

# 7 Financial Savings and Interest Rate Structure

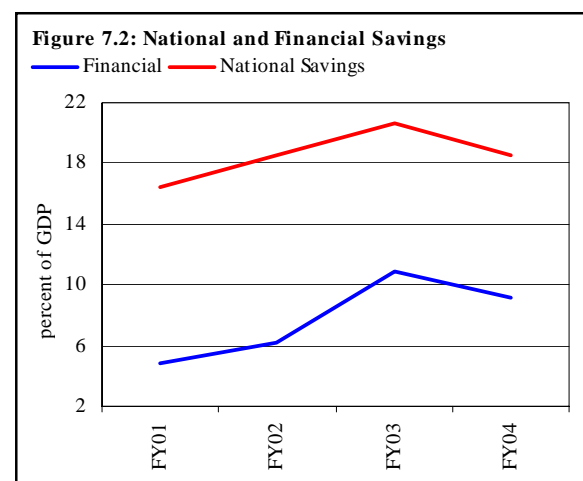
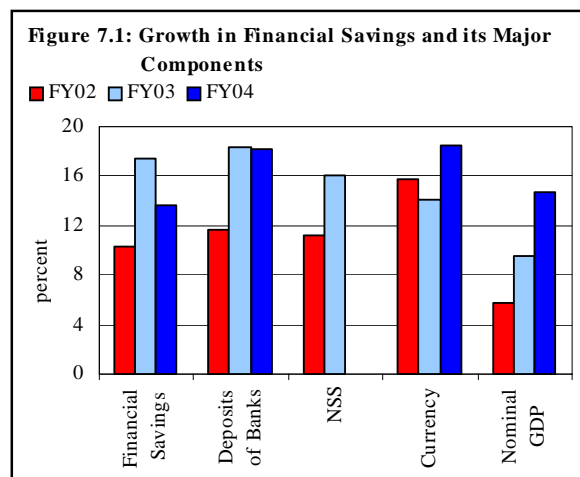
## 7.1 Structure of Financial Savings<sup>1</sup>

The structure of financial savings plays a crucial role in the economic development of a country, given that the nature of savings determines the nature of investments in the economy. The structure of savings is even more critical for an economy which is in a transition phase; from a pre-dominantly public-sector based ownership of economic activities to an increasing role of the private sector in all spheres of the economy, which has strong bearings on both the volume and the composition of aggregate savings. Higher domestic financial savings reflect the confidence of households in domestic financial markets. Thus the growth rate of private savings is positively correlated with the confidence of the private sector in the strength of the financial system.

Financial savings grew by 13.6 percent in FY04. Interestingly, while the growth of financial savings during FY02 and FY03 was significantly higher than the growth in nominal GDP, in FY04 the growth could not keep pace with the growth in nominal GDP (see **Figure 7.1**). While the former was due to low inflation, which resulted in low growth in nominal GDP, the latter was due to the strong economic performance, which also had an inflationary impact on the economy, resulting in a substantial growth of 14.7 percent in nominal GDP. Consequently, financial savings as a percent of GDP inched up from 60.3 percent at the end of FY01 to 66.8 percent by end-FY04 (see **Table 7.1**). The strong growth in financial savings was largely due to the growth in the deposits of scheduled banks, as well as increased activities in the Mutual Funds sector. This is reflected in the increased share of the stock of deposits in nominal GDP which reached 35.7 percent by end-FY04 from 30.4 percent at end-FY01, whereas the share of mutual funds, while still small, increased from 0.3 percent in FY01 to 1.5 percent in FY04.

In Pakistan, while the national savings rate has been around 19 percent on average in the last 3 years, the financial savings rate continues to be less than half of national savings (see

**Figure 7.2**), though it has shown an increasing trend since FY01, with the exception of FY04. A similar trend is true for National Savings, and is largely attributed to the more than proportionate increase in nominal GDP.



<sup>1</sup> The scope of financial savings, as detailed in Table 7.1, has been enhanced to include Mutual Funds and GP Fund, and the figures have been revised on this basis from FY01 onwards.

Specifically, developments in the areas of banking and finance like the introduction of e-money, online banking, increasing usage of credit and debit cards, and the inflow of a substantial amount of remittances from expatriate Pakistanis have had a significant impact on financial savings. In FY04, however, the extent of withdrawal of funds from CDNS does not reflect a corresponding growth in bank deposits, the primary reason for which is the diversion of funds into the stock market due to the opportunity of making phenomenal gains on the back of an exceptional performance of the stock market during the year.<sup>2</sup>

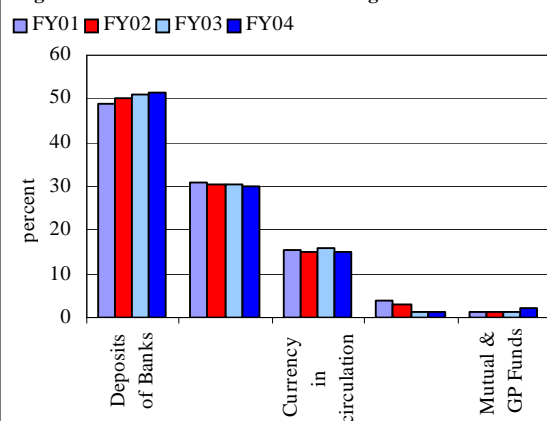
In absolute terms, the deposits of scheduled banks recorded a mammoth increase of Rs 304.3 billion during FY04, the highest increase in absolute terms, compared to an increase of Rs 259.2 billion during FY03. The other major contributors of financial savings in terms of absolute volume are currency in circulation (Rs 91.4 billion) and mutual funds (Rs 49.6 billion<sup>3</sup>), largely on account of increased stock market activities and growth in the net asset value of existing funds in addition to the introduction of several new funds during the year.

In relative terms, the growth momentum of scheduled banks' deposits continued during FY04, which recorded a healthy growth of 18.2 percent, roughly the same as the FY03 growth of 18.4 percent. This was followed by the growth in currency in circulation and deposits of NBFIs,<sup>4</sup> which registered an increase of 18.5 percent and 16.2 percent respectively. It is also to be noted that mutual funds have recorded a growth of 88 percent in FY04.

