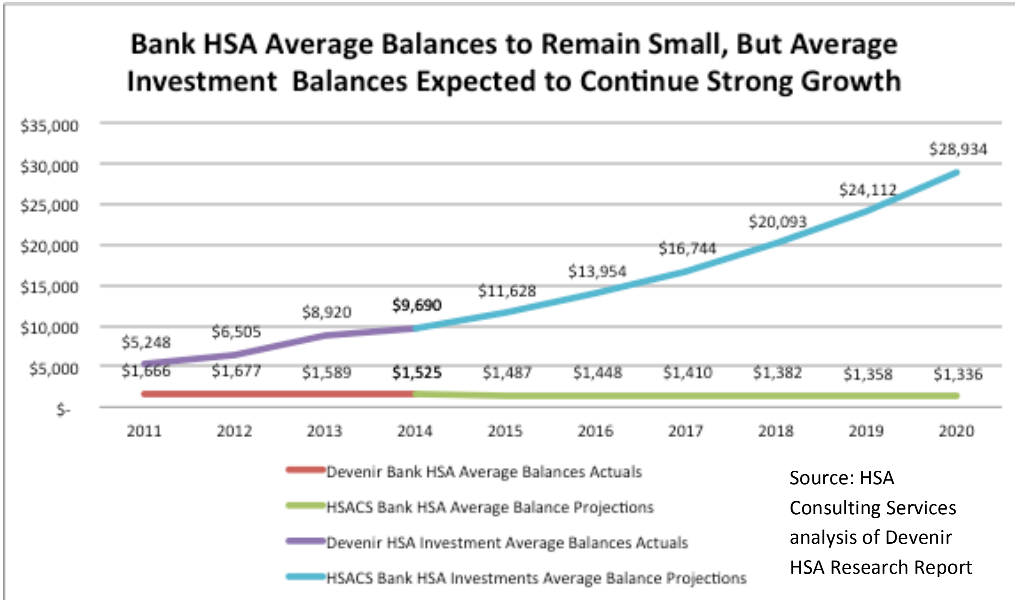
HSA owners who have embraced the saving and investing capabilities of their HSA are a rare, but happy group. According to research by Devenir Group, only about 3% of all HSA accountholders invest. This small group, however, represents 19% of total HSA assets, up from 12.8% in 2011. The average amount invested is just under $10,000. Investors also hold a significantly higher balance in the cash account, nearly 1.5 times higher at just under $3000 per HSA account. So all in all, the average HSA investor holds nearly $13,000 in the HSA, almost 7.5 times larger than the average HSA account and about one-fourth of the average 401(k) balance (American Benefits Council April 2014). In my experience, balances in HSAs equate to peace of mind and satisfaction with the concept. There is something very powerful about having money left over at the end of your first year in an HSA – wind at your back as you enter a new health plan year! Even more powerful is the feeling of having enough socked away in your HSA to cover your deductible or maximum out of pocket exposure for the year.



Source: HSA Consulting Services analysis of Devenir HSA Research Report

HSA investment growth is bound to accelerate due to account demographics alone; focused education could throw gas on the fire. Devenir Group predicts that investments in HSAs will grow from $3.2 Billion today to $8.3 Billion in 2017, a compound growth rate of 37% per year. We have analyzed the numbers and project even faster growth, predicting that HSA investments could grow to $11.5 billion by 2017 and could grow to $40 billion by 2020, averaging just north of 50% per year compound annual growth. The reason is three-fold: First, demographics of account growth will bring millions of newly opened accounts into the prime investment range in the next several years. Second, market growth inside accounts helps assets grow faster than bank assets earning historically low interest rates. Third, HSA investment education is much better than in the past and may strongly accelerate as more investment firms and advisors enter the space.

