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STUDY OF SCOPE & IMPORTANCE OF PERSONAL FINANCIAL PLANNING IN TODAY'S COMPETITIVE ERA

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Abstract

This research paper is written keeping in mind the growing needs for personal financial planning of the investors. Personal financial planning (PFP) has become one of the important aspects where-in the investors have become more prone towards their financial decisions and investments.

The research paper focuses on things like: Meaning of PFP, Need and scope of Financial Advisory Services, Financial Planning Delivery Process and relevance of PFP in financial investments.

The research paper specifically caters to the client's risk appetite taking into consideration the investor's age, regularity and sustainability of income, family situation, current financial picture, and overall tendencies and investment disposition. Another important element in figuring out the investor's understanding, level of sophistication and experience with investing. These factors help formulate a customized investment strategy for the investor.

Introduction:

Everybody earns money with an objective to fulfill one or many of one's life goals. People use money for purposes as simple as funding their daily household expenses to buying exotic luxuries for a better life. Money can be saved, accumulated and grown to fund various financial goals of a person; such as education, marriage, house purchase, retirement and even passing on as legacy to the next generation. So money earned is either used to fund some of the immediate expenses or some goal in distant future.

There are three ways of earning money: first, you earn a salary by rendering service to your employer; second, you earn a profit from your own business; and third, you invest and manage the surplus money and let it grow or give you an income.

When money earned is to fund one of the future goals, it needs to be invested in an optimum way to give maximum returns taking into consideration the individual's risk profile and time horizon of the goal and the taxation aspects related to personal finance.

In earlier days, managing money was not so difficult-high interest rates, assured return schemes, government sponsored retirement benefits, few financial products, a strong joint family system, a modest lifestyle and cost of living - all made it simple for a common man to manage his money without any external expertise. The economic and the personal finance landscape have changed drastically since the early 90's as the Indian Economy opened up and financial sector reforms were undertaken.

Considerable percentage of the Urban India now has a higher household income and disposable income. Interest rates on debt instruments have fallen from as high as 12% in the 90's to 7% - 8% today whereas inflation is also in the same range. The number of products and their complexity has increased considerably with no surety of returns. The manufacturers of financial products are generating a plethora of information on personal finance issues which need analysis from the viewpoint of risk, liquidity, and appropriateness apart from comparison within and across classes of such products. The cost of living and aspirations have gone up putting pressure on income, which has to generate the best return under the given circumstances. People have scarcity of time in managing their hard earned money. Moreover, the increasing complexity of financial products makes it imperative for an individual to seek experts' opinion in managing one's finances in a disciplined manner.

This is where Financial Planning as an approach to managing personal finances helps an individual to fulfill life's numerous goals with available resources. A qualified and professional financial advisor using the Financial Planning approach to offer solutions, products and services in a holistic manner to his/her clients can make a difference to their lives as well as earning an advisory fees for himself/herself.

What is financial planning?

A very commonly used definition of Financial Planning is "Financial Planning is the process of meeting one's life goals through the proper management of personal finances." It's best to understand the above definition by breaking it up into three parts;

Financial Planning is a Process: Worldwide professional financial advisors follow a standard six-step process to deliver Financial Planning services consisting of:

1. Establishing and defining client relationship
2. Gathering client data, including goals
3. Analyzing and evaluating current situation and needs
4. Developing and presenting recommendations
5. Implementing the recommendations
6. Monitoring and reviewing the Financial Plan

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Meeting one's Life Goals: Individuals and families have many goals in life to fulfill for which they will have to save, accumulate and grow their money. The most common life goals are:
1. Children's future including education and marriage
2. Buying a house
3. Comfortable Retirement

Other goals may include going on regular or one time vacations, purchasing a car/vehicle, corpus for starting own business and being debt-free (home loan, car loan), etc.