The healthy increase in the deposits of scheduled banks led to a 2 percentage point rise in their share in financial savings during FY04 (see **Figure 7.3**). There was also a

**Table 7.1: Financial Savings**

	FY01	FY02	FY03	FY04
Financial savings (billion Rupees)	2,511.3	2,770.8	3,252.4	3,696.3
<b>Share in Financial Savings</b>				
Deposits of scheduled banks	50.4	50.9	51.4	53.4
Investments in NSS	30.3	30.6	30.2	26.6
Currency in circulation	14.9	15.6	15.2	15.8
Deposits of NBFIs	3.2	1.5	1.2	1.3
Mutual Funds	0.5	0.7	1.4	2.3
GP fund	0.7	0.7	0.6	0.6
<b>As percent of GDP(mp)</b>				
Deposits of scheduled banks	30.4	32.1	34.6	35.7
Investments in NSS	18.3	19.2	20.4	17.8
Currency in circulation	9.0	9.9	10.3	10.6
Deposits of NBFIs	1.9	0.9	0.8	0.8
Mutual Funds	0.3	0.4	0.9	1.5
GP Fund	0.4	0.4	0.4	0.4
Financial savings (billion Rupees)	60.3	62.9	67.4	66.8
<b>Flows as percent of GDP (mp)</b>				
Deposits of schedules banks	3.10	3.34	5.37	5.50
Investments in NSS	1.12	1.93	2.82	0.00
Currency in circulation	0.46	1.34	1.26	1.65
Deposits of NBFIs	-0.27	-0.88	-0.02	0.12
Mutual Funds	-0.02	0.16	0.53	0.72
GP Fund	-0.02	0.00	0.02	0.04
Financial savings	4.37	5.90	9.98	8.02
National savings	16.5	18.6	20.6	18.7
<b>Memorandum Item :</b>				
Market capitalization to GDP ratio	8.1	9.3	15.5	24.5

**Figure 7.3: Share in Financial Savings**

<sup>2</sup> For a more accurate estimate of financial savings, data for stock market capitalization would need to be adjusted for investments held by banks, NBFIs, Insurance companies etc.

<sup>3</sup> Assets of Mutual Funds are adjusted for scheduled banks' investments in Mutual Funds, including NIT.

<sup>4</sup> Deposits of NBFIs are adjusted for scheduled banks' holdings of Modaraba certificates.

marginal increase in the share of currency in circulation in financial savings of 0.6 percentage points in FY04, whereas the share of Mutual Funds increased from 1.4 in FY03 to 2.3 in FY04. On the other hand, the share of NSS has decreased by 3.6 percentage points in FY04. It is important to note that there has been a visible change in the overall structure of financial savings in terms of its components during the last four years. Specifically, the share of NSS instruments has been gradually declining, with a considerable decline in FY04 alone, whereas the share of scheduled banks' deposits (which already have the largest share in financial savings) and mutual funds, is on the rise.

With respect to the growth in deposits, the underlying qualitative change of this seemingly small shift in quantitative terms is significant. This is an important development not only because the rates of return on the deposits of scheduled banks has been quite low during period under assessment but also because the ownership structure of the banking system has gradually shifted to the private sector in the last few years. Mutual Funds, which have a small share in financial savings, are also an important and growing constituent of total savings.

## **7.2 Contractual Savings**

Successful financial liberalization, among other factors, also depends on a well developed contractual savings sector. Contractual savings are the financial assets of contractual savings institutions (e.g. pension funds, life insurance companies etc.). This corresponds to the liabilities of these institutions to the public as pension benefits upon retirement, disability benefits for the insured, pensions or survivor benefits to the survivors upon death of the insured, and so forth.

The development of contractual savings plays an important role in developing capital markets, by reducing the spread between long and short-term interest rates, and the cost of capital (both equity and debt finance) thus enhancing investments and growth. The presence of efficient contractual savings institutions imply a high level of professional specialization in the market, more funding for riskier (and higher-yielding) projects, improved economies of scale and scope, reduced transaction costs, innovations in financial engineering and improved corporate governance and information disclosure.

In contrast to the banking system, which largely provides short-term finance to the economy, contractual savings are primarily long-term in nature, which allows the fund managers to achieve allocative efficiency and provide long-term finance (particularly long-term debt) to the deficit sectors of the economy.

In Pakistan, institutional investors like State Life Insurance Company (SLIC), Employees' Old-age Benefits Institution (EOBI) etc. are key players in stock markets. The increasing share of contractual savings in financial assets serves to promote the depth of securities (and bond) markets.

Some of the key contractual savings institutions in Pakistan are discussed below.

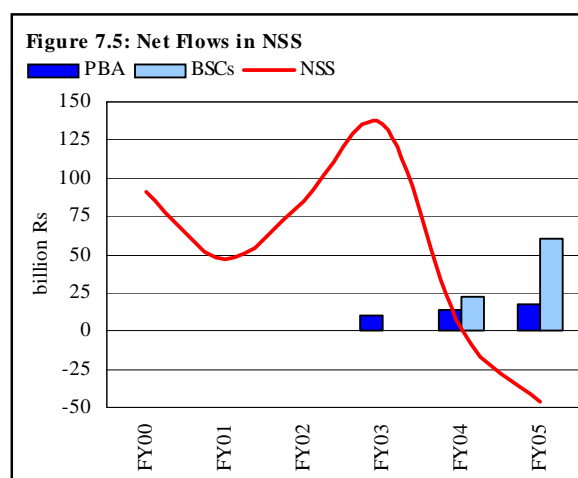
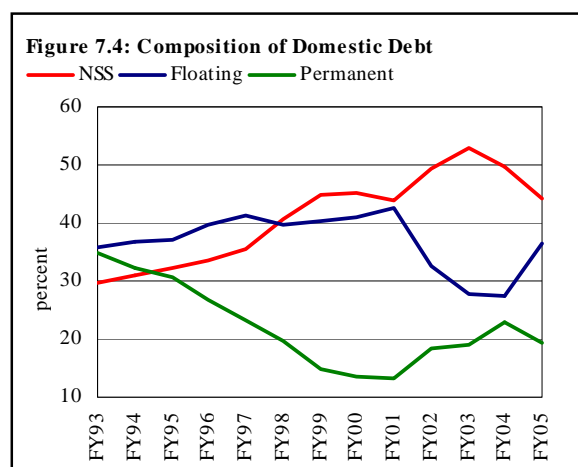
### **7.2.1 Central Directorate of National Savings**

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. Commonly known as National Savings Schemes (NSS), their popularity 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. However, in the recent past a change in this trend has been observed, specifically during FY04, when for once total repayments could not be paid through the

gross sale receipts of the NSS instruments. 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, due to which the sharp decline in 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 such as listed shares, real estate, mutual funds etc. 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, has started to decline in the last two years (see **Figure 7.4**). Even though net flows from NSS instruments have seen a declining trend in the last two years, 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 (see **Figure 7.5**).

