Chartered Retirement Advisor (CRA)

Introduction to Financial Planning

Role of Finance in our life:

- Money required throughout life
- Our life is surrounded by growing needs and aspirations
- Uncertainty in quality, quantum of future needs
- Money required more in years ahead than today
- Money is biggest savior in today's physical world

What is Financial Planning:

- Financial planning aims at ensuring that a household has adequate income or resources to meet current and future expenses and needs.
- Financial planning refers to the process of streamlining the income, expenses, assets and liabilities of the household to take care of both current and future need for funds.
- It works primarily through the identification of key goals and putting in place an action plan to realign the finances to meet those goals.

Scope of Financial Planning Services:

a. Personal financial analysis
b. Debt counseling
c. Insurance Planning
d. Investment Planning and Asset Allocation: This is one of the core functions of the adviser and many specialize in asset allocation and investment planning.
e. Tax Planning
f. Estate Planning

Step wise Financial Planning Process:

- Define profile.
    - Personal and family details
- Define Life goals
    - Emergency funding, Insurance Planning, Child Education, Owning a house, Car, Children Marriage, Planning for Holidays, Entrepreneurship, etc.
- Understand the ability to save and the need for cash flows
    - Net worth Analysis – Asset and Liability
    - Cash Flow Analysis -- Inflow and Outflow
- Understand the risk profile
    - Ability to bear the loss
    - Physiological Behavior - Greed and Fear, Herd Mentality
- Understand the tax liability and fund requirements
    - Matching changing taxation implication vis a vis changing income Inflow
- Create asset allocation plan
    - Fine Balancing between Safety, Liquidity, Growth
- Enable actual investment
    - Selecting different products from Debt, Equity
    - Deploying different strategies
- Review and rebalancing
    - Time v/s investment Risk
    - Analyzing market risk and taking corrective measures

SMART Financial Goal:

- Specific — You need to know exactly what you want and when
- Measurable —Your goal should be measurable so that you know when you can achieve it
- Achievable — Your goals should be reasonable i.e. within your reach
- Realistic — Your goals need to be based on resources and tasks that you can reasonably accomplish.
- Time bound — Goals with timelines allow you to track your progress and encourage you to keep going until you reach your goal

Assets, Liabilities and Net worth Analysis:

- The physical and financial assets represent the investments made by the investor. While these assets represent financial benefits and returns to the holder, the financial strength of the household depends upon how the assets are acquired.
- Loans and borrowings used to buy assets create a liability and impose a repayment obligation on the buyer and a charge on the future income of the household.
- Loans taken to buy appreciating assets add to the long-term wealth.
- Loans taken to buy financial assets, also called leveraging, is risky because of the higher volatility in the price of such assets.
- Assets acquired without taking on a liability add to the financial strength of the household.
- An assessment of the financial well-being of the household can be made by calculating the Net worth.
- The net worth is calculated as Assets – Liabilities. Higher this number better is the financial position of the household.
- Net worth should be calculated periodically, and the progress tracked to bring the financial situation to the desired stage.

Understanding Client's Financial Situation:

- Income is used to meet current expenses and create assets to meet future income needs and expenses.
- Expenses have to be controlled to fit into available income and to be able to generate savings.
- Savings are used to create assets that will generate income for the future needs.
- Borrowings or loans may be combined with savings to acquire assets of a large value or meet expenses.
- Borrowings impose a liability to be met out of income to pay the cost and repay the loan.
- Financial planning helps in understanding the relationship between the four elements of the personal finance situation of an individual: income, expenses, assets and liabilities so that all the current and future needs are met in the best way possible.

Identifying Financial Goals:

- Financial goal is the term used to describe the future needs of an individual that require funding. It specifies the sum of money required in order meeting the needs and when it is required. Identifying financial goals help put in place a spending and saving plan so that current and future demands on income are met efficiently.
- Financial goal contains two important components: (a) value of the goal and (b) time to goal.
- Rs. 2 lakhs required each month after 10 years to meet household expenses in retirement.
- Rs. 10 lakhs required after 5 years for a foreign holiday

- Rs. 17 lakhs required after three years as down payment for a house
- Rs. 5 lakh required after 6 months to buy a car

Goal Value

- The goal value that is relevant to a financial plan is not the current cost of the goal but the amount of money required for the goal at the time when it has to be met. The current cost of the goal has to be converted to the value in future.
- Inflation factors
- The future value of a goal = Current Value x (1+ Rate of Inflation) ^ (Years to Goal)

Time to Goal or Investment Horizon

- Short-term, medium-term or long-term.
- The term to goal refers to the time remaining for the funds to be made available to meet the goals.
- The investment horizon will determine the type of investment that will be selected for investing funds for the goal.
- Short term – Low Risk, Longer term –Higher risk, better returns

Funding the goal

- Funding goals will depend upon the existing investments and assets that are available to meet future goals and the ability to save.
- Assessing the ability to fund goals:

1. What is the current income available to meet expenses?
2. What is the level of expenses?
3. What is the amount of income that can be saved?
4. What are the assets available that can be used to meet goals?
5. What are the liabilities existing that also have a claim on income?