Management of Personal Finances: Financial Planning is all about managing finances of an individual or a family. It should not be mistaken for corporate finance although many of the concepts used in corporate finance are used in Financial Planning. While offering solutions to clients, the following aspects of personal finance should be analyzed as a whole rather than seeing them in isolation:

1. Income 4. Liabilities
2. Expenses 5. Insurance
3. Assets 6. Taxation

Need for financial advisory services:

Factors driving the need for financial advisory services are many, including a strong economic growth experienced over the last two decades and rise in the income level of the people. The launch and availability of numerous life insurance products, mutual funds (MFs), and online stock broking is yet another factor for a common man to hire a Financial Planner who can guide him through the maze of products. Interest rates on the debt instruments have fallen over a period of time forcing the investor to seek other asset classes including equity in order to beat inflation. Therefore, most of the savings which were earlier parked in investments like fixed deposits, gold and real estate are finding alternate investment avenues for the twin purpose of generating appropriate returns and diversifying risk. In general, below are some of the common factors which have people to seek professional financial advisory services:

Longer life span and lack of social security: People live longer now as compared to the earlier generations. Add to that the fact that most individuals have no retirement benefit when they retire from work. Few generations ago, someone would start earning by the time one reached the age of 20 years, work till the age of 58 years and live till around 65 years. In such a case, one earns for 38 years and lives off the retirement savings for the next 7 years. Fast forward to recent times, one starts working at 25 years of age after completing post graduation studies. Many are quitting their jobs earlier, but let us consider a retirement age of 60 years and life span of 80 years. That means, one works and earns for 35 years to support post retirement life of 20 years. The scales have really tilted. Add to that the fact that earlier, in most jobs (including private sector), pension was a given thing. Now, in most jobs (including Government jobs), "no pension" is the norm. If finances are not planned properly, the retirement years could be very challenging.

Proliferation of numerous products: Life Insurance industry was opened to private players in the late 90's. This led to proliferation of insurance products which are predominantly investment oriented. Though the Life Insurance Corporation of India (LIC) continues to dominate the life insurance industry business, new players have caught up considerably with their product innovation, aggressive marketing and new distribution channels. In the Mutual Fund industry, with over 35 Asset Management Companies (AMCs), the growth has been moderate to good with product innovations and increase in reach to a wide geography and class of investors. Many products and services have also been introduced by the banking industry which has contributed in the availability of choices for the financial consumer. There is also a reduced attractiveness of the traditional products, e.g. tax-free RBI relief bonds.

Complexity of products & services: Innovation can lead to either simplicity or complexity. In the financial services industry, however, the innovation has made the products increasingly complex. An investor today can participate in the equity markets simply by investing in a mutual fund scheme through a Systematic Investment Plan (SIP), but it is still a challenge for many in understanding how mutual funds actually work, and how market forces impact various products differently. An investor today can have both insurance and investment in a single product called ULIP (Unit Linked Insurance Policy), but appreciating his actual need for insurance and a return on investment as well as analyzing various components and charges of a ULIP product is a detailed process. Investors need informed guidance on making a finance sense out of what is being offered to them as investment or insurance, in order to achieve their financial goals.

Increasing income and savings levels: Indian Economy has been growing at a 6% - 9% rate of GDP growth driven mainly by domestic consumption. The educated and urban middle class has experienced increase in income levels. At the same time unlike our counterparts in many of the developed countries, Asians, and especially Indians believe in saving money. India has a considerable household savings ratio which is more than 25%. Here again investors need guidance to channelize their savings.

Increasing level of borrowings: In today's financial markets there is an easy access to loans resulting in increased levels of borrowings by people. If not managed carefully this leads to a serious mismatch in earnings and repayment leading to problems in cash flow. Leveraging the low interest rates is a critical aspect which needs to be explained to the borrowers.

Higher aspirations and goals: The days of building a house at retirement with accumulated savings and retirement benefits are over. With access to easy credit at a fair rate of interest and a capacity to repay that loan, given higher income levels, people want to buy house at a younger age. The lifestyle and aspirations have gone up significantly. People want to give the best education to their children, go on regular vacations, buy apartments in up-market localities and want to be financially independent in their post-retirement phase.

Inflation: Many times, prices of household items rise at a slow pace and hence go unnoticed. In such a case, it is natural to ignore the impact of such increasing costs over one's life time.

A well written financial plan will always consider the impact of inflation and have safeguards built in.

Nuclear families: Joint families provided great safety net for most individuals as it shared the resources and difficulties. Now with growing urbanization leading to nuclear families, these smaller families have a need to plan better. They can no longer depend on the support of the larger family since they might be geographically distant.

