3 ROLE OF GOVERNMENT IN PROMOTING SAVINGS: CENTRAL DIRECTORATE OF NATIONAL SAVINGS

3.1 Introduction

In Pakistan, Scheduled Banks, DFIs, some NBFCs and the Central Directorate of National Savings (CDNS) are the various types of financial institutions which mobilize savings from the economy but with altogether different objectives. While banks and NBFIs serve as financial intermediaries that accept deposits and channelize them to lending activities, CDNS promotes domestic savings by providing access to different types of savings instruments, with the objective of providing non-bank financing for the government's budget deficit. These institutions operate as direct competitors in mobilizing financial savings (**Table 3.1**).

This chapter provides a brief analysis of National Savings Schemes as an important component of financial savings (**Annexure 5**), with a share of 20 percent at end-FY10. Section 3.2 gives a brief historical review of the evolution of CDNS, section 3.3 discusses NSS instruments features and mobilization trends, section 3.4 discusses the role of NSS in deficit financing, while section 3.5 assesses its impact on the financial sector. The last section concludes.

Table 3.1: NSS Indicators*

	FY07	FY08	FY09	FY10
NSS as percent of				
GDP	10.8	10.0	10.0	9.9
Domestic Debt (Outstanding)	36.1	31.2	32.9	31.3
Non-Bank Borrowings	62.0	48.8	85.2	46.8
Deficit Financing	29.7	10.9	40.8	25.5
Bank Deposit	29.2	27.6	31.9	32.5

*Excluding prize bonds

Source: S&DWH, SBP

3.2 Brief History

The history of the national savings' organization in Pakistan dates back to 1873 when the Government Savings Bank Act, 1873 was promulgated.[1] Since the inception of the national savings' organization, this platform has largely been used by the government to mobilize funds to finance the budget deficit. During the First World War, the British government used this channel to raise funds to meet war related expenditures. Since acquiring independence in 1947, this organization remained operational in Pakistan in various forms. In August 1960, the CDNS was given the status of an "Attached Department" of the Ministry of Finance[2] and made responsible for all policy matters and execution of various National Savings Schemes (NSS). The present structure of CDNS was set up in early 1972 under the Ministry of Finance. So far, CDNS has not only remained successful in promoting financial savings in the economy but has also generated requisite funds for the government to finance the budgetary deficit. National Savings Schemes (NSS) offered by CDNS are sold through a network of 367 national savings centers all over the country, controlled by 12 Regional Directorate of National Savings (RDNS).

3.3 NSS Features and Mobilization Trends

CDNS offers various non-tradable, long-term bonds, savings certificates and schemes **(Table 3.2)**, which meet the savings and investment needs of various eligible investors, particularly the fixed income group. These saving instruments have different maturity profiles, ranging from 3 years to 10 years, with varying interest rates. The government also launched the first-ever listed, scripless and *tradable* National Savings Bond (NSB) on January 11, 2010 with maturities of 3, 5 and 10 years.

[1] National Savings Website http://www.savings.gov.pk/about_us.asp.

[2] Year Book 2005-2006, Government of Pakistan, Finance Division, Ministry of Finance, Pakistan.

Table 3.2: Profile of Selected NSS Instruments

Features	DSCs	SSCs	RICs	BSCs	PBA
Launched in	1966	1990	1993	2003	2003
Maturity Period	10 Years	3 Years	5 Years	10 Years	10 Years
Minimum holding period	1 month	1 month	-	-	-
Early encashment penalty	No Profit is payable if enchased before completion of each year.	No Profit is payable if enchased before completion of each period of six months.	0.5% to 2% of the face value	0.25% to 1% of the face value	0.25% to 1% of the face value
Profit Payments	Bullet bonds	Bi-annually	Monthly	Monthly	Monthly
Zakat	Compulsory	Compulsory	Exempted	Exempted	Exempted
Withholding Tax	@10%*	@10%*	@10%	Exempted	Exempted
Minimum Investment Amount	Rs. 500	Rs. 500	Rs. 50,000	Rs. 5,000	Rs. 10,000
Maximum Investment Limit	No limit	No limit	No limit	Rs. 3,000,000	Rs. 3,000,000
Institutional Investment	Allowed**	Allowed**	Allowed**	Not allowed^	Not allowed#

* Withholding tax is exempt if the total investment does not exceed Rs.150, 000.

** Excluding Banks and Insurance Companies

^Only widows and senior citizens aged 60 years and above are eligible to invest in this instrument.

Only pensioners of Federal Government, Provincial Governments, Government of Azad Jammu & Kashmir, Armed Forces, Semi Government and Autonomous bodies are allowed to invest.

