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## PERSPECTIVES FROM ANNA:

INTEGRATION OF DISABILITY BENEFITS WITH OTHER  
BENEFITS IN A DEFINED CONTRIBUTION WORLD*By Anna Rappaport*

*The purpose of this article is to encourage people to rethink how disability impacts retirement security in a Defined Contribution (DC) world, and to start a conversation about this topic. It is hoped that the conversation may lead to some restructuring of the intersection of disability and retirement benefits to better reflect the trend toward work schedule reductions near the end of workers' careers.*

## Basic premise

Disability is one of the major risks facing individuals as they go through life. It is linked to retirement security and for many people a significant period of disability before retirement will mean insecurity in retirement if they live to retirement, and insecurity for surviving family members if the disabled person was a major earner in the household. Disability can interfere with work and prevent people from building up assets for retirement as well as leading to premature use of funds accumulated for retirement. Disability may also mean that the spouse becomes a caregiver and gives up at least part of the opportunity to earn retirement and disability benefits based on his or her own work. Workplace disability benefits were traditionally established in a world where retirement occurred all at once, and where it was believed that there would be a clear distinction between retired and working, and between disabled and not disabled.

While Social Security covers both risks, recent trends in typical corporate benefit programs are to look at them separately, and there are two different sets of people who focus on these traditionally more strongly linked benefits. This perspective is provided because I believe that more attention needs to be paid to how disability impacts retirement security, and how employers and society integrate coverage for retirement and

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disability.

Disability is an important factor in early retirement. A study by the Congressional Budget Office (CBO) focused on reasons for early exit from the labor force.<sup>1</sup> It examined the Census Bureau's SIPP (Survey of Income and Program Participation) database to look at people aged 50 to 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 to 61, 14 percent of men and 24 percent 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 percent were retired, 64 percent were disabled, and 4 percent reported other reasons for not being in the labor force. Among the women 26 percent were retired, 40 percent were disabled, and 34 percent reported 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 at ages 50 to 61 reported as not working were twice as likely to be disabled as retired, whereas women were about one-and two-thirds times as likely to be disabled as retired. Of the total population aged 50 to 61, 9 percent of men and 10 percent of women reported themselves as disabled, and 4 percent of men and 6 percent of women reported that they were retired and did not work at all during the year.
- About 80 percent of the men and women who reported themselves as disabled received Social Security disability benefits or were in a family that received Supplemental Security Income program payments.

#### Social Security disability benefit eligibility

Social Security is the only disability coverage available to the vast majority of the working population. Social Security offers long-term disability coverage to virtually all workers who meet stringent requirements for benefits. Social Security pays disability benefits to people who cannot work because they have a medical condition that is expected to last at least one year or result in death. In general, to get disability benefits, the covered person must meet two different earnings tests:

1. A "recent work" test based on age at the time of becoming disabled; and
2. A "duration of work" test based on length of contributory coverage under Social Security.

To meet the recent work test, the youngest workers, those below age 24, need to have at least 1.5 years of coverage during the three year period ending with the quarter during which they become disabled. Workers who are at least age 31 need to have worked five years out of the last 10 to satisfy the recent work test. . Under the duration of work test, the total work required gradually increases with age, varying from 1.5 years if disabled before age 28, increasing to seven years by age 50, and 9.5 years by age 65.

Options for disability coverage and fit with private benefit programs

Disability provisions can be found not only in Social Security, but also in employer-based benefit plans through group insurance policies and as ancillary benefits in (predominantly Defined Benefit (DB)) retirement plans, as well as through individually-purchased disability insurance products. Traditional benefit programs were heavily linked to income replacement, and focused on loss of income from disability, death and eventually retirement. They were designed to work well in a world where career employment was the norm. Traditional pension benefits were designed to replace income after retirement (regardless of physical ability) and disability benefits were designed to replace income before retirement for those who were unable to work because of a health condition. Traditional final average pay DB pension plans worked well alongside insured Long-term Disability (LTD) plans since the DB plans allowed disabled employees to continue earning pension credits while disabled, and started paying benefits when the LTD coverage ended for totally and permanently disabled employees. Retirement was assumed to be all at once and at age 65. DC plans work very differently with regard to disability benefits. DC plans may pay out the account value on disability, particularly if the individual's employment terminates. Extra disability coverage could also be offered in order to provide for continued savings.

