Don’t Let Disability Derail Long-Term Financial Security: Enhancing Retirement Security in a DC World

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Long-term disability (LTD) protection, such as a defined contribution (DC) disability supplement, is critical for good long-term security in a DC environment. For those with a strong LTD program already in place, this challenge can be addressed by providing a DC disability benefit that replaces DC contributions during periods of LTD. If there is no LTD program, that is needed first. Appropriate disability coverage is vital if the DC system truly is to deliver long-term retirement security. This article discusses issues in achieving such coverage and provides ideas to help in developing programs. Few such programs exist today, but it is hoped that this article will encourage more employers to adopt them.

Introduction

Becoming disabled and having the ability to earn a living be interrupted pose a serious threat to the financial security of disabled persons both before and after retirement. One in eight workers will be disabled for five or more years during his or her working career.¹ In a DC environment, the challenges related to retirement security after disability are particularly difficult. Most Americans grossly underestimate their vulnerability to disability and do not appreciate its impact on their financial well-being when retired.² Fewer than one in three Americans working in private industry are covered by employer-sponsored LTD insurance.³

The decline of the defined benefit (DB) pension plan has made matters worse. DB plans generally included provisions to protect retirement security in the event of disability, but DC plans do not. Certain regulatory barriers to offering disability protection in DC plans were removed in 2014. This article discusses steps that employers can take to improve...
retirement security in the event of disability.

Management of Disability Risk and Its Link to Retirement Savings

Traditional DB plans often protected retirement savings in the event of LTD, either through continued crediting of service, through payment of disability pensions or both. When employers moved away from DB to DC plans, there generally was no comparable disability benefit within the DC plan. So, in the event of LTD, retirement savings just stopped in most cases. Employers that recognized the importance of offering protection for long-term savings in the event of disability and wanted to offer a benefit to continue savings in the DC plans were frustrated by regulatory uncertainty.

The good news is that the regulatory problem has been resolved. In 2014, the Treasury Department released final regulations providing guidance on the taxation of retirement plan payments for disability coverage, providing employers with a clear opportunity to address the coverage gap. The new regulations allow DC plans to continue contributions to participants’ accounts while they are disabled. This mechanism provides for a special investment option that allows savings to continue without the participant making contributions, just as waiver of premium allows life insurance coverage to continue. While a few employers have recognized the disability gap in DC plans for years, many employers are still unaware of the gap and what they can do about it. In this article, I define benefits that continue funding DC retirement benefits during LTD as DC disability supplements.

The final regulations (T.D. 9665, RIN 1545-BG12), released May 9, 2014 by Treasury and the Internal Revenue Service, state that payments from a qualified DC plan to pay a participant’s accident and health insurance premiums are taxable distributions to the participant unless a statutory exception applies. They also define the statutory exception under which the disability-related premiums and continued contributions will not be taxable:

1. Premiums for the insurance contract (which funds the DC disability supplement) are paid directly from the plan.
2. The plan receives the insurance benefit payments for the DC disability supplement.
3. The DC disability supplement benefit payments under the contract are paid because of an employee’s inability to continue employment with the employer because of disability.
4. The DC disability supplement benefit payments to a participant’s account are not more than a reasonable expectation of what the participant would have received as an annual contribution during the disability period, reduced by any other contributions.

If these conditions are satisfied, the insurance funding the DC disability supplement is considered a plan investment, and the plan’s premium payments and benefit payments to the plan are not taxable to the participant.

Participants are taxed on DC plan benefits when they are paid from the plan, without regard to whether the funding for the benefit came from contributions while a person was active or from the DC disability supplement that generated contributions during disability.

Provisions are included in the regulations for an employer to self-insure the DC disability supplement without adverse tax consequences. (See the sidebar.)

Impact on Stakeholders

This article is addressed primarily to
benefit plan sponsors, but the issues affect a much broader group of stakeholders, including:

- **The public.** The public underestimates the chances of disability and the importance of disability benefits and insurance. Once the disability has occurred, it is too late to remedy the situation. Lack of disability protection affects both current income and retirement income. A major gap in retirement income increases costs of public assistance programs and also harms the economy. Businesses are affected two ways when people are in or near poverty due to disability—higher taxes to support Medicaid and public assistance programs and fewer dollars to buy their products.

