Special Section 3: Transition to a Single Treasury Account: Potential Implications for the Banking Sector

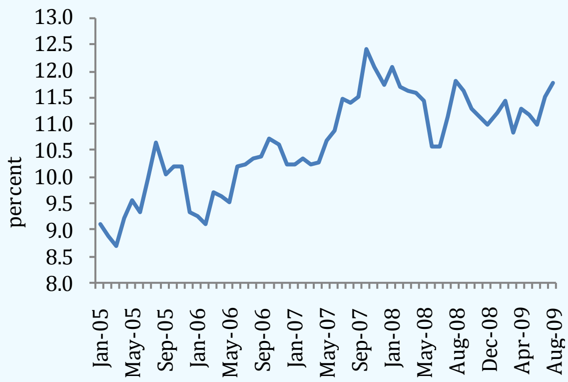
In a bid to improve public financial management, the government of Pakistan is in the process of implementing a *single treasury account (STA)* with the State Bank of Pakistan, as against the existing arrangement of specific government-entity accounts with the banking system. Keeping in view the importance of this key step for efficient cash management, the International Monetary Fund (IMF) included its implementation as one of the structural performance criteria and a benchmark for public financial management reforms under the Stand By Arrangement (SBA) signed in November 2008. As a first step, the government has converted the previously existing system of *Personal ledger Accounts (PLAs)*[1] and *Special Drawing Accounts (SDAs)* into *Assignment Accounts*[2] with effect from October 1, 2008.[3] Under this new system, all the budgetary funds are released into Assignment Accounts, which are then part of the government Consolidated Fund.[4] This measure has helped in preventing the accumulation of unspent balances outside the Consolidated Fund. Insofar as outstanding balances with the scheduled banks are concerned, these are planned to be gradually transferred to the STA by end June 2010.[5]

Government deposits held in existing accounts with various banks amounted to Rs 454.8 billion as of end June 2009. These deposits constitute 11.0 percent of the total deposit base of the banking sector. This suggests that that the decision to shift government deposits from scheduled banks to the STA with SBP entails strong implications for the banking sector, which are briefly reviewed in this note.

Government deposits: Stylized Facts

A good starting point to assess these implications is to review the trends in and composition of government deposits. **Figure 1** reveals that the share of government deposits in total deposits of the banking sector is subject to significant variation, which is a reflection of inherent mismatches in government's revenue receipts and payments of expenditures, and the large average size of its financial transactions. The bifurcation of government deposits into federal and provincial government deposits shows that the former category is more volatile as compared to the latter (**Figure 2**). This difference in volatility is primarily attributed to: (1) the limited role of provincial governments in providing public services as compared to the federal government; and (2) provincial governments' continued dependence on the federal government, given their limited financial independence.

Figure 1: Share of Govt. Deposits in Total Deposits



Source: SBP

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[1] The PLA was a "facility provided to a delegated authority in a division/department to incur expenditure up to a prescribed limit, without the requirement for certification and authorization by the District Accounts Officer/Accountant General/ Accountant General Pakistan Revenues".

[2] The Assignment Account is a "bank account opened in favor of a delegated authority, into which funds are released for specified purposes'.

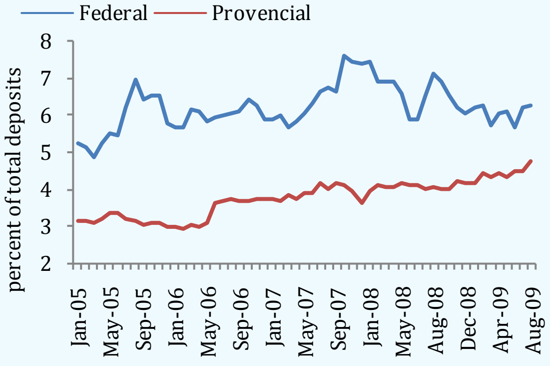
[3] http://www.finance.gov.pk/admin/images/updates/procedure.pdf

[4] The Consolidated Fund of the government comprises of "all loans raised and all moneys received in repayment of any loan by the Government".

[5] The initial plan was to transfer government deposits by end June 2009.

