Introduction to Retirement Planning

for School Students

Retirement: is a stage in the life cycle of an individual when one stops being an active part of the productive/ working population on account of advanced age.

Every individual aspires to lead a life of dignity and financial independence even after one retires. However, one needs to plan for the same. In fact, one of the most important reasons to save during one's working years is to provide for a financially independent and dignified post retirement life.

Retirement planning: Planning for the purpose of achieving financial independence after retirement.

Pension: Regular income to the individual after retirement.

Retirement planning requires three basic steps:

1. Determine how much annual income will be needed in each year of retirement.
2. Determine how much corpus must be accumulated in retirement savings by the start of retirement in order to fund the expenditure during retired years.
3. Determine how much must be contributed to retirement savings in each working year remaining in order to accumulate the required amount determined in step #2.

Step 1: Determine how much annual income will be needed in each year of retirement: this depends upon the a) existing and expected life style of the person b) cost of living at the time of retirement.

At the time of retirement, while some of the needs like transportation etc may decline; other expenses may increase like medical expenses etc. With increasing longevity, better medical facilities, one may be expected to lead a more active retired life than our parents and grandparents. Hence, the amount of annual income needed at retirement shall be broadly be same as our existing expenses factored by cost of living i.e inflation rate.

Numerical: How much monthly income is required on retirement after 35 years if one spends Rs 5000 per month today?

If you are going to retire in 35years, the general level of prices will have increased due to inflation say in the past 35 years, inflation has caused prices to increase so that something that cost Rs1 in 1975 cost Rs7.31 in 2010.

Assuming a similar rate of inflation in the next 35 years, we estimate that Rs 5000 today would equate to Rs 36550 after 35 years;

Rs 5000 * 7.31 = Rs36550

In other words, in 35 years you would need an estimated Rs36550 per month to pay for expenses that are costing Rs 5000 today.

Numerical 2: If rate of inflation is 4% p.a., the income required after 35 years in above shall be $5000\ (1 + 0.04)^{35}$i. e. Rs 19730.44.

A=P(1+r/n)^nt

P = principal amount (the initial amount you borrow or deposit)
r = annual rate of interest (as a decimal)
t = number of years the amount is deposited or borrowed for.
A = amount of money accumulated after n years, including interest.
n = number of times the interest is compounded per year

Step 2: Determining required level of accumulated retirement savings;

The next step is to determine how much you must have accumulated in your retirement savings in order to be able to withdraw sufficient funds to cover your living expenses viz Rs. 5000 per month today or Rs 36550 per month in future (35 years hence) for each year of retirement life. In order to determine this amount, you need to estimate how long you are likely to live after retiring. Life expectancy tables provide an estimate. If you plan to retire at age 60 and life expectancy tables predict that you will live to age 72, you will want to accumulate enough retirement savings by age 60 so that you can withdraw enough money each year for next 12 years to pay for your living expenses.

Targeted Corpus = Rs. 36550 (expected monthly expenses) * 12(months) * 12 (life expectancy after retirement) = Rs. 5263200/-

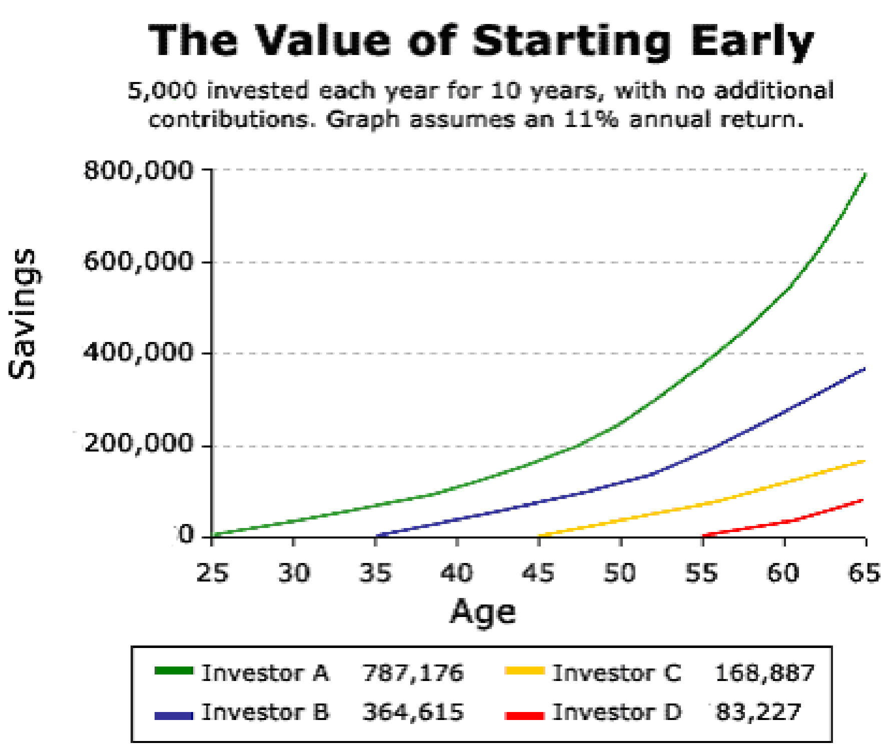
Step 3: Determining required annual contribution to retirement savings;

