401k Plans Disregard a Tough 'Safety Net' Problem

By: Philip Davis - President, Corporate Compensation Plans Inc.

Danbury, Connecticut, November 20, 2006 – As more and more defined benefit pension programs are being terminated or frozen, 401k plans have become the *only* viable retirement program for tens of millions of American workers. This means that most of these employees – and their families – are banking their financial futures on the hope that they can accumulate enough assets in their 401k accounts to be able to retire with dignity.

But what will happen to them if they become disabled *before* they retire?

The answer is that – unlike defined benefit pension plans that continue contributions for disabled employees – their 401k contributions will *stop***.** As a result, many of these disabled employees will find it impossible to achieve any reasonable degree of retirement security.

For example, take a 40-year-old employee who has accumulated $180,000 in his 401k account. His annual 401k deferrals and matching employer contributions total $14,000. Assuming an 8% return – and 3% annual increases in contributions due to boosts in compensation – he could expect to have *$2,714,340* at age 65.

However, if tomorrow he suffers a career ending disability his 401k contributions will stop and his 401k account will grow to only $1,232,726 by age 65 – nearly a *55% reduction* in his projected retirement assets.

The realities of a disability go far beyond the loss of 401k contributions

Few employees understand that they will take a substantial *pay cut* when they become disabled because their disability insurance payments rarely equal pre-disability incomes. Further the purchasing power of their disability insurance benefits will reduce each year because of the effect of inflation.

Two other factors can *increase* the gap between their pre and post disability spendable income even further:

- Many disabled people have *ongoing* medical costs associated with their disability.
- A large number of disabled employees will either *lose* their medical insurance after a short period of time or find the cost of their insurance premiums has substantially increased.

This means that a great many disabled employees will have to spend down their assets (including their 401k balances) just to make ends meet. The real financial *crunch* will come at age 65 when payments from their group disability insurance programs usually run out leaving only social security retirement benefits to live on.

The chance of becoming disabled is far greater than most realize

Unfortunately most employers – as well as their employees – do not understand the *high* odds of becoming disabled nor the threat that disability poses to the retirement security of their employees.

- *17%* of all Americans receiving monthly Social Security checks are people *under* retirement age and 8 million workers in 2004 received Social Security disability benefits. *("Disability Side of Social Security Raises Questions" by Alan B. Kreuger, the New York Times, March 03, 2005)*

- During the course of a career people are 350% more likely to need disability insurance than to die and need life insurance. *(Health Insurance Association of America, 2000)*

- *25%* of people with disabilities from ages 35-44 will never return to work. *(HIAA Sourcebook of Health Insurance Data, 1999)*

- *11.3* million Americans – one out of fifteen – from ages 16 to 64 have a severe work disability that makes it difficult to remain employed or to find a job. *(US Census Bureau, Americans with Disabilities, February 2001)*

- Health conditions that used to kill now disable.

  In the last 20 years:

Condition	Death	Disability
Hypertension	-73%	*+70%*
Heart disease	-29%	*+44%*
Vascular	-48%	*+36%*
Diabetes	-27%	*+36%*

(National Center for Health Statistics –1999)

Why plan sponsors need to address the retirement disability problem

The two most important factors that are required to accumulate adequate retirement capital within a 401k plan are investment return and *continuity* of contributions. Of the two, continuity of contributions is by far the most important because, without contributions to invest, the return one can earn on them becomes meaningless.

Other than involuntary layoffs, the primary reason for a lack of continuity of 401k contributions is a long-term *disability*. When a disability occurs, employees lose their jobs and their contributions stop.

The challenge of a disability – for both the plan sponsor and the plan participant – is that it is *random.* Actuaries can predict *how* many people will become disabled but they cannot predict *who* will become disabled. Therefore 401k plans that do not continue contributions to the accounts of disabled participants operate somewhat like a *lottery* – the lucky employees who stay healthy "win" and their 401k contributions continue; the unlucky employees who become disabled "lose" and their contributions stop.

And yet – with some notable exceptions such as IBM and White & Case LLP – the disability threat to 401k participants' retirement security has been overlooked by most employers. By not taking *responsibility* for either fixing the problem (the fact that 401k contributions stop when their employees become disabled) or providing a solution to it, employers have transferred a significant level of financial risk to their employees – few of whom understand the risk even exists, much less are able to insure it on a personal basis.

Creating the 401k Disability "Safety Net"

Employers are to be congratulated for investing substantial amounts of time, effort and money to make certain their 401k plans will provide a *real* measure of retirement security to their employees. These efforts include investment advice components, auto enrollment features, target and lifestyle funds to direct contributions into suitable investments, and annuity options to guarantee that retirees can never outspend their savings.

However, very *few* of these valuable 401k enhancements are of much use to participants who become disabled because their contributions, and the employer's matching contributions, will stop. The reality of their lifestyle will have little to do with planning for their retirement and more to do with struggling to meet their financial obligations on a reduced income.

Operating a 401k plan in which employees can lose their retirement benefits simply because they become sick or hurt should be *unacceptable* to any forward-looking employer. Therefore, implementing a solution to this serious retirement plan shortfall should be a high *priority* for all 401k plan sponsors.

IBM has provided just such a solution to its 401k participants by enabling them to purchase *disability insurance* as a plan investment with pre-tax dollars. The insurance benefit is equal to their 401k contributions and, if they become disabled, it is paid directly into their 401k accounts on a tax-deferred basis. As a result, the account balances of employees who become disabled will grow just as if they were working.

This solution should be particularly attractive to employers who have *terminated* or frozen their defined benefit pension plans, since most of them provided for a continuation of pension accruals for disabled employees. By insuring their 401k contributions, they will have restored – at least in part – the loss of this valuable benefit.

Further, the employer can insure its 401k contributions on a *cost neutral* basis. This can be accomplished by paying the premium from the additional matching contribution it usually makes to help offset the loss of their employees' pension plan benefits. Equally important is that the premium is so small that it will have little impact on the account balances of those employees who do not become disabled.

There are social consequences to the lack of disability protection in 401k plans

Actuarial statistics show that given a base of 60 million 401k participants, *3,000,000* of them will become seriously disabled over the next 10 years. Their 401k deferrals as well as their 401k matching and profit sharing contributions will *stop*, and in the aggregate, billions of dollars of incremental 401k assets will be lost.

Some of these disabled employees will have adequate resources on which to live but a greater number will find themselves *destitute* at age 65 when their disability insurance benefits run out. The lives of those Americans will, in many cases, become personal tragedies and – for society as a whole – it means they will require financial subsidies for basic living. Ultimately, the cost of these subsidies will have to be paid by the taxpayers to the detriment of all Americans.

These are serious consequences and they can be avoided if employers – and their 401k record keepers – work together to make disability protection *available* to the some 60 million Americans who are saving and planning for retirement through 401k plans.

Employers who provide this guarantee to their employees will help make the American retirement system act more *equitably* and efficiently. And many of these same employers will discover that – by providing an essential and leading edge retirement plan enhancement – they can better attract and retain the top talent needed to compete in today's global marketplace.

For more information please contact us at:
Corporate Compensation Plans, Inc. – 457 Main Street, Danbury, CT 06811 – 203.792.7300
www.corpcompinc.com ptdavis@corpcompinc.com