- Higher the return earned on investments, lower will be the current savings needed since the higher returns earned will lead to the savings grow to a larger amount.
- Longer the period available to accumulate the saving, lower will be the savings needed since the savings have a longer time to earn returns and reach the required value

Risk Profiling

- Clients' financial risk tolerance - attitudes, values, motivations, preferences and experiences, is measured with a risk profile.
- Risk tolerance is the assumed level of risk that a client is willing to accept.
- Risk capacity: the ability to take risk
  - ➢ This relates to the client's financial circumstances and their investment goals.
- Risk attitude: the willingness to take risk
  - ➢ Relating to an individual's psychology
- Conservative/Moderate/Aggressive type of risk profile

Budgeting

A budget helps a household plan its income and expenses so that the income available is utilized in the best possible way to meet current and future requirements.

The steps to making a budget are the following:

1. List and total the regular and definite incomes that will be received in the period.

2. List and deduct the mandatory expenses from the total income. What is left is the disposable income.
3. Identify essential living expenses of the household and deduct from the disposable income.

4. List the discretionary expenses and deduct it from available income to arrive at the savings

Financial Planning Delivery Process:

6-step process that is used in the practice of financial planning

1. Establish and define the client-planner relationship

The planning process begins when the client engages a financial planner and describes the scope of work to be done and the terms on which it would be done.

2. Gather client data, including goals

The future needs of a client require clear definition in terms of how much money will be needed and when. This is the process of defining a financial goal.

3. Analyze and evaluate financial status

The current financial position of a client needs to be understood to make an assessment of income, expenses, assets and liabilities. The ability to save for a goal and choose appropriate investment vehicles depends on the current financial status

. Develop and present financial planning recommendations

The planner makes an assessment of what is already there, and what is needed in the future and recommends a plan of action. This may include augmenting income, controlling expenses, reallocating assets, managing liabilities and following a saving and investment plan for the future.

5. Implement the financial planning recommendations

This involves executing the plan and completing the necessary procedure and paperwork for implementing the decisions taken with the client.

6. Monitor the financial planning recommendations

The financial situation of a client can change over time and the performance of the chosen investments may require review. A planner monitors the plan to ensure it remains aligned to the goals and is working as planned and makes revisions as may be required.

Steps in Insurance Planning

a. Identify insurance need

- Income replacement needs
- Income protection needs
- Asset protection needs

The type of insurance required depends upon the age and stage in the life of the individual.

b. Estimate the amount of insurance required

The amount of insurance required must be calculated giving

due consideration to factors such as the future value of the costs being sought to be replaced, the period for which protection is required and, the ability to bear the cost of insurance.

c. Evaluate the type of policies available for their costs and features

- A product should be chosen based on the features that are applicable to the individual, and not merely on the basis of multiplicity of features available in it.

- The cost associated with the insurance is an important parameter while evaluating insurance products. Insurance is a long-term commitment, and exiting midway is difficult and has financial implications.
- It is therefore essential to consider the suitability of the product, features and cost before signing on.

d. Evaluate insurance needs periodically since needs keep changing

- Every change in the lifecycle of the individual will warrant a review of the adequacy and coverage provided by insurance.
- These include change in status from single to married, having children and approaching retirement.
- Similarly, changes in financial situation and commitment such as higher or lower income levels, purchase of home, all trigger an insurance review.

Life Insurance Needs Analysis:

Human Life Value (HLV)

The amount of life insurance cover required depends upon the economic value that can be attached to human life.
This is the value that insurance needs to compensate for if there is a loss to the life, or disability which results in a reduction in the ability to generate income.

HLV is the present value of the expected income over the working life of the individual that is available for the dependents.

That is Human Life Value and would be the amount of insurance required after considering the future value of assets already available that will contribute to this value.

Income Replacement Method

This is a method of calculating the amount of life insurance a family will need based on the income that they would have to forego if the insured were to pass away today.

It is usually calculated by taking into account a number of factors including but not limited to the insured individual's age, gender, planned retirement age, occupation, annual wage, employment benefits, as well as the personal and financial information of the spouse and/ or dependent children.

The information required to calculate HLV:

- The number of years the individual is likely to earn (Retirement age less present age).
- Average annual earnings during the earning years.
- Amount of personal expenses like taxes, personal costs, insurance premium which is deducted from

annual income.

- The rate at which the income is expected to grow over the earning years The rate of return expected to be earned on the insurance proceeds or corpus

Need Based Approach

This is a method of calculating the human life value, and therefore the amount of life insurance required by an individual or family, based on the amount required to cover their needs and goals in the event of the demise of the earning member.

The need based approach considers what is already available in the form of investments, assets, and dues such as EPF, gratuity that will contribute to the corpus. Insurance will be taken for the remaining value.

The information required to calculate HLV:

- The needs and goals that have to be met and their current value
- Inflation rate applicable
- The current value of the available investments
- The rate at which the investments are expected to grow