As mentioned above, the most pertinent objective of establishing the Central Directorate of National Savings (CDNS) was to mobilize private savings to finance the budget deficit. However, the highly attractive rates of return on these schemes made them a popular avenue of investment not only for the general public but also for corporate investors. The popularity of NSS instruments rose to the extent that every year the government received a net inflow of private funds from NSS, and serviced the returns, in addition to repaying the principal, from gross receipts**.** As a result the government did not need to separately allocate funds in the budget to service these schemes or to repay the principal when required. Subsequent to FY04 however, a change in this trend was observed, specifically during FY04, when for once total repayments could not be paid through the gross sale receipts of the NSS instruments.[3]

One of the main reasons for this was the ban on institutional investments in NSS instruments in March 2000, which substantially reduced their gross sales. Another major contributory reason was the linking of the NSS rates with the rates on Pakistan Investment Bonds (PIBs), a market-based instrument in FY00.[4] Consequently, the sharp decline in market interest rates during FY03 and FY04 impacted the rates of return on these schemes as well, resulting in a diversion of private savings towards other investment options. In addition, banks were also prohibited from selling NSS instruments from June 15, 2003 in order to discourage arbitrage opportunities due to the wide interest-rate differential between NSS rates and lending rates on loans secured by these instruments. As a result, the share of NSS in total domestic debt, which had been rising until FY03, started to decline. However the introduction of Pensioners' Benefit Accounts (PBAs) and Behbood Saving Certificates (BSCs) during FY03 and FY04 respectively, with returns significantly higher than other NSS instruments, attracted many customers from among the people eligible to invest in these schemes. In a rising interest rate environment, as seen from FY05 onwards with a brief respite in between,[5] the rates of return on NSS instruments have also increased, giving rise to positive inflows. The removal of the ban on institutional investment (except banks and insurance

[3] As detailed in Financial Sector Assessment (FSA) 2004, State Bank of Pakistan.
[4] In the 1990s, the rate of return on these instruments were determined administratively, and remained higher than prevalent market rates, which added to their appeal.
[5] There was a brief period of monetary easing in 2009.

companies) also helped mobilize savings from October 2006 onwards. The shares of each type of instrument in total outstanding stock are shown in **Table 3.3.**

Table 3.3 : Shares of various NSS Instruments in outstanding NSS Stock

percent

	FY06	FY07	FY08	FY09	FY10
1. Certificates	73.6	72.1	71.1	74.4	74.1
Defence Saving Certificates	33.6	30.7	27.9	20.2	15.4
Special Savings Certificates	15.9	15.6	15.7	22.7	24.1
Regular Income Certificates	7.9	5.5	5.0	7.2	9.3
Behbood Savings Certificates	16.2	20.2	22.4	24.2	25.2
Others	0.1	0.1	0.1	0.0	0.0
2. Accounts	13.7	16.2	18.1	17.2	18.3
3. Others	12.7	11.8	10.7	8.4	7.6
Total (1+2+3)	100.0	100.0	100.0	100.0	100.0
NSS Stock (million Rupees)	**882**	**940**	**1,020**	**1,271**	**1,456**

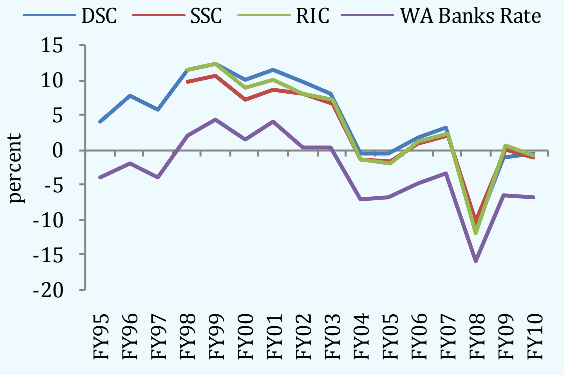
Source: S&DWH

Table 3.4 shows that NSS rates of return, indicating that CDNS invariably offers higher rates of returns on various NSS schemes as compared to the weighted average rates on bank deposits.

In December FY00, with the objective of eliminating market distortions and moving to a market mechanism for the determination of rates, the rates of return on NSS instruments were linked with the cut-off rates on Pakistan Investment Bonds.[6] Following the declining trend in PIB rates from FY02-FY04, rates of return on NSS instruments started declining and reached 7.1 percent (average) in FY05, from 12.4 percent in FY00. From end-FY08 onwards, there have been several upward revisions in NSS rates in line with the changes in the rates on PIBs, driven by monetary tightening by the central bank. Consequently, NSS recorded historical net inflows of Rs. 250.1 billion in FY09. However, a fall in PIB rates in the brief period of monetary easing in 2009, led to a reduction in NSS rate by 283–300 bps. Consequently during FY10, net flows of Rs. 185.7 into NSS were below the targeted amount of Rs. 231 billion. Subsequent to the reversal in the monetary stance from FY11 onwards, the rate of profit on these Schemes were also enhanced **(Table 3.4).**

Although NSS instruments do not provide inflation adjusted returns, nevertheless, their relatively higher rates make them attractive investment instruments (**Figure 3.1)**. Given resurgent inflationary pressures in FY10, the real rate of return on both NSS instruments and bank deposits are hovering around the negative zone.

