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INSURANCE

Why You Need Disability Coverage

A group policy from work probably won't replace enough of your income to meet your needs.

BY KIMBERLY LANKFORD

YOU MAY THINK THAT YOUR FINANCIAL life is in perfect order. You have a solid plan to reach your goals, including maxed-out retirement savings and enough life insurance to protect your family in case you die while you're still earning an income. But it's a safe bet you've left one gaping hole that could jeopardize all of your planning: the risk that you will become disabled and unable to work.

Missing a paycheck for a few years could make it difficult to pay your bills, forcing you to resort to expensive debt or to raid your retirement savings—and derailing your ability to save for your future. "Disability insurance is one of the less-talked-about types of insurance, but from a financial planning standpoint, protecting one's income is critical," says Peter Creedon, a certified financial planner in New York City.

Many people have some disability insurance coverage through work, with premiums paid or heavily subsidized by their employer. That's a great start. But it can give you a false sense of security because the coverage would likely fall short of providing enough money to meet your needs. With consolidation among disability insurers and more sophisticated underwriting, it's now easier for workers with certain types of jobs, including people who are self-employed, work at home or work as independent contractors, to get coverage. However, they still need to provide extra documentation to demonstrate stable income.

SUPPLEMENTING WORKPLACE COVERAGE

When Rachel and Wesley Hudson, both 31, bought their first home, in New Fairfield, Conn., they worked with their financial adviser to make sure they could always afford their mortgage. "We don't ever want to be without a house," says Rachel.

They both had disability insurance through their employers, but they discovered that their work policies covered only 30% to 40% of their incomes, which wasn't nearly enough to pay their bills. So the couple bought extra insurance from Northwestern Mutual. Each of them now has enough insurance to cover roughly 70% of their total income. The cost: about $40 per month each.

The Hudsons' situation isn't unusual. "Very few people know what their long-term disability insurance will cover if they become disabled," says Lawrence Hazzard, vice president of disability product strategy for Guardian Life. If you have disability insurance through work, contact your human resources department to find out exactly how much your policy would pay each month and under what circumstances.

Group disability insurance generally covers up to 60% of your income, and benefits are taxable if your employer pays the premiums. Many group policies cap monthly benefits at $5,000; some go up to $10,000. "People with incomes under $75,000 or $100,000 per year may have adequate coverage through work," says John Ryan, of Ryan Insurance Strategy Consultants, in Greenwood Village, Colo., who helps financial advisers find disability coverage for their clients. But higher earners may receive less than half of their income. And calculations usually don't include bonuses and commissions, which could leave you with an even smaller portion of your pay.

An individual policy to supplement your employer's group coverage may bring your total coverage up to 70% to 85% of your compensation, including bonuses and commissions, with a much higher monthly cap. (You can't replace 100% of your income because insurers want you to have an incentive to work.) Benefits aren't taxable if you pay the premiums yourself, and the individual policy offers a safety net in case you leave a job that offers group coverage and your new employer doesn't offer it. In that case, an individual policy may cost more, and you might have trouble qualifying for it if you have developed health problems. You generally can't convert a group policy to individual coverage.

Tony Stubbs, 46, an IT salesman in Dallas, has disability coverage through his employer. Although he thought the policy would replace enough of his income to cover his expenses, when he worked with a financial planner, he discovered the calculations didn't include bonuses and commissions. In fact, the policy covered only about 15% of his total compensation—not enough to meet his family's needs, says Stubbs. "My kids are in private school and college-bound, and I didn't want to interrupt our life plans."

He shopped for an individual policy to supplement his group insurance and now pays $3,220 per year to bring his total coverage up to 40% of his total compensation, including bonuses and commissions. He qualified for more coverage, but he and his adviser, Wade Chessman, calculated that this was enough to cover his expenses while keeping his premiums manageable.

Chessman learned the importance of disability insurance from the experience of his father, a bank executive who developed an autoimmune disease at age 51. His father spent months in intensive care, then several years recovering, and was never able to return to work at his previous level. "This was during his peak earning years, when he was going to put away more dollars for retirement," says Chessman.

His dad's disability insurance—group coverage through work and a supplemental policy—made a big difference for his family. "It replaced enough of his income to allow my parents to retire comfortably," says Chessman. Chessman tells clients that if they can afford it, they should get coverage that continues until their full retirement age for Social Security benefits. "If not, at least get a five- to 10-year policy," he says. "It gives you more flexibility and choices."

BUYING AN INDIVIDUAL POLICY

Premiums for an individual policy—either to supplement group coverage or as your only coverage—are based on your job, the policy's definition of disability, the benefit amount, your gender and age, and other coverage details. (You can use the calculator at www.guardianlife.com to get quotes from Guardian.)

