



# KARVY BAZAAR BAATEIN

**A Weekly Investment Newsletter From KARVY**  
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## Have A Full Cover

Comprehensive financial planning begins with identifying and understanding the importance of resources which generate wealth and taking the necessary precautions to protect these resources as well as the wealth created, from any kind of unforeseen eventuality. While many people concentrate on wealth creation by investing in quality IPOs, frontline stocks and high quality mutual funds, the aspect of wealth protection often takes a back seat in the larger framework of personal financial planning. This aspect of wealth protection not only includes life insurance, but it encompasses the entire ambit of insurance covers like health insurance, property insurance, liability insurance, mortgage redemption plans, etc.

In this issue of Karvy Bazaar Baatein, we attempt to discuss the importance of insurance as a wealth protection tool, with the emphasis on adequate and right insurance cover.

As an individual travels through the journey of life, his profile keeps changing. Consequently, his insurance requirements also undergo a change. For example:

**(i) Initial years** – During the formative years of a person's life, he/she may not have any dependants. However, a loan may have been taken to finance ones higher education / profession studies or for the purchase a house or a car. This loan needs to be repaid and requires a suitable insurance cover against the loan amount so that in the event of the repayer's unfortunate death, the burden of paying the EMIs does not fall on the surviving members of the family. Moreover, a health and an accident insurance plan provide for the reimbursement of hospital bills

and the required financial assistance to the individual, respectively.

- (ii) At the time of marriage** – Marriage requires the person's insurance requirements to be revisited. The individual should either look at enhancing his/her life insurance cover or at taking a policy in the name of his/her spouse.
- (iii) Birth of a child** – This is perhaps the most significant phase in the life of a person. The arrival of a child brings with it moments of great joy and also loads of responsibility. This is yet another phase where the person's insurance needs should be re-considered. Here, the possibility of taking up a child insurance plan cannot be ruled out.

From the above discussion, it becomes evident that one needs to have a proactive approach towards insurance. Non revision of ones insurance needs can result in the risk of over-insurance and under-insurance (later discussed in this article). Also, in addition to taking up an insurance policy, another very important decision that needs to be taken into consideration is that the insurance cover needs to be appropriate to cope with future exigencies.

Insurance planning seldom has an important position in the list of priorities of an individual. More often than not, consideration of an insurance plan primarily for the purpose of management of risks to which an individual is exposed to, is one of the most neglected financial decisions. An insurance plan is usually taken for purposes like tax planning, investment returns, etc. However, the main reason for taking up an insurance policy should be for the risk cover that the insurance plans provide. Here, it becomes

very critical to carry out a close introspection of one's needs and requirements before finalizing on an insurance policy. Some of the aspects that need to be taken care of are:

- (i) Selection of an insurance plan(s) according to one's financial needs and requirements. Those needs that cannot be met in other ways should especially be factored.
- (ii) The cost of taking the policy should not outweigh the benefits from the same. The policy holder should be in a position to comfortably afford the insurance premiums. For example, taking up a 'money back plan' can be an expensive proposition in case the individual does not have adequate financial reserves to provide for the comparatively higher premiums.
- (iii) As discussed earlier, a periodic revision of the insurance portfolio so as to take stock of the changing needs and requirements.

When considering taking an insurance policy, a question that strikes every person is how much of insurance am I supposed to take?" Though this remains one of the cornerstones of insurance planning, most investors approach this issue rather arbitrarily.

Here, we briefly discuss some of the different methods that are actually used for ascertaining the quantum of insurance that is required to be taken by an individual. These methods are:-

**Rule of thumb method** – Across the country, many insurance advisors use this method to compute the required quantum of insurance cover. This method is simple and easy to implement. According to this method, the insurance requirement of an individual will be six to eight times the annual income. For example, a person's annual earning taken to be Rs.3,50,000, his insurance requirement could range anywhere from Rs.17,50,000 to Rs.28,00,000. The main disadvantage of this method is that it is too simplistic and in many cases it fails to reflect the true insurance requirements that an individual may have.

