Prudential
Bring Your Challenges℠

DIAGNOSING WHAT AILS YOUR DISABILITY PLAN

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INTRODUCTION

A major challenge faced by today's employers is how to maintain a competitive benefits package while containing or reducing costs. But you may not need to take drastic steps to see real results. Minor plan design changes can have a significant impact on benefit costs without decreasing the value or effectiveness of the coverage you offer.

What follows is a discussion of long-term disability (LTD) plan provisions that may have cost-savings opportunities for employers and employees. Definitions of key terms are located at the end of this guide.

Striking a Delicate Balance

In Prudential's **Sixth Annual Study of Employee Benefits**, plan sponsors were asked about their top benefit objectives. The top three responses rated as "very important" were "controlling health care-related costs" (65%), "retaining employees" (53%), and "reducing the cost of benefits administration" (52%).[1] The juxtaposition of an employee satisfaction goal between two cost-savings objectives highlights the delicate balance employers must strike when considering changes to their benefit plan designs.

When companies look to cut long-term disability benefit costs, they may think their only option is to make drastic plan changes, such as significantly decreasing benefit amounts or limiting plan eligibility. But due to the real—or perceived—impact this has on their ability to attract and retain talented employees, most employers reject this approach, believing that their plan designs have limited flexibility. Instead they shop for lower rates at the risk of losing customer service, or they consider alternate funding arrangements such as non-insured plans administered in-house.

But employers can experience cost savings—sometimes significant ones—just by making relatively small changes to plan provisions. And, because such changes are minor, they don't decrease the overall value of the benefit package for employees. Moreover, some plan changes can actually reduce the volatility of benefit expenses, making it easier for companies to predict their plan costs year over year.

In the pages that follow, we discuss specific LTD benefit provisions, including how each contributes to plan performance and volatility. We then offer lower cost alternatives that employers may wish to consider. Ultimately, any decision to alter your LTD benefit provisions must also take into consideration the plan's claim experience, as well as important, non-cost related factors such as company culture, plan objectives, and the benefit offerings of other employers with whom you compete for talent. Just like one diagnosis is not the same for all patients, one LTD plan design will not necessarily be the right fit for all employers.

Addressing the Obvious Symptoms

If we asked employers to name the plan design features that most directly impact LTD benefit costs, most would list elimination period (the period a claimant must wait before benefits begin), maximum benefit (the claim amount), and maximum duration (the length the claim will be paid). While directly linked to cost, employers only cautiously make changes to these provisions because they know that these are the plan features that employees value. Benefit amount, duration, and waiting period determine the level of income replacement employees receive when they become disabled. That said, employers should review these cost and volatility-contributing benefit levels as part of their overall LTD examination.

Elimination Period. How long a person must remain disabled before disability payments begin is a key element in determining plan costs as it's directly linked to claim incidence or the number of payable claims. Generally, the longer the elimination period, the lower the plan cost because of the higher likelihood those employees will return to work before benefits begin. For example, an employer with a 90-day LTD elimination period could potentially decrease their premium rate by approximately 17%–35% by increasing the waiting period to 180 days.[2]

But not all of this potential cost saving is achieved: consider that most employers who decide to lengthen their LTD elimination period will, at the same time, make a change to extend the length of salary continuation benefits so that there is no gap between benefit payments. Employers generally have the LTD elimination period dovetail with their salary continuation plan so that as soon as sick pay ends, LTD benefits begin.

Another alternative that employers may want to consider is separating their salary continuation plan from the start of LTD benefits. This can have a positive impact on LTD claim experience, as employees have an incentive to try to return to work when they stop receiving a paycheck. Decreasing the number of STD claims that roll over and become LTD claims will ultimately decrease plan costs.

Maximum Benefit. Most LTD plans pay a percentage of an employee's pre-disability earnings (for example 60%); the maximum benefit provision establishes a ceiling for monthly benefits payable for each claimant. This maximum is generally determined based upon the average salaries of the covered population. A plan covering lower wage earners may be limited to $5,000 per month; higher salaried groups may have a monthly maximum of $10,000 or more.

Many employers design their LTD plans so that very few employees will have benefits that exceed the maximum. However, if your plan is experiencing wide swings in claim costs year over year, and your goal is to limit volatility, a potential strategy is to reduce the plan's maximum benefit. Consider a plan that pays 60% of earnings to a maximum of $15,000. The majority of claims for this employee population will not approach the maximum benefit; however, just a few claims paid to the $15,000 maximum will skew the claim experience. Reducing the maximum benefit prevents wide benefit swings and increases the predictability of plan claim costs.

