

THE NAVIGATOR

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*Disability insurance is a powerful but often overlooked risk management tool. Most Americans focus on auto and home insurance to protect what they consider to be their most valuable assets. However, for most individuals, future potential earnings actually represent their largest asset. An individual 35 years old earning \$150,000 per year will likely generate over \$4.8 million of **after-tax** income prior to retirement.¹ An unforeseen long-term disability would materially hamper or even eliminate his or her ability to ultimately realize this income potential. Therefore, a comprehensive financial contingency plan, such as obtaining a suitable disability insurance policy, should be an important consideration as a risk management tool. In this Navigator, we discuss the basic structure of disability insurance as well as several important considerations that should be taken into account when considering a disability insurance policy.*

MITIGATING TAIL RISK WITH DISABILITY INSURANCE

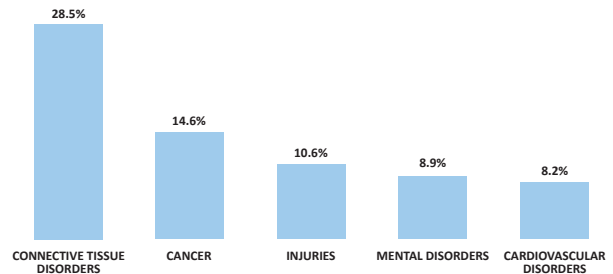
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When developing a comprehensive financial plan, disability insurance tends to be little more than an afterthought for most Americans. However, this type of insurance should, at the very least, be considered and evaluated as an insurance option. According to the Council for Disability Awareness, individuals in their 20s have a 25% probability of being disabled prior

¹ Assumes 35% tax rate, 3% annual raise, and retirement at age 65.

to retirement; the Social Security Administration estimates this probability to be greater than 30% based upon disability claim filings. Somewhat surprisingly, among disability benefit claims filed with the Social Security Administration, approximately 90% of these claims are the result of illnesses rather than accidents.² Disability protection helps to protect against these unforeseen but not so uncommon occurrences.

LEADING CAUSES OF NEW DISABILITY CLAIMS



Source: Council for Disability Awareness

DISABILITY INSURANCE POLICIES

There are two primary types of disability insurance policies: short-term and long-term. Both types of policies have distinct terms and coverage guidelines that should be well understood prior to purchasing a policy. These products are complementary as they protect against different types of disabilities.

The purpose of short-term disability insurance is to replace or subsidize reduced earnings due to a temporary inability to work. Common circumstances in which short-term disability insurance would be highly valuable include recovery from surgery and minor injuries. Most short-term disability

² Per Council for Disability Awareness' 2013 Long-Term Disability Claims Review.



policies range from a duration of 60 to 180 days and often cover the majority of the policyholder's gross income. Employers often provide short-term disability insurance to their employees; accordingly, we would encourage clients to first determine what, if any, coverage they may already have through their employer. Certain employers, while not directly providing disability coverage, subsidize the cost of short-term disability coverage for their employees. Additionally, a handful of states provide short-term disability coverage to workers, either directly or indirectly through employers.³

Long-term disability insurance coverage is useful when short-term disability coverage expires, which, in most cases, occurs after 180 days of disability. Long-term disabilities are usually associated with degenerative diseases (such as cancer) or other catastrophic injuries. Unfortunately, the most common long-term policies only cover about 60% (at most) of the policyholder's salary, and such policies are rarely provided by employers or by state governments. The Social Security Administration does provide long-term disability insurance; however, it typically requires a disability that prevents an individual from any type of work (not just their current profession), and the paid benefits are usually quite low. On the positive side, most long-term disability insurance policies pay benefits up until the typical retirement age of 65.

Many insurance companies provide instant short-term disability insurance quotes via their respective websites. To provide a simplistic example: a 35 year old professional can expect an approximate \$5,000 monthly benefit for a premium of \$85 per month, with a 60-day elimination period.⁴ Obtaining a quote for long-term disability insurance is a more complex endeavor than that for short-term disability insurance, due to the various available options and the unique circumstances of each individual.

THE STRUCTURE OF DISABILITY INSURANCE POLICIES

The options available across disability insurance contracts are seemingly endless. Just as with most other insurance products, when the coverage provided in a disability policy increases, the premiums also increase. Therefore, it is important to be mindful of both the cost and the benefit associated with each coverage option available from a

³ The state of Illinois does not provide short-term disability coverage for its residents.

⁴ Source: www.mutualofomaha.com

disability insurance policy. Set forth below are the most common options to consider, along with brief descriptions of their corresponding benefits.

- **Disability Definition**

Insurance policies provide coverage for different types of disabilities. Most policies separate disabilities into two types: *partial* or *total*. Partial disability refers to conditions that allow individuals to perform the minimum daily responsibilities of their jobs but with certain limitations. For example, a dentist that recently underwent back surgery may still be able to perform his/her daily responsibilities but must limit the number of patients that he/she may see due to reduced physical capabilities.