Though these two schemes have certain conditions attached to them, the sales of these instruments show that PBAs and BSCs are more popular than all the other NSS instruments like Defence Savings Certificates (DSCs), Special Savings Certificates (SSCs) etc. due to the higher rate of return. The net inflow through BSCs was even substantially higher than the initial budget estimates of FY05 (see **Table 7.2**). These two particular schemes cater to the investment needs of specific investors like senior citizens, pensioners and widows etc.

The stock of NSS instruments recorded a decline of Rs 46.2 billion during FY05, in



**Table 7.2: Net Flows in NSS during FY05 (Estimates vs Actual)**

billion Rupees

Instruments	Estimates		Actual FY05
	Budget	Revised	
Savings Accounts	-3.70	-2.40	-2.12
PBAs	16.00	20.10	17.74
DSCs	5.00	-6.70	-8.71
BSCs	20.00	66.90	60.65
SSCs	-10.95	-58.79	-83.16
RICs	-40.00	-45.00	-40.46
Prize Bonds	27.50	27.50	9.74
Other	0.04	0.10	0.10
<b>Total</b>	<b>13.89</b>	<b>1.71</b>	<b>-46.22</b>

Source: Central Directorate of National Savings

contrast to a marginal increase of Rs 1.9 billion during FY04. PBAs and BSCs together generated a net amount of Rs 78.4 billion during this period whereas DSCs and SSCs together recorded a decline of almost Rs 92 billion in the same period. The other major decline was in the Regular Income Certificates (RICs), which witnessed a reduction in its stock by Rs 40.5 billion during FY05. However, the stock of Prize Bonds registered an increase of Rs 9.7 billion during this period.

In relative terms, BSCs registered a very sharp increase in their overall share in NSS stocks from 2.3 percent to 8.9 percent during FY05 (see **Table 7.3**). In contrast, the share of SSCs declined to 21.1 percent from 28.5 percent in the same period whereas the share of RICs declined from 12.8 to 9.1 percent. The share of DSCs however increased a little to 32.35 percent during FY05. Moreover, the share of the stock of NSS instruments in the GDP, which had reached 17.8 percent by the end of FY04, decreased to 14.3 percent by end-FY05.

**Table 7.3: Shares of Major NSS Instruments**

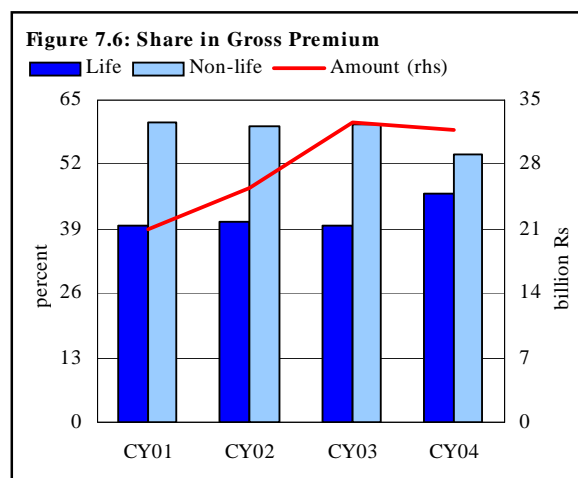
percent	FY04	FY05
Defence Savings Certificates	31.72	32.35
Special Savings Cert.(Reg.)	28.53	21.08
Regular Income Certificates	12.79	9.11
Behbood Savings Certificates	2.30	8.88
Special Savings Accounts	5.56	5.65
Pensioners' Benefit Accounts	2.37	4.38
National Prize Bonds	15.52	17.33
Others	1.20	1.22
<i>Amount Outstanding (billion Rs)</i>	<i>984.43</i>	<i>938.20</i>

As mentioned at the beginning of this section, funds generated through NSS have been an important source of financing the budget deficit. Since this avenue can no longer be relied upon, government's reliance on other financing sources like external financing, borrowings from the banking system and privatization proceeds, has increased significantly in the last two years. However, in a rising interest rate environment, as a result of which the rates of return on NSS instruments have also been increased,<sup>5</sup> the investment preferences of private savers might change again which can lead to net positive inflows in NSS.

### 7.2.2 Insurance

Entrepreneurs and households make use of insurance products to minimize the risk of severe loss from a variety of risks outside their control such as death or natural disasters. The cost of insurance, known as premiums, constitutes the savings of the insured, and hence insurance is a form of contractual savings.

The penetration ratio of the insurance industry in Pakistan is rather low, at 0.6 percent of GDP at end-CY04. Gross premiums of the industry at end-CY04 were Rs 31.8 billion, out of which the shares of non-life and life insurance were Rs 17.1 billion and Rs 14.6 billion respectively (see **Figure 7.6**). A detailed discussion of the insurance industry is given in Chapter 8.



<sup>5</sup> In July 2005.

### 7.2.3 Social Protection Funds

Social protection can be defined as “public and private interventions designed to assist individuals and communities in managing risks, and in providing financial support to the poor”. In specific terms, social protection comprises of programs which aim to provide a minimum level of sustenance to low income households. There are many kinds of social protection programs like social insurance, social safety nets, child protection, labor welfare programs etc. These programs can be in terms of cash transfers, food subsidies, health facilities, disability and old age insurance, public works programs, individual and community debt relief programs for the most vulnerable income groups, provisions against natural disasters, micro credit, and employment generation for the population of remote areas, etc.

Social protection interventions contribute to the social cohesion and stability of a country and can provide support for sustainable economic development in a participatory manner.

Just like any other developing country, the prevailing social protection system in Pakistan covers only a small proportion of the population. The existing system includes retirement benefits and other social insurance like invalidity and widow pensions, health care, and specifically, Workers’ Welfare Funds (WWF) and Workers’ Participation Fund (WPF). Retirement benefits consist of pensions, General Provident (GP) fund and the Employees’ Old-age Benefits Institution (EOBI) scheme.

#### *Employees Old-age Benefits (EOB) Fund*

The main objective of the EOB Fund is to provide pension and old-age grants to the people covered under this scheme. The EOB Fund was established under Section 17 of Employees’ Old Age Benefits Act 1976.<sup>6</sup> Workers’ share in the annual allocation of funds is determined according to their wages, subject to the maximum limit of Rs 3,000. Share of a worker is fixed in units of face value of Rs. 10 each. Moreover, the income of the fund, including capital gains, is exempt from income tax.