Figure 3.1: Real Rates on NSS and WA Banks Rate



Source: S&DWH

Notably, NSS instruments are immune to market fluctuations in interest rates due to their non-tradable nature. Another prominent feature of these instruments is their availability 'on tap', and the embedded 'put' option, which enables the investor to encash his investment and reinvest at a higher rate each time there is an upward revision in the rates of return. The early encashment

[6] Profit rates on 10 year DSCs are linked with 10-year PIB, 5 year RICs with 5 year PIB and 3 year SSCs with 3 year PIB.

Table 3.4: Return Structure of Bank Deposits, Government Securities and NSS instruments

Rates in percent

	National Savings Schemes					NSS Stock (Bln Rs)	PIB/FIBs$			Banking Sector Deposits*				
	DSC	SSC#	RIC	BSC	Avg;		3Y	5Y	10y	Savings	1y	3y	5y	Overall
FY95	16.0				16.0	219	13	14	15	7.3	8.0	11.8	14.7	8.2
FY96	18.0				18.0	262	13	14	15	7.3	8.2	12.1	14.9	8.2
FY97	18.0	16.3	15.6		16.7	322	13	14	15	7.4	8.3	12.4	14.9	8.5
FY98	18.0	16.3	18.0		17.4	425	13	-	15	7.4	8.8	12.1	14.0	8.4
FY99	16.0	14.3	16.0		15.4	557	-	-	15	6.9	9.4	10.1	12.3	8.0
H1-FY00	16.0	12.3	16.0		14.8	592	-	-	-	6.3	8.5	9.3	11.2	7.3
H2-FY00	15.0	12.3	14.0		13.8	652	-	-	-	5.8	7.8	8.7	10.4	6.6
H1-FY01	14.0	11.2	12.5		12.6	643	12.5	12.9	14	5.6	8.2	8.9	10.0	6.5
H2-FY01	14.0	11.2	12.5		12.6	694	12.5	13.0	14.0	5.7	8.2	8.4	10.0	6.6
H1-FY02	15.0	12.4	12.5		13.3	689	11.6	12.1	12.5	4.6	8.3	9.0	9.4	5.6
H2-FY02	14.1	12.4	12.5		13.0	792	8.8	9.8	10.6	3.5	7.2	8.2	8.7	4.6
H1-FY03	11.6	10.5	10.6		10.9	779	6.7	7.3	8.1	3.5	5.9	7.2	7.7	4.2
H2-FY03	10.0	8.7	9.1		9.3	909	2.9	3.6	4.8	1.7	3.1	3.8	4.7	2.1
H1-FY04	8.5	7.7	7.7	10.1	8.5	844	4.0	5.0	6.2	1.3	2.6	3.1	3.4	1.6
H2-FY04	8.0	7.2	7.0	10.1	8.1	899	4.4	5.4	7.4	1.3	2.7	3.0	3.2	1.3
H1-FY05	8.2	7.0	6.8	10.1	8.0	821	-	-	-	1.0	2.7	3.0	3.2	1.3
H2-FY05	8.2	7.0	6.8	10.1	8.0	854	-	-	-	1.2	4.3	4.0	4.0	1.9
H1-FY06	9.5	7.0	8.9	11.0	9.1	775	-	-	-	1.7	4.8	5.5	5.0	2.6
H2-FY06	10.0	8.6	8.9	11.5	9.8	882	9.5	9.7	9.9	1.7	5.3	5.2	5.6	2.7
H1-FY07	10.0	9.3	9.2	11.5	10.0	903	9.7	10.0	10.5	1.9	6.0	7.1	6.0	3.4
H2-FY07	10.2	9.3	9.5	11.6	10.2	940	9.3	9.6	10.1	2.1	6.8	7.2	6.3	3.5
H1-FY08	12.2	9.3	9.5	11.6	10.7	971	9.7	9.8	10.2	2.1	6.9	6.7	7.2	3.6
H2-FY08	12.2	11.3	11.5	13.6	12.1	1020	12.3	-	13.4	4.9	7.3	8.6	8.7	5.6
H1-FY09	12.2	14.5	15.0	16.8	14.6	1069	13.7	-	14.6	5.0	8.4	8.5	9.1	6.0
H2-FY09**	12.2	13.2	13.6	16.1	13.8	1271	12.5	12.4	12.6	5.1	8.5	9.6	9.1	6.5
H1-FY10	12.2	11.7	12.0	14.2	12.5	1368	12.3	12.4	12.4	5.0	8.2	9.1	8.9	8.6
H2-FY10	12.2	11.7	12.0	14.2	12.5	1456	12.5	12.6	12.7	5.0	8.3	9.7	8.9	6.0
H1-FY11^	12.6	12.1	12.4	14.6	12.9	-	-	-	-	-	-	-	-	-

