



Research Paper

Disability Insurance – The Basics

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1. The information in this material is not intended as tax or legal advice. Please consult legal or tax professionals for specific information regarding your individual situation.
2. Clients are encouraged to talk to licensed insurance professionals for specific policy recommendations and details.
3. The content herein was developed from sources believed to be providing accurate information.
4. Investing is subject to risk, including the possible loss of the money you invest.
5. All final investment and planning decisions are at the discretion of the client.

INTRODUCTION

This research paper is intended to provide the reader with introductory information related to private disability insurance, including its purposes, the types of disability insurance offered, and key factors to consider when purchasing disability insurance. We will include terms and definitions, a couple of examples of Employer coverage policies related to Disability Insurance, and resources for further investigation.

This paper will not go into detail on Social Security Disability Insurance or Workmen's Compensation Insurance.

Eustace Advisors offers a Financial Education Class that is based on the material in this research paper. Please contact us if you are interested in learning more about our Financial Education Services.

Eustace Advisors does NOT sell any type of insurance product – our role is to help our clients better understand how life and disability insurance works, the factors that affect a decision to purchase such insurance, and how to calculate the amount of coverage needed. We encourage our clients to talk to licensed insurance professionals for specific policy recommendations and details.

HOW DISABILITY INSURANCE WORKS

Similar to life insurance, disability insurance is intended to provide financial support in case a key earner can no longer earn an income via employment. In simple terms, disability insurance is a contract in which the insurance policy owner makes regular payments — also known as premiums — to an insurance company. In return, the insurance company pays a benefit to the insured party if the insured party cannot work due to a qualified illness, injury or medical condition.

Disability insurance benefits replace a portion of the individual's income during the period of disability, helping them cover living expenses and maintain financial stability.

There are two main categories of disability insurance:

1. Short-Term Disability Insurance provides benefits for a limited duration, usually ranging from a few weeks to several months. It offers income replacement during the initial phase of disability, often covering temporary illnesses, injuries, or childbirth recovery.
2. Long-Term Disability Insurance provides coverage for an extended period, often until retirement age or until the individual is able to return to work. It offers income replacement for more severe disabilities that result in long-term impairment or inability to work.

The disability insurance company will base their premium costs on factors such as age, gender, occupation, and the amount of income to be replaced.

PURPOSES OF DISABILITY INSURANCE

For most individuals, the primary purpose of disability insurance is to replace their income in case they cannot work. The disability insurance benefits can be used by the recipient to:

1. Replace work-related income in case of a short-term or long-term disability.
2. Cover ongoing critical family living expenses such as rent/mortgage, utilities, transportation, etc. that would have been paid via the disabled person's income.
3. Prevent financial hardship by providing a steady stream of income during periods of disability, reducing the need to dip into savings or rely on assistance from family and friends.
4. Protect assets, such as a home or retirement savings, by ensuring the insured has the financial means to continue covering living expenses and making contributions to retirement accounts.
5. If you have dependents, disability insurance can help ensure that they are protected financially if you're unable to work due to a disability.
6. For those nearing retirement age who experience a disability, disability insurance can serve as a bridge until retirement benefits such as Social Security or pensions kick in.

TERMS AND DEFINITIONS

1. Insurance: a contracted financial structure in which risk is transferred to an insurer, tied to a promise to pay, in return for equitable premiums. Insurance is used to transfer a large amount of individual risk across a wide pool of insured parties.
2. Life Insurance: insurance that provides economic protection for survivors in case the insured party dies.
3. Disability Insurance: insurance that provides financial protection to individuals who are unable to work due to a disability. A disability may be related to an illness (physical or mental), injury, or pregnancy.
4. Workers Compensation Insurance: a type of insurance that pays benefits for job-related causes, like a workplace injury. These policies are paid for by the employer.
5. Social Security Disability Insurance (SSDI): only covers total disability and is very hard to qualify for. These policies are paid for by payroll taxes.
6. Insurer: a person or company that contracts to pay another party in the event of disability.
7. Insured: the person who is covered by the disability insurance policy. May be different than the policy owner.
8. Premium: the payments made to keep a disability insurance policy active.
9. Needs Determination: the process used to calculate the disability benefit amount needed to cover the immediate and projected expenses that the deceased's earned income would have covered.
10. Benefit Amount: this is the monthly payment paid while the insured is disabled, typically calculated as a % of the insured's current income.
11. Elimination Period: the # days between when your disability starts and when your insurance provider will begin paying your benefit.
12. Coverage Duration: how long your disability benefits will be paid from the time they start.
13. Rider: an extra provision that can be added to an insurance policy. Riders add more coverage in exchange for increased premium cost. Riders allow people to customize their insurance policies so they can pick and choose benefits they want while not paying for benefits they don't want.
14. Agent: state-licensed insurance company representative who solicits and negotiates insurance contracts and provides service to the policyholder on behalf of the insurer. An agent can be independent (represents at least two insurance companies) or a direct agent who represents and sells policies for only one company.

