The HSA Opportunity for Financial Organizations

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Introduction

The passage of the Medicare Modernization Act of 2003 introduced Health Savings Accounts (HSAs) beginning in 2004.[1] This legislation places banks and credit unions in a leading position to capitalize on the potential of this emerging market. This is especially significant given the size of the healthcare industry and its historical reliance on insurance companies—not banks and credit unions—for its financial foundation.

The HSA Purpose—Consumer-Driven Healthcare

Health Savings Accounts are the centerpiece of a new trend in healthcare called “consumer-directed health plans,” allowing individuals to exercise more control over their healthcare dollars. By placing control with the individual, the belief is they will make wiser decisions on spending their money and look after their best interests more fully than employers or health care companies.

Too often in today’s healthcare environment, consumers are unaware of the actual costs of the healthcare they receive and have little to no financial incentive to learn more about the issue. Most employers that currently provide insurance offer first-dollar coverage or low-deductible insurance, and attempt to control costs by limiting service, requiring co-pays, or passing on some of the insurance cost to employees. Employers may find cost effective alternatives to health care options by evaluating the benefits of a HDHP paired with a HSA.

Generally, a High Deductible Health Plan (HDHP) will provide 100 percent coverage for costs associated with preventative and wellness health care. Costs associated with things such as routine office visits, medications, and other minor disorders are generally paid by the consumer using money they’ve amassed in their HSA or, alternatively, paid directly out of pocket. Once a deductible is met, the HDHP covers major medical expenses—such as surgery or serious illness—and will kick in once the deductible is met. In order to qualify as a HDHP, the plan must meet a minimum deductible threshold, published in the Internal Revenue Code. A qualifying HDHP is a prerequisite for participation in a HSA.

It seems logical enough, but what makes Health Savings Accounts so special? Prior to the HSA legislation, a HDHP did not make sense for most people, especially from a tax perspective. Healthcare costs provided by the employer are deductible as a business expense, while expenses paid by individuals are generally not deductible.[2] Accordingly, most employees want as many healthcare expenses paid through the employer as possible, including costs for routine care. HSAs offer individuals a method to save and pay for healthcare expenses with tax advantages.

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[1] Section 1201 of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, Pub. L. No. 108-173, added Section 223 to the Internal Revenue Code to permit eligible individuals to establish Health Savings Accounts for years beginning after December 31, 2003.
[2] Tax relief is available for individuals who itemize and whose medical expenses exceed 7.5 percent of adjusted gross income.

HSA Legislative Review

Overview. HSAs provide a tax-free method to save and pay for qualified medical expenses. HSA rules require that the funds be held in custodial or trust accounts with banks and credit unions generally pre-approved to serve in that capacity.

Eligibility. To qualify for a HSA, an individual must meet the following criteria with respect to any month:

- Be covered under a High Deductible Health Plan (HDHP)
- Not be covered under another health plan that is not a HDHP
- Not be eligible to be claimed as a dependent on another person's tax return
- Not be enrolled in Medicare

The key requirement is being covered under a HDHP. For 2007, a HDHP is a plan with at least a $1,100 deductible for individual coverage and at least $2,200 for family coverage.[3] To alleviate the concern that individuals will try to avoid spending money by not seeking preventative care, HDHPs may offer preventative care benefits that are not subject to the deductible.[4]

Contribution Limits. The contribution limit for 2007 is $2,850 for individual coverage and $5,650 for family coverage. For 2007, an $800 catch-up contribution is available for individuals between ages 55 and 65 with the limit increasing each year until 2009.

Tax Benefits. Contributions made to a HSA are tax deductible and distributions used for qualified medical expenses are tax free. The deduction is "above the line" and does not require an individual to itemize. This provides a substantial tax benefit and is a big part of the reason that HSAs are so popular. Many employees have enjoyed a similar tax benefit through Flexible Spending Accounts, Cafeteria Plans, or Health Care Reimbursement Accounts.

