AMERICAN ACADEMY of ACTUARIES

Statement before the ERISA Advisory Council
on Employee Welfare and Pension Benefit Plans

ISSUE: Managing Disability Risks In An
Environment of Individual Responsibility
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Good afternoon. My name is Don Fuerst and I represent the American Academy of Actuaries.[1] The Academy is a 17,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. I am the Senior Pension Fellow at the Academy and in that role I am the spokesperson for the actuarial profession on issues related to retirement. I am pleased to be here with you today to discuss issues related to retirement security and the risk of long-term disability.

Background

The traditional model of retirement security in the United States provided a base level of retirement income from social security, a lifetime income from an employer pension plan, and supplemented these incomes with individual savings. Individuals who became disabled would receive social security benefits during periods of disablement and often, but not always, would receive additional benefits from their employer-sponsored pension plan or long-term disability plan. At retirement, social security benefits would be paid. Employer pension benefits for the non-disabled period would be paid and sometimes, but not always, additional benefits for the period of disability also would be paid.

This model worked reasonably well for those who actually experienced it. But this model never covered all American workers. The employer-sponsored pension system is voluntary and coverage has never been universal. The disability provisions mentioned are also voluntary and were never near universal—even among those employers who did sponsor pension plans. Vesting requirements minimized or eliminated benefits for short-term workers and the erosive effects of inflation reduced the purchasing power of these benefits which were generally based on earnings at the time of disablement.

[1] The American Academy of Actuaries is a 17,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

The current model for retirement security

Regardless of how effective the traditional model might have been, it is not our current model or the model of the future. Social Security remains relatively unchanged, but today's workers, particularly those entering the workforce, seldom participate in an employer–sponsored defined benefit pension plan.

Most employers now offer defined contribution plans (DC) rather than defined benefit plans. These plans often require an employee to contribute to the plan with the employer making a matching contribution. In some plans, the employer makes additional contributions beyond the matching portion. All contributions are generally invested in funds of the individual's choice. At retirement, the individual is entitled to the balance of the account. This amount can be left in the fund or rolled into an IRA. Spending in retirement can be financed by periodic withdrawals from the fund or the IRA for as long as the funds last. The individual also can buy an annuity with the funds to guarantee lifetime income, but relatively few individuals actually exercise this option.

The traditional model of retirement security functionally has deteriorated into two sources of income rather than three. The employer contributions to defined contribution plans essentially become employee savings once the employee is vested in the account. The employer has no further role in the financial security of the future retiree other than maintaining the plan. Even that can cease at any time of the employer's choosing. In particular, the employer has no role in assuring that the future retiree has an income for life.

The tax sheltered savings in the DC plan is often the only significant savings of the individual, other than perhaps equity in a home. But home equity has been seriously compromised in recent years and always has been difficult to convert to retirement income.

Typical challenges to this model

This model can work well if individuals follow ideal behavior. Starting to save early, saving consistently, investing prudently, and avoiding early use of retirement funds can lead to a financially secure retirement. But there are many potential pitfalls and challenges:

- Starting early is important and allows an individual to save a more manageable portion of income each year. But saving early in one's career is difficult, especially when establishing a new household or paying off college debt.
- Consistent savings without interruption helps accumulate sufficient funds in retirement But frequent job changes and periods of unemployment often make this difficult.
- Prudent investing is not an innate skill of every American worker. While many new tools are being developed to address this, many individuals still tend to chase the "hot funds" and ignore long-term investment strategies.
- Leakage: The early use of retirement funds for purposes other than retirement – reduces the ultimate amounts available at retirement.
- Decumulation – Unlike traditional defined benefit plans, with a DC plan the individual generally must manage his/her funds to last a lifetime without the benefit of pooling

longevity experience. Although annuity purchases are possible, most retirees do not elect this option.

Many DC plans are addressing these issues by implementing new tools such as auto-enrollment, auto-escalation of contributions, target date funds, specially managed investment accounts, and longevity annuities or longevity insurance. Most of these new tools simply tend to encourage an individual to take actions that they could generally take on their own if they were well disciplined and possessed the appropriate knowledge and skills.

Disability: A challenge of a different nature

Unfortunately, there is much less activity in addressing another serious threat to the retirement security of workers: A threat that an individual cannot mitigate through disciplined savings and investment —the loss of earnings and the related ability to save for retirement due to a long-term disability.

While most of the challenges mentioned earlier can be addressed by improving individual decisions, the individual generally has little control over the onset of a disability. Losses due to disability are not adequately mitigated by saving more or starting earlier.

The Nature of Disability Risk

Everyone is at risk of becoming disabled. An automobile accident, a weekend sports injury, or any of a number of chronic or sudden illnesses can limit a person's ability to work. In general, older people are more likely to become disabled than younger people, and females are more likely to become disabled than males, but disability can happen to anyone at any time.

Frequency of Disability

The risk of becoming disabled is greater than most people think. The probability of becoming disabled during a working career ranges from 15% to 30% varying with age and gender. The risk of disability lasting 90 days or longer is greater than the risk of premature death.[2] Most people routinely insure against the risk of premature death, often through employee benefit programs. But disability insurance is much less common.

Causes of Disability

Many associate disability with serious accidents, but in reality the overwhelming portion of disabilities are caused by illness—more than 85% of short term disabilities and almost 90% of long term disabilities are related to illness.

[2] These and all statistics cited in this statement are from Disability Insurance: A Missing Piece in the Financial Security Puzzle, Society of Actuaries Disability Chart Book

Length of Disability/Return to Work

Short-term disabilities generally interrupt savings and might be an event that causes greater leakage of retirement savings, but longer term disabilities are what pose a serious threat to retirement security. Of those workers who experience a serious disability lasting more than 90 days, many remain unable to return to work for years. More than one-quarter of disabilities occurring at age 35 last five years or more. That proportion increases to more than one-third at age 45 and more than one-half at age 55.

