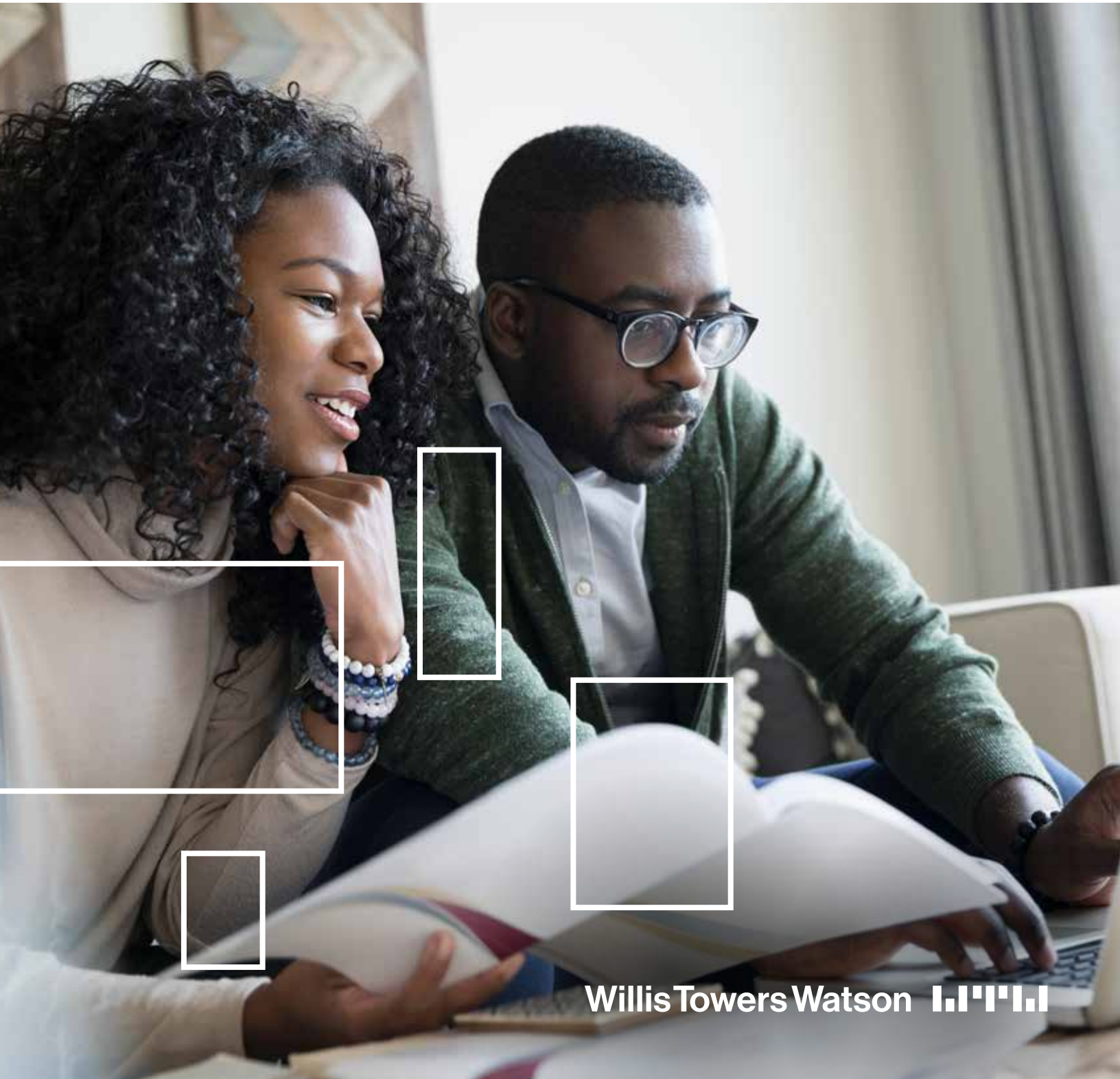
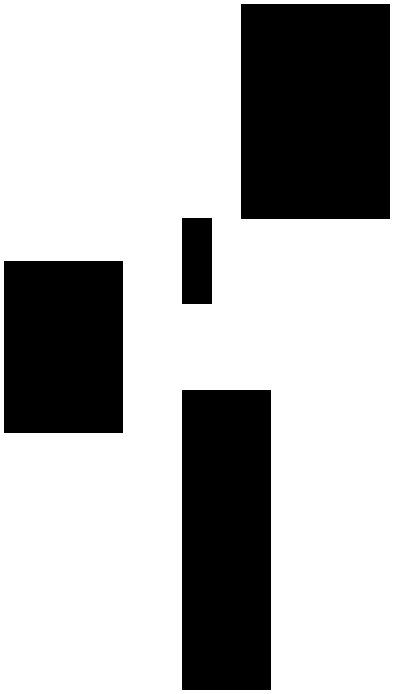
Financing Health Care in Retirement

The Role of the Health Savings Account





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Introduction

This paper explores the importance of health savings accounts (HSAs) for saving for health care in retirement and makes the case for employers to provide decision support tools and educational programs that encourage a disciplined use of the accounts. Employers will play an essential role in that process by helping employees determine their health care costs in retirement, understand different retirement health care options and create an appropriate savings plan that fits their individual needs.

This paper considers:

- **The health care cost that Medicare-eligible retirees must pay** through premiums and point of care cost sharing. The average retiree will have costs of $5,000 to $6,000 per year even after considering the services covered by Medicare.
- **The different ways Medicare-eligible retirees can access coverage.** Most retirees can either purchase a Medicare supplement plan with a prescription drug program or replace Medicare with a Medicare Advantage plan that also covers prescription drugs.
- **The aggregate cost that a retiree will likely face** and the variability of that cost depending on the retiree's health as well as the plan the retiree selects. Helping retirees make the best selection will go a long way to making their money last.
- **The tax efficiency of an HSA,** the only funding vehicle where amounts are never taxed if used to purchase eligible health care expenses. No other retirement savings vehicle has the same tax advantages as an HSA, meaning that a tax-adjusted dollar saved in an HSA can be worth significantly more than an unmatched dollar saved in a 401(k) plan.
- **The ability for an HSA to fund the cost of health care in retirement.** Those who start saving early in their career (over 25 to 30 years) can fund the full cost of health care in retirement but may limit their ability to cover current year out-of-pocket costs or fund a significant health care event prior to retirement. Those who start saving later in their career are restricted by limits on HSA contributions that limit their ability to fund the full cost of health care in retirement.

The second part of this paper explores how best to leverage an HSA. We discuss the importance of getting an employee to participate in a health plan that allows the employee to use an HSA and the value of an HSA when compared with a 401(k). We explore saving strategies such as paying for some cost while working with after-tax dollars so that more can be saved for retirement on a tax-free basis as well as some of the considerations around spending the money in retirement.

