The New Rx for Retirement

Solving the equation to maximize retirement and health savings

JUNE 2018

EMPOWER INSTITUTE

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A WHITE PAPER

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The white paper, "The New Rx for Retirement" presents a savings optimization model to help determine how to allocate funds between retirement plans and HSAs for maximum spending power in retirement.

What we'll cover

1. The relevance of HSAs
2. The retirement savings optimization model
3. The savings optimization model in action
4. Putting it all together

What are high-deductible healthcare plans?
To be considered a high-deductible plan in 2018, a health insurance plan must include:

1. A deductible of at least $1,350 for single coverage and at least $2,700 for family coverage.
2. Out-of-pocket maximums set no higher than $6,650 (single) and $13,300 (family).
3. No benefits other than preventative care exempt from application to the deductible.

INTRODUCTION

Funding your future

The trifecta of rising healthcare costs, uncertainty about the future of health insurance (including both Medicare and the Affordable Care Act) and increasing longevity presents a formidable challenge for Americans preparing for retirement. It's no wonder that the number of employees who plan to work past age 70 has quadrupled since 1991.[1] Yet despite the complexities of meeting the financial challenges of healthcare in retirement, the advice from financial professionals remains simple — people must save more money today. For many Americans struggling to even maintain their current savings rates, that message can be deflating. However, savers can use an existing tool to help improve their standard of living in retirement without affecting their disposable income today. The solution lies in the strategic use of health savings accounts (HSAs).

The health savings account is a unique savings vehicle for those enrolled in a qualified high-deductible healthcare plan (HDHP)

These plans have become increasingly common: 54% of employers with 500 or more employees offer HDHPs, and 10% use HDHPs as their sole health insurance offering.[2]

1

The relevance of HSAs

HSAs were designed to foster the overall move toward healthcare consumerism. Historically, they have been positioned as a tax-advantaged strategy that allows employees to use the savings from an HDHP's lower premiums to save against the higher deductible. For example, say an individual had been paying $400 per paycheck to fund a traditional health insurance plan, but upon enrolling in a HDHP will pay $250 per paycheck. The standard approach has been that the employee should allocate the $150 difference to an HSA to help prepare for the potential out-of-pocket costs associated with a higher deductible.

One of the much-touted benefits of HSAs is the fact that savers can use the account to pay for their current out-of-pocket healthcare expenses. And if any balance remains at the end of a year, it rolls over for future use. Yet simply using up the funds as you go means the HSA is never able to deliver its full potential benefit; this approach is akin to putting a high-speed train on a mile-long track. We have developed a savings optimization model that can help keep the train rolling at high speed until it reaches the end of the line, when the funds are needed in retirement.

We'll discuss the savings optimization model shortly. First, it's worth taking a look at why employees may want to consider saving specifically for their healthcare expenses in retirement and how HSAs may benefit employees and employers.

Why save specifically for healthcare?

The retirement savings industry has expended a great deal of effort helping Americans understand the importance of investment diversification. The concept of expense diversification has not received the same level of attention — but it's a discussion we need to be having. Expense diversification is the concept that savers need to plan during their accumulation years for the major expense categories they expect in retirement.

The financial services industry commonly addresses expense diversification during the working years, encouraging people to plan for discrete financial goals, such as college, a down payment on a home or a vacation. Savers understand that each goal has a different time horizon and should be treated differently.

Applying the concept of planning for specific expenses to retirement planning is a bit of a departure from the common assumption that retirement is a single, overarching savings goal. Yet planning separately for healthcare costs makes sense.

