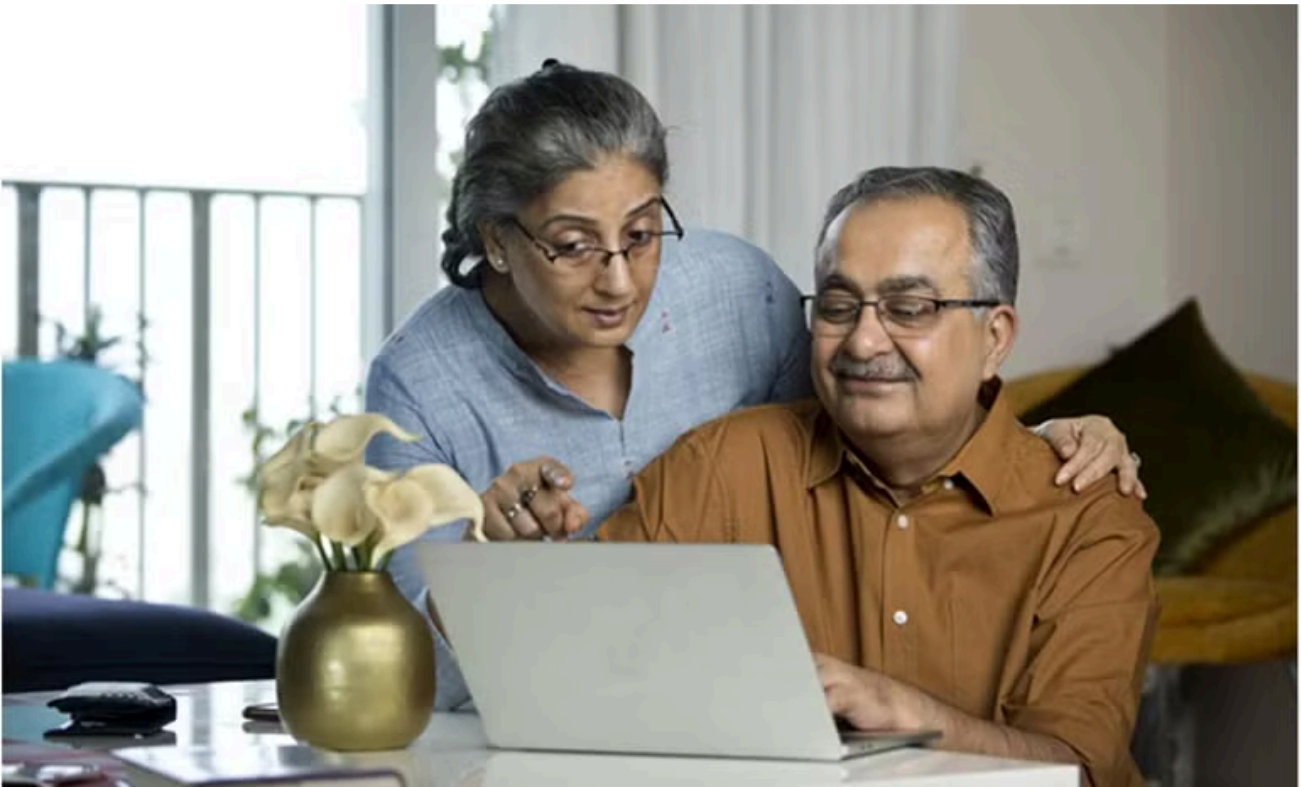


Business Standard

No free lunch: Annuities reveal why the retirement corpus has to be large

Annuities show that a 60-year-old couple needs a total of Rs 12 crore to be able to live in a two-bedroom apartment in Bangalore during retirement

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Representative image from file.

Most people do not grasp why they have to accumulate such a large corpus to retire. It is partly because they cannot figure out which Securities and Exchange Board of India (Sebi) Registered Investment Advisers (RIAs) are being realistic and which ones are being wildly optimistic. Looking at the sales brochures of annuities while not investing even a single rupee in them is probably the best way to fix this. This is because with annuities, the math is relatively more grounded in facts rather than in wildly varying opinions.

Life Insurance Corporation of India (LIC)'s sales brochure deals with a 60-year-old couple (let's call them 'X'). LIC has quoted terms for investing Rs 10 lakh in an annuity. Let's instead deal with a more realistic case of investing Rs 10 crore in an annuity. LIC says that they will pay Rs 73.7 lakh in the first year increasing by a simple (not compound) rate of 3 per cent per annum over the life of one person. This has at least three problems.

The first problem is that inflation is likely to be 6 per cent. The sales brochure says that to provide the 3 per cent simple rate increase, LIC has already reduced the annual payment by 19 per cent. Let's assume that to provide a 6 per cent simple rate increase, LIC would reduce the amount by a further 19 per cent. So, LIC would be willing to pay Rs 59.7 lakh in the first year. Note that all of this is describing an imaginary world in which good annuity products exist.

The second problem is that useful annuity products do not pay anything after the person dies. So even if the couple splits the investment across their two names, then if one of them dies, then the amount that LIC will pay will drop to half. But expenses of the household do not drop much. The sales brochure implies that to keep paying the full annuity if one person in the couple is alive, LIC would have to reduce the amount by 15 per cent. So, LIC would pay Rs 50.7 lakh in the first year.

The third problem is that a simple rate increase of 6 per cent per year is useless. Inflation works in the form of a compound rate increase. For example, in the 25th year of retirement, the simple rate increase would result in a 40 per cent reduction in the standard of living of the couple (compared to the first year of their retirement). The sales brochure does not provide any clue about how much LIC would charge to provide a compound rate. My rough estimate is that to provide a compound rate, LIC would reduce the amount by 17 per cent. So, LIC would pay Rs 42.1 lakh in the first year.

Let's assume that Couple X does not have health insurance. Annuities do not allow you to get more money to take care of large medical emergencies. So, let's assume that X have separately kept aside a total of Rs 2 crore in fixed deposits for life threatening health problems. The entire amount that they get from the annuity is subject to a marginal income tax rate in the ballpark of 20 per cent. So, post-tax, X will get Rs 33.7 lakh in the first year of retirement. This is Rs 2.8 lakh in the first month of retirement.

A sensible household budget would show that X can afford rental expense (excluding maintenance) of Rs 36,000 per month. In Bengaluru, they could afford a semi-furnished two-bedroom apartment with some amenities.

So, a 60-year-old couple needs a grand total of Rs 12 crore to be able to live in a two-bedroom apartment during retirement. Annuities make this scary math, visible.

(The writer is an hourly-fee financial planner and a Sebi RIA at Fiduciaries.in. He was a private-equity investor for 12 years)

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