The third step is to determine how much you must save each year between now and the start of your retirement in order to accumulate the desired retirement corpus. Again, you would like to consider that accumulated contributions will earn an expected rate of return and will also lose some purchasing power due to expected inflation.

Targeted Corpus	Starting age for retirement savings	Years to retirement	Yearly savings	Monthly savings
5263200	18	42	125314	10443
5263200	25	35	150377	12531
5263200	30	30	175440	14620
5263200	35	25	210528	17544
5263200	40	20	263160	21930
5263200	45	15	350880	29240
5263200	50	10	526320	43860

Thus, we can conclude that the earlier one starts savings for retirement, the easier it becomes during financial planning as the burden on consumption expenditure is reduced.

The EFFECTS OF COMPOUNDING



PENSION

Pension provides regular income to an individual after retirement .The need for pension is uniform across all section of society —the requisite amount of pension will depends on the lifestyle that an individual needs to maintain along with the estimated cost of living during their retirement. Accrued amount of pension is crucial function of savings during the working years as also number of years taken to build sufficient corpus for desired amount of pension.

TYPE OF PENSION PLANS

Defined Benefit (DB)

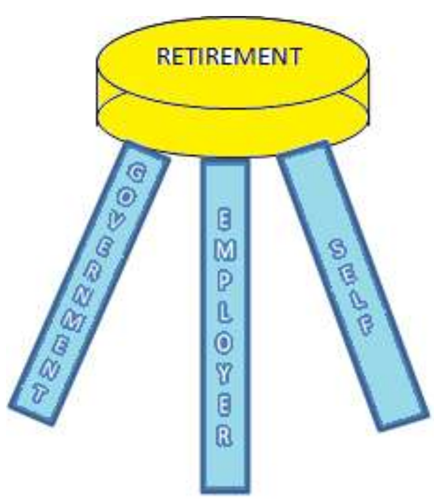
Defined Benefit Pension plan is one in which a specified monthly benefit (payment) is available on retirement. It is predetermined by a formula based on the employee's earnings history, tenure of service and age, e.g. 50% of last pay drawn is paid as pension to central government employees (pre 01.01.2004).

Defined Contribution (DC)

Defined Contribution Pension plan in which the pension amount is dependent upon the aggregated retirement corpus which in turn is determined by the amount of individual contribution. Individual contributes for her/his own pension & parallely contribution can also come from employer/Central or State Government in addition to individual contribution. The amount of contribution is predetermined.

HISTORY OF PENSION IN INDIA

Traditionally, pension schemes in India have primarily been funded by the employer. Government sector defined benefit pension scheme was financed by Government for their employees. This pension system was inherited from the British Administration.



Indian Pension System has 3 distinct broad groups:-

Group I covers citizen of the country through a standardized, Govt. run pension schemes which offers basic coverage and is primarily focused on reducing poverty in old age amongst the most destitute like BPL, widows & disabled.

Govt. financed pension has very limited coverage in our country- It covers persons above 60 years for poor, elderly and persons employed by the Government.

Government of India launched **National Social Assistance Program (NSAP)** w.e.f 15th August 1995 for providing social assistance benefit in the form of pension to the aged, the BPL households, in the case of death of the primary breadwinner and for maternity.

Indira Gandhi National Old Age Pension Scheme (IGNOAPS)

Scheme provides old age pension to BPL population above 60 years of age. Central Government assistance for pension @Rs.200/-per month per beneficiary up to 79 years & Rs.500/- per month for 8 years and above.