Maximum Duration. The majority of LTD plans pay benefits until the employee reaches retirement age, provided that he or she continues to be disabled. When you consider that the average long-term disability claim lasts 31.2 months, employers need to weigh the value of this extended income protection with the cost.[3]

By reducing the maximum period of benefit payment from the employee's Social Security normal retirement age (SSNRA), you can achieve cost savings. For example, instead of paying benefits to the employee's retirement age—which could be decades away—limit benefits to a fixed period of years, say, five. Changing the maximum duration from SSNRA to five years could result in a rate discount of approximately 24%–34%.[4]

Of course, employers may be reticent to limit LTD to a fixed period of years in the event that an employee becomes catastrophically disabled. However, such limited plan designs may be a practical solution for companies facing limited benefit budgets and the possibility of dropping LTD coverage entirely.

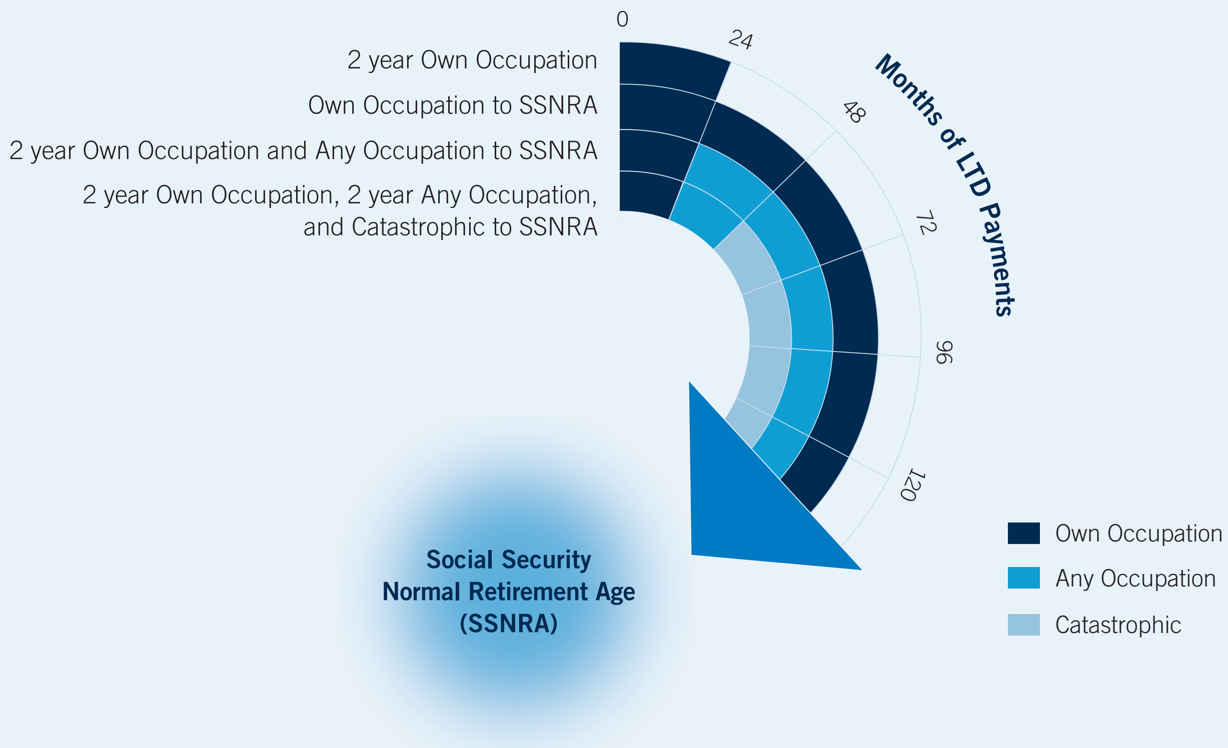
Conducting a More Thorough Exam

Once you move beyond the more obvious plan provisions, you can take your examination a step further. Some of these benefits or definitions may not be applicable to your plan, but could provide insight into other opportunities for making your overall benefit package more cost effective.

Definition of Disability. This is the two part "test" that an employee must pass in order to be considered disabled under the terms of the contract and therefore become eligible for benefits. The first part, which some plans remove, is a minimum earnings loss as a result of sickness or injury. The second part is the inability to perform tasks material to the employee's job.