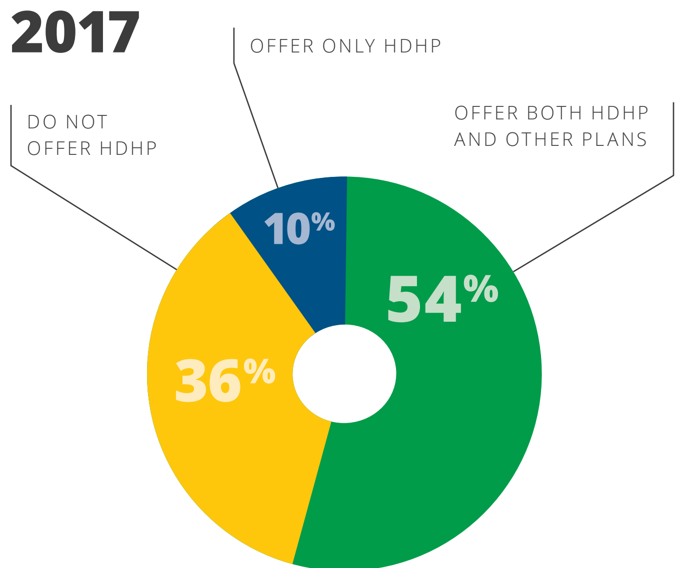
Healthcare will be one of the largest, if not the largest, categories of expenses for many Americans in retirement.

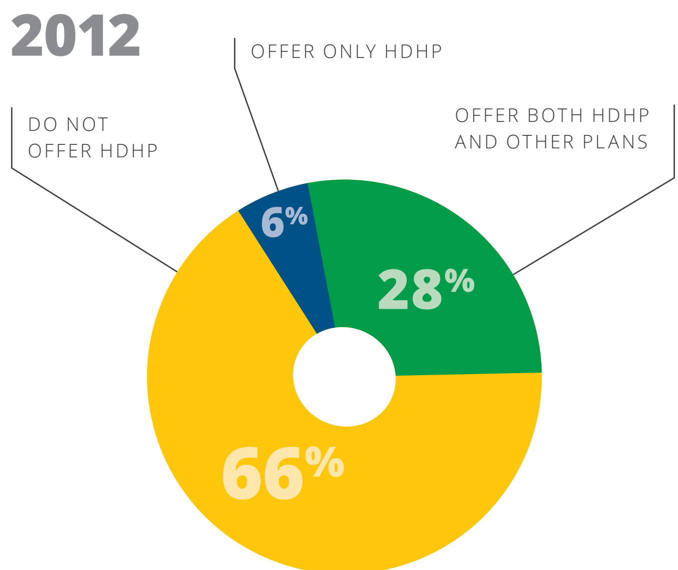
Projected retirement healthcare-related insurance premiums and out-of-pocket costs for the average 65-year-old couple retiring in 2017 were recently reported to be $404,253.[3]

If there's an optimal way that people can save specifically for their future healthcare expenses, we would serve them well by helping them understand it. Incorporating HSA savings strategies into retirement planning is not only a best practice — it is a critical element of a truly holistic discussion of retirement.

HIGH-DEDUCTIBLE HEALTHCARE PLAN ACCESS

PERCENTAGE OF EMPLOYERS WITH OVER 500 EMPLOYEES OFFERING A HIGH-DEDUCTIBE HEALTHCARE PLAN (HDHP)





SOURCE: MERCER'S NATIONAL SURVEY OF EMPLOYER-SPONSORED HEALTH PLANS

The dual benefit of HSAs

Employees benefits: HSAs offer a number of benefits for consumers. These individually owned accounts are often called “triple tax-free”:

1. Contributions are federal-tax deductible regardless of income.
2. Federal tax on investment earnings is deferred until withdrawal.
3. All withdrawals (including earnings) used to pay for qualified healthcare costs are free from federal taxes regardless of when they are made.

As of 2017, HSAs are also exempt from state income tax, except for residents of Alabama, California and New Jersey. When HSA contributions are deducted directly from payroll under a section 125 cafeteria plan, they are also exempt from FICA tax, resulting in the considerable additional savings of 7.65% for employees and 7.65% for employers up to the Social Security Wage Base (SSWB). If an account holder makes a withdrawal after age 65 for a nonqualified expense, the amount withdrawn is simply subject to income tax.[4]

In addition, HSA assets are flexible in that they can be used to pay for qualified healthcare expenses at any time. No other workplace savings option can boast these tax benefits.