**Not only is LTD one of the greatest financial risks individuals face, but it is inherently linked to retirement security. A significant period of disability before retirement will cause financial hardship in retirement for many workers. Disability also leads to financial insecurity for dependent family members if the disabled person was a major earner in the household. Poverty rates more than double following a disability occurrence for adults who become disabled between the ages of 51 and 64.**

- **Employers.** Employers are concerned about the financial well-being of their employees. Adequate disability coverage should be a major issue for employees, but most fail to recognize the need. And sadly, when employees do not focus on an issue, employers are less likely to address it. If employers don’t address coverage, risks shift to the employee, the employee’s family and society at large. This risk shift can have negative public and community relations impact for the employer. As public awareness of this issue grows, employers will get more credit for offering this benefit. A DC disability supplement is an important aspect of the overall adequacy of disability coverage whenever retirement security is provided primarily through a DC plan.

- **Plan administrators.** Plan administrators that want to offer a comprehensive array of benefits and services to their clients will need to offer and support comprehensive service, including robust disability risk protection. We can expect availability of these and similar features to become a critical basis of competition.

- **Insurers.** This is an area of opportunity for insurers, but it involves complexity because the disability administration must be coordinated with the 401(k) plan administration. Insurers that want to offer comprehensive employee benefit programs should offer this coverage and assist policyholders in structuring such programs. The programs will offer smaller premium income than LTD products and are more complex to administer, but insurers will figure out how to address these matters efficiently.

We note that coverage provided to all employees or through autoenrollment should work well, but purely voluntary coverage may experience low participation and be less efficient.

**Link to Retirement Security**

Not only is LTD one of the greatest financial risks individuals face, but it is inherently linked to retirement security. A significant period of disability before retirement will cause financial hardship in retirement for many workers. Disability also leads to financial insecurity for dependent family members if the disabled person was a major earner in the household. Poverty rates more than double following a disability occurrence for adults who become disabled between the ages of 51 and 64. The percentage below the federal poverty level increases from 7.4% before disability onset to 15.5% afterward. It reaches 20.6% for the 40% who are most severely disabled.5
Disability affects retirement security in several different ways. First, disability may lead to a discontinuation of further retirement savings as well as a loss of earnings. The vast majority of working Americans are covered by Social Security but, for most, Social Security Disability Insurance (SSDI) coverage is not enough. If disability income doesn’t cover the earnings loss, families may need to dip into retirement savings for current expenses. In the past, traditional benefit programs often included both LTD benefits and DB pensions, with pension benefits continuing to accrue during periods of disability. Increasingly popular DC plans do not provide continued savings during disability, and the accumulated DC savings too often get spent during long periods of disability. Current DC plans do not offer any benefit that is parallel to the continuing accrual of benefits formerly provided under traditional DB pension plans.

In addition, disability, if very severe, may require the spouse to become a caregiver. This can cause affected spouses great emotional strain and sometimes force them to reduce their work schedule or even leave the labor force.

LTD insurance, even when offered by the employer, is becoming more likely to be elective and contributory. Table I shows major potential sources of disability coverage and their link to retirement security. Table II shows the prevalence of disability coverage. Table III shows average amounts of annual SSDI benefits and demonstrates that SSDI coverage alone is not enough to fully protect the families of disabled workers.

Larger corporate employers usually provide LTD coverage, but it is increasingly voluntary and contributory. The majority of public employers also offer LTD coverage, but not as commonly as large corporations. Most individuals covered by multiemployer plans have no private LTD coverage and have to rely solely on Social Security.

Table III provides examples of SSDI benefits. The Social Security system replaces a relatively high percentage of income for very low-wage earners but a significantly lower percentage for even moderately higher wage earners. Social Security benefits should be considered a base; they need to be supplemented with private coverage or there will be a significant drop in living standards.

Disability’s Effect on DC Account Balances

The effect of disability on a DC account balance can be devastating. Table IV shows the accumulated value of lost contributions when an employee is disabled for the long term.

Social Security provides both disability and retirement benefits and uses similar methods to determine its benefit. In contrast, the typical private benefit program looks at disability and retirement separately. In fact, different human resources professionals specialize in each benefit. This article advances the proposition that more attention is needed with regard to how disability impacts retirement security and how both public and private programs should integrate coverage for retirement and disability. I look forward to more public discussion on this topic.

Early Exit From the Labor Force

The discussion above focuses on how disability can affect a DC plan balance at the age of 65. There is other evidence that disability is a very important factor in early exit from the labor force.

