

Personal Finance

Supplementary Reading

Material

Department of Education in Social Sciences
National Council of Educational Research and Training
New Delhi

FOREWORD

Personal Finance is an aspect of our lives which everybody needs to know about, wants to know about and often feels lost about how to deal with it. We believe learning to deal with this from school onwards will help in financial inclusion. If individuals and households are financially literate to make informed decisions about how to save, borrow and invest, this may help generate a sense of financial well being.

The present book also includes a discussion on helping the financially marginalised also improve their situation, because children need to be sensitised to such issues of access and social justice.

The NCERT has been receiving requests from the Ministry of Human Resources and Development and Ministry of Finance, Income Tax Department for inclusion of personal finance and components of taxation in the school curriculum. The Reserve Bank of India has also constituted a Core Committee on Financial Education of which NCERT is a member. Thus, the present book is an outcome of the initiatives by several organisations to impart financial education among young learners, enabling the country to pursue its goal of financial inclusion. This practical-oriented material has been developed by the Department of Education in Social Sciences, National Institute of Education to supplement the material already developed in Commerce and Economics.

It has taken a little longer than expected to develop this material because it is the first of its kind. Several academics in the country have also been looking forward to it, to use in their teaching. The Council welcomes comments and feedback from all users, viz., students, parents, teachers and others interested in promoting financial education.

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CHAPTER 1

FINANCIAL PLAN

Anita and Raju are two children wondering why their parents are always debating over household expenses. They often, hear them talk about saving for buying another car, new model of television, double-door refrigerator, latest model of washing machine and so on. There seems to be a never ending list and nobody seems to agree upon any purchase of a particular item. The children desire an LCD television set, their mother wants a refrigerator while father wants to possess a new car and grandparents want to deposit money in the bank to be used at a later date. The priorities of the family members differ in terms of their needs, utility and the price of various household items. However, all of them are making a choice which has financial implications for the family. The option will require a careful analysis of the families' income, expenses and savings. Since the amount of money available with the family is limited, some purchases may have to be deferred or postponed to a future date. Therefore, it would be appropriate if they decide in advance what to buy keeping in view their income and expenses. They take a decision to purchase a car as it would serve the interest of all and everyone will enjoy its benefits.

All of us at some time or the other have taken major and minor financial decisions in our life. Your parents may have asked you to choose between going for a school trip or purchase a new computer game. The school trip may cost ₹. 3000/- and the computer game ₹. 3500/-. Even if you do not have any income you have been involved in financial decision making. Sometimes your parents may have deferred buying you a new bicycle because their house loan instalment had to be paid. We are all part of the financial decision making process and are affected by our family's financial situation. You have observed in your daily life that spending, financing, investing are becoming part of your routine activities. These decisions are all components of personal finance. Therefore, personal finance can be said to be the process of planning your spending, financing and investing activities that affect your financial situation. However, before you begin to

plan, you will have to think about your needs and then accordingly prioritise your goals. Thus, the process of financial planning will include two steps:

- (i) to specify your goals, and
- (ii) to describe your spending, financing and investing plans to achieve those goals.

Financial planning helps you to ensure that you will have funds available to meet your present as well as future needs.

In India, there is a culture of saving for some future event or contingency or an asset to be acquired. Usually, some money is kept aside for this if it is surplus. In the middle income groups, there may be little or no savings due to high prices of essential items. This is where it becomes important to think of a personal financial plan. In contrast in advanced countries, like America, individuals tend to rely too much on credit cards which sometimes puts them in debt. They do not think of saving money and usually spend all their monthly income. Despite the difference in the cultural as well as economic position of the countries all individuals need to plan their finances in order to have some surplus and avoid debt.

When people or households do not have any savings, it becomes problematic in difficult times or emergencies like paying for hospital expenses, repairs in case of accident or other necessities. Similarly, if you have savings then there are numerous options to channelise your savings such as like bank deposits, insurance plans, shares etc. Thus, being financially prepared for such exigencies makes life much easier. Once you have a financial plan, a lot of financial issues relating to savings and expenses get streamlined.

Why Personal Finance

The main purpose of personal finance education is to positively influence financial behaviour. It has been observed that such education is delivered more effectively to younger children than to their older counterparts. Knowledge of personal finance is beneficial for everyone in many ways.

Make your own financial decisions

An understanding of personal finance helps you take informed decisions about your financial situation. When you spend money on a particular thing you are giving up something else. For example, if you purchase a book for ₹. 500/- you are sacrificing maybe, a video game of the same amount or you could have saved that money for the future. There are various alternatives which you could have considered and you have to choose one and forgo the others. What you give up as a result of your buying decision is what we call opportunity cost.

Evaluate the advice of financial advisors

You may have come across various insurance agents, trying to sell policies or agents for different mutual funds. If you are aware of financial matters then it becomes easy to assess the various alternatives given by financial advisors. Financial advisors usually give you advice and guide you on your savings and investment. They may sometimes make false claims and guarantee high returns on particular investments. Your understanding of personal finance will enable you to determine whether their advice is in your best interests or theirs.

Become a financial advisor

There are many people who do not understand financial matters or are not interested in taking financial decisions at all. At times, many employees go on paying high taxes because they do not know that by investing in certain securities or contributing to their provident funds they may save on taxes. There is a demand for financial advisors and a course in personal finance or other finance related courses can help you pursue a career as a financial advisor. They usually charge a commission on the amount of investment made from the source of the securities, for example, the post office or the company connected with the mutual funds. At a later stage, if they are enterprising and have a good understanding of financial matters they get paid for their specialised knowledge.

Instilling Financial Discipline

All of us need to be disciplined when it comes to spending money. If you have to live with a limited income your expenses have to be regulated. Same is true for your pocket money; you have to make sure your money lasts through the whole month. Parents have to make sure that the money is not misused and is judiciously spent.

Preparing a financial plan - PRACTICAL CONSIDERATIONS

Each individual or family is different so will have their own financial plans. One cannot expect to have same financial plan as another even if two people are earning the same salary. This is because financial situations and risk taking ability are different. Suppose a person already has to pay a housing loan instalment (EMI) and take care of other personal responsibilities, then his risk taking ability would be much lower than a person who does not have to repay a loan.

How exactly do you go about preparing a financial plan?

- Assess your finances. Make a list of your bank accounts, investments, fixed deposits, mutual funds, shares etc.
- What are your expenses per month? How much do you spend on rents or instalments (EMIs), your kids' education, monthly kitchen expenses and so on. You will be able to understand where you are with respect to your income, expenses and savings.
- Now the next step would be to list down your goals which could be short term, medium term or long term.

Your short-term goals could be buying a car or going on a vacation, let us presume in the next 5 years.

Your medium-term goals could be your child's education, buying a house, or setting up your own business. This could be planned for may be 10-15 years.

For long-term goals you could plan for 20 years after and think of retirement, clearing all loans and keeping some money aside for emergency.

- There are three parameters which you have to consider –time, money you can save and the rate of return.
- Based on your goals and your risk taking ability, you can diversify your money among different asset categories such as shares, bonds, fixed deposit and cash.

Source: The Economic Times

Components of a Financial Plan

In a financial plan there are personal finance decisions related to six major areas.

- i) Budgeting
- ii) Managing your money
- iii) Financing large purchases
- iv) Protecting assets
- v) Investing money
- vi) Planning your retirement
- vii) Tax Planning

Budgeting

We have heard people say that spending is going out of our budget. What is a budget? A budget is a statement of your income, expenses and saving. Budgeting therefore, is the process of forecasting future income and expenses for a given period. The surplus shown in your budget would be savings. Savings may be less or more depending upon how much you spend. Budgeting can therefore help you estimate how much of your income is required for monthly expenses and how much you will be able to save each month. You may use your saving for investing in bank deposits or in the financial markets or purchasing an asset such as a car or paying off your loan. Budgeting is a process where you evaluate your current financial position by assessing your income, expenses, assets and liabilities. Your budget is influenced by your income because you can only spend what you earn. Then the next step in the budgeting process is to estimate your expenses to be incurred every month. If you are able keep current expenditure levels low, your savings will be higher and you will be able to accumulate wealth in the future. Budget is the foundation of your financial plan, as it provides a base for making personal financial decisions.

Managing your money

You need cash to meet your daily expenses. Cash is required for daily minor expenses as well as major contingencies like repairs or medical treatment etc. For all this access to funds is necessary to cover any short-term cash needs. Your liquidity position is basically

determined by how much cash you have in hand or what can be accessed immediately. Money management and credit management are two techniques to enhance your liquidity position. Money management involves decisions regarding how much money to carry in liquid form and how much to allocate to short-term investment. Credit management involves decisions about how much credit you need to support your spending and the sources of credit to use. If you fall short of money then what other sources can you fall back on? Can you go to a bank, friends, employer or credit card facility? Credit card facilities should be used less as interest rates are exorbitant. It is normally used to cover expenses that cannot be covered by current income.

Financing large purchases

Huge expenditures like purchase of a car or a house often are financed by a loan. How much loan to take will depend upon your savings and the purchase price of the assets. The capacity to repay the loan is also an important consideration. Loans are available in easy instalment of monthly, six monthly or annual system of repayment. The interest rate charged also is different for different schemes of loan and its repayment. There are, therefore, four things to consider: (i) how much loan to take, (ii) Maturity or length of the loan (iii) Interest rate and (iv) Instalment plan.

Protecting assets

Insurance plans are available to protect your assets. Insurance companies offer different types of insurance policies with varying amounts of premium to be paid depending on the risk associated. Car insurance, house insurance, health insurance are some of the popular policies for different amounts.

Investing money

The extra funds which you have can be invested in shares, bonds, mutual funds and property to earn a higher return. You may invest your saving in bank deposits for different periods with varied rates of interest if you wish to opt for a safe investment. Or if you are willing to take risk you may invest in the capital market, i.e., in shares or bonds

or mutual funds. A risk return analysis may be done and funds may be invested according to your requirement.

Planning your retirement

After retirement you do not get a fixed amount as salary, therefore a certain amount must be set aside and invested so that some return is assured at a later stage. This type of planning could be done well in advance so that sufficient money is accumulated to support yourself and your family. For example, you may be investing in provident funds, public provident fund, national saving certificate, etc., which can give you an income after retirement.

Tax Planning

Taxes are an essential component of financial plan. Whatever you earn, part of it has to be paid to the Government in the form of taxes. However, tax planning enables you to plan your investment in such a way so as to minimise your tax.

Have a plan and watch your investments grow

Discipline

Discipline is a key to managing your money better. Go through these points and add others. Having a discipline and planning for the future is a must. One must adopt a method, i.e., asset allocation and stick to investment in various assets and financial products without getting swayed by short-term changes.

Financial Plan

Determine your financial goals, get a certified financial planner to help you reach your financial goals based on the risk you wish to take.

Stick to your financial plan and do not get swayed away with new products and new promises. There are many investment proposals that promise to double your money in a year. There is a need to filter the advice of financial advisors.

Managing the Portfolio

Financial plans result in arriving at an asset allocation which takes into account risks, returns as well as liquidity. When there are changes in the market, asset allocation needs

to be reviewed. New offers like online investments, digital tax returns can be some of the change agents, we may have to learn to live with. Financial plans help in judiciously allocating money in different assets.

Buy Life Insurance

Buy the cover that you need today. Remember to get the terms plan first so that the sums assured is adequate for your family needs.

Close all unnecessary bank accounts

How many of us opened new bank accounts with each new job and haven't even checked the balance in these accounts in the past one year.

Pay full credit cards bill on due date

Remember if you do not pay the entire bill on the due date, interest is charged from the date of spending and not the due date for payment. That factor alone can push up the credit rate to over 40% per annum and this makes it probably the most expensive form of credit.

Source: The Economics Times

As evident, children are fast becoming part of the financial decision making process in their families. Awareness of personal finance enables them to reflect upon crucial details such as interest rates, mortgages, credit cards, saving, investment and expenditure and helps them to prepare for uncertainty in life. The value of living within one's means and saving as much money provides for a good financial outcome as well as a guarantee for the future.

CHAPTER 2

BUDGETING

When we get cash in the form of pocket money from our parents or salary from our employer on the first of every month, it seems to disappear very fast. What did we spend it on? We have nothing to show for it. This happens because we do not correctly assess our expenses and plan accordingly. Therefore, we need to be in control of our personal finances.

If we make a budget, a statement showing cash flows and a personal balance sheet we know what our position is and what further steps may be taken to control the situation. A budget, as we all know, is a statement showing future income, expenses and savings. It is based on some estimates.

These estimates are one income which are our source of cash inflows and expenses which are cash outflows. We need to prepare a personal cash flow statement which measures cash inflows and cash outflows. By keeping a check on our cash outflows we may be able to monitor our spending and allocate some amount towards savings.

Cash Inflows – Where does our cash come from ?

For working people, salary is the main source of cash inflows. Other sources may be interest from bank deposits, dividends on shares or rent from property.

Cash Outflows – Where does our cash go ?

Cash outflows are in the form of expenses. Expenses will include both large and small. In our daily life we incur so many small expenses like buying groceries, paying for our bus tickets, paying bills for telephone, water and electricity which may all add up to huge amounts. Paying rent, purchasing a car or paying your monthly instalments are examples of large expenses. It is normally the small expenses which go out of hand and is difficult to keep track of them. Recording these transactions will help you sum up your cash outflows.

Preparing a personal cash flow statement

Now that you have an idea of your cash inflows and outflows, it is easy to prepare a personal cash flow statement. First of all you need to record your cash inflows, i.e., how much is your income, how much cash you receive from interest or dividend or any other source.

Then, you may add up your expenses for that period (it may be monthly or annually). Thereafter, by deducting your expenses (outflows) from your income (inflows) you will arrive at the figure of net cash flows.

Some tips about budgeting

Budgets are necessary.

They're the only practical way to get a grip on your spending and to make sure your money is being used the way you want it to be used.

Creating a budget generally requires three steps.

- Identify how you're spending money now.
- Evaluate your current spending and set goals that take into account your long-term financial objectives.
- Track your spending to make sure it stays within those guidelines.

Electronic devices like mobile phone, calculator, digital diaries, laptop, etc., can be used for recording income and expenses.

You can create your personal financial statement so as to get a quick check on your financial position.

Don't overburden yourself. Monitor your spending but don't get over involved with accounting for every rupee.

Example

Arun after finishing college gets a placement as an Assistant Manager with a business firm exporting garments. The firm pays him a salary of ₹. 27,000/- per month. After paying taxes of ₹. 2000/- Arun wants to monitor his spending so he decides to prepare personal cash

flow statement for the last month. Arun does not have any other source of income from interest or dividends. He has expenses like travelling to his place of work, he pays ₹. 3000/- as conveyance p.m. to the taxi driver, his mobile telephone charges costs him ₹. 1000/-, he contributes ₹. 5000/- to household kitchen expenses, he decides to buy a gift for his parents for ₹. 2500/- from his first earnings and ₹. 3000/- he spends on tea/coffee with his friends.

Personal cash flow statement for Arun

Cash inflows

Salary	27,000
Interest on deposits	0
Dividend income	0
Less income tax	<u>2000</u>
Total cash inflows	25,000

Cash outflows

Travelling expenses	3000
Mobile telephone	1000
Household expenses	5000
Parents' gift	2500
Recreation (tea/coffee)	<u>3000</u>
Total cash outflows	14,500

Net Cash Flows $25,000 - 14,500 = ₹. 10,500$

The excess cash of ₹. 10,500 he can allocate to savings and other purposes.

Basically, to increase your net cash flows you will either have to earn more or spend less, i.e., maximize cash inflows and minimize cash outflows.

Factors affecting cash flows

We will have to analyse both cash inflows and cash outflows. It is only the net cash flows which enhance your wealth since you can save it or invest it further to earn a higher income.

Cash Inflows

Your income is the major source of cash inflows. Your qualifications and the stage at which you are in are the two factors affecting your income level. Then other sources are interest income, dividend, rent from property etc.

Stage in career path

People at initial stages of their career earn a lower salary. As they grow and develop in their career, their salaries increase, allowances increase, their experience enables them to get other higher post jobs, etc. This normally has a direct correlation with your age. The older you get your salary structure and status improve. But it may so happen that when jobs are changed older people do not get the commensurate salary. Your cash inflows or your salary therefore depends upon your career and the stage of your career.

Type of job

Some jobs are very well paid. In India, professionals or people with specialized skills earn much more. Engineers, management professionals, lawyers, are usually paid higher salaries. Doctors who are also highly qualified, unfortunately, in India, are not well paid. If you are self employed, then your cash inflows will depend upon the hard work and the time, energy and dedication you put into your work.

Number of working people in your household

The households' cash inflows also depends upon the other earning members in the household. Obviously, the household with more than one income earner will be more comfortable and the total cash inflows will increase.

Cash Outflows

Cash outflows are the expenses incurred on various items and assets. These depend upon the person's family size, age and consumption patterns.

Family size

If you are the only earning member and supporting a large family, then expenses will be high. It also depends upon the number of school going children where high fees are to be paid, expenditure on clothing, transport, etc., will also be high. Where the numbers of dependants are less, expenses are lower and these households normally have a capacity to save.

Age

As people grow older their expenses change and they may tend to spend on assets like cars, houses, land, etc. Their expenditure on school tuition fees, household items decreases and they have more cash to spare for purchasing a house or a car or going for vacations abroad. And then they may still have some money to spare for investing.

Personal consumption patterns

People have different consumption patterns, some like to spend extravagantly and spend most of their money on expensive things as soon as they get their salary. Middle class families usually spend their money in the beginning of the month and they are left with little to save. Then there are some people who are always saving for some contingency or some dream house they want to buy. Their expenditure is the bare minimum but their savings are large. Cash flows will therefore depend upon consumption behaviour. Savings will also depend on a family's/individual's consumption pattern and spending. Consumption pattern is also affected by the amount you have to spend. The income you earn will determine your consumption behaviour like if there are two persons earning in the family, that household spends more.

Preparing a Budget

In the personal cash flow statement, we recorded actual income, expenses and savings. If we need to find out net cash flows in the future we can forecast the cash inflows and outflows for each item on the personal cash flow statement. This cash flow statement based on forecast income and expenses for a future time period is called a budget.

A budget may be prepared to determine whether your income (cash inflows) will be sufficient to take care of the expenses (cash outflow) that you are likely to incur in the next month. It is possible that your expenses (out flows) are less in the next month and you may be able to save the excess amount of cash for purchasing something you want. Or else your expenses will

exceed your income (cash inflows) and you will have to make some kind of arrangement either borrow or pay through your credit card to cover your extra expenses. If you know in advance what is to be done, you are better prepared to face the situation.

In the same example taken earlier, suppose Arun anticipates his spending to go up next month by ₹. 1000/- due to extra travelling and he would have to pay ₹. 12,000/- towards his father's medical treatment.

Revised personal cash flow statement

Cash Inflows	Next month	Last month
Salary	27,000	27,000
Interest on deposits	0	0
Dividend income	0	0
Less income tax	2000	2000
	25,000	25,000
Cash Outflows		
Parents' gift	-	2500
Travelling expenses (1000)	4000	3000
Mobile telephone	1000	1000
Household expenses	5000	5000
Recreation	3000	3000
Medical treatment	14000	-
	27,000	14,500
Net cash flows	(-2000)	(+10,500)

Thus, we see that next month there is an unexpected cash payment of medical expenses for which Arun will fall short by ₹. 2000. He then has to arrange for this contingency.

Create your own budget

Assess your monthly expenses.

Make sure you record all your regular monthly expenses, including what you spend on eating out, entertainment and hobbies.

Total your earnings.

Calculate how much you make per month, including any money that you receive from investments and other forms of residual income.

Match your expenses with earnings. This will test how effective your budget is and how much you have left over at the end of the month.

Rework your budget.

If your expenses exceed your income; you will have to cut down unnecessary expenses.

Keep some money for debt reduction.

Your budget should have provision for paying off your debts each month.

In case of huge debts it is better to sacrifice and make a lump sum payment. A part of your income may be saved for an emergency, retirement investments, vacation, family celebrations, etc. These financial goals may be highlighted in your budget.

Put your budget to work.

Now that your budget is ready covering all expenses and financial goals, make sure you follow it and live within it.

Assess your budget

If you are not able to live within your budget, you need to limit your spending and rework your budget. Be realistic about your spending habits.

Why prepare a budget?

Preparing a budget actually helps in anticipating cash shortages, checking the accuracy of the budget and forecasting net cash flows for future .

Anticipating cash shortages

If you are likely to have a cash shortage in the next month you can make arrangements to overcome it. Maybe you could withdraw funds from another account and manage somehow. If the amount is large, you might need to borrow from a friend or relative or maybe take a loan against a fixed deposit or dissolve the fixed deposit. The deficiency can be covered if one is

forewarned and has sufficient time to arrange for funds. An emergency fund could also be created and some money kept aside for such purposes.

Assessing the accuracy of the budget

Since a budget is a statement of anticipated cash inflows and outflows, it will be generally prudent to compare the actual cash flows with forecast cash flows. Usually, we tend to overestimate cash inflows (income) and underestimate a cash outflows (expenses), as a result the net cash flows are less than expected. Budgeting, therefore, helps us to limit our spending so as to adjust to the limited income inflows. Or else, we try to increase our income to pay for those extra comforts.

Forecasting net cash flows

Budgets can be prepared weakly, monthly or annually. Expenses can be forecast months in advance and by following the same procedure a sum total of cash outflows can be determined. Similarly, if there are any other sources of income like interest on fixed deposits, or rent from property they can also be summed up for each period and net cash flows can be computed. In this manner, at least over the next few months, things can be quite accurately predicted.

Positive net cash flows

If positive net cash flows over a period of time are anticipated, you can plan for purchasing property, can or actually buying in instalments and pay equated monthly instalments (EMIs) towards owning an asset. These positive net cash flows are your savings which can turn into investments. You may invest your savings in fixed deposits, mutual funds, or share market.