* Provisional data. Scheduled Bank's WA Rates, Interest Based and P&L Sharing - All Banks (it includes Foreign Deposit rates as well)

**: Detail of rates revised during FY09 is as follows: (1) on 1-Oct-08 upward revision in SSC (13), RIC (13.3) and BSC(15) (2) Second upward revision on 1-Dec-08 in SSC (14.5), RIC (15) and BSC(16.8) and third downward revision on 1-Apr-09 in SSC (13.2), RIC (13.6) and BSC(16.1)

^ Up to 1-Oct-2010, # Average rates of periodical profit on SSC. $ FIB's rates from FY95 to FY99

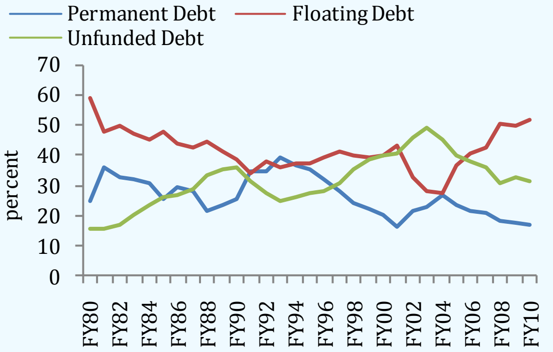
Source: S&DWH and CDNS

facility without any cash penalty reinforces this particular behavior. These various features of NSS instruments tend to create distortions in the financial system.

3.4 NSS and Deficit Financing

Over the years, NSS flows have helped the government to finance its budget deficit with non-inflationary borrowings. During the early 1980s, growth in Pakistan's stock of domestic debt remained in check due to substantial external inflows in the form of foreign aid and large influx of foreign remittances. Share of unfunded debt (comprising of NSS) in domestic debt was only 16 percent during FY80-81. However, in the 1990s Pakistan's stock of domestic debt started rising mainly on account of widening revenue-expenditure gap and decline in concessional foreign lending, which severely impacted government's ability to meet its internal and external obligations. Consequently, the government started raising funds domestically through unfunded debt (NSS). As a result, during FY96-FY00, total domestic debt (outstanding) shot up by 77.2 percent and share of unfunded debt (NSS) in domestic debt surpassed the share of other components of domestic debt to 40.1 percent in FY00, subsequently rising further to its peak of 49.1 percent in FY03. However, in subsequent years, due to the decline in NSS rates and use of other financing avenues, share of unfunded debt in domestic debt started declining, reaching 31.3 percent in FY10 **(Figure 3.2).**

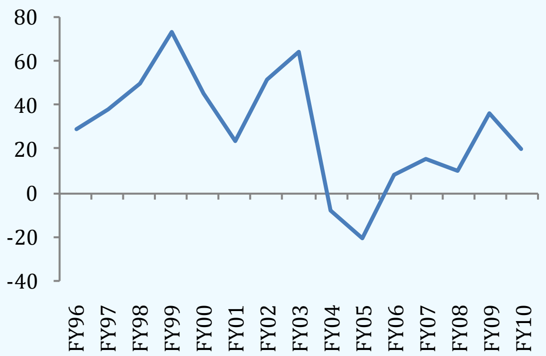
Figure 3.2: Composition of Government Domestic Debt



Source: S&DWH, EAD

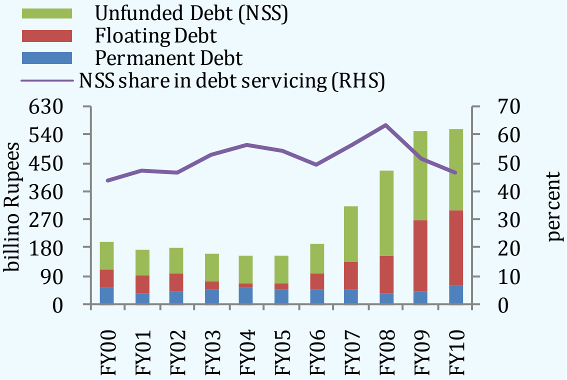
Annual trend in deficit financing through NSS is presented in **Figure 3.3.** NSS was the primary source of financing of the budget deficit during the 1990s. In 1999, around 74 percent of total budget deficit was financed by NSS mainly by offering higher rates. During FY00-FY03, average share of NSS in total deficit financing stood at 46.4. Subsequently however, NSS contribution in total deficit financing reduced sharply, turning negative in FY04 and FY05 respectively. This was mainly due to the substantial downward revision in NSS rates. As mentioned earlier, in FY09 there was significant upward revision in NSS rates given the burgeoning fiscal deficit, which attracted historic net flows of Rs. 250.1 billion. Consequently, share of NSS in total deficit financing rose to 37 percent, from 10.3 percent in FY08. However, by end-FY10, the share declined to 20 percent with the decline in NSS rates.

