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News from EBRI

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New from EBRI:

Health Savings Accounts Unlikely to Cover Retiree Health Costs

WASHINGTON, DC—Health savings accounts (HSAs) are likely to play a minor part in savings for health care costs in retirement, according to a report issued today by the nonpartisan Employee Benefit Research Institute (EBRI).

That's because both statutory contribution limits and currently low interest rates constrain the amount HSAs are able to generate, compared with the large amount needed to pay for retiree health expenses.

The report, in the April 2010 *EBRI Notes* (www.ebri.org), evaluates the use of HSAs to generate savings needed to cover health insurance premiums and out-of-pocket expenses for health care services in retirement, using both estimated Medicare payments and earlier EBRI research on retiree health costs.

Based on current interest rates, if an individual age 55 in 2009 were to contribute $3,000 to his or her HSA and also contribute the $1,000 catch-up contribution each year for 10 years, a total of $48,300 would be in the account after 10 years at a 2 percent interest rate. And if the interest rate was 5 percent, $55,100 would be accumulated at the end of 10 years.

However, as the EBRI analysis notes, such savings levels by themselves are inadequate to cover health costs in retirement:

- A man age 55 in 2009 would need between $144,000–$290,000 by the time he reached age 65 in 2019 (depending upon his use of prescription drugs in retirement) to have a 50 percent chance of being able to cover premiums and out-of-pocket expenses for Medigap and Medicare Part D. Thus, a 55-year-old man would be able to use an HSA to accumulate between 16–32 percent of needed savings for insurance premiums and out-of-pocket expenses in retirement for a 50–50 chance of having enough savings.
- For a 90 percent chance, the maximum HSA savings would cover between 7–16 percent of the necessary savings amount. Women, who live longer than men on average, will need more.

"One of the difficulties in using an HSA to save money for premiums and out-of-pocket expenses during retirement is that contributions to the HSA are limited by law," said Paul Fronstin of EBRI, author of the report. "As a result, the *savings needed* for retiree health care far exceed the *savings potential* of an HSA."

Fronstin noted that individuals can (and may need to) use the money in the account to pay for health care services during their working years or to pay COBRA premiums and insurance premiums during periods of unemployment. Distributions from the HSA prior to becoming eligible for Medicare will erode the value of the account and create a bigger gap between needed savings and the amount of money that an HSA would have once a person retires.

An HSA is a tax-exempt trust or custodial account that an individual can use to pay for health care expenses. Contributions to an HSA are deductible from taxable income and distributions for qualified medical expenses are not counted as taxable income. Once enrolled in Medicare, beneficiaries are not permitted to continue making contributions to an HSA. Earnings on contributions are also not subject to income taxes.

The EBRI report notes that there are several options that individuals may have to save for retiree medical expenses, such HSA, health reimbursement arrangements (HRAs), retiree medical accounts (RMAs), and voluntary employee benefit associations (VEBAs). However, the report focuses only on health savings accounts because these are the only accounts that are always portable for the employee and owned by the employee.

The analysis notes that the present value of lifetime benefits from Medicare for a husband and wife turning age 65 in 2010 has been estimated at about $376,000. Since Medicare on average covers a little more than one-half of health care costs for beneficiaries, the average husband and wife will need a little less than $376,000 in savings to cover what is not covered by Medicare.

However, as previous EBRI research has shown, the issue with using this average is that individuals cannot simply assume to *be* average. While 50 percent of men turning age 65 in 2008 will live to age 81, and 50 percent of women will live to age 84, about 25 percent can be expected to live until ages 87 and 90, respectively. Furthermore, 1 out of 10 men currently age 65 can expect to live until 91, while 1 out of 10 women can expect to live to 95.

This means that a significant number of individuals will live far longer than the average for their gender, and uncertainty related to life expectancy and other factors makes saving for retirement increasingly complicated.

"This research shows that while HSAs can be used to save for health care expenses in retirement, the maximum savings that can be accumulated in an HSA will be far from sufficient to fully cover the savings needed in retirement for insurance premiums and out-of-pocket expenses," Fronstin said.

The full report is online at www.ebri.org/pdf/notespdf/EBRI_Notes_04-Apr10.HSAs-TaxExpends1.pdf

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