Indira Gandhi National Widow Pension Scheme (IGNWPS)

Scheme provide pension to BPL widows in the age group of 40-59 yrs. Central Government assistance for pension @Rs.200/-per month per beneficiary.

Indira Gandhi National Disability Pension Scheme (IGNDPS)

Schemes provide pension to BPL persons with severe or multiple disability in the age group of 18-59 years. Central Government assistance for pension is @Rs.200/-per month per beneficiary.

State Governments may also provide the various pension schemes at state level for different target groups(BPL population , farmers, widows and senior citizen etc) e.g. Madubabu Pension Scheme launched by Orissa Government, Destitute Agricultural Laborers Pension Scheme launched by Tamil Nadu Government, Manipur old age pension Scheme, Sanjay Gandhi Niradhar Scheme launched by Govt. of Maharashtra, Sanjay Gandhi Niradhar Scheme launched by Govt. of Maharashtra, Sandhya Surkasha Scheme launched by Govt of Karnataka, Kerala Agriculture Workers Welfare Pension and Kerala Unorganized Retired Workers Pension Fund Scheme etc.

Group II is mandatory occupation pension system where employee and employer contribute towards their pension. It covers workers in the organised sector through a Defined contribution-cum-Defined benefit scheme.

Civil Servants' Pension (CSP) is a traditional defined benefit scheme which runs on the basis of pay-as-you-go-system, for employees of Central Government who were recruited up to 31st December, 2003 and employees of State Governments recruited up to the effective date mentioned in notifications issued by those governments.

Employees Provident Fund Organization (EPFO) administers the following two old age income schemes, which are mandatory for all employees in the organized sector, earning a monthly salary of less than Rs.6,500/:-

(a) The Employees Provident Fund (EPF)

(b)The Employees Pension Scheme (EPS)

<u>The Employees Provident Fund (EPF)</u> Scheme is an individual account defined contribution scheme wherein both the employee and employer contribute to the fund at the rate of 12% of the employee's pay which can be withdrawn at the time of retirement. There are a number of provisions under the scheme for pre-mature withdrawal of accumulation.

<u>The Employees Pension Scheme (EPS)</u> is a defined benefit scheme, based on a contribution rate of 8.33% from the employee to which government makes an additional contribution of 1.16%. EPS was introduced in 1995, and is applicable to the workers who entered into employment after 1995. In case of death of a member the scheme provides for a pension to the spouse for his/her remaining life

Group III is a voluntary, private funded system, including individual savings plans, insurance, etc. Purely voluntary schemes are present in a very restrictive form through PPF, superannuation schemes and personal pension plans provided by Insurance Companies.

Personal Pension Plans and Group Pension Products offered by the life insurers are being supervised by the Insurance Regulatory and Development Authority (IRDA). Schemes offered by the Mutual Funds are regulated/supervised by the Security Exchange Board of India (SEBI).

Need for pension reforms in India

India has nearly eighty million elderly people, which is one eighth of world's elderly population. This segment of population is growing at a rate of 3.8% per of 1.8% for the overall population and the existing pension system only covers 12% of Indian workforce.

Non-sustainability of the existing pension system by the sharp increase in financial burden on the Government and the other employers on account of pension liabilities. Challenge is to provide a pension solution for the 90% of the informal sector workers and vast majority of this population is not covered by any formal old age income scheme. They are dependent on their earnings and transfer from their children or other family members. These informal systems of old age income support are imperfect and are becoming increasingly strained.

Increase in life expectancy due to improvement in healthcare facilities ,evolution of nuclear family systems and rising aspirations due to increase in per capita income, education etc. are some of the factors likely to exacerbate the problem of old age income security in future.

Pension reforms

From 2000 to 2007, a marked shift in pension policy in India was witnessed after introduction of a New Pension System. Initial milestones on the road to pension reforms for Government of India was to reduce the burden of providing Defined Benefit pension to Government employees and the provision of pension for un covered population from the unorganized sector respectively.

Pension Fund Regulatory and Development Authority was established by Government of India on 10th October 2003, PFRDA to act as a regulator for the pension sector. The mandate of PFRDA is development and regulation of pension sector in India.

The New Pension System, based on defined contribution .gives a direction to the pension reforms for a long term viable model and sustainable solution to the problem of old-age income security.