Figure 3.3: NSS as Percent of Budget Deficit



Source: S&DWH

Figure 3.4: Trends in Domestic Debt Servicing



Source: S&DWH, CDNS

Given the costly nature of NSS instruments, rising share of NSS stock in total domestic debt holds implication for government debt management as the interest payments related to NSS have grown sharply. As shown in the **Figure 3.4**, with the rise in share of debt financing through NSS, share of its debt servicing had surged to 63 percent in FY08, as compared to average share of 52 percent during FY01-FY07.

3.5 Implications of NSS for the Financial Sector

Presence of CDNS as a parallel financial intuition in the public sector has a strong bearing on the financial sector. A similar case has also been seen in India. The Indian government has designed various Small Savings Schemes (SSS) for the investors of rural and semi urban areas. Various features of Indian SSS are similar to those of NSS in Pakistan. Like Pakistan, presence of SSS in the government sector also creates distortions in the Indian financial market **(Box 3.1).**

Box 3.1: Small Savings Schemes of Government of India

In India, Small Savings Schemes (SSS) came into being in the years following Independence. These SSS were largely designed to provide safe and attractive investment options to the rural and semi urban areas and at the same time mobilizing resources for development purpose. In this regard, the Indian government framed various saving schemes under the Government Savings Bank Act, 1873, Government Savings Certificates Act, 1959 and Public Provident Fund Act, 1968. In addition to that, two non-statutory schemes have also been introduced through executive orders. The SSS currently in force include: Post Office Savings Account, Post Office Time Deposits (tenors 1, 2, 3 & 5 years), Post Office Recurring Deposits, Post Office Monthly Income Account, Senior Citizens Savings Scheme, National Savings Certificate (VIIII-issue),Kisan Vikas Patra and Public Provident Fund (PPF). These schemes are operated through the world's largest postal network with 154,000 post offices throughout India. PPF Scheme, in addition to the post offices, is also operated through about 8000 branches of public sector banks.

Similar to Pakistan, SSS in India are mobilized through quite attractive rates as compared to other schemes in the financial market **Table 1**. However, unlike Pakistan, (where institutions (excluding banks and insurance) are allowed to invest in such schemes) institutions are not eligible to invest in SSS which are primarily designed for small urban and rural investors. Moreover, interest rates on SSS are determined administratively by the government of India, while the rates on NSS are linked with the long-term sovereign bond i.e. PIBs since FY00.

Over the last ten years, outstanding deposits under various SSS have grown by 191 percent, reaching Rs. 5.5 trillion in FY09 as compared to Rs. 1.9 trillion in FY00. Similarly, since FY00- FY06, small savings as percent of bank deposits have grown constantly, which have risen to 30.1 percent in FY06 from 23.1 in FY00. Moreover, resource mobilization through small savings has also been a major source of financing fiscal deficit in India as well, which during the 1990s contributed around 17 percent, on average, (highest 21.3 percent in 1994) mainly due to higher interest rate on these schemes. However, from FY00, interest rates on these schemes started declining; as a result share of SSS had reduced to 7.2 percent in FY05 from 20 percent in FY00 (**Figure 1)** which then increased to 16.4 percent in FY08.

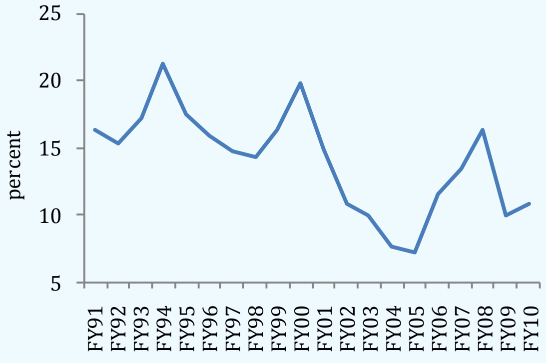
Table 1: Trends in Small Savings and Bank Deposits in India

