Disability Income Plans

# Introduction

Disability income benefits provide for the partial replacement of income lost by employees as the result of an accident or an illness. Generally, disability income policies are divided into two types—those that provide benefits for up to two years (short-term) and those that provide benefits for a longer period, usually for at least 5 years but often to age 65 or for life (long-term).

The amount of the benefit may vary depending upon whether disability is total or partial, and the duration of benefits may vary depending on whether the disability is the result of an accident or an illness. Some policies include a provision whereby monthly income benefits are increased each year according to a predetermined formula which may be related to the cost of living.

When provided on a group basis, the benefits are often integrated with benefits from Social Security and other public programs. The total level of benefits from these sources is generally set at a level that does not exceed 60 percent of salary at the time of purchase.

Individual disability income policies usually provide a fixed dollar amount of coverage. This amount may be greater for those who are turned down by Social Security. Individual disability income policies take many forms, designed to fit the special needs of the individual policyowner.

Such policies include Key Person Disability, Business Overhead Expense, and Disability Buy-Sell Policies. Other types of coverage that may include disability income benefits are travel accident, automobile (including no-fault), accidental death and dismemberment and hospital indemnity insurance.

There are many disability programs mandated by state and federal law and employer sponsored plans should be carefully tailored so that protection does not overlap nor miss any needed coverage.

# Types of Plan

Security and Workers' Compensation Benefits. Social Security benefits have some distinct limitations. Any such benefits paid are reduced by the amounts provided by workers' compensation payouts. Combined payments from the two plans are not to exceed 80 percent of normal pre-disability compensation. This figure can be adjusted, however, to reflect cost-of-living escalations. If a disability is due to a job related cause,

Disability Income Plans

workers' compensation takes over. If the disability becomes long term, then social security payments are involved.

A practical disability program will incorporate coverage for both short and long term periods of coverage. Usually six months is the term chosen for short term disability, often with the exclusion of the first one or two weeks from the program, in order to prevent excessive usage.

Short Term Disability and Sick Pay Programs. With many employers, short term disability is an extension of regular sick pay programs. Many sick pay programs simply maintain salary while the individual worker is disabled. This solution may work well for smaller organizations, however, larger employers have made it part of personnel practice to incorporate various plans which set up formal schedules of allowable days per year for sick pay. These plans usually define whether or not, as with some companies, such days will be used to substitute for waiting periods under workers' compensation or insured disability plans.

Accident and Sickness Plans. Such plans will begin payment for disability after a certain waiting period, 30 or 60 days or longer, depending on the company sick pay allowances. Payments average a fixed percentage of regular salary, the norm being about 60 percent of compensation. These payments will typically extend for anywhere from thirteen weeks to a full year, depending on the kind of coverage purchased. There may be lesser waiting periods for benefits to begin in connection with disabilities due to accidental injuries. Insurers generally limit benefit levels to a maximum of 70 percent of compensation and typically cap payments with a flat dollar maximum. Federal regulations now require that disability due to pregnancies be covered in the same manner as other disabilities.

Long Term Disability. Some pension plans include provisions for long term disability, however, most employers provide an insured long term disability program. Waiting periods typically involve such time frames as 26 weeks after the onset of disability, thus bringing down the cost of insured plans. In cases where the payee returns to work and experiences a recurrence of the ailment for which benefits are being paid, the waiting period can be waived, and benefits recommence immediately. Benefits in some plans will pay until the insured reaches age 65, with nervous disorders or drug and alcohol related disabilities payable only for a two year period.

Some plans incorporate cost of living increases, although many have a cap of 2 to 3 percent for such increases. If there is integration with Social Security benefits, some

Disability Income Plans

insurers agree to freeze the offset at the time of initial payments and thereby refrain from increasing the offset as government benefits rise due to inflation.

# Buy-up Options

Insurance carriers have been adapting and changing how their products are packaged and purchased. Most employers who offer disability coverage start with a base of group long-term disability. Depending on a company's resources, an employer may offer a bare bones policy of just the basics or a more comprehensive group plan.

In the past, an employee could seek to supplement employer-provided group coverage with an individual policy. However, this approach, if available at all, is subject to stringent underwriting requirements and is relatively expensive. Today, many insurance carriers offer "buy-up" options, where the employer buys the core long-term group policy, and the employee pays for and chooses from a menu of group upgrades.

Available options may include shorter elimination periods and higher benefit maximums and percentage of income replacement. Some "core buy-up" plans also offer extended benefit periods, cost-of-living increases and conversion provisions. Employer-sponsored group buy-up plans offer special appeal to industries where obtaining individual disability coverage can be costly or difficult, such as in the manufacturing sector.

