ASPECTS

Spring 2020 | Retirement planning

India's population

- *68%, 35 years or lower of age*
- *7%, more than 60 years of age*

Investment

- *Property*
- *Financial assets (FD's , stocks, bonds, Mutual funds etc.)*
- *Physical assets (gold, cars etc.)*
- *Insurance plans*
- *Retirement plans*

India draws strength from a relatively young population profile with 68% of its population below the age of 35 years[1], in terms of potential for productive growth and consumption. However, with increasing life expectancy and slowing population growth, over time more individuals will enter retirement age desiring a comfortable life beyond their working years.

Most affluent households invest in property, physical assets, financial assets (mutual funds, stocks, bonds, FD's etc.) and insurance plans. An important component of many asset profiles is investments in workplace or other retirement accounts.

NPS, EPF's, PPF and PPP's

In our current context, many public and private sector

[1] 2011 census, Government of India,

National Pension Scheme, NPS

- *10% employee contribution*
- *10% employer match*
- *Range of investments from government bonds to equities*
- *Non sponsored plans available for all citizens*
- *Favourable tax treatment at contribution, growth and withdrawal*

NPS Tier I annual returns %

Equity 5 year period

- *SBI: 6.83%*
- *ICICI: 6.71%*
- *HDFC: 7.83%*

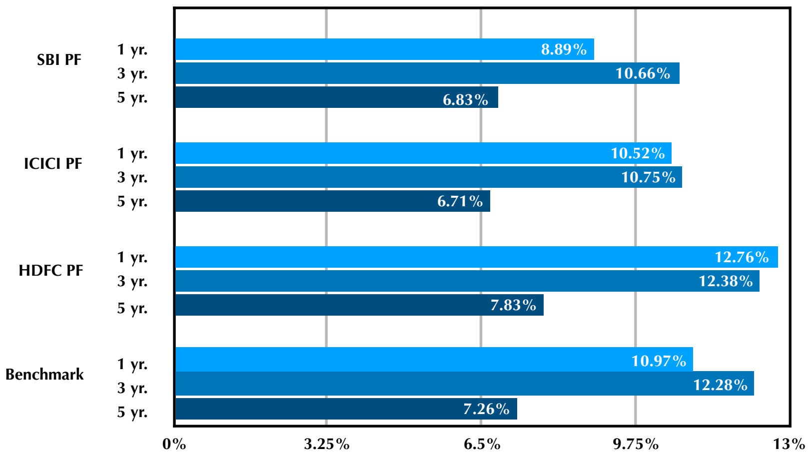
Corporate debt 5 year

- *SBI: 8.88%*
- *ICICI: 9.10%*
- *HDFC: 9.10%*

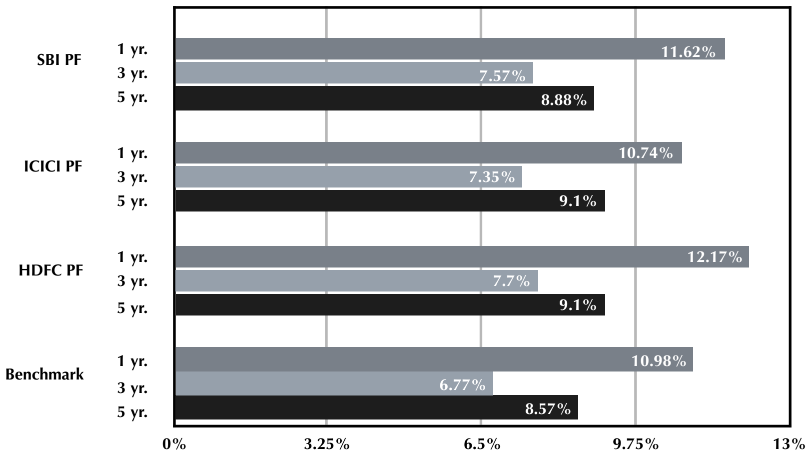
employees subscribe to the **National Pension Scheme**, via their employers. NPS is administered by dedicated providers, and regulated by the Pension Fund Regulatory Development Authority (PFRDA). Usually employees contribute 10% of Basic+DA wages and employers match with another 10%[2]. NPS schemes are grouped as Tier I (mandatory, held till retirement) & Tier II (optional, flexible) schemes and provide for market linked rates of return from funds which invest in a). Equities, b). Corporate bonds, c). Government debt, d). Balanced plans (mix of corporate debt, government debt and equity). Employers or employees are free to choose where they want to invest, and can change investment elections, usually annually.