The bifurcation of government deposits on a federal and provincial basis provides interesting insights. First, SBP's liquidity forecasts can be significantly improved by incorporating information on federal government's receipts and payments which are of a more volatile nature, in accordance with the timing of these flows into the STA. Furthermore, changes in federal government deposits are generally considered as one of the autonomous factors effecting the liquidity position of banking sector especially of interbank market. Information on financial flows of the government will be help in liquidity management. This will ultimately contribute towards a more effective implementation of monetary policy, as SBP will then have a fairly accurate forecast of the liquidity in the market. Second, although information on provincial governments' receipts and payments is relatively less important for improving the liquidity forecast, it is still important for efficient cash management, as provincial government deposits constitute approximately 35.0 percent of the total government deposit base, and their share is gradually increasing over time on account of strengthening financial autonomy of the provincial governments.

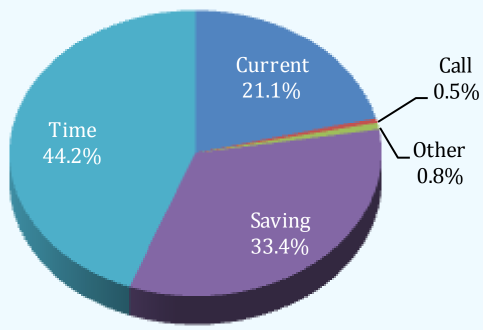
Figure 2: Trends in Federal and Provincial Governments Deposits



Source: SBP

In addition to the overall trends in government deposits, assessing the composition of these deposits by types of maturity is instructive in understanding government's approach to cash management. The composition of government deposits as of end June 2009 indicates that 44.2 percent of these deposits are categorized as time deposits, as against 21.1 percent current deposits and 33.4 percent savings deposits (**Figure 3**). This suggests that the government is trying to manage its deposits in a cost effective manner as: (1) fixed deposits placed with banks are remunerative; and (2) the government earns a return on savings deposits due to the introduction of the minimum rate of return of 5 percent on savings deposits by the SBP with effect from June CY08.

Figure 3: Composition of Government Deposits



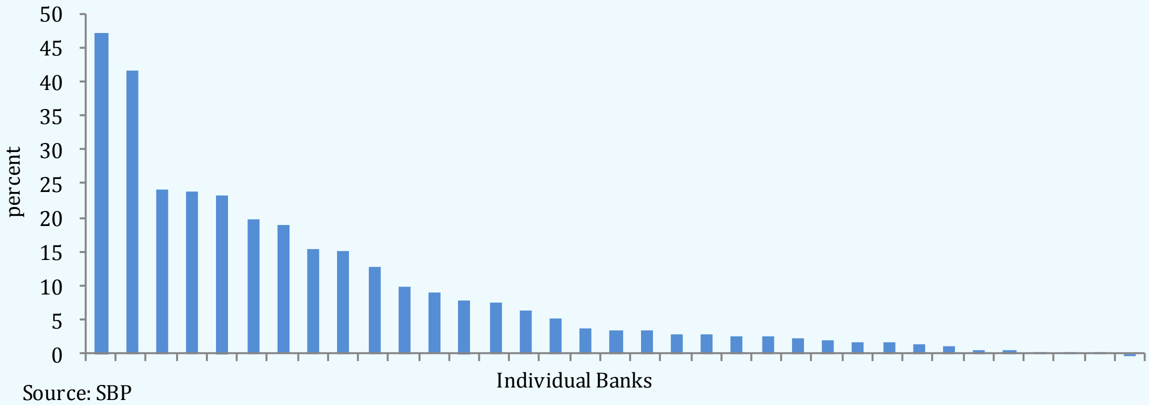
Source: SBP

Institutional break up of government deposits reveals that the Ministry of Finance and Finance Departments at provincial levels jointly hold deposits of Rs 33.1 billion, which are only 7.1 percent of total government deposits. This implies that the majority of government deposits held with scheduled banks are owned by government institutions including federal and provincial ministries, non-financial government corporations, government universities, and other federal and provincial institutions. The breakup also indicates the concentration of government deposits among few institutions. Specifically, the top ten federal government institutions hold deposits of Rs 111.6 billion as of end June 2009, which form 47.8 percent of federal government deposits. Classification of deposits by types indicates that time deposits account for 33.9 percent of the total deposits held by top 10 institutions, in addition to savings deposits of 36.1 percent. These statistics suggest that 70.0 percent deposits of the top ten institutions are remunerative.