INTERESTING FACTS

1. Disability is a greater risk than death for most individuals. A 30-year-old is 4x more likely to be permanently disabled than die before they reach 65 years of age. This ratio is 2.7x for a 40-year-old.
2. Approximately 90% of disabilities are caused by illnesses rather than accidents.
3. About 51% of American workers have disability coverage (2023). This is a decline from 58% in 2018.
4. The average long-term disability lasts 35 months.
5. Workers' Comp: Less than 5% of disabling accidents and illnesses are work related. The other 95% are not, meaning Workers' Compensation doesn't cover them.
6. Social Security DI: ~70% of claims are rejected, and the average monthly payment is ~\$1,500. The insurance payment amount is tied to income and does not vary based on severity of disability.
7. Most employer-paid long-term disability policies only cover 50-60% of the employee's income.
8. Payments received from employer-paid disability policies are taxed as income. Payments received from individual-paid disability policies are not taxed.
9. Much like employer-paid life insurance, employer-paid disability insurance coverage typically stops when the employee leaves the company.
10. Most disability coverage is based entirely on salary and doesn't include commissions/bonuses in payment calculations.
11. Disability policies and related claims are more complicated than life insurance.

DISABILITY INSURANCE – TYPICAL FEATURES

Feature	Short-Term	Long-Term
Types of Disabilities Covered	Illnesses, minor injuries, childbirth that are temporary in impact	Chronic illnesses or major injuries that result in a long-term impairment
Coverage Duration	Up to one year	Up until retirement age
Waiting Period	0 to 30 days	30 days or longer (up to a year)
Benefit Amount	60-80% of salary	50-60% of salary
Group (Employer) Coverage	Typically offered by employers	Offered by some employers (often funded with employee contributions); Individual policies are popular due to portability and flexible terms.

KEY FACTORS TO CONSIDER

Is Disability Insurance Needed?

To determine if disability insurance coverage is needed, we encourage the client to assess the impact a disability will have, from a financial perspective, on others.

- Is someone dependent on the insured's income? If so, the proceeds from a disability insurance policy can help replace that income and cover future expenses.
- Is the insured a private business owner or key employee that warrants disability insurance coverage to protect the company or be used to purchase the insured's equity?
- Does the client have significant assets which can be drawn from to cover expenses on a short or long-term basis in case they are disabled and unable to work?
- Is the client retired, and thus no longer earning income via work? In this case, a pension, retirement plan distributions, annuity payments or other sources of income likely negate the need for disability insurance coverage.

How Much Disability Insurance Do I Need?

This is the calculation of the amount of future income that needs to be replaced via the insurance policy proceeds. We will cover this in more detail in a later section.

Disability Insurance Coverage Via Your Employer.

When calculating the total amount of disability insurance required, the client should include coverage offered by their employer. Be aware that such coverage may not fully cover the employee's income amount and the coverage will lapse upon termination of employment, which may lead to a need for individual coverage as a supplement. Some employers also have a minimum vesting period before their disability coverage begins, which may also prompt establishment of individual coverage until the employee is vested under the employer's plan.

Many employer's allow their employees to purchase voluntary, supplemental disability coverage through their Group Plan. This isn't always the least-expensive option but may be simple to manage regarding premium payments (via payroll deduction) and claim processing. With Employer Group Plans, the employee will typically not have to go through an Underwriting process or medical exam, and these Plans are typically more flexible regarding pre-existing conditions.

Available budget for insurance premiums.

Budget allowances for disability insurance is a key factor. For many employees, their employer will pay for all or part of their disability insurance coverage; however, the percentage of employers who do so has declined over the past decade.

Price differences for comparable coverage by different insurers.

Comparing disability insurance rates from multiple insurers can help you select the most cost-effective policy. A true comparison takes into account several factors, including the policy type, disability conditions covered, waiting periods and coverage duration, treatment of pre-existing conditions, riders, and any discounts for which you may be eligible.