The New Pension System (NPS) was made operational through a Government of India notification dated 22nd December, 2003. It has been made mandatory for new recruits in the Central Government (except Armed Forces) from 1st January 2004 and Twenty eight (28) State/UT Governments have also notified the New Pension System for their new employees.

It marks a paradigm shift from the defined benefit to a defined contribution regime. It is based on the principles of defining upfront the liability of Government, giving choice to subscribers, facilitating portability of labour force and ensuring transparency and equity in the pension industry.

Later the New Pension System is changed to National Pension System. NPS is also made available to **all Citizen of India w.e.f 1.5.2009** on a voluntary basis and extended its coverage to unorganized Sector (May 2011), corporate sector and caters to economically disadvantaged sector through low cost model. The New Pension

System has been designed to enable the subscriber to make optimum decisions regarding his/her future and provide for his/her old-age through systemic savings from the day he/she starts his/her employment. It seeks to inculcate the habit of saving for retirement amongst the citizens.

About 11 Lakh Central Government employees (excluding employees of autonomous organisations) and 16 Lakh State Government employees from 22 States are covered under National Pension System (NPS). Remaining other State Governments has made significant strides in this direction.

Swavalamban Yojana is launched by Government of India on 26.09.2010 to support individuals in the unorganized sector in achieving old age security. Any citizen of India, belonging to the unorganized sector, is eligible to open a NPS account subject to the following conditions:

- Should be between 18 — 60 years of age.
- Subscriber should not be covered under any social security scheme.

Government of India will contribute Rs 1000 per annum to all eligible NPS Swavalamban accounts where the subscriber deposits a minimum of Rs 1000 to maximum Rs. 12000/- per annum. The incentive is presently available till 2016-17 and around 16 Lakh subscribers are covered under this scheme till 2012-13.

MAIN FEATURES AND ARCHITECTURE OF THE NATIONAL PENSION SYSTEM

1. The National Pension System is based on defined contributions. Subscriber can open NPS account through POP or Aggregator. NPS tier-1 Account is non withdrawal account and there will be seamless transfer of accumulations in case of change of employment and/or location. It will also offer a basket of investment choices and Fund managers.

2. NPS is mandatory for new recruits to the Central Government service (except the armed forces). The monthly contribution would be 10 percent of the salary and DA to be paid by the employee and matched by the Central Government. A similar contribution pattern is also prescribed for employees of the autonomous bodies of Central Govt.

3. Individual who has opened NPS A/c can have a voluntary tier-II withdrawal account at his option. The NPS A/c assets in tier-II would be managed in the same manner as the NPS tier-1 pension A/c. The accumulations in this account can be withdrawn anytime without assigning any reason.

4. National Securities Depository Service Limited (NSDL) has been appointed as the

Central record keeping agency (CRA) under NPS .The recordkeeping, administration and customer service functions for all subscribers of the NPS shall be centralized and performed by the CRA.

5. Pension Fund Managers (PFMs) are appointed by PFRDA to manage the retirement savings of subscribers. The PFMs are required to invest strictly in accordance with guidelines issued by the PFRDA.

6. Annuity Service Providers (ASPs) are appointed by PFRDA for delivering a regular monthly pension to the subscriber for the rest of his/her life post retirement.

7. Individuals exit at attainting the age of 60 years from the NPS. At exit, the individual is required to invest minimum 40 percent of pension wealth to purchase a pension from ASP. The individual would receive a lump-sum of the remaining pension wealth, which she would be free to utilize in any manner; individuals have the facility to invest more than the minimum prescribed 40% for receiving higher pension. Individuals would have the flexibility to leave the NPS prior to age 60. However, in this case, the mandatory annuitisation would be 80% of the pension wealth.

Abbreviations

DB: Defined Benefit

DC: Defined Contribution

ASP: Annuity Service Provider

CRA: Central Recordkeeping Agency

NPS: National Pension System

PFMs: Pension Fund Managers

PFRDA Pension Fund Regulatory and Development Authority

PRAN Permanent Retirement Account Number

POP: Point of presence

BPL: Below poverty line

Definition

Aggregator: Aggregator shall be the point of interaction between the subscriber and the NPS. Corpus: Subscriber contributions accumulated and invested for specified period.

Lum Sum: A single payment for the total amount due.

Annuity: Monthly sum (pension) that will be received by the subscriber at the time of

retirement.

Annuitisation: The amount invested to receive annuity (monthly pension) by the subscriber at the time of retirement.