Amount in billion Rupees

	Interest Rates on Small Savings (%)	Small Savings Outstanding	Avg; i-rate on banks' term deposits (%)	Bank term deposits outstanding	Small savings as % of Bank Deposits
1991-92	9.95	586	9.1	2,308	25.4
1992-93	9.48	609	9.6	2,686	22.7
1993-94	12.21	677	8.7	3,151	21.5
1994-95	13.20	833	7.0	3,869	21.5
1995-96	11.33	937	8.5	4,338	21.6
1996-97	13.03	1,061	9.4	5,056	21.0
1997-98	11.92	1,268	8.8	5,985	21.2
1998-99	10.34	1,553	8.9	7,140	21.7
1999-00	11.50	1,875	8.6	8,133	23.1
2000-01	11.60	2,251	8.1	8,201	27.4
2001-02	11.61	2,629	9.6	9,503	27.7
2002-03	11.56	3,138	8.7	10,809	29.0
2003-04	10.88	3,758	6.5	12,794	29.4
2004-05	9.37	4,577	6.2	14,487	31.6
2005-06	8.91	5,276	-	17,444	30.1
2006-07	-	5,643	-	-	-
2007-08	-	5,094	-	-	-
2008-09	-	5,458	-	-	-
2009-10	-		-	-	-

Source: Paper on Monetary Policy Transmission in India by R.Rakesh Mohan, December 2006.

Figure 1: Share of Small Savings in Gross Fiscal Deficit in India



Source: Reserve Bank of India website

Similar to Pakistan, offering higher rates on SSS also creates distortions in the Indian financial markets and implications for the effectiveness of monetary policy, as banks have to compete for funds with small saving schemes. “The rates offered on long-term deposits mobilized by banks set the floor for lending rates at level higher than would have obtained under competitive market conditions, which is the main factor contributing to downward stickiness of lending rates in India”[1].

However, from time to time, several measures have been proposed to remove the distorting impact of these administrative SSS rates which include: benchmarking these administered interest rates to market-determined rates or to secondary market yields of government securities of corresponding maturity so as to impart flexibility to the SSS structure but these proposals were never implemented in letter and spirit.[2] In the recent past, the Indian government once again considered to deregulate these administrative rates on SSS and linking it to market based interest rates[3]. If this is implemented then it would reduce returns on such schemes. At present, interest rate on PPF is 8 percent, which is tax-free, whereas post-tax return on bank deposits is around 5.5 percent for those who fall in the highest tax bracket of 30 percent.[4]

[1] *Monetary Policy Transmission In India - BIS Papers No 35, January 2008*
.[2] *Jadhav, Narendra (2007). "Fiscal Sustainability in India: An Assessment and Implications.*
[3]*Sinha, Prabhakar (2010), "Small Savings May Lose Sheen", The Times of India, Jul 14, 2010.*
[4] *See Footnote No.3*

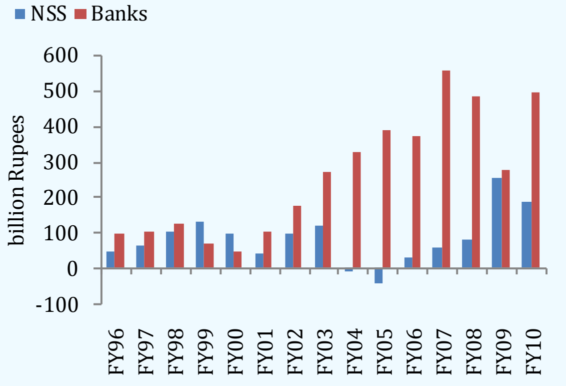
Table 3.5: Trends in NSS and Bank Deposits
Amount in billion Rupees, ratio in percent

	NSS			Bank Deposits			Size of NSS as % of bank deposits & NSS
	Stock*	Growth	% of GDP	Stock	Growth	% of GDP	
FY00	652	16.9	17.0	1037	4.4	27.1	38.6
FY01	694	6.4	16.5	1139	9.9	27.1	37.8
FY02	792	14.2	17.8	1314	15.3	29.5	37.6
FY03	909	14.8	18.7	1581	20.3	32.4	36.5
FY04	899	-1.1	15.9	1906	20.6	33.8	32.1
FY05	854	-5.0	13.1	2291	20.2	35.3	27.2
FY06	882	3.2	11.6	2662	16.2	34.9	24.9
FY07	940	6.6	10.8	3218	20.9	37.1	22.6
FY08	1020	8.6	10.0	3703	15.1	36.1	21.6
FY09	1271	24.5	10.0	3980	7.5	31.2	24.2
FY10	1456	14.6	9.9	4475	12.4	30.5	24.6

*excluding prize bond
Source: SBP

Table 3.5 presents comparative trend in NSS instruments and banks deposits. NSS instruments have posed a major challenge for the banking industry in competing for funds. However, over the years, the share of NSS stock as percent of total deposits in the system (NSS stock plus Bank deposits) has been declining, reaching 25.6 percent in FY10 from its peak of 38.6 percent in FY00 (**Figure 3.5**).

