6

Savings products

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Learning objectives

After studying this chapter, you should be able to:

- identify the need for professional advice on savings products;
- explain the factors that determine the savings needs of individuals;
- describe the main features and benefits of savings products;
- discuss the key savings products available in the market;
- describe the tax and inflation implications on savings products;
- describe the implication of interest rates on savings products;
- prioritise the savings needs of individuals and apply savings and investment products to meet those needs.

Introduction

In the previous chapter we learned about the types of **life insurance** plans that can meet a client's protection needs arising out of death or disability. As we saw in chapter 1, a life insurance agent's role is not restricted to advising on and selling just life insurance – you will also be expected to advise your clients on other financial products, including savings products.

In this chapter we will focus our attention on the range of **savings products** that are available in the market, from which we shall move on to look at some other financial products, such as health insurance and accidental death products in the next chapter.

Historically the word 'savings' was used to describe the process of setting aside small amounts of funds on a regular basis to accumulate capital. The word 'investment' has been used mainly to describe the use of lump sums of capital or surplus income in certain products with an expectation of good returns. These days the words 'savings' and 'investment' are being used almost interchangeably.

Be aware

Most people need the help of a savings/investment plan to achieve their financial objectives in life.

There are various savings/investment products that are available in the market for an individual to choose from: they can choose whether to invest in products by means of a lump sum or by making small periodic payments. We will look at some of these products and also highlight the important role that professional advisers have in selecting suitable savings-related products for their clients.

Key terms

This chapter features explanations of the following terms and concepts:

Asset management company (AMC)	Compounding	Gratuity	Traditional deposits
Bank deposits	Disposable income	Lock-in period	Savings needs
Bonds	Financial planning analysis process	Investor's convenience	Shares
Child plans	Post office savings	Mutual funds	Speed of transactions
Cumulative deposits	Fund managers	Interest rates	Taxation and tax planning

A The need for savings/investment advice

The savings needs of each and every individual are unique. Most individuals do not make wise decisions in terms of investments as they will often invest in certain products without fully evaluating the product features and their own financial needs. These decisions are often taken at random, based on peer influence or even as a last-minute resort to save on taxes.

In this section we will discuss the two major reasons for which professional advice should be taken by individuals with regards to their savings and investment needs.

A1 Ignorance about the financial planning process

Individuals are often unable to identify their own savings and investment needs. They concentrate more on meeting their short-term needs rather than on their long-term requirement for funds. Also, the tendency to spend rather than save is greater as the immediate appeal of consumer goods is more apparent and persuasive than the intangible, future benefits of saving.

Professional insurance agents help individuals by taking them through the financial planning process in which they can identify their present and future financial needs. Some of the long-term goals an individual may have include saving money for their children's education and marriage, saving money to purchase a house, or repaying the existing home loan at an earlier date and planning for their retirement.

A2 Ignorance about the full range of financial products available

The majority of people are not aware of the various savings and investment products that are available in the market. As a result they are unable to select suitable products which meet their financial needs.

It is here that the insurance agent can offer assistance by:

- having a good knowledge of the various products that are available;
- matching the products with the individual's financial needs; and
- evaluating the tax efficient returns of the products, taking into account the tax treatment of the products and the tax eligibility criteria of the individuals.

In summary, agents should guide the prospective investor using their financial planning skills to offer quality advice thereby encouraging saving in a purposeful and needs-based manner, and not necessarily just for maximising returns.

Suggested activity

Visit an IRDA certified life insurance agent of any company of your choice. Conduct a personal interview with them to understand how they identify the financial needs of their clients, and discuss how the financial planning process works.

B Factors that determine the savings needs of an individual

In this section we will look at the various general saving needs an individual might have, and some of the factors that determine their specific savings needs.

B1 General savings needs

Individuals can save for their future by investing in various savings products. Individuals with no existing capital need to accumulate it by saving from income, and individuals with sufficient capital need to invest it wisely to preserve its value.

B1A Individuals without capital

The precise savings needs of an individual are unique to them. Many people undertake financial planning in a rather disorganised way by saving for a particular need or goal and not going through a comprehensive financial planning process where they identify **all** their financial needs. As part of the comprehensive financial planning process some of the **common** savings needs/financial goals of an individual may include the following:

- Building a contingency/emergency fund to meet unexpected financial difficulties owing to a medical contingency, temporary job loss etc.
- Planning and investing for children's higher education.
- Planning and investing for children's marriages.
- Buying a home or a second home (depending on whether the individual already owns one). And repaying the home loan as early as possible.
- Planning and investing for other goals like buying a car, annual vacations with the family, planning and investing for children's primary education, accumulating initial capital for their own business and donating money to charity etc.
- Planning and setting up a retirement fund to maintain the same standard of living when regular monthly income stops, without compromising on anything.