Budgeting may enable you to value your financial health. In case there is any recklessness, which is impossible to eradicate, efforts can be made to minimise its influence. At the same time budgeting also ensures that your money plan grows steadily over a period of time. It generates a sense of financial well-being as we tend to be less stressed about managing money and are prepared for life's contingencies in future.

CHAPTER 3

MANAGING YOUR MONEY

Ashish working in a company manufacturing surgical equipment received his salary in the form of a cheque. He joined this company just about 25 days before. He was told by his company that salary for all its employees is given only through cheques and that he has to open a savings bank account in a nearby bank to get salary in cash. He was perplexed. Why? Later on, when he applied for a credit card he was told by the bank issuing credit card that he has to have a bank account, monthly statement and his financial transactions of his account for the previous six months. Why?

Managing money is an important component of our life. If we study in a school, college or in an institution, we need to learn to manage money we get from parents and guardians for paying fees, to buy books and stationary or to use as pocket money. As grown-ups, when we work for a firm or running our own firm, we need to learn to manage our incomes from our work or profits from our firms. In this chapter we will try to answer questions Ashish has raised and suggest him what to do.

In our day-to-day life, we manage our money in the form of coins and currencies and deposits with banks; we also use cheques, withdraw cash from automated telling machines (ATMs) using debit cards and purchase goods using credit cards. In India, besides banks, we also put our money in post offices as well.

Banks are financial institutions which collect funds from the people and place them in financial assets such as deposits, loans and bonds rather than in tangible property. We get a variety of services from banks ranging from selling gold to work as financial advisors. We get interest on savings we make and we are charged interest on loans we get from banks. You can also get similar banking services from post offices as well. Even though we do not get a variety of banking services that we get from banks, post offices play a very important role in promoting savings habit among people in rural and urban areas and at the same time contribute to country's development by meeting its financial requirements. In India, more than 150 banks with hundreds of their branches – both in public and in private sectors and nearly 1.5 lakh post offices play crucial role in managing our money.

We will learn some important banking services provided by banks and post offices such as (i) savings account; (ii) current account; (iii) fixed deposit and (iv) recurring deposit and support services such as (a) cheque book facilities; (b) ATM cum-debit cards; (c) financing credit cards (d) money transfer and the Internet and mobile banking facilities.

Savings Account

We can use this facility to save a part of our current incomes to meet our future needs and also intend to earn an income from our savings. Banks offer a reasonable rate of interest for our savings but impose restrictions on the savings account. From our savings account, we cannot withdraw beyond the stipulated amount within a given period. The number of withdrawals in a month or a day is also restricted. In savings accounts, we need to deposit a minimum amount in the beginning and also retain certain minimum amount with the bank. This amount varies if we want to avail other facilities such as cheque books.

Requirements for opening an account in a bank

Most banks in India require one of the following documents for opening an account.

Photo Identity: (i) Passport; (ii) Permanent Account Number (PAN) card; (iii) Voter ID card; (iv) Driving licence; (v) Government ID card; (vi) Ration card; or (vii) Senior citizen ID card.

Address Proof: (i) Passport; (ii) Telephone bill; (iii) Electricity bill; (iv) Bank Statement with Cheque; (v) Certificate/ ID card issued by post office.

Even though most banks insist on any of the above documents, you can also submit other identification proof which can satisfy the bank. When you visit the bank for opening an account, you need to produce before the bank only the original document(s) for verification along with a photocopy of each document.

Source: www.icici.com

Banks impose service charges on savings accounts when (i) minimum balance is not maintained and (ii) the number of withdrawals and amount of withdrawals

exceed the stipulated limit. Banks also have the discretion to waive these service charges to a few customers on certain grounds.

The rate of interest payable by the banks on deposits maintained in savings account is prescribed by the Reserve Bank of India. However, a few banks are authorized to give an additional interest of $\frac{1}{4}$ or $\frac{1}{2}$ per cent. At present, most banks including post offices pay about 3.5% as interest for savings account deposits. The rate of interest is paid irrespective of whether cheque book facility is availed by the account holder or not. Interest is paid on savings account to encourage people even with moderate incomes to save through banks and post offices. Now-a-days, in rural areas workers engaged in unorganised sector jobs such as works available under Mahatma Gandhi National Rural Employment Guarantee Act, 2005 and those working in private sector are encouraged to open savings account in banks and post offices. If you are a farmer, banks encourage you to open savings account and avail various banking services.

Discuss

Renuka and her husband sell vegetables on the roadside. They are able to save about ₹. 400 per day after meeting all the expenses of running the vegetable shop. They wish to put their savings either in post office or bank. Which one they can choose and why?

Post offices and a few banks issue passbooks containing our transactions with the bank. A few others such as ICICI do not have this option but keep their customers updated by sending a monthly statement. Some banks also give their phone numbers so that we can call over phone to know our transactions.

While there is no limit imposed by banks to deposit our savings, we can only save up to a certain amount in post office savings account. Individuals can save only up to ₹. 1 lakh. If the savings account is opened by more than one person, also known as joint account, you can save up to ₹. 2 lakh only. Income earned as interest is taxable in banks' savings account, no tax is charged on the interest received from post office savings account. In order to attract customers of different income groups, banks and post offices offer a variety of savings account facilities.

Minor Account

A child account is similar to regular savings account. However, it is opened under a minor saving account. The account includes a free passbook, a debit card on the permission of a parent, facility to transfer money from parents' account, cheque book and the Internet banking access. There is usually an additional balance account that parents must maintain for a child's account. Such accounts instill financial discipline in a child by familiarizing him to the banking world.

Children like Julie then are introduced to the fundamentals of banking transactions and facilities, such as debit cards, cheque books, fund transfers, withdrawal and deposits of money. Her parents are enabling her to decide on expenses and savings with an account. The account is opened in the name of Julie but her parents hold the transaction rights. The parents cannot use the account for depositing cheques received in their name. Julie is now introduced to the excitement and decision making skills imparted through the study of financial literacy.

However, in the absence of such course, a child needs the support of her parents to understand the implications of spending and saving. A stark reminder of financial indiscipline is the increasing chances of account being inactive when not used for a year. A child will not learn unless parents spend time with her.

At the same time child's account is aimed at infusing financial rigour. In case of misuse, the parents need to be strict with the expense. For example, one can deposit ₹. 5000 at the beginning of any month as a pocket money for let's say five months. In case she spends the entire money she will not get any compensation for the coming four months. In case of resistance the parents may give him nominal ₹. 300 to 500 per month. The amount can then be deducted after four months from his pocket money. In this way parents need to inculcate some discipline in the child.

Debit card is generally discouraged for a child unless coached about its use. Children are provided a separate login ID and password from the Internet banking. The cost related to child's account is the same as that of an adult. Bank charges are levied for transactions that exceed the limit. Banks do not waive off penalties because it is a child's account. Private banks charge ₹. 250-300 for violating the minimum balance requirements.

Source: The Economic Times

Current Account

It is another kind of account facility generally maintained by entrepreneurs, companies, institutions, government and private offices. By opening current account, we can do numerous financial transactions every day. Normally, money is withdrawn or payments are made through cheques. There is no restriction on the number and the amount of withdrawals from a current account. There are no interest payments for money kept in current account. Generally, banks do not collect any service charge for maintaining current accounts. Most banks do not provide any interest for current accounts. Current account carries certain privileges which are not given to a savings bank account holder. For example, (i) third party cheques¹ and cheques with endorsements can be deposited in the current account for collection and credit; (ii) overdraft facilities – you can issue cheque to make payments even if you do not have money in your account at the time of issuing cheques. The loans and advances made by the banks to their customers are not given in the form of cash but through current accounts. In this way, current accounts earn some interest on all the types of advances made by the banker.

Do you know?

Suppose you opened an account and deposit some amount and did not use for long time, say, for more than 10 years, what will happen?

Such accounts are known as non-operative accounts whose money is transferred to the bank's suspense account. The banks are required to issue notices to account holders to take back the money along with the interest. Banks are required to make all efforts to locate the customer and in case, it fails to find the person, the bank should contact the person who introduced the account holder. If the balance in such non-operative account is below the prescribed minimum amount and banks can recover the charges periodically and close the account.

Fixed Deposit Facilities

In fixed deposit accounts, we can deposit a specific amount for a specific period ranging from 15 days to 10 years. The longer the period we keep our money, higher

¹ Cheques drawn in favour of persons or entities other than the bank and the account holder.

will be the interest we get. The amount we deposit can be withdrawn only at the end of the specified period. However, if we need money, we can take a loan against our fixed deposit by paying interest.

Like banks, post offices also offer a variety of fixed deposit facilities with attractive interest rates and advantages. Any individual or two adults can jointly open the account. The minimum amount you can put in fixed deposit is ₹. 200. The duration of fixed deposit is 1, 2, 3, and 5 years and the rates of interest are 6.25%, 6.50%, 7.25%, 7.5%. The amount you earn from interest payments is compounded quarterly for 1, 2, 3 and 5 years. Unlike savings account in which you cannot save beyond a limit, post office fixed deposits allow to save as much as possible. People who save in post office fixed deposit account also need not have to pay taxes for the amount they deposit.² Suppose you have opened a fixed deposit account for either 2, 3, or 5 years, you need to wait at least one year to complete.

Post offices also offer an account facility called Post Office Monthly Income Account which ensures a regular monthly income. In this scheme, a maturity period (6 years) is fixed. Suppose you deposit ₹. 12, 000 with the post office, you will get ₹. 80 per month to your savings account. Rate of interest for such an account is 8% per annum. However, you can deposit only a fixed amount. For example, if you are an individual, you can deposit ₹. 4.5 lakh and the maximum limit for joint account of two adult persons is ₹. 9 lakh. If you want your deposits back for some emergency purposes or for putting into some other forms of investment, you may withdraw the amount after a certain period. In such cases, post offices deduct one or two per cent of your deposits and allow you to close your account prematurely.

Facilities for Senior Citizens

By now we are aware that rate of interest is an important consideration for people to deposit their incomes or savings. Post offices offer a deposit facility in which retired persons or persons aged 55 and above who are willing to deposit their savings and pension and other social security benefits for a specific period and wish to earn a high rate of interest regularly. Known as Senior Citizens Savings Scheme, this deposit account facility allows old age people either individually (aged 55 and above) or with their spouse to deposit up to ₹. 15 lakh. The rate of interest for this account facility is around 9 per cent with the maturity period of 5 years. As in the case of

² Benefits of Section 80C of the Income Tax Act, 1961.

other fixed deposit accounts, you can also close your accounts prematurely but the post offices will charge 1 or 1.5 per cent interest. These account holders need not have to pay taxes for the amount they save but will be required to pay a very small amount for the interest they earn. Suppose you have savings account facility in the same post office where you have deposited, you can convert your interest automatically to get credited to your savings account. You can also convert your savings you earn through your fixed deposit to recurring deposit so your income from savings rises. In this way, people save, put their money in post office in fixed deposits and earn rate of interest of around 10.5% per annum as well.

Read the following table showing interest rates paid by two large banks in India (with effect from October 2010) for fixed deposits and answer the questions given below.

Bank 1 – a public sector bank		Bank 2 – a private sector bank		
Maturity Period	Interest Rate	Maturity Period	Interest Rate	
	General		General	Senior citizens
15 days to 90 days	4.00	7 days to 45 days	3.75	4.25
91 days to 180 days	5.50	61 to 90 days	4.25	4.75
181 days to less than 1 year	6.00	91 to 184 days	5.75	6.25
1 year to 554 days	7.00	185 days to 269 days	6.25	6.75
555 days	7.50	270 days to less than 1 year	6.50	7.00
556 days to less than 2 years	7.25	1 year to 389 days & 591 days to less than 2 years	6.75	7.25
2 years to 999 days	7.50	390 days	7.25	7.75
1000 days	7.75	790 days	7.75	8.25
1001 days to less than 5 years	7.25	590 days, 2 years to 780 days, 791 – 989 days & 991 days to less than 3 years	7.50	8.00

5 years to less than 8 years	7.50	990 days, 3 years up to 10 years	8.00	8.50
8 years and up to 10 years	7.75			

Questions

- (i) Ram Prakash, a student of class X has been asked to advise his grandfather aged 65 to select a bank to put his savings for 3 years. Which bank can he choose and why?
- (ii) Ajit working as a sales executive in Ahmedabad likes to deposit his savings for not more than 5 years. Suppose he deposits ₹. 1.7 lakh, in one of the banks. Find out the differences in the interest he will get at the end of the maturity period.

Sweep Accounts: Make your idle cash earn more

Your deposit in savings account (SB) gives only a small return but is highly liquid whereas the fixed deposits (FD) earn relatively a higher return but are not liquid. In recent times, banks offer a deposit option combining the positive sides of both deposit facilities. Referred to as sweep, auto-sweep, flexi deposit or some hybrid scheme (for example, SBI has named as Savings Plus), this facility allows you to link your SB account to a FD.

Sweep accounts allow you to transfer some amount kept in savings account to fixed deposit, known as sweep-out. Sweep-in facility allows you to shift the required amount from FD to the SB account. Any amount that exceeds the pre-set threshold in a SB account is automatically transferred to the FD account, earning you a higher interest. If you need to withdraw some money that is more than the threshold limit, the required amount gets swept into your SB account. This arrangement eliminates the need to break the fixed deposit and you lose interest only on the amount that is actually used. Sweep accounts also do away with the need to keep a large sum in the savings account for liquidity which would earn only a small interest.

Source: *The Economic Times Wealth*

Recurring Deposit Facilities

There are other ways people save their money. For example, roadside vendors selling flowers, vegetables, fruits and all such things cannot save a large amount. Banks and post offices also have a provision for opening account facilities for such people. They can save a fixed amount every day, week or month for a fixed period. This is called recurring deposit. The interest we get in this account is relatively higher than what we get from savings account facilities.

One important recurring deposit facility available in post offices is 5-Year Post Office Recurring Deposit Account. Any individual or two adults jointly can open this account. We can deposit minimum of ₹. 10 per month (and the multiples of 5 and thereafter). In case we are not able to pay for a month, we can pay within two months. In these five years the account holder is excused four times for defaults of payment of instalment. We can also partly withdraw our savings (about 50% of the balance after one year). About 7.5% is paid as interest every three months. In case we get some additional income and wish to deposit in this account, we can also get a rebate.

Using Cheque Book Facilities

When we deposit money in our account in a bank, we can withdraw money from our account in many ways. We need to visit the bank and fill in the withdrawal form in which we can fill the details of our account and put our signature and submit along with the passbook to the bank. Bank deducts the amount we wanted from our account and will give us cash. The other way is to use cheques issued by the bank and withdraw money from your account or make payments.

Minimum Balance

In order to use cheques, we need to maintain a minimum balance in our account. This amount varies with locations we reside and banks. A few banks also provide cheque book facility with zero balance in the account as well. People maintain accounts with cheque book facility so that they do not have to carry much cash when making purchases.

Payment of Bills

Another advantage of cheque book facility is that if we want to send money to someone, it is safe to send the cheque rather than cash. Banks deal with account with cheque book facility in the following way:

Suppose you pay a telephone bill of ₹. 1500 to MTNL / BSNL by issuing a cheque. The MTNL/BSNL sends your cheque to the bank it has an account with. The bank electronically increases MTNL/BSNL account balance by ₹. 1500. At the same time, the bank reduces your account balance by ₹. 1500 if your account (with cheque book facility) is at that bank, or electronically signals to the bank where your account is to reduce your balance by ₹. 1500. When we get a confirmation from MTNL / BSNL about our payment, this also means the cheque we issued got cleared.

Suppose you do not have sufficient balance in your account, the bank will not honour your cheque and the MTNL / BSNL will return the cheque to you. This is called dishonour of cheque by the bank. As per the bank laws in India, you will be penalised for issuing cheque without having sufficient balance.

Keeping track of our money

One precaution we need to take while making payments through cheque is to record the amount in our cheque book so that we can always come to know how much money is left in our account. We can also check our balance through the Internet or as shown by the ATM. By keeping track of our account balance, we can make sure that the cheque does not bounce back. When our cheques bounce, we also lose credibility, even if we make payment without looking at our account balance unintentionally.

Updating Your Pass Book

Account holders look at their bank passbook to know their financial transactions and to know the balance amount. Since most banks in India have been computerized, when we ask bankers to record our transaction, they use printers and provide update of our transactions. Some banks send monthly statement containing our transactions. Whenever we engage in a financial transaction, particularly while making payments through cheques, we need to check with our cheque book transactions and mark off cleared cheques.

Let's do some calculation for knowing account balance.

Last month Kavita had a cheque book savings account with a balance of ₹. 5000. This month, she received her salary of ₹. 7000 to her account. She made payments through cheques totalling ₹. 7500 and all the cheques got cleared. She did not withdraw any funds from her account. Calculate her balance for this month.

Solution:

Last month's balance	₹. 5000
+ Deposits	+ ₹. 7000
- Cheques that cleared	- ₹. 7500
New balance	= ₹. 4500

We need to be careful while looking at the monthly statement to determine our bank balance. Suppose in a month you had no financial transaction in your account, the balance from your monthly statement should be the same as the balance on your passbook as long as all the cheques you issued got cleared. But if some cheques have not yet been cleared, the balance on your monthly statement will exceed the balance on your account by the amount of the cheques that have not yet been cleared. If you issue more cheques, you will land up in negative balance and cheque bouncing problem.

Clearing of Cheques

When we issue a cheque, our balance is not reduced until the time the cheque is cleared. The time between issuing a cheque until the money deducted from our account balance is referred to as the cheque float. This float is due to the time it takes for the bank where the cheque was deposited to contact your bank. Sometimes postal / courier delays also lead to delay in making payments. Earlier it used to take 3-15 days for clearing outstation cheques. Suppose you send a cheque from Kolkata to buy a book in Chennai from a book publisher, cheques and requisition form reach Chennai which would take 2-3 days and the cheque has to be deposited to the service branch of your bank in Chennai. All the transactions used to take 10-15 days. Now-a-days, due to the Internet and improvement in electronic communication, the float period has been reduced considerably to a few days particularly in cities. The local cheques in these cities – cheques issued for making payments within the same city get cleared even within a day also.

Post offices also issue cheque book facility provided we maintain ₹. 500, a minimum balance you need to keep in the account for using such facilities.

Bank to Bank Clearance Facilities

One limitation of cheque facility is that suppose you issue a cheque to your sister studying in a faraway place, your sister has to deposit your cheque in the bank

she has account and the bank will take a few days to transfer money from your account to her account. Even if you issue a cheque for somebody residing in your town or city, that person has to contact your bank to encash or will have to deposit in a bank and will have to wait till your money is transferred to his or her account. Cheques cannot be used as money. Suppose you are issued a cheque, you need to encash within six months from the issue date. Banks such as State Bank of India has also introduced a new facility called multicity cheques (see box) to attract customers to use cheque book facilities.

Multi-City Cheque

A multi-city cheque (MCC) is one that can be written by the customer in favour of his client and is payable at par at all branches of the bank. MCC can be issued in cheque operated accounts (SB and current), in addition to normal cheque books. The MCC facility is to be used only for genuine transactions / bona fide remittances. No cash payments will be made to third parties at other branches. The upper limit for issue of MCCs is ₹. 2 lakh. The issue charges for MCC are ₹. 3 per cheque leaf and will be debited from the account at the time of issue of the cheque book. There are no transaction charges.

Source: www.statebankofindia.com.

Automated Teller Machines (ATM Cum-Debit Cards)

Banks also provide their customers digitally made plastic cards popularly known as ATM-cum-debit cards for withdrawing cash from ATMs located in numerous convenient locations in the country. By using ATM card and entering the personal identification number (PIN), banks allow the ATM card holders to withdraw cash 24 hours a day, any day of the year. Banks issue ATM cards with a PIN. Banks suggest changing PIN frequently so that your card cannot be misused by other persons.

Banks also collaborate with other banks and credit card companies so that we can withdraw cash from ATMs of collaborating financial institutions or purchase goods and services using ATM cards. However, a limit on the total amount withdrawn in a day has been imposed. For example, in most ATMs in India, we can withdraw upto ₹. 10, 000 at a time. Also in a day, we can withdraw not more than ₹. 45,000. In case we wish to withdraw from ATMs other than your bank, we can withdraw

₹. 45, 000 in a day and up to 5 times in a month. A service charge is collected for every extra withdrawal from other ATMs. Duplicate ATM cards are also provided if we lose our ATM card.

Credit Cards

Credit cards are also one instrument through which credit card companies allow us to purchase goods and services on credit and pay in a stipulated time period, with or without interest payments. The time period and the interest vary with company. The most popular credit cards available in India are *Master Card*, *Maestro* and *Visa*.

How does a Credit Card Work?

In India, credit cards are mostly issued by banks and credit card companies. These cards are accepted by most business outlets. Banks honour transactions made on the credit cards. Credit card companies receive a percentage (commonly between 2-4 per cent) of the payments made to business outlets with their credit cards. For example, if you buy a colour television in a shop using *Master Card* and paid ₹. 10,000 in a retail shop, that retail shop will pay Master Card a percentage, about ₹. 200. Even though most retail shops accept credit cards, some shops require this 2 per cent to be paid by customers as they do not wish to incur this cost.

Banks collaborating with credit card companies, issue credit cards, send bills to credit card holders and finance when necessary. They provide financing facilities for credit card holders who choose to pay their balance in full when they receive a monthly statement. Banks benefit by providing financing facilities so that they could earn a high rate of interest on the credit extended. This is also one of the reasons why people do not use credit cards for purchases involving a large amount of money such as buying a house, car and so on.

Monthly Statement

We will receive a monthly statement in which the details of previous balance, purchases they made with the credit card during that period, cash advances, payments made, finance charge, new balance and the minimum amount we need to pay before the due date. The statement also shows the method of calculating interest rate or finance charge and the detail of various services and charges.

How to Apply for a Credit Card

When we apply for a credit card, banks require information to assess our ability to repay credit such as our monthly income, monthly expenditure, past history of borrowing and savings and the details of our assets. They expect positive details of all information. However, banks issue credit cards even if some requirements are not satisfactory. For example, for people working in the unorganised sector – working in private companies, banks extend a limited credit limit and issue credit cards. Some banks require the details of income and existing debt level to assess the existing debt level as a percentage of income. If your debt is only a small fraction of your income, banks provide credit cards. Some banks also extend credit at higher interest rates to individuals who they think have a higher risk of defaulting.

