How to Determine Who Needs Income Protection Insurance

The quick-witted cultural commentator Oscar Wilde observed, "To expect the unexpected shows a thoroughly modern intellect." While most people don't expect to lose months or years of earning power due to illness or injury, 25% of all US adults live with a disability. This shocking statistic stresses the importance of ensuring that your clients have adequate income protection in place to protect themselves and their families when the unexpected happens.

Protecting your client's most valuable asset: A vital ingredient in sound financial planning

A person's ability to work and earn a living is their most valuable asset. Losing this ability – even temporarily – without sufficient income protection can spell the difference between a comfortable standard of living and one of perpetual financial insecurity. Identifying the need for disability insurance likely exposes a financial blind spot in an individual's personal finances – an exposure often caused by confusion, a lack of knowledge or simply being overwhelmed.

This article offers simple guidelines for financial planners and advisors to use when evaluating the suitability of disability insurance for their clients. Decisions about income protection can be complex. Policy solutions must be tailored to the client's unique circumstances. We initiate these conversations with clients by looking at six (6) key considerations:

1. **Examine your client's demographic, lifestyle and risk profile**

   Factors like your client's age, marital and family status, career or job duties and lifestyle preferences are core components of the client's risk profile. A client with a substantial financial reserve will have different coverage requirements than a client who relies on a paycheck. An empty-nester close to retirement may no longer need income protection, while a professional balancing peak earning years with raising a family may need it urgently.

2. **Identify your client's professional status, career choices and overall health**

   Most professionals who wish to insure their ability to work in highly specialized occupations such as physicians, attorneys, CPAs, Ph.D. scientists and highly-compensated executives, etc., find having disability insurance crucial. However, the self-employed – like freelancers, consultants and sole proprietors – rarely have adequate protection, neglecting themselves as they protect their businesses. They are left to discover and purchase appropriate coverage on their own.

   Therefore, it becomes critical to review and analyze your client's specific work/life situation to determine their need for income protection insurance. As their financial advisor, you may have a fiduciary responsibility to ensure certain living expenses and retirement goals are adequately protected should they become too sick or injured to earn their income.

   Finally, medical history that includes cancer, diabetes, heart disease or musculoskeletal pain could result in your client receiving a modified offer for coverage through a policy rating, exclusion or limitation of benefits. The possibility also exists that a more severe history could result in no coverage being offered.

3. **Conduct a deep dive into disability plans your client already has**

   Most large employers provide robust benefits to their employees – such things as medical benefits, worker's compensation, paid time-off and access to retirement planning options. Yet, one of the key benefits differentiators we see most often is income protection provided through employer-paid Group Short-Term Disability (STD) and Group Long-Term Disability (LTD) Plans. These provide a terrific base of income protection coverage that all employees will welcome. However, it is critical to the client's planning process to know what is – and more importantly, what is not – covered under these plans.

   A typical plan protects only a portion of your client's income, with a "60% of gross monthly salary" formula being most common. Additionally, these plans will commonly have a designated cap on the amount to be paid (e.g., $5,000, $7,500,

$10,000, etc.). In other words, an individual earning $175,000 in annual salary would receive the $7,500 cap on monthly benefits under a “60% to $7,500” LTD plan – resulting in an income replacement percentage of only 51% of gross monthly income. It is also critical to note that employer-paid LTD benefits are likely taxable to your client when received, further eroding the purchasing power of the benefit provided.

Finally, many STD and LTD plans do not include bonus, commission or ownership compensation in the “income” formula to determine monthly benefits. That same individual earning $175,000 in yearly salary may also have a history of receiving a $50,000 annual bonus, taking total annual compensation to $225,000. The “60% to $7,500” LTD formula would result in only 40% of total compensation being paid in the event your client becomes sick or injured and unable to work.

Conducting a deep dive into these plans is a critical part of the planning you can provide.

4. **Conduct a budget assessment**

   Income protection insurance provides monthly benefits if your client cannot work for an extended period because of illness or injury. A confident, well-protected client is one who has utilized, with your guidance, a calculator to measure monthly expenses – **home expenses** (mortgage/rent and utilities), **loans/debts** (including credit), **food/dining**, **insurance** (home, health, auto, dental and vision), **transportation**, **children** (education and daycare), **entertainment** (vacations, movies and concerts), **savings and investments** (monthly retirement contributions and personal savings) and **any other costs**. These monthly expenses are then measured against your client’s after-tax monthly income (salary, bonus, commissions and ownership compensation). Finally, the results are offset by current STD and LTD coverage in force to determine the gross income replacement gap your client is facing.

   It is then prudent to factor in any time limits and disqualifiers for any employer-provided insurance coverage, additional income sources available to the family, passive income from investments, alimony and so on. Ultimately, you can help your client see any shortfall that exists.

   Finally, you can begin a conversation about the best benefit amount, ideal waiting period, suitable benefit period and acceptable costs for coverage.

5. **Be prepared to explain that government-issued Social Security Disability Insurance (SSDI) is barely a stopgap solution**

   The SSDI program pays benefits to individuals and certain family members if they are “insured.” Insured is defined as someone who has worked both long enough and recently enough while also paying Social Security taxes on their earnings.

   If an individual meets the non-medical requirements, monthly benefits are paid only if the medical condition is expected to last at least one year or result in death. Even then, the average monthly disability benefit amount that Social Security anticipates paying out is shockingly beneath the poverty line for a two-person household.

   While some income is better than none, your client should not expect to rely on Social Security to meet their expenses and will likely have to tap into savings to pay their bills throughout their disability.

6. **Examine your client’s overall financial health**

   One final consideration is your client’s overall financial health. Do they have enough savings and investment income to sustain their lifestyle no matter what? Have they inherited a large estate, are they nearing retirement, are plans in place to sell a high-priced asset or have they adequately planned for a comfortable retirement? If so, they may be one of the lucky few who do not need an income protection plan.

Bottom line: Most people are underinsured when it comes to income protection. By offering your clients the option to purchase an individual income protection plan, you are providing them with a vital component of a sound strategy for safeguarding their financial future.