Financial Planning – IV: Retirement Planning

After Insurance and Investment Planning modules, the next in line is the 'Retirement Planning'. This is may be consider as the most important and vital one, as the benefit of it come at the end of one's earning phase. Any error in the calculations would have severe implications, as there would be no opportunity left for rectification. Hence, all assumptions like inflation rate, return on investments etc are to be taken correctly and reviewed periodically.

Retirement is a state of being relived from active working (earning) life. As the active working life halts, benefits like income (in the form of salary/ remuneration), other facilities and / or services that are availed during the services period like staff- quarter , car with/ without chauffer, peons/ gardeners attached to home, level- travel-concessions, medical reimbursement, and other perquisites either gets reduced or stops. Life becomes quite difficult without these facilities; to continue with these facilities which are expensive in the days of reduced income (i.e. post- retirement) is an equally difficult proposition.

Why is Retirement Planning Needed? Earlier not many people used to worry as to how they will take care of the retirement needs due to prevalence of joint family system. With the disintegration of the joint family system & nuclear family system taking centre stage, people are fast realising that post- retirement with reduced income, they are way short of resources to enjoy a secured retired life.

Progress in healthcare & preventive medicines, improved nutrition and other good living factors have resulted in increased life expectancy of people. Life expectancy is the average length of survival of an individual. It has direct effect on retirement planning. Increased life expectancy means provision for increased retirement period. Further as unemployment and population is growing. Government thinks of reducing retirement age for giving employment to the giving employment to the new generation. This would be imply that, working people might have shorter working life and longer retirement life.

Longevity could pose serious threat in the absence besides maintaining the existing standard of living, additional expenses on health problems are very likely to arise. Early retirement due to sickness, retrenchment (due to closer of unites or in a difficult economic environment) etc can cause heavy burden on anybody if adequate retirement fund is not available.

Modern facilities and change in lifestyle have prompted people not only to have a peaceful retirement life but also to have luxuries, vacations, charity etc independently as a way of life.
Planning for all these would have become simply had the value of money remained constant. Unfortunately, effect of inflation erodes part of the monetary value of the savings. Hence, in order to protect retirement income from inflation, retirement planning becomes all the more significant.

Key Factors for Retirement Planning.
In simple terms we may define retirement planning as, 'to accumulate wealth during one's active working life so as to enjoy the benefits & luxuries of the working life till one survives'. The process of wealth creation needs a long- term systematic approach. Further, the amount of wealth that to the following conditions:

- Working life (years) of an individual,
- Ability to save,
- Socio- economic changes,
- Any unexpected interruption in the accumulation process (temporary unemployment).

The main factors one should consider for retirement planning are,

i. Investment (including insurance and health insurance)
ii. Retirement Plans provided by the employer (Gratuity, PF etc)
iii. Social security measures available
iv. Taxation issues
v. Retirement age & life expectancy
vi. Emergency retirements.
vii. Changes in lifestyle &
viii. The most important factor, i.e. Inflation.

A systematic retirement planning would lead towards targeted wealth creation and hence provide a regular income flow to maintain the required standard of living, funds for lifestyle requirements, resources for large capital outlay (purchase of residential accommodation), charity, building estate, etc.

When should Planning for Retirement Start? It is a misconception that people think retirement planning is a tool for those who are nearing retirement. It should be noted that longer the saving period, easier is targeted wealth accumulation.

We have discussed earlier how 'Power of Compounding' works (Financial Planning – III: INVESTMENT PLANNING; published in the December issue of Yogakshema).
Let us consider the following data: X (25 years) & Y (50 years) start saving for their retirement corpus; retirement age for both being 60 years. X saves Rs. 1000 per month while Y saves Rs.5000 per month. Supposing the return on investment is 8% per annum, accumulated corpus for X & Y would be, Rs 22, 93,882 and Rs. 9, 14,730 respectively.
The above illustration suggests, despite Y's monthly savings amount being five (5) times that of X, the amount of corpus accumulated by X is much more than Y. This proves that if an individual saves for a longer period, he/ she will benefit more as compared to an individual who starts late.