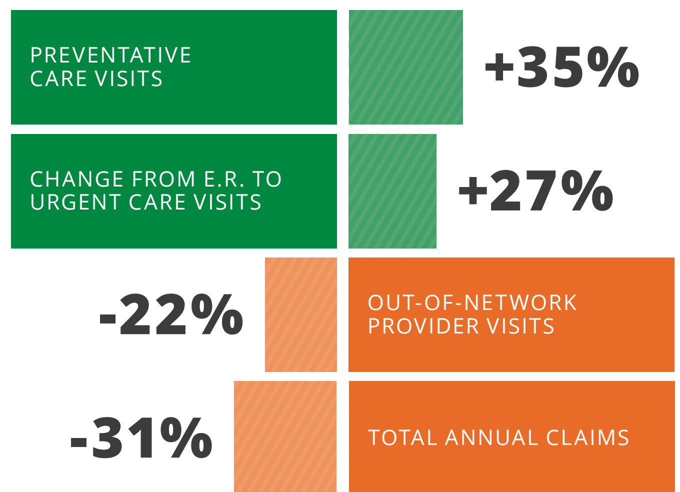
Employer benefits: Employers have offered HSAs for multiple reasons, ranging from simply expanding their benefits packages to encouraging employees to take more responsibility for their healthcare spending. Employers receive two additional benefits from reframing HSAs from a current-year spending account to a long-term investment account. First, as an increasing number of employees take advantage of the HSA offering, more dollars will be exempt from the employer’s portion of FICA. Reducing wage costs on contributions by 7.65% can result in meaningful savings.

Second, research shows that when HSA holders accumulate and invest a balance, they begin to consume healthcare differently. Data from Optum Bank, the largest HSA provider by number of accounts, suggests that these employees did not consume less healthcare, but did consume it more efficiently. In fact, the population experienced a 35% increase in preventive visits, a 27% shift from emergency room care to urgent care, and a 22% decrease in out-of-network care. Why the shift? These account holders may have more “skin in the game” than those who were simply using the HSA as a pass-through for current-year healthcare expenses.[5]

Helping employees build a balance in their HSA could very well be one of the most powerful wellness programs on the market today

Ultimately, changes in consumer behavior resulted in a 31% decrease in total annual claims.[5] That type of claims savings is significant to any employer — especially for those who self-insure.

HSA USE AND RESOURCE UTILIZATION[5]



DIFFERENCE BETWEEN EMPLOYEES WHO HAVE SIMPLY ENROLLED VS. THOSE WHO HAVE BECOME HSA INVESTORS

2

The retirement savings optimization model

Given the favorable tax treatment and flexibility of HSAs, it's easy to see why it's beneficial to incorporate them into an employee savings plan. The real questions, then, are the following:

1. How can HSAs be incorporated into the retirement planning process?
2. How should savers allocate their limited savings dollars toward their employer-sponsored retirement plan and/or their HSA?

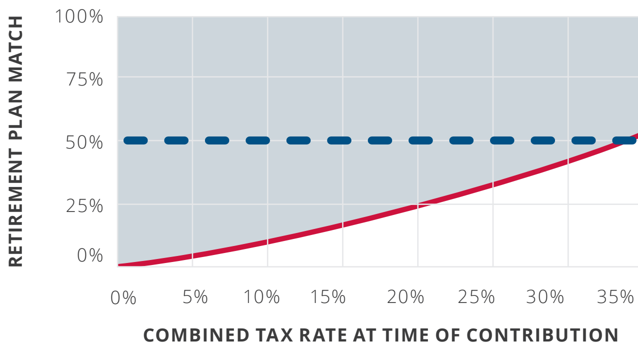
One solution is to offer employees a simple structure — a savings optimization model — to help determine how much of their savings to put into which accounts during their working years. This model directs each dollar to a particular savings vehicle based on that dollar's most efficient projected future value.

To provide a clear structure for savers, we built a savings optimization model that includes HSAs.[6] In each example provided, we also identify the impact that the savings dollars have on the model.

The charts on the following page illustrate the results of a break-even analysis showing when it is most advantageous to allocate savings first to an employer-sponsored retirement plan, and when it is most advantageous to contribute the first savings dollars to an HSA. This analysis assumes an employer-matching contribution. Our optimization model looks at the amount the investor can save on taxes when contributing to an HSA relative to the amount of money they can get from an employer through the match. In all the following charts, if the employer's match percentage is above the line for the employee's combined tax rate,[7] the retirement plan is the most

THE IMPORTANCE OF THE 50% MATCH

If an employer offers a match of 50% or higher, employees at nearly all tax rates should consider allocating their first savings dollars to the retirement plan up to the maximum matched contribution.



