Disability Insurance: Background and Basics

Disability insurance may represent the most important financial product individuals need during their working years. The ability to generate an income is the foundation for all financial planning and allows individuals to maintain their lifestyle, providing funds for current expenses and future retirement.

For the purpose of this guide, disability insurance will be assumed to be long term in duration (to retirement, typically age 65 or 67) unless otherwise indicated. Additionally, disability insurance is referred to by many names and abbreviations, many of which are interchangeable. These include disability insurance, disability income, income protection, and long-term disability (LTD). Another version—Social Security Disability Insurance (SSDI)—is covered later in the guide.

History and Evolution of Disability Insurance

Disability insurance has greatly evolved over time with its earliest beginnings traced back to the 17th century. The term “loss of use” was first used in policies by the Dutch. In 1663 they provided policies that covered soldiers at war for what might be known more commonly today as catastrophic, presumptive, or accidental dismemberment benefits with triggers for the benefit that included the loss of sight in both eyes, or the loss of both hands, both feet, both arms, or both legs.

Early disability policies in the United States have roots that can be traced to the mid-19th century in Massachusetts. Before insurance
companies issued disability coverage there were Establishment Funds, which furnished small cash benefits to employees who experienced an illness or accident. Many of these early versions of U.S. disability policies were “accident-only” and were frequently part of life insurance contracts. These initial policies were also cancelable and an insurance company could raise premiums or terminate the policy with limited notice.

Basic standalone disability policies were introduced in the United States during World War I. Non-cancelable and guaranteed renewable contracts were introduced in 1916. In 1918, a company, which later became Paul Revere Life Insurance Company, issued its first contract. Group insurance policies were introduced during this same period to provide coverage for groups of employees working for a common employer who were unable to work, while workers’ compensation only provided coverage to those employees while they were working.

After World War I, major life insurers offered riders to their whole life policies. These “Total and Permanent Disability” riders experienced a surge in claims during the Great Depression, and life insurers backed away from disability coverage. This allowed smaller, specialty carriers to compete effectively.

The Social Security Act of 1935 opened the door for more government-sponsored disability benefits. When Social Security added an amendment in 1954 introducing a disability insurance program, group disability plans became a popular ancillary benefit. This growth in the 1950s and 1960s extended beyond what had been available in the past. Definitions of disability evolved to protect one’s ability to perform his or her own occupation, with a focus on white-collar industries and executives.

The 1990s was a difficult period for disability insurance carriers. The increasingly liberal policies written by the carriers experienced a sharp increase in claims, creating loss ratios that were much higher than expected—exceeding 100%—and putting pressure on their financial health. This led to consolidation of carriers and changes to policies to help carriers mitigate their future risks of issuing disability policies.

From 2001 to 2011, premiums paid for individual disability, non-cancelable policies grew from $2.7 billion to $4 billion. Guaranteed renewable premiums grew from $413 million to $562 million. Meanwhile, carriers continued to innovate with new benefit features available with their policies, such as serious illness and retirement benefit riders. Disability carriers continued to place emphasis on coverage to groups of employees, or multi-life programs, as a way to reach more individuals in their target markets. Traditional professional industries—medical, law, and financial—and new industries were also finding value in executive disability programs, creating new opportunities for growth beyond traditional target markets.

The Need for Disability Insurance

According to the U.S. Social Security Administration, a 20-year-old entering the workforce today has a one in four chance of becoming disabled for 90 days or more before he/she retires. Figure 1.1 shows the percentage of new claims by
age in 2011. Statistics show that once an individual has been disabled for at least 90 days, the average disability claim lasts 2.5 to 3 years, depending on the age at which disability occurs. If the claim lasts at least 180 days, the average claim increases another two years to approximately 4.5–5.5 years.\(^3\)

### FIGURE 1.1

**Percentage of New Long-Term Disability Claims by Age in 2011**

![Percentage of New Long-Term Disability Claims by Age in 2011](image)

*Source: Council for Disability Awareness, CDA 2012 Long Term Disability Claims Review.*

These statistics do not align with public perception. Most people are not aware of their risk of being disabled and the effect it would have on their financial position. When asked, a majority of employees and human resource professionals estimate that the risk of a disability is 1 in 100.\(^4\) In fact, the likelihood of disability ranks high relative to other known risks individuals typically take action to mitigate (see Table 1.1). Because of this lack of awareness, it is important that advisors help educate clients about the disability risk and its potential disruption during their working career.