For LTD coverage, those tasks are defined in terms of the employee's current job (also known as "own," "regular," or "usual" occupation). After a period of LTD payments—generally 24 months—the tasks used in the test may change to be those of any job that they are qualified for by training and experience (also known as "any" or "gainful" occupation). The chart below graphically shows the different definitions of disability and how they impact the length of LTD benefit payments.

Definitions of Disability



Because employers may have invested significantly in their employees' training and development, the best outcome is to get the employee back to performing the job he or she was doing prior to the disability. However, if an employee medically can no longer perform that job, the goal becomes returning him or her to another job that provides comparable income and leverages training, skills, and experience. Depending on the type of work involved, it is oftentimes more difficult to get someone back to their regular occupation as opposed to trying to find the person a different occupation. As a result, from a cost perspective, the longer the "regular occupation" test period, the higher the premium.

Most LTD plans have a 24-month own occupation period followed by any occupation. Significant savings can be achieved by changing an LTD plan from an own occupation to maximum duration plan to a 24-month own occupation plan. Employers considering this option may be concerned about the message such a change sends to employees. But many employers terminate employees on LTD after 12–24 months, so those employees don't have a regular occupation to return to, regardless. Moreover, disabled individuals who are unable to work in a gainful capacity would still be eligible for benefits.

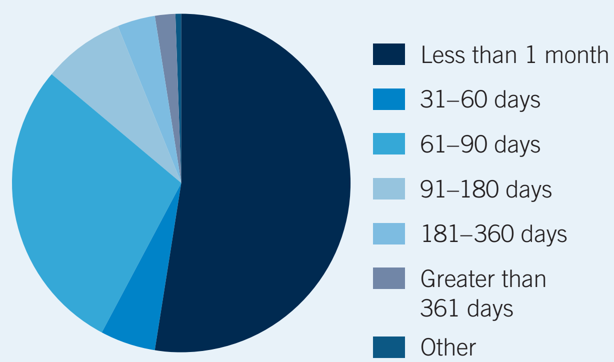
Another option for employers looking for cost savings is to add a catastrophic definition of disability to their plan design. This additional disability test kicks in after a standard, own, or any occupation definition of disability limiting benefit eligibility to claimants who are unable to perform at least two Activities of Daily Living (ADLs) or who have severe cognitive impairment. It's like having a two- or four-year maximum benefit duration for all but the most severely disabled employees.

Eligibility Waiting Period. Has this ever happened at your company? A new employee becomes eligible for benefits shortly after being hired and almost immediately goes out on disability. The truth is that while a competitive benefit package attracts employees, newer employees may have less loyalty to their employer and less motivation to return to work following a disability. Extending the waiting period for new employees to become covered, or adding a waiting period to a plan that doesn't currently have one, may be an effective strategy for some employers to contain benefit costs.

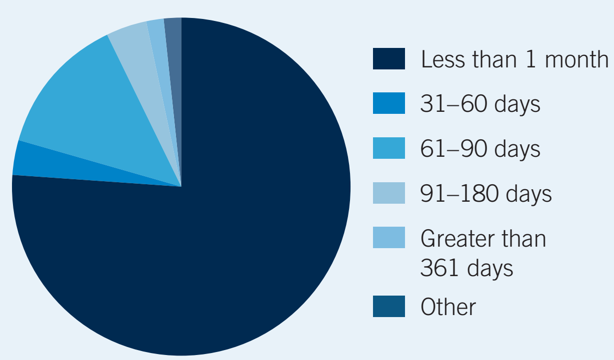
Eligibility waiting periods for disability plans generally range from none (coverage begins on the first day worked) to one year or longer. Employers in industries with high turnover rates, such as Retail, should make sure that they have a waiting period that links eligibility for benefits to employee service. This approach may not work for the entire employee population, so consider having longer waiting periods for certain employee classes, divisions, or locations.

The charts below suggest that employers in different industries have significantly different approaches to this provision, as seen in their design of companion short-term disability coverage. According to data obtained by Group MarketShare, LLC, 53% of employers in the Retail Industry have eligibility waiting periods of less than one month. Longer eligibility waiting periods make sense when you consider the relatively high employee turnover this industry experiences. Contrast this with 76% of Public Administration employers where the trend is toward long-term service. While this data suggests that some employers are paying attention to this often overlooked benefit provision, there is opportunity for others facing similar challenges.[5]

Retail Industry



Public Administration



Definition of Earnings. When it comes to how your LTD plan defines earnings, the question to ask is, "Should variable earnings be included?" Because most LTD plans pay a percentage of an employee's pre-disability earnings, what does and does not get included in those earnings is key. A standard definition of earnings used by insurers is: *Gross monthly income from your employer in effect just prior to your date of disability. It does not include income received from commissions, bonuses, overtime pay, any other extra compensation, or income received from sources other than your employer.*