Credit card Debt trap

People usually don't understand a credit card statement. They wrongly interpret the minimum amount due, taking for granted that they have to pay 5% of the due amount. They never check that the company charges exorbitant interest on the remaining amount. It is advisable to use credit cards while travelling but one should remember to pay off the amount on the due date. When this is not done there is a danger of falling into a debt trap, especially when people use multiple credit cards and the revolving credit facility.

Use Credit Cards with Caution			
Card	Grace Period	Purchase Interest rate	Last payment charge
Kotak Trump Gold card	Up to 48 days	41.79%	₹. 300-600
Citibank Indian Oil Gold card	Up to 55 days	41.69%	₹. 300 for up to ₹. 10,000, ₹. 600 later
ICICI Bank Ebony Credit card	Up to 50 days	41.69%	30% of minimum amount due

Axis Bank Gold Plus card	Up to 50 days	39%	₹. 250-500
SBI gold credit card	Up to 50 days	41.80%	₹. 100 for ₹. 501-100 ₹. 350 for Rs 1001 – 10,000
Source: apnapaisa.com			

Specialised Credit Cards

Some companies issue credit cards for making purchases in their shops located within India and worldwide. For example, Petro Cards are issued by Indian Oil Corporation, a public sector company to buy petroleum products from its company outlets. Such retail cards are popularly used in developed countries. One disadvantage of these retail cards is that you cannot buy any other materials from other shops which make the general credit cards attractive. Credit cards are also of different types. Some cards known as gold cards or platinum cards provide extra benefit to card holders covering insurance. You will receive upgrade to a gold or platinum card if you prove that you are creditworthy by making more and more purchases and make your credit card payments on time.

Credit Limit

Banks issuing credit cards set a credit limit which specifies the maximum amount of credit allowed. This limit varies with individuals and is determined by the banks on the basis of creditworthiness of persons applying for credit card. Credit card providers also allow us to make purchase beyond our stated credit limit. This help in preventing situations in which we try to use credit card, but rejected as our maximum credit limit has reached. A separate fee is charged for such purchases. A similar fine is levied if we buy above the credit limit and without availing overdraft protection.

Free Credit Period

Whenever we make our payments through credit card, credit card companies allow a free credit period in which we are not charged any interest on our purchases. The free credit period is usually about 20-50 days from the time the credit card statement is “closed” (any purchases after this date are put on the next month’s bill) and the time the bill is due. This shows that credit cards provide us with free credit

from the time we made the purchase and the bill is due. However, credit card providers such as SBI allow using the interest free credit period only on retail purchases and if previous month's outstanding balance is paid in full.

Credit Card Charges

The interest that credit card holders must pay for using credit is called finance charge. It is generally calculated by the simple interest rate on monthly basis and annualised. For example, SBI card Finance Charges for an ordinary credit card is 3.35% p.m. (40.2% p.a.). Purchases after the monthly statement closing date are not normally considered when determining the finance charge because of the free credit period, as they will appear on our next monthly statement. The finance charge applies only to balances that were not paid in full before their due date in the current billing period. Credit card companies charge an annual fee for using their cards. However, some companies waive this fee depends on a variety of factors.

Other Schemes

Credit card companies float various schemes to attract people to use their credit cards and on occasions they also waive annual fee. Some companies also offer bonus to card holders by awarding points for each purchase. If credit card holders accumulate a specific number of points, they are offered schemes like free travel to tourist locations and so on. Credit card providers also make a tie up with many business firms and encourage credit card holders to buy goods and services at a discount rate.

Some banks also allow us to withdraw a limited amount of cash using credit card through ATMs. There is no free credit period and the interest rate is very high. For example, in SBI cards, if a person has credit limit of say ₹. 45, 000, the cash limit (as part of credit limit) is ₹. 18, 000. Out of this cash limit, one can withdraw about ₹. 12, 000 and ₹. 15, 000 for gold and platinum cards in a day. A fee called *cash advance fee* or 2.5 per cent of money if withdrawn from SBI ATMs or ₹. 300 is charged. The interest charged on cash advances in SBI cards is 3.35% per month (40.2% p.a.).

High Interest Rate if Payment is Postponed

People also use credit cards as a means of financing their purchases. This means, we can pay only a portion of the credit card bill at the end of the month and

the bank extends credit for the remaining period, but with interest. You can inform credit card providers that you wish to pay on monthly basis (EMI). Interest rate charged on credit is relatively high and ranges between 18% to 24% depending on the credit card provider and is calculated on an annualised basis and does not vary much over time. Although it is a convenient way of making payments for those who cannot make payments at one time, it is expensive and should be avoided if possible.

Using credit cards – some precautions

- (i) When we receive the monthly statement, we need to verify it carefully. There may be some arithmetic error, double charge for a purchase, or an incorrect amount on a purchase. Sometimes a wrong entry might have been included. For example, when you were issued the credit card, you were promised that there would be no annual fee. However, after 2-3 years of use, you may find a monthly statement having included the annual fee in your account. In such cases, we need to immediately contact the bank or credit card company about the new charges debited to your account. Credit card providers also specify duration say, 15 days (SBI card) and locations for jurisdiction for settling our disputes as required by our consumer protection laws.
- (ii) Due to aggressive marketing strategies, we tend to acquire too many credit cards from different credit card providers. This can complicate record keeping and increase the probability of losing one or more credit cards. It is better to use only one credit card to cover your purchases. In that case, we need to (i) ensure whether the credit card is acceptable to shops in which you use credit card most. MasterCard, Maestro and Visa are accepted by most shops; (ii) look for credit card that does not charge an annual fee and (iii) examine the interest rate / finance charges and other fees and choose a suitable credit card which has low charges and fees. Sometimes, credit card providers charge a very low interest but charge a high annual fee and other charges (for cash advances, late payment, service taxes, changes in the finance charges when late payments are made, fee for accessing credit beyond the maximum limit). Customers need to be cautioned of these hidden costs which the companies do not reveal to them.

Activity

You plan to apply for a credit card A because it has no annual fee, while credit card B has an annual fee of ₹. 3000. You typically have an outstanding credit balance ₹. 10,000 each month. Credit card A charges an annual interest of 40 per cent on balances carried forward, while credit card B charges an interest rate 30 per cent on balances carried forward. Which credit card you will choose and why?

- (iii) You need to do some basic arithmetic before choosing a credit card. Sometimes, credit card holders also specify that the low fee or charges are only for a short duration. You need to ask them the details of duration.
- (iv) The details of free interest period and whether such period is available for cash advances also are to be explored.
- (v) Use credit card only if you are sure to cover the payment before the end of free interest duration on or before the due date.
- (vi) Determine the maximum amount of credit you may require each month only after deducting for all your expenditure as well as a specific amount of savings.
- (vii) Avoid carrying a balance on your credit cards when you have money. You will not believe that the amount of interest you will earn on any other investment (keeping in savings bank account or invest in term deposits) would always be lower than interest payments you are making for credit cards. It may not be over exaggeration if we say that use savings if necessary to pay the credit card bills on or before the due date.
- (viii) If you are not able to avoid using credit cards, prioritise yourself that you pay the minimum amount you need to pay on due date. If possible, try to avail low interest loan facilities to pay the credit card debts because the credit card companies levy a variety of charges in such a manner that you will be forced to pay a huge amount in the end.
- (ix) Use ATM-cum-debit cards as they offer the same convenience of not holding cash but also will put a hold on your spending habits.

Using Money Transfer Facilities

Banking

Banks provide various money transfer facilities. Customers conventionally use banks for making payments through cheques and drafts facilities. Suppose you are residing in Chandigarh and have to send ₹. 10,000 to your friend in Bangalore. You can go to a bank in Chandigarh, hand over ₹. 10,000 with a small commission and ask for a bank draft on another bank in Bangalore. The Chandigarh bank writes a draft in favour of your friend in Bangalore directing the bank in Chandigarh to pay him the amount on demand. You can take the draft issued by the bank and post it to your friend in Bangalore. On receipt of it, your friend can submit the draft in the bank in which he has an account. He gets ₹. 10,000 deposited in his account. Similarly, money can also be transferred from one country to another.

Core banking transfer

It is another advance facility offered by banks. Suppose you wish to send / transfer money to your uncle having an account in another branch either within the town or city or elsewhere, you can pay the amount in the nearby bank / issue a cheque and request the bank to transfer the money to your uncle. Within a few minutes, your money gets transferred electronically. Some banks charge a small amount for this service and others charge only for large amounts. For example, State Bank of India allows us to transfer about ₹. 50,000 without any service charges on a day.

Other Services

People also use draft facilities to pay for various services provided by organisations or for paying institutional fees. Suppose you wish to apply for government job or for taking admission to a course offered by colleges and universities run by governments, people pay the required amount to the bank and get drafts and apply. When you apply for a draft for paying outside the city or town you are residing, it is called draft. For making payments within the city, banks issue banker's cheques. Similar services are also offered by post offices also. It is known as postal orders. Suppose you want to apply for a job in a central government office, you can ask for postal orders for the specific amount. Post offices have a printed postal order for specific amount. You can retain the counterfoil and send the postal order along with application form.

Post Office

Post offices also offer similar services. You are aware that you can send your money through money order. One advantage of money order is that you do not need to post anything as in the case of drafts. Post offices take the responsibility of paying the money to the payee and also the message you wish to pass on. These days, post offices allow us to know the status of money orders that we sent through telephone and the Internet facilities. However, the service charge for money order is relatively higher than the bank drafts. At present, post offices charge ₹. 5 for every ₹. 100 as money order charges (see Box for the details of service charges for bank drafts). One suggestion is that for making large payments beyond ₹. 1000, we should use draft facilities and for lesser amounts we can use money order facilities.

Internet and Mobile Banking

Going to post offices and banks and requesting their banking services to send or transfer money generally require sufficient time. Technological advancements provide a lot of options today. One latest option is the Internet banking. Suppose you have a savings / current account, you can approach your bank. After completing the formalities required by the bank, you will be issued two secret codes – a username and a password. Using these details, you can transfer your money or receive money from others electronically using computer and the Internet. You can also use this facility to pay your bills. For example, if you wish to pay for electricity, you can pay through the Internet banking facilities. The Internet banking allows you to check your account balance, view your account, request for a cheque book, drafts, banker's cheques, and give instructions to stop cheque payment. We can also give instructions such as request for third party transfers, invest and renew term deposits.

However, you need to take certain precautions while using these facilities. For example, you should not divulge the details of username and password to others (see box). Banks provide all such precautions when we approach them to avail this facility. Very recently, banks also enable us to use cell phones for money transfer and other services.

Using the Internet Banking: Some Precautions

1. Access your bank website only by typing the URL in the address bar of your browser.
2. Do not click on any links in any e-mail message to access the site.
Most banks including State Bank of India never send e-mail and embedded links asking you to update or verify personal, confidential and security details. NEVER RESPOND to such e-mails/phone calls/SMS if you receive.
3. Do not be lured if you receive an e-mail/SMS/phone call promising reward for providing your personal information or for updating your account details in the bank website.
4. Scan your computer regularly with Antivirus to ensure that the system is Virus/Trojan free.
5. Change your Internet Banking password at periodical intervals.
6. Always check the last log-in date and time in the post log-in page.
7. Avoid accessing the Internet banking accounts from cyber cafes or shared PCs.

Source: www.statebankofindia.com

Protecting your online transactions

When you are making a payment through the Internet using credit and ATM or debit cards, details like name, card number, CVV (card verification value) code, and expiry date are usually asked. All these could be misused by persons other than the card holder. To prevent this, the RBI directed in August 2009 that an additional level of security be provided for online payments. Visa and MasterCard offer facilities termed Verified by Visa (VBV) and Secure Code respectively. This can be done when you use your card to make online payment by contacting the registered merchant establishments. The list of member-establishments is available at www.visa-asia.com/verified or www.mastercard.com/securecode.

In India, for many of us, we may tend to feel that we do not have the choice of selecting a financial institution. By now you are aware that banks and post offices offer a variety of banking services and you have a choice depending on the amount of money you earn, spend and save. Three important issues you may consider before making a choice of financial institution.

The financial institution should be located close to your residence or workplace. You also have to see its ATM network. It should provide all the banking services you require in the long and short term. Sometimes, you may not have the Internet facilities. You need to see whether you are able to do most financial transactions without modern gadgets such as computers and the Internet.

You are aware that interest rates offered on deposits vary with banks. Depending on your financial position, you will have to do some arithmetic to estimate your income earned from interest rates. You may also need to borrow from your financial institution. You have to see whether they provide loans to their customers with low interest or not.

Many banks do not operate physical branches all over the city. They may deal mostly with ATM counters and through the Internet. They may also tend to pay a higher interest rate on deposits than institutions with physical branches because they have lower expenses and can afford to pay higher deposit rates. We must weigh the trade-off between high deposit rates and other facilities at these financial institutions.

Banks and post offices charge fees for various services. For example, if you issue cheques beyond the free-limit, you will have to pay a fee for additional cheques issued. Similarly, commission for making demand drafts and core transfers also vary with banks. Choose the one which charges you a low fee.

We need to read all the instructions given when we deal with a banking service, whether it is with credit card, ATM card, or any other deposits. Reading the instructions carefully and enquiring from the staff of financial institutions can help us to understand and benefits of their services better.

Websites

www.statebankofindia.com

www.indiaposts.in

www.icici.com

www.rbi.org.in

CHAPTER 4

FINANCING ASSETS

Personal assets represent items of utility or comfort which people purchase, as they earn, usually over their lifetime. They are different from items of daily use such as food items, cosmetics, clothes, etc., because they usually last for a much longer period of time, and the owner does not have to replace them frequently.



The same is not the case with items like a toothbrush, or a t-shirt – they wear out soon.

However, personal assets also tend to be much more expensive than items of daily use – good examples of such are a house, a piece of land, a car, an expensive computer, etc. The purchaser of personal assets may need to seek financial help to arrange money to complete the purchase. We will discuss the types of financial help available to people to complete the purchase of various types of personal assets.

Loan

If you plan to buy an asset, you may seek a loan from a bank or a financial institution (called ‘lenders’) against the security of the asset. The loan is provided at the time of purchase and it can be repaid over a period of time through instalments. The security of the assets means that the lender can seize the asset in case you fail to pay the loan back, either partly or completely – this is called ‘default’. In case of you ‘defaulting’, the lender can retrieve the lent money by selling the asset.

Applying for a loan

While applying for a loan, you need to provide information about your personal financial position to the lender to show your ability to repay the loan. Your personal financial position means a record of the assets you already own, the debts you owe to other people or lenders, and your monthly/ annual income and expenses. A loan contract is made between you and the lender which specifies the amount of loan, the rate of interest, the repayment schedule, maturity time

and the collateral (security of an asset to back the loan). Mostly, the asset to be purchased serves as security to the lender. If you buy a house on loan, and do not repay the loan, the lender can seize the house and sell it to recover the money lent to you.

Repayment of loan

EMIs or Equated Monthly Instalments are used, in most cases, to repay loans taken to finance personal assets. EMIs are calculated in such a manner that the same amount is payable by the borrower to the lender every month over the tenure of the loan, and by the time the last EMI is made, the entire loan amount is repaid. The critical thing about understanding EMIs is that this amount captures both the repayment of the loan principal, as well as the loan interest.

Managing your personal finances well is the key to leading a secure life. You must always correctly estimate the amount of assets you can purchase, and also keep a check on your expenses. Losing track of these and over-estimating your purchasing capacity, say by taking a loan, for which EMI payments are more than what you can bear, could lead you into financial troubles.

Education Loan

Acquisition of any type of asset requires money. If you do not have the entire quantum of funds required to obtain the desired asset, you turn to financial institutions, mostly banks, which provide funding in the form of loans. Human resources are a part of the social capital of a country.

Why Education loan?

Education creates academic and professional skills and knowledge in human beings, thereby creating human capital. People use such skills to gain employment and generate income for themselves. Thus, it is important that no deserving student is denied education for want of funds. Financial institutions provide loans to support education, and development of skills to sustain the social capital of the nation. The objective of these loans is to bring education within the reach of students and help them improve their future prospects.

Amount

The loan amount ranges from ₹. 1 lakh to 10 lakh. The foremost criteria for obtaining an education loan is that one must have secured admission to a general / technical course in India or abroad. It is generally provided to people within the age group of 16-26 years.

Composition: What does it include?

Education loans may cover apart from the tuition fee, a list of other expenses like boarding costs, costs of books/stationary, and other ancillary expenses. The entire cost incurred to complete the course is not financed by the bank. A certain portion, called margin, has to be paid by the applicant as his own contribution. If the loan amount exceeds ₹. 4 lakh, you are required to pay 5 per cent of the amount as margin money. It means if you want a loan of ₹. 5 lakh, you are required to pay ₹. 25,000/-, the rest will be paid by the bank.

Processing of loan

A processing procedure entails submission of the loan application form, along with the mark sheet of the last qualifying exam, proof of admission, schedule of expenses during the course period, bank statement and details of asset which is not fixed and varies according to the course. A processing fee is usually charged by the loan granting institution, which has to be either paid separately by the applicant, or is deducted from the amount disbursed as loan.

Repayment of loan

The repayment has to begin immediately after the student secures employment or six months post the completion of course, whichever is earlier. The repayment tenure is between 5 to 7 years repaying the amount (student or co-borrower) can claim a tax deduction on interest paid on this loan under section 80E.

Education Loan

Interest rates on education loans in India range from 10-13% per annum, depending on factors including the lending bank, loan amount and collateral offered.

For **female students**, most banks offer a concession on 5100 basis points in interest rates.

Repayment has to start 6 months after the completion of the course, whichever is earlier.

The repayment period ranges from 5-7 years.

Deduction from income tax payable can be claimed under section 80E on the interest paid.

Banks can ask for **margin money** of up to 15% of the loan amount for loans exceeding ₹. 4 lakh.

Query

✦ **I did my masters from a Spanish university. The university helped me obtain a loan for Euro 20,000 from a local bank to help me pay my tuition fees. I have to pay back the loan in Euros over four years in quarterly instalments. After the course, I have been working in India and transfer money to my loan account in Spain. Can I get any tax exemption on this loan repayment?**

Section 80E of Income Tax Act says that the education loan should have been obtained from 'a financial institution' defined therein. A foreign bank (operating outside of India) does not fall under the definition of a financial institution. Hence, you cannot get any exemption under the section.

Source: *The Economic Times*, November 24, 2009.

Case Study

Rahul needs admission in ABC College which has a total fee of ₹. 5,00,000 for a 5-year course. His father has ₹. 1,00,000 cash in a fixed deposit account which, if and as required, can be spared for his son's admission to the college. However, the balance amount needs to be funded through a loan from a bank. Rahul has the option to approach any of the five banks as shown in the table. The choice of bank from which Rahul will take loan will depend on the terms and conditions on which the loan is given by each bank. These are shown in the table. Major conditions to be noted are:

- (i) Rate of interest on loan
- (ii) Period of repayment (tenure)
- (iii) Own contribution (margin money) needed by the bank from the borrower, and
- (iv) Total equated monthly instalments (EMIs)

Bank Name	Great Bank	Small Bank	Huge Bank	Square Bank	Earth Bank
Total Fee	5,00,000	5,00,000	5,00,000	5,00,000	5,00,000
Own Contribution	0	25,000	50,000	75,000	1,00,000
Loan Amount	5,00,000	4,75,000	4,50,000	4,25,000	4,00,000
Loan Interest (%)	12.00	12.25	13.00	11.75	11.50
Tenure (years)	5	5	5	5	5
EMI	11,122	10,626	10,239	9,400	8,797

Rahul may calculate the best option available to him on the basis of above terms and conditions and decide the bank from which it is profitable to obtain the loan.

Rate of interest and period of repayment

First, Rahul will look at the rate of interest and the period of repayment of loan. Usually, if the rate of interest is lower and the period of repayment is longer, the cost of the loan is lower. In this particular case, the period of repayment of all loans is the same. Hence, this is not a consideration, and Rahul will be guided by the rate of interest alone.

Margin money

However, in making his choice, Rahul should also consider the fact that he will save money if he is not required to give margin money. In case of the Great Bank, savings of Rahul's father will not be used as margin money and thus will earn interest on his fixed deposit. This income will reduce the total cost of the loan for him.

Interest lost on fixed deposit

In case of the Earth Bank which requires margin money, Rahul's father will have to lose his fixed deposit in order to pay the margin money. Thus, he will lose interest on the fixed deposit. The total cost of the loan should therefore include the interest lost on the fixed deposit in this case.

Equated monthly instalment

Rahul will also need to know the amount of EMI before deciding on the loan as the EMI is linked to his father's capacity to repay the loan. If the EMI is very high for his father's monthly

income, Rahul will find it difficult to service the loan over the long term. He will have to choose the loan with lower EMI.

Thus, the choice of loan to be obtained by Rahul from any bank will depend on all the above considerations

Let us do some calculation

You are planning to buy a laptop which costs ₹. 1 lakh. Given below is a chart which shows the EMI for a loan of ₹. 1 lakh.

Interest Rate @	5 Years	10 Years	15 Years	20 Years	25 Years
8%	2,028	1,213	956	836	772
10%	2,125	1,322	1,075	965	909
12%	2,224	1,435	1,200	1,101	1,053
15%	2,379	1,613	1,400	1,317	1,28

Source: *The Economic Times*

There is a calculator given here to calculate your EMI. If you take a loan of ₹. 50,000/- for 10 years at the interest rate of 12%, what will be your EMI?

Purchasing a Car

Which car to buy?

When you decide to purchase a car, the first thing you have to do decide is your budget and make an effort to stay within the budget. The next thing is about the size and brand of the car and make a list of the selected cars. You have to decide whether you want a petrol car, a diesel or a CNG car. You have to see how much total mileage the cars give per litre of petrol. Certain other factors also have to be considered, such as insurance charges, repair charges and resale value of the car. These factors differ in case of different cars.