Figure 3.5: Trends in Net Flows NSS vs Bank Deposits



Source: S&DWH, EAD

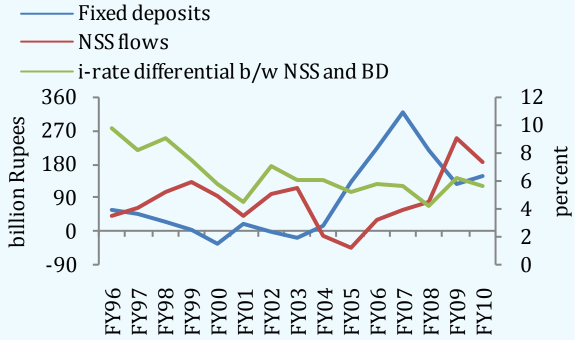
The wide spread[7] of around 6.4 percent between NSS rates and bank deposits, has a strong bearing on banking system deposits. The reason for the degree of substitution between bank deposits and NSS instruments, despite the apparent difference in tenors, arises from the early encashment facility which can be utilized without incurring any penalty. This encourages the investors to divert their funds from banks to NSS in a rising interest rate environment.

Figure 3.6 shows the interest rate differential between the rates on NSS instruments and bank deposits plotted against net flows in NSS and bank deposits. The figure shows that

[7] Spread between WA NSS rates and overall WA rates on Banks deposits. Spread figure is of FY10.

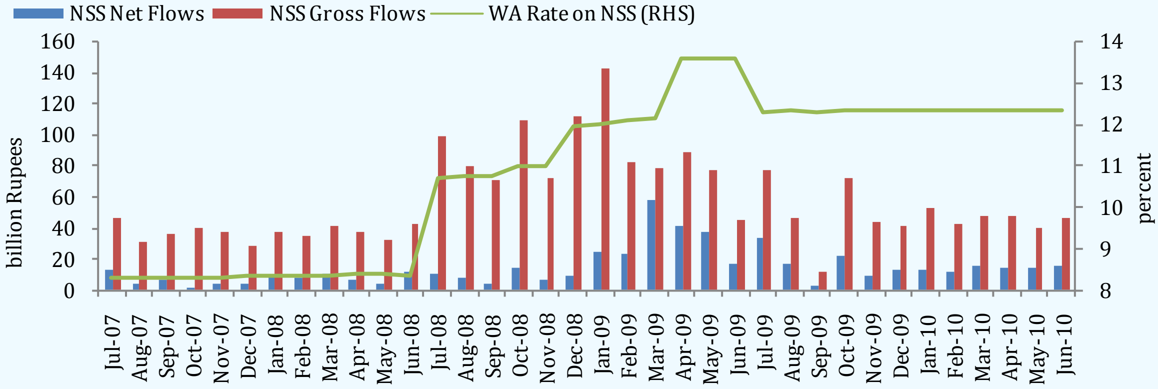
during the 1990s, significant interest rate differential (of around 7.5 percent to 9.8 percent) between the two remained instrumental in fetching substantial flows towards NSS. However, this differential was squeezed in the latter period when NSS rates were linked with PIBs in FY00. Although the interest rate differential of 6.0 percent (on average) during FY02-06 was quite sufficient to attract flows toward NSS, but despite that, NSS recorded significant decline in net flows, which was mainly due to banning institutional investments in NSS, suspension of DSCs and SSCs sales through banks and disallowing banks to lend against NSS instrument. These circumstances led to the diversion of institutional deposits towards banks, as evident by steep rise in banks' fixed deposits. However, this situation was largely reversed when the ban on institutional investment was finally lifted during October 2006, which largely remained instrumental in bringing the institutional funds back toward NSS **(Figure 3.6)**. Similarly, by the end of FY08 onward, the interest rate differential between the two had widened significantly due to sharp upward revision in the NSS rate, as a result NSS recorded historic net flows (**Figure 3.7),** whereas flows towards banks' fixed deposits had reduced significantly in FY09.

Figure 3.6: Substitution b/w Fixed Deposit&NSS: Net Flows



Source: S&DWH, CDNS

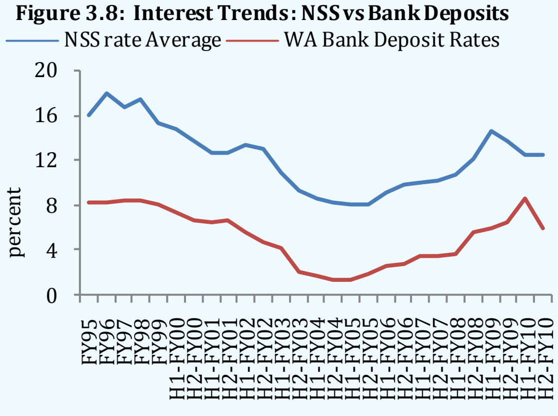
Figure 3.7: Trends in NSS Rate, Net and Gross Flows