An individual’s specific risk of disability is determined by age, gender, occupation, health, and the activities in which he or she engages. There are many risk assessment

### TABLE 1.1

**Risks and Insurance Statistics**

<table>
<thead>
<tr>
<th>Risk</th>
<th>Personal Odds</th>
<th>Today’s Cost</th>
<th>Insured?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fire in home</td>
<td>1 in 1,177</td>
<td>$500–1,000 deductible</td>
<td>Yes</td>
</tr>
<tr>
<td>Car crash</td>
<td>1 in 303</td>
<td>$100–$500 deductible</td>
<td>Yes</td>
</tr>
<tr>
<td>Hospitalization</td>
<td>1 in 15</td>
<td>$0–1,500 deductible</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Disability</strong></td>
<td><strong>1 in 4</strong></td>
<td><strong>Cumulative Future Income until Retirement</strong></td>
<td>No or Partially</td>
</tr>
<tr>
<td>Long-term care</td>
<td>1 in 2</td>
<td>$270,000 (average 3-year stay)</td>
<td>Maybe</td>
</tr>
</tbody>
</table>

resources, including calculators, to help people determine their risk of disability. By reviewing an individual’s current financial picture and goals, an advisor can help clients reach their future financial goals with protection from a potential disability.

Working Americans may be covered by basic programs such as Social Security or may have additional employer-sponsored disability insurance employer-sponsored (group long-term disability). Getting approval for Social Security disability benefits can be difficult and may take much longer than expected. Nearly 70% of workers in the private sector do not have employer-sponsored LTD coverage, and even fewer individuals have purchased individual policies, either on their own or through their employer.

Individuals who are fortunate enough to have coverage may not understand the extent of the benefits they would receive through a claim. The average monthly Social Security disability benefit in 2013 was $1,146 per month. For nearly all individuals, especially those with higher incomes, SSDI is insufficient to maintain their lifestyle. In addition, if an individual does have private employer-sponsored group disability coverage, it may not provide enough coverage due to monthly maximum benefit limits (often no more than $10,000 per month), the taxability of those benefits when received at claim, or limits on durations of benefits for specific disabling conditions. High-income earners often suffer as a result of low income replacement percentages from both Social Security disability and group LTD benefits, creating an opportunity to supplement existing coverage utilizing individual disability policies that contain more comprehensive benefit features.

**FIGURE 1.2**

**U.S. Households by Annual Income Level**

Source: U.S. Census Bureau, 2011 American Community Survey.
As Figure 1.2 indicates, the annual household income for most Americans exceeds $50,000, or $4,167 per month. The income replacement provided by Social Security disability benefits alone, an average of $1,146 as noted above, would be insufficient to cover the cost of basic monthly expenses. The percentage of income replaced becomes even lower for higher incomes.

Despite the risk of disability, American workers of all income levels underestimate their risk of experiencing a disability that would cause them to miss three or more months of work. Studies show that 64% of working adults believe they have a 2% or less chance of experiencing this. Clearly individuals have an “it won’t happen to me” mentality and have not discussed the risk with their advisor or been properly educated on the risk.

Additionally, when individuals believe government programs will be able to assist them, they may not realize that the future of SSDI is in jeopardy unless corrective action is taken. The Social Security Board of Trustees has projected that SSDI trust fund reserves will be exhausted by the end of 2016. As a result, benefits to existing beneficiaries or future claims may be reduced. This places additional importance on the need for a comprehensive income protection plan.

Many also fail to consider the long-term consequences of a disability. Potential future earnings are significant, especially for those with an upward earnings trajectory early in their careers. Figure 1.3 shows the future earnings potential with an initial annual income of $75,000, assuming 5% income growth. Future earnings and cumulative lost income can be significant:

- At 5 years: $406,224
- At 10 years: $900,458
- At 20 years: $2,233,356
- At 30 years: $4,206,370

**FIGURE 1.3**
Cumulative Future Income Potential
Due to the combination of the factors discussed, the risk that an individual will experience a disability during his or her working career, the potential for a disability to last to retirement, the lower income replacement and difficult process of navigating social programs and potential cumulative income potential, disability insurance becomes an obvious solution for insuring income.

**Impact on Lifestyle and Retirement Accumulation Goals**

Because income is the financial foundation used to fund expenses and other financial instruments, coverage amounts and benefits should be regularly evaluated as part of the financial planning process. A disability may render an individual unable to work at all, or only partially limit what type of work can be performed or how long it can be performed. Everyday lifestyle expenses will change after sick time, vacation time, and personal emergency funds are exhausted, and income is reduced or eliminated based on the ability to work. With income no longer near 100% of pre-disability levels, any household income received will need to be reallocated to core necessities while discretionary activities and purchases are reduced. A disabled individual without a plan may need to seek out other sources of income, such as having a spouse return to work, in order to make ends meet.

