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How Disability Insurance Can Protect Your Income

By Sheryl Nance-Nash

Disability insurance is often the forgotten child. You have your home, life, medical, and auto insurance, but disability coverage is likely not on the top of your agenda.

That's a big mistake. Much as you may think otherwise, you really could need to use it. Three in 10 workers entering the job market today will become disabled before retiring. Despite this, only 57 percent of full-time employees say they have disability income insurance protection, according to the 7th annual MetLife Study of Employee Benefit Trends (March 2009). The majority of working Americans, 68 percent, feel unprepared if a principal wage earner can no longer work because of a disability.

Disability insurance 101

Now that you're paying attention, here's what you need to know about disability insurance.

Maybe you're wondering what is disability insurance and what can it do for you? It is insurance protection that pays benefits if you become too sick or hurt to work, explains Tara Reynolds, corporate vice president, U.S. Insurance Group, Massachusetts Mutual Life Insurance Co.

What's covered — a percentage of your earned income. Generally speaking, the benefits paid on an individually owned disability income insurance policy are tax-free. However, if a group long-term disability income plan is employer-paid, then 100 percent of the benefit will be taxable. Individual coverage is typically paid for with after-tax dollars, so these benefits are generally income tax-free, explains Lynn McDonough, vice president, MetLife Individual Disability Income Insurance.

Employer coverage may be insufficient

While 71 percent of employers offer disability insurance, according to the MetLife study, only 57 percent of employees own disability insurance through their workplace.

If you're lucky enough to have company-sponsored coverage, truth is, it may not be enough. Although workplace programs provide a base, most are capped, and when workers become disabled they could find their disability income falls short, says Reynolds.

In fact, policies paid in part or entirely by the employer, generally claim to replace 60 or 70 percent of an employee's income when he or she is disabled beyond the typical 90 or 180 day elimination (or waiting) period.

“However, these promises are empty and deceptive. Insurers are allowed to reduce the benefits they pay dollar for dollar for any benefits the disabled employee receives from his state workers’ compensation program, Social Security program, the state’s disability program, and even cash settlements received for pain and suffering if the employee was injured in an accident that caused his disability,” says Jimmy Williamson, a member of the American Institute of Certified Public Accountant’s National CPA Financial Literacy Commission.

Then too, with employers continuing to slash costs, a disability plan could be eliminated at any time, he adds.

There are also a growing number of single-income families, so the need to protect that one income is greater than ever, says Reynolds. Consider getting a supplemental policy.

Get a policy on your own

If you venture out on your own there are a few fundamentals to help you make wise choices.

Know that the cost of disability insurance varies widely, based on factors such as your age at purchase, occupation, sex and health status. Smokers and women will pay more, for example, because they have a higher likelihood of becoming disabled. You must prove you are in good health and you will probably be asked to verify your income. Pre-existing conditions may increase premiums or be excluded from coverage. Insurance features also affect the price, of course, including the type of contract, the length of the waiting period before coverage begins, how long the benefits period will last and the monthly dollar amount of coverage, explains Richard McGrath, president of McGrath Insurance Group.

Begin by deciding which features are essential to you. “Insurance that fails to provide the protection your family needs is not worth buying, no matter how little it costs,” says McGrath, who recommends buying a policy that is non-cancelable and guaranteed renewable. Such insurance cannot be canceled and can guarantee that your premiums stay the same until age 65, at which point presumably you will be retired and you will not need to replace income. This feature may add to the cost, but disability insurance is worth having, only if coverage is there when you need it, adds McGrath.

As with other types of insurance, be sure your company is creditworthy and will have the financial means to pay any claim you may have. Most insurers include their rating on their website, but you can also check at rating company sites such as A.M. Best (www.ambest.com) and Standard & Poor’s (www.standardandpoors.com).

What counts most?

How much do you need? A great way to start figuring this out is to visit (www.halfapaycheck.com) to use a special, free calculator that can help determine how a disability could affect your ability to cover your typical monthly expenses, how long your savings could protect you, and how a disabling injury or illness could impact your retirement savings, suggests Reynolds.

Most disability insurance replaces at least 60 percent of gross income, but if you want to continue your current lifestyle, it’s best to purchase coverage that will replace at least 80 percent of your income. Generally, the higher the percentage, the higher your premiums will be.

Another key consideration is whether you will need coverage if you are able to return to work part time or in a different job. Some policies provide coverage for partial disabilities and others do not. Highly skilled

professionals often seek “own occupation” coverage, which provides them with full benefits if they are unable to work in their chosen occupation, even if they are fit for other work. Such coverage is expensive and may not be easy to find. How long the policy will pay benefits is also important. It is typically worth purchasing coverage that extends benefits to age 65.

Shop wisely

Like elsewhere, shop wisely for the best policy. You can cut your premium by increasing your waiting period from 90 to 180 days, says Williamson. This should reduce premiums by about 20 percent, compared with a 90-day wait, but this strategy only makes sense if you can afford to live half a year without income, he adds. With a six month waiting period, you begin to accrue payable benefits in the seventh month and would get a check at the 225th-day (seven-and-a-half month) mark.

Women should ask their agents to check whether unisex policies are available. These might cost 10-20 percent less, says Williamson.

Look out for an “except fraud” provision. If an “except fraud” clause is written into your contract, your insurance company can attempt to take away your policy at any time by claiming that you materially misstated your medical, financial or occupational status when you applied for coverage.

“Insurance companies sometimes use this clause to deny benefits to honest policyholders when they find the slightest hint of an error on the application,” says Williamson.

Instead, ask for a “two-year contestability policy”. After your contract has been in force for two years, the insurance company cannot contest any statements in your application.

Whatever you choose, the goal, says Williamson, “Is to prevent medical disasters from becoming financial disasters.”

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*Disability income insurance policies have exclusions and limitations. For costs and complete details of coverage, talk with your insurance representative.

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