First savings dollars allocated to employer-sponsored retirement plan

efficient destination for savings dollars; if the match is below the line, the HSA is most efficient.

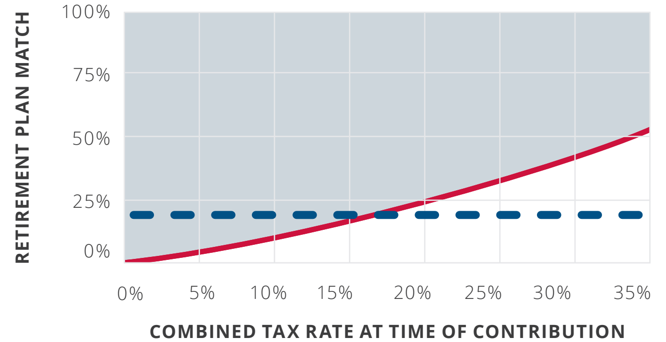
For nearly every applicable combined tax rate, HSAs are the most efficient use of the first savings dollar only when retirement plan match formulas are below 50%.

“Compensation and the 20% match” (above right) shows that for the average American saver (annual compensation of $70,000), the match formula threshold is even lower — approximately 20%. So the average American saver’s employer match formula needs to be just 20% or greater to make the employer retirement plan more advantageous for the first savings dollars.

“Where existing match formulas fit in” (at right) illustrates where match formulas found on the Empower recordkeeper system fall in this analysis. Significantly, the vast majority of plans — approximately 97% — offer a match formula that meets or exceeds the 50% threshold, with varying levels of contributions matched. One other important consideration in creating a savings optimization model

COMPENSATION AND THE 20% MATCH

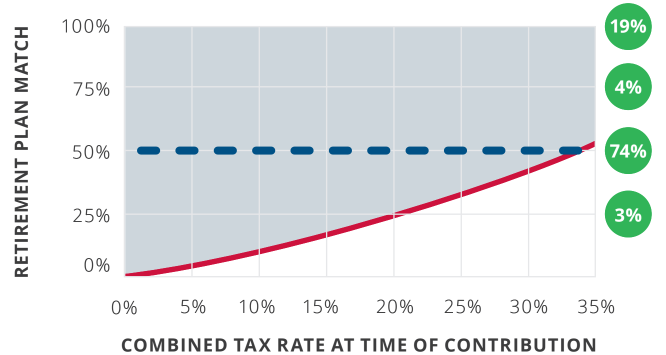
With a match formula of just 20%, the employer retirement plan is more advantageous for the average American saver’s first savings dollars.



Max. HHI - Single	$52K	$60K	$71K	$87K	$112K	$157K	$275K
Max. HHI - Married filing jointly	$121K	$140K	$166K	$203K	$261K	$367K	$616K

WHERE EXISTING MATCH FORMULAS FIT IN

The vast majority of employers already offer a match formula that exceeds the 50% threshold



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Max. HHI - Married filing jointly	$121K	$140K	$166K	$203K	$261K	$367K	$616K

Percentage of plans at different match levels (when offered)

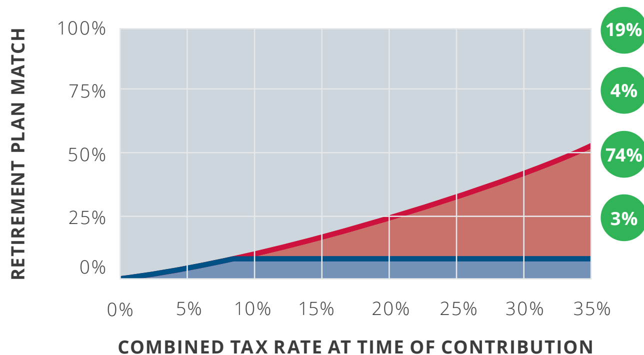
MATCH REPRESENTATION INCLUDES BOTH SINGLE-TIER AND MULTI-TIER FORMULAS. FOR SIMPLICITY, WE INCLUDE THE FIRST TIER FORMULA IN MULTI-TIER FORMULAS.

