4 TRENDS IN FINANCIAL SAVINGS

While Asia is awash with liquidity which finances the developed world's financial imbalances, Pakistan continues to be categorized among the low savers of the world. Historically, the highest national savings rate has been much lower than regional peers at the same income level. This article discusses the possible reasons of low savings in Pakistan, and argues that when we characterize Pakistanis as spenders rather than savers, we should also acknowledge the paucity of savings instruments that an individual has access to, which in turn is possibly one of the strong reasons for the informal saving channel to exist. It is argued further that the financial system now needs to focus on providing innovative liability products to give the investors and savers various options to choose from, according to their risk/return preference. The role of Private Pension Schemes is particularly highlighted as an incentive to smooth out consumption patterns over the life-cycle, by providing a forced saving mechanism aimed at enhancing overall social security. Extending outreach of financial services to currently unbanked areas is also expected to enhance the level of financial savings.

4.1 Introduction

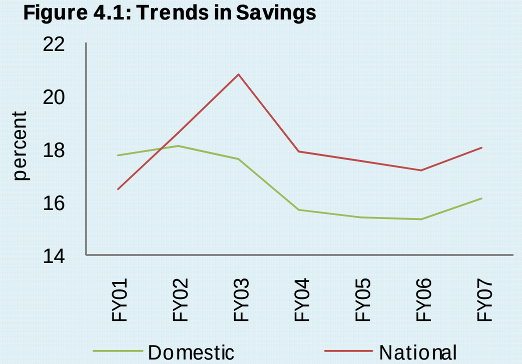
Despite sounds economic fundamentals sustained over a period of 5 years, Pakistan continues to be categorized among the low savers of the world. The highest national savings rate of 21.4 percent in the history of Pakistan[1] is much lower than other regional countries at the same income level. As investment activities in the economy are financed by domestic and external savings (in the form of foreign exchange inflows), the low savings rate has strong implications for continued economic growth, especially in the long run. While this low savings rate reflects the consumption preference of economic agents, the role of an incentive mechanism for savings offered by the financial sector can be hardly over-emphasized. Savings mobilization is considered to be one of the core functions of financial institutions. Innovative products for savings provide an opportunity to save according to various risk/return profiles. The role of Private Pension Schemes is particularly significant in mobilizing savings as they provide an incentive to smooth out consumption patterns over the life-cycle of an individual.

An obvious question in case of Pakistan is how best to increase the low savings rate in the country. The answer to this question needs a detailed analysis of factors affecting savings in the economy.

4.2 National Savings: Stylized Facts

Figure 4.1 clearly shows that the savings rate has been declining since FY03, while inching up marginally in the last year or so. A modest rise of 80 bps during FY07 pushed the savings rate to 18.0 percent – still lower than the local peak of 20.6 percent. The low savings rate has negative implications for the sustainability of the current strong economic growth. Interestingly, although the Pakistan economy is categorized among the emerging economies of Asia due to its improved economic fundamentals, the domestic savings rate in Pakistan is visibly lower as compared to other emerging economies. The savings rate in Pakistan does not even seem comparable to India which has almost similar socio economic conditions (**Figure 4.2**).

Figure 4.1: Trends in Savings

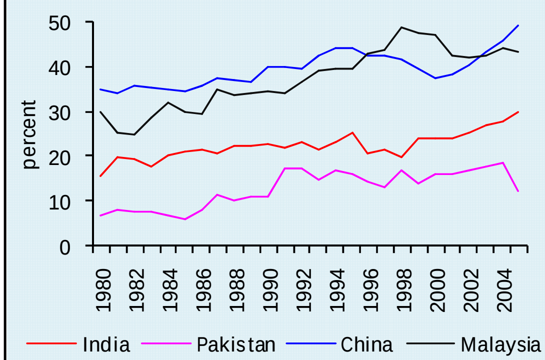


Source: SBP Annual Reports

[1] Taking into account data from FY60 onwards.