Partial disability may also refer to disabilities that still allow for employment but force a change in occupation. In the example above, the dentist may be physically unable to perform procedures on patients anymore due to a chronic illness, but the dentist is both capable and able to teach dentistry in an academic setting.

Total disability, on the other hand, refers to conditions that prevent a policyholder from engaging in any type of employment.

- **Own-Occupation**

Insurance policies that provide coverage for own-occupation disabilities refer to coverage for an individual's primary, regular occupation, while engaged at the time of disability. With the preceding example, a dentist with own-occupation coverage would be able to receive benefits if the disability prevented the dentist from typical dentistry responsibilities, even if he/she was still able to find employment elsewhere (such as a dentistry professor). As expected, this type of coverage requires substantially higher premiums.

- **Benefit Period**

The benefit period specifies how long the policyholder may receive payments due to a disability. As previously discussed, short-term disability policies typically have benefit periods of up to 180 days, whereas long-term policies are designed to provide benefits for much greater durations. However, benefit periods can vary greatly from policy to policy and may also depend on the specific type of disability incurred.



- **Elimination Period**

The elimination period specifies the number of days the policyholder must wait before payments commence. For short-term disability, the elimination period is rather short—typically a week or two. For long-term disability, the elimination period is typically 90 days but may be considerably longer.

- **Non-Cancelable / Guaranteed Renewable**

This policy option guarantees that the policy will be renewed annually, so long as the policyholder is current on his or her premiums. In addition, most policies include language that specifies that no changes will be made to premiums or benefits prior to retirement age without consent from the insured.

- **Rehabilitation Benefit**

A rehabilitation benefit clause allows the insurance company to provide physical therapy (or related services) to assist a policyholder in the rehabilitation process. This option is typically provided at the expense of the insurer, as the company has an incentive to help the disabled individual recover and rejoin the workforce as quickly as possible, thereby minimizing benefit payments.

- **Waiver of Premium**

This option allows a disabled policyholder to stop paying premiums and receive a refund of any premiums paid during the elimination period.

- **Survivor Benefit**

Disability policies with survivor benefits allow policy benefits to be passed from the policyholder to his or her beneficiaries (as periodic payments or a lump-sum payment) if the policyholder passes away while collecting disability benefits.

While the preceding list includes many of the most common options associated with disability insurance policies, it is far from exhaustive. Anyone who is considering a disability insurance policy should carefully review all available options and riders and choose the coverage that best addresses her specific needs and preferences. However, it bears repeating that, as the benefits or coverage provided by a policy increase, so do the required premiums.

IS DISABILITY INSURANCE RIGHT FOR YOU?

Although disability insurance can help replace lost income

due to the inability to work, it should not be considered the *only* option for mitigating this risk. A number of other strategies may prove optimal for certain circumstances, and of course no single amount of coverage is suitable for everyone. Individuals must decide how much, if any, disability coverage will meet their own unique needs. The following considerations should help to serve as a guide for anyone who is contemplating purchasing or altering existing disability insurance coverage.

- **Employer / Government Policies**

As previously discussed, certain employers and local governments provide disability insurance coverage for employees and residents. Anyone who is looking to purchase disability coverage should first determine what coverage, if any, is being provided by his or her employer or local government. In some cases, employer or government sponsored disability coverage will be sufficient. However, in other cases, this coverage falls short of meeting an individual's needs, requiring the purchase of additional coverage. In such cases, one should determine that the additional coverage being purchased can, in fact, complement the existing employer or government provided coverage.

- **Occupation**

An individual's occupation is a key factor in determining how much disability insurance coverage is needed. Professionals that provide specialized services where physical abilities are required are typically more vulnerable to lost income due to disability. For example, an insurance salesperson could likely still function at a normal level with a broken arm. However, a surgeon would likely find it impossible to perform at a normal level with a broken arm. In fact, such an injury could have detrimental long-term effects on a surgeon's career. Therefore, when determining a suitable level of disability coverage it is extremely important to consider exactly how common disabilities might impact one's ability to perform his or her specific job functions.

TOP 5 OCCUPATIONS PURCHASING INDIVIDUAL DISABILITY INSURANCE

- DENTISTS
- ATTORNEYS
- EXECUTIVES
- ANESTHESIOLOGISTS
- SURGEONS

Source: www.disabilityquotes.com



- **Savings**

Disability insurance may not be appropriate for individuals with significant savings or emergency funds, especially with respect to short-term disability coverage. Individuals with material emergency funds may be best served by forgoing the cost of short-term disability insurance in favor of “self-insuring.” For people with substantial emergency funds, the financial consequences of a short-term disability would likely be immaterial relative to the cost of short-term disability insurance premiums. It should be noted that taxable savings are a preferable source of emergency funds in the case of an unexpected disability, as early withdrawals from tax-deferred portfolios such as IRAs or 401(k)s carry undesirable tax consequences. Individuals with significant savings may also simply choose to obtain a lower level of disability coverage (even zero coverage) that is suitable for the individual’s risk tolerance and financial goals.