However, employers have the option to include commissions, bonuses, overtime pay, and other variable earnings averaged over the 12 months prior to disability. The type of employee population often drives this decision. For example, the definition of earnings for plans covering salespeople often includes commission income because base salaries for these individuals are usually kept to a minimum. Including commissions for these employees ensures that a percentage of their true income is replaced at point of claim. Similarly, incorporating overtime income is common for groups with many non-exempt employees and bonuses are included particularly when that bonus represents a large portion of the employees' annual earnings. Employers may want to consider including these variable sources of income for only certain classes of employees.

How the plan defines "monthly earnings" also impacts benefit costs. Disability insurance premiums are calculated based upon the total covered payroll the employer is insuring (e.g., the LTD rate is expressed as $0.40 for every $100 of covered payroll). By including variable earnings such as bonuses in covered payroll, the employer is directly impacting the total cost of their benefit plan and increasing the cost per employee.

By definition, variable earnings fluctuate and add volatility to the cost of an LTD plan. To address this, employers can chose to either remove variable earnings from their definition of earnings or increase the time period over which these earnings are averaged—for example, go from 12 to 24 months. If a good financial year in which commissions and bonus are high is followed by a more typical year, averaging the two together will smooth out such fluctuations, making the overall benefit costs more predictable.

Why Deductible Sources of Income Matter

Deductible sources of income, also known as offsets, are yet another cost-control feature of LTD plan designs. When an employee is disabled, he or she may receive income from other sources in addition to employer-sponsored disability benefits (e.g., third-party settlements, retirement payments, or workers' compensation). When the LTD benefit is calculated, all of these sources of income are considered to ensure the appropriate income replacement level for that claimant.

Offsets keep benefit costs low and encourage return-to-work by ensuring that claimants cannot earn more while disabled than when they are working. LTD plans contain a standard list of offsets and most employers understand the risk—and premium impact—of removing a deductible source of income from their plan. We include offsets in the discussion of cost-effective benefit plan designs to stress their importance to the overall health of your benefit plan.

Social Security Disability. One of the most common offsets on LTD plans is Social Security Disability Benefits (SSDB). SSDB is a federal program that pays benefits to a disabled person and qualified family members if he or she cannot work and the disability is expected to last for at least one year. Both employees and employers are required to pay into Social Security—even those employees covered by worksite disability insurance.

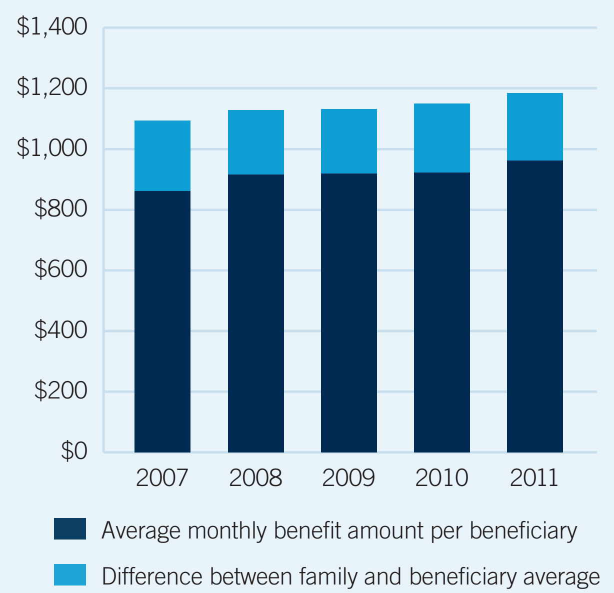
Most LTD plans offset SSDB because without it, employees can receive both their LTD benefit plus SSDB. (In 2010, the average new SSDB award for disabled workers was $1,129/month.[6]) As discussed previously, full income replacement creates a disincentive for employees to return to work.

A question many employers have is: Shouldn't employees be able to collect the benefits we paid for? What they may not realize is that disability premium rates are calculated assuming that a certain percentage of claimants receive income from SSDB that can be offset from their benefit. If that offset is removed, the employer's premium rate will increase to account for higher benefit costs. As a result, the employer is actually paying twice to replace the same income—Social Security taxes plus insurance premium.

Social Security Disability offsets are generally designated as either "primary" or "family." Under primary, only the SSDB payable to the disabled worker is offset; with a family offset, the benefits payable to the spouse and children are also deducted. The table below illustrates the average monthly benefit per single beneficiary and how much this increases when the disabled person has qualified family members who are also eligible for SSDB benefits.