You can find out these details either by newspapers/the Internet or through car dealers directly.

You can also discuss with your friends and relatives who own the cars which you plan to buy

Negotiating the price

Some of the car dealers negotiate prices, although this is not common. Also, in course of the negotiation, the dealer may offer you free insurance for 1-2 years, free music system and interiors at reduced prices. These features are priced at a higher than market price to make you feel that you are getting a good deal.

Car loans

In most of the cases, the organization you are working with also provides loans to their employees. There are a few standard types of car loans available in India. You can choose the one which suits your repayment capacity.

Margin money scheme

Here the customers are required to pay only the margin amount of money, i.e., 10 or 20 per cent of the total cost of the car along with the first instalment of EMI. The balance amount is paid through post-dated cheques. This is the most sought after scheme as it has a repayment period of 1-5 years, thus resulting in the lowest EMI.

Security deposit scheme

The consumers are required to deposit a particular amount of money as security deposit against the amount provided as loan. The EMI under this scheme is normally higher than other schemes. However, the security deposit also earns an interest and is returned after the maturity of loan to the buyer.

Hire-purchase scheme

Under this scheme an agreement is made between the owner of the car (the 'asset') and the user of the car for its hiring. The agreement is made in such a way that the hirer of the car has the option of purchasing the car in accordance with the terms of the agreement. This scheme is offered by non-banking financial institutions.

Financing plan

Once you decide a particular car, you should estimate the monthly repayment of the loan you may take to finance the car. For example, Anita plans to buy a car. She has shortlisted two cars, one costs ₹. 5,85,000.00 and the other costs ₹. 4,75,000.00. She has to decide the amount of down payment and the amount of loan. She has to make a comparison between some of the cars shortlisted by her.

Down Payment and Loan Amount

	Car I	Car II
Purchase Price	₹. 5,85,000.00	₹. 4,75,000.00
Down Payment (out of savings)	₹. 1,35,000.00	₹. 1,75,000.00
Loan Amount needed	₹. 4,50,000.00	₹. 3,00,000.00

Now she can compare between these two cars. After the decision is taken, she has to compare her monthly instalments for both the cars. Suppose she gets the car loan at an annual rate of interest of 9 per cent, she has to calculate how much monthly payment is required on EMI basis to repay the loan over 3 years, 4 years or 5 years. For this, she will do the following comparative analysis.

Monthly Loan Payments on EMI basis @ 9% rate of interest per annum

	<u>Loan Amount (₹.)</u>	
Loan maturity	4,50,000.00	3,00,000.00
36 months (3 years)	14,310.00	9,540.00
48 months (4 years)	11,199.00	7,466.00
60 months (5 years)	9,342.00	6,228.00

Anita notices that the amount of monthly repayment decreases if she extends her loan period. If she borrows ₹. 4,50,000.00, her EMI will be ₹. 14,310.00 for a three-year loan, ₹. 11,199.00 for a four-year loan and ₹. 9,342.00 for a five-year loan. The other alternative through which she can reduce her loan amount is to borrow a lower amount such as, ₹. 3,00,000.00.

Purchasing a House

If you plan to buy a house, you have to take into account certain financial considerations:

Affordability

It is advisable to be within your purchasing capacity and avoid purchasing a house that is not affordable. Financial planners suggest that the price of the house should be not more than double the gross annual income of the purchaser. Similarly, the monthly household debt payment

(including the loan taken to purchase the house) should be no more than about 40 per cent of total monthly gross income.

Insurance

If you choose to buy insurance on your house, then a bigger and costlier house requires high insurance than a smaller one as it costs more to replace parts of the house that are damaged.

Taxes

Taxes are imposed on houses to pay for local services like park, school, etc, in the vicinity. The taxes are calculated annually and they range between 1-2 per cent of the market value of the house.

Resale value

Many people buy a house with a plan to sell it after a few years. The resale value depends on the location of the house. You can calculate the resale value by knowing the value of similar properties in that location that were sold a short while ago. Resale of houses also involves a commission that is usually 2 per cent of the selling price and is shared equally by buyers and sellers.

Price approximation

On the basis of the above-mentioned considerations, you may shortlist three or four desirable properties which match with your preferences. In order to estimate the average price of a house in your preferred location, the below mentioned calculation can provide a good guidance:

Suppose you want to purchase a home with an area of 1,100 sq. ft. You have shortlisted 4 houses of your choice in your preferred location, and also have the price and size of each –

Size (Sq. ft)	Price (₹.)	Price per sq. ft (₹.)
1200	60,00,000	$60,00,000/1200=$ 5000
1000	48,00,000	$48,00,000/1000=$ 4800
900	42,30,000	$42,30,000/900=$ 4700
800	30,00,000	$30,00,000/800=$ 4500

Based on these prices, you can calculate/assess the average price of the house based on the price per square feet. This would approximately be ₹. $(5000+4800+4700+4500)/4 = ₹. 4750$. Since your requirement is for a house having a size of 1,100 sq. ft, its market value will be average price per sq. ft multiplied with area (in sq. ft) of the house. The estimated price in this case, is ₹. $4750 \times 1100 = ₹. 52,25,000$.

Negotiating a price

Once you finalise the location and size of the house you want to buy, you need to negotiate the price with a seller. You want to make sure that you do not pay more than you need to pay. The seller quotes a certain price of the house, say ₹. 58,00,000. You can try to negotiate the price by offering a lower price, i.e., ₹. 45,00,000, keeping the average price assessed by you as your reference. The seller may accept your offer or reject it or may tell you to revise it. After negotiations, the seller may lower the price but you may find it still higher than you are prepared to pay. Now, it depends on you whether you accept it, reject it or request the seller to further lower it. This goes on until the seller and you come to an agreement. In case you negotiate hard and are able to convince the seller, the final price may be agreed at a point somewhere in between the average price (assessed by you on the basis of average price) or the price offered by the seller.

Hidden Price!

Your dream house may come at a hidden price. Before you work the maths for buying your precious house, make sure that you have done enough homework and have sufficient funds to pay for 'extra' costs. Apart from the cost of the property in question, which is calculated as price per square feet, the cost of the house may actually turn out to be higher. The first additional cost the buyer will incur is stamp duty. Since most properties in India are bought through home loans, one has to consider the cost of the insurance policy to cover the home loan, which may add up to a sizable amount. Further, society charges towards maintenance and a yearly property tax are other costs that most buyers do not consider prior to purchase. In some of the housing societies, a number of facilities such as swimming pools, gymnasium, community centres, landscaped garden also involve all time additional cost. If you are buying a resale property you should check about the outstanding registration cost. It is advisable to negotiate with the seller and ensure that he bears the registration cost before you buy the

house. Certain liabilities pass on with the ownership such as electricity and other property tax dues. Telephone services too refuse new connections for address where previous bills remain unpaid.

Source: The Economic Times

Mortgage Loan

A mortgage loan, in simple terms, is a loan given to consumers to purchase a house – it allows the lender to take possession of the house in case the borrower defaults, and sell it to recover the lent money. A mortgage is a legal agreement which assigns the ownership of the house to the bank or lender till the loan is fully repaid. Since this legal agreement (or mortgage) is an inherent part of the loan sanctioning procedure by banks or lenders, such loans are called mortgage loans. In a mortgage loan, usually the bank expects you to cover a portion of the total price with your own money, which is known as ‘down payment’, and is usually 10-20 percent of the total price. Lenders (banks or financial institutions) give mortgage loans at different rates of interest. You should obtain a mortgage loan that has a low interest rate, as this will help keep the monthly instalments lower than those paid at high interest rate mortgage loan. The maturity period of mortgage indicates the duration by the end of which you will be required to pay off the loan. Shorter maturity period mortgages loans have higher monthly instalments, but also help in reducing the interest paid on the loan and, in turn, the total amount of repayment. The benefit of longer duration loans is that you have smaller monthly instalments and you have more cash available on hand with you.

If the cost of house of your choice is ₹. 52,25,000. You make a down payment of the total amount of loan, i.e., ₹. 5,22,500 (10% of the price) out of your own savings. You need a loan of ₹. 47,02,500 from the bank at the rate of interest of 9.50% per annum. Now you have to take a decision whether you will take the loan for a period of 10 years or 20 years. You can make a comparison between the repayment schedule of the short and long duration loans.

20-Year Repayment Schedule

Timeline	EMI No.	EMI	Interest	Principal	Outstanding Principal
1 Month	1	43,833	37,228	6,605	46,95,895
2 Years	24	43,833	35,915	7,919	45,28,665
4 Years	48	43,833	34,265	9,569	43,18,613
6 Years	72	43,833	32,271	11,562	40,64,797
8 Years	96	43,833	29,862	13,971	37,58,100
10 Years	120	43,833	26,951	16,882	33,87,504
12 Years	144	43,833	23,434	20,399	29,39,696
14 Years	168	43,833	19,184	24,649	23,98,589
16 Years	192	43,833	14,048	29,785	17,44,745
18 Years	216	43,833	7,843	35,991	9,54,676
20 Years	240	43,833	344	43,489	0
			58,17,533	47,02,500	

10-Year Repayment Schedule

Timeline	EMI No.	EMI	Interest	Principal	Outstanding Principal
1 Month	1	60,849	37,228	23,621	46,78,879
2 Month	2	60,849	37,041	23,808	46,55,071
1 Year	12	60,849	35,088	25,761	44,06,374
2 Years	24	60,849	32,531	28,318	40,80,857
3 Years	36	60,849	29,720	31,129	37,23,034
4 Years	48	60,849	26,631	34,218	33,29,698
5 Years	60	60,849	23,235	37,614	28,97,324
6 Years	72	60,849	19,502	41,347	24,22,038
7 Years	84	60,849	15,398	45,451	18,99,582
8 Years	96	60,849	10,887	49,962	13,25,272
9 Years	108	60,849	5,929	54,921	6,93,964

10 Years	120	60,849.20	477.94	60,371.26	0.00
			25,99,404	47,02,500	

Thus, you look at the total repayment schedule, principal as well as interest, for both 10 years and 20 years mortgage loans which are as follows:

	20-Year Mortgage Loan	10-Year Mortgage Loan
Total Principal Payments	47,02,500	47,02,500
Total Interest Payments	58,17,533	25,99,404
Total Payments	1,05,20,033	73,01,904

As evident from the above table, you will pay ₹. 32,18,129 more in interest with 20-year mortgage loan than with 10-year mortgage loan. Now the decision is yours, whether you want to pay off loan in 10 years and save ₹. 32,18,129 or repay it in 20 years.

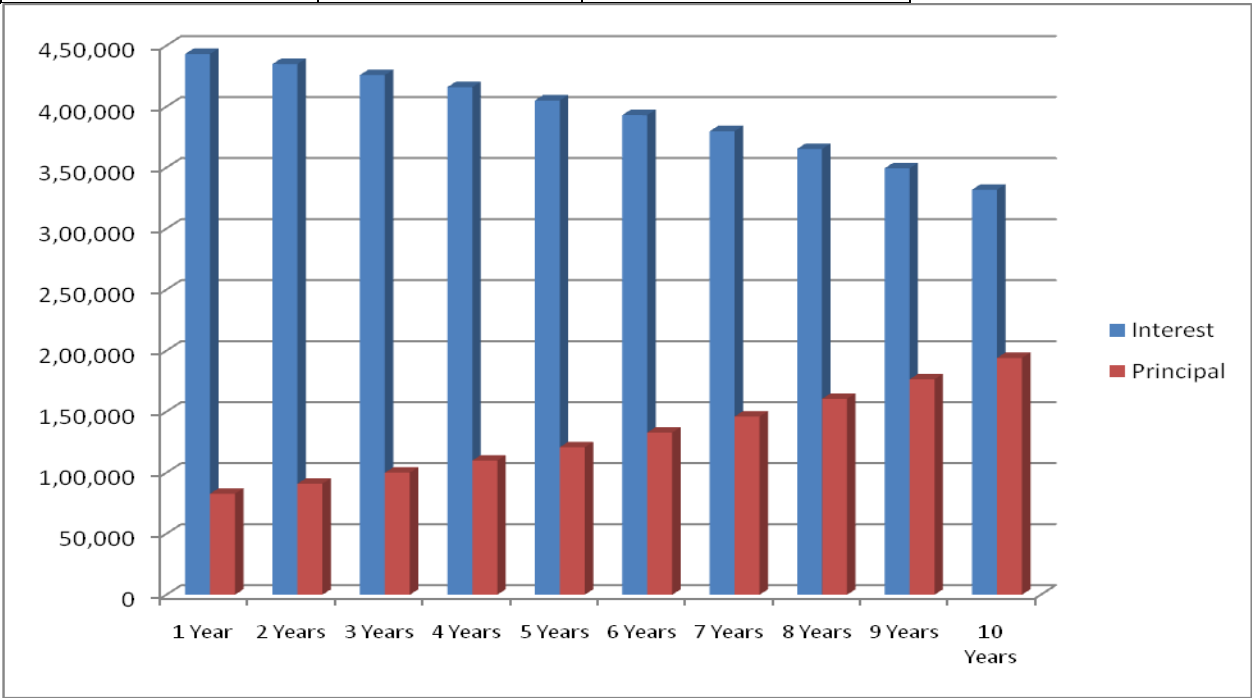
Allocation of Repayment between Principal and Interest

You have taken ₹. 47,02,500 as loan on 9.5% interest rate. The table below shows how your loan payment is allocated between principal and the interest payment each year. You will notice how the initial payments are allocated mostly to interest payment with a relatively small amount used to pay off the principal. For example, in the second year, the total interest payment is ₹. 4,34,975 and the principal amount paid is ₹. 91,027. Thus initially most of your payment is needed to cover the interest owed. As time passes, the proportion of payment allocated to the principal increases and interest payment decreases. Notice that in the 20th year, the total interest payment is ₹. 26,096 and the principal amount paid is ₹. 4,99,905.

Allocation of Interest versus Principal per year on ₹. 47,02,500 at annual interest rate of 9.5% for a 10 year loan

Timeline	Interest	Principal
1 Year	4,43,193	82,808
2 Years	4,34,975	91,027
3 Years	4,25,941	1,00,061

4 Years	4,16,010	1,09,992
5 Years	4,05,094	1,20,908
6 Years	3,93,094	1,32,908
7 Years	3,79,903	1,46,099
8 Years	3,65,403	1,60,599
9 Years	3,49,464	1,76,538
10 Years	3,31,943	1,94,059



Thus we see that it is not difficult to purchase any asset or enrol for higher education or study abroad as there are many options available to pursue your goals of life. You need to be confident of your decisions as there are various schemes that can simplify your repayment schedule.

CHAPTER 5

PROTECTION OF ASSETS

You must have heard your parents talking about payment of insurance premiums or seen your friends, elder brother or sister applying for an auto insurance. Do you know what this premium is and how it is determined? How does insurance actually help?

Let us assume that there is a colony which has 1000 houses valued at ₹. 15,00,000 each. All these owners need to protect their property against uncertainties like fire, theft or any other damage to the house. They pay a certain amount say ₹. 10,000 as premium to an insurance company to protect themselves against any loss. The insurance company, thus, pools the amount paid as premium by the owners and assures them that it would compensate the house owners in case of any loss by fire, theft etc. The owners benefit by such an arrangement as by paying a sum of ₹. 10,000 annually, they are now assured of protection against risks or uncertainties since they will be compensated by the insurance company. The insurance company will pay the amount from the premiums which it had charged from the owners.

In case there is fire, the owners who have got their property insured and paid the premium on time will be compensated by the insurance company. In this manner, the economic burden is shared by all the house owners in the colony. Since all the house owners are contributing premiums, the insurance company is able to pool this premium into a fund or corpus and accordingly when required compensate the owners against the loss. The probability that all the houses will be on fire is very remote, hence the insurance company also benefits by this agreement and the owners too are assured in exchange for a premium. This means if the risk is higher the insurance company will charge a higher premium.

There is also a chance that some owners may refuse to contribute to compensate the victim. The insurance company then needs to collect funds in advance to meet the loss. This will require some calculations on the basis of past experience to estimate the amount of loss. Here, it is presumed that 2 out of 1000 houses may burn or bear loss annually. This also means that contributions made by the landowners annually may increase to ₹. 15,000. The increased sum will meet the cost of loss as well as other expenses incurred in the operation of the programme.

By paying a certain amount as premium, the owner is protected against the risk of uncertainty. In insurance, we can say, the risk is transferred or shifted from one person to a group (i.e., all the owners) and a person's loss is shared by all the members of the group.

From the above example we can say that insurance is a protective device to one's health and property. In this case the individual incurs a certain cost (the premium) for a large uncertain financial loss (the contingency insured against) that would exist if there were no insurance.

Can you manage risk in life?

When any individual buys insurance, he/she transfers a portion of risk for compensation to the insurance company. The company in turn provides him/ her protection at a price, but it's a fraction of recurring expense borne by you annually. It is true that events cannot be predicted but the probability of events occurring can be calculated on the basis of past experience. Henceforth, steps need to be taken to reduce the chance or extent of loss to one's health and property. For example, the use of seat belt in the car can reduce the chance of auto injuries and deaths. Therefore, we buy an insurance policy and we transfer the risk to the insurance company in exchange for a fee called premium.

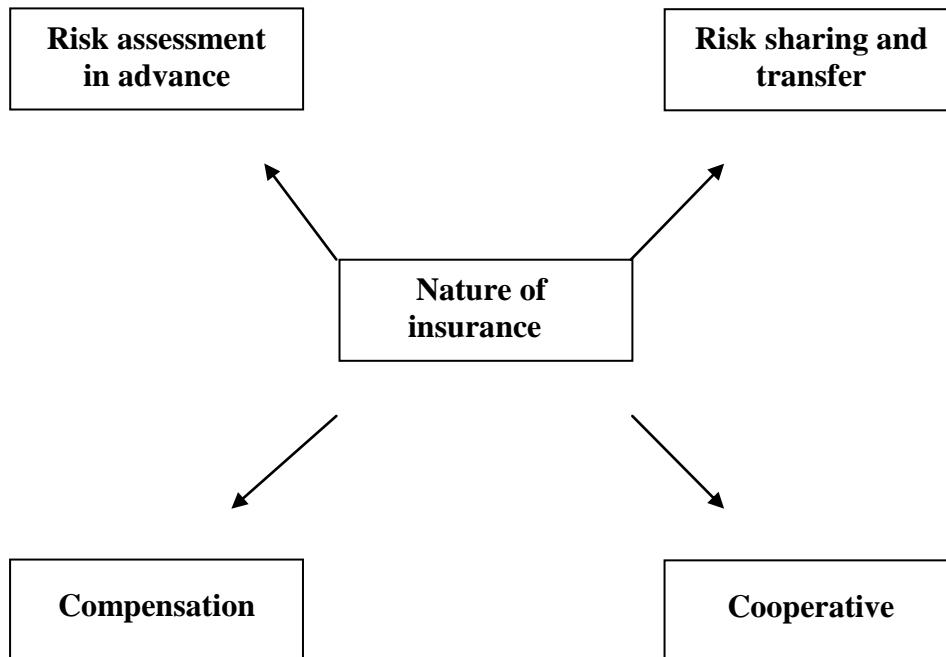
Nature of Insurance

Insurance is a cooperative device under which a group of persons who agree to share the financial loss to either of them may be brought together voluntarily by a registered company. These companies are called insurers and are the risk bearers. They provide insurance to the customer / client who are called the insured. The risk is evaluated by the insurer and an amount is charged from the insured. This amount is called the premium. The insurance companies provide insurance policies. These policies are legally binding contracts between the insurer and the insured. The insured or the policy holders pay insurance premium to the insurance company for sharing the risk.

Insurance provides security and safety to an individual and guarantees payment in the time of loss. It ensures compensation for losses suffered due to the incident on unanticipated events.

It has two fundamental characteristics:

- Transferability or shifting of risk from an individual to a group
- Sharing of loss, equally by all the members of the group



Elements of Insurable Risks

It is not feasible for an insurance company to ensure all kinds of loss, rather few elements of loss can be insured at a reasonable price. In fact, insurers are not willing to accept all the risk that client may wish to transfer to them. Certain characteristics should exist to be considered as a proper subject for insurance. For example:

- (i) The loss produced by the risk must be definite and measurable
- (ii) The loss must be fortuitous or accidental
- (iii) The loss must not be catastrophic

What the customer expects?

The customer expects information on different products, i.e., policies, their terms and conditions (grace, waiting periods, and exclusions). The customer may desire that particular insurance policy should be linked to her needs. For example, a parent who is worried about the future of her child would prefer educational loan to retirement policy.

There should be active involvement of the company at the times of settlement of claims. There should also be regular contact with the company to dispatch payment to the customer when policy matures or to ensure payments in times of emergency. The company should make effort to instantly dispatch policy document, health card and other claim settlements.

Functions of Insurance

The purpose of insurance is generally to protect the insured against uncertainties.

Certainty

Insurers reduce the uncertainty of loss and the insured is given guarantee of payment at the time of loss or damage.

Protection

The insured is assured of protection from probable chance of accident or loss.

Assist in capital formation

The accumulated funds in the form of premium are invested in various income generating schemes.

Prevention of loss

Insurance does not eliminate or decrease the uncertainty for the individual as to whether or not the event will occur, but it will reduce the extent of financial loss connected with the event.

Insurance provides security and safety

The insurance provides safety and security against the premature death of a family member or payment at the time of old age. Similarly, the property can also be insured so as to provide security to the owner against damage or loss in a fire.

Peace of mind

It ensures peace of mind against uncertainties like fire, automobile accidents, deaths and other contingencies which are beyond human control.

Elimination of dependency

What happens to other family members when one of its earning member expires? The insurance company assists the family and provides adequate amount of financial assistance at the time of suffering or unforeseen accident.