First, we will explore the cost of health care in retirement, assuming the commonly used retirement age of 65 when Medicare begins. While we recognize that many employees may plan to retire post-65, many leave the workforce sooner due to health and job concerns.

The onset of COVID-19 in 2020 has upended basic business operations and the way our work gets done. It has also led many to reassess their wellbeing to address changes that have taken not only an emotional toll but also a financial one. Given their tax efficiency, HSAs must be at the forefront of that examination.

Part I: **Financing health care coverage in retirement**

Medicare 101

We offer this brief tutorial for readers who are unfamiliar with the basics of Medicare or who want a refresher. If you're already fully aware of how Medicare works, feel free to skip to the next section, Average cost of health care in retirement.

Medicare has three basic components that are subsidized by the federal government:

- **Part A (hospital coverage)** provides for hospital care and the associated services and supplies. For most retirees, there is no premium for this coverage. While it covers a significant portion of the hospital cost, there is a substantial deductible for each hospital stay and some cost sharing after 60 days in the hospital.
- **Part B (medical coverage)** covers physician services and other medically necessary services to treat or prevent a condition. Retirees must pay a monthly premium to purchase this coverage. This program charges a deductible and 20% cost sharing on most services.
- **Part D (prescription drug coverage)** covers all drugs (except for drugs administered while a retiree is in the hospital) through private prescription drug insurance subsidized by the government. There is generally a premium to purchase a Part D prescription drug plan unless it is part of a Medicare Advantage (MA) plan. While plan designs are not standardized, they do follow a structure, and most charge copays and other cost sharing for prescription purchases. The copays and cost sharing depend on the type of drug (e.g., generic, brand name), and after a certain amount of spending, the cost sharing generally increases to 25% of drug costs. After a catastrophic spending threshold is reached, cost sharing drops to 5%.

Each of these Medicare programs provides substantial coverage, with Part B and Part D plans requiring Medicare-eligible retirees to pay premiums. Each component requires payment for a portion of the cost at the point of care (or point of purchase in the case of prescription drugs), and the retiree's portion is not insignificant.

Many retirees purchase supplemental coverage to address the cost of these gaps in Medicare coverage. There are two options for a retiree to acquire additional coverage. In the following scenarios, we only explore individual coverage options. Some employers do offer group MA or supplement plans to provide coverage to retirees. Those are not explored in this paper, though the features and cost are similar.

Option 1:

Medicare supplemental coverage + Part D

Many retirees purchase a Medicare supplement plan. This type of plan fills in some gaps that Medicare does not cover and allows retirees to see any doctor who accepts Medicare. A person who purchases a Medicare supplement plan also needs to purchase a Part D plan to cover prescription drugs. The individual may also require additional dental and vision coverage because these plans do not cover those services.

There are several versions of Medicare supplement plans, which are labeled by letters (e.g., Plan G, Plan N, Plan K). Each letter-labeled plan has standard features across most states and carriers, with the exceptions of Massachusetts, Minnesota and Wisconsin. The premium varies by age and region, but the benefit design is the same. For example, coverage is generally more expensive in certain areas of Florida and less expensive in several states in the Midwest.

Option 2:

Medicare Advantage or Part C

A MA plan effectively replaces Medicare and usually also covers prescription drugs, in which case it will often be designated as "Medicare Advantage + Part D," or MAPD. Individuals who join an MA or MAPD plan must continue to pay their Medicare Part B premiums separately to the Social Security Administration.

Many of these plans are structured as either a health maintenance organization (HMO) or a preferred provider organization (PPO) with a network of doctors and hospitals the retiree can visit. The HMO generally restricts the retiree to a network of doctors and hospitals, while the PPO will have a network but allow the retiree to go outside the network where it will cost the retiree more at the point of care.

The design of an MA plan typically varies by location, carrier and network. Generally, these plans have a deductible, a hospital copay and other cost sharing with an out-of-pocket maximum. In some cases, MA plans also provide coverage for wellness, basic dental and/or vision benefits. The cost sharing is usually more significant than under most Medicare supplement plans; however, in many cases, MA plans (including Rx) have $0 premiums along with higher point of care cost sharing.

Average cost of health care in retirement

Medicare Part A: Anyone fully qualified for Medicare will not be charged a premium for Part A.

Medicare Part B: Retirees pay premiums for Part B regardless of whether a Medicare supplement or MA plan is purchased. For those fully eligible for Medicare, the premium for Part B in 2020 is $1,735 per year. (This amount usually increases slightly each year; the Part B premium will be $1,782 in 2021.) The premium increases if the retiree's earnings are over a certain level, but it does not vary by region or age. For example, the premium for an individual with income between $87,000 and $109,000 increases to $2,429 per year.

Medicare supplemental coverage + Part D cost example:
Figure 1 summarizes the national average cost in 2020 of a Plan N Medicare supplement with Part D for a retiree with average health. We show the cost with and without dental and vision because they must be purchased separately.

Figure 1: **Medicare supplemental option**

Element	Average 2020 cost	Key contributors to cost variation
Part B	$1,735	Income
Medicare supplement Plan N premium*	**$1,390	Geography, carrier, plan type, age
Medicare supplement Plan N point of care	$483	Plan type, usage
Part D premium	$275	Plan features, geography, carrier, income
Part D point of care	$921	Plan features, geography, usage, carrier
Total without dental and vision	$4,804	
Dental premium* and point of care	$671	Plan features, geography, usage, carrier
Vision premium* and point of care	$330	Plan features, geography, usage, carrier
Total with dental and vision	$5,805	

*Certain premiums (e.g., Medicare supplement) cannot be paid on a pre-tax basis from an HSA.
**Premium average at age 65

The average national cost of Plan N in 2020 is $1,390 per year at age 65. Typically, Medicare supplement plans are priced based on the individual's age, and the premium goes up as the age increases.

Our modeling shows that retirees with Plan N spend an average of $483 per year on point of care costs. This amount varies based on the utilization of services. Other Medicare supplement plans have a different mix of premium and average out-of-pocket costs. Plan G has higher premiums and lower point of care cost sharing, while Plan K has lower premiums but higher out-of-pocket cost sharing.

A retiree purchasing a Medicare supplement plan also needs to purchase a Part D prescription drug plan. The average premium for a Part D plan in the U.S. is $275 per year. This cost varies by carrier, income, plan design and geography. Like Part B, Part D adds a surcharge for higher-income retirees.

Based on our modeling, the average point of care cost for a standard Part D plan is $921 per year. This amount can vary widely depending on the prescriptions filled by the retiree.

Medicare Advantage or Part C cost example:

Figure 2 summarizes the average cost of this option, which is slightly higher than the Medicare supplemental option without dental. When dental and vision, typically included with an MA plan, are considered, the cost is slightly less.