A study by the Congressional Budget Office (CBO) focused on reasons for early exit from the labor force. It examined the Census Bureau’s Survey of Income and Program Participation (SIPP) database to look at people aged 50-61 who were not participating in the labor force in 2001. In this study, status was based on self-reporting, and people were classified as retired or disabled. Some of the key findings included:

- Those not in the labor force because of disability generally had much lower income, higher poverty rates and fewer assets than those who were retired. Disability was the most common reason for early exit among both men and women.
- Of the total population aged 50-61, 14% of men and 24% of women were reported as not being in the labor force at any time during the year. Of the men not in the labor force, 32% were retired, 64% were disabled, and 4% reported other reasons for not being in the labor force. Among the women, 26% were retired, 40% were disabled, and 34% re-
### TABLE I

**Sources of Long-Term Disability Coverage** and Method of Calculating Benefit

<table>
<thead>
<tr>
<th>Social Security Disability</th>
<th>Employer LTD Program</th>
<th>Employer Pension Plan</th>
<th>Individual Disability Policies</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Type and amount of disability benefits</strong></td>
<td>Monthly income during disability based on lifetime earnings history and benefit formula</td>
<td>Income based on current earnings and benefit formula</td>
<td>DB—plan defines: commonly continued service credit or income</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>DC—usually no benefit, but could continue contributions</td>
</tr>
<tr>
<td><strong>Employer role in program</strong></td>
<td>Pays Social Security tax</td>
<td>Plan sponsor, program could be self-insured</td>
<td>Plan sponsor, employer control design</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Usually none, but can offer supplemental coverage at the worksite</td>
</tr>
<tr>
<td><strong>Prevalence of coverage</strong></td>
<td>Social Security has requirements with regard to work history for coverage to be effective.</td>
<td>Less than one-third of workers are covered. Very common at larger companies, particularly for salaried employees.</td>
<td>DB in state of decline. More prevalent at larger companies.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>DC growing but rarely includes disability coverage</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Many workers have no pension DB or DC.</td>
</tr>
<tr>
<td><strong>Persons with no Social Security earnings record such as homemakers have no coverage.</strong></td>
<td>May be voluntary, and many people may choose not to participate. Not very common in smaller companies.</td>
<td></td>
<td>People who feel employer coverage is not adequate or who do not have employer coverage may purchase subject to evidence of insurability.</td>
</tr>
<tr>
<td><strong>Link of disability to ultimate resources at retirement</strong></td>
<td>Affects earnings history, so benefit may be reduced somewhat</td>
<td>No direct connection, but LTD benefit may enable continued saving for retirement</td>
<td>No direct connection, but benefit may enable continued saving for retirement</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Some DB plans provide continued accrual of service for pension benefit; some offer a disability pension. DC plans can offer continued retirement savings.</td>
</tr>
<tr>
<td><strong>Type of disability definition</strong></td>
<td>Total and permanent, expected to last for at least a period of one year or result in death</td>
<td>Can be own occupation, any occupation or a combination based on own occupation first—depends on coverage</td>
<td>Can be own occupation, any occupation or a combination based on own occupation first—depends on coverage</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Depends on plan provisions; may be similar to LTD program</td>
</tr>
</tbody>
</table>

*Source: Author’s analysis.*
ported other reasons. People who gave reasons besides disability or retirement generally indicated that they were caring for others or were not interested in working.

- Men aged 50-61 reported as not working were twice as likely to be disabled as retired. Women were about 1½ times as likely to be disabled as retired. Of the total population aged 50-61, 9% of men and 10% of women were reported as disabled. Of the total, 4% of men and 6% of women reported themselves as retired and did not work at all during the year.
- About 80% of the men and women who reported themselves as disabled received SSDI benefits or were in a family that received Supplemental Security Income (SSI) program payments.
- At ages 50-61, disabled men had median annual family income of $20,000, compared with $62,000 for men in the labor force and $30,000 for retired men. The median net worth for disabled men was $19,000, compared with $148,000 for those in the labor force and $231,000 for those who were retired.
- For women aged 50-61, the median annual family income for those who were disabled was $19,000, compared with $54,000 for those in the labor force and $34,000 for retired women. Median assets for the disabled women were $14,000, compared with $132,000 for those in the labor force.

### Table II

**Prevalence of Employer-Sponsored Disability Coverage**

<table>
<thead>
<tr>
<th>Type of Employer</th>
<th>Corporations</th>
<th>Public Employers</th>
<th>Multiemployer Plans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percent offering LTD</td>
<td>88.1%</td>
<td>75.0%</td>
<td>22.2%</td>
</tr>
<tr>
<td>Of those offering, benefits go to the age of 65 or retirement age</td>
<td>77.2%</td>
<td>76.0%</td>
<td>54.8%</td>
</tr>
<tr>
<td>Percent continuing employer contribution to DC plan during some part of disability leave</td>
<td>15.8%</td>
<td>16.7%</td>
<td>4.8%</td>
</tr>
</tbody>
</table>