This may compound even further as investment success will likely spur more investment-oriented firms to enter the HSA market space, although the impact of the Cadillac Tax on HSA contributions through payroll may slow down account growth after 2018. Our projections assume that existing relationships between average balance and investment activity will hold; in fact they are likely to accelerate in coming years. To illustrate, average investment balances have more than doubled in the last five years from $4,100 to nearly $10,000. Account balances grow in very predictable increments each year, even in the absence of good investor education. The average investment size in recent years has grown 27% annually; we are predicting only 20% growth in average balances over the next few years to nearly $17,000 in 2017 and nearly $29,000 by 2020.



Source: HSA Consulting Services analysis of Devenir HSA Research Report

Math drives the rest. In our estimate, 7.5 million of today's 13.7 million HSA accounts are less than two years old. The average balance of these accounts is only $817. The vast majority of these do not meet minimum requirements to invest in their HSAs. Early experience shows us that the vintage of the account is highly related with balance growth and investment activity. After two years, only 1.4 percent of accounts are investing. After five years that number will predictably grow to 5.6% and by the eighth year the number of investors reaches 10.5%.

Vintage Year	Percent Investors	Average Invest Balance
1	0.5%	$ 1,000
2	1.4%	$ 2,500
3	2.2%	$ 4,000
4	3.6%	$ 5,500
5	5.6%	$ 7,000
6	7.8%	$ 8,500
7	10.0%	$ 10,000
8	10.5%	$ 11,500
9	11.0%	$ 13,000
10	11.5%	$ 14,500
11	12.0%	$ 16,000
12	12.5%	$ 17,500
13	13.0%	$ 19,000
14	13.5%	$ 20,500

Source: HSA Consulting Services Analysis of Devenir Data

Therefore, this huge number of new accounts is just becoming aware and qualified to invest and is likely to adopt investments in unprecedented numbers. All this will accelerate as HSA Trustees improve their investment education or if investment firms enter the space in force. If this projection plays out as projected, investments will constitute more than one-third of $110 billion in more than 50 million HSAs by 2020.

Investment firms and financial advisors have largely ignored the growing HSA phenomenon.

HSAs have shown steady growth, but it has largely been under the radar of most investment firms and financial advisors. In many ways, while the health firms and brokers have been focused on the current spending aspects of the HSA, investment firms are equally ill equipped to focus on health care. It is out of their comfort zone and in some cases, can even impede product sales such as life insurance or long-term care where adverse health can raise costs if disclosed. The most often cited reason for investment firms to stay away is the low balances that HSAs have experienced to this point. Clearly a $500 median balance is not enough to turn any heads in the investment industry, but more and more financial advisors are beginning to see the value for a couple nearing retirement being able to sock away another $8,650 in an HSA on top of 401(k) or IRA limits, with no income phase-outs or mandatory minimum distributions. "Retirement advisers, those on both the defined contribution and private wealth management sides of the equation, need to be able to articulate how health care savings and investing are converging with retirement income planning," said Ryan Tiernan, Access Point HSA, a client of Avidia Bank whose business focuses on HSAs in the investment advisor market.

Bankers have been naturally focused on operational scalability and card usage, not long-term growth of account balances. Even bankers and other HSA Trustees have been focused on other areas and have been slow to embrace the HSA investment opportunity. Part of the reason is the rapid growth of the HSA concept. Operational impacts concentrate on the fact that two-thirds of all new accounts are funded in the first week of January; therefore much of the effort has been focused on operational scaling. Similarly, card usage provides familiar convenient access for consumers and an important source of revenue for HSA Trustees.

Finally, historically low rates have squeezed interest rate spreads and made many banks less deposit hungry. Even when spreads were stronger a few years ago, most banks would prefer to manage balances on their own books versus in investment funds where there is less opportunity for spread income and fees. This is short-term thinking and may prove to be an opportunity for investment oriented firms. By focusing on the accountholders long-term needs, the balances will be dramatically higher – 7.5 times higher according to early results – and opportunities to make money and retain balances will abound. Banks should be careful to avoid losing this market to investment firms as a repeat of the early IRA experience that virtually created the modern mutual fund industry because banks tried to keep long-term money in savings and CD balances and were susceptible to the creation of the “IRA Rollover” to an investment firm with the promise of higher long-term returns.