Figure 2: **Medicare Advantage option**

Element	Average 2020 cost	Key contributors to cost variation
Part B	$ 1,735	Income
Medicare Advantage with Rx premium	$ 0	Geography, carrier, plan features
Medicare Advantage medical point of care	$ 2,412	Plan features, geography, usage carrier
Medicare Advantage Rx point of care	$ 921	Plan features, geography, usage carrier
Total without dental and vision	$ 5,068	
Dental point of care	$ 183	Plan features, geography, usage, carrier
Vision point of care	$ 124	Plan features, geography, usage, carrier
Total with dental and vision	$ 5,375	

In 2020, approximately 90% of retirees have access to a zero-premium plan in their geographic area.

Because these programs are not standardized in their benefit design, the point of care cost can vary substantially. Willis Towers Watson estimates that the average out-of-pocket cost for a $0 premium MA plan will be $2,412 per year; however, this cost can vary due to many factors, including medical and prescription drug utilization, plan features, carrier and geography.

Many MA plans include a prescription drug benefit that is similar to the standard Part D plan. The average cost per year to cover prescription purchases is $921 for a total medical and prescription drug out-of-pocket cost sharing of $3,333.

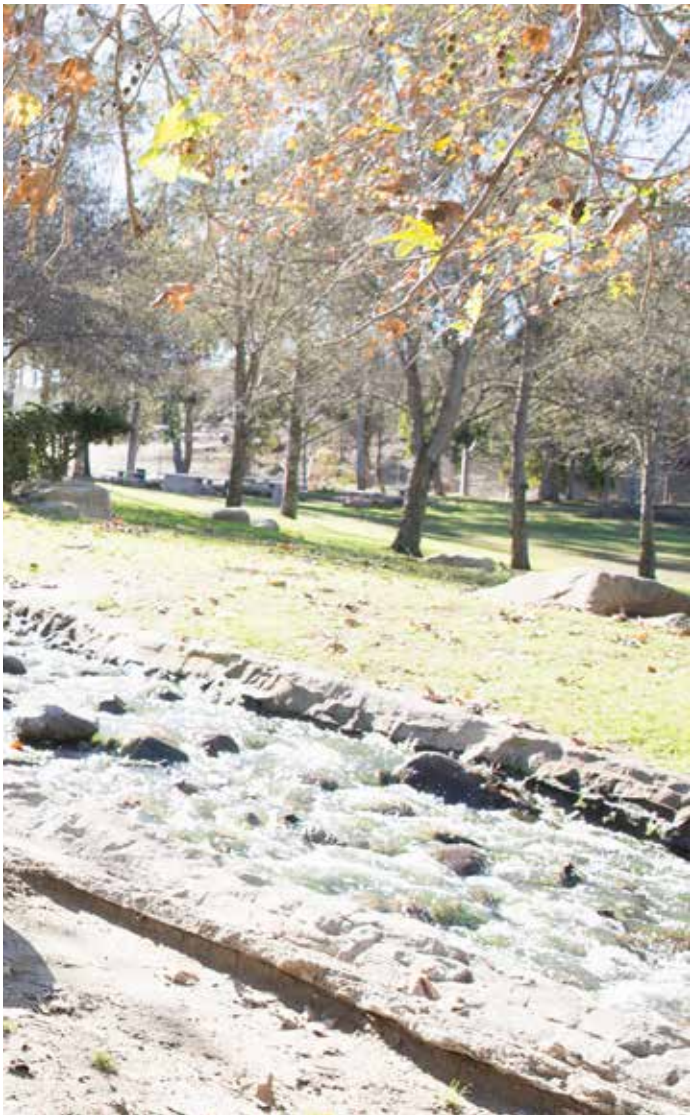
Dental and vision: While these costs are not as significant as medical, they are not covered by Medicare. The average U.S. premiums are as follows:

- Dental coverage average premium cost is $488 per year with $183 of average annual out-of-pocket cost.
- Vision coverage average premium cost is $206 per year with $124 of average annual out-of-pocket cost.

Retirees need to review their MA plan features to determine whether they need to purchase separate dental and vision coverage, as it may be covered by their program.

Long-term care: Medicare does not cover long-term care. This added cost is not included in our analysis, although retirees can pay long-term care premiums tax-free using HSA dollars. Not everyone requires long-term care; however, the odds of needing it increase the longer someone lives. Women are more likely to require long-term care because they live longer; they also end up spending longer periods of time in a facility than men for the same reason. Saving for this contingency is an important consideration for people approaching retirement.

In summary, the cost of health care for a Medicare-covered retiree is significant: $5,000 to $6,000 per year represents a meaningful portion of many retirees' incomes. Planning and saving for this cost are fundamental considerations to ensure financial wellness in retirement.



Total health care cost over retirement lifetime in 2020

Over a lifetime, the average cost of health care can be significant for an individual retiring today at age 65. Figure 3 offers two scenarios to demonstrate just how significant. The Medicare supplement Plan N plus Part D scenario shows that a male who retires in 2020 at age 65 and lives until 85 (the average life expectancy) would spend approximately $139,000 during retirement without dental and vision. With dental and vision, the total cost increases to approximately $165,000. For a female at age 65 in 2020 who lives to 87 (the average life expectancy), the corresponding costs are approximately $159,000 (excluding dental and vision) and $189,000 (including dental and vision). For a couple, the total cost, if both are age 65 today, would be $354,000 over a lifetime (with dental and vision), and that does not include the cost of long-term care or early retirement. These estimates include the average lifetime costs of Part B, Plan N and Part D premiums and all point of care costs.

$140,000

Approximate amount spent on health care in retirement for a man who retires at age 65 in 2020 and lives until age 85

(without dental and vision)

According to our models, for a retiree in average health, the cost of the MA plan will be similar overall to that of a Medicare supplement plan (e.g., Plan N) when dental and vision are not considered. It will cost less if supplemental dental and vision coverage provided by these programs are considered. A male who retires in 2020 at age 65 and lives until 85 will spend approximately $140,000 during retirement without dental and vision. With dental and vision, the total cost will increase to $149,000. For a female who retires in 2020 at age 65 and lives to 87, the corresponding costs are approximately $159,000 (excluding dental and vision) and $170,000 (including dental and vision). Many MA plans cover basic dental and vision, making the associated additional premium costs over a lifetime potentially avoidable.

Figure 3: **2020 retirement lifetime health care costs**

	Supplement Plan N + Part D		Medicare Advantage with Part D	
	Male	Female	Male	Female
Without dental and vision	$139,000	$159,000	$140,000	$159,000
With dental and vision	$165,000	$189,000	$149,000	$170,000

Saving for retirement

How can retirees finance this $140,000 to $190,000 lifetime cost for health care after they retire? An HSA provides a powerful tool to do it — but this subject is complex, and the cost of coverage is not transparent. Employees need education and decision support tools to help them connect the amount they need to save with the cost of health care in retirement.

Employees need to understand that most of the costs of health care in retirement can be covered by an HSA on a tax-free basis. That means that, essentially, the money deposited into an HSA is never subject to federal income taxes when deposited into the account, the earnings on the growth in the account are not taxed, and the contributions and earnings are not subject to federal income taxes when withdrawn from the account to pay eligible health care expenses. They are not subject to payroll taxes either, if contributions are deducted pre-tax under a section 125 cafeteria plan.