### Table III

**Social Security Disabled Worker Annual Benefits**

<table>
<thead>
<tr>
<th>Lower Earner</th>
<th>Higher Earner</th>
</tr>
</thead>
<tbody>
<tr>
<td>Age in 2010</td>
<td>Earnings in 2009</td>
</tr>
<tr>
<td>25</td>
<td>$11,438</td>
</tr>
<tr>
<td>35</td>
<td>$19,421</td>
</tr>
<tr>
<td>45</td>
<td>$21,932</td>
</tr>
<tr>
<td>55</td>
<td>$21,280</td>
</tr>
</tbody>
</table>

*Source: Social Security Administration, Actuarial Note 2010.4, Table 2, February 2011. Estimates use methodology similar to Social Security statements.*
force and $218,000 for those who were retired.

Employer Decisions Are Linked to Disability Generally

Employers need to consider how important it is to them to help their employees deal with disability risk. Employer-paid or voluntary disability programs are vital to this endeavor. Employee education is important as well. Employers that have not yet addressed primary disability coverage should do that before considering how disability interacts with employees’ retirement benefits.

In addition, employers should consider how their disability decisions relate to other benefits such as medical and life insurance. (These other issues are beyond the scope of this article but are still important.)

Employer Decisions Linked to Disability and Retirement

The first question is whether retirement benefits will be offered in a DC-only plan, a DB-only plan or a combination of DB and DC plans. The following discussion focuses on issues for plan sponsors where the DC plan is primary.

The big question is whether disability and its impact on retirement savings are important enough for the employer to address. This will be important for employers focused on how major risks affect employees but less important for employers simply trying to encourage employee savings and not focused on risk protection.

Questions for the employer that has a primary DC plan or a plan with a significant DC component and an interest in risk include:
- Who will pay? Will contributions be split? How will contributions be collected and forwarded to the appropriate party?
- Will coverage be for employee contributions only? For employer contributions only? For both? Will employees be allowed to choose?
- If autoenrollment is used, what will the coverage amount be? How will enrollment be handled? If coverage for the match is provided, will it be automatic?
- Will the benefit include automatic increases for inflation?
- After what period of disability will benefit payments begin? How will they be linked to the plan? What is the definition of disability? At what point will they stop? Will they be paid during disability before retirement or accumulated until retirement age?
- Will benefits be paid directly into the plan or to the covered individual? What restrictions will there be on accessing funds prior to retirement age?
- How will claims be handled? Will the process for determining whether someone is eligible for the LTD benefit be used for this coverage?
- Under what circumstances would underwriting be required in order for an employee to be covered?
- How many people will join if the program is voluntary?
- Is there potential for antiselection?
- Is there a link to an LTD plan?
- What service providers are needed, and how do we find them?

Benefit Structure Approaches

Three approaches to enhancing retirement security linked to DC plans have been identified. More are pos-

### Table IV

**Loss of Retirement Assets at the Age of 65: Accumulated Value of Lost Contributions**

<table>
<thead>
<tr>
<th>Age at Disability</th>
<th>$6,000 Annual Contribution</th>
<th>$25,000 Annual Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>30</td>
<td>$569,000</td>
<td>$2,371,000</td>
</tr>
<tr>
<td>40</td>
<td>$301,000</td>
<td>$1,253,000</td>
</tr>
<tr>
<td>50</td>
<td>$136,000</td>
<td>$566,000</td>
</tr>
<tr>
<td>55</td>
<td>$79,000</td>
<td>$330,000</td>
</tr>
</tbody>
</table>

*Source: 401kSecure® website. Calculations assume a 5% investment return and a level contribution.*
sible. Two are based on financial products that have information available on the Internet and the third in an article published earlier. One of these three depends on the 2014 regulations, and the other two do not. It is my understanding that patents apply with the financial products. All three approaches assume that the employer already offers LTD coverage.

Example 1—Noncontributory Insured Program Covering All Employees

This approach uses insurance underwritten by Lloyds. Normally, at least the employer contribution will be covered, and 100% of eligible employees get coverage for the specified amount. Some features include:

- Guaranteed issue (no individual underwriting required)
- Tax-deductible premiums are paid by the employer sponsoring the plan.
- Assets held in a bank trust fund on behalf of the disabled participant
- Benefit based on actual contributions up to qualified plan limits
- Benefits deferred until normal retirement age; paid after retirement as income.

