CHAPTER II

Financial Planning

2.1. Introduction

Financial planning is the process through which an individual moves towards meeting personal and financial goals through the development and implementation of a comprehensive financial plan. In general, financial planning is series of steps taken by an individual for planning his future. It involves planning and directing individual’s resources to grow and accumulate assets so that financial goals of an individual can be achieved within pre decided time period. Financial planning is a complex process which needs knowledge and time.

Financial planning is specific to the individual, as no two individuals are identical nor their finances. Every individual has varied sets of background, income, expenses, risk taking ability, future outlook, assets, needs, financial situation, knowledge, responsibilities, etc.

Financial planning is not a static concept but is a dynamic ongoing process. Financial planning process is complex as it involves various situations, asset classes, dynamic external environment etc. Financial planning takes time as it is comprehensive planning which involves integration of personal and financial goals. It includes risk management (insurance), income tax management, retirement planning, estate planning, child education planning, and investment management.

---

Figure- 2.1: Elements of Financial Planning

Figure- 2.1 enlists important elements of financial planning for an individual. These are the broad elements which constitutes financial plan for any individual. All the elements need attention while planning as per the priorities of an individual. As financial planning is complex, tedious, and time consuming process it needs advice from experts like financial planners. Financial planner has detailed knowledge and understanding of all the facets of financial planning. They help an individual to achieve financial goal through planning and its implementation.

2.2. Financial Planning Process

Figure -2.2 represents steps in the process of planning, undertaken by a professional financial planner. This is an ongoing process and needs continuous monitoring, review and fine tuning. This is important as continuous changes takes place in the environment, needs, and priorities. Thus financial plans need to adapt these changes quickly to get desired outcome.
Each individual should have good financial planning. Financial planning should start at an early age in life; ideally when a person starts earning. Every individual has varied needs which broadly depend on his age, income, expenses and family responsibilities. Young earning individual has high risk taking ability compared to an individual with higher age; as he has more number of earning years in hand and less responsibilities. Individuals in the later life-stage have less risk taking ability. Thus life stage based planning has gained importance while deciding financial plans for individuals.

Diversification of assets is also important in financial planning as higher concentration towards particular assets will increase risk. Allocation of assets as per the needs and risk taking ability is crucial as it makes impact on the returns and overall performance of a financial plan. Time is the most important factor which needs higher attention in the process of financial planning.
2.3. Life Stage based Financial Planning

Figure-2.3: Life Stage based Financial Planning

Figure- 2.3 represents a relationship between individual’s income and life stage based financial planning. A young person normally starts earning after the age of 20 years. His income increases with age, has less responsibilities and liabilities. In the early stage of earning phase he should focus on contingency and insurance planning, along with tax planning.

A person acquires and develops family till the age of 40 years, where he starts planning for children’s education and property (mainly residential) planning. In the process he also acquires few financial liabilities. His career progresses with increase in income till the age of 60 years. During this period his income as well as expenses also increases. Saving and investment planning is an integral part of person’s earning phase. Major portion of these investments goes towards planning children’s education and estate planning.

Retirement phase which start from t60 years of age is very crucial as income reduces or stops at this age. A person has to depend up on children, savings or investments made for
retirement. This phase is becoming very challenging because of changes in socio-economic structure in India. Children may not look after old parents as erosion of joint family system has started. There is a risk that senior citizens may outlive their savings and investments. They may incur higher expenses towards medical treatments during old age. This will leave them in financial crisis and with very low or no income.

An individual’s financial life stages can be divided into two important phases-

1. Pre-retirement or accumulation phase
2. Retirement phase

Life stage based financial planning is helpful in managing important elements of an individual’s life like- income, savings, cash flow, capital, family security, investments, standard of living, and assets.

It is imperative that a person should start saving and investing in very early earning age, towards retirement planning. He/she should wisely select various assets and instruments like Mutual Funds, Equity Shares, Retirement Plans, Real Estate, Gold, Silver, Provident fund (PF), Life Insurance Plans, Bonds, and Deposits etc. He should take advice of professional financial planner to decide where to invest, asset allocation, tenure etc. He should diversify investments into these assets so as to reduce risk and get optimum returns. Retirement planning of an individual should focus towards creating monthly income streams for retirement phase.

There are many retirement planning models are available along with exclusive retirement planning models. A person should be aware of monthly income required during the retirement phase considering various factors like age, life expectancy, time to retire, current savings, current assets, expenses, rate of return, and rate of inflation. This helps a person to track his current retirement planning and take appropriate steps to ensure adequate planning for retirement phase.
2.4. Retirement Planning Calculator

Retirement planning calculators are developed to ascertain retirement corpus, analysis of income and expenses, investment amount needed etc. A typical retirement planning calculator needs inputs like current age of an individual, expected retirement age, annual income, monthly expenses, valuation of current assets, annual savings towards retirement, expected rate of growth of value of assets, details of assets and expected rate of inflation etc.