Timeline of insurance companies in India

	Date of Registration	Name of the company
1	23-10-2000	HDFC Standard Life Insurance Co. Ltd
2	15-11-2000	Max New York Life Insurance Co. Ltd
3	24-11-2000	ICICI Prudential Life Insurance Co. Ltd
4	10-01-2001	Kotak Mahindra Old Mutual Life Insurance Ltd
5	31-01-2001	Birla Sun Insurance Company Limited
6	23-10-2001	Reliance Life Insurance Co. Ltd
7	30-03-2001	Tata AIG Life Insurance Co. Ltd
8	02-08-2001	ING Vysya Life Insurance Co.Ltd
9	03-08-2001	Bajaj Allianz Life Insurance Co.Ltd
10	06-08-2001	Metlife India Insurance Co.Pvt Ltd
11	14-05-2002	Aviva Life Insurance Co. India Pvt Ltd
12	06-02-2004	Sahara India Insurance Co. Ltd
13	30-07-2006	Bharti Axa Life Insurance Co. Ltd
14	3-01-2007	Shriram Life Insurance Co. Ltd
15	4-09-2007	Future General India Life Insurance Co. ltd
16	30-03-2001	SBI Life Insurance Co. Ltd
17	19-12-2007	IDBI Fortis Life Insurance Co.

How much should you insure?

One way to deal with risk is to purchase an insurance policy. The amount of the policy will depend upon a number of factors.

Need for minimum protection

The amount of insurance that any client should purchase depends upon the analysis of the needs that would have to be met by dependents when the family earner dies. In this case there is a need to follow three steps – first to identify the basic needs that would have to be met after the death of an individual. Second, resources available to meet these needs must be sorted out. Last, the difference between the existing needs and available resources which needs to be fulfilled has to be identified.

Current income level

Payment of premium results in an outflow of disposable income. While deciding for insurance, one should keep in the mind the regular payment of insurance premium.

Tax benefits

The tax benefits under Section 80 C can be availed on purchase of different insurance policies. Individuals can avail tax benefits by paying life insurance premium according to the provisions of the Income Tax Act.

Specific schemes

An insurance scheme can be bought for a special scheme like education and wedding of children. There is provision for acquiring a property through a loan under the various insurance schemes.

Annuities for regular income during retirement

Investment made for retirement purpose will not create any undue financial worries.

Present age

Life insurance requires a periodical review based on individual needs in order to ensure that the coverage is adequate. One can buy more insurance policies for the same premium at a younger age than at an older age.

A guideline for purchase of insurance policies in different age groups

Age	Life Insurance	Non-Life insurance
Young 20's adult	Buy only if you have dependants	Buy accident and health insurance, requisite asset cover
Young 30's family	Subtract existing assets from future expenses, and cover the difference	Extend health insurance to family; continue accident and asset covers
Mature 40's family	Maintain cover to balance the shortfall in the existing assets	Same as above
Matured 50's family	Maintain cover till you are earning	Top up health cover for self and spouse; continue asset cover
Retired and over 60	No life cover needed,	Continue health insurance

	unless you have dependants	for self and spouse; continue asset cover
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At a younger age you can undertake risks since you have ample time to check your decision. The payment of premium is spread over a longer duration of time compared to policies opted at later stage in life. However, at this stage you should minimise the risk and opt for safe policies.

Principal function of the Insurance Regulatory and Development Authority

IRDA was set up by the Parliament in 1999 to regulate, promote and ensure orderly growth of the insurance business.

Section 14 of IRDA Act, 1999 specified the composition of the authority consisting of 10 members.

The authority is a ten-member committee consisting of:

- a) Chairman
- b) five whole-time members
- c) four part-time members

It was formed with the following objectives:

- to set up capital adequacy, solvency and other prudential norms for insurance companies;
- to decide on granting licences for conducting insurance business and to function as a registered authority;
- to set standards for insurance products, to monitor and modify their rates, terms and conditions;
- to ensure compliance with prescribed ceilings for management expenses of insurers and agency commissions;
- to monitor the quality and performance of inward and outward reinsurances;
- to ensure maintenance of adequate technical reserves by the insurers;
- to review insurers' asset distribution and management and to monitor compliance with prescribed potential prudential norms and patterns of investments;
- to detect sickness in the industry and to take suitable corrective actions;
- to act as a dispute resolution forum for consumer grievances;
- to prepare and publish an annual report on the state of the insurance industry; and
- to ensure, set and monitor accounting standards and transparency of reporting of accounts, to scrutinize and accept annual accounts, valuation reports and solvency margin statements.

Ombudsman

New legislation came into force in 2013 wherein the insurers can ask questions about any matters that could be used as an excuse for not paying a claim. On investigation, the ombudsman can find out whether the facts were withheld which cause difficulties in taking decisions.

How and When to Approach the Ombudsman

1. Write to the grievance cell if the insurance claim is rejected.
2. In case of unsatisfactory answer or no response, write to the insurance ombudsman.
3. One should complain within one year of the rejection of claim. The matter should not be pending in any court, consumer forum or with an arbiter.
4. Any complain can be submitted personally or through the post.
- 5 All the relevant documents should be attached with the complaints.
- 6 One should also give written consent to the ombudsman for acting as a mediator
7. In case the recommendation is acceptable to you, write within 15 days to the ombudsman, who will then pass an award within three months of the date of complaint.
8. The final award is binding on insurance companies, but you can approach a consumer forum or a civil court.
9. You can get in touch with the Insurance Regulatory and Development Authority's Grievance Redressal cell through a **toll free number 155255**
10. Complaints relating to conduct of agents can be taken up by IRDA's Grievance Redressal Cell
11. No outsourcing: Ensure that you send your complaint personally and not involve lawyer or agents.

Types of insurance: Life Insurance, Health, Home and Auto

There are many types of insurance such as life insurance, health, home and auto insurance. Life insurance covers the risk of unexpected death. Health insurance meets the need of expensive medical treatment. Similarly, home insurance covers the risk on burning of the house or when there is robbery in the house. In the same fashion car insurance covers the risk of an accident.

Whole- life Policies

A whole-life policy is one that covers the insured for almost all his life. Under this type of policy, the premium is payable throughout the life of the insured person. The policy amount is paid to the beneficiary upon the death of the policy holder. Due to its long duration, the premiums may be low. The policy matures after a fixed period since the insurance cover ceases to exist and the insured amount is then paid to the policy holder.

Life insurance is also considered an investment. However, before opting for a policy some factors like

The company's financial strength and integrity, terms and conditions of the policy needs to be carefully looked into. One may choose from a variety of policies to suit one's needs.

As an investor in life insurance policy how much would you like to invest? What other factors would you consider before opting for a policy?

Stages of life	Needs	Assets
Initial stage. No responsibility	Premature death leads to minimal needs	No worthwhile assets
Married, with children	Premature death leads to financial hardships	Growing assets
Empty nest	The needs decline once children are settled	Strong asset base

Source; Yayaswy N.J (2010)

Life insurance: How to estimate your insurance needs ?

In the event of any misfortune, a policy can save the family from financial hardships. Therefore, it becomes essential to estimate the amount of life insurance required to meet exigencies.

Guidelines to estimate insurance needs

Income Rule

It states that individual cover should be around six to eight times of the customer's gross annual income. For example, a person earning a gross annual income of ₹ 1,00,000 should have between ₹ 6,00,000 ($6 \times 1,00,000$) or ₹ 8,00,000 ($8 \times 1,00,000$) in life insurance cover.

Income plus Expenses Rule

This rule indicates that individual insurance need to be equal to five times your gross annual income plus the total of basic expenses like housing or car loans, personal debt, child's education, etc.

Premiums as Percentage of Income

In this case, payment of insurance premiums depends on disposable income. One should decide the quantum of insurance after meeting the regular outflows from the salary.

Family Need Approach

Under this rule, one has to divide family needs into two main categories: immediate needs at death (cash needs), and ongoing needs (net income needs). The amount of insurance should cover the immediate and ongoing needs of the family.

An agent should not influence your decision since you are already aware of how to calculate the amount of insurance required. Your agent may try and convince you that an insurance scheme has the feature of a saving plan as well as an investment plan. However, since the rate of return on a policy is generally low, it cannot be compared with a saving scheme of a bank or any investment plan. A saving or investment plan may fetch you much higher returns than what you would get on an insurance policy. The purpose of insurance is only to assure your life, health or property against risks.

Some Dos and Don'ts related to policies

Do not over insure or underinsure

Pay the premia promptly

Keep the premium receipts

Opt for group schemes

Do not switch from one policy to another frequently
Can take loan on your policy
Keep your parents well informed regarding policies
Surrender your policy at the right time
Buy adequate personal accident insurance

Health Insurance Schemes

It is also called accident insurance, sickness insurance and disability insurance. It provides risk coverage against unforeseen health expenses that may result in financial hardship. Health insurance schemes also cover outpatient department (OPD) expenses for illness, injuries and women during pregnancy and childbirth.

Health insurance is a critical component of financial planning. It means an individual or group is purchasing health care coverage in advance by paying a fee called 'premium'. It is an arrangement that helps to defer, delay, reduce or altogether avoid payment for health care incurred by individuals and households. It is expensive but at the same time necessary. It ensures medical care and limits potential liabilities. Its need is felt more in old age. People's lifespan in general, has increased, partly due to effective health care and medical facilities available. This facility is provided by both private insurance companies as well as by the government.

The existing health schemes can be categorized as:

- a) Voluntary health insurance scheme or private-for-profit schemes
- b) Employer-based schemes
- c) Insurance offered by NGO's/ community based health insurance
- d) Mandatory health insurance schemes or government run schemes (namely ESIS, CGHS)

An example of Community-based Health insurance Scheme

This scheme was established in 1992, provides health, life and assets insurance to women working in the informal sector and their families. The scheme operates in collaboration with the National Insurance Corporation (NIC). Under SEWA's (Self Employed Women's Association) there is a policy which has a low premium per individual and is paid by the women for life, health and assets insurance. At an

additional payment, her husband too can be covered. In addition, some amount per member is also paid to the National Insurance Corporation (NIC) which provides coverage to a maximum of ₹. 2000 per person per year for hospitalization. After being hospitalized at a hospital of one's choice (public or private), the insurance claim is submitted to SEWA. The responsibility for enrolment of members, for processing and approving of claims rests with SEWA. NIC in turn receives premium from SEWA annually and pays them a lumpsum on a monthly basis for all claims reimbursed.

Social Insurance or Mandatory Health Insurance Scheme or Government Run Schemes (namely, ESIS, CGHS)

Social insurance is an earmarked fund set up by the government with explicit benefits in return for payment. It is usually compulsory for certain groups in the population and the premiums are determined by income (and hence ability to pay) rather than related to health risk. The benefits packages are standardized and contributions are earmarked for spending on health services. The government run schemes include the Central Government Health scheme (CGHS) and the Employer State Insurance Scheme (ESIS).

Queries raised when considering health care insurance policies

Questions regarding costs

- Monthly premium
- Deductible expense
- Limits on coverage
- Other major expenses not borne by the company

Questions regarding the doctors/ health care providers

- How many doctors are in the plan?
- Who are the doctors in the plan?
- Doctors and their specialization.
- Where are the doctors located?
- What health services do the doctors provide?
- What hospitals/labs/diagnostic centres are in the plan?

General questions

- Is access to specialists only allowed with a referral from primary care physicians?
- What coverage is provided if the patient receives out of the primary network?
- If a physician is accessed outside of the plan, are there out-of-network benefits?

Contents of Health Care Insurance policies

Identification of insured person

A health insurance contract identifies the insured person.

Location

The health insurance benefits may be confined to a particular area.

Pre-existing condition

A policy may exclude coverage for pre-existing conditions, which existed with the individual prior to the grant of policy.

Cancellation operation

A health insurance contract may allow the insurance company to cancel the contract at any time. Other contracts guarantee continuous coverage as long as the policy holders pay premium on time.

Medical claim

It provides for reimbursement of hospitalisation expenses incurred for illness/diseases or injury sustained.

Disability Insurance

The disability insurance policy will provide benefits if you are unable to do the duties required of your occupation.

Types of Disability Insurance

Individual disability insurance

The insurance premium varies with the type of job. For example, workers employed in any steel plants are more at risk than any individual working in office building.

Employer disability insurance

Employers at some firms are either provided the insurance free (fee borne by the firm) or participate in a plan by paying for the coverage.

Insurance from Worker's compensation

In case of disability, one may receive workman's compensation from the company or organization.

Home owner's insurance

One of the easier ways of acquiring a house property is through a loan provided under various insurance schemes, where a life insurance policy is accepted as a collateral security. The proceeds of the policy can be adjusted towards the housing loan.

It ensures protection in case of theft, damage to the property, personal liability relating to home ownership. Financial loss to the ownership of a house can also occur from a wide variety of adverse events like flood and earthquake. In case of damage or loss of the property, the insured has to produce proof of the loss. Therefore, the insured must notify the loss to the police and register a first information report (FIR).

The insurance company under the India Home Insurance policies, provides its customers with instant home insurance quotes. Some of the factors which cover home insurance include area of the house (sq. ft), location of property, approximate rate of construction (₹./sq. ft) and type of construction (only pukka/ permanent). However, 50 years and above old properties are exempt from insurance cover. According to the sum insured the customer has to pay the premium for every month/quarter/six months. Home insurance policies offer different policies to suit the needs of the customer.

Home Insurance policy covers broadly two things

Building structure

Insurance covers for a building structure includes compensation paid for losses due to fire, storm, tempest, flood, riot, strike, lightning, explosion and implosion, landslides and rockslides, bursting or overflowing of water tanks, apparatus and pipes, earthquake and damages to the structures due to acts of terrorism. The market value of the house is not under the coverage, whereas, the cost of the land is included within the price of the house. This land cannot be insured. The insurance price is only for covering the construction cost of the building.

Contents inside the Home

The coverage is for the loss or damage of the valuables inside the building like the electronics and electrical goods, furniture, clothing, jewellery, and any other precious

contents. The contents are covered on the market value of the items and in case of a loss the insurance claim is paid on the value of purchasing a similar new item exempting the depreciating value.

Do you have adequate insurance to protect your wealth?

How much insurance should you plan to have in the future?

Home Inventory	Item description	Model/ registration No	Date acquired	Estimated cost	Estimated replacement cost
Electronics					
Laptop					
Computer/ Mobile					
Camera					
Major Appliances					
Refrigerator					
Gas/stove					
Blender					
Clothing and Accessories					
Belt, Ties					
Dresses					
Jewellery					
Watches					
Furniture					
Living Room					
Bedroom					

Try to complete the above table of home inventory and find answers to the following questions:

1. Based on your inventory how much personal property coverage should you have?
2. How will you estimate the replacement cost?

3. Have you seen the copies of sale receipt and purchase contracts in your house?

Replacement Cost Coverage

Personal property replacement cost coverage depends upon its estimated cost. As indicated in the table, home owner's policies also cover assets for their cash value. For example, if any home entertainment system is priced at ₹. 5,000 and is assumed to have a life of five years. Let us assume it has been used for half of its life. Based on this amount of depreciation, the insurer will pay the cash value of ₹. 2500.

After completing the table, you can take pictures of individual items or audiotape/ videotape all the items for further documentation if you wish to insure your assets.

Factors that affect home/house owner's insurance premiums

Value of insured house

Since the value of the house is taken into account, therefore, premium is higher for expensive ones.

Deductible

A higher deductible reduces the amount of coverage provided by the home/house owner's insurance, and therefore results in lower insurance premium.

Location

The chances of damage vary from area to area. It is high for coastal areas than for the houses located in the plains.

Degree of protection

Protection against natural calamities like flood or earthquake require a higher premium.

Discounts

Discounts are provided to the insurer if other insurance (such as auto, health) is purchased from the same insurance company.

Other Home Insurance Related Points

Hut Insurance

This insurance applies to those huts used for dwellings and constructed in rural areas with financial assistance from banking/cooperative/ government institutions.

The scope of cover of this policy is against loss or damage due to fire, including fire resulting from explosion and short circuiting) lighting, explosion of boiler or gas used for domestic purpose, earthquake, flood, and other allied perils.

Fire Insurance

A fire insurance is a contract whereby the insurer undertakes to compensate for any loss or damage caused by fire during any specified period. This policy is applicable for one year and has to be renewed from time to time. A claim for loss by fire should satisfy the following conditions:

- i) There must be actual loss and not just wear and tear of the asset.
- ii) Fire must be actual and non-intentional.

Insurable Interest

Insurable interest is an important component of the insurance contract. The insurance company only allows persons having insurable interest in the subject matter to opt for a fire insurance policy.

- i) A person has insurable interest in the property he owns.
- ii) A businessman has insurable interest in his stock, plant and machinery and building.
- iii) Partner has insurable interest in the property of partnership firm.
- iv) Mortgage has insurable interest in the property, which is mortgaged.

It is important to define insurable interest since the company has to pay compensation to the policy holder.

Motor Insurance

Motor insurance has been classified according to types of vehicles i.e., scooter/motor cycles, private cars, commercial vehicles and other vehicles. No motor vehicle can run in a public place unless it is insured against third party liability.

Motor insurance is a mandatory requirement for all vehicles owners whether needed for personal and commercial uses. The premium varies from car to car like costly car has high premium and cheap car has lesser rate of the premium.

The claims offered by the car insurance company in India can be categorized as

- a) Accidental claims, b) theft or burglary claims and c) third party claims.

Auto insurance provides protection against damage to an automobile and expenses associated with accidents. The policy specifies the coverage provided by an insurance company for a particular individual or a vehicle. In this way, it protects the vehicle

and also limits potential liabilities (expenses due to accidents). The rates of premium vary substantially among locations, insurance companies and even among the policy holders

Factors that affect motor insurance premium

Insurance policy is determined by the claims an insurer submits to the company. An auto insurance premium will be higher for a policy that specifies a greater amount of liability coverage and lower deductible.

Coverage offered by motor insurance companies in India

In case of motor insurance the liability incurred is in respect of :

- Death or personal injury to owner of the goods or his authorised representative in goods vehicle.
- Liability insured in respect of death or bodily injury of any passenger of a public service vehicle.
- Liability arising under Workman Compensation Act, 1923 in respect of death or bodily injury of:
 - i) Paid driver in a vehicle
 - ii) Conductor or ticket examiner in a public service vehicle
 - iii) Workers carried in a goods vehicle
- Liability in respect of death/ injury to passengers who are carried for hire or by reason of or in pursuance of contract of employment.

The risk covered by the Third Party policy includes death or injury to a third party and damage to a third party property. Liability in the case of death or injury is unlimited.

Auto Insurance Coverage will not cover the following:

When car is used beyond the geographical territory.

Depreciation, consequential damage, electrical and mechanical breakdown, snag or breakage, Intoxicated driving.

Characteristics of your car

Value of car determines the amount of premium. Insurance premium is high for new cars. In addition, the premium is high for expensive cars.

If You Are In an Auto Accident

In case of an auto accident, contact the police immediately. You may also note down licence plate numbers from witnesses, if the other driver leaves before the arrival of the police. If possible take pictures of any evidence that may prove that you are not at fault. Write down the details of the accident. After the arrival of police ask for the police report.

File a complaint with the insurance company immediately. The company will examine the police report and may also contact the witnesses. An agent employed by the insurance company may investigate the details of the accident. He will survey the site and the automobile and assess the damages to determine the amount of compensation paid by the insurance company.

Hit-and-run accidents

In hit-and-run accidents the insurance companies are not held liable since the vehicle which has hit the victim cannot be traced. The victim can be compensated by the solatium fund established by the government. The comprehensive auto insurance policy provides for damage caused to the vehicle due to man-made or natural calamities.

Renewal of Auto Insurance

If a vehicle's auto insurance policy is not renewed, driving that vehicle is illegal. Also if the vehicle meets an accident the insurance company will not pay any claims. No claim bonus will be forfeited. Auto insurance can be renewed with another insurer, including the bonus at your earlier insurer.

Insurance sector plays a vital role in the process of economic development of the country also. The process of capital formation is encouraged by the insurance services. The sector acts as mobiliser of savings, as financial intermediary, as promoter of investment activities, as stabilizer of financial market, and as risk manager. Insurance services lead to efficient and productive allocation of capital resources, prevent the losses to the firms by encouraging loss preventive measures, facilitate growth of trade and commerce, complement government social security programmes and assist the individual and firms in efficient management of the risks. In turn, economic development also facilitates reach of insurance both in terms of its dispersion and concentration.

CHAPTER 6

INVESTING MONEY

In the chapter on managing your money, you have read about fixed deposits in banks on which you are assured a fixed return in the form of interest. These are considered safe investments as returns are guaranteed by the bank. Other safe investments are provident fund, public provident fund, saving schemes in post offices, etc.

There are many other avenues for investment which may give higher returns than banks. Of course, the risks will also increase as higher returns are expected. For this, you may invest in shares and debentures of a company, mutual funds, bonds and other investment plans. These are generally known as financial products. Mutual funds are of various types and investment in them can be tailored to suit your requirements. We shall learn about this and other financial products in this section.

Why Invest?

When we have surplus money, we think about investing it in something which gives us good return. We may start on our business if we are enterprising, and willing to undertake risk. In this case, we are using our surplus money or funding a business and expect to earn a good return.

In case we are not willing to start our business, we may invest our money in other companies through shares or debentures. If we do not have enough information about the stock exchange operations then we may consult a financial advisor for investment in other financial products like government bonds, mutual funds, etc.

Saving money in an almirah is not an investment. However, saving money in a bank is an investment as it assures some return on your investment. Investor buys the shares of a particular company in expectation of earning a better return in terms of appreciation in the market price of the share. Similarly, when an investor subscribes to the debentures of a company, he expects a fixed interest return for a given period. When a person invests in a house he either plans for his own stay or to earn some rental income. Investment in insurance assures security as well as minimum return to the insurers.

The basic objective of any investment is to minimize risk and maximize the expected returns besides ensuring stability, liquidity and tax benefits. Today managing one's investment has become challenging and complex. Due to new economic and political situations, stock markets across the globe witness unprecedented volatility. Domestic markets, too, have been integrated with the global markets ever since the boom in technology. Therefore, investment in different types of products in one's portfolio at this juncture would be beneficial to any individual in many ways.