STA: Implications for the Banking System

As mentioned earlier, government deposits held with scheduled banks constitute over 10 percent of total deposits. Bank-wise information indicates that government deposits are concentrated in few banks. Specifically, 5 scheduled banks hold 80.8 percent of total government deposits, as against their share of 43.5 percent in the overall deposits of banking sector. Moreover, government deposits account for over 10 percent of the total deposits for 10 of the 40 scheduled banks operating as of end June 2009 (**Figure 4**). The share of government deposits is over 20 percent for 5 scheduled banks, which includes one small private sector bank and 4 public sector commercial banks. Among other 5 banks, 3 are small private sector banks and 2 are the public sector specialized banks. This distribution of government deposits indicates that some of the scheduled banks have a heavy reliance on government deposits to fund their assets and for liquidity management.

Figure 4: Bank-wise Share of Government Deposits in Total Deposits

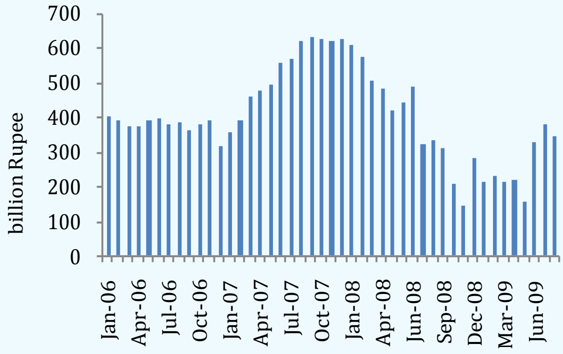


Source: SBP

The classification of banks on the basis of ownership indicates that public sector banks hold Rs 266.0 billion of the government deposits, which is 58.5 percent of the total government deposits, and 28.5 percent of their own total deposits base. On the other hand, government deposits with private sector banks form only 5.8 percent of their total deposit base. In sum, the distribution of government deposits with banking sector indicates that public sector banks and some of the small private sector commercial banks will be the hardest hit by the planned STA implementation. While the gradual pace in the shift of deposits for the intended implementation of the STA is likely to provide some breathing space to these banks, the asset expansion of these banks will be severally constrained at least in the short run. Notably, some of the small private and public sector banks are already operating with weak financial fundamentals (for details, please see Chapter 4, Stability of the Banking System), which is expected to give rise to a few more M&A transactions in the banking sector, keeping in view the phased implementation of SBP's minimum capital requirements.

In addition to bank specific problems, growth of the overall banking industry will be severally constrained as YoY increase in bank deposits, the predominant source of funding for banks, is well below the outstanding amount of government deposits. Specifically, the annual increase in deposits has been less than Rs 400.0 billion since June 2008 (**Figure 5**). Furthermore, the YoY maximum increase over the same period was only Rs 318.9 billion if government deposits are excluded from total deposits. This implies that the shift of

Figure 5: YoY Change in Total Deposits

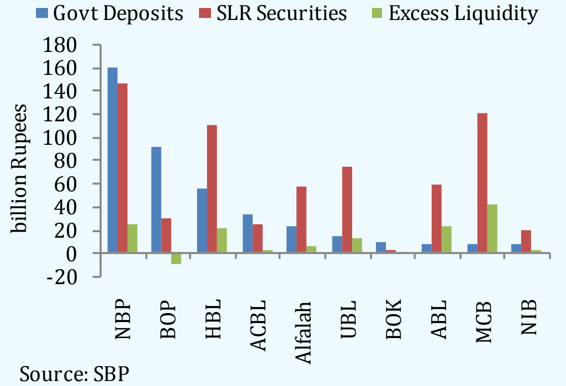


Source: SBP

government deposits during a year (as mentioned in the IMF Country Report No. 09/265) from scheduled banks to the central bank, will seriously undermine the growth of the deposit base of the banking sector.

Besides constraining asset expansion, the reduction in deposits will also create liquidity strains in the banking sector. Some of the banks will be the worst hit. **Figure 6** depicts that 8 out of the top 10 banks ranked on the basis of their holdings of government deposits have their excess liquidity well below the government deposits held by these banks. Moreover, stock of SLR eligible securities is less than the government deposits for 4 of the 8 banks. These 4 banks hold 65.3 percent of government deposits and 23.9 percent of the total deposits of the banking sector. In sum, the planed shift of the government deposits during a year will squeeze liquidity of the banking sector.

Figure 6: Govt. Deposits and Banks' Liquidity - July 2009



Source: SBP

STA and Government's Cash Management

The implementation of a Single Treasury Account will pave the way for efficient government cash management. Some of the major benefits include:

1. Minimum idle cash: implementation of the STA will help in minimizing idle cash held by government institutions outside the Consolidated Fund. As of end June 2009, various government bodies held Rs 95.8 billion in current deposits with scheduled banks, which are largely non remunerative and primarily used for transactional purposes. This amount is likely to reduce as a large number of financial transactions among government bodies will be settled within the consolidated account, and there wouldn't be any need to hold transactional balances by each government institution. The overall amount of cash balances to be held for transactional purposes in STA will be decided according the government policy for cash management.