Savings Benefit. The money in a HSA belongs to the individual—not the employer. Accordingly, unused money in a HSA rolls over for future years. The HSA rules are quite flexible. For example, if you save $2,000 this year and incur a $2,000 qualified medical expense in a future year (even a year you are no longer covered by an HDHP), you can use your HSA to pay that expense. Conversely, if you incur a $2,000 expense this year and only have $500 in your HSA, you can pay the remaining $1,500 medical bill with other funds and then use future years' HSA contributions to reimburse yourself. Distributions after age 65 for anything other than qualified medical expenses would be taxable but not subject to penalty. The HSA works best for financially responsible individuals that save and plan—exactly the type of people most financial organizations want as depositors.

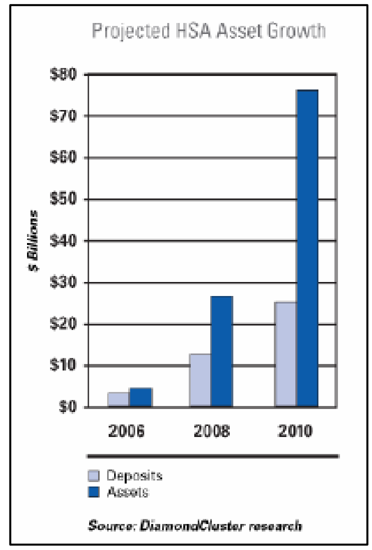
Qualified Medical Expenses. Qualified medical expenses include: prescription drugs, certain nonprescription drugs, doctor visits, medical tests, eyeglasses, dental treatment, and a long list of additional expenses.[5]

The concept of consumer-driven healthcare is in the early stages but has shown some promising results. Individuals and employers are quickly adopting the new plans. As a result, many of the original HSA legislation's goals are becoming realized: value consciousness, improved wellness behavior, and cost control.[6]

[3] High Deductible Health Plans are plans with a minimum annual deductible of at least $1,100 for individual ($2,200 for families) and a maximum out-of-pocket expense of $5,500 ($11,000 for families).
[4] Some examples of allowable preventative care include: periodic health examinations, pre-natal and well-child care, immunizations, tobacco cessation, obesity control, and screenings. See IRS Publication 969.
[5] See IRS Publication 502 for a complete list.
[6] *Consumer-Directed Health Plan Report–Early Evidence is Promising*, McKinsey & Company, June 2005.

Market Overview

Over One Million HSAs and Growing. Individuals have opened over one million HSAs[7] since the law passed, with over 50,000 new HSAs being established each month.[8] According to data gathered by Inside Consumer-Directed Care (ICDC) in the February 24 newsletter, more than $1 billion has been invested in HSAs. Projections from TowerGoup estimate $26 billion in assets by 2010.[9] DiamondCluster research is even more optimistic, estimating over $75 billion in assets covering 15 to 25 million HSAs by 2010.[10] The size and growth of HSAs are enough to draw a variety of providers into the market.



Market Dynamics. The HSA marketplace is still developing with fragmented vendors experimenting with different approaches. At least three distinct types of vendors are entering the market: banks/credit unions, insurance companies, and third-party administrators. Brokerage firms and mutual fund companies also appear to be taking a closer look at the market with some early entrants.

Historically, this is insurance company territory with insurance premiums covering most medical expenses. They are responding to the new legislation by moving quickly to offer HDHP solutions. For HSA solutions, insurance companies are trying multiple approaches. While some are offering their own HSA (e.g., Fortis) and some are using a wholly-owned bank subsidiary (e.g., UnitedHealth Group and Exante Bank), the partnership approach appears to be the most popular model, as most insurance companies have been partnering with a bank or credit union (e.g., HealthPartners and Wells Fargo).

Third-party administrators are also entering the HSA marketplace. As historical administrators of Flexible Spending Accounts (FSAs), Healthcare Reimbursement Accounts (HRAs), and other health insurance solutions, it's a logical service extension. However, third-party administrators are generally not approved as custodians or trustees, and experience in reviewing and approving medical claims is not necessary for HSAs.

Banks and Credit Unions Are Positioned to Win in the HSA Market. Banks and credit unions are in a strong position to capture HSA market share. Although it's still early, the most common approach seems to incorporate existing banking solutions, such as DDAs, CDs, and share accounts. Banks and credit unions enjoy a large advantage over other financial organizations in offering such a hybrid because they have experience in providing these types of solutions. Early results show this to be true with two banks being the largest providers of HSAs (albeit one owned by an insurance company): HSA Bank in Sheboygan, Wisconsin, and Exante Bank in Salt Lake City, Utah—together holding approximately half of all HSA deposits to date.