For example, a company may purchase a core plan that covers 60 percent of an employee's earnings up to $2,000 per month with a 180-day elimination period. The employee could choose options that add 60 percent of another $2,000 per month and reduce the elimination period to 90 days. The net result: a plan that replaces 60 percent of earnings up to $4,000 per month, with a 90-day elimination period. With such an option, higher paid employees could supplement employer-provided base coverage (that only provides 60 percent of salary up to a specific maximum monthly amount) with employee-paid additional coverage. In so doing, the higher paid employee could ensure that he or she would receive 60 percent of his or her full salary in the event of disability. This would enable the executive to maintain his or her lifestyle.

Companies can make this benefit available in two ways. For example, employer-paid supplemental disability coverage for key executives and/or employee-paid supplemental disability coverage for key executives, and employee-paid supplemental disability coverage for white-collar employees. The combination sale—offering a non-cancelable individual policy on top of a group long-term disability plan base—offers the best of both worlds, these being the strengths of group and individual coverage, portability and flexibility for key employees, and simplicity and economy for other employees. The

Disability Income Plans

supplemental coverage typically is priced less than an individual policy due to multi-life premium discounts and underwriting concessions.

In the case of employer sponsorship, the agent would follow a straightforward, five-step process: (1) the company endorses; (2) the agent presents to employees; (3) the employees buys; (4) the insurer bills; and (5) the employees choose to pay typically through payroll deductions or pre-authorized checking debits.

Disability income coverage is an important employee benefit. There is no doubt that there is a crucial need for it. The small business market is especially in need of disability income coverage. The major carriers have disability specialists with whom the agent should team up. They can help the agent to analyze his or her clients' needs and then work with the agent to develop and present proposals.

# Integrated Coverage

Combining Disability Insurance with Social Security Integration. Social Security disability benefits, as is the case with government retirement benefits, were never intended to provide full coverage for either retirement situations or disabling events. Their main purpose is to provide a floor of benefits, which may then be supplemented by private insurance plans. Many insurers are now providing disability income plans that are integrated with government benefits.

Integrated Disability Coverage. The typical integrated coverage that is available from commercial carriers offers a significant savings in premium dollars, as long as the insured also files a claim with Social Security. From the standpoint of the insurer, integrated disability coverage also reduces the risk of over-insurance, in which the amount of insurance may actually exceed 100 percent of the income of the insured prior to disability. These integrated programs should be investigated by anyone purchasing disability insurance.

Types of Coverage Provided. Insurers vary widely in the types of integrated coverage that is offered. Riders are provided on many policies that provide for integration only with Social Security benefits, and some companies also offer integration with benefits from workers' compensation, state cash-sickness programs, government retirement, occupational disease, employer liability and railroad retirement plans. Even no-fault automobile payments may be taken into consideration when benefit payments are calculated.

The method of payment itself varies in degrees. Generally, there are four types of payment methods used. These are the "all-or-nothing," fractional, dollar-for-dollar, and

Disability Income Plans

residual methods. In the all-or-nothing approach, which is the most restrictive, no benefits are payable at all if the insured collects any Social Security disability benefits. The fractional approach pays a benefit based on whether or not the insured or the insured's family is receiving government benefits

When the insured is not eligible for the Primary Insurance Amount (PIA) from the Social Security program, the full amount of the disability benefit rider will be paid by the insurance company. If only the insured is eligible for Social Security benefit payments, but there is no coverage for any family member, some fraction of the rider may be paid to the family. Generally, benefits paid are in the range of 30 to 40 percent of the face amount of the insurance rider. If both the insured and the family are receiving Social Security payments, no rider payments are made. The fractional approach, therefore, is designed to replace the amount of coverage that is not provided by the government.

The dollar-for-dollar plan and the residual method provide similar results. With each approach, the total amount payable under any social insurance program is recognized, and in the dollar-for-dollar plan, the benefit rider is offset equally by any amount payable from government insurance. For example, if the insured has a rider that is to pay a benefit of $1,000 monthly, and Social Security pays $500, then the insurer would pay the other $500. With the residual program, any benefit payable under any social insurance programs is recognized as income. The amount that would be paid under this method is in proportion to a percentage of income loss from all sources.

No matter which method of payment is chosen, certain stipulations must be met if benefits are to be guaranteed. The primary mandate is that the insured make timely application for payment of Social Security disability payments. The insurance company must have access to current status of the claim for government benefits. If the claim for Social Security benefits is denied, an appeal process must be followed by the insured. To access the information, the insured is required to give written authorization to the insurer for the disclosure of government information concerning the claimant's case.

These disability riders are offered only to persons covered under the Social Security system. In addition, many insurers will offer optional coverage's to higher income applicants but will make it mandatory for individuals in lower occupational classifications. The maximum amount of private insurance covered is generally limited to match the amounts that will be paid under Social Security.

Premiums for these integrated disability programs can be substantial, offering savings of as much as 45 percent over regular long-term coverage, and discounts of 20 to 30 percent are quite common. These types of policies can save unnecessary premium

Disability Income Plans

expenditures which might be more suitably channeled to life insurance purchases and should be examined in a selling situation wherever practicable.