The EOB Fund balance at the end of FY04 was Rs 81.6 billion compared to Rs 69.3 billion at the end of FY03 (see **Table 7.4**). As shown in the table, the primary contribution to the EOB Fund now is the income on investments made by EOBI. EOBI has earned Rs 42.4 billion during the last five years whereas the employers have contributed Rs 10.1 billion in same period. As shown in **Table 7.4**, the

**Table 7.4: EOB Fund<sup>7</sup>**

billion Rupees

	Fund at the beginning	Government Contribution	Employers' Contribution	Income	Expenses	Pension Payments	Funds at year end
FY94	11.6	0.7	0.8	2.0	0.1	0.4	14.5
FY95	14.5	0.6	1.0	2.5	0.1	0.5	18.0
FY96	18.0	-	1.2	3.0	0.2	0.5	21.4
FY97	21.4	-	1.3	3.6	0.2	0.6	25.5
FY98	25.5	-	1.3	4.3	0.2	0.6	30.3
FY99	30.3	-	1.4	5.0	0.2	0.7	35.9
FY00	35.9	-	1.5	5.4	0.3	0.9	41.5
FY01	41.5	-	1.7	6.3	0.3	1.3	47.9
FY02	47.9	-	1.9	8.4	0.5	1.4	58.9*
FY03	58.9	-	2.3	10.3	0.5	1.6	69.3
FY04	69.3	-	2.7	12.0	0.6	1.7	81.6

\* Adjustment of Rs 2.6 billion made due to change in accounting policy.

<sup>6</sup> For more details, please see “Pakistan : Financial Sector Assessment 2003”, State Bank of Pakistan.

<sup>7</sup> FY05 data is currently not available.

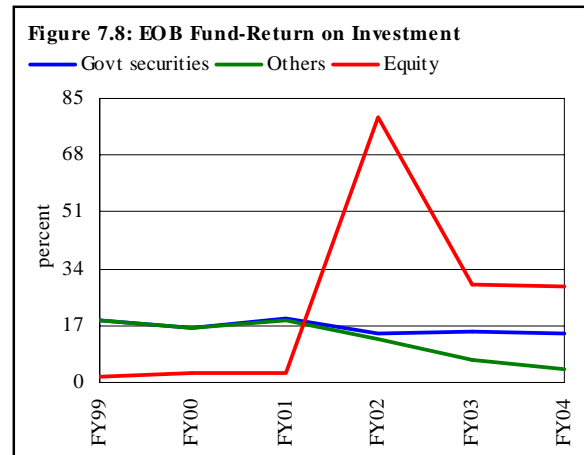
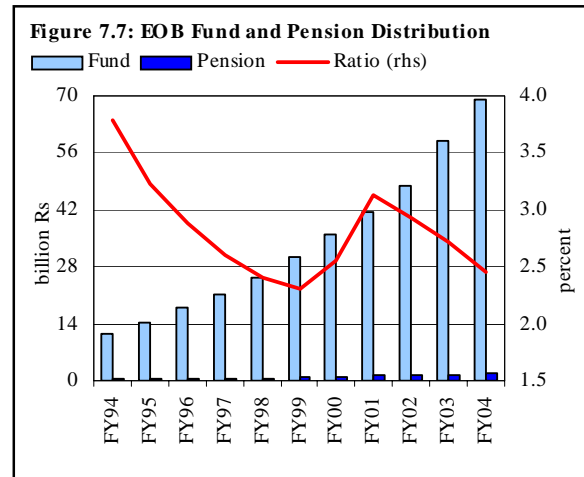
last time the government contributed to the fund was in FY95. It is important to note that the growth rate of the EOB Fund is significantly higher than the growth in employers' contribution. The prime reason for this higher growth is the substantial amount of return on EOB Fund investments and a relatively smaller distribution of the Fund to the pensioners. Moreover, EOBI has a very low operating cost. The EOBI pension has a minimum amount of Rs 700 and a maximum amount of Rs 1,600 per month. Surprisingly, the distribution of the Fund is very low, even as low as 16.3 percent of the income during 11 years. Moreover, pension distribution has been around 2 to 3 percent of the total Fund available (see **Figure 7.7**).

The investment profile of EOB Fund shows that more than 90 percent of the investments in government securities are classified in the 'held-to-maturity' category. Investments categorized as held-for-trading indicate that EOBI has invested only in reputable listed companies.

The held-to-maturity portfolio shows that government securities have an over 95 percent share in total investments. The largest portion is of Defence Savings Certificates (DSCs), consisting of 91.5 percent of the held-to-maturity portfolio. The next largest category is of WAPDA bonds followed by Pakistan Investment Bonds (PIBs) and HBL special saving deposits. However, the ban on institutional investments in NSS has resulted in the gradual depletion of the stock of DSCs and the maturing funds would probably be invested in other longer term papers such as PIBs, or corporate debt instruments.<sup>8</sup>

EOBI's total investments have grown from Rs 27.3 billion in FY99 to Rs 80.8 billion in FY04, reflecting an annual growth of 24.2 percent. During FY04, there was an increase of 19.0 percent in EOBI's investments. As shown in **Figure 7.8**, returns on these investments (excluding investments in shares) vary from 0.95 percent (on short term deposits with banks) to 18.0 percent on DSCs, whereas the return on equity investments have stabilized by end-FY04.

By June FY04, the number of employers registered with EOBI<sup>9</sup> was 52,856. The number of insured persons registered was around 2.1 million, while 246,000 people have benefited from the scheme until June FY04, which indicates that the EOBI scheme needs to broaden its coverage.



<sup>8</sup> It is important to note that the increase in the stock of DSCs as shown in the balance sheet of EOBI is due to the accrued profit on DSCs, whereas the principal amount is gradually declining.

<sup>9</sup> Any establishment of 10 or more employees.



According to the actuarial valuation of the EOB Fund at end-June 2002, this scheme is not financially viable due to the reduction in real yields on the investments, and the EOB Fund would start depleting by year 2024, and will become negative by year 2035. This valuation has also proposed some changes in the contributions made by the employer and the employee along with setting a flat rate of pension, in order to improve the survival prospects of the Fund.

#### **Workers' Welfare Fund (WWF)**

The main objective of WWF, which was established under an ordinance in 1971, is to allocate funds for development projects and other welfare measures. Some of the welfare projects of WWF include : (1) provision of education to the children of industrial workers; (2) scholarships given to workers' children for higher education; (3) construction of a hospital in Lahore for industrial workers; (4) near-completion of 4 kidney centers in 4 cities of the country; (5) arranging plots and houses for industrial workers; and (6) various grants given by WWF.

Under WWF, every industrial establishment in the private sector is required to deposit 2 percent of its assessable income exceeding Rs 100,000 in an accounting year to the Ministry of Labor. In addition, WWF also gets the left over amount of Workers' Profit Participation Funds (WPF).

As a matter of policy, this Fund can either be invested in government securities or utilized for development projects for the welfare of workers at the provincial level. The major development in the WWF investment portfolio was the introduction of Treasury Bills (T-bills) in its profile. Specifically, the structure of WWF investments shows that the share of PIBs has reached 64.6 percent from 50.6 percent, while T-bills constitute 17.8 percent of total investments at end-FY05 (see **Table 7.5**).