Investors in general spend a lot of time deciding about a financial product. In India, investors prefer to invest in secured debt products that guarantees return from it. Therefore, banks fixed deposits or saving deposits form one of the biggest components of investment. Be it a share or a mutual fund, they are looking for returns and checking whether it is beating the benchmark indices. This kind of haphazard investment is not recommended. A financial advisor would want investors to set their goals and accordingly decide the different products/assets to include in their portfolio.

How can Varmas benefit by diversifying their investment portfolio

Rohit Varma decides to invest in real estate. He thinks that it is the best investment option. Rohit is a director in a private company and brings home an impressive six digit salary of ₹. 1.5 lakh every month. He is married to 33-year-old Ritika who, too, is an executive in a private company. They have three-year-old daughter and two-year-old son.

On analysing Rohit's investment plan, it has been found that they had heavy bias towards investment in real estate. The couple had been investing money in two bulky loans undertaken to purchase a house. Their investment approach has not only jeopardized the fulfilment of their financial goal but also indicates concentration of funds in one asset, i.e., real estate.

There is no dearth of funds with the family. Insufficient surplus is not the issue rather the couple needs to be apprised regarding diversification or allocation of assets. The financial planner never advises to put all the eggs in one basket. Investment in different assets is based on the notion that even when there is a fluctuation in some assets (in terms of up and down movement in an economy) one is assured of consistent average return from one's portfolio. It is, therefore, advisable to distribute one's investment in other forms of assets like gold, mutual fund, equity, real estate and so on. In this case we find the couple has no investment in equities. Apart from

mandatory employee provident fund, they have no debt cushion. What will happen if there is a burst in the price of real estate? The volatility in interest rate may reduce the credibility of real estate. Further, real estate is a highly illiquid asset and there are maintenance costs associated with it.

The couple also feels the need of saving for the education of their children. Nevertheless, they want to stock an ample amount of money for their kids' future needs also. They plan to have some investment in health cover also.

Let us analyse Varma's investment decisions in real estate

Advantages associated with Varma's investment	Disadvantages associated with Varma's investment
Investment in real estate	No investment in equities
Investment at an early stage	No debt cushion
	No insurance policies

Relevance of allocation in different assets: Why are we investing in particular financial products. What are our expectations from that investment?

Safety

A well functioning system helps people reduce their exposure to risks. For example, you expect to earn 15% rate of return on your investment but in actual you earn only 12% thus you fail to minimize your risk. Safety is an important factor to consider while allocating funds to assets.

Liquidity

Liquidity is conversion of your assets into cash. Investment of funds in some securities may provide high return after a fixed period of time. In the meantime if you need cash, buyers may not be available as they may be infrequently traded shares. Here you may have to compromise by selling at a lower price. We see, that this share was not easily converted into cash and hence not so liquid. However, there are other assets which are considered to be more liquid and may be converted into cash when required. Thus, our portfolio should consist of different kinds of assets.

Tax Benefits

Investors plan their investment in such a way so that they can avail tax incentives on the given investment opportunities. For example., if an investor invests his money in National Saving Certificate (NSC), he would be entitled for tax rebate u/s 80-c of the Income tax Act, 1961. Likewise investment in insurance policies and mutual funds also provides tax rebates under the same section.

Purchasing power stability or hedge against inflation

The investor ensures that the return earned on his investment shall be greater than the inflation rate. For example, if an investor invests ₹. 200 at the rate of 10% per annum therefore, he will get ₹. 210 after one year. If the price of the commodity increases by more than ₹. 210 then the very purpose of investment gets defeated.

Why investment is encouraged at an early age?

The effect of compounding can work better in early years. It is one of the effective ways of making the money multiply for you. It is also necessary that we stay on track of committed and disciplined investor. Let us understand with the example of Uday and Rajesh. They both entered the job market at the age of 23. Uday decides to keep aside ₹. 25,000 every year from the age of 25 until he turned 30, that is, for a period of five years. After 30, he did not touch his investment that is he neither added nor withdrew anything from his capital till he turned 60.

Rajesh, on the other hand decided to start saving only when he turned 35. From then on till he turned 65, that is, for the next 30 years, he kept aside ₹. 25,000 every year.

Guess who saved more?

At 65, Uday's investment of ₹. 1.5 lakh was equivalent to ₹. 54.2 lakh, while Rajesh's savings of ₹. 7.5 lakh yielded ₹. 45.23 lakh.

Source: *Layman's Guide to Retirement Planning*.

Five steps to help to avoid investment blunders

At the beginning of every month chalk out how much you intend to save and invest every month in different assets. Then spread out this amount as per your convenience.

Determine your financial goal like child's education, retirement and insurance cover or a house to dwell in. On the basis of your plan invest in a tax saving option.

Automate your investment to ensure even if you forget to invest every month, banks can make your payment.

In case of insurance do not commit yourself to multi-year payments. Purchase of insurance assessing its features. Buy health insurance after careful considerations of its features and clauses.

Be cautious against your deductions. Take into account deductions such as tuition fees of children and home loan repayment while estimating saving needed under section 80c

Rajiv and his new project

Rajiv after completing his course in management has opted for a new project which requires him to stay abroad for three years. He got married recently to Seema who happened to be his friend in college. His posting in a new place along with new project may provide him opportunity to earn additional income.

How do you think Rajiv, after covering major expenses, should invest his surplus which he has earned abroad?

Where to invest the surplus?

His parents advised him to buy a house in Bangalore, where he is likely to return after his posting. His wife thinks of investment in gold jewellery. His uncle thinks he should invest the saving in safe instruments such as bank deposits.

The additional income that Rajiv will earn from his new project provides him good opportunity to build some assets. His prime consideration should be liquidity of his assets depending upon his needs. Another objective that should determine his choice is growth in the value of his assets. Let us critically analyse the various options available to Rajiv for investment. Buying a house would be an attractive option as it would ensure roof and value would appreciate over a period of time. However, the disadvantage erupts when he is transferred to other place or he undertakes

some other projects abroad. At a time when his career needs flexibility, the house would be an inflexible investment.

Investment in gold too would be limiting his choice since it may turn out to be an illiquid investment. Selling gold may not give a lucrative return and a tough decision considering his wife's passion for jewellery.

Bank deposits are no doubt a safe option, but the rate of interest is very low and does not ensure growth over a period of years.

It would be optimum for Rajiv to opt for mix of investments in different assets. He can make small investment in a house, a proportion in jewels and some amount may be invested in bank deposit and mutual funds to ensure liquidity and higher flexibility.

In fact, the growing number of investment avenues has also made investment decisions difficult. According to Association of Mutual Funds in India (AMFI), the number of mutual funds has grown considerably since 1964 when US-64 was launched by erstwhile UTI. When it comes to investing in shares, an investor like Rajiv has an option of choosing from over 5000 different types of securities.

Investment in shares

Investment in the equity of a company involves buying shares of private and public companies. It is one of the most rewarding and at the same time volatile instruments for investing. When you invest in shares of a company, you become part owner of the company and, hence, share both the profit and losses that the companies make. They can be brought from either the primary market--directly from the company during a public offering--or the secondary market, i.e., the stock exchange. Stock market deals with trading of shares and their prices fluctuate on a daily basis. Let us assume Rajiv has brought 10 shares of company X for ₹. 1000. After five days share prices increase to ₹. 1500, that means Rajiv can make a profit of ₹. 500. However, if the price falls to ₹. 500, then he makes a loss of ₹. 500.

A return on investment in shares is obtained through dividends and share price appreciation. The market price of the share depends on the number of buyers and sellers of the share. In addition, the demand and supply of the share for sale is also influenced by the firm's business performance, as measured by its earnings and other characteristics. When the firm performs well, its stocks become more desirable for the investors. Conversely, when a firm has negative

earning, its market value declines. Some firms distribute quarterly income to their shareholders in the form of dividends rather than reinvest the earnings in the firm's operations.

Some individual investors called day traders buy stock and then sell them on the same day. They hope to earn a return on a very short term movement in share prices. Day trading is not recommended for most investors. Moreover, this type of investment is risky because the stock prices of even best managed firms periodically decline.

Where do you think Rajiv should invest?

There are certain sunrise industries like biotechnology, and sunset industries like jute. There are high-tech industries (instrumentation), and low tech industries (solvent extraction). Then there are capital-intensive industries like petrochemicals, and labour-intensive like textiles. Thus, industries can be classified into several types. Each industry goes through a certain life cycle from a small beginning to massive growth, to stagnation and eventual decline. Thus, Rajiv has to take a decision on the basis of the information he collects about various companies.

Bonds

Bonds are issued to raise funds in the same way an individual borrows funds from banks. An individual has to hypothecate its assets with the bank as security in proportion to the demand for the loan. In case of failure of an individual to refund the money, the bank has the right to sell off these assets to recover its dues. On similar lines, a corporate can borrow funds from the general public. Here the sole borrower is a company and there are many moneylenders in the form of individual investors. Since a company cannot pledge or mortgage its assets separately with each individual, it pledges its assets with a trust constituted for this purpose. The trustee is conferred with the power to dispose of the assets of the company in case of failure to meet the commitment of individual investors. A company issues certificates to bond holders while borrowing funds from the individual investors. This is known as bond certificate.

National Saving Certificates

National Saving Certificates are bonds issued by the central government with tenure of six years and sold through post offices. Individuals including minors and trusts can invest in NSCs. They are issued in denominations ranging from ₹. 100 to 10,000. They offer interest rate of 8% compounded half yearly. The accumulated amount is paid on maturity. Premature encashment

can be done after a period of three years after deducting some amount. It is eligible for tax rebate under section 80c.

Take A SIP (Systematic Investment Plan) to Grow Your Wealth

A SIP helps you invest small amounts on a regular basis. You can invest in equity, debt or balanced scheme using a SIP.

You should continue with your SIPs irrespective of stock market conditions. Never close your SIP even if the economy faces depression.

SIPs offer you dual benefits of averaging and compounding through market cycles.

You can choose a date of your SIP based on your cash flow.

You can invest in SIPs by using the electronic clearing service or post- dated cheques.

Do remember that SIPs do not ensure assured returns or safety of principal.

Mutual funds

Investors who desire to invest their funds in corporate securities lack information regarding profiles of companies. Such investors can invest their funds in corporate securities through mutual funds. The pooled funds are invested by expert portfolio managers. They help the clients to invest in SIPs. Since mutual funds allow investment in numerous stocks, it enables investors to achieve broad diversification with an investment as low as ₹. 500. Unit Trust of India was the first mutual fund set up in 1964. The main objective of the UTI was to mobilize the savings of the household sector.

A mutual fund can generate a capital gain for individual investors, since the price at which investors sell their shares can be higher than the price at which they purchased their shares. However, the price of the mutual fund's share may decline over time, which would result in a capital loss.

Mutual Funds

Check out the asset allocation schemes from mutual funds. These funds will help you in allocating money across different asset classes depending on your investment goals and risk taking ability. The fund first defines the asset allocation and then identifies a basket of different

funds in which it will invest. There are good options for an investor looking for expert advice to invest based on asset allocation.

It is the risk profile and life stage of the investor that will decide which of the options he or she will choose. Franklin Templeton AMC has come out with plans with life stages, e.g., a twenty-five-year-old person can choose to invest in FT India Life Stage Fund 20's plan. This fund has defined the asset allocation as 80% for equity and 20% for debt. Money is invested in Franklin India Blue Chip Fund (50%), Franklin India Prima Fund (15%), Templeton India Growth Fund (15%), Templeton India Income Builder Fund (10%), and Templeton India Income Fund (10%). This makes the investment process much easier for investors and the inbuilt rebalancing features help in maintaining the target asset allocation, which could go awry due to market movements.

The best part of investing in asset allocation fund is that you will get access to a basket of funds with different investment styles that will invest according to your asset allocation plan. It saves time needed for investing in multiple schemes and tracking them.

Source: *Economic Survey?*

Debt

Fixed Deposits

One of the oldest investment avenues in India is bank fixed deposits. It gives a returns of 6%-8% per annum depending on the tenure. It is a safe investment device for those who do not have a risk appetite and have traditionally put their money in them.

Insurance

It is an investment-cum-risk management instrument. The objective of insuring one's life is to provide financial security to oneself and to the family members. The details of this policy have been discussed in the next chapter. A policy can be opted after evaluating one's needs.

Other investment avenues for Rajiv

Investment in agricultural land

Income from agricultural land may be in various forms like land rent and sale proceeds of agricultural produce. The value of agricultural lands has been highly appreciating in some parts of the country.

Farmhouse

Income can be generated by investment in farmhouses by giving them on rent or by selling the produce of the agricultural land. A farmhouse is any building owned or occupied by a cultivator.

Urban land

Due to increasing pressure of population on land, land prices have gone up all over the world. Investment in urban land can also be profitable.

Gold

It lends stability to the portfolio and acts as a hedge against inflation and is highly liquid.

Bars, coins and biscuits

Bars and coins can be purchased from jewellers or bullion traders. In the past few years, banks have started retailing 24 carat gold biscuits. It retains its purity and comes in tamper proof covers. An individual can gain by selling the bars, coins and biscuits when there is hike in gold prices

Gold Electronically Traded Funds(ETFs)

It is equivalent to 1 gram of gold, are held electronically in the demat form and traded on exchanges. They offer investors the advantage of security, convenience and liquidity. These products are regulated by SEBI and the risk is lower. Income from ETFs is treated as long-term capital gains and taxed at lower rate if the holding period exceeds one year compared with three years as in the case of physical gold. Unlike physical gold, investors are assured transparency in pricing as there are no making charges or premium involved and units are traded on the exchange.

E-gold

E-gold offers liquidity more than most of the gold. Each unit of e-gold is equivalent to one gram of physical gold and is held in the demat account. It is the only form of paper gold that allows conversion to physical gold, or rematerialisation. Offered by the National Spot Exchange Limited (NSEL), e-gold can be bought by setting up a trading account.

Test Your Money Quotient

Are you a savvy investor and an informed spender? Take this quick test to find out your money quotient.

- 1) It is best to invest in tax-saving mutual funds at one go when the markets fall. Y/N
- 2) In case of a child's bank account, there is no penalty if minimum balance is not maintained. Y/N
- 3) This is the right time to invest in the infrastructure sector through infra funds. Y/N
- 4) If you sell a flat within three years of buying it, the profit is added to your income for that year and taxed accordingly. Y/N
- 5) Cost inflation indexation of capital gains will always help reduce tax liability. Y/N
- 6) If you are a doctor, you may get a discount on your car insurance premium. Y/N
- 7) NSC investment is eligible for tax benefit under Sec80. Y/N
- 8) If you shift to 3G mobile services, you pay extra for voice calls and SMSs. Y/N
- 9) You cannot avail of more than ₹. 20 lakh if you take an education loan from a bank. Y/N
- 10) Long-term capital gains from stocks are tax free. Y/N

Give yourself one point for every correct answer.

8-10 You are smart investors and know the tricks. Try fine tuning your portfolio.

4-7 Well, your money quotient is average. You know the basics but you have a lot to learn.

0-3 You have a lot of catching up to do. Remember it is never too late.

Answer 1) No, 2) No, 3) No, 4) Yes 5) No 6) Yes 7) Yes 8) No 9) Yes 10) Yes

Individual Investors and Institutional Investors

Investing money requires considerable expertise since there are so many avenues of investment as discussed. Individual investors, like us, may wish to invest directly in shares and the stock market, if we are willing to take risk. However, if we do not have adequate information about the stock market, we may prefer safe investments like fixed deposits in banks. Or, we may decide to invest in mutual funds.

As an investor you can do it on your own or seek help of **institutional investors**. Institutional investors are professionals employed by financial institutions who are responsible for managing money of clients like Rajiv. They advise the client to invest in different kinds of mutual funds and other securities. They select shares and securities of different companies so that investors get a reasonable return on their investment. The employees of financial institutions who make investment decisions for clients are also referred to as portfolio managers.

Like institutional investors, **individual investors** invest a portion of their money to earn a reasonable return on their investment. Individual investors may hold their stock for more than a year. These investors usually analyse the changes in share prices regularly and accordingly take decision to buy or sell different shares. Some stocks may promise a higher return but an individual should keep his capacity for risk bearing intact. An investor should not get swayed by ups and downs in the market. This kind of investor needs to patiently watch the market rather than change decisions on a weekly basis.

Chapter 7

RETIREMENT PLANNING

Sheila lives with her parents in a joint family. She attended the farewell party organised by her grandfather's office colleagues on his retirement. She wondered how he would manage his expenses without his usual salary. Her grandfather then explained since he was working in a government office, he would be getting a sum every month known as pension. Had he worked in a private organisation or engaged in business, he would not be getting pension. In that case he would have to plan or invest money to get a regular flow of income. Sheila suddenly realised that her grandfather still willingly provided her with pocket money. She wondered if there was no pension what would her grandfather have done?

Retirement planning is a part of overall financial planning process. It is an attempt to figure out how much money you need to save each month in order to have a comfortable retirement and be financially secure by making best of the accumulated retirement assets. Planning for retirement acquires added importance because, normally, people over-estimate what they have and under-estimate how much they would need for their post-retirement. At the verge of retirement, your needs will rapidly be changing. You will be asking the big questions – what does retirement mean to me, and will I have enough? How can I be better off? As our lives change, our financial needs and priorities change too.

Whether you are a salaried person employed with a government organisation or a private sector organisation or a self-employed person, the fact remains that you have to retire one day. The benefit with the person employed with any government organisation is that there is a provision for a pension scheme which serves as a regular income to the retired person to support his/her monthly expenses in the post-retirement years. But, the people outside the pension scheme coverage need to take concrete steps to plan for their post-retirement income and earnings.

Why do you need to save?

You have to retire one day. You can choose the age but cannot postpone it indefinitely. The biggest question is, when the time of retirement arrives, will you have enough income to continue the lifestyle you were enjoying before retirement. The amount of pension alone will not be sufficient for most of us. Remember, the average life expectancy is improving with the advancement in the health care sector. The average person who retires at the age of 58-60 looks forward to another 20 years of life. For this it becomes imperative to save enough funds in your 30-35 working life.

Thus, in order to be comfortable in the post-retirement years, there is a need to start planning from today itself. The sooner you start investing, the better it is. You can then experience the **effect of compounding**. Let us take an example: Yogesh, who is now 25 years of age in 2011, starts investing ₹. 10,000 every month. If his investments grow by 6% p.a., he will end up with ₹. 1.38 crore in 2046 when he attains the age of 60. If he puts off this exercise for next 10 years, that is, till 2021, he will end up with ₹. 67.95 lakh.

Did you notice that this amount is less than half the amount that he would have if he had began investing early? It is crucial to stay on track, that is, remain committed and disciplined. If you give up the habit of saving and investing midway, it will not yield the expected returns and affect the financial plan for retirement.

In order to know how much you need to save, you first need to ascertain how much funds you will need after retirement. This involves calculating your monthly earnings (from occupation, interest, dividends, pension or any other investment that you might have). Here, it is necessary to take into account the **rate of inflation**.

Inflation is a widespread and sustained increase in the general price level of goods and services. Economists say that when prices go up 3 per cent or more a year, the country is in a state of inflation. While just about everyone gets hurt by inflation, people who live on fixed incomes may feel the crunch more than others because prices rise but their income doesn't. That's why it makes sense to build-in inflation into your retirement plans.

For example, Sunitha would like to retire in 10 years. She expects inflation to be at an average of 6% throughout the period. After retirement she wants to maintain the same level of living standard which she is presently enjoying. At present she is spending ₹. 10,000 p.m. To calculate how much she should save today will depend how much she would need 10 years from now. With inflation of 6%, the worth of ₹. 10,000 p.m. today would approximately be ₹. 17,900 p.m.¹, i.e., ₹. 2,14,800 p.a.

What you can do to achieve your retirement goals

The retirement is a new chapter in one's life and the life is not over by any means at the time of retirement. The people either decide to start another job to spend the time or they choose to spend their time with the family and friends. It does not matter what you choose, what matters is that you live a happy life once you have retired.

1. Define your need and financial objectives.
2. Diversification and optimal asset allocation in accordance with one's risk appetite is a key to successful financial and retirement planning.
3. If you start early, you can build large corpus for retirement. It is a myth, that one should start planning for retirement when you are 40+. Remember the power of compounding.

This chapter will help you understand how much you need to grow your wealth before you retire and how to plan for it.

Tools for Planning

Financial Independence

Financial independence is the goal of retirement planning. It is not something that can be done in a day, a week, or even in a month. It is not an event but rather a recursive and cyclical process. The key aspect of retirement planning is to choose the right investment vehicles which will help you reaching your financial goals.

Portfolio planning/Asset allocation

A good retirement planning depends on asset allocation rather than confining oneself to a single investment. For this reason, it is good to spread your investment capital around and understand the income and growth objectives for future performance. You should not put all your eggs in the same basket. What is required is a portfolio with right combination of

¹ $10,000 \times 1.06^{10} = 17900$

assets. You may have various financial assets, namely, shares, debentures, bonds, life insurance, annuities, mutual funds, fixed deposit, company deposits, PPF, monthly income schemes, national savings certificates, etc., in your portfolio. In addition to this, it may also contain tangible assets that can take the form of gold, silver jewellery, precious stones like diamonds, real estate, painting, carvings, etc., and other collectibles. Apart from providing good hedge against inflation, they also emerge as an attractive alternative investment avenue. You may also have some insurance to cover risk.

What assets?

