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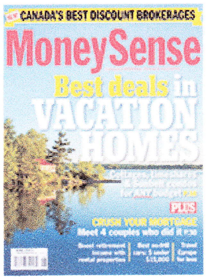
Disability insurance: Preparing for the worst

If you had a crippling accident or were diagnosed with a critical illness tomorrow, would your family be able to cope?

By Julie Cazzin | From MoneySense Magazine, December/January 2012



Ten years ago, Janet Freedman was rushing out the door of her home for work. Her arms loaded with tax returns, she missed a step on the stairs on her front porch and fell, hitting her head on the concrete. When her neighbours found her, she was barely conscious, with her head trapped between her own front steps and those of the house next door.

Paralyzed, with a partially severed spinal cord, it took more than six months of hospitalization and two years of intensive physiotherapy for Freedman to resume her life. She was unable to work and had no one to support her. "Thank goodness I had a good private disability insurance plan," says Freedman, a certified financial planner and author of *Hit by an Iceberg: Coping with Disability in Mid-Career*. "Those payments allowed me to concentrate on my rehabilitation and to live my life without worrying about where the money was coming from for daily living expenses. That made a big difference to me and my recovery."

While many of us understand the importance of life insurance, the truth is that insurance against an accident or disease that prevents you from working is arguably even more important. A typical 30-year-old has a four times greater chance of becoming disabled than he does of dying before age 65. A full one in six Canadians will be disabled for three months or more before the age of 50.

There are two main options: long-term disability (LTD) and critical illness (CI) policies. Both pay you money in case of an illness or disability, but they do it different ways. Disability insurance provides a monthly income if you're unable to work due to a serious injury or illness, while critical illness insurance pays out a tax-free lump sum payment following the diagnosis of one of several illnesses covered by your policy. So which one is right for you?

Regular pay if you can't work

If you work for a large company, you likely already have some kind of long-term disability insurance. Typically, such a plan will pay you a set portion of your monthly income if you are unable to work. Payments end when you start working again, reach age 65, or die. Coverage differs greatly from one employer to another, and if you're self-employed or you work for a smaller company, you may have no coverage at all.

Such disability plans will either cover you for "any occupation" or "own occupation." The latter is much better, because under this definition, total disability means the inability to work at your regular job. With "any occupation," total disability means the ability to perform the duties of any job. That means that if you become disabled, but you could perform a less demanding job, you may not get the benefit. Often plans offer "own occupation" coverage for the first two years of the benefit period and then switch to "any occupation" after that.

To figure out whether you have enough coverage, contact your company's HR department—if there is one—or your office manager. If you have coverage, ask them to walk you through your group benefits. If you find that your company plan covers at least 60% of your pay in the event of an accident or illness that prevents you from working, you likely have enough coverage. If you don't have kids and your mortgage is paid off, you likely could get by on a policy that pays 40% to 50% or your salary. "Basically, you want enough coverage to meet your living expenses—meaning mortgage payments, taxes, hydro, food and transportation costs," says Lorne Marr, an independent insurance broker and founder of LSM Insurance Services in Markham, Ont.

When evaluating your plan, keep in mind that many disability plans include a cap on benefits. For instance, your plan may cover 60% of your gross income, but only up to $2,500 a month. That means if you're earning more than $50,000 a year, you may not have enough coverage. If you made $130,000 annually, you would only get the $2,500 a month maximum, which amounts to only 23% of your pay.

If you earn a high income, you may want to consider a private disability plan to supplement your group benefits. To give you a quick idea of the cost involved, a private "own occupation" disability policy for a 40-year-old male white-collar non-smoker that pays $3,000 a month until age 65 (90-day waiting period) would cost about $140 a month. The same policy for "any occupation" would cost about $75 a month.

When calculating your coverage, keep in mind that payments from private disability insurance are tax-free, while the payout from most corporate plans is taxable.

A single payout if you get sick

A second option is critical illness (CI) insurance. You can buy a critical illness policy through an independent insurance broker and it will pay out a lump-sum benefit if you are diagnosed with one of the illnesses specified in the policy. The benefit is tax-free and receiving this benefit doesn't affect the amount of disability benefits you may also be receiving. When you collect, there are no requirements as to how the money is spent.

The idea of receiving a lump-sum payment of perhaps hundreds of thousands of dollars to help pay for top-notch medical treatment if you are diagnosed with cancer or another critical illness sounds like a smart idea, but unfortunately critical illness insurance is costly and the situations it covers are limited. Typical premiums for a $200,000 policy for a 40-year-old non-smoker add up to $2,000 a year for a 10-year term. More problematic is the fact that the policies are not standardized and problems often arise when payouts have to be made. For instance, some policies will cover only five illnesses, while more comprehensive ones cover up to 25. Such policies can also have stringent requirements regarding survival periods that have to be met after the disability is sustained before a payout is made. If your illness doesn't meet the requirements exactly, the policy may not pay out a dime.

For instance, if you have a $100,000 critical illness policy, it may specify that no payment will be made if you have a benign melanoma. The same goes for some of the less serious cancers, such as stage one or stage two prostate cancers. "Read the fine print in the policy carefully," says Barbara Garbens, a certified financial planner in Toronto. "The list of illnesses it covers will be a lot shorter than the exclusions. So it can be a bit of a mug's game."

Which type should you get?

If you don't already have long-term disability insurance and you're choosing between the two types of coverage, disability insurance is the clear winner. That's because it will kick in to help you pay the bills in the event of any illness or accident that prevents you from working, while critical illness insurance only helps if you happen to encounter one of the specific illnesses covered by your plan. As well, collecting critical illness insurance often involves more paperwork and delays.

Stanley Morris's experience with critical illness insurance clearly shows the difference. Last year at age 59, Morris (not his real name) was diagnosed with a brain tumour. Before his diagnosis, he was an active skier, cyclist and entrepreneur. Six years earlier, while reviewing his benefits, Morris had purchased both private disability insurance coverage as well as a critical illness policy.

When he was diagnosed with the tumour, his disability insurance started paying benefits right away, but because of severe headaches, he was unable to file the critical illness insurance documents quickly. After a couple of months, a close friend stepped in to help him with the paperwork and eventually, his claim was filed. But unfortunately, Morris died before he could collect a penny.

Still, there is one situation where critical illness makes sense, and that's if you help to support your family, but you can't get disability insurance because you have no earned income. For instance, a 35-year-old spouse who stays home with three small kids and doesn't work may be a good candidate for a comprehensive critical illness policy (although even then, only for a brief period of time, say 10 years while the children are young). "A family's lifestyle would change drastically if the stay-at-home spouse was critically ill," says Rona Birenbaum, a certified financial planner in Toronto. "Paying people to replace the duties he or she performs is expensive. The coverage may not be perfect but it may helpful in these cases."

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