

# Disability Insurance

by Sophia



## WHAT'S COVERED

In this lesson, you will examine the need for disability insurance and the key features of disability insurance policies. You will use your problem solving skills to explore the importance of being agile. Specifically, this lesson will cover:

## 1. Overview of Disability

Has there ever been a time when a medical condition prevented you from working? Did this cause you any financial strain? To face situations like these, it is critical that you take the time to use your **problem solving skills** to plan ahead.

### 1a. Definition of Disability

Let's start with what exactly is meant by the term **disability**. According to the stringent definition used by the [Social Security Administration](#), a disability is characterized by the following three requirements:

- You cannot do the work you did before an accident or illness.
- You cannot readjust your skills because of your medical condition.
- Your disability has or is expected to last for at least one year or until death.

This is considered an 'any occupation' disability definition. Qualifying as disabled using this definition is quite difficult. However, most insurance companies use a more lenient definition. For example, an 'own occupation' definition means that you will be considered disabled if you are unable to perform the material and substantial duties of your own occupation (and do not make money doing something else).

#### IN CONTEXT

Say you are a police officer who becomes injured during an arrest and are unable to physically meet the job requirements. Under Social Security rules, you would not qualify as disabled because you could adjust your skills to do something else, such as being a school teacher or police academy instructor. Under an 'own occupation' definition, you would likely be considered disabled.

Today, it is more common for insurance companies to sell modified own occupation disability coverage. A modified own occupation insurance plan pays a benefit if you are unable to perform the material and

substantial duties of your own occupation and cannot find another position in which you are suited by education, experience, or training. If you do find another position, your disability coverage will be reduced by the amount you earn in the new job.



#### TERM TO KNOW

##### Disability

Includes the following three requirements: (1) you cannot do the work you did before an accident or illness, (2) you cannot readjust your skills because of your medical condition, and (3) disability has or is expected to last for at least one year or until death.

### 1b. The Costs of Disability

A disability can stop your progress toward financial goal achievement. [The National Association of Insurance Commissioners](#) recently noted the following:

- Fewer than 40% of Americans could pay their bills or meet expenses if they were to become disabled and not return to work.
- Worse still, only 44% of U.S. workers have any form of disability insurance coverage.

These are sobering facts and a good reason to protect yourself against the risk of becoming disabled. Before we move on, a word of caution is in order for those who believe Social Security will help them.

1. Recall that the Social Security definition of disability is very strict. This means it is hard to qualify.
2. Even if you do qualify, you may not receive benefits. To receive Social Security disability benefits, you must have earned 20 credits in the past 10 years. Credits are based on your total wages and self-employment income during the year.
3. You can receive up to 4 credits for every year worked. In 2018, you must have earned \$1,320 in covered earnings to get one Social Security credit or \$5,280 to obtain the maximum 4 credits for the year.
4. If you are younger than age 24, you may qualify if you have 6 credits earned in the past 3 years.

You should now be convinced that protecting yourself using disability insurance may be a worthwhile investment. At a minimum, disability insurance is something that will help protect your human capital and wealth during your lifetime financial journey.



#### Agility: Why Employers Care

Being able to pivot is critical when life throws you curveballs like an injury or other health issue. Employers also like to see this agility skill. If unexpected issues arise or circumstances change, they want to know you can still find a way to complete the task in front of you.

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## 2. Disability Insurance

When it comes time to purchase a disability insurance policy, most people buy insurance through their employer, but you can also buy coverage in the insurance marketplace.

## 2a. Types of Disability Insurance

You typically have two choices when it comes to disability coverage:

1. **Short-term disability insurance** will replace a portion of your salary for 3, 6, or 12 months. The longer the coverage period and the more income replaced, the higher the premium.
2. **Long-term disability insurance** usually kicks in after you cannot work for 6 to 12 months. Most policies extend from a few years up until age 65 (at age 65 you can then enroll in Medicare). Higher premiums are associated with increased incomes and duration of coverage.

Further, when it comes time to purchase disability insurance, you should seek out own occupation or modified own occupation insurance. As noted previously, these policies pay if you are unable to perform the material and substantial duties of your own occupation (and do not make money doing something else).



### TERMS TO KNOW

#### Short-Term Disability Insurance

Replaces a portion of your salary for 3, 6, or 12 months. The longer the coverage period and the more income replaced, the higher the premium.

#### Long-Term Disability Insurance

Effective after you cannot work for 6 to 12 months. Most policies extend from a few years up until age 65 (at age 65 you can then enroll in Medicare). Higher premiums are associated with increased incomes and duration of coverage.

## 2b. Recommended Amount of Disability Insurance

How much disability insurance do you need? If you have already established a 3- to 6-month emergency savings fund, then you probably do not need a short-term policy. Why? Because you can use your emergency savings to fund your short-term disability need. In most situations, long-term coverage is more important. Here is a simple rule to help you determine how much disability insurance you need.