Example 2—Voluntary or Automatic Approach Based on Using a DC Plan Investment Option

This approach depends on the new regulations. Under this approach, the LTD administrator would also administer the program linked to the 401(k), and the same claim filing would be used for LTD and the 401(k) contributions. The 401(k) disability benefit contributions must be left in the plan until the age of 65 or the LTD benefits are discontinued. The plan works as follows:

- DC disability supplement provides disability insurance offered as a plan investment. The plan buys insurance from an insurance carrier, most likely the LTD carrier. (It can also self-insure.)
- The plan pays premiums each month.
- If the plan is voluntary, employee contributions are used to pay for the DC supplement insurance coverage.

- If the employee becomes disabled and qualifies for LTD, a claim is triggered on the DC disability supplement insurance, and the benefits from the DC disability supplement insurance are paid to the plan to replace the employee contributions otherwise lost because of disability.

A hypothetical example will provide more insight into how this works. An employee is now 35. The employer contributes $10,000 to the 401(k) and the employee $5,000. It is assumed that these contributions will remain level. The employee's plan balance at the age of 40 is $120,000. The DC disability supplement insurance is purchased to cover both employer and employee contributions. Premiums are paid by the DC plan to the insurance company.

The employee is disabled at the age of 41 and qualifies for benefits. The DC disability supplement insurance pays $15,000 per year into the plan during the continuation of disability. The plan balance continues to earn investment income, and it is assumed that there is a 5% rate of return. At the age of 65, the 401(k) balance is projected to be $1,071,000 with the disability insurance, versus only $387,000 without the disability insurance.

If the plan is voluntary, open enrollment could be only when first eligible, each year or something in between. The plan sponsor and the insurer would need to agree on whether to request evidence of insurability and how much to request. This might be tied to the requirements for LTD.

Example 3: Enhance the LTD Program

This is an example based on how one employer changed its disability coverage to adapt to the new work/retirement environment. It may provide insights for other employers. A financial services organization with more than 35,000 employees changed its benefits so that continued accruals during disability in the DB plan were replaced by an added benefit in the LTD welfare plan to replace the value of lost accruals and DC plan contributions. This organization focused on a number of steps taken over several years to improve the adequacy of disability coverage and to make it work well considering current taxation. Some of the steps included:

- Autoenrolling new hires into after-tax LTD coverage so that an affirmative action would be needed to opt
out. After autoenrollment, 78% of new hires were covered, compared with 51% before autoenrollment.

- Offering coverage on both a pretax and after-tax contribution basis, with benefits from the after-tax plan being tax-free
- Adding a new benefit to the LTD plan to accumulate an amount to replace what would have been saved for retirement
- Allowing disabled employees to continue accruing service to make them eligible for retiree medical coverage
- Defining compensation for LTD to include variable pay.

Where Do We Go From Here?

Does the regulatory change solve the problem so that LTD will no longer derail retirement security? No, not by itself. Here are some of the things that need to happen:

- The public does not understand the magnitude and importance of LTD risk, and many employers have traditionally not placed a high priority on it. More work is required to increase awareness of disability risk and to influence stakeholders to place higher priority on it.
- A variety of stakeholders must be involved: the employer, the 401(k) plan administrator, the bearer of the disability risk (this could be an insurer or the plan sponsor) and employees.
- Products and administrative services need to be developed for implementation of such disability coverage.

Conclusion

Disability is an extremely significant financial risk facing all Americans. Disability during working years creates both immediate and long-term problems. This article focuses on disability and retirement security and sets forth the proposition that LTD protection such as a DC disability supplement is critical for good long-term security in a DC environment. For those with a strong LTD program already in place, this challenge can be addressed by providing a DC disability benefit that will replace DC contributions during periods of LTD. Employers without an LTD program should establish one. Appropriate disability coverage is vital if the DC system is truly to deliver long-term retirement security. This article discusses issues in achieving such coverage and provides ideas to help in developing programs. Few such programs exist today, but it is hoped that this article will encourage more employers to adopt such programs.

Author’s note: The Society of Actuaries has a work group focusing on the link between retirement security and disability within DC plans and on how to improve retirement security. I thank the members of the Society of Actuaries work group for their assistance with this paper.

Endnotes

2. Sixty-four percent of wage earners believe they have a 2% or less chance of being disabled for three months or more during their working career. The actual odds for employees entering the workforce today are about 25%. Most American workers estimate that their own chances of ex-
periencing LTD are substantially lower than the average worker. Statistics from the Council for Disability Awareness Disability Statistics (downloaded on September 25, 2015).

6. Short-term disability coverage often is provided by employers but has not been included here as the basic topic is LTD.
8. Data is from 2001 SIPP and has not been updated.
10. A product of this type is 401KSECURE offered through Corporate Compensation Plans. See www.401ksecure.com.