As mentioned earlier, after the ban on institutional investments in NSS, the possible avenues for investments are PIBs and T-bills, therefore the WWF portfolio is now focusing on these available government securities while the share of other government papers has been declining in line with their maturities. WWF's investments in PIBs increased by Rs 2.7 billion during FY05 compared to an increase of Rs 1.7 billion during FY04.

While there were compositional changes in the investment portfolio, the pattern of returns on these investments has also changed. Since the rates of return on PIBs and treasury bills are significantly lower than the maturing investments in NSS, WWF's interest income has declined considerably by FY05 (see **Table 7.6**). In fact, the rate of return on WWF investments has come down to single digits during FY05, at 8.3 percent.

With respect to the Fund's distribution, the governing body of WWF allocates funds to the provincial governments for the establishment of labor colonies, schools and health facilities.

**Table 7.5: WWF Investments**

(Amount million Rupees, share in percent)

Type	FY04		FY05	
	Amount	Share	Amount	Share
FIBs	2,593.0	27.20	467.0	4.00
PIBs	4,825.0	50.60	7,515.0	64.60
RICs	500.0	5.20	0	0.00
DSCs	1,088.9	11.40	1,088.9	9.30
US\$ bonds	28.0	0.30	0	0.00
WAPDA bonds	500.0	5.20	500.0	4.30
T-bills	0.0	0.00	2,071.7	17.80
<b>Total</b>	<b>9,534.9</b>		<b>11,642.6</b>	

**Table 7.6: Interest earned by WWF on Investments**

million Rupees

Period	Interest income	Rate of return %
FY00	1,127.8	14.1
FY01	1,182.1	13.8
FY02	1,301.4	14.7
FY03	1,330.8	12.8
FY04	1,343.6	14.1
FY05	977.6	8.3



During FY05, the funds released to the provincial governments were double the amount of the funds released during FY04 (107.2 percent higher). In fact, this is the highest amount released to the provincial governments in the last many years (see **Table 7.7**). The share of the Punjab government was the largest during FY05 followed by Sindh, N.W.F.P. and Balochistan (see **Figure 7.9**).

**Table 7.7: Consolidated Statement of Expenditure on Account of Releases to Provincial Government**

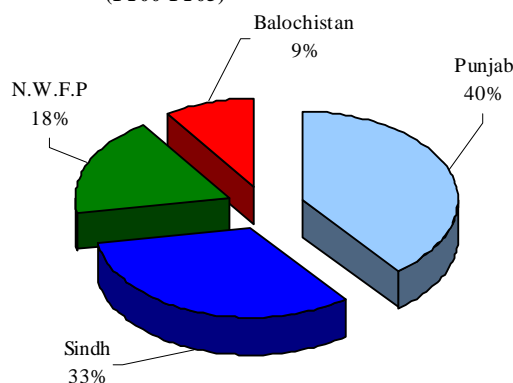
Year	Punjab	Sindh	N.W.F.P	Balochistan	Total
FY00	604.6	311.3	193.6	303.2	1,412.80
FY01	452.6	514.6	392.4	149.5	1,509.10
FY02	692.7	602.1	245.3	170.9	1,711.10
FY03	570.9	366.2	119.9	121.7	1,178.70
FY04	550.8	600.6	263.2	137.9	1,552.40
FY05	1,316.20	1,082.30	703.4	114.9	3,216.80

### Workers' Participation Fund (WPF)

The objective of Workers' Participation Fund is to distribute its profits among the low-salaried workers and provide funds for other welfare measures. Under the Companies Profits (Workers' Participation) Act, 1968 and Rules, 1971, every registered company, with 100 or more employees, is required to establish a workers' participation fund by paying 5 percent of its net profits to this fund. The annual income of the fund, including capital gains, is distributed by each company every year to its workers in proportion to their unit of entitlement based on their average monthly wages. As mentioned in the WWF section, the left-over portion of these funds is transferred to the Workers' Welfare Fund (WWF).

The details of WPF show that during the last five years, around Rs 4 billion were appropriated each year to WPF by the companies, however nearly 80 percent of this amount was not utilized and then transferred to WWF (see **Table 7.8**). There is a need to expedite the process of transferring the left over funds of WPF to WWF, so that the collected funds can be utilized for the welfare of industrial workers.

**Figure 7.9: Share in WWF Released to the Provinces (FY00-FY05)**



**Table 7.8: Collection and Distribution of Funds under the Companies Profits (WP) Act, 1968 (1973-74 to 2003-04)**

million Rupees					
Financial Year	Number of Companies	Total Amount Allocated	Total Amount Distributed	Left over Amount Transferred to WWF	Total Workers Benefited (Thousands)
FY01	814	4,682	1,325	3,357	362.4
FY02	565	5,031	1,132	3,899	500.4
FY03	533	5,726	1,292	4,434	331.0
FY04	639	4,989	936	4,053	778.2
FY05*	361	3,513	632	2,960	343.6

\* July-April

### General Provident Fund (GP Fund)

The provident fund arranged by the government is the most common form of financial savings of salaried employees. All government employees, employees of public sector organizations and corporations, who have completed two years of service and are eligible for pension at the time of retirement, can contribute to the GP Fund. The contribution from the salary of an employee varies in line with the employee's option as well as the Rules of the scheme for the organizations.

The stock of GP fund increased sharply by Rs 13.0 billion, from FY97 to FY00, to reach a cumulative amount of Rs 18.9 billion by the end of FY00 (see **Figure 7.10**). During FY03-FY04, there was an increase of Rs 2.9 billion in the Fund. By April FY05, the outstanding amount of the Fund stood at Rs 21.5 billion.

#### 7.2.4 Private Pension Schemes

Private Pension Schemes (PPS) are mainly aimed for self-employed individuals and businesses where employees do not have occupational pension schemes. PPS are also used by individuals using other conventional modes of pension schemes and it also act as a supplement to the U.S. based social security system. Basically, a PPS is a defined contribution scheme in that the benefits are determined by the contributions paid into the scheme and the return on investments on the contributions.