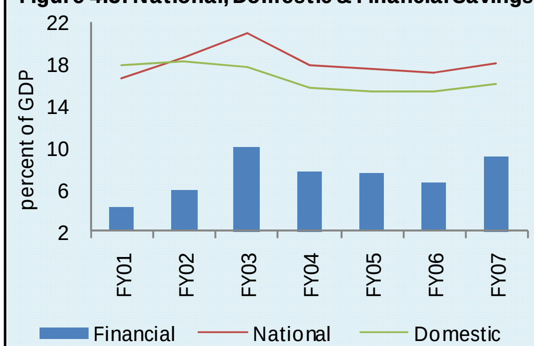
The breakup of domestic savings indicates that the level of *financial savings* – an important component of domestic savings and the overall stability of the financial system – is not very encouraging. Financial savings have picked up during FY07 after a declining trend since touching their peak level in FY03. Data for recent years indicates that the consistent gap between domestic and financial savings is also a cause of concern with regard to financial stability (**Figure 4.3**).[2]

Figure 4.2: Domestic Savings as percent of GDP



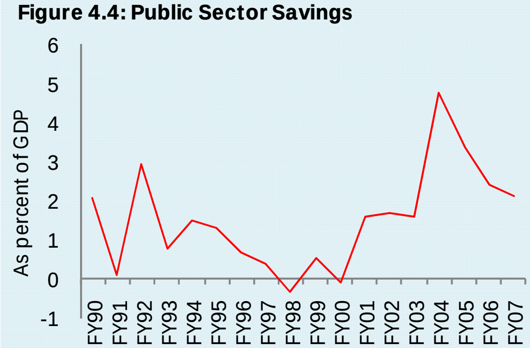
Source: World Development Indicators, World Bank

Figure 4.3: National, Domestic & Financial Savings



Source: SBP Annual Reports

Figure 4.4: Public Sector Savings



Source: Various Issues of Economic Survey

4.2.1 Components of savings

National savings can be decomposed at various levels. In a broad sense, national savings comprise of public and private sector savings. Public sector savings include government savings and savings produced by public sector enterprises in the form of internal resources. The position of public sector savings has not been very impressive over the years. Specifically, not only has the level of the overall public sector savings been low, but it has also witnessed notable variations from year to year (**Figure 4.4**). However, there has been some improvement over the 1990s when public sector savings were particularly low. As the share of public sector savings in overall national savings is low, the analysis in this article is based on private sector savings.

Given the low savings of the public sector, the savings base in the economy largely originates from the private sector, which includes savings of households and the corporate sector. The household sector, which constitutes the largest portion in national savings, has seen a varying trend over the years (**Figure 4.5**). It touched the peak level (17 percent of GDP) during FY03, and has come down to 13.3 percent of GDP in FY07. This decline in household savings can be traced to various factors related to the rising cost of living and a consumption driven growth in the economy in the last few years.

On the other hand, savings trend in the corporate sector[3] has been largely stagnant over the years (**Figure 4.5**). The low savings of the corporate sector, despite rising profitability in

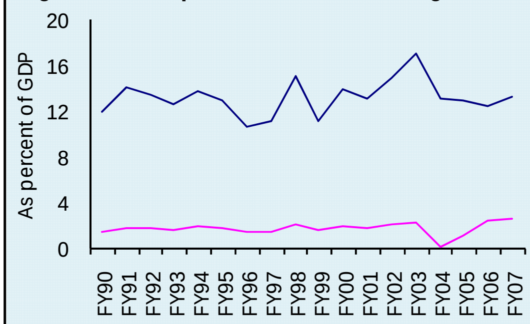
[2] In economics, a country's national savings base is the sum of private and public savings. It is generally equal to a nation's income minus consumption and government purchases, while domestic saving is the difference between national savings and net factor income from abroad.

[3] The private corporate sector comprises of (i) non-government non-financial companies, (ii) commercial banks and insurance companies operating in the private sector, (iii) co-operative banks, credit societies and non-credit societies, and (iv) non-banking financial companies in the private sector.

recent years, is generally attributed to increased dividend payouts, especially in the last couple of years.

Keeping in view the trends of national savings, an analysis of financial savings will not only be instructive in understanding the role of financial institutions in deposit mobilization, but will also help in explaining the impact of savings on the stability of the financial sector in general and the banking sector in particular.