Be aware

It is important to remember that financial planning is not a one-off activity. The investments needed to achieve these goals need to be reviewed regularly until the goals are achieved.

B1B Individuals with capital

Individuals who have capital will generally have the following savings needs:

- The need to increase their existing wealth as much as possible for future needs. These may include initial capital for starting a new business, taking a world tour, making donations to charitable causes and so on.
- The need to ensure that a sufficient amount of capital is left behind as an inheritance for their children.
- The need to ensure that there is sufficient income for maintaining a certain lifestyle once they retire.

B2 Factors that determine the savings needs of a particular individual

The main factors that determine the precise savings needs of an individual are as follows:

B2A Duration of investment

The duration for which an individual needs to keep the money invested is an important factor that determines savings needs. The life insurance agent should help individuals to determine the amount they need to save for their future. Where individuals need to achieve a **savings target** at the end of specific number of years, the length of the savings period determines how much must be invested as a lump sum or as a series of regular contributions.

Be aware

The savings target depends upon the individual's income, number of dependants, their assets and liabilities, disposable income, the expected return on investment and the length of time they wish to keep the money invested.

Case study

Gopal, Deepak and Pavandeep are salaried individuals working for a reputable Multinational Company (MNC) and they all plan to retire at the age of 60.

Gopal is 30 years old and is married with one child. He has set himself a retirement fund target of Rs. 1 crore.

Deepak is 40 years old and is married with two children. He has also set himself a retirement fund target of Rs. 1 crore.

Pavandeep is 50 years old and has also set himself a retirement target of Rs. 1 crore.

Gopal has 30 years to achieve his target, Deepak has 20 years and Pavandeep 10. Assuming the return given by their investments is 12%, the following table shows the monthly investments that all three men will have to make if they are to achieve their retirement targets.

Individual name	Current age	Years left to retire	Retirement fund target	Annual return expected	Monthly investment required
Gopal	30	30	Rs. 1,00,00,000	12%	Rs. 3,277
Deepak	40	20	Rs. 1,00,00,000	12%	Rs. 10,975
Pavandeep	50	10	Rs. 1,00,00,000	12%	Rs. 45,060

As we can see from the above table the more time the individual has to invest, the lower the monthly investment amount required to reach the target will be. So it is always a good idea to start saving for retirement as early as possible.

Be aware

In the long run the practice of compounding works wonders. In compounding, the returns earned (quarterly, semi-annually, annually etc.) are reinvested along with the existing investments to earn higher returns.

B2B Amount of disposable income

The amount of the regular investment also depends upon the surplus amount or the disposable income that the individual has. This in turn will depend on the individual's income, the number of dependants they have and their current liabilities. The surplus amount is the spare amount of money left over after an individual has paid all their monthly liabilities.

Generally, there will be different times in an individual's life when the amount of disposable income they have will vary. For example, an individual who is married with young children would have higher liabilities and their income would be low compared to an individual who is married with older children. As a result of this the surplus amount available for investment will be low. As the individual moves into the next life cycle stage, their income will increase which will result in higher savings and also higher investments.

Therefore you can see that a suitable product which provides considerable flexibility to the individual with respect to their savings needs should be chosen.

Be aware

Remember that nobody should be encouraged to commit more to savings and investment than they can genuinely afford.

B2C Existing assets and liabilities

Professional advisers must also consider the individual's current assets and liabilities as these affect both the client's needs and their ability to finance them. Individuals can use their assets as security for borrowing to meet their financial needs.

Example

A person can use their assets, like property or gold, as security and take a loan against them in order to finance paying off the outstanding balance on a credit card, paying off personal loans or borrowing money to pay for children's higher education.

An individual may accumulate liabilities at various life stages, such as taking out a home loan, car loan, education loan for children, personal loans and credit card debts, and the professional adviser must take account of a client's liabilities as part of their savings and investment advice.

Consider this…

What are the savings needs of your family? Prepare a list of the various needs.

C Features and benefits of savings products

We will now look at the main features and benefits offered by the various savings products and how these features influence their suitability to meet a particular individual's needs.