What is a Retirement Corpus? The total accumulated funds from all sources of investment (including terminal benefits like Gratuity, PF from the employment source) that become available to an individual on or around the retirement date is known as the retirement corpus. This accumulated fund should be invested & utilized in such a way that, besides taking care of the daily needs, it should suffice for any more contingencies not only till the survival of the individual but also would cater to the needs of his/ her spouse till he/ she survives.

How much should be the corpus? Retirement corpus varies from individual to individual depending upon one's income & ability to save and standard of living one intends to maintain post- retirement. It becomes difficult to compromise on the standard of living and accordingly one need to target for the retirement corpus.
An Adult human life is divided into parts i.e. 1. Earning phase & 2. Spending phase. In the earning phase an individual earns and saves; while in the spending phase, his/ her accumulated savings are utilized for his/ her needs.
There are two different methods to arrive at the retirement corpus are; a. Expenses method & b. Income placement method as follows:

a. Expenses Method

i. Expenses at the current is arrived at by taking the inflation and calculated at the retirement date (age)
ii. Retirement corpus is arrived at by taking the inflation adjusted expenses as expenses for the remaining period (life expectancy- retirement age) at real rate of interest.

iii. Monthly/ yearly savings to achieve the target corpus during the earning phase is calculated at the nominal rate of return.

(Steps 1 & 2 are part of the spending phase while step 3. pertains to the earning phase.)

Let us understand the calculation of retirement corpus and savings needed for the same under the Expense method through a simple illustration as given below:
Example: A, 40 years, earns a gross monthly salary of Rs 50000/-. His monthly household expenses is Rs. 20000/-. Let us arrive at his retirement corpus and monthly savings needed to achieve the targeted corpus, considering he maintains the same living standard post- retirement, his retirement age to be 60 years, life expectancy to be 85 years, inflation rate for the total period may be assumed to be 6% and return on investment be 9%.

Step 1: Current expenses of Rs. 20000 pm to be adjusted for inflation (6%) to his retirement date (i.e.20 years) become Rs.64143/- (PV= -20000, n=20, i=6%, FV=64143)

Step 2: On the 1'st month post- retirement his expenses would be Rs. 64143/-. His total expenses from the date of retirement (60 years) till his survival i.e. 85 years (total period of 25 years / 25×12 months)
Retirement corpus required = Rs 13814060/- (n=25×12, PMT = -64143, i=0.23585; PV= 13841060)

Step 3: Monthly savings required over his balance service period [(60-40) × 12 months] to achieve target corpus of Rs 13814060/-, return on investment being 9% pa.
Monthly savings required = Rs20683/- (n=20×12, i=9/12, FV 13814060; PMT= -20683)

b. Income Replacement Method: In the income replacement method, retirement corpus is calculated through the following steps:

i. A fixed amount (usually 80% of the current expenses) is saved over the balance service period at the nominal rate return. Total savings over the service period is calculated which serves as the retirement corpus.

ii. With the retirement corpus available, permissible expenses is to be arrived at by considering the balance survival period (life expectancy- retirement age) and the corpus growing at real rate of interest.

Let us arrived at the retirement corpus under this method, with the data of the earlier example:
Step 1: 80% of the current expenses i.e. Rs 20000×0.8= 16000/- is saved every month over the balance service period of 20×12 months; return on investment = 9% pa

Retirement corpus = Rs 10686200/- (n= 20×12, i=9/12, PMT = -16000; FV= 10686200)

Step 2: Retirement corpus = Rs 10686200/-, balance survival period (life expectancy – retirement age) = 25×12 months, With the corpus growing at real rate, amount permissible to be spent/ withdrawn every month would be Rs 49620 (n=25×12, real rate of interest = 0.23585, PV= - 10686200; PMT= 49620)

As may be seen from both the illustrations, Expense method gives a higher figure than the income replacement method. Expense method is more realistic as the as actual expense at the current rate is inflation- adjusted to arrive at the expenses or withdrawals required during post- retirement phase. Further, it is suggested to slightly overestimate the expenses and arrive at the Retirement corpus through the expense method.
Investment products for wealth creation for Retirement Planning: Having arrived at the Retirement corpus, one needs to work at achieving the targeted corpus by investing in suitable financial assets used for wealth creation and generation of income to support the present living standard in the post- retirement phase is as under:

- Life insurance
- Mutual fund investment
- Post – office deposits
- Employee's provident fund (EPF)
- Public Provident Fund (PPF)
- New Pension Schemes

As a social security measures, employers also provide certain facilities to their employees to accumulate funds during the service period for the post- retirement phase. PF (Provident Fund) , Additional Provident Fund, Gratuity, Leave Encashment (at Superannuation), Group Insurance, Pension ets form part of such facilities.