Source: S&DWH, CDNS

The substitution possibility between banks deposits and NSS instruments has a strong bearing for the banking system, as more net flow towards NSS tend to shift medium term fund or fixed deposits away from the banking system that limits the bank's ability to invest in the medium term projects (**Figure 3.8).**

Figure 3.8: Interest Trends: NSS vs Bank Deposits



Source: S&DWH, EAD

3.6 Launch of National Saving Bonds

The Government launched its first-ever listed, scripless and tradable National Savings Bond (NSB) on January 11, 2010. NSB is available in maturities of 3, 5 and 10 years offering 12.50, 12.55 and 12.60 percent rates of return, respectively. The Government received Rs. 3.7 billion from the first issue of this bond. Currently, the list of eligible investors in NSB includes individuals, mutual funds, provident/pension/gratuity funds or trusts. NSB offers bi-annual (net of tax) profit payments and redemption before maturity is not allowed.

Launch of NSB serves as an alternate channel for government's deficit financing, enabling the government to mobilize funds domestically, while curtailing government borrowing from the banking system, hence minimizing the crowding out of the private sector. In future, launch of similarly bonds would help government to increase the share of non-bank borrowing in the overall government domestic borrowing.

Box 3.2: Proposed Reforms to Pakistan's Debt Capital Market – With Special Reference to Structure of National Savings Schemes.

In June 2006, Securities and Exchange Commission of Pakistan (SECP) formed a special committee "The Debt Capital Market Committee (DCMC)" to investigate and identify the critical issues hindering growth of the debt capital market in Pakistan and make suitable recommendations for the development and promotion of the debt capital market. DCMC was comprised of leading experts and various industry stakeholders under the chairmanship of SECP chairman. On April 2007, the committee submitted its report to SECP regarding Pakistan's Debt Capital Market.

Among other issues pertaining to the development of debt capital market in Pakistan, this report also reviewed/investigated specific issues pertaining to the structure of NSS which pose a major challenge in reforming debt capital markets and gave several recommendations to overcome the distorting impact of NSS schemes on the debt market. Recommendations of this committee with reference to NSS are given below.

Major Issues highlighted by DCMC:

According to the findings of the DCMC committee, current structure of NSS is the most significant challenge in the reform of Pakistan's debt capital markets, which is mainly due to the subsidized nature of its saving products. While discussing distinct advantages and disadvantages of the NSS system, the report said that:

- *"On* the positive side, it provides a reliable source of long-term funding to the government and a widespread distribution network that provides access to the retail investor base."
- "On the negative side, it has historically been a costly source of funding for the government due to the inefficient pricing structure and the free embedded put option."

Moreover, the report has also concluded that although several measures have been implemented to bring the NSS rates of returns in line with PIBs but despite all these measures, NSS products are quite attractive as compared to other market product mainly due to higher interest rates, embedded government guarantee, and most importantly, the in-built put option that allows investors to redeem the investment at any point in time without any redemption charges. Subsequently, comparable market based instruments, in contrast, seem unattractive and non-competitive to the retail investor base. Furthermore, the government has limited control over the amount of money that can be raised due to the 'on tap' nature of NSS instruments.

Recommendations by the Committee

- DCMC stressed the need to integrate the NSS instrument into the mainstream capital markets and gave two options for doing so. The first was to convert the NSS instruments into market-based instruments and pass them on to retail clients directly through the NSS network. The second option suggested the withdrawal of the "implicit put option" that allows redemption at zero penalties. This is necessary step in order to make NSS instruments competitive with market instruments.
- Further, In order to use the NSS retail distribution network efficiently, DCMC recommended that "NSS retail distribution network can be leveraged and its retail investor base made more resilient by allowing private sector mutual funds access to the platform for distribution of their investment products. Mutual funds will be attractive to the retail investor base as they can be tailored to varying needs and investment/saving profiles".
- The report further suggested that instead of NSS, government should fulfill its long-term investment needs through PIBs. This would provide the government more control over its financing needs unlike the NSS, whose 'on tap' nature puts it outside the realm of government control.

Source: Security and Exchange Commission of Pakistan (2007), "Proposed Reforms to Pakistan's Debt Capital Market", April 2007

3.7 Conclusion

While NSS play an important role in mobilizing financial savings in the economy, the outstanding stock of NSS instruments along with the unique characteristics of these schemes create distortions in the financial sector. It is suggested that CDNS is restructured in such a manner that it can continue to play its vital role in mobilizing financial savings in the economy without creating significant distortions in the financial sector. To meet this objective, NSS instruments need to be integrated into mainstream capital markets by making them tradable (as suggested by the SECP in its report, (**Box 3.2**), and by withdrawing the implicit put option, which is a potential source of liquidity problems for the government. It is also important to upgrade CDNS infrastructure by utilizing IT services. Given the huge size of investments in NSS, a restructured and well-equipped CDNS can be strategically used to promote outreach of financial services to remote areas.

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