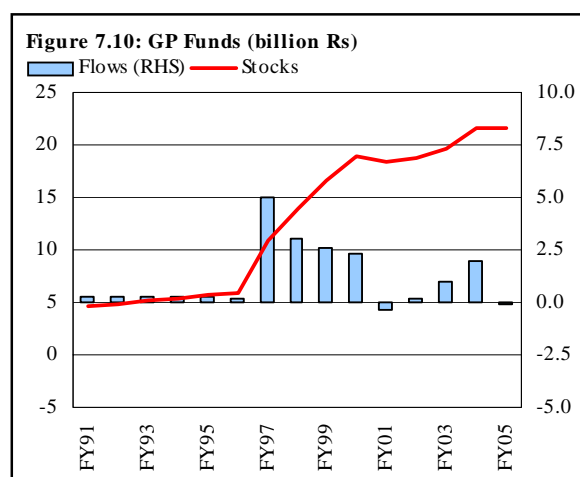
Typically, consultants or actuaries devise the plan of the prospective scheme for an organization and the trustees or the fund managers decide how much and in which investment avenue to invest. Further, the participants bear the investment risk, whereas the employer bears the risks of the schemes. The amount of pension a participant receives on retirement depends on his age and the value of his personal fund.

Usually, PPS are used by the employers mainly to retain existing employees and also to attract prospective employees by offering them higher retirement benefits. Moreover, employers also take into account PPS because of favorable tax treatments. A tax rebate is given to employers who formulate, manage and invest in these schemes.

PPS are managed by either one employer or by multi-employers. At times, collective bargaining also takes place between the employers and the workers' union on the terms and benefits of the scheme.

The economic significance of PPS is that it provides investment funds in the capital markets that in turn leads to the development of the financial sector. In line with the life-cycle hypothesis, PPS not only provides financial security to the contributors but also maintains a regular stream of income.

Country wise data shows the importance of PPS in the allocation of savings in the economy. **Table 7.9** shows the percent share of PPS in the GDP of various countries for 2001. The developed countries with strong insurance and social security systems tend to have a sound private pension market whose size often exceeds the country's GDP, as in the case of Switzerland.



**Table 7.9: Private Pension Funds in Selected Countries in 2001**  
billion US Dollar

	Size	Share of GDP
Australia	418	62
Canada	419	48
Germany	63	3
Italy	48	4
Korea	12	3
Japan	812	21
Switzerland	267	102
U.K	1,226	85
USA	5,116	75

Source: OECD

In Pakistan, the trend of offering private pensions among multinational companies has increased in recent years (see **Table 7.10**).<sup>10</sup> Further, with a growing stock market and new bond issues in the corporate debt market, the allocation of PPS' investments has also seen a diversified trend. However, the declining net investment income on the total portfolio creates an interest rate risk for the participants of the PPS. On the regulatory front, SECP has introduced the Voluntary Pension Rules<sup>11</sup> in 2005 in order to promote the development of such schemes.

As the social security system and other pension schemes are under severe pressure in developed countries where beneficiaries outnumber the fund participants, Pakistan with a relatively smaller size of social protection funds, also faces similar issues in the state-run pension schemes. In this respect, the government has created a task force to recommend fiscal incentives to boost the private pension industry.

**Table 7.10: Size of Private Pension Schemes**  
million Rupees

	2001	2002	2003	2004
Unilever Pakistan	673	670	670	N/A
Abbott Laboratories	N/A	329	383	557
Packages Limited	185	228	279	391
Nestle Pakistan	112	158	133	168
Colgate Palmolive Pakistan	2	2	32	37
Shell Pakistan Limited*	718	722	835	951
Pakistan State Oil	N/A	553	525	508
ICI Pakistan Limited	576	857	934	N/A
Engro Chemical	222	261	288	293
National Refinery Limited*	N/A	830	852	948
Sui Southern Gas Co. Ltd*	N/A	358	383	481
<b>TOTAL</b>	<b>2,488</b>	<b>4,968</b>	<b>5,314</b>	<b>4,334</b>

\* Represents fair value of asset plans.

The future prospects of Private Pension Schemes in Pakistan are bright and promising. Under SECP's regulatory framework, it is expected that more schemes will be formulated not only by multinational companies but also by the state-owned and public enterprises. Pension funds will be managed by professional asset management companies which would provide individual savers more feasible options for investment and would also serve to increase the size of the private pension funds' market.

### 7.3 Interest Rate Structure and Levels

The structure of interest rates prevalent in an economy is of vital importance for economic decision making. In fact, interest rates are one of the important price variables that have a vital role in both intra and inter-temporal allocation of resources in an economy. A wide variation among interest rates, if not explained by the difference in the term and risk profile of various instruments, is generally not desirable. This is because it creates arbitrage opportunities and promotes speculative activities, which may have negative implications on the real economic activities in a country. It is therefore crucial to have some degree of convergence in various interest rates and the difference should only reflect the term and risk premium. Generally, distortions in interest rates result if the rates for one sector of the economy are market-based, and administered for the other. In order to achieve a higher degree of integration among different interest rates it is vital to allow market forces to operate freely.

The interest rate structure of Pakistan's economy mainly consists of: rates on banks' deposits and lending schemes; yields on government securities (T-bills, PIBs and profit rates on national savings schemes); interest rates charged and offered by NBFIs and rates of return on term finance certificates (TFCs). Historically, a wide variation has been observed in these rates, which not only provided interest rate arbitrage opportunities but also led to segmentation in the government debt market, in addition to being an impediment in the development of the corporate bond market.

<sup>10</sup> Table 7.10 is an *indicative* analysis of the size of private pension schemes, in the absence of a centralized source of verifiable information.

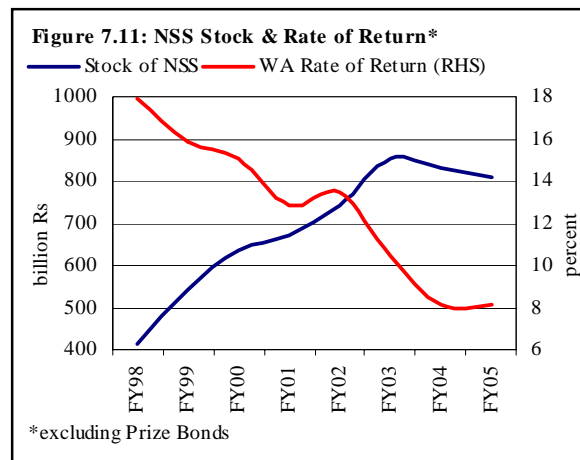
<sup>11</sup> For details, please see Chapter 2, section 2.8.

Until the recent past, the single most notable component in the structure of interest rates has been the rate of return on NSS instruments. The high and rigid profit rates on NSS had strong negative implications for the pricing of term finance certificates. Specifically, in order to make TFCs attractive modes of investment, all the corporate debt instruments had to be priced significantly higher than the profit rates on comparable NSS instruments, which carry a zero risk of default. In this way, the cost of borrowing for the corporate entities from the bond market was substantially higher than borrowing from the banking sector. Therefore, as mentioned above, high NSS profit rates not only adversely impacted the financing options available to the corporate sector but also negatively influenced the development of the bond market. During the second half of the 1990s in particular, the higher profit rates on NSS diverted funds from the banking sector towards NSS instruments.

