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Annuity - a Cash-flow Option for Retirement

Whether to opt for an annuity – periodic cash flows – or a lumpsum amount is a dilemma that many retirees struggle with. An annuity provides the closest thing to a regular income, mimicking a salary, but they are probably stuck with that amount for some time. A lumpsum gives a sense of security and the freedom to choose what they want to do with the money. But, which is better?

Girish Aswani, CFP™

Just like every other investment option Annuity has its own pros and cons. It is important to understand the intricacies involved prior to making annuity as a choice for cash inflows. There are several factors that need to be considered when choosing an annuity - how much of annuity would be enough and for how long would the annuity be needed; what do you need to factor in before concluding the amount; and what are the safety measures that need to be in place in case of any unforeseen occurrences that affect the economy?

Importance of Annuity

To fully understand the importance of annuity, adequate study of a person's financial statement is essential. A detailed review of three primary columns, which are "credit, debit and balance" of a bank statement, needs to be carried out. On every last day of the month or on the first week of the month, salaries are credited into bank accounts. Deductions are made from salary to cover expenses like house rent or home loan monthly repayments (if any), grocery bills, credit card payments, utility bill payments, children's school/college fees and other necessary expenses.

A statement of account which reflects the balance, after deductions are made, is provided. This cycle of credit and debit goes on every month for the entire working phase of every working professional. It is a fact that at a point in time credit ceases and only debit transactions occurs. Everything still tends to go on as normal for the first few months after retirement with no discomfort. At that point retirement is viewed as a holiday, a period of no work and no stress but usually after the first quarter (three months of retirement)

reality begins to seep in and the retiree becomes aware of the challenges resulting from continuous expenses without an attendant income.

What is an Annuity?

Annuity is a series of payments made or received for a specified period or during an individual's entire lifetime with prefixed frequency. It is an agreement made by an individual and the annuity provider. In this contract the annuitant makes payment of a lump sum amount to the annuity provider, and, in turn, the provider manages the fund and pays the annuitant a fixed annuity amount for a period specified or throughout the lifetime either only for self, or for self and spouse, with pre-agreed frequency (monthly, quarterly, semi-annually or annually). By opting for this annuity an individual can be assured of some amount of regular monthly cash flows. An individual's lifestyle would have to be adjusted to accommodate the size of the annuity; but the advantage is that he has no need to adopt any active financial management techniques to augment his stock of money.

Facts about Annuity

According to studies only 11% of all employees purchase annuity and most Indians fund their own retirement. Many surveys, reports and statistics show that Indians are getting more responsible and serious about saving for their retirement, but their confidence in annuities, especially without return of purchase price, is weak. This might be due to the realization that after retirement there would be no regular cash inflows forthcoming and the only provision and resources they have, to ensure survival and maintaining their



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independence (without having to rely on their children), is through their hard-earned lifetime savings.

Keeping their retirement corpus with them gives them a sense of satisfaction and safety in case of any emergency situation resulting due to old age, although doing this could be a right or wrong decision. When people retire they normally confide in friends and seek advice and suggestions from them. It is important to have a back-up plan for emergency needs and select an appropriate method to replace salary, that is, arrange for a regular income for the rest of the life. This regular income could be in the form of an annuity.

Keeping large amounts of money as reserves with oneself provides only a temporary sense of security. These reserves can be affected by economic changes and inflation which reduces purchasing power of money and increases amount spent on expenditure.

Aging is inevitable and with a few exceptions managing money becomes an increasingly difficult proposition for most ordinary people unless they have very sound knowledge of the financial markets. Cash management becomes important at this point of time even more. Individual financial management involves financial research on a regular basis which may be weekly, daily and hourly due to the dynamics of the markets.

Mode of Operation of an Annuity

An individual makes a single lump sum payment and in turn the annuity provider makes a series of payments to the annuitant or beneficiary. Important factors should be considered when choosing an annuity provider, such as the annuity rate, availability of annuity options which can change the dynamics of post retirement planning and cash flow management. It is important to make an appropriate choice at the time of buying the annuity because once it is done there is no opting-out feature and even when available, opting-out would come with heavy cost and charges.

Who Can Buy an Annuity?