The HSA account lives at the intersection of health care, banking, and investments – if investments lead, the value picture changes dramatically. So the little understood health savings account sits at the intersection of three powerful industries – health care, banking, and investments - industries that do not normally associate with each other or even speak the same language, yet are on a collision course toward the problem of planning, saving, and paying for health care costs as we all live longer lives. This gem called the HSA could be a powerful tool to prepare people for the task, but only if these industries work together to create education and systems to meet the short and long term health, spending, and savings needs for the average consumer.

In my view, the power of the investment aspects of the account is the most often overlooked and holds the key to long-term success of the HSA concept. Financial firms and advisors who enter the fray will be rewarded with rich opportunities to help accountholders prepare for the most under-planned aspect of their retirement lives – paying for their health care.

Ryan Tiernan agrees, "Financial advisers and consultants in the employer and individual wealth management arenas are extremely well positioned to make the HSA part of their service offering. The advisory community has deep relationships at the "C-Suite" and other decision making levels, they understand the long term investment story and are intimately tied to the ongoing educational efforts of the employers."

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Removing the Obstacles – Common HSA Misconceptions for Financial Advisors

My clients often have the wrong kind of health insurance. This is a common concern for financial advisors while HSA plans still have a small market share of US commercial insurance. However, as more and more Americans adopt HSA qualified plans, this obstacle diminishes. Many people do not pick the high deductible plans because they do not understand them. But if their financial advisor suggests that they seek out these plans in order to save on premiums and save money for retiree health, that could turn the tide. Increasingly, companies are adding HSA plans to the mix and individuals have more control in their choice of plans. Some financial advisors even go so far as to get licensed in health insurance and control their own ability to sell the health plan as part of the full financial offering to clients.

Estimating future health care costs is not easy and is often uncomfortable. In the same way health brokers are not comfortable talking to clients about financial aspects of HSAs, financial advisors may avoid health cost discussions. This is a big mistake as studies increasingly show that health costs in retirement are expected to be large and growing and many people fear that they haven't set aside enough for retirement to cover those costs. Research is published each year highlighting hundreds of thousands of expected out of pocket costs in retirement for current retirees. Tools are increasingly available to empower advisors and individuals to create personal estimates based on key indicators such as height, weight, age, and health conditions and to match expected costs to individual savings balances and growth rates. While it may produce some uncomfortable discussions at first, with enhanced tools and experience, investment advisors can meet a deep client need and turn it into a competitive advantage.

No room for financial advisors in today's model - banks charge high fees and often lock down investment choices if they are even offered. This has been true in the early days of HSAs, but may be changing. Financial institutions like Avidia Bank offer high-quality HSA accounts that financial advisors can recommend to their clients free of charge and provide valuable assistance in supporting all involved with educational support before, during, and after enrolling in the accounts. Further, Avidia and other HSA Trustees are exploring new models in which the financial advisor could take a more active part in advising clients in the investment process and potentially earn on-going income on the growing asset base within the HSA program.

HSAs involve operational complexities that are hard for investment firms to do on their own. It is true that there is a lot going on inside the Health Savings Account and much of the enrollment and transactional activity could be daunting for an investment firm to tackle on its own. The good news is that many of the larger players have created turn-key offerings to white label a high-quality HSA offering for investment firms, TPAs, banks and credit unions and other players want to leverage the investment these firms have made in HSA infrastructure but don't want to handle certain parts of the process themselves. A firm can do as much or as little as they wish to take on such as taking calls, managing card transactions, holding deposits, creating investment offerings, and other key aspects of running an HSA account offering.