### 7.3.1 Rates of Return on NSS

Prior to FY00, returns on the National Savings Schemes were managed on an administered basis. This policy created a huge differential advantage for NSS over comparable savings' opportunities, which led to a distortionary impact on the economy in the face of : (1) weak growth in deposits of banks and NBFIs, especially during the second half of the 1990s; (2) underdeveloped bond market in Pakistan; and (3) increasing burden of domestic debt<sup>12</sup>. Due to these persistent problems faced by the economy, there was a need to rationalize the rates of return on NSS. This need paved the way for an alteration in the policy on the administrative pricing mechanism of NSS, which led the government to take several initiatives, such as: (1) gradual reduction of NSS rates since FY00; (2) complete ban on institutional investments in NSS since FY00; (3) linkage of profit rates on NSS with market determined PIB yields in FY00; (4) imposition of withholding tax on NSS instruments; (5) introduction of new schemes/certificates for pensioners, widows and elderly citizens such as Pensioners' Benefit Account (PBA)<sup>13</sup> and Behbood Savings Certificates; and (6) the elimination of arbitrage opportunities in June 2003.<sup>14</sup>

Above all, the linkage of PIB yields with the rates of return on NSS instruments has helped in reducing the interest rate distortions in the economy. While the rates on NSS instruments have been declining since the first reduction in FY00, however, the pace of decline since FY02 has been relatively sharper. This can be seen from the fact that the weighted average return on NSS declined by 440 basis points from FY98 to FY02, and by 540 basis points from FY02 to FY05 (see **Figure 7.11**).



Convergence in the rates of return between PIBs and NSS was achieved during FY05.<sup>15</sup> Initially the differential in the PIB yields and NSS rates widened, following the introduction of new schemes and

<sup>12</sup> For details, please see, "Pakistan : Financial Sector Assessment 2001-02 and 2003", State Bank of Pakistan.

<sup>13</sup> The rate of return on PBA is two percent higher than Regular Income Certificates (RIC), with a maximum investment limit of Rs. 3 million.

<sup>14</sup> During FY03, a steep fall in the rates of return on government securities (other than NSS), significantly low lending rates and the unchanged rate of return on National Savings Schemes created interest rate arbitrage opportunities in the market. In response, the government suspended the sale of NSS instruments through bank outlets with effect from June 16, 2003.

<sup>15</sup> In the discussion in this section, secondary market yield is used instead of the primary market yield because the government scrapped all the auctions of PIBs during FY05.

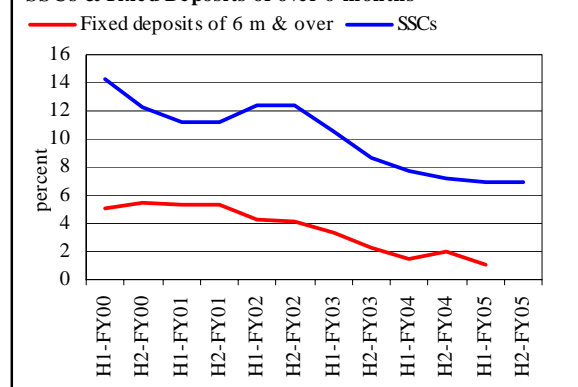
imposition of tax on NSS interest income during FY02 and FY03 (see **Table 7.11**). However, the rise in PIB rates for all tenors and a persistent decline in the rates of return on NSS instruments narrowed the differential between PIB yields and NSS profit rates during FY04. In FY05, the rates of return on Defence Savings Certificates (DSCs) and Special Savings Certificates (SSCs) were kept unchanged despite the rise in PIB yields. As a result, the rates on NSS fell below the PIB yields during FY05.

**Table 7.11: Profit Rates on Major NSS Instruments and PIBs<sup>16</sup>**

Percent	National Savings Schemes			Pakistan Investment Bonds		
	DSCs	RICs	SSCs	10 Years	5 Years	3 Years
H1-FY00	15.97	16.00	14.33	--	--	--
H2-FY00	15.01	14.00	12.33	--	--	--
H1-FY01	14.01	12.48	11.17	--	--	--
H2-FY01	14.01	12.48	11.17	13.95	12.93	12.38
H1-FY02	15.01	12.48	12.37	13.04	12.04	11.58
H2-FY02	14.13	12.48	12.37	10.57	9.56	8.65
H1-FY03	11.61	10.56	10.47	8.74	7.72	7.01
H2-FY03	10.03	9.12	8.67	5.02	3.96	3.50
H1-FY04	8.50	7.68	7.67	5.55	4.40	3.40
H2-FY04	7.96	6.96	7.16	6.63	5.06	3.99
H1-FY05	8.15	6.84	6.95	7.99	6.35	5.37
H2-FY05	8.15	5.70	6.95	8.81	7.79	7.11

As a result of these initiatives, the interest rate distortion reduced considerably in the last few years. This is reflected in the narrowing spread between SSCs and comparable fixed deposit rates<sup>17</sup> (see **Figure 7.12**). However, the problem resulting from the pre-specified schedule of the rate of adjustment in NSS instruments and the current linkage methodology between PIB yields and NSS rates needs to be strengthened further for minimizing the distortion in the interest rates.<sup>18</sup> Specifically, the PIB market yields change immediately subsequent to an auction, while the profit rates on NSS are only adjusted with a lag of 6 months. Therefore, in a declining interest rate environment, NSS is a costlier financing option for the government during this period. This also results in a sharp increase in gross inflows prior to the adjustment period. Therefore, the linkage of profit rates on NSS and PIBs should be strengthened. In fact, the rate should be adjusted when the differential surpasses a set limit.

**Figure 7.12: Interest Rate Spread between SSCs & Fixed Deposits of over 6-months**



<sup>16</sup> Pakistan Investment Bonds were launched in December 2000.

<sup>17</sup> The spread between the rates on SSCs and fixed deposits increased in FY03 due to arbitrage activities.

<sup>18</sup> The rates of return on NSS instruments are adjusted with effect from 1<sup>st</sup> January and 1<sup>st</sup> July each year, since FY00. The rates on DSCs, SSCs and RICs are adjusted provided the post-tax returns on these schemes exceed those on PIBs by at least 0.5 percentage points.