A long-term disablement often functions much like a choice not to participate in a retirement savings plan. Although in reality it isn't the individual's choice, the result is the same—no savings, no employer match, and a very significant decrease in the amount available at retirement.

Financial Consequences of Disability

Loss of Earnings

For most workers, the ability to earn a living is their most significant financial resource. A lengthy disability can be financially devastating to workers and their families.

A disability frequently turns a breadwinner into a dependent, drastically reducing income while increasing expenses. When people are disabled and cannot work, they don't just lose their current income, they also lose the ability to save for retirement, as well as other employee benefits such as employer-sponsored medical benefits.

A serious disability also can lead to higher living expense due to greater health care needs, the need for assistance in performing routine functions, and other costs. While leaving the workforce can reduce costs such as commuting and wardrobe costs, these are likely to be small compared to the additional expenses incurred.

It can get even worse. The disabled individual often needs care. Family members are the most likely care-givers. Demands on family members' time to provide care reduce their ability to provide income for the family. In such a situation, individuals tend to deal with their immediate needs. Long-term savings is usually one of the first resources tapped. This has a dual effect.First it results in a reduction of current savings to make more income available for expenses. And second, it results in tapping funds previously designated as retirement savings. The effects can be long lasting.

Effect on Retirement Savings – An Illustration

A 35-year-old worker who suffers a permanent disability may lose the ability to produce an income for extended periods, perhaps even the reminder of his/her life. For someone earning $50,000 a year that could be as much as $1.5 million in lost wages. If retirement contributions of 10% of wages were being made by a combination of employee and employer contributions, more than $150,000 of retirement savings will be lost. With investment earnings, those contributions would have accumulated to a far greater sum at retirement. Although the magnitude of the dollar loss decreases if disability is at a later age, as an individual ages the probability of a permanent disability increases, making this a serious risk at any age.

Few workers have adequate savings available to support themselves during an extended disability. In the absence of adequate insurance, many disabled employees are at risk of becoming dependent on public programs. But even with adequate insurance for a current loss of earnings, retirement savings are likely to be seriously damaged. Insurance for loss of earnings typically replaces only part of lost income; insurance usually does not replace retirement savings, and expenses often increase.

Public Disability Programs

Public disability programs include Social Security, workers compensation, and a few state temporary disability programs. While these programs provide some with assistance when suffering a loss of income, they do little or nothing to alleviate the loss of retirement savings. Social security uses stringent definitions of permanent disability and provides relatively low levels of benefits—especially for above average wage earners. Workers compensation covers only disabilities resulting from the workplace, and only a handful of states have temporary disability programs.

The result is not surprising. If we examine poverty statistics, we find that poverty rates more than double following disability.[3] But this is only the more extreme part of the problem. Disability can strike at any income level and almost always significantly lowers the financial security of those affected.

Private Insurance Programs

Long-term disability (LTD) is a risk that has proven to be reasonably addressed by insurance. The likelihood of occurrence is difficult to predict for an individual, but much better able to be assessed for large groups. The potential loss is great, but the cost to insure against this loss is relatively small. The infrastructure for protecting against this risk currently exists—group LTD insurance provided through payroll deduction. This is an ideal environment for insurance.

To deal with this issued effectively, two significant changes need to occur. First, LTD insurance programs should be more widely available. And second, income replacement programs should include replacement of retirement savings contributions.

Disability insurance as an employee benefit is common, but not universal. Less than one in three U.S. workers has disability coverage. Many disability plans provide optional coverage rather than automatic enrollment for all employees. But critical to our issue of discussion today, most disability benefits provide only a replacement of part of an employee's earnings and leave the disabled employee unable to save for retirement because he/she has less income and possibly

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[3] Older Americans' Economic Security, The Urban Institute, January 2010

greater expenses. In addition, since they no longer are earning wages from their employer, long-term disabled workers are generally ineligible for any employer contribution to a defined contribution retirement plan.

This does not have to be the case. Disability is a risk that can be addressed well by insurance. Premiums for disability insurance are relatively inexpensive. Disability premiums are far less than health insurance, generally less than auto or home insurance, and generally comparable to term life insurance. Adding retirement contribution insurance to the typical income replacement coverage would involve generally small increases in premiums. Technical changes in some statutes and regulations may be necessary to facilitate this coverage as others are addressing today. But the basic insurance principles are clear—this coverage can be provided at a relatively reasonable cost.

Some additional incentives are probably still necessary to increase coverage of this risk. We can look to other insurance coverages and see that incentives help. For example, most homeowners maintain fire insurance on their property. Perhaps this is partly because mortgage lenders generally require insurance be in place before a loan will be funded. Most car owners maintain liability insurance, at least partly because it is required in almost all states. Most employers provide some basic level of life insurance and health insurance, perhaps because employees have come to expect this as a necessary part of a compensation practice.

We should explore ways to make both employees and employers more aware of the risk that disability poses to both current income and retirement security and encourage the use of effective insurance products to mitigate this risk.

Summary

Retirement planning in an era of individual responsibility is especially challenging. We as a society are making progress in many areas by changing our systems to encourage individuals to save early and often. We are creating default options that result in higher probabilities that individuals will be able to attain a secure retirement.

But we need to address a broader scope of risk to which individuals are exposed. Disability is a potentially serious threat to any American worker. We have the tools to mitigate these risks. We need to encourage much wider utilization of these tools so that a serious accident or chronic illness does not doom an individual to a life of poverty.

Thank you for the opportunity to discuss this issue today.