- **Spousal Income / Other Income**

Other sources of income (such as that of a spouse) can also supplement lost wages while a primary wage earner is disabled. Individuals should decide what minimum level of lifestyle would be acceptable in the case of a disability and then determine whether or not that lifestyle could be maintained with sources of income other than that of the primary wage earner. This consideration is most pertinent for decisions involving long-term disability insurance, as short-term disability coverage is likely unnecessary with multiple incomes.

- **Willingness to Downsize**

For some, a temporary downsize in lifestyle may be an acceptable strategy for coping with a reduction in income due to a disability. For example, partial disability insurance coverage may be unnecessary for someone who is willing to accept a different lifestyle brought on by a decrease in employment earnings. Similarly, individuals with material savings may choose to forgo any and all forms of disability insurance and simply accept the lifestyle that their savings can provide.

- **Social Security Disability Insurance**

As mentioned previously, the Social Security Administration provides some degree of long-term disability insurance for qualified claimants. However, one should be wary of relying on this option. Per the Social Security Administration, only 32% of Social

Security disability insurance claim applications were accepted in 2015, and the average monthly payment to qualified claimants was approximately \$1,200.⁵ Given the very low acceptance rate for claims and the paltry level of payouts, this type of insurance coverage should be considered as an insufficient band-aid for a potentially much larger issue.

- **Insurance Company Solvency**

While insurance regulations vary from state to state, most insurance policyholders enjoy some regulatory protection from losses arising from insurance company insolvency. State guaranty funds, statutory capital requirements, and other safeguards have been put in place in most states to provide a backstop in the case of insurance company failures. However, despite these protections, we strongly encourage clients to only purchase insurance products from financially sound, reputable companies with strong track records in order to minimize the possibility of losses or complications related to insurance company mismanagement.

Given the above considerations, it should be clear that the decision to purchase disability insurance is highly subjective and should be tailored to each individual situation. However, in general, we suggest that clients who have occupations that require highly specialized physical abilities at least consider both short and long term disability insurance. More specifically, highly compensated individuals should consider own-occupation disability coverage to ensure that lost income is adequately replaced. Similarly, clients who depend on a single income and have any number of dependents should also consider short and long term disability insurance coverage.

In contrast, clients with substantial assets or alternative sources of income (from a spouse or other source) may be able to support their lifestyles temporarily without the help of short term disability insurance. For these individuals, the incremental cost of short term disability coverage is unlikely to be justified by the benefits that it confers. However, these individuals may still be well served to consider obtaining long term disability coverage to protect against asset erosion in the case of a long term illness or injury.

For clients who are able to “self-insure” due to multiple incomes, large asset bases, and/or a willingness to downsize their lifestyles, both short term and long term disability insurance coverage is likely to be unnecessary.

⁵ U.S. Social Security Administration, Disabled Worker Beneficiary Data, <https://www.ssa.gov/oact/STATS/dibStat.html>



There are clearly a number of important factors to consider when determining if and how much disability insurance coverage should be included in one's overall financial plan. If disability insurance does, in fact, make financial sense, then attention must turn to constructing a policy that is tailored to meet that person's unique needs. In all cases, the benefits of a given policy or option should be analyzed relative to its respective costs, which importantly includes opportunity costs.

If you need help making a decision, **please call us!** We are more than happy to help you sort through any disability insurance decision you are considering.

CLOSING THOUGHTS

Our goal with this Navigator was to shed some light on an effective, yet sometimes marginalized, financial risk management tool. Disability insurance can provide enormous value, but the highly customizable nature of these products can make them difficult to analyze. In addition, the high cost of disability insurance can turn off individuals seeking such risk management policies. The information provided here is intended to help our clients better understand who should own a disability insurance policy and what types of policy options may be most useful for their circumstances. However, we understand that our analysis is far from exhaustive and that there may be a number of other policy options and features that we have not discussed. If you are considering purchasing disability insurance coverage or altering existing coverage, your portfolio manager can provide advice to help guide you toward the right coverage for your personal financial situation.

RESOURCES

For those seeking additional information about disability insurance, the websites listed below are quite informative:

- Council for Disability Awareness
<http://disabilitycanhappen.org/>
- America's Health Insurance Plans
<https://www.ahip.org/>
- Life and Health Insurance Foundation for Education
<http://www.lifehappens.org/>
- Consumer Affairs, Disability Insurance Reviews
<https://www.consumeraffairs.com/insurance/dis.html>

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