**Proportionate premium method** – This method is based on

the computation of the premium of an insurance policy rather than the amount of life insurance coverage. In other words, this method tries to compute the amount that needs to be spent on insurance premiums and accordingly the sum assured is arrived at. This method will have its relevance in the context of unit linked insurance plans where the coverage depends upon the premium that one chooses to invest. According to this method, close to 6% of the bread winner's gross income plus an additional 1% for every dependant should be the amount that needs to be spent on insurance. For example Kishore is earning Rs.6,00,000. He has married to Saadhana who is a housewife. They have a child by name Akshay. As per this method, the amount that Mr. Kishore would have to spend on insurance policy will be

$$[(6/100*6,00,000)+\{2*(1/100)*6,00,000\}] = \text{Rs.48,000.}$$

Hence, Kishore should spend close to Rs.48,000 on life insurance so as to have an optimal cover. As compared to the earlier method, the proportionate premium method takes into account the premium amount. This helps in getting a clear picture of the actual cash outflow that the investor will have to cope with in case he takes an insurance policy. However, this method is also a highly generic approach and does not cater to a person's unique needs and requirements.

**The Human Life Value (HLV) approach** – The human life value approach for calculation of amount of sum assured for which an individual should assure his life takes into consideration the following aspects:

- ❖ Average of present value of the annual future earnings of the individual.
- ❖ The number of years the individual is expected to work before he / she retires.
- ❖ The expenses that the incurred by the individual on him / herself.

For example, Mr. Hitesh Rathod will on an average earn an annual income of Rs.10,00,000 in future and his expected number of

working years is 20. With an annual expenditure of Rs.2,00,000 to be incurred on himself (in the form of maintenance expenses, taxes, etc.), the human life value of the person will be

$$= [(10,00,000 - 2,00,000) * 15] = \text{Rs.1,20,00,000}$$

where, 15 is the inflation adjusted rate of return for 20 years

This means that Mr. Rathod, will need to have a life assurance cover of Rs.2.40 crore on his life.

**The Need Replacement approach** – The need replacement approach is based on the principle that even in the absence of the breadwinner, the dependants should have the requisite financial buffer to sustain the same kind of lifestyle that they led before. In other words, according to this method, the objective of life insurance should be to cover the surviving family's immediate needs as well as their ongoing expenses into the future. These needs are classified as "immediate needs" and "deferred needs".

In the event of the unfortunate death of the breadwinner, some of the immediate expenses that the surviving dependants may have to cope with could be:-

- ❖ Final medical treatment costs, including the medical bills that are pending.
- ❖ Funeral and last rite expenses.
- ❖ Repayment of the various loans, etc. that had been taken by the deceased.
- ❖ Re-adjustment expenses, that will need to be incurred by dependants to adjust to life style that will be required to be lead in the absence of income of deceased. This is usually a phase of 1 – 3 years after the death of the breadwinner.
- ❖ Expenses pertaining to school fees, tuition fees, etc. which are required to ensure that the children's education is not compromised in any way.

Some of the deferred expenses and financial outflows that can be thought of are:

- ❖ A provision for the higher education of the children.
- ❖ A lump sum required to celebrate daughter's marriage and / or to provide for the start in life for son.
- ❖ A corpus sufficient to provide for the old age needs of the surviving spouse.

The need replacement approach, hence, takes into consideration all the above and more such financial needs that will be adequately covered by the insurance cover.

The following steps need to be adopted in order to compute the sum assured under this method.

**Step I – Assessing the needs of the person** – This will involve quantifying the various expenses that the person that will need to be incurred. The expenses will be the immediate and deferred expenses as mentioned above.

**Step II – Ascertaining the available resources** – Once the needs are ascertained, the next step is to ascertain the existing assets that can be easily converted into cash. These assets could be (i) bank accounts (credit) balances, (ii) market linked assets like mutual funds, stocks, bonds, etc, (iii) post office savings schemes, (iv) other insurance policies that the person may have taken, etc.

In simple terms, the insurance equation will be life insurance will be total needs of the person (both immediate and deferred) minus expected available assets.

Note: While computing the needs, it will be appropriate to discount the expenses to present value so as to arrive at an accurate life insurance estimate.

This method of ascertaining the insurance requirement can be understood with the help of the following illustration.

Mr. Rohan Kanhai is 35 year old software professional. His annual income is Rs.15,00,000. His monthly expenses constitute the following items:

## Expenses schedule

| Expense               | Per month (Rs.) | Per annum (Rs.) |
|-----------------------|-----------------|-----------------|
| Rent                  | 5 000           | 60 000          |
| Telephone             | 1 000           | 12 000          |
| Conveyance            | 3 000           | 36 000          |
| Groceries             | 5 000           | 60 000          |
| Entertainment         | 2 000           | 24 000          |
| Electricity           | 1 500           | 18 000          |
| <b>Total expenses</b> | <b>17 500</b>   | <b>2 10 000</b> |

In addition to basic expenses, Mr. Kanhai has taken a loan of Rs.25,00,000 for 25 years. The loans and other obligations that the individual will have to cope should also be factored into while computing the insurance requirement.