**Sources of disability coverage and bases for calculating benefits**

	Social Security Disability	Employer LTD program	Employer STD program	Defined Benefit Pension	Individual Disability Policies
Prevalence of coverage	Everyone is Social Security system is covered, but Social Security has requirements with regard to work history for coverage to be effective.  Traditional Non-working spouses have no coverage	Very common at larger companies, particularly for salaried employees. May be voluntary and many people may choose not to participate.  Not very common in smaller companies.	More common than LTD. Very likely in larger companies, and prevalence declines with employer size.  (Also a few states have mandates for short term disability coverage)	In state of decline. Most likely at larger companies.	Minority of the population. Most likely among higher paid professional, white collar, business owners, etc.
Disability benefit amount based on:	Lifetime earnings history and benefit formula	Current earnings and benefit formula	Current earnings and benefit formula	Formula in plan and disability provision	Amount of coverage purchased
Type of disability definition	Total and permanent, expected to last for at least a period of one year or result in death.	Can be your occupation or any occupation, or a combination based on your occupation first – depends on coverage.	Likely to be your occupation	Depends on plan provisions, may be similar to LTD program	Can be your occupation or any occupation, or a combination based on your occupation first – depends on coverage
Link of disability to ultimate resources at retirement	Affects earnings history so benefit may be reduced somewhat	No direct connection, but LTD benefit may enable continued saving for retirement	No connection	Some plans provide continued accrual of service for pension benefit	No direct connection, but benefit may enable continued saving for retirement
Employer role in program	Pays Social Security tax	Plan sponsor, program could be self-insured (giving employer discretion in structuring program)	Plan sponsor, program could be self-insured (giving employer discretion in structuring program)	Plan sponsor, program usually self-insured	None

*Click on the chart for a bigger view*

Disability and emerging patterns of retirement

Retirement has recently tended to become much more of a *process* rather than a discrete, single-point event at predefined "early" or "normal" retirement ages. The concept of retirement has become somewhat blurred and characterized by earlier "phased retirement" ages and later "final retirement" ages that depend more and more on individual circumstances. Scaled-back work schedules are becoming a part of the retirement process for many workers, and health limitations are one of the more common reason for this scale-back. As retirement has changed, final average pay DB plans, for various reasons, have also become much less common. Defined contribution plans typically pay out benefits to disabled employees, and the money may well be spent before retirement age. Disability plans, as a rule, are not being adapted to reflect the new reality. They are not intended to pay benefits to phased retirees, but rather are intended to pay benefits to full-time employees who can't work because of physical or cognitive limitations. There is an increasing focus on rehabilitation, keeping employees with manageable health challenges at work and helping to get people who have suffered light to moderate (temporary) disabilities *back* to work. In addition, employers are required to provide reasonable accommodations to disabled employees under the Americans with Disabilities Act (ADA). The Social Security administration has been working to improve the operation and administration of its disability programs including helping persons who are entitled to benefits return to work. Some employer based disability programs offer rehabilitation and partial disability benefits today. Employers who are

developing innovative or leading edge work options and phased retirement programs will want to be sure that there are no anomalies or unintended gaps with regard to disability benefits or the ADA.

There is the potential that people who elect phased retirement due to health limitations will then become disabled, and there are questions about how best to make sure that these two sets of programs intersect in a logical fashion. In addition, people going on phased retirement can lose disability coverage or see it reduced, so that they should probably not elect to reduce their schedule if they believe that they are likely to become disabled soon.

Care is needed in communicating with employees who have health limitations and are considering part-time or reduced work options. As noted above, reduced work schedules can adversely affect disability eligibility and/or benefits. The employee may view a reduced work schedule as desirable and it may indeed be beneficial to both parties. However, if the employee is eligible for work disability benefits under legal or contractual terms, the relationship between full-time vs. part-time work and disability benefits should be completely understood and clearly communicated.

Will changing work schedule change disability coverage?

In general, a short-term change in work schedule (e.g., a few years at the end of a long career) should not materially impact Social Security benefits, but a long period of reduced hours could substantially reduce benefits, which are based on career average (indexed) earnings. Private individual disability insurance may not be directly affected by a reduced work schedule, but employer provided coverage will nearly always suffer, since the worker could lose eligibility altogether, and even if he/she remains eligible, there is likely to be a reduction in benefits, which in this case are based on *current* earnings.

Summary of issues

So what are the issues as we think about the intersection of work, disability and retirement?

- People who are disabled need to continue to save for retirement for themselves and their dependents. Often this will not happen, and it is a problem with most DC plans.
- Retirement funds should not be used at time of disability, as this will reduce or deplete assets needed for future retirement for the individual and family. This is another potential problem with DC plans.
- People who are disabled need income replacement, and many

working Americans have only Social Security disability benefits to rely on. Traditional nonworking spouses have no coverage under Social Security (nor do they have outside earned income that needs replacing). Still, the family will often need to pay for services previously provided by the disabled nonworking spouse.

- Current designs for disability programs do not contemplate—and thus do not have a good fit with—the increasing trend toward phased retirement. Disability programs are primarily designed for people who go from full-time work to full retirement all at once.
- Employer-based disability benefit programs are most often designed to work with a normal retirement age of 65. As work lives lengthen along with improved life expectancy and associated past and future changes in Social Security, these benefit programs will need to be adjusted.

*Editor's note: Anna does not hold herself out as an expert on disability insurance issues, and hopes that any misstatements—however subtle, regarding the current state of governmental, employer-based or individually-contracted disability income replacement programs—will be taken in stride. As stated up front, the purpose of this article is to encourage people to rethink, in a general sense, how disability impacts retirement security in a DC world, and to start a conversation about this topic.*

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#### Footnote

<sup>1</sup> Disability and Retirement: the Early Exit of the Baby Boomers from the Labor Force, CBO, November 2005