Interestingly, while the profit rates on RICs continued to decline in FY05, the rates of return on PBAs remained the same. This led to a higher spread between the yields of PBAs and RICs, which increased from 1.92 percentage points during Jul-Dec FY03 to 4.38 percentage points during Jan-Jun FY05 (see **Figure 7.13**). Although, this differential exhibits a deviation from the set limit, but it is acceptable given that the primary objective of the scheme is to provide investment opportunities to pensioners, widows and small savers.

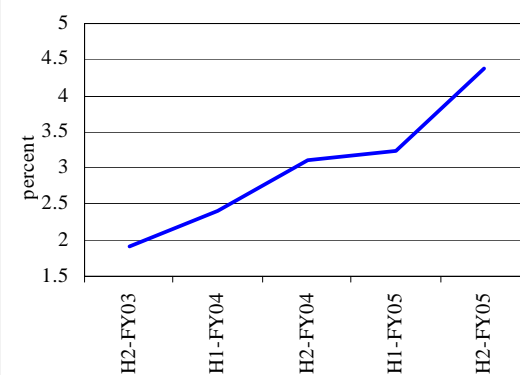
Going forward, the rise in NSS rates will be important from the investors' perspective especially in the context of rising inflation in the economy due to which the returns on NSS instruments were negative in FY05 (see **Figure 7.14**). Even the returns on PBAs, which are higher than other instruments, are negative when adjusted against the growth in CPI inflation. This is quite a discouraging factor from a saver's perspective and may result in a decline in the financial savings of the economy, unless inflation is brought down to the desirable level.

### 7.3.2 Banking Spread

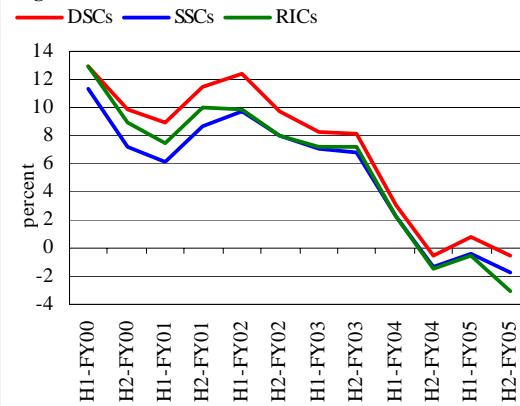
Banking spread, the difference between weighted average lending and deposit rates, can be termed as a crude measure of the cost of intermediation in the banking industry. In general terms, higher banking spreads are unfavorable as these depict institutional inefficiencies. In the year 2002, the banking spread was around 8 percent, which was quite high from any standard. Factors such as high administrative costs, overstaffing and a mounting burden of non-performing loans, were primarily responsible for this high spread (see **Figure 7.15**).

It was during FY02, post 9/11, when the dynamics of the banking spread changed altogether. In particular, current account surpluses flushed the market with liquidity. Subsequently, during November 2002, SBP cut the discount rate by 150 basis points signaling a further easing of monetary policy. As a result, the increased competition among banks to productively deploy the excess liquidity led to a sharp decline in banking spread.

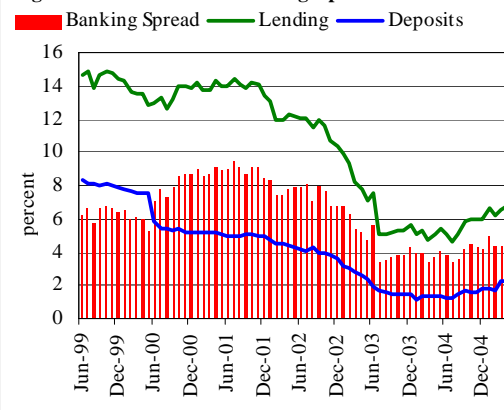
**Figure 7.13: Spread between rates on PBA and RIC**



**Figure 7.14: Real Returns on NSS**



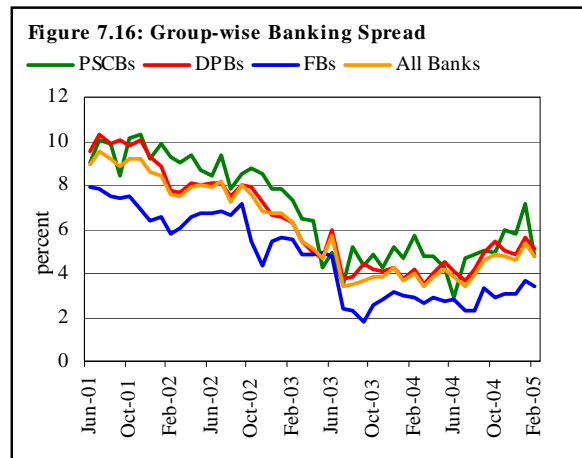
**Figure 7.15: Nominal Banking Spread**



Although both deposits and lending rates tend to decline in an easy monetary policy environment, but the extent of decline was quite small in the latter. This was due to the fact that banks had limited room for adjustment as the real deposit rates were already negative. More importantly, banks were in a position to taper the spread due to the decline in certain financial expenses that were largely responsible for widening the spread earlier. These included, (1) a fall in non-performing loans; (2) low reliance on costly borrowings due to a relatively liquid inter-bank market; (3) reduction in the corporate tax rate which has been brought down to 38 percent in FY05 from 58 percent in previous years; (4) reduction in the surplus work force in the three major public sector banks; and (5) healthy competition among the banks to capture a larger share of the market.

From FY03 onwards, banking spread continued to decline especially as competition among banks increased substantially in the subsequent years. Whereas the reduced burden of non-performing loans, improving administrative efficiencies (following the measures introduced for corporate governance within institutions), and realized/unrealized capital gains on government securities were some of the enabling factors which allowed banks to operate at a lower spread, excess liquidity in the interbank market forced banks to expand and diversify their loans portfolio, and to operate at a lower spread.

During the first three quarters of FY04, both the lending and deposits rates remained almost stable (see **Figure 7.15**). However, since Q4-FY04, SBP started to gradually tighten the monetary policy which continued during FY05 as well. The aim of this policy shift was to check the rising inflation and the depreciation pressure on the domestic currency. The tight monetary stance was also transmitted to the banks lending and deposits rates (see **Figure 7.15**), however, the increase in former was more pronounced, which resulted in the widening of banking spread during FY05. Bank-wise data shows that although the spread has started to widen, there is convergence in banking spread across the different groups of commercial banks (see **Figure 7.16**) with the exception of foreign banks<sup>19</sup>. The convergence in banking spread has resulted primarily from increased competition, improved efficiency and better performance of the banking sector. All these factors are largely a function of the growing activities of banks, privatization of public sector banks, and improved asset quality in the last few years.



<sup>19</sup> At present, foreign banks are operating with the lowest spread mainly because the exposure of this group in riskier areas, like SMEs and agriculture, is quite limited.