C1 Capital or income growth

Some savings products provide regular **income** (interest paid by a bank fixed deposit), some provide **capital growth** (gold) and others provide a mixture of the two (equity shares). All of these products will be discussed later in the chapter. Remember that the objective of the individual investor should be matched with the investment profile of the product.

C2 Guarantees

Some products are available with guaranteed returns, some provide variable returns and others provide a mixture of guaranteed and variable returns. So products should be chosen based on the risk profile of the individual client.

Example

Insurance Company ABC has launched a guaranteed return insurance product. For this product the company is **guaranteeing** the following additions:

- Rs. 60 per thousand maturity sum insured, per year, for a five year policy term.
- Rs. 65 per thousand maturity sum insured, per year, for a ten year policy term.

This effectively means that Insurance Company ABC is guaranteeing returns of 6% and 6.5% for a policy of five and ten years respectively.

C3 'Lock-in' period

Most savings products have a stipulated 'lock-in' period during which the funds cannot be withdrawn by the individual. Therefore the client should carefully determine their needs and the length of time for which their money will be inaccessible before deciding which product to invest in.

Example

Investments made in a tax savings bank fixed deposit have a lock-in period of five years. So during this period the investor cannot withdraw their funds from the fixed deposit. Also they cannot take out a loan against this fixed deposit, which they can normally do in case of other bank deposits.

Investments made in equity-linked savings schemes (tax saving mutual funds) have a lock-in period of three years. During this period the individual cannot withdraw money from these mutual funds (but they can do in the case of other mutual funds that do not have a lock-in period).

C4 Penalties

Penalties are associated with the premature withdrawal of funds from fixed term contracts. This is an important consideration which needs to be evaluated before investing in such products.

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Example

Ajay has opened a two-year recurring deposit account in a bank in which he makes a monthly deposit of Rs. 1,000. After seven months Ajay is unable to make any further monthly deposits. In fact he also wants to withdraw the deposits that he made in the previous seven months and close the account. So in this case the bank will charge a penalty to Ajay for premature withdrawal of his money and closing the account before the scheduled tenure of two years.

Some mutual funds have a lock-in period of, say, six months or one year. If the customer withdraws their money before the expiry of the lock-in period, the mutual fund deducts an **exit load** (a charge for early withdrawal within the lock-in period) and pays the balance amount.

C5 Risk

All savings products carry a level of risk and these can be rated as low risk, medium risk and high risk. Low risk products offer lower returns compared to high risk products. Hence the products should be carefully chosen based on the individual's circumstances and their **risk appetite**.

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Example

The risk appetite of individuals will vary depending on their circumstances:

- A young individual in their early twenties who is just out of college and has started earning may have a high risk appetite, as their responsibilities would be low.
- For an individual in their mid-thirties who is married with children it is not advisable to invest in high risk investments as they have more responsibilities to take care of. Hence the level of risk appetite can be moderate for them.
- For an individual in their mid-fifties who is nearing the end of their working life, the appetite for risk is very low.

C6 Buying and selling mechanisms

Buying and selling mechanisms are important in two ways: convenience to the individual investor and the speed of the transaction.

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Example

Savings products can be purchased through various channels such as individual agents, the internet, call centres, ATMs, and corporate agents like banks and brokers etc. Procedures for purchasing savings products are normally straightforward provided the individual submits all the documents promptly. The purchase of savings products via the internet not only provides convenience to the individual investor but also speeds up the transaction.

An individual can buy and sell shares online through a broker's website. This is convenient for them and also ensures immediate execution of the transaction. They do not need to visit the broker's office and they are not required to call up the broker's office or the call centre.

Similarly, an individual can take out a bank fixed deposit via the bank's website or through the bank's call centre even while they are on holiday as they will not be required to visit the bank branch. This again ensures convenience to the customer.

C7 Flexibility

Flexibility refers to the ability to switch between different forms of investment, the payment of variable contributions, and even to temporarily stop making contributions altogether. These features can easily increase the attractiveness of the product. Flexible products also allow for the partial withdrawal of funds without affecting the product in force. Generally, the greater the product flexibility, the more suitable it is. However, features like allowing a temporary break in contributions and partial withdrawals can result in lower long-term investment returns.

