Institute of Actuaries of India

Subject CP3 – Communication Practice

March 2021 Examination

INDICATIVE SOLUTION

Introduction

The indicative solution has been written by the Examiners with the aim of helping candidates. The solutions given are only indicative. It is realized that there could be other points as valid answers and examiner have given credit for any alternative approach or interpretation which they consider to be reasonable.

Solution 1:

Personal Finance Knowledge Series – Retirement Savings Part 2

Welcome to this week's newsletter on Personal Finance. Last week, in our newsletter we talked about the options available to individuals to save towards their retirement. In this week's letter we cover the options available for individuals who are about to retire for utilizing their retirement savings.

To start with we will do a quick recap of the means available for savings towards retirement. Most employers would have a scheme which contribute towards your retirement savings which would be available to you as a lump sum at the time of retirement. Additionally, or, if you have been self-employed, you may have some savings from insurance products which are targeted towards retirement as well as the lump sum from your National Pension Scheme savings. Of course depending on your individual circumstances this could be your main savings or you could have additional savings. However, in this edition of the newsletter we will talk about the options available to you on utilizing the savings from these schemes.

The current rules for such lump sums or pension corpus as it is called permit you to withdraw one third of the total corpus at the time of retirement. You would be free to utilize this amount which can be withdrawn from the scheme i.e. commutation as it is usually referred to, in any way you wish. You could choose to save this money and manage it yourself or spend it in any way you wish e.g. children's marriage, a holiday. The balance of the corpus would need to be utilized for buying products that cater to meeting your requirement for an income in your retirement. Remember that Commutation is a choice and you could instead choose to use the entire corpus towards buying your retirement products.

What are the offerings or products which are available for the uncommuted portion of the corpus?

Pension rules require that the uncommuted portion of the corpus should be used to buy an "Annuity" from a life insurance company. What is an Annuity and how does it work? You would pay the uncommuted portion to the life insurance company as a lump sum. The life insurance company in turn provides you with an income or annuity for the rest of your life. The income that is provided depends on a two key factors, your age and the interest rates that are prevailing at the time of purchase of the annuity. If you are older this income would be higher. If interest rates are higher the income would be higher. This income is guaranteed for the rest of your life.

There is a second option which has been introduced recently. You may be aware that interest rates have been coming down over the last few years. This has resulted in a hardship for retirees as the pool of money which they had saved towards retirement may not provide the kind of income which they had originally envisaged. The Government has therefore recently relaxed the rules for compulsory purchase of an annuity. The rules now permit retirees to buy anther product from life insurance companies called the "Income drawdown". As in an annuity the uncommuted portion of the corpus is paid into a life insurance company. However this amount would be invested in a fund of your choice and you would be periodically able to drawdown a portion of the fund. The fund choices that are available vary, funds can be low risk investing in say only Government bonds, medium risk investing in a combination of Government bonds and debentures or higher risk investing in shares of companies. The amount that you withdraw can be fixed or can vary based on your need. The value of the balance fund would go up when returns are positive and fall down when returns are negative. You have the option of changing your mind at any time and using the balance of fund for buying an annuity. The "income drawdown" therefore provides you with a lot more flexibility as compared to buying an "annuity".

In order to help with your understanding we have drawn up an example. Ms.Bee is about to retire and she is 60 years old. She has Rs.25 lakhs in her pension corpus. She can withdraw Rs.8,25,000 which is one third of the corpus. This is the first choice she needs to exercise, whether to withdraw or not. Having made this choice she has to then decide whether to buy an annuity or opt for an income drawdown plan. At the current rates of interest if she uses her entire corpus to buy the annuity she will get an amount of about Rs.1.6 lakhs for the rest of her life. If she commutes one third and uses the balance to buy an annuity, the income will reduce to Rs. 1.1 lakh.

Remember that these amounts are guaranteed and she will be assured of getting this income for the rest of her life. In case she decides she is better off using the income drawdown approach, she first needs to decide how much of the money she would want to drawdown every year. For the time being let us assume that she is happy with what she would have got as an annuity which could be Rs.1.6 lakh or Rs.1.1 lakh depending on whether she has commuted one third of the corpus. We have given below a small table to illustrate the possible number of years that her savings would last. We have also made some assumptions of the returns that her funds would earn.

Amount invested	Number of years the fund would last at 3% return	Number of years the fund would last at 4% return	Number of years the fund would last at 5% return
25 lakhs	21	25	31
16	19	21	26

As can be seen Ms.Bee lives with the risk of savings running out especially if her investments do not give her good returns. On average a female aged 60 is expected to live for 25 years. Depending on an individual's health this could be higher or lower. Remember, that these are all very simple illustrations and in reality the variability of the fund could be much higher or lower. Therefore this option comes with the added responsibility of continuously monitoring the funds and making decisions as to how much to withdraw.

We have summarized the pros and cons of annuity versus income draw down

Annuity

Pros

- Known income guaranteed for life
- Freedom from having to manage the funds

Cons

- Current Interest rates low and therefore would be locked into these interest rates with no ability to benefit if interest rates move up

Income drawdown

Pros

- Possibility of benefitting from potentially higher returns in future
- Flexibility to buy an annuity later
- Flexibility of income

Cons

- Having to self-manage investments
- Possibility of further drop in interest rates
- Fund values can fluctuate
- Possibility of fund running out and not lasting for lifetime

As always keep in mind that this is an educational newsletter and these choices should be exercised carefully. You should also discuss with an expert financial advisor who will be able to look into your individual circumstances before advising you.

Until next week

Team at ABC Financial Advisors

[90 Marks]

Solution 2

Any valid explanation

e.g

I ensured that I kept the newsletter in a conversational style which would make it easy for people to read. I did not use any jargon and tried to explain the options available in as simple terms as possible. I tried to address important factors for someone at that stage of life.

The most important factor for a person retiring is that their savings last for the rest of their lives. Due to the current low interest rate situation it may be tempting for retirees to opt for the income drawdown option. I also highlighted that commutation was also an active choice. I highlighted the advantages and disadvantages of choosing this option. Factors that need to be considered are the variability of funds and the possibility of savings being exhausted. The summary which shows that the fund returns can vary and the possibility of the fund lasting different tenures brings out these aspects.

[4 Marks]

Solution 3

Any term explained

e.g.

This newsletter is to the general public where awareness levels may vary significantly. Any of the following terms may not be clear to the public

Pension corpus

Commutation

Expected mortality

Longevity risk

Annuity

Income drawdown

[4 Marks]

Solution 4

Any valid explanation

Example

I brought out the variability in the annuity that would be available in case commutation option is chosen. I also summarized the results of the variability of returns and the number of years the funds would last.

[2 Marks]

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