For a retiree over age 65, qualified health care expenses include the following:

- Part B premiums
- Part D premiums
- MA premiums (Part C)
- Point of care cost sharing not covered by Medicare for medical, dental and vision
- Prescription copays and coinsurance
- Employer premiums for group coverage (Medicare supplemental or group MA or prescription drug coverage)
- Long-term care insurance premiums
- Long-term care point of care costs

Some health care costs cannot be reimbursed on a tax-free basis, however. These include:

- Medicare supplement plan premiums
- Individual dental and vision premiums

Medicare supplement, dental and vision plan premiums can be paid from the HSA after paying taxes on the withdrawal. These taxes can be avoided, however, if the HSA owner has previously unreimbursed eligible health expenses that can be "cashed in" tax-free in retirement. In other words, if after saving their HSA dollars, retirees have paid some other health care costs outside the HSA, those receipts can later justify taking money out of an HSA on a tax-free basis to pay for other things, such as a Medicare supplement plan, that would not otherwise be payable with tax-free dollars.

Using HSA funds to pay for noneligible expenses such as Medicare supplement premiums is not tax-free, but there are no penalties. For such expenses incurred after age 65, withdrawing the money from an HSA is equivalent to withdrawing money from a standard 401(k) plan. An excise tax of 20% does apply to nonqualified withdrawals from an HSA before age 65.

Saving levels required in an HSA to cover health care in retirement

Employees who begin saving early with an HSA can accumulate enough assets to fund health care in retirement; however, it may be unrealistic to think that an employee will be in an HSA-qualified plan for the 25 to 30 years necessary to accumulate these assets. Because of this, many employees will not be able to fund health care from one source and will need help making the money last through retirement.

The examples that follow demonstrate that financial modeling tools can help employees determine the amount they want to save in an HSA. With appropriate tools, employees can understand the true value of an HSA to their saving goals.

In this first example, an employee who starts later in life will have trouble accumulating enough assets in an HSA to meet retirement goals (Figure 4).

The first employee is a 55-year-old man in average health throughout his life, with a current HSA balance of $15,000.

The other key assumptions in these examples include:

- HSA contribution and contribution limit increase rate: 2%
- Net investment return: 5%
- Tax rate: 30%
- Catch-up contributions starting at age 55

Figure 4: **55-year-old male with an HSA balance of $15,000**

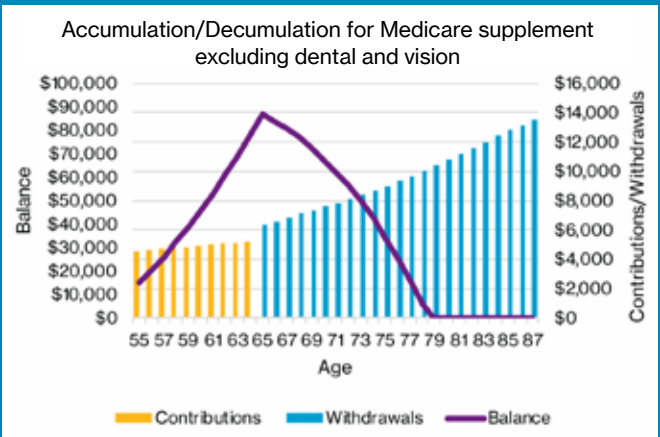
	Medicare supplement	Medicare supplement with dental and vision	Medicare Advantage	Medicare Advantage with dental and vision
Annual cost of coverage at select ages				
Age 65	$6,350	$7,700	$7,200	$7,650
Age 75	$9,000	$10,800	$9,200	$9,900
Age 85	$12,800	$15,200	$12,000	$13,050
Total cost of coverage over lifetime	$207,300	$247,700	$208,900	$225,200
Savings using an HSA				
First-year contribution	$7,510	$9,530	$6,650	$7,280
Total contribution (age 55 to age 65) necessary to cover lifetime cost	$82,200	$104,400	$72,800	$79,800
Total contributions allowable (up to HSA contribution limits)	$48,900	$48,900	$48,900	$48,900
Savings using a pre-tax 401(k) without match				
First-year contribution	$9,900	$12,190	$10,250	$11,150
Total contribution necessary to cover lifetime limits	$108,400	$133,500	$112,300	$122,100

Option 1:
Medicare supplement

If this individual wants to purchase a Medicare supplement plan and a Part D plan without dental and vision at age 65 when he retires, he must save $7,510 per year – with a 2% increase per year every year thereafter – in an HSA, for the funds to last until age 86 (his life expectancy) before being exhausted; however, HSA contribution limits, even with catch-up contributions, are only $4,550, so he can only accumulate assets to last until age 78 if he saves the maximum amount in an HSA. With dental and vision, the amount of savings necessary to meet the goal increases to $9,530. It's clear that he will need supplemental savings in another vehicle – for example, an individual retirement account (IRA) or 401(k) – or income from Social Security or a pension.

Saving though a 401(k) plan is more costly, as the required annual savings using only 401(k) increases by 30%. As shown in Figure 5, it is very difficult to start saving for health care in retirement this late in a career.

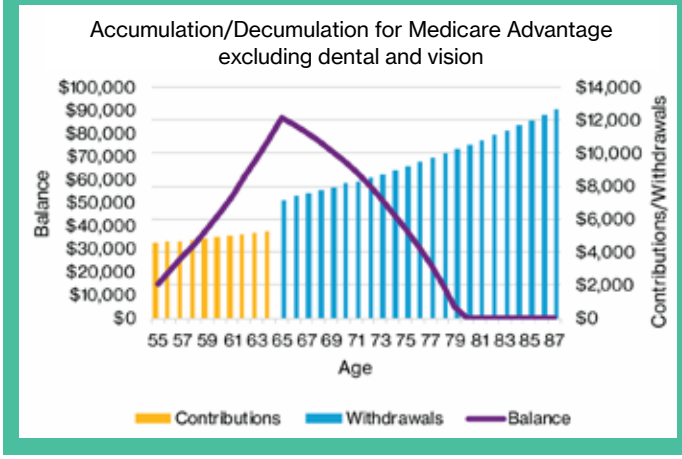
Figure 5: **Saving HSA maximum limits – Medicare supplemental + Part D**



Option 2:
Medicare Advantage

If this individual wants to purchase a MA plan at age 65 when he retires, he must save $6,650 per year in an HSA for the funds to last until age 86. Again, this is more than the maximum amount he can save in an HSA; however, it is less than the amount required to pay for a Medicare supplement plan. The reason he is required to save less money and the money lasts longer is that a MA plan can be purchased with pre-tax dollars – that is, the premiums can be paid for out of the HSA – while the Medicare supplement plan premium is generally paid with after-tax dollars even if the HSA is used to purchase the plan. In this case, if he saves $4,550 per year, the money will last until age 79, as shown in Figure 6.