- Take your current gross income and multiply this by 65%.
- For example, if you make \$50,000 per year, you will need approximately \$32,500 in long-term disability coverage ( $\$50,000 \times 65\%$ ).
- Because many long-term disability policies have a 6-month **elimination period** – the amount of time between the disability occurring and the insurance company paying the claim – you will need about \$16,250 ( $\$32,500 \div 2$ ) in your emergency fund to cover short-term expenses. If you don't have this amount, you might consider purchasing a short-term disability policy.
- If you do have enough saved to cover the elimination period, you should shop for high-benefit, low-cost, long-term disability coverage.



### TERM TO KNOW

#### Elimination Period

The amount of time between the disability occurring and the insurance company paying the claim.

## 2c. When to Buy Disability Insurance

There are a lot of myths surrounding disability insurance. For example, some people assume that only older people should worry about buying disability insurance. This is wrong. In fact, for those who are working, age should never really factor into the decision to buy insurance. Instead, the need for disability insurance is

driven primarily by income and wealth considerations.

- As shown in the following table, as your wealth increases, your need for high-value disability coverage declines.
- The reason is that you can afford to self-insure (through your savings and investments) potential losses in income.

Need More Insurance	Need Less Insurance
High debt	Low debt
Modest assets	High net worth
One source of income	Multiple sources of income

As a result, for those who are just starting out on their lifetime financial journey, the need for disability coverage is going to be higher. With a probability close to 30% that a 20-year-old will become disabled before age 67, the need for income replacement insurance just makes sense.

### 3. Disability Insurance Costs

When it comes to insurance, you must always balance your need with your ability to afford premiums. You never want to be in a position where you are insurance-rich but cash-poor. This means that, although it is certainly prudent to reduce and transfer risk through insurance, you can sometimes have too much coverage or coverage that is too expensive. When this happens, you will have less cash available to allocate toward savings, investing, and other household expenses.

#### 3a. Determining Premium Costs

Although there are no absolute rules, you can benchmark the cost of a disability policy using the guidelines shown in the illustration below. For this example, assume your insurance need is \$32,500 yearly.



Younger workers and those without a preexisting health condition will probably pay a bit less than others.



If you are healthy and working in a low-risk occupation, multiply your insurance need by 1%.

**= \$325 per year**



If you are unhealthy and working in a low-risk occupation, multiply your insurance need by 2%.

**= \$650 per year**



If you are healthy and working in a high-risk occupation, multiply your insurance need by 3%.

**= \$975 per year**



If you are unhealthy and working in a high-risk occupation, multiply your insurance need by 4%.

**= \$1,300 per year**

### 3b. Workers' Compensation Insurance

One last thing is of importance regarding disability coverage. Sometimes people confuse disability protection with workers' compensation insurance. **Workers' compensation** provides benefits when you are injured or become ill as the result of work. Every state requires employers to pay into state-managed insurance pools to help pay claims made by injured employees. There is no direct cost of this coverage to workers.

How, then, does workers' compensation differ from disability insurance?

- Disability insurance provides coverage regardless of the cause of the disability.
- Generally, disability insurance is provided as a benefit or something that an employee will need to purchase.
- Workers' compensation, on the other hand, only pays benefits if you are hurt on the job; you must prove without a doubt that your disability was a function of your job.

A basic financial planning rule is this: never rely solely on workers' compensation insurance as a replacement for disability insurance.



## TERM TO KNOW

### Workers' Compensation

Provides benefits when you are injured or become ill as the result of work.



## SUMMARY

In this lesson, you covered an **overview of disability insurance**. You learned the **definition of disability** and the high **cost of disability** in terms of lost wages and stunted progress on your financial achievements. You considered how agility can help you adapt if an issue does arise. There are two primary **types of disability insurance** policies: short-term coverage and long-term coverage. The **recommended amount of disability insurance** depends on your situation. At times, emergency funds can substitute for short-term disability. Long-term disability tends to be more important. One rule of thumb for long-term coverage is to carry 65% of your gross income. **When to buy disability insurance** depends on your debt, net worth, and number of income sources. You can use your problem solving skills to determine what will be best for you.

So, what is the **cost of disability insurance**? Expect to pay premium costs between 1-4% of your insurance need, depending on your health and hazards on the job. Finally, you can expect to receive **workers' compensation insurance** from your employer in case you are injured on the job. The premiums are paid by your employer.

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## TERMS TO KNOW

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### Elimination Period

The amount of time between the disability occurring and the insurance company paying the claim.

### Long-Term Disability Insurance

Effective after you cannot work for 6 to 12 months. Most policies extend from a few years up until age 65 (at age 65 you can then enroll in Medicare). Higher premiums are associated with increased incomes and duration of coverage.

### Short-Term Disability Insurance

Replaces a portion of your salary for 3, 6, or 12 months. The longer the coverage period and the more income replaced, the higher the premium.

### Workers' Compensation

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