is intended use, or the way the dollars will be used in the future. HSAs' tax benefits apply as long as withdrawals are used exclusively for paying qualified healthcare expenses at any time prior to or in retirement. However, the account's tax benefits are quickly negated when HSA assets are used for any other purpose, given that any amount used for nonqualified purposes is taxed as income in the year in which it is withdrawn. Withdrawals for nonqualified expenses prior to age 65 trigger an additional 20% penalty.[8]

When intended use is considered, the match formula threshold becomes even lower. As you can see in "The importance of qualified withdrawls" below, without HSAs' tax-free withdrawals, the only real advantage the accounts provide is the immediate return associated with the HSA FICA exemption.

THE IMPORTANCE OF QUALIFIED WITHDRAWALS

Taxable HSA withdrawals for nonqualified expenses negate the accounts' financial advantages



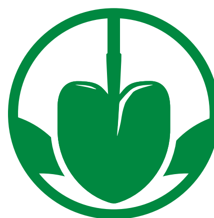
Single	$52K	$60K	$71K	$87K	$112K	$157K	$275K
Married filing jointly	$121K	$140K	$166K	$203K	$261K	$367K	$616K

Percentage of plans at different match levels (when offered)

First savings should be applied toward:

- Workplace savings plan (up to match)
- HSA when applied to qualified medical expenses
- HSA when applied to nonqualified medical expenses

In light of this analysis, it's clear that when an employer-matching contribution exists, savers generally should allocate their savings dollars to their retirement plan until they have taken full advantage of the match formula. For example, an employee with access to a 50% match on the first 6% of compensation may benefit most by allocating savings dollars up to 6% of their income before starting to contribute long-term savings to an HSA.



Consider offering the following advice to employees:

If your employer-sponsored retirement plan offers a match ...

1. Allocate every dollar toward the retirement plan, up to the match formula threshold.
2. Allocate each additional savings dollar to the HSA up to the maximum contribution amount.
3. Allocate additional savings dollars to the retirement plan up to the annual contribution limit.

If your employer-sponsored retirement plan does not offer a match ...

1. Allocate each savings dollar to the HSA up to the maximum contribution amount.
2. Allocate additional savings dollars to the retirement plan up to the annual contribution limit.

3

The savings optimization model in action

It should be clear by now that HSAs may allow Americans to improve their standard of living in retirement without changing their level of disposable income today. Consider how the savings optimization model applies to four different employee scenarios.[9]

Scenario 1 - Joe

Following the savings optimization model, Joe would allocate 6% ($4,800) of his pretax income to the retirement plan to maximize the employer match ($2,400). Under his current savings strategy, he still has $1,600 to allocate.

Due to the FICA exemption, Joe can allocate $1,733 toward an HSA without impacting his take-home pay. Assuming he continues to save the same amount over the next 20 years in this manner, he would accumulate $380,000 in the 401(k) and $47,000 in the HSA, bringing the total saved to $427,000.

Joe

3.4% or $12,000 more spending power in retirement

MARITAL STATUS	SINGLE
YEARS UNTIL RETIREMENT	20
ANNUAL INCOME	$80,000
MATCH FORMULA	50% MATCH ON FIRST 6%
CURRENT 401(K) BALANCE	$100,000
CURRENT SAVINGS RATE	8%, PRETAX

Assuming Joe will need to replace 75% of his current salary in retirement, his retirement income target would be $60,000 and his effective tax rate in retirement would be 16%. If he uses the entire amount in his HSA for qualified healthcare expenses, Joe will have the equivalent of $367,000 of after-tax purchasing power in retirement.

Compare that to a scenario where he continues saving only in the retirement plan at 8%. In that case his overall purchasing power would be reduced to $355,000. The use of the HSA added $12,000 in purchasing power without affecting Joe's take-home pay during his career.

Scenario 2 - Natasha

With the savings optimization model, Natasha would allocate 4% ($4,600) of her pretax income to the retirement plan to maximize the employer match ($4,600). Under her current savings strategy, Natasha still has $6,900 to be allocated.

