

CONTINGENCY FUNDS

BY UDAYAN RAY

Emergencies happen in even the best-regulated households. Here's how you can stay in control even during a financial crisis.

Expect the Unexpected

The dictionary defines an emergency as: "A serious situation or occurrence that happens unexpectedly and demands immediate action." Most of us take insurance so that we are not caught too badly off in an emergency—the sudden loss of the earning member of a family, illness or accidents... But what if the risk is uninsurable? A sudden job loss, for instance, or temporary disability that prevents you from working but is not covered by medical insurance. What will you do to meet your existing commitments? If, like, most people, you don't have ready access to liquid funds, you may be forced to make a distress sale of your assets or long-term investments. Worse, you may have to take an expensive personal loan or run up debt on your credit card. We suggest you do what wise housewives have been doing down the ages—putting aside money for a rainy day. Kids call it breaking the piggy bank; financial planners call it the emergency fund.

Getting started

It's important to distinguish an emergency fund from your regular savings and use it only in cases of non-insurable emergencies. But how do you decide how much is enough? Saving for an emergency that may not happen is tricky. And you'll never know if your emergency fund is sufficient till the emergency is upon you. But if you put in too much, you stand the risk of getting low returns. That's because an emergency fund must necessarily be invested in bank savings accounts or funds that offer easy liquidity.

S.K. MALIK

Took voluntary retirement over two years ago. He has kept aside Rs 1 lakh in a flexi bank deposit for emergencies.



GREESH G.V.

Long-term options like PPF and debt funds offer better returns but are not as liquid. A savings account today, for instance, gives 3.5 per cent per annum, a liquid fund at best gives a little less than 5 per cent, while a one-year fixed deposit offers 5-5.75 per cent.

Financial planners suggest that your emergency fund comprise some multiple of your monthly expenses—say three, six or nine months' expenses. But three months' savings may be too little and nine months' too much. So, how do you decide what's right for you? To get an answer, you have to identify the uninsurable risks that can affect you.

Once you have identified your uninsurable risks, you can get a fix on how much money you need in your emergency fund. "You have to make a distinction between a temporary emergency situation, which can, at the very worst, be rectified in six months, and a permanent change," says Gaurav Mashruwala, director, ACE, a Mumbai-based financial planning company. For instance, if you lose your job and are unlikely to find a job for a long time, no emergency fund will be adequate; other financial planning measures are called for. However, the rule of thumb is that you keep at least three months' regular expenses in an emergency fund and 15 per cent of your net worth in income-generating assets.

The risks

Most uninsurable risks can be classified into two categories—income reduction risks and expense bloating risks. Depending on the risks you identify, you can decide on an emergency fund and where you should save.

Income reduction risks. If job security is not a characteristic of your profession, your income will definitely be shaky. But expenses are pretty much a constant—living expenses, insurance premium payments, loan repayments, school and college fees and the like. Your emergency fund will have to be large enough to cover all these expenses till such time as your income flow stabilises.

Arun Mukherjee, 58, a Kolkata-based folk theatre artist, is familiar with the risk of erratic income. Mukherjee tours different areas of West Bengal with drama troupes and gets paid for each show. This means some 120 substantial but irregular payments a year. To insulate his family from the vagaries of his income stream, Mukherjee maintains a separate savings account in which he parks enough money to run his household even when he does not make money.

Mukherjee's case is not unique. Uncertain income was the only thing Himanshu Kohli, 31, was certain about when he set up a wealth management company with a friend 18 months ago. Kohli began the practice of keeping six months' living expenses in liquid funds, something he continues till today.

If you are setting up an emergency fund to take care of income reduction risk, you don't need a very high level of liquidity. As Sridhar K., vice president and country head-distribution, Karvy Securities, says: "You wouldn't need six months' living expenses at once if you were to lose your

advice to heart and keeps Rs 1 lakh in a bank FD-cum-savings account. Although IOC will provide for medical care in his retired life, Malik has taken care to earmark Rs 25,000-30,000 for medical emergencies that may not be covered. Another Rs 30,000 has been set aside for emergency travel. The rest will be used to assist family members.

When you are determining how much you need in your emergency fund, take into account your medical and accident insurance. The more insurance net you have, the less you need in your emergency fund. Also, if you have access to cheap



SWAPN KATAK

ARUN MUKHERJEE

A theatreperson, he has an erratic income, but has created a buffer to meet his family's living expenses.

job." So, you can spread the emergency fund money in absolutely liquid options like bank savings accounts, and those with lesser liquidity like liquid funds that can be liquidated in 24-48 hours.