Figure 6: **Saving HSA maximum limits – Medicare Advantage**



Our second example follows a mid-career employee who is just starting to consider saving for health care in retirement. We again use a male employee, now age 40, who is just starting to save. The example compares the necessary savings though an HSA and a 401(k) without an employer match.

Figure 7: **40-year-old male with no current savings**

	Medicare supplement	Medicare supplement with dental and vision	Medicare Advantage	Medicare Advantage with dental and vision
Annual cost of coverage at select ages				
Age 65	$9,600	$11,650	$10,500	$11,350
Age 75	$13,800	$16,600	$13,700	$14,950
Age 85	$19,550	$23,400	$17,850	$19,700
Total cost of coverage over lifetime	$337,300	$405,100	$328,200	$359,600
Savings using an HSA				
First-year contribution	$3,430	$4,190	$3,020	$3,300
Total contribution (age 40 to age 65) necessary to cover lifetime cost	$109,900	$134,100	$96,800	$105,800
Total contributions allowable (up to HSA contribution limits)	$123,700	$123,700	$123,700	$123,700
Savings using a pre-tax 401(k) without match				
First-year contribution	$4,340	$5,220	$4,320	$4,720
Total contribution necessary to cover lifetime limits	$139,000	$167,200	$138,300	$151,100

Figure 7 demonstrates that an individual who starts saving by age 40 can accumulate sufficient savings in an HSA to cover the cost of health care in retirement under most, but not all, options and still have enough money to pay for some current-year out-of-pocket costs not covered by his health plan (such as a deductible) or an unexpected medical expense.

Option 1:
Medicare supplement
(with and without dental/vision)

The total amount of cash required when this retiree turns 65 in 2045 is estimated to be $337,300 without dental and vision and $405,100 with dental and vision. If he opts to purchase a Medicare supplement plan at age 65, he must save $3,430 per year – with a 2% increase per year every year thereafter – in an HSA without dental/vision for the fund to last until he is 87. Including dental and vision, the required savings increases to $4,190. Because the 2020 HSA contribution limits are $3,550 for an individual under age 55, he won't be able to save enough to cover all his retirement health care. Over his working lifetime, this employee is only allowed to contribute $123,700, while he needs to contribute $134,100. If he wanted to save in a 401(k) and still be able to fund health care in retirement through age 87, he would need to save $4,340, and $5,220, respectively. He could use savings in a 401(k) to make up the difference, but because an unmatched, pre-tax 401(k) does not cover health care cost on a tax-free basis, it is less efficient as a vehicle to save for health care in retirement.

Option 2:
Medicare Advantage
(with and without dental/vision)

The total amount of cash required when this retiree turns 65 in 2045 is estimated to be $328,200 without dental and vision and $359,600 with dental and vision. If he opts to purchase an MA plan at age 65, he would need to save $3,020 per year – with a 2% increase per year every year thereafter – in an HSA without dental/vision. Including dental and vision, the required savings would increase to $3,300 per year. This savings level would allow him to also save some money to cover current health care events because the 2020 HSA contribution limits are $3,550 for an individual under age 55 and $4,550 for an individual 55 or older. If he wanted to save in a 401(k) instead of an HSA, he would need to deposit $4,320 and $4,720 per year, respectively, in his 401(k) plan.

If we look at the same analysis for a woman in this second example, the savings required are greater, because women are expected to live two years longer. In general, being female would increase the required savings each year by between 7% and 8%. HSA funding limits reduce the ability of women to save for both retirement and other near and emergency health events. In addition, women are more likely than men to require long-term care. Saving for these costs through an HSA may not be feasible given the limits on contributions, unless a woman starts very early in her career.

Variations in cost

Because different plans have different cost levels depending on health status, the choices a retiree makes in selecting a plan can have a substantial impact on the total cost of health care, thereby affecting the amount of savings needed to cover health care during retirement. Figure 8 summarizes variation in 2020 costs based on the health of the retiree and the plan he or she chooses.

Figure 8: **Variability of total cost based on health status, excluding dental and vision**

	Medicare supplement Plan N + Part D	Medicare Advantage + Part D
2020 low utilization	$3,698	$1,922
2020 medium utilization	$4,804	$5,069
2020 high utilization	$6,230	$10,084

The MA plan is considerably less expensive than a Plan N Medicare supplement if a retiree is relatively healthy, but considerably more expensive if he or she is in poor health. The plans have a similar cost for a retiree in average health. For those who remain healthy for an extended period or are not excessively risk-averse, there are some cost advantages to selecting an MA plan. Ignoring future inflation and without taking account of taxation, consider a person who spends three years with low utilization and one year with high utilization. The net savings over four years is $1,474 if he or she elects the MA plan (three years' savings of $1,776 per year versus one year of cost of $3,854); however, for those who are risk-averse or in poor health, the additional cost of MA plans for high utilizers may outweigh the tax advantages of the MA plan over the Medicare supplement plan.

Choice

Because a retiree's health status and prescription drugs taken are likely to change over the years, plan election and utilization patterns have a direct impact on cost. Based on simulated scenario modeling, we estimate that individuals can save 10% to 20% by making "good" choices in retirement. For example, a retiree who is in good health from age 65 to 79 but poor health from age 80 to 85 can save by the choices he or she makes during retirement. If he or she elects a rich Plan G Medicare supplement with a Part D plan, the costs in retirement will total approximately $140,000; however, if this same person purchases an MA plan, the costs will total only $125,000, an 11% savings. In addition, because the MA plan can be fully funded by the tax-efficient HSA, the pre-tax saving can be even greater.