Figure 4.5: Composition of Private Saving



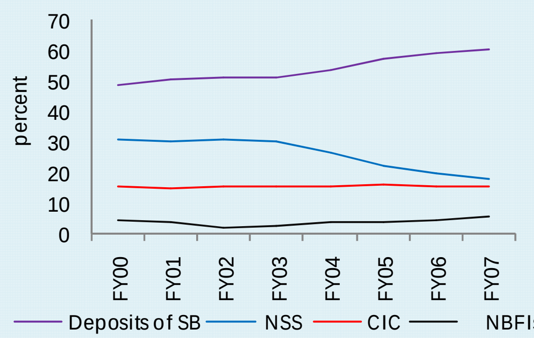
Source: Various Issues of Economic Survey

4.3 Financial savings[4]

Financial savings, which are considered to be a subset of national savings, posted an average growth of 12.4 percent from FY00-07, and the stock of financial wealth increased to Rs.5.4 trillion from Rs.2.3 trillion in FY00. Financial savings have been declining since FY03, however growth has picked up again to 17.1 percent in FY07 (**Table 4.1**). With strong GDP growth since FY02, a declining trend in financial savings as percent of GDP is analyzed on the basis of its various components.

For the purpose of this analysis, financial savings include currency in circulation (CIC), bank deposits, investments in National Saving Schemes (NSS), deposits of NBFIs, investment in mutual funds and GP fund.[5] The dominance of the banking sector is again visible here, as the deposits of scheduled banks constitute 60.3 percent of accumulated financial savings (financial wealth). Investments in the national savings schemes (NSS) are next in line with a share of 18.2 percent, despite a gradual decline in net inflows since FY03 (**Figure 4.6**). An important point to note is the steady share of currency in circulation (CIC). Moreover, thanks to the buoyant growth in mutual funds, the overall NBFIs were able to just maintain their tiny share in the stock of savings. Excluding mutual funds, the share of NBFIs deposits drops to less than 1.0 percent by end FY07, as compared to over 3 percent in FY01. These shifting patterns in the shares of various instruments are the result of a host of factors, which are discussed below (please also see **Box 4.1**).

Figure 4.6: Share in Financial Wealth



Source: SBP calculations

- Banking sector deposits have maintained a double-digit growth since FY03. Continued rise in workers' remittances and strong economic growth over the same period are the key factors for the strong growth in deposits. Bank deposits might also have benefited from the on-going mergers and acquisitions, especially with NBFIs. The widening network of the banking sector is another contributing factor in the high deposit growth. Ease of flow of funds is the primary reason for banks' complacency in offering innovative liability products to their customers.

- After the gradual decline in the volume of savings in NSS instruments over the last three years due to maturing institutional investments in NSS which could not be re-

[4] Gross financial saving of the household sector include savings in the form of currency, bank deposits, non-bank deposits, saving in life insurance fund, saving in provident and pension fund, claims on government, shares and debentures inclusive of investment in mutual funds and net trade debt.

[5] General Provident Fund.

invested until the restriction was removed in October 2006, investments in NSS posted a 7.1 percent growth in FY07.[6] This increase in NSS investments is linked to both increased institutional investment, ongoing flows in the schemes for elderly and retired individuals, and a relative rise in NSS rates during FY07.