Plethora of Information: Today, thanks to television, internet and press, there is profusion of public information on various personal finance topics to the investors and consumers. The media has made a huge impact in the availability of financial information and analysis on real time basis to consumers. Although this has helped many investors to take measured investment decisions, others are exposed to many new concepts and terms leaving them more confused than before. Also there is a dearth of availability of relevant information to the investor enabling him to take the right investment decisions. Since many of this information are disseminated in smaller bits, the consumers/investors need expert financial planner who can put it all together and give need based advice.

Scope of Financial Advisory Services:

Financial Advisory in general has a very wide scope and encompasses all the areas of personal finance. Financial Planners can offer any one or all the services based on what the client needs and also based on what the planner is capable of offering in terms of his tie-ups with product manufacturers, education and regulatory framework. The scope can be bifurcated into pure advisory services and transaction based services as follows:

Advisory Services

Insurance Planning: Insurance Planning is determining the adequacy of insurance cover required by the client to cover the risk associated with one's life, medical emergencies and assets. While offering Insurance Planning services, a Financial Planner should address the following requirements of his clients:

- In case of pre-mature death of the bread-winner of the family, the family's income will stop or reduce to a great extent. In such a case, the family will have to depend on some money that can generate income to at least cover the expenses, commitments and liabilities for the rest of their life. How much would the amount required?
- How much of health insurance is required to protect a client and his/ her dependents to meet with a medical emergency?
- Which type of accident policy and critical illness policy will suit the client?
- Is there a need to have insurance of household goods?
- Determine whether the client has adequate insurance or not. Also determine if the client is over-insured.
- What are the risks to the client's (or family's) income earning capacity?
- What are the risks of loss with respect to the assets owned by the family?

Retirement Planning: Retirement Planning is determining how much of corpus is required to fund the expenses during the retirement years and ways to build that corpus in the pre-retirement period. It also dwells upon the utilization of the corpus accumulated during the retirement years. And while offering the service to a person who has already retired, a planner can offer investment advisory services to help client generate required income from the retirement corpus and also manage the investment portfolio. While offering Retirement Planning Services, a Financial Planner should address the following questions of his clients:

- What is the retirement corpus required to lead a similar lifestyle after retirement?
- How will inflation affect the sustainability of Retirement corpus in postretirement years?
- What are the various options and what is their role in investments for retirement?
- Is there scope for early retirement, or retirement is postponed due to inadequate corpus?
- What additional investments should be made to build retirement corpus?

Investment Planning: Investment Planning determines the optimum investment and asset allocation strategies based on the time horizon, risk profile and financial goals of the client. There is a wide range of investment options available today. A Financial Planner offering Investment Planning services should understand and analyze various asset classes as well as the products available under each asset class before recommending an investment strategy to the client for achieving financial goals. While offering Investment Planning Services, a Financial Planner should help answer the following questions pertaining to a client:

- What are the life goals? How can these be translated into financial goals?
- What is the client's risk profile?
- What is the time horizon available for investments?
- What should be the ideal Asset Allocation?
- Which asset allocation strategy should be followed?
- How to achieve diversification of investments?
- What is the investment objective 'income', 'growth' or just capital protection?
- How much to invest either in a lump-sum or regularly to achieve the given goal?

Tax Planning & Estate Planning: Tax Planning includes planning of income, expenses and investments in a tax efficient manner to gain maximum benefit of prevailing tax laws. The following questions pertaining to a client need to be answered:

- Is the client making optimum use of all available tax benefits?
- How to lower the tax liability? How to increase tax-adjusted returns on investments?
- What are the changes in tax laws that may affect cash flows, investments and savings?
- What is the effect of capital gains on investments?

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- How to calculate tax liability for the previous year?
- How to avoid just the year-end tax saving and do strategic tax planning?
- Which investment option to choose amongst the various options available u/s 80C of the Income-tax Act, 1961?

Comprehensive Financial Planning: Comprehensive Financial Planning is the act of planning for and prudently addressing life events. It addresses everything from buying a new car or home, to planning for a child's education, preparing for eventual retirement or creating a plan for your estate. But it goes well beyond these basic life events. It addresses the planning part of all major financial transaction which has a bearing on long-term finances, cash flows and asset creation. While the financial goals are met at different time periods, the associated liability and risk to life and assets are to be adequately covered with tax efficiency of financial transactions. A Financial Planner offering comprehensive Financial Planning should offer customized advice to help his/her clients meet their goals and objectives.