Possible core essential expenses budgeted:

- food
- rent/mortgage/utilities
- transportation
- insurance
- medical expenses
- family obligations (parent/childcare).

An accident or illness can significantly increase out-of-pocket medical expenses. Other hidden expenses may include travel and/or lodging if seeking medical care at a location in another city or state, or a spouse taking unpaid leave from work.

Expenses that may be forced to be eliminated or reduced:

- retirement savings
- child education savings
- travel/recreation
- entertainment
- restaurant dining.

A recent Consumer Federation of America/Unum study confirmed these financial impacts:
• 44% of those surveyed would no longer be able to afford to stay in their home without employer-sponsored disability benefits; and
• 85% cut back or completely stopped saving for retirement; this included cases where individuals were receiving disability benefits but the benefits fell short of covering all expenses.

Most people hope to contribute to their children’s primary and secondary education expenses. In addition to saving for future college expenses, a disability can disrupt retirement savings. A disability’s financial impact on retirement is greatest early in a working career due to the effect of compounding investment growth and expected growth in future earnings potential. Figure 1.4 illustrates a $2 million impact to a retirement account if a disability occurs and contributions cease.

**FIGURE 1.4**

**Disability Impact on Retirement Accumulation Value**

Assumptions: Retirement savings start at age 25, every year deferring $17,500 to a 401(k) plan with a 3% employer match or $4,500 with a $150,000 annual income and contributing $5,500 to a personal IRA. A 5% compound growth rate is assumed. Total disability occurs at age 35 and continues to age 65 with no further retirement contributions.

Regardless of age, a disability can have a far-reaching impact and it may seem that a younger employee may have the most to lose. However, for an executive in mid-career or later, a few years of lost income and lost retirement plan contributions can have a dramatic effect on portfolio growth. Often these individuals are experiencing their peak earnings years later in their careers. With many Americans delaying when they start saving for retirement, these late working years can be crucial toward accumulating sufficient retirement funds. The government
recognizes this and allows “catch-up” contributions for employees age 50 and older through their employer-sponsored 401(k) plans and individual retirement account (IRA) plans. Further, with life expectancies increasing, individuals need to accumulate more funds to fulfill their retirement goals.

While the focus of disability planning is primarily on the financial impact, the benefits of disability insurance can extend beyond that of income protection. The Consumer Federation of America/Unum study found recipients had psychological, social, and health-related benefits in addition to the monthly benefit payments of the coverage. Of those receiving employer-sponsored LTD benefits, 88% agreed that the benefits helped them maintain a healthy emotional outlook and positive self-esteem as a provider for their family. Additionally:

♦ 76% indicated that benefits helped reduce feelings of stress caused by the disability and financial strain
♦ 77% said benefits helped alleviate and avoid strain in their relationships with family and friends
♦ 65% were aided by benefits, allowing them to maintain their social life
♦ 66% were able to focus on their health without worrying about their finances
♦ more than 66% agreed that their health would have been worse without disability payments.

To help with the emotional support during a claim, the relationship between the person on the claim and the claims manager at the insurance company is important. The claims manager can help provide the emotional support and encouragement needed to help a disabled individual return to work. Policies frequently offer rehabilitation and return-to-work programs to assist employees in returning to their prior job or, in some situations, finding new employment. The claims manager can also explain benefits built into an insurance policy to incent and motivate the individual to return to work when authorized by his or her physician.

Disability insurance can be more meaningful to policyholders and their families than the individual financial protection it provides. Employers often play a key role in providing this important coverage to their employees. According to research by Charles River Associates, employer-sponsored benefits save U.S. taxpayers up to $4.5 billion a year. Employer-sponsored disability programs are responsible for saving 280,000 to 575,000 families from needing public assistance as a result of these programs.

Life Insurance versus Disability Insurance

Disability insurance, like life insurance, protects future earnings. However, the risk of a disability versus a premature death during an individual’s working years is quite different. Most individuals can grasp the difference between what
each product is designed to do; but the risk of disability, and how the product is
designed to protect them in the event of a disability, is not as well understood.

**FIGURE 1.5**

**Risk of Disability versus Risk of Death**

<table>
<thead>
<tr>
<th>Age 30</th>
<th>Age 40</th>
<th>Age 50</th>
</tr>
</thead>
<tbody>
<tr>
<td>Female</td>
<td>Male</td>
<td>Female</td>
</tr>
<tr>
<td>2.3</td>
<td>2.9</td>
<td>4.0</td>
</tr>
</tbody>
</table>

The Likelihood of Becoming Disabled Versus Dying Before Life Expectancy


Figure 1.5 illustrates that it is much more likely that an individual will experience a disability than premature death. It is important to realize that just as the likelihood of death increases with age, the same is true of the likelihood of experiencing a disability. Additionally, as age increases, the average duration of a disability claim also increases. Educating people about the relative risks of disability is very important. From the client’s perspective, it is easier to comprehend the consequences of a death and its effect on his or her family and business, while questions about the relative risk of a disability may be less appreciated.