Returns[3] from prominent NPS funds are graphed below:

NPS Equity Tier I plans, NAV annual returns



NPS Corporate Tier I debt plans, NAV annual returns



[2] For central govt. employees, employer contribution is 14% w.e.f 01/04/2019. Source: www.financialservices.gov.in

[3] NAV based returns as of 31/01/2020, for largest funds from providers. www.npstrust.org.in

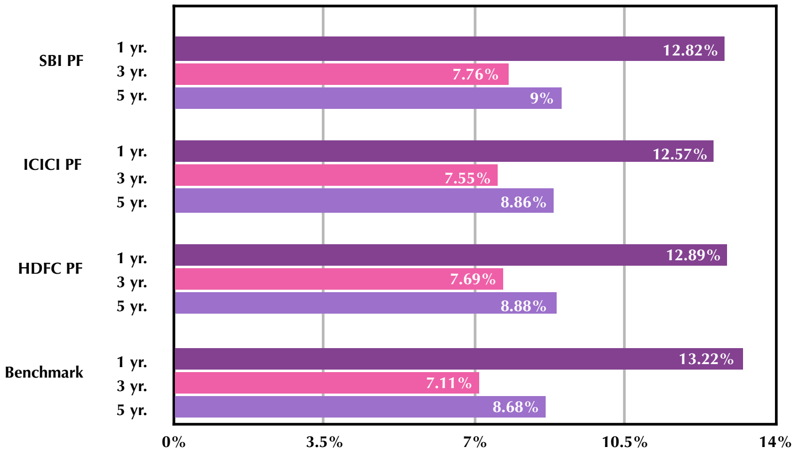
Government Debt 5 year

SBI: 9%

ICICI: 8.86%

HDFC: 8.88%

NPS Govt. debt Tier I plans, NAV annual returns



Employees enrolled in company plans can invest more than 10% of their salary, without a corresponding company match. Self employed, homemakers and small business owners can invest any amount in NPS on their own volition.

NPS Tier I contributions are eligible for 80C deductions upto 2 lacs in the existing tax system, while for filings in the new system 80C deductions are done away with and tax slabs are revised lower. Employer contributions from FY 21 onwards are tax free upto 7.5 lacs/annum[4].

Funds grow tax free and upon retirement, 40% or more of corpus has to withdrawn as an annuity, payable over time. This portion does not get taxed upon purchase of annuity, however, returns generated by the annuity amount in future years are taxable as income. The remaining corpus can be withdrawn lumpsum, tax free, subject to conditions[5].

The second large workplace retirement plan is the **Employee Provident Fund** (EPF) scheme offered by employers. EPF's usually involve pre tax contributions from employees (12% of basic + DA) matched by pre tax contributions from employers (12 % of basic + DA distributed between EPF and EPS), a life insurance contribution and employer borne administrative charges. Similar to NPS, employee contributions in the existing tax system are eligible for 80C deductions upto 2 lacs, while in the new tax structure, tax

[4] Beyond 7.5 lacs/annum, employer contributions across retirement plans are taxable with employees.

[5] Lumpsum withdrawals upto 40% of the total corpus are tax free, and beyond that gains are taxed.

Employee Pension Fund, EPF

- *12% employee contribution*
- *12% employer match between EPF & EPS*
- *Fixed rate of return, specified upfront every year, 8.65% for FY 20*
- *Favourable tax treatment at contribution, growth and withdrawal*

slabs are revised lower but 80C deductions are removed. Matching contributions by employers are tax free upto 7.5 lacs/annum from FY 21.

Funds invested in EPF schemes were earning 8.65%/annum interest for FY 20[6].

Let's walk through an example:

Employee (basic + DA) salary = 1 lac/month

Employee contribution[7] to Employee provident fund (EPF) @ 12% = 12000/mo

Employer contribution has 4 parts:

Employee provident scheme (EPS) @ 8.33% of monthly salary (with salary cap of 15000) = 1249.5/mo

Employee provident fund (EPF) @ 3.67% of (basic + DA) salary + excess of 8.33% of (basic + DA) over monthly cap of 15000 = 3670 + 7080.5 = 10750.5/mo

Employee disability & life insurance (EDLI) @ .5% of monthly salary capped at 15000 = 75/mo

Plan administrative expenses, usually @ .5% of total contributions

Upon retirement, the employee is entitled to

Employee pension scheme monthly benefit, calculated as

No. of years of service (EPS contribution) * Avg. monthly wages for 60 months before retirement (capped at 15000/ month)/ 70.

For someone, having worked for 30 years, with average monthly wages greater than 15000 for the last 5 years,

= 30*15000/70 = 6428.5/mo

Employee provident fund corpus, including employee and employer contributions and tax free growth, as a tax free lumpsum.