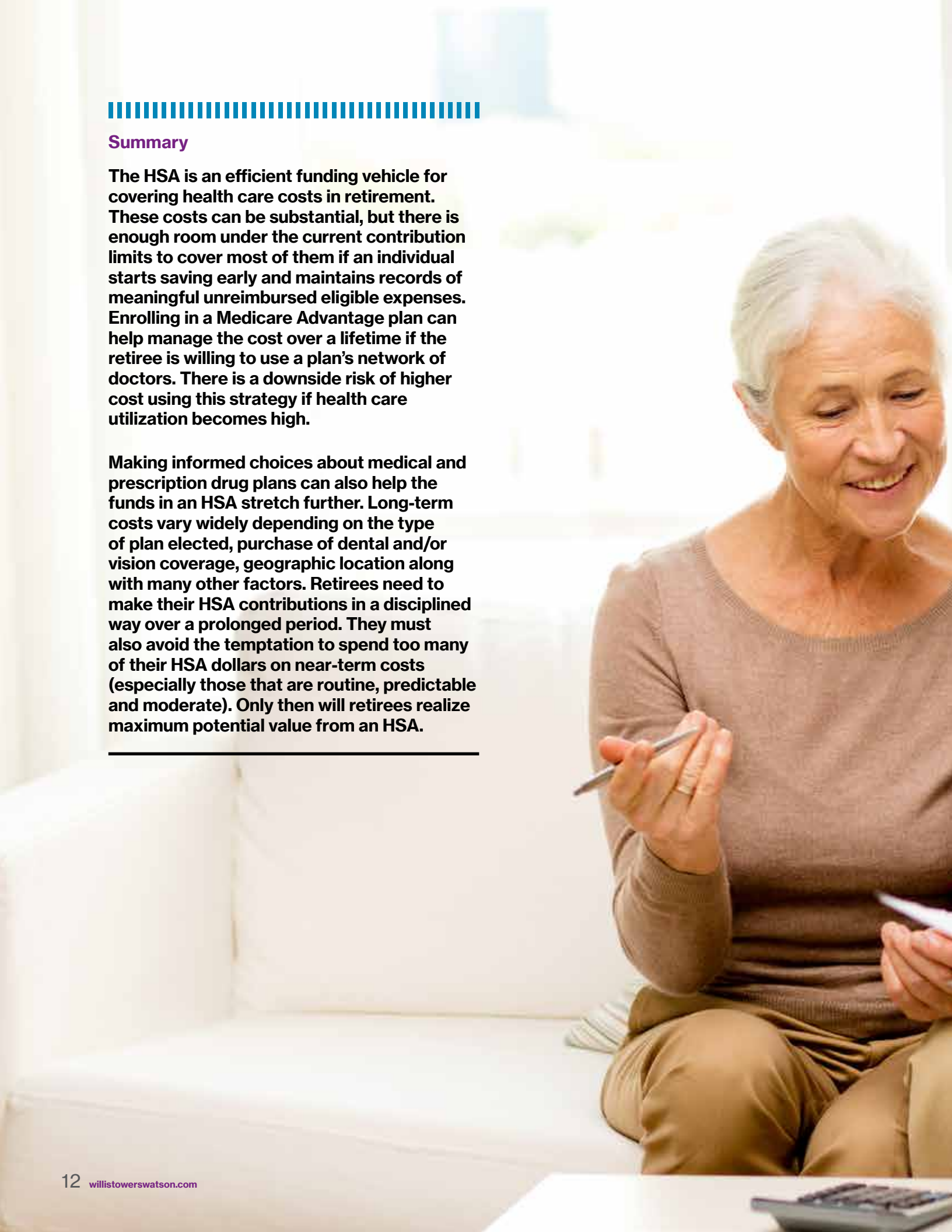
Choice plays a critical role in managing cost not just in avoiding "over-insurance," as this example indicates. It also plays a role in finding a Part D plan with a prescription formulary that aligns with the retiree's prescription requirements. Finding the specific Part D plan that best matches the retiree's needs can enhance the savings even further, and these savings add up over a lifetime.

While it is possible for a retiree to change medical plans in order to reduce the financial burden, there are some restrictions when moving to a Medicare supplement plan from MA. These restrictions may limit a retiree's ability to move from an MA when healthy to a more robust Medicare supplement plan later in life, so it is prudent to seek advice from an insurance advisor.

Summary

The HSA is an efficient funding vehicle for covering health care costs in retirement. These costs can be substantial, but there is enough room under the current contribution limits to cover most of them if an individual starts saving early and maintains records of meaningful unreimbursed eligible expenses. Enrolling in a Medicare Advantage plan can help manage the cost over a lifetime if the retiree is willing to use a plan's network of doctors. There is a downside risk of higher cost using this strategy if health care utilization becomes high.

Making informed choices about medical and prescription drug plans can also help the funds in an HSA stretch further. Long-term costs vary widely depending on the type of plan elected, purchase of dental and/or vision coverage, geographic location along with many other factors. Retirees need to make their HSA contributions in a disciplined way over a prolonged period. They must also avoid the temptation to spend too many of their HSA dollars on near-term costs (especially those that are routine, predictable and moderate). Only then will retirees realize maximum potential value from an HSA.



Part II: **HSA strategies for health care in retirement**

Applications of learnings from Part I

The link between health care spending and retirement savings are an ongoing and long-term challenge for U.S. citizens that an HSA can help address. Many individuals assume Medicare covers all health care costs in retirement, but as we've shown, out-of-pocket costs can be significant especially for retirees on a fixed income. We can use the discussion in Part 1 of this paper to evaluate strategies for saving for health care in retirement.

As with managing 401(k) savings vehicles, employees make several important decisions for their HSAs. They can be broadly grouped into five categories:

1. The decision to participate
2. The amount to save
3. Where to save
4. How to invest
5. How to use the money in retirement

1 Participation

The decision to participate in an HSA is more complex than the decision to participate in a 401(k), as the employee is really making two choices. The first is whether to choose an HSA-compliant high-deductible health care plan (i.e., a plan that requires a government-mandated minimum deductible and complies with other design restrictions), if the employer makes one available. Generally, these plans have lower premiums than PPO and HMO alternatives but higher out-of-pocket expenses. Individuals in poor health or averse to high out-of-pocket cost risk may prefer not to participate in an HSA-compliant plan, making them ineligible to participate in an HSA. For such individuals, the main tax-preferred saving alternatives will be a 401(k) or IRA.

While most employers offer an HSA-compliant plan, only a small proportion of individuals insured through employers utilize an HSA. According to the Kaiser Family Foundation,[1] 157 million individuals in the U.S. under the age of 65 get their insurance from an employer-sponsored plan; however, according to Devenir,[2] there are only 29 million HSAs today. One of the goals of employee education should be to help employees avoid over-insuring so they can deploy some of their resources to save for future health care expenses. An HSA paired with an HSA-compliant plan is often a valuable solution for those who are trying to achieve the right balance.

For individuals who elect a high-deductible health plan, the second decision is whether to set up an HSA and begin to save. Most employers have established relationships with HSA providers that make this process simple; however, there are still many employees who need support and ongoing communications to encourage their participation. Unlike a 401(k), automatic enrollment with a default contribution is not used extensively with an HSA because of regulatory and administrative concerns; therefore, many employers "seed" HSAs with an initial contribution to incent employee participation, and a few employers even choose to match employee contributions.

2 Savings amounts

There are more considerations when saving in an HSA than with a 401(k) because the employee is accumulating funds for three possible events:

1. Current-year out-of-pocket costs not covered by the HSA-compliant health plan
2. A significant health care emergency prior to retirement
3. Health care in retirement

Savings strategies vary by many factors, including but not limited to:

- **Age HSA savings begin:** Our research shows that those who start early can accumulate enough resources to cover health care expenses in retirement assuming normal retirement at age 65. Specifically, in our examples (figures 4 and 5), the age 40 employee was able to cover the cost of health care in retirement when electing Medicare Advantage options. In addition, he still had room to cover a portion of the deductible in his HSA-compliant health plan. Those who start even earlier, and spend their entire career in an HSA, would have additional savings to cover the deductible and/or a future emergency; however, given the need to be in an HSA-compliant plan, few employees will likely spend over 25 years contributing to an HSA.