With the FICA exemption, Natasha can allocate $6,900 toward an HSA (the 2018 limit for family coverage) and still contribute $530 more in the retirement plan without impacting her take-home pay. Assuming she continues to save the same amount over the next 25 years with this allocation strategy, she'll accumulate $541,000 in her 401(k) and $257,000 in her HSA, for a combined total of $798,000.

Assuming Natasha will replace 75% of her current salary in retirement, her retirement income target would be $86,000 and her effective tax rate in retirement would be 19%. If Natasha only used her HSA for qualified healthcare expenses, she'd have the equivalent of $695,000 of after-tax purchasing power in retirement.

Compare that to a scenario in which she does not contribute to the HSA: Her overall purchasing power would decline to $614,000. Again, the use of the HSA added $81,000 in purchasing power without any impact to Natasha's current take-home pay.

Natasha

13% or $81,000 more spending power in retirement

MARITAL STATUS	SINGLE, TWO CHILDREN
YEARS UNTIL RETIREMENT	25
ANNUAL INCOME	$115,000
MATCH FORMULA	100% MATCH ON FIRST 4%
CURRENT 401(K) BALANCE	$75,000
CURRENT SAVINGS RATE	10%, PRETAX

Scenario 3 - Steve

In this example the saver uses the HSA as a pass-through for current annual medical expenses. By moving to an HDHP, Steve will save approximately $1,500 in premiums annually. He has committed to putting that $1,500 toward his HSA to cover the additional out-of-pocket costs he anticipates, which leaves him with a total of $4,790 to put toward the savings optimization model ($3,290 from existing retirement plan savings and $1,500 from insurance premium savings).

Steve

1.2% or $3,000 more spending power in retirement

MARITAL STATUS	MARRIED, THREE CHILDREN
YEARS UNTIL RETIREMENT	30
ANNUAL INCOME	$47,000
MATCH FORMULA	50% MATCH ON FIRST 6%
CURRENT 401(K) BALANCE	$20,000
CURRENT SAVINGS RATE	7%, PRETAX

Following the model, Steve would allocate 6% ($2,820) of his pretax income to the retirement plan to maximize the match. As a result, he would receive $1,410 from the employer match, leaving $1,970 still to be allocated. Given the FICA exemption, Steve can allocate $2,133 toward an HSA without affecting his take-home pay. Note that this amount includes the $1,500 Steve plans to use to cover current-year qualified health expenses.

Assuming he continues this approach over the next 25 years, he'll accumulate $255,000 in the 401(k) and $31,000 in the HSA, bringing the total saved to $286,000. (This calculation assumes he will continue withdrawing $1,500 from the HSA annually for qualified expenses.) Assuming Steve will replace 75% of his current salary, his retirement income target would be $35,000 and his effective tax rate would be 0% in retirement. Given these assumptions, Steve will have the equivalent of $286,000 of after-tax purchasing power in retirement.

Compare that to a scenario where he continues to put 7% in the retirement plan and allocates $1,624 (the after-tax equivalent of $1,500) to fund the HSA. His overall purchasing power in that case would be reduced to $283,000. In this example, Steve still realizes an additional $3,000 in after-tax spending power in retirement, even though he used the earmarked savings from the reduced premiums for current-year healthcare costs.

Scenario 4 - Jill

Following the savings optimization model, Jill would allocate 6% ($15,900) of her pretax income to the retirement plan to maximize the match, and would receive $7,950 in the form of the employer match. Under her current savings strategy, Jill would still have $2,650 to allocate. The FICA exemption means that Jill could allocate $2,712 toward an HSA without affecting her take-home pay. The additional amount she saves from the FICA exemption is limited to the Medicare tax and Medicare excise tax (2.35% combined).[10]

If she continued to save the same amount over the next 15 years in this manner, she'd accumulate $1,235,000 in her 401(k) and $54,000 in her HSA, for

Jill

2% or $17,000 more spending power in retirement

MARITAL STATUS	MARRIED
YEARS UNTIL RETIREMENT	15
ANNUAL INCOME	$265,000
MATCH FORMULA	50% MATCH ON FIRST 6%
CURRENT 401(K) BALANCE	$500,000
CURRENT SAVINGS RATE	7%, PRETAX

a total combined amount of $1,290,000. Assuming Jill will replace 75% of her current salary, her retirement income target would be $199,000 and her effective tax rate would be 27% in retirement. If the entire amount in the HSA were used for qualified healthcare expenses, Jill would have the equivalent of $956,000 of after-tax purchasing power in retirement.

