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Looking beyond annuity products

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Though they may suit your future plans, inflation and expenses will eat into your corpus.

Raman has just got his retirement dues and wishes to supplement his pension income. His son, Prasad, 28, wants to plan for his own retirement. They have heard of pension plans and annuities but are not clear about it. Do these products meet both their requirements is the query.

Annuities are any kind of recurring payments. In terms of retirement, they are the pension received through various sources. Insurance companies offer both, deferred and immediate annuity products. For those like Raman, immediate annuity products are available. For people like Prasad, who still have several years, there are deferred annuity products.

If Prasad wants to retire at the age of 60, he has 32 years to accumulate his retirement corpus. He can do it either through buying a deferred annuity product or investing in other products like stocks or mutual fund systematic investment plans (SIPs). In a deferred annuity product, he will pay regular premiums during his working life. If Prasad buys a deferred annuity product, he can either go for a traditional policy or a unit-linked insurance plan (Ulip). If he pays a premium of Rs 50,000 per year for 32 years, and we assume a rate of return of six per cent on the traditional policy and 12 per cent on a Ulip, at the end of 32 years he will have a corpus of Rs 45 lakh from the traditional policy and Rs 1.52 crore from the Ulip.

	Traditional	ULIP
Assumed Rate of Return(%)	6	12
Annual Premium(Rs)	50000	50000
Tenure (years)	32	32
Anticipated Corpus (Rs)	45,44,488.90	1,52,42,385.96

CHOICES

This illustration is simplistic and does not take into account the various charges that will be levied. When Prasad retires, he needs to buy an immediate annuity product. This need not be from the insurer with whom he had bought the deferred annuity product. There is an option to commute a third of the corpus, tax-free, and use the balance to buy an annuity. Currently, all annuities are taxable. Earlier, you could buy a deferred annuity product for investments alone. Now, it is mandatory to have risk cover with every pension or annuity product sold. The premium of a pension plan is deductible from taxable salary under Section 80CCC.

Raman receives some pension from his employer's superannuation fund which is a deferred annuity product. But, it is offered as a group product where the employer deducts a certain amount from the salary and builds a corpus. On retirement, this is used to offer pension to the employee.Raman is looking to complement this income.

Under an immediate annuity offer, he could choose from several payout options:

Annuity for life: Here the purchase price is not returnable on death of the annuitant.

Annuity for a fixed number of years and for life thereafter: There are options that provide annuity for a fixed number of years even if the annuitant dies before the tenure. The period could be anywhere from five to 20 years. The purchase price is not returnable on death of the annuitant.

Life annuity with a per cent to spouse after death: Provides annuity to spouse on death of annuitant. This could be 50 or 100 per cent. Again the purchase price is not returnable on death of the annuitant.

Annuity with return of purchase price: This is one of the most popular schemes. Since purchase price is returned to the nominees on death of the annuitant, it works out to be the lowest amongst all options. The annuity is paid for life.

Annuity with annual increment: Incremental annuity amounts at one, two or three per cent are disbursed at pre-decided rates. Purchase price is not returnable on death of the annuitant.

Raman's choice of annuity will depend on factors like his expected longevity (based on family medical history), dependency of spouse, whether he plans to bequeath the principal to his heirs and so on. He will need to keep in mind, that the amount he invests will be blocked for life. You cannot have a premature withdrawal or surrender. Second, the amount payable is fixed for life, except where you choose an option of incremental payouts. This might not suffice in the face of rising inflation.

Raman's corpus	Rs 20,00,000
At 7.5% monthly payout for 25 years(with return of purchase price)	Rs 12,500
Other income	Rs 10,000
Monthly expenses	Rs 20,000

From the data in the table, Raman's expenses will exceed his income in the fourth year if the inflation is six per cent. So, there has to be a supporting investment which gives inflation-adjusted returns, to manage any gaps that arise.

The fixed return scenario can work out in favour of the policy holder when subsequently the interest rates on deposits go very low. Many people who have invested some years earlier in immediate annuity products are still earning returns in the range of 12 per cent. In such cases, the insurer generally comes out with an option of premature surrender of policy to reduce the payout burden. Thus, this opens an exit route. But to buy the product with a hope of getting this option later is not very wise.

So besides the income from annuities, Raman should also opt for some equity-linked products to sustain his expenses. Prasad also needs to look at other investment avenues besides the deferred annuity product to create a corpus for his retirement.

The writer is a certified financial planner