Figure-2.4 shows a typical retirement planning calculator. Input sheet needs details to be entered for an individual. Result sheet shows the important information i.e. whether current retirement planning is adequate or not. It gives gap between current savings and money required for retirement phase, if any. This gap is further represented into annual and monthly savings required so as to receive required income, during retirement phase. This simple calculator ensures monitoring and reviews of the retirement planning, at regular intervals so as to take corrective actions required, if any.

Figure-2.4: Retirement Calculator

Input Sheet

http://www.easyinsuranceindia.com/lifeRetirementCalc.do
### About You

- **Your Present Age in completed Years**: 33
- **Age You Plan to Retire**: 60
- **Till what age you would like to receive Retirement Income**: 60
- **Your Present Monthly Expense (include food, transport, rent & other expenses)**: 20000
  (do not include EMI if any)

### Asset calculation

- **Savings / Bank Deposit**: 50000
- **Shares / Mutual Fund / Other Investments**: 80000
- **PF / PPF**: 300000
- **Investment in Insurance**: 100000
- **Other yielding Assets (Second Home)**: 200000
  (do not include Primary Home)

**Current Asset value**: 700000

### About Your Income

- **Present Annual Earning**: 90000
- **Expected Inflation Rate (5-12 %)**: 8%
- **Your assumption of growth of value of your assets**:
  (for ex, interest rate on above assets) (3-12 %): 12%
- **How much can you save for Retirement per annum**: 15000

---

## Summary

- **Present Age**: 33
- **Age at Retirement**: 60
- **Monthly Expenses**: 20000
- **Assets**:
  - Savings: 50000
  - Investments: 80000
  - PF / PPF: 300000
  - Insurance: 100000
  - Other Assets: 200000
- **Projected Income**: 90000
- **Expected Inflation**: 8%
- **Assumed Growth Rate**: 12%
- **Savings for Retirement**: 15000
### Result Sheet

<table>
<thead>
<tr>
<th><strong>Savings</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Savings towards Retirement Per Annum</td>
<td>Rs.15000</td>
</tr>
<tr>
<td>Savings at the Age of Retirement</td>
<td>Rs.2540610</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Asset Value</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Asset Value</td>
<td>Rs.700000</td>
</tr>
<tr>
<td>Asset Value at the time of Retirement</td>
<td>Rs.14927417</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Expenses</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Present Annual Expenses</td>
<td>Rs.240000</td>
</tr>
<tr>
<td>Annual Expenses at the time of Retirement</td>
<td>Rs.1917135</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Additional Money Required</strong></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>The Total Amount of Savings Required to maintain Current Life Style</td>
<td>Rs.26751644</td>
</tr>
<tr>
<td>Gap Between Money Required and Savings</td>
<td>Rs.9283617</td>
</tr>
</tbody>
</table>

So You need Additional Annual Savings Of [54811](#)
So You need Additional Monthly Savings Of [4568](#)
2.5. Need for Retirement Planning

Retirement phase has become very challenging in the life of senior citizens. Earlier stages in the life can be managed as those stages falls in earning phase, of an individual. At a young age expenses are in line with the income, but during the old age expenses goes up while income reduces drastically or stops. Maintaining similar life style has become difficult during old age; mainly due to inflation, health care and medical expenses etc. In country like India, senior citizens are dependent upon their children, pension, or life time savings. Many senior citizens in India are finding it difficult to get this support due to socio-economic changes.

Following are the factors which emphasizes need for retirement planning-

- Increasing life span.
- Inflationary trends.
- Low returns in conventional modes of investment.
- Unexpected contingencies.
- Increasing medical cost.
- Changing demographics.
- Diminishing trend of joint family system.
- Erosion of defined benefit pension system.
- Absence of social security system by government.
- Falling interest rates.
- Uncertain returns on other investment options.
- Pursuing hobbies.
- Dynamic social environment.
- Increasing cost of other supports.
2.6. Investment Options and Risks

An individual can choose from an array of investment options/products as everyone wishes to get higher returns in shortest time period. It is equally important diversify among various investment options. Each individual has different risk taking ability which depends on various factors. One should consider relation between risks and return proposition of each product before deciding to invest, as per his/her risk taking ability.