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Example

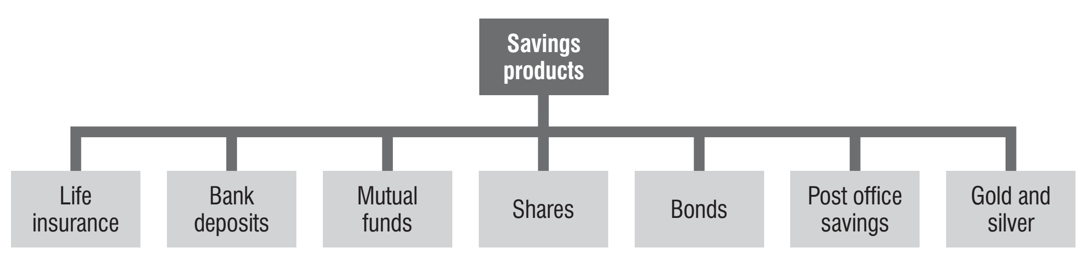
Unit-linked insurance plans (ULIPs) allow policyholders to switch their investments from one fund (equity) to another fund (debt). They also allow policyholders to take premium holidays (temporarily stop making contributions) and to make partial withdrawals.

> **Consider this…**
>
> Companies rate their investment products according to the risk associated with them. These products are rated as high risk, medium risk and low risk. Which types of clients should invest in each of the investment product categories as described above?

D Types of savings products

In this section we will outline the following types of savings products:

Figure 6.1



D1 Life insurance

Many life insurance products, along with the primary life cover, come with a savings element. The savings component of the premium is invested by the insurance company on behalf of the policyholders and the returns earned are shared among policyholders in the form of bonuses.

In participating plans like endowment plans and whole life plans the insurance company takes the investment risk. In ULIPs the investment risk is borne by the policyholder.

Besides meeting protection needs, life insurance products are an excellent choice for investors to invest funds for long-term goals like children's education and marriage, retirement and others.

D2 Bank deposits

Bank deposits are one of the oldest and most preferred savings products. They are an instrument where an individual has to invest a lump sum amount with a bank for a fixed tenure at a fixed interest rate. Bank deposits are commonly known as fixed deposits or term deposits. Bank deposits are considered safer than many other investment products and they offer decent returns. In a bank deposit the amount, tenure, interest rate and method of payment of interest are decided at the inception of the deposit.

The investor can choose from three types of deposits:

Traditional deposits	With this type of deposit the bank pays the interest on the depositor's fund on a monthly/quarterly/half yearly/yearly basis as chosen by the depositor at the time of making the deposit.
Cumulative deposits	With this type of deposit the bank pays the principal and the total interest at the end of the term. In a cumulative deposit the interest is normally compounded on a quarterly basis.
Recurring deposits	With this type of deposit the investor deposits a specified amount every month over a chosen time horizon. These deposits are ideal for people looking to accumulate money for financial goals like children's education, marriage, buying a vehicle etc.

The interest rate on these deposits varies with the maturity period. Bank deposits provide returns in the form of an interest payment. The principal amount deposited with the bank at the time of opening the deposit is returned back to the depositor on the maturity of the deposit.

D3 Mutual funds

A mutual fund is a fund that brings people with a common objective together. Money collected from these people is invested on their behalf and the returns are shared back amongst them. Mutual funds are managed by Asset Management Companies (AMCs). The AMCs invest the money according to the objective of the scheme in equities, debt instruments, money market etc. The AMCs employ qualified and experienced fund managers (also referred to as portfolio managers) who are responsible for investing the funds based on the type of fund (or scheme) that is chosen by the investor.

The main advantage of investing in mutual funds is risk diversification. The individual's funds are spread over different securities to get optimum returns with minimal risk.

Mutual funds provide two types of income:

- **regular income** in the form of dividends declared by the mutual fund scheme from time to time; and
- **capital appreciation** where the mutual fund units are sold at a price higher than the price at which they were bought.

However, there can also be capital loss in mutual fund investments. If the financial performance of the companies in which the mutual fund scheme has invested is poor, it will lead to a fall in the share prices of those companies. This in turn will reduce the value of the investments of the mutual fund investors who have invested in the units of that scheme. You can see therefore that the performance of a mutual fund scheme is based on the performance of the securities in which the scheme has invested.

D4 Shares

Equity shares represent ownership of a company. Whenever a company wants to raise money for its growth, set up a new production unit, acquire another company, acquire technology, working capital etc. the company may offer shares (ownership in the company) to the public.

Example

Let's assume a company's total capital of Rs. 10,00,000 consists of 1,00,000 equity shares of Rs. 10. If the owners (promoters) of the company want to raise money for the company's expansion by offering 10,000 shares to the public; then it is said that the owners are diluting 10% of their ownership in favour of the public. If an individual acquires 100 shares from the total 10,000 shares on offer, they are said to have acquired 0.1% (100 shares out of a total 1,00,000 shares) shareholding (ownership) in the company.