Compare that to a scenario where she makes no changes (and does not contribute to an HSA): Her overall purchasing power would be $939,000. Again, using the HSA added $17,000 in purchasing power with zero impact to Jill's current take-home pay equivalent.

In each of these scenarios, the retirement saver ends up with greater after-tax spending power in retirement by utilizing the savings optimization model. Savers are able to maximize the immediate return and increase the actual amount saved by leveraging the FICA exemption associated with the HSA — without affecting their take-home pay.

The model applies even in cases without an employer match. Absent an employer match, the saver would first apply all savings dollars to an HSA up to the contribution limit, then allocate the remaining savings dollars to the retirement plan. This approach proves more effective even if the funds in the HSA are not used for qualified withdrawals.

4

Putting it all together

The savings optimization exercise is important and revealing, but engaging employees is challenging. Adding the complexity of savings optimization could prove frustrating unless it is done in a way that is simple, intuitive and actionable.

In "Experience Matters," we reported data related to Empower's online participant experience over a period of six years. Through EmpowerUp™, an interactive participant experience, employees can access personalized retiree healthcare cost projections as well as predictions of the impact those costs will have on retirement income. When participants engaged with that page, 37% made a change to their savings rates. The average savings rates rose from 8.64% to 10.54%, a 22% increase.[11]

We know from experience that calls to action alone do not produce this type of result. Employers and recordkeepers must make action easy by pairing the call to action (how much more an employee should contribute to close a shortfall) with the ability to take action seamlessly (changing their payroll contributions). Based on our experience with EmpowerUp, we know increasing awareness of retiree health costs while integrating the ability to easily change payroll contribution amounts prompts a significant percentage of users to take

action. Similarly, giving employees guidance about their contribution strategy based on the savings optimization model can reduce friction, allowing employees to accumulate more income in retirement without decreasing their take-home pay.

Key takeaways for plan design

Implications for plan design — What does the HSA savings optimization model mean for workplace retirement plans?

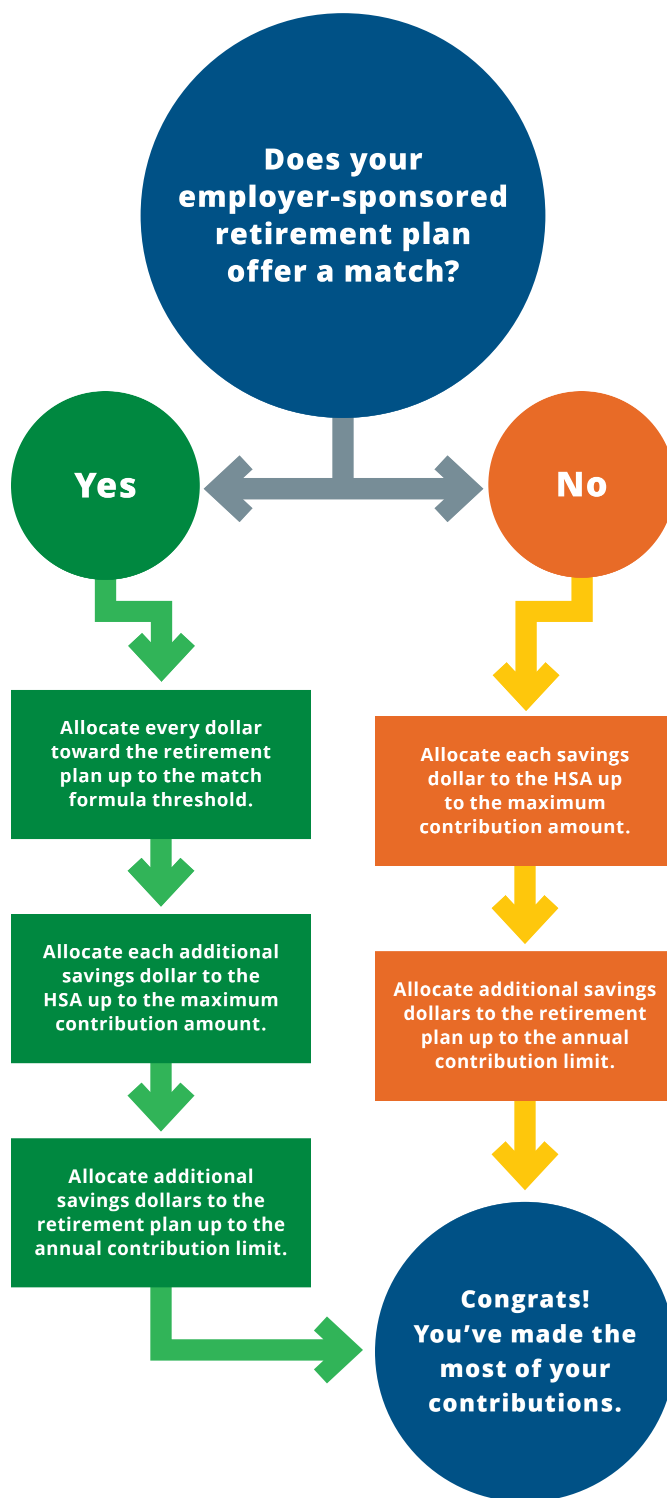
Health savings accounts can make a substantial difference in savers' abilities to fund their expenses in retirement — especially when contributions are directed strategically. Consider updating your plan design to incorporate the following best practices:

