Security at a price

Annuities provide you with a secured income after retirement for the rest of your life, but they have their disadvantages too

During your working life, your main challenge vis-a-vis your retirement goal is how to save and accumulate more. But once you retire, the major challenge is how to invest your savings so that you are able to lead your retired life without financial distress. Indeed, the risk you run now is that you may outlive your savings.

A retiree should first concern himself with creating a regular income flow that will substitute his salary and allow him to lead a comfortable life. Many investment options are available that help you create a monthly income stream — Post Office MIS (POMIS), Senior Citizens Savings Scheme (SCSS) and monthly income plans (MIPs) from mutual funds, and annuities which are sold by life insurance companies.

What are annuities?

Annuities do not provide life insurance cover. Instead they offer you a guaranteed income either for life or for a stipulated duration. They are specifically designed to protect an individual against the risk that he may outlive his own resources. Instead this risk is borne by the insurance company.

Types of annuities

Depending on when you buy them, annuities can be divided into two categories: deferred and immediate.

Deferred annuity. A deferred annuity requires you to first build a corpus, which you then use to buy an annuity at the time of retirement. Most insurers enable the building bit through a pension plan. When the tenure of the pension plan ends, you use the accumulated money to buy an annuity.

If at the accumulation stage you have invested in a pension plan from an insurance company, then it is compulsory to invest at least one-third of the amount that you get from this instrument in an annuity at the time of retirement.

Immediate annuity. An immediate annuity refers to the instrument for which you pay a lump sum, rather than paying a number of premiums over time. In lieu, this instrument starts making you regular guaranteed payouts. An immediate annuity is purchased by someone who is about to retire and would like to receive a monthly income right away.

Advantages

Offers a sense of security. An annuity provides you the security that you will continue to receive money each month for the rest of your life. The insurance company takes

on the risk of figuring out how to make the money last as long you will live, so that you don't have to worry about it.

Choose your payment frequency. You may choose to receive your fixed payouts at intervals that suit you best — monthly, quarterly, half-yearly or annual.

Remove re-investment risk. According to Vishal Dhawan, a Mumbai-based financial planner, the biggest advantage that annuities offer is that they eliminate the re-investment risk. Since in India we are structurally moving towards lower interest rates, the risk is that when you go to reinvest the principal, you may get a lower rate of interest. Short-term instruments like the Post Office Monthly Income Scheme (POMIS) carry reinvestment risk. But once you invest in an annuity, you are guaranteed the same rate of payout for life.

No investment cap. While there are investment caps on SCSS (Rs 15 lakh) and POMIS (Rs 3 lakh), there are no such caps on annuities.

Disadvantages

While annuities do provide a guaranteed sum of money, and hence security and stability to retirees, they have a few glaring disadvantages too.

No access to capital. Most financial planners such as Pune-based Veer Sardesai and Dhawan are of the view that annuities are not very popular in India mainly because people want access to capital. This is not available in the case of an annuity. "Because access to principal is lost, a lot of investors are not comfortable buying annuities," says Dhawan. On the other hand, in the case of an instrument such as POMIS, the capital comes back to the investor after six years.

Lower rate of return. The returns (annual) on annuities have not been that attractive — 6.4-7.5 per cent — as compared to other products. In fact they offer the lowest returns. By comparison, a POMIS and a five-year bank deposit offer 8 per cent return. Other assured income options like the Senior Citizens' Savings Scheme (SCSS) offer 9 per cent (the highest).

Do not fight inflation. Another disadvantage of annuities is that they do not fight inflation. Prices will continue to rise even after your retirement. Hence, the impact of inflation needs to be factored into your retirement planning. Take an example. If at the age of 60, Rs 30,000 suffices to meet your monthly living expenses, then by the time you are 80 you will need at least Rs 1,16,090 per month to maintain a similar standard of living, assuming an average inflation rate of 7 per cent. But an annuity pays you a fixed sum of money which will prove woefully inadequate 10-20 years down the line.

Premature withdrawals not allowed. Annuities do not allow premature withdrawal, as is permitted in the case of SCSS and POMIS. In the case of SSCS, you can withdraw money after two years by paying 1 per cent penalty. So if you may need access to your principal, an annuity may not be appropriate.

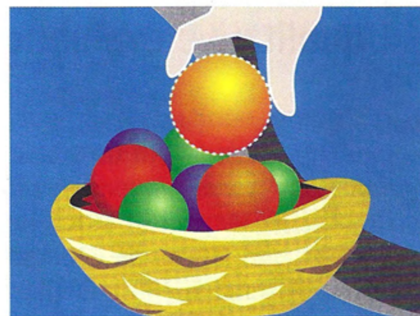
Work on simple interest. "While annuities usually work on simple interest, SCSS compounds interest quarterly," informs Sardesai.

Should you invest in annuities?

According to Dhawan, if there is a chance that an investor may face a fund deficit during retirement, or he may need to make a large, unexpected expenditure, then he may get into trouble if he has tied up his assets in an annuity. However, there could be another investor who has accumulated a large enough corpus so that he is unlikely to face a deficit. For such an investor an annuity is a good idea because of the secured payment stream that it provides. **WI**

Priyanka Sahni
priyanka@valueresearch.in

Financial planning tips for retirees

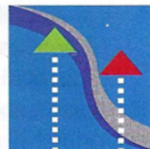


Do not keep all eggs in one basket. Diversification is the key. You should not put all of your retirement savings in an annuity.

Go for a strong insurer. The annuity business is a long-term arrangement. A life insurance company that has a strong financial position should be preferred.

Maintain an emergency corpus. Keep some money set aside for emergency expenses, special needs or unexpected costs.

Combat inflation. Investing in conservative investments such as annuities alone will not help you keep up with inflation. Over the long term investments in the equity markets offer the greatest chance of higher returns, and therefore, of keeping up with inflation. But equities also carry higher risk of loss. So it makes sense to divide your investment amount between assured return schemes for capital security and market-linked scheme for higher returns. This will enable you to get the best of both the worlds.



Compare. Comparing rates among different insurers involves time and energy. But nowadays insurance portals have made the task easier. Understand all the fees and expenses associated with annuities.

Irreversible decision. Ensure you understand the terms of the annuity contract before opting for one. The terms of an annuity contract are not subject to change once agreed upon and signed.