Once the shares are offered to the public, the buying and selling of shares takes places through stock exchanges. Stock exchanges act as intermediaries and offer a trading platform for the buying and selling of shares between individuals. However, individuals cannot directly buy or sell shares through the stock exchanges, they have to place their buy and sell orders through stock brokers (members) of the stock exchanges. The two main stock exchanges in India are the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE).

Individuals who purchase shares have the right to receive a share in the company's profits in the form of dividends. The profits are distributed in proportion to the number of shares held by the shareholders.

Equity shares provide three types of income to the investor:

Dividend income	The company may share a portion of the profits that have been earned with the shareholders in the form of a dividend declared from time to time.
Bonus shares	When a company accumulates large cash reserves, it capitalises them by issuing bonus shares (free shares) instead of distributing them as dividends. Bonus shares are issued in proportion to the existing equity share capital of the company. The issue of bonus shares is a vote of confidence from the management to its shareholders about the good financial performance and future prospects of the company.
Capital appreciation	When shares are bought at a lower price and sold at a higher price, the difference between the two prices is known as the profit or capital appreciation.

Be aware

An investor can also incur a capital loss on equity investments. The returns on equity investments depend on the financial performance of the company. If shares are bought at a higher price and later sold at a lower price due to the deteriorating financial performance of the company, it will result in a capital loss.

D5 Bonds

Bonds are similar to bank fixed deposits in that they provide regular income to the investor in the form of interest payments. However, bonds can also be traded between buyers and sellers. Apart from banks, bonds are also issued by the Government, companies and other institutions to raise money from the public. In simple terms, a bond is a loan provided to the issuer by the investors. Hence in the case of bonds, the investors are the lenders who receive interest on their loan. At the end of the tenure the original amount (principal) is returned back to the lender.

There are different kinds of bonds in which the investor can invest, these include:

- corporate bonds;
- Government securities (G-secs);
- commercial paper; and
- treasury bills.

D6 Post office savings

Post offices in India offer several savings products such as:

- National savings certificate (NSC).
- Kisan vikas patra (KVP).
- Public provident fund (PPF).
- Post office savings account.
- Recurring deposit account.
- Time deposit account.
- Post office monthly income scheme (POMIS).
- Senior citizens saving scheme (SCSS).

These are all products in which an individual has to invest a lump sum amount for a fixed period of time (except for recurring deposits where regular investments are made and savings accounts). The investor earns a fixed interest rate which is specified at the time of investment.

D7 Investment in gold and silver

India is one of the world's largest importers of gold, and gold and silver are one of the most popular and oldest savings instruments in India. There are various ways of investing in gold and silver, the most popular in India being jewellery. Other ways of investing in gold and silver include bars and coins sold by banks and jewellers. Apart from physical gold, investing in gold in electronic format is also increasing. Gold ETFs (exchange traded funds) are like mutual funds in which gold units can be traded in electronic format on a stock exchange, just like shares. In gold ETFs one unit represents one gram or half a gram of gold.

Reasons for investing in gold and silver include:

- good returns;
- portfolio diversification;
- hedge (protection) against inflation; and
- insurance against uncertainties.

Question 6.1 ?

What is a mutual fund?

E Tax and inflation implications for savings products

An individual's personal tax position will have considerable influence on the choice of suitable savings products.

E1 Tax implications

The last quarter of the financial year is the busiest time for insurance agents and other financial advisers. It is during this time of the year that salaried individuals and others are busy tax planning and making investments in tax saving products to minimise tax deductions from their salaries. In fact it could be said that many people make investments purely to minimise their tax liabilities.

This is the wrong approach towards savings and investment, as there needs to be a proper financial plan in place before a particular investment product is chosen. In this section we will look at the tax implications for savings products.

E2 Income Tax Act 1961

This Act came into effect on 1 April 1962 and has undergone several amendments since then. Every major amendment is effected through a Finance Act (at the time of the union budget presentation) and other amending acts. Additionally, the Central Board of Direct Taxes (CBDT) issues circulars clarifying the various provisions related to income tax.

When working on effective tax planning, it is important to understand the exemptions and deductions provided by the Government. The investor can take advantage of the following tax deductions under various sections of the Income Tax Act as per prevailing income tax rules.