Primarily, all assets are divided into two categories:

- i. Real assets
- ii. Financial assets

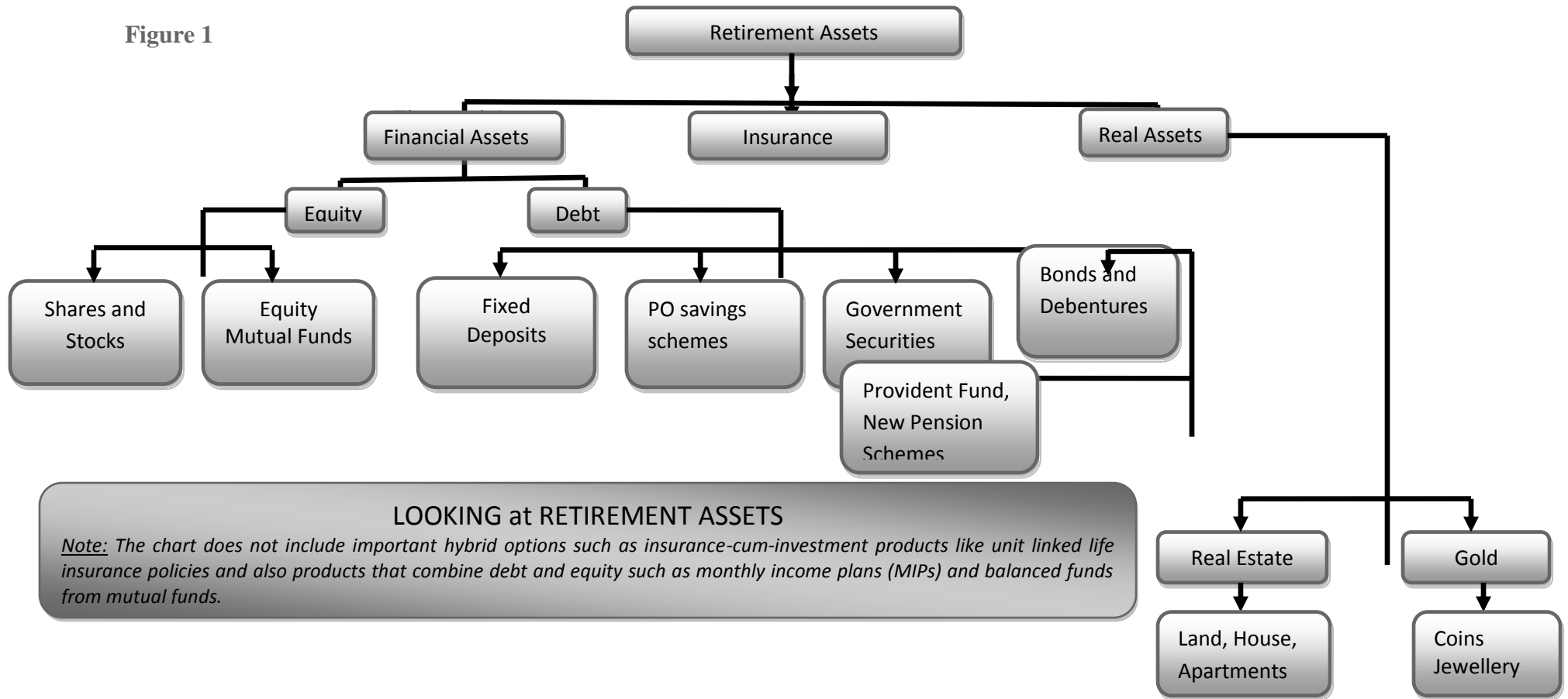
Your *real assets* are the physical assets that you own and are tangible. It means investing in immovable property such as a house, a flat, a plot of land or a commercial space. The other item under real asset is *gold* and other precious stones. However, investment in gold jewellery is mostly done with the intention of safe keeping rather than for sale-resale purposes. The positive side of investing in gold is its high liquidity value.

Financial assets are the claims on real assets and can be converted into cash easily. Depending on the nature of investment, financial assets are of two types: equity and debt.

Equity implies investing in stocks and mutual funds. Investment in stocks involves buying shares of public and private companies. When you buy shares of a company, you become a part owner of the company and share the company's profit and bear losses. Shares can be bought from both primary market (public offering) and secondary market (stock exchange). Shares are traded in the stock exchange and their prices fluctuate on daily basis. Investment in share market should be a purely long-term investment. Mutual funds are essentially a pooling of small resources of individuals which are handed over to a professional fund manager who invests this money in the stock exchange and according to the objectives of the scheme.

Debt: Bank fixed deposits is one of the very popular investment avenues in India. This investment is commonly done by the people who have a very low risk taking aptitude and wish to make safe investment in banks. Similar to the bank fixed deposits, the postal saving_schemes continue to be one of the most popular fixed income instruments in India. The post office small saving schemes like Kisan Vikas Patra , Monthly Income Scheme, Public Provident Fund, Time Deposit Scheme, Recurring Deposit, National Saving Scheme and Senior Citizen Scheme are backed by sovereign guarantee and are zero risk investments. These schemes, however, have a lock-in period between 1-15 years (refer Figure 2). The services of the post office has been successfully tapped into the rural savings market by offering higher rate of return than that extended by scheduled banks. Nearly all post office schemes give returns of about 8% p.a.

Figure 1



LOOKING at RETIREMENT ASSETS

Note: The chart does not include important hybrid options such as insurance-cum-investment products like unit linked life insurance policies and also products that combine debt and equity such as monthly income plans (MIPs) and balanced funds from mutual funds.

Benefits of investing in post office schemes

- These schemes are offered by Government of India.
- Safe, secure and risk-free investment options.
- No tax deduction at source.
- Nomination facility is available.
- Nomination can be changed any time.
- The instruments are transferable to any post office anywhere in India.
- Attractive rate of interest.

Other debt instruments

In addition to these, government securities (G-secs.) issued by Reserve Bank of India, in lieu of the central government borrowings programme, bonds and debentures issued by companies, financial institutions or even by governments are also available for the public as debt instruments. Over and above the scheduled interest payments, the par value of the instrument is received at a specified maturity date. The risk in these instruments is almost nil.

Pension Schemes

Further, the new pension schemes introduced by the government to give people a way to get a pension during their old age. Employees of the government sector already get a pension, so this scheme is introduced as a security measure that enables people from the unorganised sector to draw a pension as well. The working mechanism is simple. You contribute a certain sum every month during your working years, which is then invested according to your preference. You can then withdraw the money when you retire which is currently at 60 years. NPS is meant to be a pension scheme , so it is geared towards giving you a steady stream of income on your retirement.

Figure 2

Post office Small Savings Schemes

Kisan Vikas Patra	<ul style="list-style-type: none">• Money doubles in 8 years 7 months.• No limit on investment.• Available in the denomination of ₹. 100, 500, 1000, 5000 , 10,000 and 50,000 in all head post offices
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Monthly Income Scheme	<ul style="list-style-type: none"> • 8% p.a. payable monthly. • Minimum ₹. 6000, Maximum ₹. 3 lakh in single account and 6 lakh in joint account. • Maturity period 6 years
15-year Public Provident Account	<ul style="list-style-type: none"> • 8% p.a. compounded yearly. • Minimum ₹. 500 maximum ₹. 70,000 in a financial year. • Deposits can be made in lump sum or 12 monthly instalments. • Interest is completely tax free. • Withdrawal is permissible from the 7th year.
Post office Time Deposit Account	<ul style="list-style-type: none"> • Interest payable annually but calculated quarterly. • Minimum ₹. 50 maximum no limit
5-year post office recurring deposit account	<ul style="list-style-type: none"> • Minimum ₹. 10 per month any amount in maximum limit. • One withdrawal up to 50% of the balance allowed in the multiple of ₹. 5 after 3 years.
Post office savings account	<ul style="list-style-type: none"> • Minimum of ₹. 50 and maximum of ₹.1,00,000 for an individual account. • ₹. 2,00,000 for joint account. • No limit on group, institutional or official capacity accounts.
National Savings Certificate	<ul style="list-style-type: none"> • Interest compounded six monthly payable at maturity. • Certificate can be purchased by an adult or on the behalf of a minor.
Deposit Scheme for Retiring Govt. Employees	<ul style="list-style-type: none"> • 8% p.a. payable half yearly. • Minimum ₹. 1000 maximum not exceeding the total retirement benefits.

But, how can you be sure that your portfolio has all the components adequate enough to cover all your retirement needs? There are certain investments which every individual ought to make though their relative priority changes with age as illustrated below:

	Young (25-35 years of age)	Middle aged (35-45 years of age)	Senior (45-60 years of age)	Retired (60 + age)
Life insurance	Medium	Medium	Low	Nil
Medical Insurance	Low	Medium	High	High
House/Flat	Medium	High	High	High
Tax oriented savings schemes	Low	Medium	Medium	Low
Mutual Funds	Medium	High	High	High
Debt Instruments	Low	Medium	Medium	High

Also, savings bank accounts have to be maintained by all of us for meeting ongoing liquidity needs. Each type of investment has distinct advantages and disadvantages, which tends to behave differently in different types of economic mood and swings. Your retirement portfolio should broadly be diversified and well balanced.

Estimating the Retirement Expenses

Let us now review various factors that you should consider while building your retirement portfolio.

The Power of Compounding

For sound financial planning, cash flows should be related to the relevant time period. Distinction has to be made between ₹. 100 received today and ₹. 100 to be received at a future date. This is because the ₹. 100 received today can earn interest on it. Assume the rate of interest at 15% p.a. and consider the following example:

Now	100	Interest in the 4 th year	22.81
Interest	15	At the end of IV year	<u>174.90</u>
At the end of I year	<u>115</u>		
Interest in the 2 nd year	17.25	Interest in the 5 th year	26.24
At the end of II year	<u>132.25</u>	At the end of V year	<u>201.14</u>
Interest in the 3 rd year	19.84		
At the end of III year	<u>152.09</u>		

The example shows the calculated compound interest from year to year, i.e., ₹. 100 invested today grows to 201.14 in the fifth year if invested at 15% compound interest p.a. at the end of the 5th year.

Hence, ‘compounding’ implies earning interest on your interest. Here, the point to note is that the more often interest is compounded, the more you accumulate. Thus, semi-annual compounding pays more than annual compounding, quarterly more than semi-annual and monthly more than quarterly. (*see table 1.*)

Growth of an investment of ₹. 5000 invested @12% p.a.		
Frequency of compounding	Amount at the end of 5 years	Amount at the end of 10 years
Monthly	9,083	16,502
Quarterly	9,031	16,310
Semi-annual	8,954	16,036
Annual	8,810	15,530

The simple way to figure out the impact of compounding is illustrated by the 'rule of 72'. When funds are invested on a compound interest basis, your investment doubles at regular frequencies depending on the rate of interest and frequency of compounding. There is a simple method of calculating how long it will take for your money to double: divide 72 by the interest rate. For example, at 8% it takes 9 years ($72/8$), it takes approx. 6 years ($72/12$) and at 24 % it takes 3 years ($72/24$). This rule applies to compound interest only. The impact of compound interest is solely reaped in the long run. The longer you keep your investments on compound interest basis, the greater is your gain. The best way is to invest in mutual funds or set up a RD account with a bank. The decision regarding choosing between an RD and SIP depend on one's requirement, risk taking aptitude and the time period of investment.

Align your Assets

Creating a regular income

It is always better that you align your assets as one portfolio. Your assets or your investments need to be arranged in such a manner that there is a regular flow of income at different intervals. Though the reasons for your investment may be different, you must see your portfolio as one. This will enable you to review your investment in different assets. In your portfolio you must reallocate these assets from time to time to optimise their returns. Whatever the amount of corpus you have, you must have a mode of regular income in the form of dividends, interests or systematic withdrawals. Hence, you must create an *income ladder* with manageable diversified portfolio to suit your needs and requirements.

One of the best options to get a regular income is *annuities*. Annuities are monthly payments you receive from a financial institution after you invest a lump sum in it. The returns from these investments along with a part of principal form the monthly payment accruing to you. You can buy an annuity plan from a life insurance company or a mutual fund. A regular income can also be generated from a variety of investment instruments such as National Savings Certificates or deep discount bonds that give you a pre-determined lump sum on maturity. If you invest in these at regular intervals your investments will mature at regular intervals in your retirement years creating a regular income flow.

For example, Mr. Prakasa Rao who will be retiring in 2016 does not want to utilise his pension money to meet regular (both periodic/recurring) capital expenses like house repairs. He wants to invest some money for such expenses. For him, small saving schemes like NSC's-- six year tenure, 8% interest compounded half yearly is a handy option. If he invests ₹. 5000 quarterly beginning 2010, this is how his investments will flow to him in 2016, i.e., his first year of retirement:

Investment		Payback	
Jan 2010	₹. 5000	Jan 2016	8005
April 2010	₹. 5000	April 2016	8005
July 2010	₹. 5000	July 2016	8005
October 2010	₹. 5000	October 2016	8005

Other avenues which can be tapped for a regular income are post office monthly income schemes (POMIS), senior citizen's savings scheme, bank FD's and bonds and other debt products. Income could also come from dividends, monthly income plans of mutual funds, systematic withdrawal plans (SWP) of mutual fund schemes along with the rent from any property you might own.

Creating a Lump Sum Income

Besides a regular income, you will also require lump sum amount in your post-retirement years. Your requirements may relate to the higher education of your children, children's marriage or a sudden illness, etc. In this case, the needs are classified as :

Future needs: These needs are known and can be listed in terms of the amount required as and when they arise. You have two alternatives: (a) Invest the lump sum (large amount) and receive a lump sum on maturity. You may opt for infrastructure bonds with a suitable tenure. Other options available are NSC's and Government of India Savings Bonds (RBI bonds), Kisan Vikas Patra and fixed maturity plans which mutual fund companies launch regularly and (b) invest a fix amount regularly and receive a lump sum on maturity. If you choose to save regularly, a mutual fund SIP or post office and bank recurring deposits will be most suitable for you

Unforeseen needs: Needs may arise due to sudden illness requiring prolonged hospitalisation. You need to keep certain reserves for such contingencies.

Tax Planning

Taxes are levied on your retirement funds. Therefore proper tax planning is required before you retire if you wish to take advantage of your retirement benefits. Your investment in mutual funds, shares, real estate and other assets need to be reallocated so that you are not burdened with tax after retirement

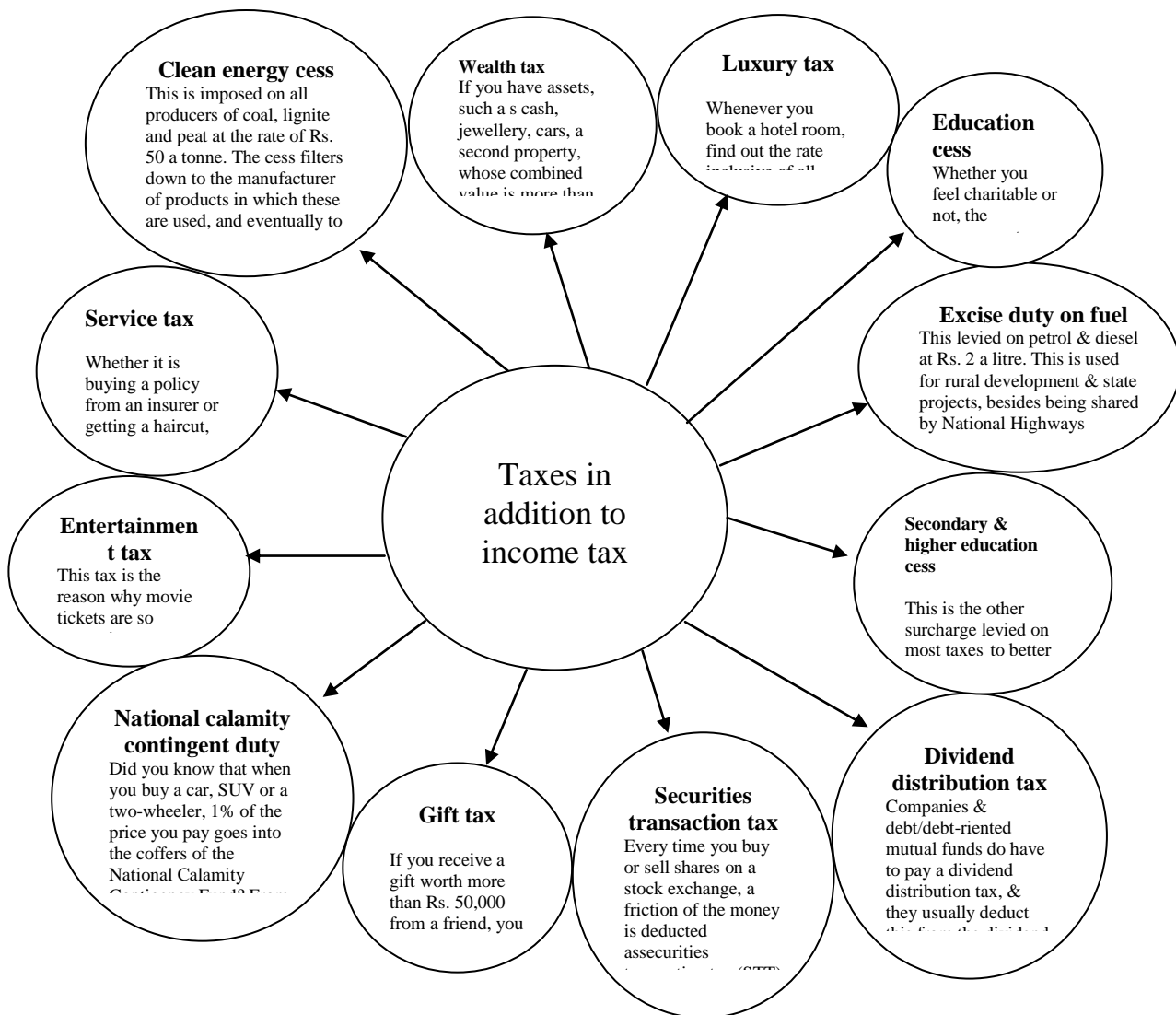
Managing Risk

If you want your investment to be 100% safe, bank fixed deposit can be your choice. But there is some risk involved in other types of investment whether it is debt or equity. In equity funds you are subject to market risks and in debt funds there is the risk of inflation. At times you would like to keep your funds handy for emergencies, meaning thereby you want liquidity. This kind of liquid money earns higher returns. People in general fear that they have not saved enough for the future and therefore they need to manage their retirement funds carefully. Taxes are another unplanned expense which has to be taken care of.

CHAPTER 8

TAXES & YOU

Have you ever wondered how the government runs its offices or pays the salaries of the police department, army, air force and navy employees? The government requires money for all these and a variety of other essential services such as electricity, water provided to you. The government collects money from the general public in the form of taxes which it uses for different developmental schemes and functioning of the economy. The general public may comprise salaried people, business people, industrialists and many other service providers. All these people pay taxes with the expectation that the government would function efficiently.



In your lifetime, you definitely have to pay taxes, in fact, you have probably already paid sales tax. Have you wondered or questioned why you had to pay more at times? The prices that we pay when we buy things in the market, is inclusive of taxes that have been charged on them. We bear taxes when we spend money and also when we earn money. Not many of us willingly part with their hard earned money for taxes. You must have often heard your elders' say, "what do we get that we should pay taxes?" Payment of taxes is not only the duty of every citizen but an essential requirement for existence of our country as a prosperous, secure, stable and a just nation-state.

You know that government spends money for providing many public services, like, highways, police, defence, etc., and basic facilities such as schools and hospitals to the poor and underprivileged thus creating an egalitarian society. It is also used for funding developmental programmes and services. Government gets money from taxes and therefore it is vital for all its citizens to pay taxes. However, at the same time it is important for us to learn to be wise and smart so that all taxes that we legally owe are paid – and not a rupee more.

Did you know?

How taxes affect our economy?

Taxes, the main source of revenue are used by the rulers or the government to carry out many functions. No government in the world can run its administrative offices without funds and it has no such system incorporated in itself to generate profit from its functioning. Therefore, it can be well understood that the purpose of taxation is very simple and obvious for proper functioning of a state. The expenditures of the government include providing economic infrastructure (roads, railways, etc.), public services (education systems, health care systems, public transportation, etc.), public utilities (energy, water and waste management, etc.) for the enforcement of law and order, to meet expenditures on defence, and the operation of government itself. The money is also utilized for relief and rehabilitation in case of natural disasters such as floods, earthquakes, tsunamis, etc. Space programme, missile programme and nuclear programme are also funded from the revenue collected as tax.

Taxes, apart from being a source of revenue to government also are used to influence the functioning of the economy (the government's strategy for doing this is called fiscal policy), or to modify patterns of consumption or employment within an economy. It influences

the economy by affecting resource allocation, consumer behaviour and even the nation's productivity and growth. To reallocate its scarce resources for ensuring welfare, government may tax highly some commodities (say luxuries). It regulates consumption of some commodities (tobacco is taxed, for example, to discourage smoking, and other injurious commodities like alcohol, etc). To ensure long-term growth it may impose taxes on production of consumer goods and give concession for production of capital goods. Apart from interest rates, the deductions allowed in taxes for the savings also inspire people to save. The provision of exemptions of income that have been diverted into various saving schemes results in increased saving in the economy. Taxes also help in redistribution. Normally, this means transferring wealth from the richer sections of society to poorer sections, thereby reducing inequality in the income levels. When government imposes taxes on the richer section and uses it for the welfare of its citizens, it is transferring wealth from few high income groups to low income groups. Taxes also make the government accountable. The government tax citizens, and citizens in turn demand accountability from their government.

Tax planning implies minimization of taxes-- pay as little as possible by saving and investing wisely. The goal is to arrange financial affairs so as to minimize taxes. How can we do this? The key lies in prudent and effective tax planning. It is important to plan for taxes as it affects your personal budget-- your savings, expenditure and consumption so dearly. Tax planning means devising strategies all the year round so as to minimize the liability of tax that one owes to the government. You have to plan sensibly so as to pay less money to the government as tax thereby reducing your tax burden. As a result save more money for yourself. Planning taxes reduces the burden of tax on a person and also helps him to make savings by investing in various saving schemes.

India has a well-developed taxation structure. The tax system in India is mainly a three-tier system, comprising the Central government, State Governments and the local government's organizations which include panchayats and municipalities.