Table 4.1: Trends and Structure of Financial Savings

	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07[P]
				Billion Rupees				
Accumulated Savings (Stock)	2,329	2,511	2,771	3,252	3,690	4,183	4,663	5,487
Deposits of scheduled banks	1,135	1,264	1,411	1,671	1,975	2,405	2,772	3,310
Investments in NSS	715	762	847	982	984	940	934	1,000
Currency in circulation	355	374	434	494	578	666	739	839
Deposits of NBFIs	91	80	41	40	47	48	61	38
Mutual funds	13	12	19	45	85	103	135	257
GP fund	19	18	19	20	22	22	22	43
				Accumulated Savings Growth (%)				
Accumulated Savings (Stock)	8.5	7.8	10.3	17.4	13.5	13.4	11.5	17.1
Deposits of scheduled banks	2.4	11.4	11.6	18.4	18.2	21.8	15.3	19.4
Investments in NSS	14.7	6.5	11.1	16	0.2	-4.5	-0.6	7.1
Currency in circulation	23.8	5.3	15.8	14	16.9	15.1	11.1	13.4
Deposits of NBFIs	-12.5	-12.3	-48.6	-2.2	16.2	3.4	26	-37.7
Mutual funds	107.2	-5.9	56.7	132.1	88.1	21.6	31.2	89.9
GP fund	13.9	-2	1.2	5.3	9.9	1	0.6	-2.6
				Accumulated Savings as percent of GDP				
Accumulated Savings (Stock)	61.4	60.3	63.0	67.4	65.4	64.4	61.4	63.0
Deposits of scheduled banks	29.9	30.4	32.1	34.6	35.0	37.0	36.5	38.0
Investments in NSS	18.9	18.3	19.2	20.4	17.5	14.5	12.3	11.5
Currency in circulation	9.4	9.0	9.9	10.3	10.3	10.2	9.7	9.6
Deposits of NBFIs	2.4	1.9	0.9	0.8	0.8	0.7	0.8	0.4
Mutual funds	0.4	0.3	0.4	0.9	1.5	1.6	1.8	3.0
GP fund	0.5	0.4	0.4	0.4	0.4	0.3	0.3	0.5
				Flows as percent of GDP				
National savings	16.5	16.5	18.6	20.8	17.9	17.5	17.2	18.0
Domestic Savings	16.9	17.8	18.1	17.6	15.7	15.4	15.3	16.1
Financial savings (Flows)	4.8	4.4	5.9	10.0	7.8	7.6	6.3	9.2
Deposits of scheduled banks	0.7	3.1	3.3	5.4	5.4	6.6	4.8	6.2
Investments in NSS	2.4	1.1	1.9	2.8	0.0	-0.7	-0.1	0.8
Currency in circulation	1.8	0.5	1.3	1.3	1.5	1.4	1.0	1.1
Deposits of NBFIs	-0.3	-0.3	-0.9	0.0	0.1	0.0	0.2	-0.3
Mutual funds	0.2	0.0	0.2	0.5	0.7	0.3	0.4	1.4
GP fund	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Source: Statistical Bulletin and Annual Reports of SBP;

[6] Banks, DFIs and Insurance Companies are still barred from investing in NSS.

Box 4.1: Probable factors responsible for low savings rate

A variety of factors can be analyzed to determine the reasons for a low savings rate in Pakistan. Generally, the factors which influence the rate of savings in the economy include economic growth, rise in per capita income, favorable demographic structure, prudent fiscal stance, positive real returns, expected inflation rate, development of the financial sector, and cultural and psychological issues. However, the following factors may also give us some logical links for the current low level of savings in the economy.

1. There is a lack of investment avenues which provide inflation adjusted returns. High inflation reduces the value of savings and is a disincentive to save in financial assets. Some of the related issues are :
   - The existence of high financial intermediation cost and low deposit rates.
   - The rise in the consumption propensity due to leasing/consumer finance schemes of the commercial banks.
   - Lack of awareness about the existing financial products due to lack of financial literacy and general awareness.
   - Generally, access to financial products such as stocks, mutual funds, modarabas and other saving instruments are concentrated in big urban area such as Karachi, Lahore and Islamabad. Moreover, a select group of people is involved in transactions in these instruments, due to a general lack of awareness of the existence and the perceived risk factors of these instruments.
   - The equity market, despite recent developments, has a narrow base and is largely being used by the big investors. Many companies have listed themselves mainly for tax gains, without any substantial trading in their shares and little interest in developing investor relations or dividend payouts. Both the issuer and the investor base is very narrow, with trading heavily concentrated in a few sectors.

2. There are also cultural factors behind the low savings rate. For instance, Pakistanis are generally pro consumption;
   - Generally, Pakistanis spend extravagantly on marriages, social functions and religious ceremonies.
   - People invest in real estate for the purpose of ownership of houses, while some indulge in such investments for speculative purposes.

3. The higher dependency ratio. Due to the prevalent joint family system, the dependency ratio is very high in the case of Pakistan. Thus, it leaves a meager amount for saving for the sole bread-earner of the family.

4. There are other factors like the incidence of declining but still high poverty and inequality in the country. A consistent increase in disposable income is a necessary condition to accelerate the rate of household savings.