E2A Section 80C

Under section 80C a deduction from taxable income is allowed for investments made in the following products:

- Life insurance premium paid for traditional products.
- Unit-linked insurance plans (ULIPs).
- Pension plans.
- Repayment of the principal component of home loan.
- Employee provident funds (EPFs).
- Equity linked saving schemes (ELSs).
- Tuition fees paid for children.
- Five-year tax saving bank deposits.
- Public provident funds (PPFs).
- National savings certificates (NSCs).
- Senior citizen savings schemes (SCSs).
- Stamp duty and registration charges.
- Infrastructure bonds.
- Pension funds.
- Post office time deposit – five years.

Be aware

The above list of the financial products is for the Financial Year 2010/11. The list is revised from time to time. The amount allowed as deduction from taxable income is also subject to review each year.

In the 2010 union budget, section 80CCF has been introduced which allows deductions from taxable income for investments up to a specified limit in infrastructure bonds. This deduction is over and above the deduction allowed under section 80C.

E2B Section 80D

Section 80D allows deductions from taxable income for the premium paid towards health insurance for the individual, their spouse and children. For premiums paid for health insurance for parents, an additional deduction is allowed. For premiums paid for senior citizens, a higher deduction from taxable income is allowed compared to the deduction made for other individuals.

The amount allowed as deduction from taxable income is subject to review from time to time.

E2C Section 80DD

Under this section a deduction from taxable income is allowed for expenditure (up to specified limits) incurred on medical treatment/training/rehabilitation for a disabled/handicapped dependant. The expenses can be for the treatment for disability, disease/ailment (as specified under this section) of the individual or a dependent relative. To take advantage of this deduction a certificate in the prescribed format needs to be produced by a medical practitioner.

E2D Section 80E

Under section 80E a deduction from taxable income is allowed for the interest paid on an education loan.

E2E Section 24(b)

Under section 24(b) a deduction from taxable income is allowed on the interest paid (subject to specified provisions) on a home loan.

Question 6.2

List five financial products for which an individual can claim a tax deduction under section 80C of the Income Tax Act 1961.

E3 Inflation implications

We looked at the impact of inflation on insurance cover in chapter 5. When considering financial planning the investor must make sure that the amount required for meeting future expenses is calculated taking into consideration the impact of inflation on the prices of goods. If inflation is running at 5% and you earn 8% on your investments in a bank fixed deposit, you would have earned a return of 3% **net of inflation**.

Of course, in real life the situation is not quite as simple as this. The inflation rate would not be **exactly** as predicted. It could be higher or perhaps even lower. It is always a good practice to assume a higher rate of inflation rather than the actual inflation rate for the past five or ten years when producing future calculations. The returns on investments may also be subject to taxation. Inflation and taxation together suppress the real returns which may turn out to be lower than the anticipated returns.

As a result, an investor has to make sure that the returns on their investments should be sufficient to provide them with enough income after taking into account inflation and tax deductions.

F Implication of interest rates on savings products

Changes in interest rates will affect those offered by savings and investments products and can, therefore, have an adverse effect on the investment decisions of an investor.

In this section we will look at the effects of changes to interest rates.

F1 Increase in interest rates

In the case of an increase in interest rates, the interest rates on deposits and loans go up. The decision to increase interest rates is made by the Central Bank of the country (**Reserve Bank of India**) when it is in the interests of the country's economy to encourage savings and to discourage people from borrowing for unnecessary expenditure, and thereby reducing the demand for credit. The effects of an increase in interest rates are as follows:

- The demand for lending products from banks and financial institutions suffer as borrowing becomes expensive for the individuals and they postpone their purchases.
- On the other hand, bank deposits with higher interest rates become more attractive and people choose them resulting in an increase in savings. There is also an increase in the purchasing of bonds which have higher interest rates.
- However, a high interest rate scenario is not good for the stock markets. Borrowing becomes costly for companies which leads to higher interest payments. This can put pressure on the profitability of companies which can lead to the selling of shares and subsequently lower share prices.

F2 Decrease in interest rates

In the case of a reduction in interest rates, borrowing becomes cheaper and there is an increase in investments made by companies. This is done to stimulate the economy so that there are more investments and an increase in the demand for goods and services in the economy. The effects of a decrease in interest rates are as follows:

- Low interest rates increase the demand for lending products. Investors take out loans for the purchase of financial assets, which results in increased consumption.
- Investment in other financial products (like equities and real estate) is preferred compared to investment in bank deposits due to the low interest rates offered.
- Investors who have already locked-in their investments at a higher interest rate in bonds and bank deposits are at an advantage when interest rates fall.