Set the match at 50% or more. When employers match 50% or more of an employee's retirement savings contribution, the retirement plan is the most efficient destination for the employees' first savings dollars, regardless of the contribution match amount.

Educate employees about optimal contribution order. Employees don't need to understand the complex calculations related to which account they should contribute to first; they just need to know what to do. Consider sharing the flow chart at right.

Make it easy. Once you've informed employees about the optimal contribution order, enable them to act accordingly. Make it easy for them to tweak contributions to both the retirement plan and their HSA. Using an interactive participant experience such as EmpowerUp can give employees valuable insight on their progress toward their retirement savings goals and allow them to take action easily.

Make the most of your savings dollars



References

1. EBRI Retirement Confidence Survey, March 2017.

2. Mercer National Health Survey, November 2017.

3. HealthView Services 2017 report.

4. To encourage restricting use to qualified healthcare costs, account holders who use HSA assets to pay for any other purpose prior to reaching age 65 are subject to income tax and a 20% penalty.

5. IRS Publication 969 (2017), Health Savings Accounts and Other Tax-Favored Health Plans.

6. Calculations assume that the current governmental constructs (statutory, regulatory and tax code) are in place. They also assume 5% state income tax rate, 5% real rate of return, 7.65% FICA tax, standard federal income tax deduction, SSWB, standard Medicare tax above the SSWB and additional Medicare tax. For purposes of this analysis, we limit the tax rate to 35% because it reflects the top combined rate for an individual's maximum compensation that can be used for calculating deferrals and matching contributions to the 401(a)(17) annual compensation limit of $275,000.00 in 2018.

7. For purposes of this paper, the combined tax rate prior to assumed age-65 retirement includes federal income tax based on single or married filing jointly, application of the standard deduction and FICA (Social Security tax up to the Social Security Wage Base, Medicare tax and Medicare excise tax). For simplicity purposes, we assumed 5% state income tax. Post-age 65 combined tax rate assumptions exclude FICA.

8. For purposes of this paper, we assume each savings dollar someone has to allocate is earmarked for retirement, so we do not show the impact of the 20% penalty levied for nonqualified use of HSA assets prior to retirement.

9. These scenarios take into consideration current savings rates only, not current disposable income, and do not consider the possible differences in investment earnings that can be made in a retirement plan versus an HSA. The difference could impact long-term savings, especially for a younger employee who may have a more aggressive investment mix in the retirement plan.

10. Because Jill's compensation is well above the Social Security Wage Base, she does not save the full 7.65%. Instead, she saves 2.35% because her reportable Medicare income will be reduced from $265,000 to $262,288.

11. Empower Retirement, "Experience Matters: The connection between personalized projected retirement income and retirement readiness," October 2017.

Disclosures

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