It is for the benefit of the individual that one remains aware of such facilities provided by the employer. With uncertainties prevailing in the socio- economic environment, rising inflation rate & low interest rate regime, one should have a proper retirement planning and should find out investment avenues for optimizing the Retirement corpus. For instance, investment in PPF being an investment product for Retirement should be allowed to be extended by the permissible 3 blocks of 5 years each after the initial investment period of 15 years. By such extensions, investment is taken for a total 30 years period and would be available as part of the Retirement corpus.

Similarly, person working in a organizations that offer their employee to contribute through Additional/ Voluntary Pf should necessarily take the advantage of APF/VPF, which has a definite edge over PPF for optimization of the Retirement corpus.

A comparison between APF/VPF and PPF can be accounted as given below:

	Additional Provident Fund	**Public Provident Fund**
1	Total emoluments excluding the amount contributed towards PF may be contributed as APF	Maximum Rs 70000/- pa
2	Option for be given for deduction throughout one's service period	Term is for 15 years, which can be extended by 3 blocks of 5 years each. So maximum term can be 30 years. A member can continue without further deposit and earn interest till the account is closed.
3	Earns at the decided by EPFO every year, rate was 805% compounded annually from 2005-06 to 2009-10 which is revised to 9.5% for FY 2011	Earns @ 8% compounded annually
4	Once option is given, gets deducted from the salary regularly on monthly basis.	Has to be deposited at any designated PF Bank A/C
5	Loan not allowed	Loan is allowed once a year upto 25% of balance in PPF a/c including interest at the end of the second year in which loan is applied.
6	Withdrawal is not allowed	Withdrawal, once a year, is allowed after the expiry of 5 financial years from the end of the year in which the initial subscription was made (other conditions to be referred to)
7	Contribution gets qualified under sec 80C of IT Act within the overall limit of Rs 1 lac.	Contribution gets qualified under sec 88 of IT Act within the overall limit of Rs 1 Lac Amount withdrawn can also be deposited in the PPF a/c and such deposit gets qualified under sec 80C of IT Act within the overall limit of Rs 1 lac.

Let us consider a simple example to understand the advantage of contributing to APF over PPF:
Suppose a person aged 24 years working in an organization (having APF facility), deposits Rs 70000/- pa on PPF and Rs 5834 pm (Rs 70000/12) in APF.

His investment will benefit him as below:

	Additional Provident Fund	Public Provident Fund	Remark
Amount pa (Rs)	70000(5834*12)	70000	
Term	30 years	30 years @	@ 15 years extended by 3 blocks of 5 years each
Maturity* value (Rs)	8695030	7929825	* calculations for APF have been done taking the rate of interest as 8.5 % compounded annually
Maturity* value (Rs) #	14705690	12583635	# - Retirement age 60 years, service period, 60-24=36 years. He contributes to APF for further 6 years and leaves PPF Without any withdrawal.
Maturity * value (Rs) $	18469250		$- supposing that he contributes Rs. 5834 pm for the first 10 years, Rs 8000pm for next 10 years, Rs 12000 pm for the balance 16 years of his service (all deductions are within the permissible limit)

Hence, people working in organization like LIC, where deduction through APF is available, should take the definite route of APF to maximize the retirement corpus. A general thumb rule says, retirement corpus should be around 20 times one's annual income just before retirement. Post- retirement, one generally needs 75 to 80 % of his pre-retirement living expenses.

Hence, to make the golden days (post- retirement period) more meaningful, let your retirement planning be based on the following:

- Start early, start from today
- Estimate your expenses
- Set realistic goals (post-retirement lifestyle and living standard)
- Save & invest in a systematic way
- Grow to beat the inflation
- And, last but not least, enjoy a peaceful retirement phase!