The Policy's Definition of Disability

Each disability insurance policy will document their definition of disability, as this is how the insurer will base their response to any claim for benefits and may affect the amount of benefits paid. There are three common definitions used by disability insurance companies:

1. Own-occupation: Also known as true or pure own-occupation, this is a more specific definition of total disability available. It pays benefits if the insured is not able to perform the material and substantial duties of their occupation. The insured would collect full disability benefits if they could no longer work in their occupation, even if they decided to transition into another occupation.
2. Modified-own occupation: This is the most prevalent type of definition of disability, and it typically pays benefits if the insured is unable to perform the substantial and material duties of their occupation and are not working. This definition will not allow an insured to continue receiving full disability benefits if they work in another occupation.
3. Any occupation: The most general definition of disability, this is often found in employer-group policies. Under this definition, an insured is eligible to receive benefits only if found to be unable to work in a profession they are educated, trained for or experienced in. If the insured is capable of working, even in a lower-paying job within their field of expertise, this type of policy would not pay benefits.

Pre-Existing Conditions

Most disability insurance policies will have terms defining if benefits are paid for conditions that existed before the policy went into effect. A policy may not cover work disruptions caused by a pre-existing policy or may define a minimal period of time after the policy goes into effect before they will cover work disruptions related to a pre-existing condition.

Policy Portability

Portability allows an employee the opportunity to continue coverage when it would otherwise end due to certain events such as termination of employment. In most cases, employer-paid disability insurance coverage is not portable, and ceases upon termination of employment. Individual policies (those established by and paid for by an individual) are portable and remain in effect if the policy holder changes jobs (or is temporarily unemployed) as long as premiums are paid.

Are the Insurance Benefits Taxed?

Disability benefits paid from an employer-funded policy are typically taxed as income; benefits paid from a private policy funded by an individual are typically not taxed as income.

Availability of Financial Resources to Pay Expenses

Some individuals may have access to other financial resources, such as savings, a spouse's income, a pension or retirement plan, or investments which can cover a portion of their expenses in the case of disability. These assets can be taken into account when defining if disability coverage in excess of any employer-funded coverage is needed.

TYPES OF DISABILITY INSURANCE RIDERS

Residual or Partial Disability: This rider provides benefits if you are partially disabled and can work but with reduced earnings due to your disability. It supplements your income to make up for the lost earnings.

Future Increase Option (FIO): This rider allows you to increase your coverage in the future without undergoing medical underwriting. It's useful if you anticipate an increase in income and want to ensure that your disability benefits keep pace.

Cost of Living Adjustment (COLA): The disability benefits are adjusted annually to account for inflation, helping to maintain purchasing power over time.

Return of Premium: This rider refunds a portion of your premiums if you remain disability-free for a specified period, typically at the end of the term of the policy or upon reaching retirement age. It provides a way to recoup some of the premiums paid if you never need to use the policy.

Own Occupation: This rider defines disability based on your ability to perform your own occupation rather than any occupation. It ensures that you receive benefits if you're unable to work in your specific profession, even if you could work in another capacity.

Non-Cancelable and Guaranteed Renewable: This rider guarantees that the insurance company cannot cancel your policy or increase your premiums as long as you continue to pay premiums on time.

Student Loan Protection: This rider provides additional benefits specifically earmarked to cover student loan payments in the event of disability, ensuring that your student loan obligations are met even if you're unable to work.

Catastrophic Disability: This rider provides additional benefits if you experience a severe disability that results in significant impairment or loss of independence, such as the loss of limbs or cognitive functions.

Business Overhead Expense (BOE): This rider helps cover the overhead expenses of a business if the owner becomes disabled, such as rent, utilities, employee salaries, and insurance premiums, ensuring that the business can continue operating during the owner's disability.

HOW MUCH DISABILITY INSURANCE DO YOU NEED?

We use a 3-step process to determine the amount of Disability Insurance Coverage needed:

Step 1: Estimate the income needed to cover the disabled person's ongoing expenses. A client's Income Statement and/or Budget will have this information.

Step 2: Define the amount of Employer-Paid Disability Insurance coverage that will be received.

Step 3: Subtract the amount in Step 2 from the amount in Step 1. The result will define the amount of Supplemental Disability Insurance needed.