Individuals tend to be more comfortable with life insurance. Eventual death is a certainty, but not everyone will become disabled. Life insurance is much more visible. Life insurance policies are available to all age groups, including infants and children. Typical consumers tend to be familiar with basic features of a life insurance policy such as the death benefit and basic riders. They may also be aware of different policy types such as “term” versus “permanent” insurance.

Advisors are also more comfortable having discussions, selling basic policies, and may even focus on this business line. Ultra-affluent, high-net-worth individuals, however, need the expertise and support of a trusted advisor to properly evaluate and select coverage for their financial planning needs. They require assistance with product selection and the more sophisticated applications of life insurance (estate planning, wealth transfer) that may extend beyond the expertise of the general licensed insurance broker.
Disability insurance receives much less attention. There is little media coverage regarding disability insurance. While many financial advisors recognize the risk and consequences of disability, fewer are familiar with the various policies and contract provisions. Certainly, advisors focusing on corporate benefit planning and serving specialized occupations, such as physicians and attorneys, are more familiar with the details of disability insurance.

While many life insurance policies are complex contracts, disability policies can be equally sophisticated in terms of contract language, and can vary greatly from policy to policy. Disability claims can be subjective; when recommending a policy, proper analysis and evaluation of key provisions and contract language can help avoid adverse client experiences.

Long-Term Disability versus Long-Term Care Insurance

Long-term disability (LTD) and long-term care (LTC) insurance are very different. However, in both cases, it can be difficult to motivate healthy people to think about an unhealthy future. A critical task for an advisor is to help the client understand that LTC insurance protects the client from a need that is separate and distinct from a need caused by a disability.

While disability income insurance provides income replacement in the event of a disabling injury or illness, LTC insurance provides income for the cost of care resulting from a disabling injury or illness. The two products are natural complements. In addition, LTC insurance provides wealth protection, care coordination, caregiver support, and discounted provider services. In short, disability insurance protects one’s income, while LTC insurance protects one’s accumulated wealth.

LTC insurance is a product that provides a predetermined monthly benefit for a specified duration in the event a disabling occurrence is expected to last at least 90 days and require care with everyday activities of daily living (ADLs). Qualifying for benefits requires the loss of two of six ADLs—bathing, eating, dressing, transferring, continence, or toileting—or a cognitive impairment. Benefits are usually reimbursed monthly, based on the expenses provided, which could include care from an appropriately licensed home care service, adult day care, assisted living, or nursing home facility. While most people are prepared for the medical costs of a severe injury or illness through their medical insurance, without LTC insurance they are not prepared for the expense of care resulting from an extended health care event. People who rely on assets to generate income during retirement to pay their living expenses should seriously consider LTC insurance to protect such earnings for themselves and their family.

The LTC and disability income insurance industries have not based their marketing efforts on the risk of dying or becoming disabled, but rather on educating the client about the consequences to those he or she loves if these unexpected events ever occur. It is important to emphasize the need to create a plan to mitigate
consequences. Once the plan is created, an insurance product is suggested as a means to fund the plan. Investments may then be positioned as a funding solution. Once the plan is in place, LTC insurance will be positioned not as a product that protects the client, but as a funding source for the LTC plan.

Several years ago, a few insurance companies offered features in their disability income policies that would allow for the guaranteed purchase of LTC insurance, providing a premium credit for the purchase of LTC insurance, or would allow the disability policy to be exchanged for an LTC policy without evidence of insurability. The intent of these additional or optional features was to provide a more comprehensive benefit package offering with a continuum of income protection (disability income insurance) to asset protection (LTC insurance). However, as many insurance companies exited the LTC market and discontinued their LTC products, the disability income insurance features also went by the wayside. The insurance companies were no longer able to support the sale of these products. Low lapse rates, low interest rates, and higher claims experience were all factors contributing to the problem and subsequent changes. These factors were all greater than anticipated and, with no option to increase rates on non-cancelable disability insurance policies, the sale of the riders on new policies was discontinued.

While disability coverage can be purchased at any time, LTC insurance is not often purchased or recommended by advisors until assets and net worth accumulate to a significant level. LTC insurance can continue to provide coverage beyond an individual’s working years and throughout retirement if premium payments continue or if the policy is paid up. Disability insurance, meanwhile, should be considered by all working individuals, as generating an income provides the means to fund their financial plan.