1. Kaiser Family Foundation, 2018 statistics, Health Insurance Coverage of Total Population
2. Devenir, 2020 Midyear Devenir HSA research report, for period ending June 30, 2020

An employee who starts to save later in life, even with catch-up contributions, could not save enough to cover health care in retirement. Individuals in this situation will need to deploy other strategies to meet their savings needs. For example, an employee may be able to put aside additional pre-tax money in a limited purpose FSA (a health care flexible spending account that can be used to pay for dental and vision coverage) to avoid spending on dental and vision from the HSA. Individuals with enough resources might consider funding their HSA while also paying for current health care expenses from personal savings. In general, starting to save later in life requires a delicate balance: If an employee uses the HSA to cover too many current health care expenditures, there may not be enough remaining to cover health care expenses in retirement. These employees will also need to utilize other savings vehicles, such as an IRA or 401(k).

- **Current health status:** Because an individual might be saving for both near-term and long-term goals, the employee's current health circumstances matter significantly. Those in poor health may be forced to withdraw funds from their HSA annually, making it difficult to save for retirement even if they start at an early age. Also, the goal of saving for retirement may be out of reach given current HSA limits. These employees will need to consider other savings in addition to the HSA to address this gap.
- **Current financial status:** The financial situation of an individual also plays a key role. Employees who struggle financially will find it difficult to save extra amounts each year, which makes it essential to use the correct vehicle to optimize value. For lower-wage earners or employees struggling financially, paying current health care costs tax-free may be a more important and immediate goal than saving for retirement. Having a modest balance in the HSA as emergency savings might be a better goal for these employees.
- **Age at retirement:** Early retirees (those retiring before age 65) tend to have more significant long-term health care costs. Because they cannot rely on Medicare as the primary payer of medical expenses until age 65, their pre-65 medical costs are typically higher and thus they will likely require additional savings to cover the cost of health care throughout their retirement. An HSA can play a key role in helping employees retire early but will likely require saving at the limits in combination with other savings.
- **Needs in retirement:** Employees should consider their health care needs in retirement. The amount needed will depend on several factors, including:
  - Whether they elect a Medicare supplement plan or MA plan: Understanding and comparing the options available at retirement equips employees to save and fund accordingly. A MA plan may have a financial advantage over a Medicare supplement plan; however, there are reasons beyond financial concerns for electing different plans. For example, the disadvantages — beyond cost — of electing the MA plan include restricted access to doctors through an HMO or PPO network, more volatile out-of-pocket costs and difficulty later switching to a Medicare supplement plan due to possible underwriting requirements.
  - Dental, vision or long-term care benefits: Dental, vision and long-term care expenses are not covered with Medicare supplement plans, so those costs must also be considered and possibly prefunded.
  - Health status: Future health status may be more difficult to predict while an employee is in the earlier stages of saving in an HSA but may factor into how he or she adjusts savings when approaching retirement.
  - Employer support: Some employers may provide some level of support for health care for retirees over age 65. This often takes the form of a tax-preferred health reimbursement arrangement (HRA) credit that can be used to pay premiums and qualified out-of-pocket expenses. A stipend like this will reduce the amount of HSA funds needed in retirement to cover health care cost.

3 Where to save – 401(k) versus HSA

Another question many employees ask is whether the HSA is the best savings alternative when compared with a 401(k) with an employer match. Data show the HSA is the preferred savings vehicle for health care in retirement when compared with a 401(k) without an employer match; however, it is less clear once the 401(k) match is considered.

Look at saving using a 401(k) up to the limits of the match. Will an employee's 401(k) with match cover his or her expenses in retirement? This analysis should factor in other retirement income resources, such as Social Security, pension and personal savings. If the answer is yes, then the employee should compare whether the HSA tax advantages outweigh the match in the 401(k).

Assuming HSA funds are used for tax-free health care benefits, Figure 9 suggests that an HSA can be as valuable as a modest match; however, given that marginal tax rates for many employees don't reach 40%, many company matching programs will be more valuable.

Figure 9: **Required match to outweigh tax benefit of HSA**

Marginal tax rate	Required 401(k) match to outperform an HSA
20%	25%
30%	43%
40%	66%

This table assumes that marginal tax rates for federal and state taxes do not change. We have also not considered differences in FICA taxation (payroll taxes). HSA employee contributions are not subject to FICA taxation, while 401(k) employee contributions are subject to FICA taxation. While this makes the HSA even more tax-efficient, not taxing these amounts can affect the level of Social Security benefits at retirement.

If an employee's 401(k) with match along with other resources will not cover all his or her expenses in retirement, the HSA will provide significant advantages over the 401(k) for every extra non-matched dollar saved for health care. These include:

- Tax advantages: Figure 9 shows that for someone with a 20% marginal tax rate, every $1.00 saved in an HSA is equivalent to $1.25 saved in a 401(k).
- Withdrawal flexibility: HSAs allow an individual to withdraw money at any time for current or future health care expenses.

In addition, the HSA is no less efficient than a 401(k) for distributions paid after age 65. HSAs allow use for non-health care expenses after 65 just like a 401(k) plan – after paying taxes on the distribution. There are also some protections against money being forfeited at death because money can be passed on to a spouse to be used for his or her health care costs.

4 Investing

Unlike a 401(k) plan, an HSA is generally held in a cash account because a significant portion of the funds may be used for current expenditures; however, the vast majority of HSA platforms allow for assets to be invested in institutional mutual funds once they have reached a certain amount (e.g., $1,000). How these funds are invested is a critical part of growing assets. Most platforms will allow for investment in target-date and other funds that provide the necessary diversity to build a nest egg for health care in retirement. As part of an individual's due diligence when making investment choices, there are several issues to consider:

- It is important to understand the fees charged by each fund to ensure they will not adversely affect the growth of assets. If the amount invested in the HSA is small, investment fees may inhibit growth of the fund.
- Because of medical emergencies, there may be requirements to liquidate assets; therefore, typical 401(k) investments such as target-date funds may not always be appropriate to meet the cash flow requirement of paying for health care.
- Institutional shares are also an important consideration, as the management fees can be lower than with retail funds. Because assets are smaller than with a 401(k), it is important to ensure institutional shares are deployed with the fund options and 12(b)-1 fees are minimized.[3] This will maximize the value for participants.

3. 12(b)-1 fees are an annual marketing or distribution fee on a mutual fund that is typically paid to providers of services (e.g., recordkeepers).

5 Using the money for health care in retirement

An HSA's maximum value is often realized when funds are saved to pay qualified health care expenses in retirement. Anything done to manage the cost of retirement health care can help the money last as long as possible. Making wise, rational annual plan elections is one way to manage this cost; healthy retirees are more likely to realize maximum value by not over-insuring. With the help of an insurance advisor or broker, retirees can manage their elections annually to minimize expenditures. This is especially true with prescription drug plans. A retiree's prescriptions can change over time, as can the formulary of a Part D plan; making sure the Part D plan offers an appropriate formulary can reduce expenditures in retirement. Part D plans can be changed every year without penalty, so an annual review of drug coverage is critical to managing cost and helping HSA dollars to go further. MA plans can also be changed without underwriting, but Medicare supplement plans may require it, so getting appropriate insurance advice is important during a retiree's lifetime.