Considerations:

1. If an individual has a sufficient Emergency Fund in place, they may not need Short-Term Disability coverage.
2. Based on an individual's net worth, they be able to draw from savings to cover a portion of their expenses while disabled. This contribution can be included in Step 2 above.
3. Stay-at-home spouses may require disability insurance coverage, if their inability to perform tasks such as childcare, housekeeping, etc. would warrant additional expenses to hire others to perform these tasks. However, there are very limited offerings for disability insurance coverage on persons that are not generating work-related income.

If you need help defining your disability insurance needs, we encourage you to speak to a financial advisor who can help you assess your financial situation to determine your life insurance needs.

POLICY EXAMPLE – DUKE UNIVERSITY

Duke University offers voluntary short-term disability coverage, voluntary long-term disability coverage, and Employer Group long-term disability coverage.

The voluntary LTD coverage is intended for use during the initial three years of employment, until the Employer-Paid Group LTD coverage kicks in.

Feature	Short-Term	Long-Term
Vesting period	<p>Not offered as an Employer benefit.</p> <p>Duke offers a voluntary Short-Term Disability option via The Hartford Company.</p> <p>Duke also offers voluntary supplemental Long-Term Disability coverage via The Hartford Company.</p>	3 years of continuous full-time employment
Coverage Duration		To age 65 (or longer in certain cases)
Waiting Period		90-120 days
Benefit Amount		60% of salary (capped)
Benefit Calculation		Base pay as of the day before disability began. Does not include bonuses, mid-year rate changes, commissions, shift or overtime pay.
Employer Contribution		100% of premium cost
Employee Eligibility		Active, regular, full-time (at least 30 hrs/week)

The 3-year vesting period may be waived if the Duke employee had an employer-sponsored long term disability plan within 90 days of the start of their full-time employment at Duke.

Factors to consider for a new employee:

1. The lack of Long-Term Disability coverage until reaching the 3-year vesting milestone. We recommend LTD coverage for most clients who are still working and would suggest establishing a voluntary LTD policy until they qualify for Duke's Group LTD coverage.
2. The lack of any Short-Term Disability coverage. If the new employee doesn't have an Emergency Fund established, they should consider establishing a voluntary policy, at least until they establish other options (accrued sick days and PTO, emergency funds, etc.) to cover expenses during a short-term disability period.
3. A Duke employee can not participate in the voluntary LTD coverage plan once they are eligible for the Duke-paid Group LTD plan. Thus, they would have to acquire any supplemental LTD coverage via a separate individual plan.

ONGOING DISABILITY INSURANCE CONSIDERATIONS

As part of an annual financial plan assessment, we recommend all clients assess their insurance coverage. For disability insurance, this can be during the annual benefits enrollment process.

Life events that will warrant a re-assessment of disability insurance coverage:

1. Job loss or transition, as your employer's disability insurance coverage will lapse.
2. Family changes such as marriage, divorce, or new child which may change the amount of coverage needed.
3. Retirement.

The core of every re-assessment is to recalculate how much disability insurance is needed via the process discussed earlier and ensure that ample coverage is in place. If additional coverage is needed, consider upgrading an existing policy you have in place, or purchasing voluntary coverage through your employer.

When examining a policy during the annual enrollment period or looking at the policy for a new employer, it is important to understand any changes from your previous coverage.

BOTTOM LINE

Based on a 2023 survey by Guardian, only 20% of American workers understood disability insurance coverage, and only 13% considered this an important employer benefit. Based on the higher likelihood that an employee will face a temporary disability before retirement vs. dying before retirement, we encourage clients to consider both life insurance and disability insurance in their financial planning. It is always helpful to understand how disability insurance works, how much disability insurance you may need, and the type of insurance your employer offers before a need for disability benefits arises.

RESOURCES

The articles below were referenced in preparing this information and are excellent resources to better understand this topic.

1. www.investopedia.com – this is a great resource for financial, tax and estate related topics.
2. <https://lifehappens.org/disability-insurance-101/how-much-does-disability-insurance-cost/>.
3. <https://www.investopedia.com/how-much-does-short-term-disability-cost-7229223>.
4. <https://www.guardianlife.com/>. Numerous helpful reports and resources.
5. <https://www.guardianlife.com/reports/insuring-your-income>.
6. <https://www.northwesternmutual.com/disability-insurance/>. Numerous helpful reports and resources.
7. <https://www.policygenius.com/disability-insurance/>