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[7] *Number of HSA Plans Exceeded One Million in March 2005,* Study released by America's Health Insurance Plans (AHIP), May 4, 2005.
[8] *HSA Deposits Top $460 Million, ICDC Finds; 50,000+ Accounts are Opened Each Month,* Inside Consumer Directed Health Care,Volume 3, Number 9, May 5, 2005.
[9] *Health Savings Accounts: The Prognosis for Asset Managers,* TowerGroup, July 2005.
[10] *Seizing the HSA Opportunity,* Study by DiamondCluster, 2005

HSAs are transaction based for most owners with a small savings component. Average HSA balances appear to be settling around $1,000—below the average dollar amount attractive to many securities providers. Banks and credit unions, however, know how to profit on these accounts.

IRA Experience Matters. The HSA legislation uses IRA legal framework as a foundation and utilizes many similar rules. This is good news for banks and credit unions with decades of experience in the IRA market. Less so for insurance companies that have not traditionally excelled in offering IRAs. See the accompanying chart, HSA Custodian/Trustee Responsibilities, to give you an idea of some of the similarities.

The operational infrastructure is also fundamentally the same for HSAs as IRAs. Financial organizations can look to their traditional vendors for support services. This includes receiving compliance documentation, marketing materials, software, and government reporting and recordkeeping services.

This IRA experience and existing infrastructure combined with checking account experience provide key advantages over other organizations trying to secure a foothold in the HSA marketplace.

What About the Insurance Expertise

Required? Although HSAs are tightly tied to the HDHP, they are a separate product. One concern of banks and credit unions is the misunderstanding that they need to become insurance plan experts. That is not necessary. Since health insurance is the insurance company's product, they communicate the qualification possibilities to the owner.

Perhaps the biggest concern keeping financial organizations from developing a HSA program is the additional responsibility of tracking and verifying distributions to make sure they are used only for qualified medical expenses. Again, this is not the custodian's/trustee's role. The individual—not the custodian/trustee—is required to keep records that substantiate that distributions were spent for eligible medical expenses. In fact, the custodian/trustee reporting for eligible and non-eligible expense distribution are the same in most cases.

HSA Custodian/Trustee Responsibilities

- ✓ **Custodian/Trustee for the HSA.** Serve as custodian/trustee for the HSA pursuant to IRS regulations.
- ✓ **Establishing the HSA.** Establish the HSA using compliance documents.
- ✓ **Maintaining the HSA.** Maintain the HSA using proper documents and procedures to meet IRS and other federal and state guidelines.
- ✓ **Reporting on the HSA.** The custodian must provide the following reports (in addition to other reports and statements that the custodian/trustee may elect to do, or be required to do based on the investment selection or charter type):
  - **Contribution Reporting.** Provide IRS Form 5498-SA to the IRS and HSA owner each year, including information on HSA contributions, rollovers, and the December 31 fair market value of the account.
  - **Distribution Reporting.** Provide IRS Form 1099-SA to the IRA and HSA owner for the year that HSA distributions occur.

Relationship Product. HSAs provide an additional relationship product for consumers—especially important to financial organizations seeking relationships with sole-proprietors and small businesses, as these have been the first businesses moving to HSAs.

Fee	HSA Bank	Wells Fargo	American Chartered
Set-Up Fee	$18 - $25	None	None
Monthly Fee	$2.25 waived at $3,000	$3.75 waived at $5,000	None
Checks	50 checks for $12.75	No charge	$19 for checks
Debit Card	ATM/PIN $1.50	No charge	No charge
On-Line	No charge	No charge	No charge
Termination Fee	$25	No charge	No charge
Statements	Monthly	Quarterly	Monthly

Conclusion

New product opportunities like this do not present themselves often, and now is the time to more fully explore the benefits of offering Health Savings Accounts for your account owners.

Call your Wolters Kluwer Financial Services Account Representative today to learn how we can help.

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