[6] As of March 1st, 2020. For historical rates and future updates see epfindia.gov.in

[7] www.epfo.gov.in

Employee life insurance amount capped at 6 lacs to nominee(s) upon death of employee while in service.

As such, assuming one is able to comfortably meet his ongoing expenses, save for known near and medium term expenses and create an emergency reserve, matching employer contributions, competitive rates of return and favourable tax treatment make employer sponsored plans a sound choice for retirement savings.

Public Provident Fund, PPF

- *Available to all citizens*
- *Term of 15 years extendable in increments of 5 years*
- *Fixed rate of return for term of 15 years, currently 7.9%/annum*
- *Favourable tax treatment*

The third prominent retirement savings plan is the **Public Provident Fund** or the PPF. PPF contributions can be availed by all Indians via India Post, intermediary banks and brokers. PPF's provide a tax free fixed rate of return (7.9% as of March 1st, 2020) compounded annually over a term of 15 years, extendable in increments of 5 years. The maximum investable amount is 150000/annum, and contributions are eligible for 80C upto 1.5 lacs/annum in the existing tax structure.

Private Pension Plans, PPP's

- *Usually pension and life insurance component*
- *Periodic member contributions*
- *Market linked or fixed rate of return*
- *Favourable tax treatment*
- *LIC, HDFC, ICICI, SBI prominent providers*

Then there are pension and retirement plans being offered by banks and insurers either standalone or with a life insurance component. The basic contribution structure is similar to voluntary NPS, wherein subscribers contribute a given amount (eligible for 80C deductions under old tax structure) periodically which is invested in market linked or fixed return products, usually grows tax free, and upon completion of the term can be withdrawn lumpsum or as an annuity, usually tax free[8]. Plans with a life insurance component also include a payout upon death of subscriber. Employers can chose to offer private retirement plans after approval from PFRDA[9] or other relevant authority, and otherwise any citizen can enrol for private plans, even in addition to other plans they may have enrolled for by choice or with their employers. LIC, HDFC, ICICI, SBI are amongst the larger private plan providers.

[8] Plans vary in design depending on the issuer in terms of frequency of contribution, choice of funds, and tax treatment upon withdrawal.

[9] In this case, there could be employer contributions similar to NPS or EPF.

Retirement savings example

- *Member profile: Small business owner, age 30 years*
- *Retirement age: 65*
- *Investment: 1.5 lac/year invested in PPF for 21 years*
- *Retirement corpus built: 2.69 crores*
- *Tax saving on contribution, tax free growth and tax free withdrawal*

Other retirement plans

- *Legacy plans*
- *Defined benefit plans*
- *Atal Pension Yojana*
- *Insurance based plans*

While NPS, PPF and private retirement plans could be attractive for all depending on their financial profile, they could be particularly useful for self employed and small business owners to build a retirement corpus, which insulates them from fluctuations in their business situation and provides a source of income in old age.

Let's consider a small business owner, age 30, who runs a profitable business with fluctuating yearly profits. Hence, he prefers a certain, stable retirement corpus and plans to invest 150000 in Public provident fund, PPF, at the end of every year for 21 consecutive years. Upon maturity of any given annual investment after 15 years, he would extend the term in increments of 5 years till attaining the retirement age of 65 years.

Invested amount: 150000/year

Rate of Interest: 7.9%

Assumptions:

Rate of interest = 7.9% for investments initiated at any time over the next 25 years. ***Actually, interest rate for new investments changes over time and could be higher or lower.***

Rate of interest on extending term after maturity, in increments of 5 years, is same as initial rate of interest.

Tax status upon investments or renewal: Avails 80C deduction on all new savings invested. Tax free 5 year renewals.

Withdrawal: Tax exempt lumpsum withdrawal at end of years 65 - 69.

Total retirement corpus created, tax free: 2.69 crores.

Essentially, a cumulative investment of 31.5 lacs over 21 years could help create a tax free retirement corpus of 2.69 crores.

It is worth mentioning that there are several other schemes viz. Voluntary Provident Fund (VPF), Coal Miners Provident Fund, Assam Tea plantation provident fund and other legacy pension plans which provide defined benefits (Defined benefit plans) that beneficiaries and employers continue to subscribe to for a variety of reasons. For wage earners on the low end of the income spectrum the Atal Pension Yojana provides payouts of 1000-5000/month depending on beneficiary contributions and corresponding government match.

In addition, many insurance plans double up as retirement savings vehicles in addition to providing event dependent claim payouts.