Some employers may opt to include a primary SSDB offset instead of a family offset, thinking that benefits paid to family members are unrelated to the employee's income replacement. But family SSDB benefits are payable *as a result of* a parent or spouse being unable to work; the benefits are therefore still a form of income replacement. By not offsetting SSDB benefits to the fullest extent possible, employer premium rates will increase to account for the increased benefit costs.

Average Monthly Social Security Disability Benefit Amounts Per Family



Source: Office of the Chief Actuary, SSA. Benefits Paid by Type of Family 2007-2011.

Diagnosis—The First Step to a Cure

This discussion of various plan design strategies is just the start of a larger conversation employers can have about their benefit plans and potential cost savings. Relatively minor changes in your plan may save significant benefit dollars without reducing the plan's overall value for your employees. But, as we said at the outset, not all of the ideas discussed will be appropriate for all employers.

At Prudential, we understand the challenges you face delivering cost-effective, competitive employee benefits. We can help you analyze your long-term disability plan to find opportunities for cost savings that work for your business. With our proprietary consultative reporting, we can benchmark your company's results against Prudential's book of business and other companies in your industry. From there, we'll recommend ways to enhance your plan's performance, which may lead to better financial results. Contact your Prudential representative for more information.

Glossary of Key Terms

Activities of Daily Living: The six Activities of Daily Living, or ADLs, are bathing, continence, dressing, eating, toileting, and transferring.

Any Occupation (also referred to as "gainful occupation"): Occupational test used in the contractual definition of disability. To be considered disabled, a claimant must be unable to perform the material tasks of any job for which he/she is suited based upon his/her training, experience, and education.

Catastrophic: Test sometimes used in the contractual definition of disability which follows a period of own or any occupation disability. To be considered disabled, a claimant must be unable to perform at least two Activities of Daily Living (ADLs) or have a severe cognitive impairment.

Earnings: An employee's weekly or monthly earnings from the employer used to calculate the disability benefit payable (i.e., 60% of earnings plan). Earnings are defined in the insurance contract and may include bonuses, commission, and overtime, or be based upon W-2 or K-1 reporting.

Elimination period (also known as a waiting period): Length of time an employee must be disabled before benefit payments begin. For LTD, common elimination periods range from 90 days to one year.

Eligibility waiting period (EWP): Period of time an employee must work for an employer before he/she becomes eligible for coverage. EWPs generally range between none (employee is benefits eligible on his/her first day worked) to one year.

Maximum duration: The longest period of payments an insurance carrier will make to a claimant if he/she continues to be disabled. For LTD, insurers may pay benefits until the claimant reaches his/her normal Social Security retirement age.

Maximum monthly benefit: The greatest amount of disability benefits an insurer will pay an employee on a monthly basis. For example, an LTD plan may pay 60% of an employee's pre-disability earnings to a monthly maximum benefit of $5,000.

Offsets: Other sources of income a claimant receives while disabled that are deducted from the disability insurance payment. Offsets are listed in the contract and may include sick pay from the employer, statutory disability benefits, and Social Security Disability.

Own occupation (also referred to as "regular" or "usual" occupation): Occupational test used in the contractual definition of disability, which requires that a claimant be unable to perform the material tasks of his/her own job to be considered disabled. A loss of earnings is generally required as well.

Plan experience: An analysis of a group's expected versus actual claim volume and total benefits paid, used by underwriters to determine premium.

Social Security Disability Insurance (SSDI): A payroll tax-funded, federal insurance program of the United States government. SSDI, managed by the Social Security Administration, is designed to provide income to people who are unable to work because of a disability.

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1 Prudential's Sixth Annual Study of Employee Benefits, 2011.

2 Based upon a Smith Group analysis of the public rate filings of 10 group disability carriers, including Prudential.

3 2010 Gen Re Disability Fact Book.

4 Based upon a Smith Group analysis of the public rate filings of seven group disability carriers, including Prudential. Note that some carriers reduce the five-year maximum duration if the claimant's age exceeds the Social Security Normal Retirement Age (SSNRA) at claim incurral, whereas others pay five years of benefits regardless of claimant's age.

5 Data obtained through Group MarketShare, LLC. Based on industry sales of cases with 500 or more lives, effective 1/1/2002 -1/1/2012.

6 http://www.ssa.gov/policy/docs/chartbooks/fast_facts/2011/fast_facts11.pdf, Social Security Administration.

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