History of taxation:

Taxation dates back to earliest recorded history. In the beginning, in all societies, the most common way to collect taxes was in kind. Taxes were paid in the form of gold-coins, cattle, grains, raw materials and even by rendering personal service. As economies became money based, countries started collecting taxes in cash. In addition to the revenues from land, tax on the basis of ownership of immovable properties also became prevalent. Evidence show that all historical leaders and head countrymen collected taxes to run its authority.

In India, the tradition of taxation has a long history. Archeological findings indicate a taxation system as old as about 6000 years ago at a place called Lagash. It finds its references in many ancient books like 'Manu Smriti' and 'Arthasastra'. Manu, the sage and lawgiver in Vedic times, stated in his 'Manu Smriti' that the king could levy tax and advised that taxes should be related to the profession, income and expenditure of the person. With the coming on of the Mughals in India, the country witnessed a sea of change in the taxation system of India. Although, they also practised the same norm of taxation but it was more homogeneous in structure and collection.

The period of British rule in India witnessed some remarkable change in the taxation system of India. The objectives of taxation were designed to protect and enlarge the economic and strategic interests of the East India Company and the Crown. After the revolt of 1857, the first formal income-tax on traders and professionals became operative in 1860. Setting up of administrative system and taxation system was first done in the history of taxation system in India in 1922. Independent India brought out changes in the nature and objectives of taxation, which became directly linked with national programmes for citizens' welfare. Nowadays taxation is seen as an instrument not only to augment finance of the government but also to fulfill certain social objective, both being interlinked.

Taxes are collected from a number of sources. The government raises revenue from a variety of taxes -- taxes on income (like, individual income tax, corporate income tax) taxes on property (like, wealth tax, estate taxes, death duties, property taxes), taxes on commodities (like, sales tax, excise duties, customs duties) and other taxes (like service taxes, entertainment taxes).

Different taxes that we pay

As said earlier we pay different types of taxes to the government, which can be classified as direct and indirect. Direct

taxes are those that are imposed and paid by the tax payer directly to the government (like, taxes on income and wealth) Indirect taxes are those taxes that we pay indirectly to the government (like, taxes on commodities). An understanding of these taxes is necessary for us to be aware of the payments that we have to make.

In this world nothing is certain but death and taxes

-Benjamin Franklin

Income tax

When you start earning incomes beyond the exemption limit, you will have to pay taxes which are progressive, meaning that the more you earn, the more you pay. Income tax is levied on the income of individuals or on

the profits earned by companies and businesses. Personal income tax and corporate income tax together contribute towards a major share of tax revenue to central government. The Income Tax Act was incorporated in India in 1860. Income taxes are imposed by the Government of India on taxable income of Hindu

Did you Know?

*For all financial transactions (be it investing, purchasing, etc.) that you make above a certain limit, it is now mandatory to quote your **Permanent Account Number (PAN)**. This makes it easier for taxman to trace all your investment/savings. This number is mandatory for filing income tax returns, opening a depository account, buying or selling property, large cash transaction- You need a PAN for many things that affect your life.*

Undivided Families (HUFs), companies, individuals, firms, co-operative societies and trusts (which are identified as a body of individuals and association of persons). Even the gifts that you receive from persons other than relatives come under the purview of income tax and are included in your income.

Corporate Tax

When a company earns profit, corporate tax has to be paid. Corporate tax is the tax charged on the profits earned by associations and companies by several jurisdictions. The excess of earnings that a company makes over the expenses incurred (cost of production) will be your profit. On this profit, the company has to pay corporate tax according to rules. This corporate tax also applies to foreign corporations that have economic bases in India (e.g, Microsoft,

Agro-tech, Hewlett-Packard). It applies to all people working for a corporation, including income for work done in a foreign country and work done for a corporation that is situated in a foreign country. The rate of corporate tax in India depends on whether the profits have been passed on to the shareholders or not.

Capital Gains Tax

Did you know that you will have to pay taxes on all your capital gains that you receive upon the sale of assets? A capital gain is any income generated by selling a capital investment (business stocks, paintings, houses, family business, farmhouse, etc.). The 'gain' here is the difference between the price originally paid for the investment and money received upon selling it, and is taxable.

Wealth Tax

The wealth that you possess also entails you to contribute towards the tax exchequer. Wealth tax is levied on the property owned depending on the market value of it. If you possess net wealth over a certain exemption limit (now ₹. 30 lakh) other than ownership of one residential property it is mandatory to pay wealth tax and file a return to avoid tax collector knocking at your door.

Excise Duty

You pay taxes to the government while purchasing commodities. One among the indirect tax is the excise duty which is one of the most well known forms of taxation in India. Excise duties are imposed on goods at the time of production. It is paid to the government by the factory itself, but in reality the burden of the tax falls on those who buy the goods. The producer increases the prices of goods they sell to cover the amount that they have paid in form of excise duties. The rates of excise duties vary depending on the nature of commodity. Excise tax also serves various purposes of price control, adequate supply of essential commodities, promotion of small-scale industries and industrial growth.

Customs Duty

During your visits to the market you might have come across foreign brand products varying from toys, chocolates to stationary and consumable items and probably wanted to purchase it but felt hesitant seeing the price tag. They are highly priced because of the foreign exchange rate (the value of Indian rupee compared to the foreign currency) and also it includes the customs duty imposed on them. Government imposes customs duty not just with the intention

of earning revenue but also to control the commodities moving out and moving in the country. Customs duties are charged on those commodities which we bring in from other countries (import duties) and which we export to other countries (export duties). Usually, the goods that are imported to the country are charged customs duty along with educational cess. The customs duty is evaluated on the value of the transaction of the goods. The Central Board of Excise and Customs under the Ministry of Finance manages the customs duty process in the country.

Types of state taxes

Apart from the central taxes, we also pay certain taxes on various goods and services to the state government. Let us see which these taxes are:

Sales Tax/VAT

Probably this is one of the taxes that you have been paying indirectly to the government. When you purchase commodities or when you eat at a restaurant your bills are inclusive of the sales/VAT taxes. The state governments in India impose sales tax which is paid by the dealer or shopkeeper and this amount is later added to the price of the good. The taxes range in percentages according to the type of goods. Essential commodities such as food, room and board are not taxed. Petroleum, tobacco and liquor are taxed, but the percentage varies from region to region, as the state governments have regulatory control. In most cases, sales taxes are charged on the sale of movable goods. The sales taxes have been replaced with Value Added Tax (VAT). This is the tax that a manufacturer needs to pay while purchasing raw materials and a trader needs to pay while purchasing goods. VAT is eventually expected to replace sales tax. All goods and services provided by business individuals and companies come under the ambit of VAT. The VAT rates of petroleum, tobacco, liquor and so on are higher and differ from state to state.

Goods and Service Tax (GST)

Proposals are being carried out to combine tax on goods as well as services such as VAT, excise duties, service tax and replace them with a single GST. All financial contribution made in the distribution chain will therefore be taxed under GST.

Other taxes:

In addition, there are some other state and local taxes that are applicable. They are:

- Octroi/entry tax
- Stamp duty on asset transfer
- Property/building tax
- Agriculture income tax

Tax Planning

Usually tax planning is in the air during the month Feb-March when you hear and see advertisements for everything from tax saving bonds, insurance products to tax saving mutual funds. Many of the tax saving avenues are not touched upon as we do not give due time and thought to understand and evaluate different options that are specific to the financial situation and usually end within the conventional tax saving techniques. However, if you are to think of tax planning not just as a tax saving exercise instead as a part of overall investment strategy then you have to smarten up the tax-planning exercise. The tax-saving investment that you choose can eventually play a significant part in achieving your financial goals.

How to plan for taxes

Arranging transactions helps in optimizing our tax liability. An understanding of the tax process and tax strategies will help to lower your taxes taking full advantage of the tax benefits. For this, the provisions of the Income Tax Act: all accessible allowances, exemptions, deductions, etc., are to be used judiciously.

Know the Tax process: Basics of income tax

WHO?	All residents in India, whose total income level is more than the maximum exemption limit, are under the domain of chargeable income tax. The payment of the income tax is to be calculated on the total income of the last year in the relevant financial assessment year.
WHEN?	The return has to be filed by 30 th September of the assessment year if the individual, being a sole proprietor, has his accounts subjected to tax audit or is a partner of a partnership firm whose accounts are subject to tax audit and by 31 st July of the assessment year for any other assessee.
HOW?	The income tax payments are paid in the sort of tax deducted at source (TDS), tax collected at source (TCS), and advance tax before the last due date of March 31 st .
WHY?	Government earns revenue through taxes so as to provide basic services and certain amenities to its people in the national interest.

Exemptions: Income tax

Exemptions refer to specified income, which are earned but not taxable. It means that at the

time of calculating annual income, this type of

income will not come under the purview of tax.

These include agriculture income, dividend

income, gratuity, and receipt in respect of

Tax tip: You can claim a deduction of rent paid even if you are not getting house rent allowance (HRA). If you are staying with your parents pay them the rent and avail deduction in your tax.

Tax tip: Buying medical insurance for your parents not only ensures better treatment for them but also will help you to get an additional deduction in taxes.

Tax tip: Chronic illness of a dependant and disabilities can be used to save on taxes. Avail tax deductions for the expenses.

commutation of pension, leave encashment, proceeds from an insurance company, LTA rules, etc. There are certain expenses that you incur that get you tax benefits. School fees paid for two children, the principal amount repaid of housing loan and the medical insurances premium paid for self, family and parents, expenditure on treatment cost of chronic illness of your dependant can be deducted from your taxable income. Interest paid on educational loans

is also deducted from the taxable income and is now available even to the parent or spouse of the borrower. Availing a home loan helps to claim exemptions for the interest payments of up to ₹. 1,50,000 in case of a self-occupied house. The claim can be made even on loans taken for repair, renewal or reconstruction of an existing property. The taxpayers also can claim exemption for the house rent paid. An investment in the medical insurance scheme ensures not only insurance benefits, but also helps to avail tax exemptions. The donations made to particular funds/institutions and contributions made to the recognized political parties are also exempted from taxes.

Deductions:

Deductions refer to those investments or payments which will be deducted from the total income. There are various deductions provided by the Indian Income Tax Act. The tax deductions help to deduct an amount from the taxable income and save tax.

The maximum reduction available for investing in Provident Fund, Public Provident Fund, accrued interest on National Saving Certificate, Life Insurance Premium, National Saving

Evergreen favorites that lighten tax burden

The most preferred investment tax-saving avenues are:

- ***Life insurance policy***: It has three benefits- covers risk, save tax and also is an investment strategy.
- ***Public Provident Fund***: A long-term investment instrument with assured interest rate and contributions and the interest earned thereon is wholly exempt from tax.
- ***Fixed deposit scheme***: Fixed deposits with banks having a lock-in period of 5 years earn tax exemption but the interest earned shall be taxed.
- ***National Saving Certificates***: Safest investment option as it is backed by the government with a maturity period of six years. The interest earned is taxable.
- ***Home loans***: The principal amount repaid, stamp duty and registration charges are eligible for deduction.
- ***Children's tuition fees***: Amount paid towards tuition fees of any two children of an individual is eligible for deduction.

- **Equity Linked Saving Schemes (ELSS):** As these are investments in equity, they carry an inherent risk. An investor who can take on risk in the quest for high returns, should be investing in ELSS schemes through Systematic Investment Plan (SIP) as it is the best solution to counter the volatility in markets.

Certificate, tuition fees paid for children's education (maximum 2 children), principal component of home loan repayment, 5-year fixed deposits with banks and Post Office and Equity Linked Savings Schemes (ELSS) is ₹. 1,00,000. Choices from these tax-saving avenues should be made in terms of the risk-return trade-off. Investments have to be planned in such a way that the post-tax yield is the highest possible and keeping in view the vital parameters of safety and liquidity. Investment in employment provident fund is a compulsory contribution and will give you an amount at the time of retirement. Public Provident Fund and National Savings Certificate turn out to be attractive in terms of assured returns and safety of capital. Choice between PPF and NSC depends whether you are saving to provide for a long-term need or you prefer to make lump sum investment and have a shorter investment horizon. In the former situation PPF would be a better option and in case of latter, the option may be NSC with duration of 6 years or fixed deposits with banks for 5 years. These tax saving measures provide assured rates return, however, offer only negative real returns in an inflationary scenario.

Deductions are also available on various insurance schemes. But the choice of an insurance scheme should be made without tax saving benefits taking precedence over the insurance aspect. Investment in the insurance schemes should have the best insurance cover and not just tax sops. The tax deductions help to deduct an amount from the taxable income and therefore save tax. Whereas, investment in equities through ELSS scheme will help to beat inflation and have the lowest lock-in period of 3 years.

Tax tip: Charity is good not only for the receiver, but the giver as well. You can avail deductions the charitable expenditure and contribution to recognized political parties.

However, after the direct tax code comes into effect ELSS will cease to be a tax saving option. Tax reliefs are also available on investments in long-term infrastructure bonds of specified companies. The interest rates of these bonds are not as high as that offered by the

banks on fixed deposits, but still as it is offered as an additional tax shield they turn out to be worth investing.

Example

Let us see how two friends, Latha and Prameela contributed in form of income tax. Latha works in a multinational company and Prameela is a government official, both earning a total income of ₹. 10,00,000. Latha's company provides her with some allowances-- transport allowance, academic allowance. Etc., which is exempted from tax. She has not yet bought a house and is staying in rented apartment for which she pays monthly rent of ₹. 12,000. She does not take much interest in the tax planning but still has some savings which ensure deduction of ₹. 60,000 from her taxable income. Therefore her taxable income amounts to ₹. 7,52,800 for which she shells out ₹. 85,037 as income tax.

LATHA

Salary Details	Amount	Tax planning strategies
Gross Salary	10,00,000	
Less allowances (her company provides her transport allowance, leave travel allowance, etc.)	80,000	
Exemption of house rent allowance	1,07,200	
Any other exemptions	0	She could have claimed exemptions for the interest paid towards housing loans provided she had availed home loan.
INCOME AFTER EXEMPTIONS	8,12,800	
Deductions under Chapter VI-A	60,000	
Other deductions (medical insurance, medical treatment, donation, etc.)	0	Medical insurance premium for self and family could have given a deduction of Rs. 15,000 and Rs. 20,000 in case of senior citizens.
Aggregate deduction (max. limit)	60,000	She should have some exposure to market

is Rs. 1,00,000).		so that her savings multiply at a faster rate and enable her to claim the maximum limit of exemption.
TOTAL TAXABLE INCOME	7,52,800	
TAX PAYABLE	85,037	

PREMEELA

Salary Details	Amount	Tax planning strategies
Gross Salary	10,00,000	
Less allowances (government provides her transport allowance, academic allowance, etc.)	80,000	
Exemption of house rent allowance	1,07,200	
Any other exemptions	1,50,000	She gets the maximum exemption for the interest paid towards housing loan. This reduces her home loan burden.
INCOME AFTER EXEMPTIONS	6,62,800	
Deductions under Chapter VI-A	1,00,000	She has got deduction for the maximum limit of exemption. She has reduced the principal amount that has been repaid towards her home loan and also has judiciously invested in various schemes like ELSS, PPF, NSC and New Pension Scheme with a view to get tax benefits as well as earn return for future.
Other deductions (Medical Insurance, Medical treatment, Donation etc)	15,000	Medical insurance premium for self and family has provided her a

		deduction of Rs.15,000.
Investment in Infrastructure bonds	20,000	She has availed the additional deduction on this investment
TOTAL TAXABLE INCOME	5,27,800	
TAX PAYABLE	38,687	Planning has helped in reducing her tax payment by Rs. 46,350 and she has the benefit of earning returns in future.

Final but vital Tax tip:
Plan, prepare and organise your taxes:

- *Keep records of investments/savings organized and filed*
- *Keep copies of tax returns filed for the previous years*
- *Spend time for calculating and planning for saving taxes*
- *Tax policies keep changing. Keep a track of it*

Taxes have an impact on nearly every part of your financial life, investment, savings, cash management, debt, home ownership, retirement planning, insurance, etc. Therefore taxes being crucial financial elements

needs to be understood and planned. It is not just another dreary task that has to be conducted annually instead it is an opportunity for wealth creation. So it is important to give tax planning exercise a fair attention and time. Every citizen availing the tax incentives provided by the government not only reduces his tax liability but also ensures a better future through compulsory savings.

Chapter 9

CAREER PLANNING IN PERSONAL FINANCE

Financial literacy is a challenge for India's large, young and growing population. Increasing income of the middle class, along with a high saving rate requires an understanding of financial matters even at the school stage. In addition, the country has a sound banking system and healthy financial sector. At this juncture it is important to engage our young population in financial education and also secure them financially in future.

The study of the subject helps the young to properly manage their money and make optimal decisions for their future. Personal financial literacy includes the ability to read, analyse, manage and communicate about their financial condition that affects their material well being. It helps in making a financial plan for the future, discuss issues relating to finance comfortably and enable them to take informed financial decision throughout their lives.

As is evident an advance course of personal finance will include an elaborate discussion on topics such as student's debts loan consolidation, savings, insurance, budgeting, investment in different portfolio like financial assets and real estate. It can then equip the learners with practical financial knowledge and skills needed to make informed financial decisions throughout their lives.

Scope of Personal Finance

There is a need to investigate whether an economy has scope for learners of personal finance. The world of work has changed dramatically in the last decade. On examining the nature of work, one finds ample opportunity for learners in the field of personal finance. There is a rising number of self directed investment plans and a growing number of seniors who wish to invest in effective retirement plans.

You must have observed whenever you are considering buying an insurance policy or investing in a mutual fund, you try to contact an agent dealing with such financial products. The agent then advises us on various details like premium, number of years of the policy, the risk involved and the amount assured on maturity of the policy. The agents because of their expertise and training given by insurance companies have managed to pursue such a vocation. Similarly mutual fund companies also have trained agents to sell their products. If anyone goes to the income tax office to file their returns, there are large number of people

offering to help them fill in all kinds of forms (Form 16 for salaried people). Banks also have agents to assist to fill up PPF forms, fixed deposit forms, loan application forms, etc. These individuals by virtue of their training and experience have the ability to advise others on personal finance issues.

Therefore, a course in personal finance can be an option for a lucrative career in this field.

Career planning in personal finance

Career planning means acquiring a required degree, finding a job in a good company or be self-employed, showing up for work each day and eventually securing a retired life with lump sum payment. In this field, people earn their living by advising people with respect to investment, insurance and other purchase and sale of financial products. They can also help in making plan for college funding, estate planning and general investment analysis. They can enter the field as an accountant, auditor, insurance sales agent, lawyer, commodities and financial services and personal financial consultant.

Self -Employment

As a self-employed person, the personal finance expert needs to build a customer base because they are the prospective clients. These bases can be strengthened by sponsoring seminars, lectures or through social and business contacts or simply by contacting them on telephone, taking advantage of the wide subscriber base in India. The advisors may also work for finance and insurance companies, including securities and commodities market, banks, and financial investment plans in both rural and urban areas.

Qualifications

This field of work requires certain qualifications for effective conduct of the business. They look for candidates with a bachelor's degree in accounting, finance, economics, business, mathematics or law. Courses in investment, tax planning, real estate planning and risk management are also helpful. They may also seek a certified financial planner, the chartered financial analyst and the chartered financial consultant designation. A love of mathematics and finance is necessary for financial planners. One would also need to possess computer skills, problem solving skills and decision making skills.

Competency of successful people

- i. Set goals in various aspects of life and progress towards goal.
- ii. Adapt time management techniques.
- iii. Exhibit integrity.
- iv. Accountable for decisions and actions taken.
- v. Learn good writing and communication skills.
- vi. Open to new ideas.
- vii. Share knowledge to assist and mentor others.
- viii. Take on new training and work on new skills acquired.
- ix. Anticipate problem and work proactively to implement solutions.
- x. Understand operations, structure and culture of organisations.

You can also become a highly successful financial consultant. See if you can list down the competency required for becoming a financial consultant in this field.

You can become...

Financial planners help an individual or an institution plan their saving, income and investment. They are trained with numbers and are able to understand complicated financial and legal documents. They can be self-employed or an agent of a company. They advise people on appropriate investment opportunities with respect to changing interest rates and the existing economic scenario of the country.

They also examine an individual's short-term or long-term financial situation and help them analyse their own financial matters such as saving and loans, investment services, purchase and sale of financial products, mutual funds, individual retirement account, insurance, real estate or tax sheltered investment plan.

Financial analysts analyse the financial statements of banks, firms or a companies. They assess the performance of stocks, bonds, commodities and other types of investment. They study company's financial statements and analyse commodity prices, sales, costs, expenses and tax rates to determine a company's value by projecting its future earnings. They often meet with company's officials to gain a better insight into firm's prospect and management. They provide guidance to either individual or institution regarding investment decisions in mutual funds, hedge funds, insurance companies, money managers and non-profit organisations with large endowments. They also assist security dealers, such as banks and

other firms, sell shares and bonds. These specialists are highly experienced and qualified people and usually advise education institutions and other similar organisations on how to invest their provident and pension funds.

Then, there are firms who even appoint analysts with specialisation and understand how new regulations, policies and political and economic trends may impact their investment.

Risk analysts evaluate the risks to be borne by the company considering the economic scenarios with special focus on currency futures, derivatives, short selling and other investment decisions. These are highly complex financial products. They can also calculate risks in portfolio decisions, project loss if any, and also suggest how to limit losses or volatility using measures like that of diversifying investments.

Portfolio managers managers are responsible for the overall portfolio and select the mix of products and industries. They take decisions regarding the purchase or sale of their shares in connection with the changing market conditions. Besides portfolio they also advise investors and suggest strategies for profitable investments.

Rating analysts evaluate the debt paying ability of any company. They also analyse budget, cost and credit management of the company. On the basis of their evaluation they rate the performance of the company and also find out whether the government is defaulting on its bonds.

Conclusion

Ensuring good personal finance education in schools will apprise students about asset management and prevent them from making mistakes. It cannot be denied that this supplementary reading material will enrich a student's learning experience and its content will be complementary to other curriculum material.

It is hoped that students enjoy reading this and consider the possibility of becoming a personal financial consultant. Earn well, spend carefully, save moderately and invest more.