Question 6.3

Briefly discuss the effects of a reduction to interest rates on savings products.

G Prioritising savings needs

The savings needs of each individual are unique, so it is very difficult to standardise the process of prioritising savings needs. The life insurance agent has an important role to play in helping the individual to analyse and prioritise their savings needs.

In this final section of this chapter we will discuss some guidelines that serve as a sound basis for prioritising savings needs.

We start by setting out a list of common savings needs and how, broadly, to prioritise them:

Figure 6.2

The need to have a contingency/emergency fund

↓

The need for insurance

↓

The need to purchase assets such as a house, a car etc.

↓

The need to save for retirement

↓

The need for tax planning

G1 Contingency/emergency fund

The foremost need for an individual is the easy availability of emergency funds. These funds can be required for a variety of different purposes, such as meeting unexpected medical expenses due to an illness in the family, temporary job loss, emergency travel, payment of children's tuition fees etc. The amount in this fund should be roughly enough to cover three to six months of expenses.

Individuals should invest the emergency fund money in savings products that offer easy liquidity (investments that can be easily converted into cash without much loss in value). Bank deposits and debt mutual funds are the preferred products in this case.

G2 Insurance

Insurance offers financial security to an individual and their family in case unexpected situations should arise. As insurance needs differ among individuals, there is a variety of insurance products which offer security for these different needs. Some of the needs for which an individual may seek insurance are:

- The need to have sufficient funds to cover the family in case of the unexpected death of the income provider. This need should be the top priority for any individual. Term insurance should be the preferred product to address this need. Once an individual has a suitable term insurance plan they can look at savings products like endowment plans, whole life plans, money-back plans or ULIPs to address their savings needs.
- The need to have adequate health insurance cover for the entire family to meet any medical emergencies. Major hospitalisation and treatment expenses paid from the individual's own pocket can push back the financial planning of an individual by a few years. Hence this need assumes significant priority and a family floater health insurance plan can address this need.
- The need to provide sufficient funds for children's higher education and marriage. A child insurance plan can address this need. An individual can prioritise this need once the income provider has taken out adequate term insurance for themselves and health insurance for the entire family. Child insurance plans come in two varieties. Risk averse investors can choose child endowment plans, whereas investors who are willing to take the risk can choose child ULIPs and allocate their money to an equity fund.

- The need to have a regular income or an annuity after retirement. Insurance companies provide retirement plans to address this need. An individual can invest a lump sum amount, or during their working life they can make regular contributions towards a retirement plan. This amount is invested by the insurance company on behalf of the policyholder. Initially an individual can start providing for their retirement needs with a small amount as they have other high priority needs to take care of. Later, as the individual's income increases they can step up investments for their retirement fund. These accumulated funds (retirement funds) are then used to buy an annuity plan. As we saw in chapter 5, in an annuity plan the insurance company makes regular periodic payments to the annuitant after retirement as per the terms of the plan. We will discuss annuities in more detail in the next chapter.

G3 Assets

During their lifetime, individuals will need to purchase various assets; however, some individuals may not have the funds to make a lump sum down payment. To address this need there are several lending products that are available in the market which can help individuals with the purchasing of these assets. Examples of some of these assets are as follows:

- Purchase of a home or property.
- Purchase of a car or two-wheeler.
- Purchase of consumer goods such as a refrigerator, television, laptop etc.

The need to buy a house is a priority for many individuals, but considering the huge investment involved an individual needs to do lot of planning for this. The individual should first accumulate funds to pay margin money and the remaining amount can be financed through a home loan. An individual should make sure that the money paid for the home loan EMIs does not affect their investments for other needs such as having funds to pay for their children's education, marriage, and also funds for their own retirement. There has to be a balance between the money allocated for EMIs and money allocated for meeting other needs. Care should be taken to ensure that EMIs do not exceed 40% of the monthly take home salary.

Be aware

The bank does not offer the full amount of the property value as a loan. Only a certain percentage, say 75% or 80%, of the total value of the property may be offered as a loan by the bank. The rest of the amount has to be paid by the individual. This money is known as down payment, margin money or home owner's equity.

The need to purchase a car or a two-wheeler can be placed further down the priority list. An individual can consider this need once they have provided the finances for other, higher priority, needs. Consumer goods can then be bought from regular monthly cash flows or can be financed through personal loans or credit cards.