### Loans schedule (loan taken for purchase of house)

|                   |               |
|-------------------|---------------|
| Loan              | Rs. 25,00,000 |
| Duration in years | 25 years      |
| Interest rate     | 9.50% p.a.    |
| EMI (Rs.)         | Rs. 21,842    |

Assuming an interest @ 9.5% the EMI approximately comes to Rs.21,842.

In addition to basic expenses, according to this method, it also becomes necessary to ascertain to the various expenses that are likely to be incurred at the time of death so that the necessary provisions may be made. These expenses may be:- funeral, legal expenses, costs of hospitalization, ambulance charges, etc.

Over and above these expenses, it also becomes relevant to factor in the contingency buffer that needs to be set aside to cope with immediate needs.

Based on the aforementioned data, the insurance calculation is shown below:

## Insurance Calculation

| Details  | Amt. Rs. | Perpetuity       |
|--|----------|------------------|
| Present value of expenses per annum (Ref. Exhibit 1) | 2 10 000 | 35 00 000        |
| Liabilities (mortgages and loans) (Ref. Exhibit 2)   | 2 62 109 |                  |
| Contingency buffer                                   | 52 500   |                  |
| <b>Insurance need</b>                                |          | <b>38 14 609</b> |
| Existing insurance cover                             |          | NIL              |
| <b>Insurance cover that needs to be taken</b>        |          | <b>38 14 609</b> |

Thus, from the above calculation, Mr. Kanhai needs to take an insurance policy of Rs.40,00,000.

With the discussion of the various methods by which a possibly accurate valuation of an individual's life assurance cover, it will be imperative to briefly discuss the risk of over insurance and under insurance.

Over insurance, as the name suggests, refers to the quantum of insurance or the sum assured taken being much more than what is actually required. The conservative point of view would generally advocate for over insurance to a certain extent, as it being necessary to provide for the extra buffer that the insured may need due to changes in profile and circumstances. However, a prudent insurance advisor will always discourage taking a more than required sum assured under an insurance plan. This being so because insurance comes at a cost i.e. the premium payable. And hence, over insurance results in payment of insurance premium that is greater than what actually needs to be paid. This is an unnecessary expenditure incurred that could have otherwise been invested by the individual and would have helped in the creation of wealth.

On the other hand, under insurance can lead to greater negative financial repercussions as here the insured is not adequately covered against the risks to which he is exposed. In case of life insurance, in the event of the unfortunate death of the life

assured, the dependants will receive a sum assured that is not enough to enable them to maintain the same life style and meet the financial obligations including loans, etc. outstanding at the death of the life assured. In a worse scenario, the dependants could be embarrassed for their very basic sustenance requirements. In case of a non-life or general insurance policy, the claim amount payable to the policy holder gets proportionately reduced due to the application of the under insurance clause. For example, a property (say a building) whose actual value is Rs.20,00,000 is insured for a sum assured of Rs.16,00,000. In the event of damage to the property to the extent of Rs.5,00,000 due to the happening of an insured risk (fire), the compensation payable under the insurance policy will be

$$= 5,00,000 \times 16,00,000 / 20,00,000 = \text{Rs.}4,00,000$$

Hence, the compensation actually paid is much lesser than what would have otherwise been paid if the property has been insured at its actual value of Rs.20,00,000.

The discussion on importance of adequate and right insurance cover would not be complete without a discussion on the concept of insurability.

In general, various products and services are saleable to any person who can pay the cost / price for these. There is usually no restriction as regards their availability to a particular category or group of people. In case of insurance, however, the same is not true. This is so as an insurance policy (specially a life assurance policy) can be sold only to individuals who are 'insurable'. Insurance can thus be considered as a privilege.

The aspects or the factors that constitute the basis for 'insurability' are:

1. Need for insurance
2. Capacity to pay for the premiums
3. Medical fitness

As in common knowledge, the very purpose of (life) insurance is to provide financial protection to the dependants in the event of the unfortunate death of the bread winner. Hence, an individual has a genuine need for insurance when other lives are dependant on his / her life. In other words, the need for insurance is said to exist for an individual when another person(s) is benefited from the continuity of the life of the former and will face a financial setback in the event of death of this life. It is in a very rare case that an individual will have no dependants who would look forward to him /her for their financial support. In such a case also, even if there is no actual need for insurance, the person will be insurable if he can afford to pay the premiums for the insurance policy and is adjudged as being medical fit to be insured.

The capacity to pay the premiums is simply the ability to afford the premiums under an insurance policy. Only those people who can pay for the cost of getting insured and qualify the other two insurability factors can be insured.