For those using multiple funding vehicles – for example, both 401(k) and HSA – to pay for health care in retirement, tax-efficient usage of the funds is important. Those with multiple sources and a Medicare supplement plan might consider using 401(k) assets to pay for the Medicare supplement plan while saving the HSA for other health care expenses. Those who require a Medicare supplement plan might consider a plan with lower premiums to maximize the tax efficiency of paying for costs with an HSA.

Retirees who receive an HRA subsidy from their employer can still use their HSA to cover the cost not covered by the HRA.

As outlined in Part I of this paper, employees must also consider the potential need for dental, vision and long-term care coverage in retirement. These details should be reviewed with the insurance company or the retiree's advisor as he or she considers expenditures in retirement.

Summary

Saving for retirement is a long-term proposition that requires the discipline to devote resources at an early age and the wisdom to select accounts that will best meet one's needs. As employees embark on this journey, it is important to understand that options exist not only to save for general retirement expenses but also to save specifically for health care in retirement. An HSA offers clear advantages and can play a critical role in saving for retirement health care. HSAs may not be right for all, but all employees eligible to use them would be wise to consider the power of their benefits when developing their retirement funding strategy.

Appendix

Key assumptions used to project costs into the future as well as assess point of care cost sharing in our models are outlined below. These assumptions affect the conclusions reached in this document.

1. **HSA**
   - HSA contribution index: 2% in all years
   - HSA limits: 2% in all years on base limit, 0% on catch-up contributions
   - Plan return: 5% in all years
   - Tax rate: 30% in all years

2. **Mortality**
   - Based on the PRI-2012 no collar, MP2019 projection scale: Life expectancies based on this table are rounded to the nearest age.

3. **Premiums**
   - Part B premium: Increase of $65.68/year in all years (baseline premium = $1,735); based on OLS linear regression on historic Part B premiums
   - Premium trend – Part D: 2.5% in all years; five-year historic average of post-65 retiree medical trends from Willis Towers Watson's Best Practices in Health Care Survey
   - Premium trend – Medigap plans: 2.5% in all years plus an aging adjustment based on market data on average increase in premiums associated with aging; five-year historic average of post-65 retiree medical trends from Willis Towers Watson's Best Practices in Health Care Survey
   - Premium trend – MA plans:
     - Premium baseline: 4.5% for 10 years, then 4% thereafter
     - Premium offset: 4.0% in all years
     - Premium net = Premium baseline – Premium offset = 0.5% for 10 years
   - Based on Willis Towers Watson assumptions regarding Medicare payments to Medicare Advantage plans
   - Dental and vision premium trends:
     - Dental premium: 2.4% in all years
     - Vision premium: 1.6% in all years
   - The dental and vision trends are five-year historic average trends from FEHBP.

4. **Point of care cost sharing**
   - Medical and Rx claim expenses are trended at 5.0% annually. Utilization is trended by applying the square root of the annual trend factor to the baseline norm. These results are then applied using actuarial models against the plan designs, which are indexed as described below.
   - Point of care design trend – Part D:
     - Initial RDS limit: $12.23 in all years
     - Ultimate RDS limit: $260.89 in all years
     - Standard Part D deductible: $12.23 in all years
     - Standard Part D TrOOP: $124.82 in all years
     - Standard Part D gap tripper: $116.82 in all years
     - Standard Part D cat trigger: $203.26 in all years
   - These values were estimated using linear regression on historic values for each provision. They are used in the forecasts as annual amounts of increase for each provision.
   - Point of care trend – Medigap plans: Medicare provision indexed based on linear regression of historical data
     - Part A deductible: $26.75 in all years
     - Part A copays: $6.69 (inpatient hospital days 61 – 90); $13.69 (inpatient hospital days 91 – 150); $3.39 (skilled nursing facility days 21 – 100), in all years
     - Part A lifetime max: N/A
     - Part B deductible: $2.18 in all years
     - Part B coinsurance: N/A
     - Expenses not covered by Medicare: N/A
   - Point of care trend – MA plans: Each plan design feature is indexed 4.0% in all years based on a 2018 Kaiser Family Foundation study of out-of-pocket (OOP) costs among Medicare beneficiaries, where the published value of the average growth rate under the midrange scenario was 4.3%. We collectively decided to use a value of 4.0%
   - Dental and vision point of care trend is not based on any specific plan design features:
     - Dental OOP: 4.2% in all years
     - Vision OOP: 4.2% in all years
   - Dental trend is an annualized average of OOP dental costs per capita as forecast by the Centers for Medicare & Medicaid Services (CMS).
   - Vision trend is assumed to be the same as dental.
   - These specific section four assumptions were used in the first 20 years of the projection. After 20 years, results are extrapolated at the trend rate in the last year of our 20-year projection.

5. **Baseline point of care levels**
   - Point of care baseline levels for 2019 used to project results:
     - Part A deductible: $1,364
     - Part A copay days 61 – 90: $341
     - Part A copay days 91 – 150: $682
     - Part A copay SNF days 21 – 100: $171
     - Part B deductible: $185
     - Initial RDS limit: $415
     - Ultimate RDS limit: $8,500
     - Standard Part D deductible: $415
     - Standard Part D TrOOP: $5,100
     - Standard Part D Gap trigger: $3,820
     - Standard Part D Cat trigger: $7,654
     - Medicare Advantage deductible: $400
     - Medicare Advantage OOP max: $3,500
     - Medicare Advantage OOP surgery copay: $225
     - Medicare Advantage OOP non-surgery copay: $225
     - Medicare Advantage OFV primary copay: $15
     - Medicare Advantage OFV specialist copay: $50
     - Medicare Advantage ER copay: $90
     - Medicare Advantage X-ray labs copay: $15
     - Medicare Advantage OOP rehab copay: $15
     - Medicare Advantage Ambulance copay: $365
     - Medicare Advantage vision copay: $50
   - Provisions for Medicare Parts A, B and D are taken directly from CMS documentation. Medicare Advantage provisions are assumed typical provisions used in the valuation model for a zero-premium plan.

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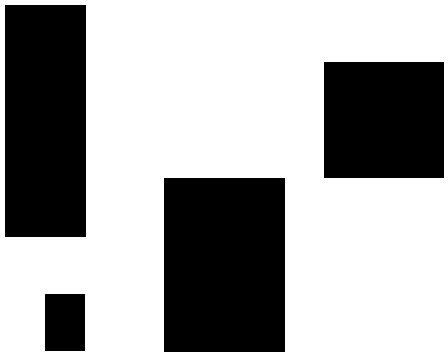

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