2. Direct Savings: There is an element of direct savings for the government as short term government borrowing to cater for revenue and payment mismatches is likely to reduce. Idle cash balances in sub-accounts can be for replenishing sub accounts in need of cash balance. Moreover, the amount in transit or waiting for clearance especially for inter-government institutions will substantially reduce as transactions are settled within the account.

3. Contain financial risk: The active management of STA is expected to mitigate financial risks. Credit risk will reduce due to limited government exposure towards private sector commercial banks. Similarly, STA will reduce operational risk by minimizing the scope of mismanagement or fraud.

It may be added here that these benefits will not be realized until the existing arrangements for cash handling and control are not improved. This will require efficient cash management to be identified as a specific objective of government entities. Also, operational procedures may be refined in light of STA implementation. The implementation of revised procedure for the operation of new Assignment Account of Federal Government with effect from 1st October 2008 was an important step in this direction.

STA and Implications for Monetary Policy

The STA has positive implications for the conduct of monetary policy. Specifically, volatility in money market is expected to reduce as the linkage of all government accounts will reduce gross balances, i.e. total amount of transactions carried out by the government institutions. A number of transactions will be netted off in a centralized account at the central bank which will help in containing autonomous factors responsible for short term changes in money market liquidity. As a result, the SBP's ability to manage market liquidity will improve.

STA and Remuneration of Government Deposits

Currently all government deposits with the SBP are non-remunerative, while the government pays market-based interest on its borrowing from the central bank. Under existing arrangement, 77.6 of government deposits with the scheduled banks are remunerative, i.e. either in savings or fixed term accounts. The shift of government deposits from scheduled banks to the central bank will deprive government bodies from earning a return on their deposits. However, a strong case can be built to justify the remuneration of government deposits held with the central bank. In this context, the following points are worth noting:

1. With the introduction of an explicit interest rate corridor for the conduct of monetary policy, SBP has provided an option to scheduled banks and primary dealers to deposit their excess balances with the central bank at a specified 'floor' rate. Currently the floor rate is 10.0 percent, as against SBP's overnight reverse repo rate of 13.0 percent, which is the 'ceiling' rate. It can be argued that the government deposits held with the central bank may also be remunerated at the floor rate, especially following the implementation of the STA. This can be viewed as a cost of ease in liquidity management. This is however an issue which needs to be mutually decided by the Ministry of Finance and SBP.

2. Remuneration of government deposits with the central bank at a rate close to the market rate is also favored to improve accounting transparency, recognize implicit cross subsidies, provide incentive for appropriate economic decisions, and to reduce risks of leakage.

Concluding Remarks

Transition to a single treasury account system to facilitate efficient cash management for the government entails significant implications for the banking sector, and involves a number of policy issues. Government deposits held with the scheduled banks accounts for 11 percent of total deposits, which is a significant portion of the deposit base. The shift of these deposits from scheduled banks to the central bank will severely undermine the liquidity position of the banking sector. The impact can be significant as banks are currently operating in a difficult macroeconomic environment, in which deposit mobilization efforts have been impacted by competition from CDNS. Bank-wise information further reveals that some of the banks have a heavy reliance on government deposits which accounts for more than 20 percent of their deposit base. The impact of implementing STA will be quite significant for these banks. It may also be noted that some of these banks are already under pressure due to their weak fundamentals, and that the depletion of their deposit base will add to the existing problems.

The analysis also indicates that the timeframe (by end June 2010) specified for shifting the outstanding government deposits with scheduled banks seems to be quite ambitious. Specifically, the annual increase in the total deposits of the banking sector (excluding government deposits) is well below the outstanding amount of government deposits. This implies that the shift of government deposit may lead to negative deposit growth of the banking system for the year FY09. Being a major source of funding, negative or low deposit growth will severely undermine the asset expansion of the banking sector.

Being mindful of overall policy implications, the government is seeking technical assistance from the World Bank for smooth implementation of STA. The survey of government deposits will help in identifying the exact amount of the government deposits from the scheduled banks to the Consolidated Fund. While implementation of STA has negative implications for the banking sector, it is at the heart of an efficient government cash management and has favorable implications for the conduct of monetary policy.