Medical fitness of an individual, from the insurability point of view, takes into consideration a number of factors such as age, sex, personal and family history of diseases, present state of health, habits and occupation (work conditions and associated hazards). All these factors individually as well as collectively help the insurance company in deciding whether or not a person is insurable at standard / special term & conditions of the insurance plan.

The above three factors form the basis for deciding whether an individual can be covered under an insurance plan. Delay in an insurance decision can render an individual uninsurable as he may: cross the maximum entry age for the insurance policy; may be diagnosed with a critical illness that constitutes a major exclusion under the policy; would simply no longer have the financial capacity to pay the premiums under the policy. Hence, it becomes very important to choose the right insurance plan with a right quantum of insurance at the earliest possible time.

## Product Showcase :: Reliance Golden Years Policy

Reliance Golden Years Policy is a unit linked pension policy from Reliance Life Insurance Company Limited.

### Unique features

The policy works in two parts – the accumulation period (i.e. the policy term) and the distribution period. The accumulation period is the time when retirement corpus is build up through premiums payment. On the chosen vesting date/age, the accumulation period ends and the distribution period begins. The policy holder can choose the age of retirement (vesting date/age). The annuity payments begin after the vesting date/age. However, the policy provides the flexibility to advance / extend the vesting age.

Policy provides the flexibility of increasing the fund value through top-up premiums, at any time at any time during the policy term (accumulation period). Minimum top-up amount is Rs.2,500 and 95% of the top-up amount gets allocated to the fund(s) chosen.

### Policy benefits

#### Vesting benefits:

At the age of vesting (retirement), one-third of the fund value can be commuted as tax free lump sum amount. The remaining amount will be required to be can be used to purchase an annuity policy from either Reliance Life Insurance Company or any other life insurance company.

Annuity options available under the policy are:

1. Life annuity
2. Life annuity with return of purchase price (amount of fund value used to purchase the annuity policy) on death,
3. Annuity certain for 5, 10 or 15 years and life annuity thereafter.

#### Death benefit:

In case of death of the policy holder during the policy period (accumulation period), the beneficiary will receive the fund

value accumulated under the policy. The beneficiary has the option of taking this payment as a lump sum or in installments under an annuity policy from the above or any other insurance company.

### Eligibility parameters

**Age at entry** – minimum – 18 years; maximum – 65 years

**Vesting age** – minimum – 45 years; maximum – 70 years

**Policy term** – minimum – 5 years and subject to the vesting age

**Premium payment options** – regular premiums; single premium (minimum Rs.10,000); top-up premiums (Rs.2,500)

**Premium payment frequency** – with respective minimum premium amount: annual (Rs.10,000), semi-annual (Rs.5,000), quarterly (Rs.2,500), monthly (Rs.1,000)

### Policy charges

**Premium allocation charges** – for regular premium policy – 10% for the 1st year and 5% subsequently; for single premium policy – 5%; for top-up premiums – 5%.

**Fund management charge** – ranging between 1.50% and 1.75% p.a. depending on the choice of the investment fund and subject to revision.

**Switching charge** – 1% of the amount switched subject to a maximum of Rs.1,000 / switch after one free switch.

**Surrender charge** – 100% of the fund value in 1st to 3rd year; 10% in 4th year; 5% in 5th year and NIL in the 6th years and afterwards.

## Investment fund choice

The premium can be invested in any one of the four funds available under the policy or a combination of these policies. The policy details are:

| Fund Name           | Investment Objective                              | Risk Profile  | Investment Allocation  |              |
|---------------------|---|---------------|--|--------------|
|                     |   |               | Fixed interest securities  | Equities     |
| Capital Secure Fund | Maintenance of investment contributions           | Low           | 100% (in Bank Deposits, Government Bonds and Debt Instruments less than 180 days duration) | 0%           |
| Balanced Fund       | Provide returns exceeding the inflation rate      | Low to Medium | At least 80%   | Maximum 20%  |
| Growth Fund         | Provide returns exceeding the inflation rate      | Medium        | At least 60%   | Maximum 40%  |
| Equity Fund         | Provide high returns exceeding the inflation rate | High          | Maximum 30% (in Bank Deposits)   | Maximum 100% |

One can invest a maximum of 40% of the premium in Capital Secure Fund.

Policy provides the option of switching between the funds. One switch is free-of-charge in a policy year. For every additional switch, a switching charge will be levied.

## Tax benefits

The premium payable under the policy is eligible for deduction under Section 80C of the Income Tax Act, 1961.