The minimum age for buying an annuity is 30 years, although there is an option for purchase at 21 years too in some cases. Payment of Rs.10,000 as a minimum annuity amount is a criteria but there is an option of Rs.100 annually, which is the lowest available in the market. The entry age and amount of purchase makes annuity suited for almost everyone. Today early retirement is a choice, and factors such as higher education, better salaries, and appropriate retirement planning along with resurgence in the economy all support this. Early retirement however, exposes an individual to the challenges of a prolonged retirement period in which an annuity could act as a savior.

Types of Annuity

There are various types of annuities available in the financial market. Of these, seven types are common and they all feature a choice of payment with monthly, quarterly, semi-annual or annual frequencies.

(I) Life annuity: Payment will be made throughout the lifetime of the annuitant, irrespective of the number of years the annuitant lives. Annuity ceases at the annuitant's death.

(II) Annuity certain and life thereafter: This type of annuity features a guarantee for a certain period like 5, 10, 15 or 20 years and thereafter till the annuitant is alive. The annuity will be received until the end of the guarantee period or death of the annuitant. If the death of the annuitant happens before the guaranteed period, annuity will continue till the end of the guaranteed period.

(III) Life annuity with return of purchase price: This option allows the entire lump sum amount paid to purchase the annuity to be given to a nominee in case the annuitant dies.

(IV) Life annuity payable with an increasing rate: This type of annuity allows for an annual increase with a specified percentage of the annuity amount at inception. The first increment



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is made one year after the first annuity receipt. This feature can take care of inflation impact on annuity to a certain extent.

(V) Life annuity with a provision for 50% of annuity to be paid to spouse on the death of annuitant: This option is available for an annuitant with a living spouse. When the couple is alive, the annuity receipts offered will be higher, to meet the bills and expenses incurred by the partners. The initial higher amount will be received as annuity when both are alive followed by 50% till the spouse is alive. Annuity ceases on the death of the spouse as a second annuitant.

(VI) Life annuity with a provision for 100% of annuity to spouse on the death of annuitant: This option has its own dynamics. Increment is not available in this option and might require higher expenses for health treatments in older age by the surviving partner. Maintaining annuity to 100% would be a sensible choice, provided the first annuity is adequate enough for the survival of the couple; if not, the option with 50% annuity receipt to the surviving spouse will be necessary. Annuity ceases on the death of the spouse who is the second annuitant.

(VII) Life annuity with a provision for 100% of annuity to spouse on the death of annuitant with return of purchase price on the death of the second survivor: This option is apt for those who give importance to creation of legacies and to take care of final expenses. All expenses can be taken care by return of purchase price to nominee or for any other purpose.

In conclusion, options (III) and (VII) return the lumpsum amount used in purchase of the annuity from annuity provider while the other options have higher annuity payouts, which is required for survival in the later years of life. Annuity can act as a savior during the period when regular income is the primary requirement over maintaining a lumpsum reserve.

When to Purchase an Annuity?

Purchasing an annuity is a personal decision. It is ideal if an individual purchases an annuity a year in advance, prior to retirement. However, considering that employee retirement benefits (like Employees Provident Fund, Public Provident Fund, leave encashment, gratuity etc.) may not be received a year before retirement, an annuity should ideally be purchased within a month after retirement provided an individual chooses monthly mode as a frequency to receive the annuity.

It is important to do this because an employee's last salary would be enough to take care of the living expenses for one month to 45 days. Therefore, it is wise to purchase the annuity before post-retirement living expenses start to make inroads on your retirement benefits. Individuals might feel that a higher amount is being received when they buy an annuity at the age of 70 or 80. The only reason behind the higher amount is the shorter duration of receiving annuity due to average life expectancy in India, which is below 70 years. Various risks and expenses of the annuity provider too get reduced if the duration is shorter.

Taxation

Annuity received will be considered as an income in the hands of an annuitant; hence it will be taxed as per the income tax slab for an individual. However, special tax slabs for senior citizens and super senior citizens reduce the tax liability of an individual. Section 80C benefits when reinvested, would be of added advantage, which would help a senior citizen to invest additional amount. Investing in a five year Fixed Deposit (Tax Saver), Senior Citizen Savings Scheme, National Savings Certificate are a few of the options to reduce tax liability, which helps individual to park excess amount with safe instruments and enjoy future benefits.

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It is important to make an appropriate choice at the time of buying the annuity because once it is done there is no opting-out feature and even when available, opting-out would come with heavy cost and charges.

Thanks for reading the above article,
Request you to share your valuable feedback on: girish.aswani@gmail.com

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