Transaction based services: While a Financial Advisor may charge a professional fee for the above mentioned advisory services, he/she may also opt to provide advisory as a complimentary service while earning a commission on the product sales that take place when the client implements the advice through him. Below are some of the transaction-based services a Financial Planner can offer:

Life Insurance products
General Insurance products
Mutual Funds
Stock broking
Others:

Other products that may be offered by a Financial Planner are:
- Banking products Loans & Deposits
- Post Office Savings Schemes
- Public issues of shares, debentures or other securities (popularly known as IPOs)
- Corporate Deposits

Financial Planning Delivery Process:

Financial Planners around the world practice the following six-step process while delivering their services. A Planner may adopt these steps to streamline the service delivery model for their advisory practice.

*1. **Establishing Client-Advisor Relationship:*** A Financial Planner should start off by explaining the scope of his/her services and ascertain the specific services the client may need. The responsibilities of both the Planner and the Client need to be defined with any situation of conflict of interest. Planner may also at this point discuss the remuneration structure and the professional fees.

*2. **Understanding Client's Situations & Goals:*** A Financial Planner should then help client define his/her financial goals and objectives, income and expenditure patterns, assets and liabilities and discuss, if relevant, client's past experience with managing money and investments.

*3. **Analyzing client Financial Advisory needs:*** A Financial Planner after collecting data and information should assess the current situation and make an analysis of Financial Planning needs. Depending on scope of services, this could include analyzing assets, liabilities, income, expenses, cash flow, current insurance coverage, salary structure, investments, tax strategies, etc.

*4. **Developing Recommendations and Strategy:*** Based on analysis and application of Financial Planning concepts, advisor should recommend goal oriented strategies and action plan. The client is then guided through the strategies to help him make informed decisions.

*5. **Offering the Right Products and Services:*** Planning without action is a futile exercise. In this process, the Planner guides client to implement the specific action points from Step 4, by suggesting the right financial products encompassing life insurance, general insurance, mutual funds, stock portfolio, deposits, etc.

*6. **Monitoring the Performance:*** The real success of the advice lies not just in making good recommendations but on achieving the desired outcomes by implementation of those recommendations. We live in a dynamic world with constant changes in economic environment, change of goals, launch of new financial instruments, etc. Therefore, the advice needs to be monitored, reviewed and aligned to these changes on an ongoing basis.

Analyzing Client Needs:

Contingency Funding: A contingency funding plan aims at keeping aside funds for emergencies. Normally, 4-6 months' expenses should be put aside so that they can be liquidated at a short notice. These can be divided between the bank account and some liquid funds.

Insurance Planning & Risk Management

Life Insurance: Life Insurance is planning for a situation when the individual on whom the family is dependant for fulfillment of their goals is not alive. One's life should be insured according to need based approach or other approaches considering one's family's expenses and future goals. The individual would have contributed to the savings over years and this income can be protected by taking insurance on his/ her life. Being under insured or having no insurance might leave the family/ dependants in a dire situation. Each earning member of the family has economic value and such a member is an ASSET to the family. Hence he or she should be adequately insured to protect the economic value of the "asset." All liabilities, for example, home loans must be insured separately anyway. In case of death, the family may incur two types of losses: financial loss and emotional loss. Whereas the latter happens in all cases, the former happens if an earning member of the family dies. Life insurance helps the family overcome this financial loss. The needs analysis involves estimating the financial loss the family is likely to incur.

Health Insurance: Health costs are rising and critical illness/ surgery might cost a fortune today. It might set an individual's plan awry. Some important goal may need to be postponed if a family member has to be hospitalized. Health insurance makes sure that this does not happen to you. The bills are taken care of by the insurer and you can continue with the plans/goals you set for your life. How much health insurance cover to take is largely a function of an estimate of expenses that one may incur on certain treatments as well as certain incidental expenses on account of such medical condition?