**Important:** In this policy, the investment risk in the investment portfolio is borne by the policyholder.

**KARVY Regional Offices:** **Hyderabad:** Karvy Centre, 8-2-609/K, Road #10, Banjara Hills, Hyderabad-34, Ph: 040 - 2331 2454/2332 0251 ◇ **Ahmedabad:** 201-203, Shail, Opp: Madhusudhan House, Behind Girish Cold Drinks, Off C G Road, Ahmedabad - 380 006, Ph: 079 - 2642 0422/2640 0527/28 ◇ **Aurangabad:** Shop No.214/215, Tapadiya City Centre, Nirala Bazar, Aurangabad - 431 001, Ph: 0240-2363517/23/24/30 ◇ **Bangalore:** No.59, Skanda, Putanaroad, Basavanagudi, Bangalore - 560 004, Ph: 080 - 2662 1192, 2662 1193 ◇ **Bhopal:** Kay Kay Business Centre, 133, Zone 1, M P Nagar, Bhopal - 462 011, Ph: 0755 - 3013113, 3010728 ◇ **Chandigarh:** Sco 371-372, Above HDFC Bank, Sector 35-b, Chandigarh - 160 022, Ph: 0172 - 5071726, 5071727 ◇ **Chennai:** G-1, Swati Court, 22, Vijaya Raghava Road, T Nagar, Chennai, Ph: 044-2815 3445 ◇ **Cochin:** Kochi, G 39, Panampally Nagar, Opp: Kerala State Housing Board, Kochi-682 036, Ph: 0484-2310884, 2322152 ◇ **Coimbatore:** SNV Chambers, 482/483, Cross Cut Road, Opp: Power House, Gandhipuram, Coimbatore-641 012, Ph: 0422 - 2237 501 to 506 ◇ **Indore:** DM Towers, 105, 106 & 107, Above Standered Chartered Bank, Near Jangeerwala Chowrah, Indore - 452 001, Ph: 0731 - 3014200-19 ◇ **Jaipur:** S-16/A, Land Mark, Opp Jai Club, Mahaveer Marg, C-Scheme, Jaipur-302 001, Ph: 0141 - 2375039, 99, 2363321 ◇ **Kolkata:** Jatin Bagchi, Road-16, Jatin Bagchi Road, Ground Floor, Kolkata -700 029, Ph: 033 - 2465 5006, 2465 5392 ◇ **Lucknow:** 94, Mahatma Gandhi Marg, Opp: Governor House, Hazratganj, Lucknow - 226 001, Ph: 0522 - 2236820 to 26 ◇ **Ludhiana:** Ground Floor, Sco 2, Aptech Building, Feroze Gandhi Market, Ludhiana - 141 001, Ph: 0161-3018445, 3018460 ◇ **Mumbai:** Transworld Bldg., 16-26, Bake House, Maharashtra Chamber of Commerce Lane, Opp: MSC Bank, Fort, Mumbai - 400 023, Ph: 022 - 2204 0229/230 ◇ **Nagpur:** 230-231, 3rd Floor, Shriram Shyam Bazar, Next to NIT Building, Sadar, Kingsway, Nagpur - 440 001, Ph: 0712 - 5612374, 5612375 ◇ **Nasik:** F-1, Suyojit Sankul, Sharanpur Road, Nashik - 422 002, Ph: 0253 - 5602542/43 ◇ **New Delhi:** 105-106, Arunachal Building,19, Barakhamba Road, Connaught Place, New Delhi -110 001, Ph: 011 - 41520316, 66305325, 2332 4401, 4409 ◇ **Pune:** Rachana Trade Estate, Law College Road, Erandwane, Pune - 411 004, Ph: 020-6604 8790 to 95 ◇ **Vadodara:** Sayajigunj, 31-34, Payal Complex, Near Vadodara Stock Exch, Opp: Vakal Seva Kendra, Sayajigunj, Vadodara - 390 005, Ph: 0265 - 2225 168/169, 2361 514 ◇ **Vijayawada:** 39-10-7, Opp: Municipal Water Tank, Labbipet, Vijayawada-520 010, Ph: 0866 - 2495 200, 400, 500 ◇ **Vizag:** 47-14-4, Eswar Paradise, Dwaraka Nagar Main Road, Vishakapatnam - 530 016, Ph: 0891-2752915 to 18

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Some activities you  
could take up soon

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by **S. Gopichand** on behalf of Karvy Stock Broking Limited.

**Editor:** S. Gopichand

**Personal Finance Team:**

Atul, Pradeep, Murugavel

**Designed by:** Raju, Priya

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