NPS Vatsalya: Start early to ensure child's financial security

Excessive investment in it shouldn't compromise marriage and education funding

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To encourage early retirement savings, the government has introduced NPS Vatsalya, a new initiative under the National Pension System (NPS). This scheme allows parents or guardians to start building a retirement fund for their children from infancy. When the child turns 18, this account will morph into an NPS tier 1 (All Citizens model) account.

Key features

As with NPS for adults, investors will have access to a variety of investment options. "The option to invest through auto choice or active choice can be utilised here," says Kurian Jose, chief executive officer (CEO), Tata Pension Management.

All the asset classes available in NPS for adults will be offered. "The guardian will be able to choose between equity, corporate debt, government securities, and alternative investments," says Rajesh Khandagale, head-NPS, KFin Technologies.

The guardian can also select any one of the pension funds registered with the Pension Fund Regulatory and Development Authority (PFRDA).

The main difference lies in the account's operation. "Until the child reaches the age of 18, NPS Vatsalya requires a guardian to manage it," says Khandagale.

NPS for adults offers both tier 1 and tier 2 accounts. "NPS Vatsalya offers only the tier 1 account," says Vishal Dhawan, chief financial planner, Plan Ahead Wealth Advisors.

Benefit from long-term compounding

The main advantage of this scheme is the ability to start early. "You do not need to wait until the child turns 18 to begin investing for their retirement. The long investment horizon—from infancy until 70—will allow the invested corpus to benefit from compounding," says Arnav Pandya, founder, Moneyeduschool.

Khandagale says such a scheme can also instil the saving habit in children.

Most existing children's schemes have a limited tenure. "They usually end after a specific term or when the child reaches a certain age. Now, another option is available that can serve as a long-term retirement tool for children," says Dhawan. He adds that in the past, parents have used the Public Provident Fund (PPF) similarly, managing it until a certain age before handing it over to their children.

The annual contribution requirement of just ₹1,000 makes NPS Vatsalya easy to open and maintain.

Low on liquidity

Liquidity may be an issue for investors in NPS Vatsalya. After a three-year lock-in period, partial withdrawals of up to 25 per cent of contributions are allowed, with a maximum of three withdrawals permitted for specified reasons.

The child can exit the scheme when she turns 18. If the corpus is below ₹2.5 lakh, the entire balance can be withdrawn as a lump sum. However, if it is equal to or exceeds ₹2.5 lakh, at least 80 per cent must be used to purchase an annuity while 20 per cent can be withdrawn as lump sum.

Receiving 80 per cent of the corpus as annuity payouts may not be helpful at this stage when large sums are needed for marriage or education. "The conditions for partial withdrawal and exit make the product restrictive compared to, say, a mutual fund, where any amount can be withdrawn any time," says Dhawan.

First, the parents contribute to the scheme and then the child must continue until retirement. "If the child does not, or is unable to contribute, it could create a liquidity issue, as only 20 per cent can be withdrawn as a lump sum," says Pandya.

The equity schemes here are likely to be large-cap focused. "The inability to build a portfolio tilted towards mid- and small-cap companies, which can offer attractive long-term returns, is another shortcoming," says Dhawan.

Who should opt for it?

This scheme suits parents aiming to secure their child's financial future. "Individuals seeking a long-term investment option with the potential for higher returns may opt for NPS Vatsalya," says Khandagale.

According to Dhawan, people seeking flexibility in investment mode (auto and active choice) and asset mix may find it appealing.

However, those who desire liquidity should steer clear of it. Dhawan says those who want 100 per cent equity exposure should also avoid it, as the maximum allowed here is 75 per cent. He also cautions against it for investors seeking mid- and small-cap exposure.

Pandya recommends that parents who are uncertain about their child contributing to the scheme when they take charge may also avoid it.

Get your priorities right

Parents should consider their risk tolerance when selecting the asset mix. "While equities may have delivered the best returns historically, that doesn't mean opting for maximum equity exposure. Factor in your risk appetite," says Dhawan.

In addition to this scheme, save for your child's other goals in more liquid instruments.

"Remember, if you fall short on your child's education or marriage goals, you won't be able to access the entire corpus in this account," says Pandya. Dhawan suggests pairing this scheme with liquid instruments, such as mutual funds.

Now that an instrument is available to save for a child's retirement, parents should prioritise wisely. "They should focus on their retirement first, followed by their children's higher education and marriage, and only then on their children's retirement," says Dhawan. Above all, they should not compromise their retirement savings.

NPS VATSALYA, PPF, SSY: HOW THEY COMPARE

Eligibility: Sukanya Samriddhi Yojana (SSY) is exclusively for girl children under 10, while Public Provident Fund (PPF) and NPS Vatsalya can be opened for any child, regardless of gender, at any age

Investment limit: Both PPF and SSY have annual investment limits, whereas NPS Vatsalya has no cap

Equity exposure: NPS Vatsalya offers equity exposure and can potentially offer higher long-term returns; PPF and SSY are fixed-income options

Taxation at maturity: The Maturity corpus of PPF and SSY are tax-free. For NPS, at retirement, 60% is tax-free but not the 40% invested in an annuity (interest is taxed at slab rate)