Figure-2.5: Risk Pyramid

![Risk Pyramid Image]

Source: Wells Fargo Advisor’s Guide

Figure- 2.5 gives risk category of available investment options. Risk pyramid clearly shows that only high risk products have potential to give higher returns. If one chooses only security or safety and income products for retirement planning, then returns will be low and in turn retirement corpus receivable will be low.
At the same time, investment in speculative and growth products poses very high risk. Returns and retirement corpus can go either way. Thus it is imperative for all investors to select products very carefully and always strike balance between high risk and low risk products; so as to accumulate adequate retirement corpus.

2.7. **Role of the Pension Fund Regulatory and Development Authority (PFRDA)**

Government of India is facing huge liability of providing pension to large number of individuals throughout their life and their family. Due to this increasing liability, the government has moved from ‘defined benefit (DB)’ based pension system to ‘defined contribution (DC)’ based pension system. As per the new system, pension receivable by any individual will depend upon contributions made by him towards pension plan, during earning phase. Apart from offering wide variety of investment options to individuals, this scheme will help government of India to reduce its pension liabilities. As part of pension reforms, Government of India has launched –“The National Pension System (NPS)”, with effect from 1\textsuperscript{st} January 204. The NPS is a defined contribution based pension system.

The Pension Fund Regulatory and Development Authority (PFRDA) is the prudential regulator for the NPS, since August 2003. The NPS today covers more than 55 Lac subscribers and corpus of Rs. 35000 crore. PFRDA was established with an objective to promote old age income security by establishing, developing and regulating pension funds. It is responsible for registration of various intermediaries like Central Record keeping Agency (CRA), pension funds, custodians, NPS trustee bank etc. PFRDA monitors the performance of various intermediaries and has a significant role to play in safeguarding interest of all the subscribers. It regulates the manner in which subscriber contributions are invested by pension funds. It also ensures that all stakeholders comply with the guidelines and regulations issued by PFRDA, from time to time. PFRDA bill, 2011, provides for market based returns and wide coverage based on several investment options in the pension sector with an aim to building confidence among the subscribers.
NPS is made available to all citizens of India on voluntary basis and is mandatory for all employees of central government (except armed forces), appointed on or after 1st January 2004. All Indian citizens between age 18 and 55 years can join NPS. Thus government has taken significant steps towards pension reforms. PFRDA is providing regulatory guidelines and security in seamless implementation of the pension reforms. PFRDA will also act as a regulator as many private players will enter into pension sector once the pension bill will be passed by the parliament.

2.8. Reverse Mortgage and Retirement Planning

Generally it is advocated that, financial planning should start at an early age so that there are enough funds at the disposal of an individual, at the age of retirement. A number of aged or senior citizens have their own house which is built out of their lifetime savings. Recently introduced concept of reverse mortgage could come as the blessings for elderly who have missed the bus of retirement planning. Reverse Mortgage can act as alternative to pension and will generate regular stream of income.

Reverse Mortgage is the ideal solution that meets financial needs of senior citizens. It can take an important position in retirement planning of the “home rich, cash poor” senior citizens. A reverse mortgage can be a new tool for annuitizing wealth, turning the equity in senior citizen’s home into a lifetime cash income stream. Thus reverse mortgage can fill the gap between assets and money required for retirement phase. It also ensures regular income streams for the remaining life, without any financial burden.

Socio economic structure is changing very fast, in India. Only around 12 percent of the active workforce in India has formal pension or social security plan. High equity in houses makes reverse mortgage a good financial product, in India. But, initial response is not encouraging as it is reflecting low interest in RML.

---

Indian scenario is different from the western countries with respect to emotional attachment that is placed on the house property by the senior citizens. Indians place high level of importance in taking care of their parents. Equally strongly, parents place heavy importance on leaving behind legacy for their kids. As a useful financial product, the reverse mortgage has miles to go before it acquires a prominent place in the retirement planning process.

In the recent past RML is also undergoing lot of transition. The fixed term RML scheme has few drawbacks, thus new variant of RML is now offered as ‘life annuity’ product in the form of RMLeA. The RMLeA scheme is significant improvement over the normal RML scheme. It offers life-long annuities, has better payouts, and offers certainty in terms of periodic payments. The country’s largest life insurer LIC is also planning to enter into the reverse mortgage business in collaboration with Corporation bank\(^{14}\), is in itself a signal that ‘RML’ market is going to see lot of changes. More players will enter the market and will get attention from all the stakeholders. This also indicates the huge market potential available in reverse mortgages business. Customers (senior citizens) will get benefited due to competition among these players through better product offerings and good customer service.

There is need for innovative products so that RML will take prominent place in the retirement plans of individuals. RML should provide better cash flows to support the senior citizens and should also act as a lifelong solution.