G4 Retirement

The next high priority need is securing funds for the future. Individuals should make sure that they have a sufficient and regular source of income once they retire. This need depends on the lifestyle that an individual needs to maintain along with the cost of living during their retirement. Both of these factors determine the amount that needs to be saved so that they can live comfortably once they have retired. We have already seen in section G2 that this need can be partly addressed by investing in a retirement or pension plan from an insurance company at an early age. For working professionals retirement needs are partly addressed through the retirement benefits that their employer provides on retirement, such as a gratuity, employee provident fund (EPF) and pension, if applicable. Self-employed people don't have the luxury of employee benefits as they are responsible for themselves.

In summary then, an individual can address their retirement needs by investing in mutual funds for the long term along with retirement plans and employee benefits appropriate to their circumstances.

Be aware

A gratuity is an employee benefit that is paid by the employer to the employee in gratitude for the services rendered by the employee to the company.

To be eligible for a gratuity the employee needs to have completed five years of continuous service. The amount of the gratuity is calculated based on the employee's number of years of service. The employer keeps making contributions to the gratuity on behalf of the employee during their employment by the company and it is paid out when they leave the company, retire or die.

Gratuity eligibility, calculation, payment and its tax treatment are defined by the **Payment of Gratuity Act 1972**.

G5 Tax planning

We have seen that the various needs of an individual include the need to make provisions for insurance, and to provide funds for children's education, children's marriage, home and retirement. An individual should make sure that while investing to fulfil these needs they select investment products which make optimum use of income tax deductions allowed under various sections of the Income Tax Act (as discussed in section E2 of this chapter).

Be aware

An individual's investment portfolio should be as tax efficient as possible, but the tax benefits of any savings or investment product should be considered as an **additional** benefit rather than the primary benefit.

Therefore, the buying decision should be based on the **need** and not the tax benefits offered by the product.

Case study

Rakesh Mohan is a software engineer and is married with a two-year-old child. He is the sole income provider in the family and his wife Radha is a housewife. He has invested in an ULIP product which he purchased in January from an insurance agent as he wanted to save income tax by gaining the deduction from his taxable income. He pays Rs. 25,000 annually for the ULIP.

Apart from this he has no other investments. He has earned a good bonus from his company this year and is looking for some savings products to invest in using this money. He meets his life insurance agent for advice on which savings products he should invest in. After discussing Rakesh's income and his current investments, the agent prepares the following list:

- Investment in a ULIP product is a good investment, despite the main reason for choosing this product being the tax benefits. However, the annual amount invested in the ULIP is quite low and this needs to be increased to meet Rakesh's future financial needs. Rakesh can keep investing in this ULIP for his retirement.
- Rakesh needs to create an emergency fund by putting aside some money in a bank deposit or in a debt fund. The agent suggests that Rakesh set aside Rs. 1,00,000 as an emergency fund.
- Rakesh should take out term insurance cover to protect his future income and liabilities. He should also take out a health insurance policy for his family.
- Rakesh should consider investing in a child insurance plan to provide for his child's education or other financial requirements that may arise in the future.
- Rakesh is currently staying in a rented apartment, so the agent suggests that Rakesh should consider purchasing his own house. In order to do this Rakesh should start accumulating money for the margin money payment for a house. The remaining amount can be financed through a home loan. Purchasing a house through a home loan will not just provide him with his own house, but it will also provide him with the tax benefits that are available on the home loan principal payment as well as the interest repayment.

G6 The difference between short, medium and long-term needs

We saw in section G1 that clients should have access to funds in an emergency, and a client's needs can be categorised into long-term, medium-term and short-term, based on the time duration within which funds will be required. Based on these needs, suitable investment products should be selected from the range of products already discussed.

Short-term needs	funds would be required within a period of, say 1-5 years. Short-term needs include saving for emergencies etc.
Medium-term needs	funds would be required within a period of 5-15 years. Medium-term needs include savings for children's education, marriage etc.
Long-term needs	funds would be required after more than 15 years. Long-term needs include retirement planning.

Suggested activity

Prepare a list of short-term, medium-term and long-term needs for your family. Once the list is prepared, prioritise them. The needs that are to be addressed foremost should be placed at the top of the list.

Summary

You will now have an understanding of both life insurance and savings products and how to go about identifying and prioritising the individual needs of your clients in relation to these types of product, and how to apply the right products to meet those needs.

Before we move on to looking at what a professional financial planning process involves in more detail in chapters 8 and 9, we shall discuss the other financial products that you need to understand in the next chapter.