HSA balances are too low to be profitable. Once again, this was the early reality, but for HSA accountholders with an investment mindset, this is changing rapidly. Some HSA accounts are now above $100,000 and the average investor has nearly $13,000 and growing in their HSA account. In fact, many investment firms and advisors are beginning to recognize the opportunity to add $8,650 to the average investment contribution for a couple that is 55 or older. They are also recognizing that as HSA plans become more mainstream, many accountholders may choose to put more money into their HSA than their 401(k) and IRA plans because of the tremendous tax advantages and flexibility they offer. The average 401(k) contribution of $3000 - $4000 could be consumed by the current HSA family contribution limit of $6,650 in 2015. At the same time, 401(k) inflows appear to be slowing. A new study by BrightScope cited by the Wall Street Journal indicates that outflows from 401(k) plans exceeded inflows for the first time in 2013.

Seizing the Moment – Adding Value for Clients while Setting Your Business Apart

No need to do it all when seasoned partners are willing to create a well-functioning offering under your banner. Early adopters of HSAs from the investment industry have an advantage to seize this opportunity and differentiate their firm or practice. Offering an HSA in your own brand may be a lot easier than you think, as many firms in the HSA space can partner with you or white label a high-quality offering in your brand. They have made large capital investments and are happy to customize a solution that leverages what you bring to the table and they will do the rest behind the scenes, adding volume to their current operations.

Use your financial acumen and experience to reframe the HSA experience in a more profitable way for yourself, your clients, and your partners. HSA accountholders are largely unaware of the most powerful weapon in the HSA arsenal – compound investment growth to save for long-term health costs in retirement. No one is in a better position to help clients see this clearly than their financial firm or advisor that they already trust with their investment needs. You not only have the skill to help them see the power of investing for the future, but also have the motivation to elevate this activity inside the HSA. By helping people see their HSA through this investing lens, you will elevate their view of how the account can best be used to prepare for uncertain future health costs.

IRA Rollover 2.0 – Use your new offering to attract rollovers from other HSAs who aren't paying attention the long-term needs of their most profitable clients. Investment firms know all about the power of transferring assets from one institution to another that is more focused on the long-term needs of the client. An HSA with a strong investment offering can be a very powerful tool to attract large accounts that are not being served well by other HSA Trustees. Like in the 401(k) world, most people open an HSA through their employer, but an HSA accountholder has full control of the HSA balance and may transfer it to another institution any time, even if they intend to continue collecting employer and employee payroll contributions into the original account. This creates an excellent opportunity to create another wave of rollover activity from institutions that are not providing the best experience for their accountholders.

Become the Investment HSA expert in your domain offering trusted expertise in the increasingly critical arena of health care planning and spending. Because investment firms have been slow to adopt the HSA concept, it is likely that you can take initiative to become the HSA Expert at your firm and take the lead in building a profitable, long lasting value for your firm. By studying the concept and creating partnerships to offer a top notch program to your clients, you can set yourself apart in your firm and show others how to create a valuable extension to the retirement savings plans of your firm. Many advisors bill themselves as retirement experts, but few offer insights into this powerful investment tool tied to a pressing need for most in our society, how to address health costs and plan for a healthy future. Ryan Tiernan adds, "From a private wealth management standpoint, many investors are looking for both investment advice and tax efficient implementation of that advice. Healthcare is the number one cost and number one concern for most Americans and the advisers that can implement a very clear and very efficient strategy to address that will deliver the most value to their clients."

About the authors and sponsors

About Avidia Bank HSA: *Avidia Bank has been offering HSAs since 2006. In 2013, the bank partnered with Alegeus Technologies in order to provide a more robust health payments experience for the customer. Avidia Bank is committed to its independent course with our strategic partners and it allows for a scalable solution and offers a No-Fee interest-bearing account, internet banking, mobile access, with multiple funding and investment options. In 2015, the bank rolled out a brand extension called AVIDIA HEALTH in response to requests for direct HSA referral business coming I from brokers and financial consultants. The bank experienced 400% deposit growth in the HSA business line for 2014.*

About HSA Consulting Services, LLC.: *HSA Consulting Services is a leading consultant focused exclusively on helping people make the most of HSA plans and accounts. The company runs AskMrHSA.com, America's #1 Educational resource for Health Savings Accounts and its President, Todd Berkley is the author of "The HSA Owner's Manual", published by Tate Publishing.*