Insuring Physical Assets: Physical assets such as household goods, jewellery, vehicles, bullion etc must be insured for their current value against fire, theft, burglary, etc. These assets are valuable and hence must be insured for the value they can be replaced with today. In case of housing unit, however, a major portion of value is accounted for by the cost of land which appreciates substantially over time. The land cannot be destroyed by fire and some natural calamities such as earthquake and storm, but the construction thereon may get damaged considerably involving a huge cost for its restoration. Hence, housing unit should be insured to the extent of current construction cost, and not the cost of buying a house (inclusive of land), which would result in over-insurance, or historical cost of construction, which may result in under-insurance.

Accident / Disability Insurance: These policies provide insurance cover if the insured is temporarily and partially disabled, permanently and partially disabled and also if totally and permanently disabled. Most such products compensate the insured for the loss of income on account of disability. The financial advisor has to help the client in assessing the amount of cover to be taken.

Investment Need Analysis

Utilizing Time Value of Money: Time value of money is the concept that teaches us that Rs. 100 in hand is better than Rs. 100 after 2 years, as the interest on this Rs.100 can be earned in 2 years, thereby making it more valuable. Hence, investing today is important and one should not let money remain idle for long.

Estimating Future Value of Goals: When an individual is planning for future goals, it becomes important to plan for their future value rather than their current value. Inflation is a very big factor in this. The goal which may be fulfilled today by Rs. 5 lac may need Rs. 10 lac after 10 years due to inflation. If we plan for accumulating Rs. 5 lac, the goal will not be met adequately.

Determining Investment Needs: Why does one need to invest? To meet a future need. A person sacrifices use of money today for a higher gratification at a later date. Identify the need/ goal and you can evaluate where the investment needs to be done.

Lump-sum Investments & Regular Investments: As and when a person is in receipt of lump-sum monies, he should ensure he is investing it according to his requirements. Apart from this, there should be a regular investment being made to ensure he is disciplined in his saving habits.

Financial Cash Flows and Budgeting

Budget: A budget is a list of planned expenses and revenues. One should ensure that there are also budgets for some items to splurge on and those that provides for some emergency situations.

Cash Flows: A cash flow is a revenue stream usually arising from multiple entries of inflows and outflows, i.e. income and expenses.

Keeping Cash Flows Positive: It is important to have a positive cash flow at all points of time else it indicates you are using your investments to meet regular requirements, which should only happen during retirement; not otherwise.

Conclusion:

Essentially, personal financial planning involves the following areas: budgeting, savings and investment, insurance, cash-flow management. The main objective is to make sure that the expenses do not exceed income which creates a surplus that can be used for savings and investment.

Proper personal financial planning should definitely include insurance. One main area of the role of personal financial planning is to make sure that one has the ability to carry on living in case of some unforeseen and unfortunate

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event. Basically, insurance provides a safety net to provide the necessary funds when one meets with events like accidents, disabilities or illnesses. One main contribution of insurance is that it helps provides peace of mind, knowing that enough funds are at hand in the event when things do not go the way it should be. This peace of mind leaves one with the energy and confidence to move forward.

One should think very carefully while purchasing expensive items. These things could be essential like houses or cars for transportation. Yet others may be considered luxury items like expensive sound systems and many other things. There is no right or wrong answer on what one should purchase. Everybody makes purchases for something for their own reasons. But the general idea in personal financial planning is never to put out cash for something you cannot afford.

Buying things on credit is usually a bad idea. The credit card companies do a great job of convincing the average folk that spending on credit is alright and that we should not delay our purchase until we can afford them in cash. Spending on credit and in the process chalking up consumer debt is a bad idea. The prudent choice will be to wait until one can afford to buy the things he wants.

There will be, without question, exceptions to this rule of thumb on financial planning. However, the exceptions are not many. One reasonable exception is the use of credit to purchase a property for residence or for investment. Not a lot of people can afford to pay up a house purchase all at once. A guy may have to wait a whole life-time if he wants to wait until the day when he can fully pay for it in one lump-sum cash.

Buying property for investment may be a brilliant idea if one knows what he is doing. The main idea is that what he pays to the bank in bank loan and interests is more than offset by the returns on the property purchase.

Financial planning allows following one's own personal financial plan based on his own financial and non-financial situation so that his financial objectives at various milestones of his life can be accomplished. It helps to lessen the unexpected, so that one would not meet with financial tragedies like nightmares come true.

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