Most individual policies will pay out if you aren't able to work at any occupation for which you're suited based on education and experience. The most-generous policies will pay if you're unable to work at your specific occupation (a definition of disability called own-occupation), even if you can do another job. The most restrictive policies pay only if you can't work at all.

It's important to have a true understanding of what you will and won't be able to do if you become disabled, says Hazzard. You may only need to pay for a basic policy if you have a desk job, without many physical duties, that would allow you to continue to work if, say, you broke your arm. This kind of policy would pay out if you developed a disability that made you unable to do your job (or any other based on your education and experience)—if perhaps you developed cancer or a debilitating illness, such as rheumatoid arthritis, that would prevent you from working for a while. "That level of coverage works for most people," says Steve Stribling, vice president of disability income for Northwestern Mutual.

For example, a 45-year-old man who earns $100,000 per year as a financial adviser and has $5,000-per-month coverage from his employer could get an extra $2,010 per month of this type of coverage from Northwestern Mutual for $871 per year (bringing his total coverage to 84% of his income, the maximum Northwestern Mutual will offer at that income level). The coverage continues to age 67 and includes a 3% annual cost-of-living adjustment. A 45-year-old woman would pay $1,358 per year for the same coverage (women pay more for individual coverage because they have more claims, but group policies usually have unisex rates).

When you're shopping for a policy, find out what happens if you are able to return to work part-time. Some policies will discontinue benefits if you work at all; others include "residual benefits," which pay partial benefits if you can work only at a reduced level. Some insurers include these benefits automatically, and some charge about 10% extra.

If you have a specialized job that could be more difficult to perform after an injury or illness, such as a surgeon, dentist or lawyer, consider a more expensive own-occupation policy. This type of policy provides coverage if you can't do the primary duties of your job but could continue working in another job. For example, a 35-year-old male attorney who earns $210,000 per year and doesn't have group coverage would pay about $2,244 per year for a Guardian Life policy that provides a $10,000 monthly benefit until age 65 after a 90-day waiting period, says Ryan. This policy would pay full benefits if the attorney couldn't practice as a lawyer, even if he could work in another occupation, such as teaching or consulting. It would also pay partial benefits if he could return to work part-time. He'd pay about $3,400 per year if he bought the policy at age 45. The policy would cost $3,540 per year for a 35-year-old woman, or $4,690 if she bought the policy at age 45. It costs about 12% to 15% more to add a cost-of-living adjustment that increases your monthly benefits by 3% per year after you are disabled.

The younger you are when you buy a policy, the lower your annual premiums. Many policies lock in level premiums for life, and some charge less at first but increase over time. You can choose the waiting period before benefits kick in, with higher premiums for shorter waiting periods (90 days is most common, and you may have enough sick leave or short-term disability coverage at work to cover the gap until disability benefits kick in).

Special Coverage

Policies for Physicians

Insurance companies offer "own-occupation" individual disability insurance for several categories of professionals, including physicians, dentists and attorneys (see the accompanying article). But insurers offer special policies tailored specifically to doctors because they tend to have huge student loans and are counting on a big jump in income to pay them off, and because they generally have physical aspects to their job.

Northwestern Mutual's special policy for physicians pays out if they can't do their main duties but can do some other parts—such as an orthopedic surgeon who has to give up surgery but can keep his office practice. "If the bulk of your income is from surgery and you can't do that anymore, and you don't want to do the office-based practice by itself, the policy will pay the full benefit," says Steve Stribling, vice president of disability income for Northwestern Mutual.

The Guardian offers extra coverage, in addition to a percentage-of-salary replacement, to pay off student loans. It can be worthwhile for younger physicians to pay extra for the option to increase coverage as their income rises, regardless of their health or other risks.

QUALIFYING FOR COVERAGE

Insurers primarily look at two factors when deciding whether to issue a policy and how much to charge: your income and your health.

You'll generally need to provide pay stubs or tax returns showing your income. It used to be more difficult to get coverage if you had recently started a new business, but now you may be able to get coverage if you can produce tax returns from the business for at least a year, and you may qualify for a policy sooner if you can show the insurer that you have contracts providing stable income for at least six months.

Insurers also assess your health to figure out the risk that you'll file a claim. People with musculoskeletal and mental conditions are some of the biggest risks; a history of chronic back pain or visits to a psychologist for depression may make it more difficult to get coverage. Some insurers may exclude those pre-existing conditions or limit the length of coverage, or they may charge extra because of them, says Larry Schneider, of the Disability Insurance Resource Center, in Beaufort, S.C. If the condition has improved after a couple of years, the insurer may drop the exclusion or reduce your rate.

Every insurer has its own underwriting requirements, so if you have a health condition, it helps to work with a disability insurance specialist who deals with several insurers to find the best deal. (Some financial advisers work with such disability insurance specialists.) Insurance specialists contact insurers ahead of time to see whether they offer coverage in more-complicated situations. ■