A relative advantage of savings in retirement plans is that upon retirement the entire corpus is available as a stream of income or a lumpsum, or a combination of both. One does not have to find a buyer for an asset he/she created during his/her working years, to sell to, before getting to liquid funds. In cases where a stream of income is offered over time via an annuity, the amount left after paying the annual or monthly instalment continues to earn interest till the end of the product's term.

Risks

Savings invested in retirement plans are locked in for varying time periods, from 15 years for PPF's to retirement age for NPS accounts. Early withdrawals are permitted in certain situations only, and may invite penalties depending on plan specifics.

Returns from market linked plans are subject to risks inherent in any given asset class and to the securities selected within that asset class. Plans investing entirely in equity securities depend on the price performance of those securities, which in turn is driven by company specific and market trends. Debt based fund returns are subject to interest rate and credit risk, amongst others; and even when fixed returns are promised, high inflation could reduce the purchasing power of the final corpus.

Another risk is of contributing less to your retirement plan(s) than what you might need to meet your retirement lifestyle, and on the flip side, of saving too much for retirement and compromising on life objectives during working years.

A summary of salient features of the 4 plans discussed above is provided below

Plan	Contribution	Growth or ROI	Withdrawal	Post term or retirement payout	Tax treatment	Comments
NPS	**Sponsored plans**: 10% of basic employee + 10% employer match **Non sponsored plans**: Min. 500/ month (tierI) & 250/month (tierII - taxable), no upper limit, and no sponsor match	Market linked returns depending on basket of funds invested in	Premature withdrawal possible with restrictions, and for certain situations	Upon retirement, atleast 40% as annuity, rest lumpsum	Employee contributions eligible under 80C upto 2 lac under old tax code. Employer contributions upto 7.5 lacs tax free per new tax code Tax free growth Redemption withdrawals largely tax free, with conditions (see NPS section)	Flexibility to invest in equity, debt or balanced plans and to change investment elections annually.
EPF & EPS	12% employee contribution + 12% employer contribution between EPF and EPS.	Fixed return stipulated by Government FY 2020 EPF: 8.65%, EPS: Provides monthly pension	Premature withdrawal possible with restrictions depending on years of service, age, reason for withdrawal	EPF portion lumpsum, EPS as monthly pension depending on years of service and salary	Employee contributions eligible under 80C upto 2 lac under old tax code. Employer contributions upto 7.5 lacs tax free per new tax code	Additional voluntary employee contributions possible without employer match
PPF	Upto 1.5 lac/year	FY 2020: 7.9% fixed for term, tax free, compounded annually	Possible with penalties	Lumpsum after 15 years	Eligible for 80C under old regime, tax free growth and payout	Employees can invest in EPF (where available), NPS, PPF and other plans if they so desire
Private retirement plans	Depends on the plan design, could include bonus contributions by plan provider at predetermined intervals	Could be fixed OR market linked to debt or equity or a combination of both	Early withdrawal may or may not be possible	Lumpsome or as annuity or combination of both. Guaranteed return or entirely market linked or combination or both	Contributions eligible for 80C, growth tax free, post term payout maybe partially or fully tax free depending on plan	Could include insurance component. Unless selected by employer as retirement option, there are no matching employer contributions

Evidently, while individual and household situations vary, retirement plans are an effective way to save for post retirement life and should be considered favourably while planning one's finances for the near, medium and long term. In selecting one or more suitable plans, individuals should consider retirement lifestyle, available employer plans (if any), contribution amount, rate of return, diversification, tax treatment, withdrawal options and insurance needs, amongst others.

Northplains Capital Partners LLP provides investment planning and advisory services to affluent individuals and households. Our basic diagnostic assessment starts at INR 5000.

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Sources

NPS: www.npsindia.gov , www.npstrust.org.in

EPF plans: www.epfindia.gov.in

PPF: www.indiapost.gov.in

Private pension plans: Websites of ICICI Bank, HDFC bank, LIC, SBI

Images: www.googleimages.co.in

Other key sources: www.financialservices.gov.in , www.incometaxindiaefiling.gov.in, www.economictimes.indiatimes.com , en.wikipedia.org , www.india.gov.in ; www.npscra.nsdl.co.in

Disclosures

Retirement plans are one important component in a well designed financial plan and the choice of retirement plans usually varies by individual situation.

Plan structures vary considerably across plans and over time. There are several variables involved in contribution rates, employer matches, underlying investments, tax treatment, early withdrawal, withdrawal options etc. that can influence long term performance.

Past plan performance is not necessarily indicative of future performance.

Information from Internet sources is not additionally verified.

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