Expense bloating risks. A medical emergency, an accident that involves repairs to

your vehicle or house... insurance does not always cover everything. And you'll find your expenses shooting up. These sudden expenses are worse for those who are retired, since they have to meet all their expenses with interest, dividends and matured investments. The absence of an emergency fund can mean the disruption of a carefully laid out post-retirement plan. Which is why most financial planners recommend that retired people maintain larger emergency funds than younger, working people.

S.K. Malik, 60, a retired senior executive of Indian Oil Corporation, has taken this

credit like overdraft facility against assets like shares, homes and cars, you can moderate the emergency fund amount.

Where to invest

Once you know how much you'll need, the important question is: where to invest. There are three main options: savings account, savings-cum-FD account and liquid funds. Depending on the liquidity requirements of the identified risks, you can allocate your funds among these options. For instance, if you foresee more expense bloating risks, savings and savings-cum-fixed deposit accounts are your best bet.

Liquid funds. If your risks are more in the nature of income reduction, you will not need the full emergency fund immediately. So, consider parking a greater portion of your emergency fund in liquid funds. They are almost as safe as FDs and are more tax efficient. Returns—if you stay invested for more than a year—will

Are You Prepared?

1. Is your job stable?

- (a) Not at all
 (b) More or less
 (c) Completely

2. How dependent are you on interest, dividends and capital gains on your investments to cover your regular expenses?

- (a) Totally
 (b) Slightly
 (c) Not at all

3. Do you have life, health, auto and disability insurance?

- (a) Little or no cover
 (b) Some risks covered
 (c) All risks covered

4. As a multiple of your regular monthly expenses (including loan repayments and insurance premia payments), how much of your investments are in liquid options like savings accounts, savings-cum-fixed deposit accounts and liquid funds?

- (a) 15 days
 (b) Two months
 (c) Three months

5. What is the percentage of regular income generating assets to your net worth?

- (a) 0-5 per cent
 (b) 6-15 per cent
 (c) Over 15 per cent

6. Do you have access to comparatively cheap credit facilities like overdraft facilities against assets like shares and home?

- (a) No access
 (b) Limited access
 (c) Ample access

Scoring

- (a) 10 points
 (b) 20 points
 (c) 30 points

120 points or more: You are well prepared for emergencies

90-120 points: You need to beef up your contingency fund.

60-90 points: Emergencies come unannounced. Act now!



HIMANSHU KOHLI

Left a regular job to go on his own. He habitually sets aside six months' family expenses in liquid funds.

be taxed as long-term capital gains at 10 per cent. This compares favourably with those in the highest tax bracket (assuming you have an annual income of less than Rs 8.5 lakh and have exhausted the Section 80L limit of Rs 12,000 per annum) for fixed deposits.

What's important is that you do a due diligence on the fund before investing in it. "The fund must have a good branch network so that your money remains accessible when you need it," says Mashruwala. He discourages people from liquid funds if there's no access to branch offices. "It is also a good idea to keep some money in bank FDs and some cash at home," he says.

Kohli's suggestion: "Consider large funds with a corpus of Rs 250 crore or more with a good track record." Experts also recommend the dividend reinvestment option. "This makes sense since you will be not be looking for regular income from this investment," says Rajat Jain, chief investment officer, Principal Mutual Fund.

Income funds. Some planners recommend short-term income funds. "They provide returns that are 65-70 basis points higher than those from liquid funds," says Jain. But others say these funds are too risky as they invest in income securities that are set to mature soon. "Short-term liquid funds will provide slightly higher returns, but in absolute terms it will be small, say Rs 500-600. This isn't justifiable when viewed in the backdrop of increased risks. Emergency funds need to be safe and liquid," says Mashruwala. Other planners echo this, and say there is little point

in making emergency funds work harder.

Building the funds

If you don't have an emergency fund, take the time and effort to build one. Most of us vaguely say that some portion of our savings is earmarked for 'emergencies'. But there's a very real danger of spending all your money, leaving little for emergencies. It is important to start stashing away some money in a separate account. As you build reserves worth one or two months' expenses, consider investing in bank FDs linked to savings accounts. As the build-up progresses, diversify into liquid funds.

Review your requirements. Like all financial requirements, your emergency fund needs may change. So, review your requirements regularly, especially when you take a loan, insure new assets, increase your insurance cover or see a significant change in income.

Insuring your life, health and assets, and building an adequate emergency fund are the first two steps of financial planning. Sadly, few people realise the importance of an emergency fund till it's too late. "I have had clients worth crores who had to borrow during emergencies," says Mashruwala. Adds Sridhar: "For many people, emergency funds are never important till the emergency occurs." Financial planners identify lethargy as the main culprit. "In a broader sense, the problem lies in people not planning," says Devang Shah, director, Right Returns Financial Planning, a Mumbai-based financial planning company. Just remember, a lot of misery can be avoided by sparing a little time to create a financial shield against emergencies. II