5. Moreover, the level of financial deepening in the economy is significantly low, due to which a significant number of households tend to rely on informal sources of savings such as the committee/Bisi system. The rise in committee system is more common in the middle class salaried households in the urban areas. Moreover, part of the remittances that come through the Hundi/Hawala mode are also saved by utilizing this informal source. According to a World Bank study, the saving generated through informal sources stands at around 2.8 % of GDP. Moreover, the study estimated that Pakistan is the fourth largest user of gold, and spending on gold ornaments constitutes around 0.25-0.45 % of GDP.

6. Overwhelming preferences for using cash to settle a variety of transactions could also be constraining savings. In fact, the preference might also be due to treatment of taxation of financial instruments that seems to discourage savings.

Source: Gallina A. Vincelette (2006), Determinants of Savings in Pakistan, August 2006, South Asia Region, PREM Working Paper Series No. SASPR-10, World Bank

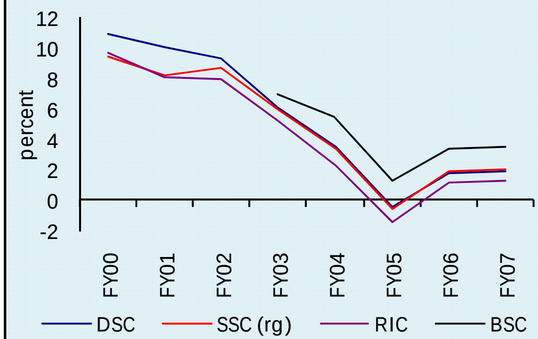
- Although share of mutual funds is still very low (2.95 percent for FY07), it has increased sharply in recent years on account of the exceptional performance of the stock market, among other factors.

- The on-going mergers and acquisitions and stiff competition from the banking sector are eroding the deposit share of NBFIs.

- Despite the widening network of financial services, a steady rise in the share of currency in circulation is not a welcome development. Besides factors such as increase in cash-holding requirements due to inflationary pressures in the economy, rise in CIC may reflect a surge in informal transactions. Furthermore, anecdotal evidence of speculative investments in some sectors of the economy, such as real estate, may also be a contributing factor towards the strong demand for currency.

- Substitution of financial assets may have taken place over the same period. Specifically, funds can easily move among financial instruments including bank deposits, investments in shares, NIT units and mutual funds. Considerations for diversification generally play an important role in asset substitution.

Figure 4.7: Real Return on National Saving Schemes



Source: SBP Calculations

NSS instruments are not only attractive financial instruments for the salaried class, pensioners and other household savers due to their risk-free nature, but are also an important source of financing the fiscal deficit of the government. NSS instruments, designed to cater to the requirements of senior citizens, widows, retired people and the general public, provide a consistent stream of income[7] and relatively higher rates of return compared to other financial instruments. However, these instruments have lost much of their appeal in recent years (**Figure 4.7**). Linking of NSS rates with PIBs, barring institutional investment in NSS (this was subsequently re-allowed in October FY07, for institutions other than banks and insurance companies) and reduction in profits rates are some of the contributory factors behind this trend. However, recent measures taken by the government, such as raising the rates of return on NSS instruments and allowing institutional investment, have been fairly successful in re-directing some of the investment inflows to NSS instruments in recent months.

4.4 Policy Suggestions

Analysis of various components of savings (including financial savings) suggests that the following steps can be taken to promote a savings culture in the economy:

- Efforts should be made to enhance accessibility of financial services to the largely excluded areas/sectors including rural areas; +

- Introduction of innovative schemes to improve the share of contractual savings;

- Wider dissemination of information regarding alternative instruments of savings such as insurance funds and creating awareness of life insurance policies[8] as a viable investment option.

There is an urgent need to develop long term contractual saving instruments such as provident and pension funds, as discussed in the next section.

4.5 Contractual Savings

The existing occupational saving and pensions' schemes exist predominantly for government employees, and there is a dire need to enlarge the scope of these schemes to the untapped private sector. This will serve to increase post retirement cash flows for individuals and will be an instrument for mobilizing long-term savings.

[7] Other than bullet bonds like Defense Savings Certificates.

[8] Life insurance policies are considered to be a channel of savings for the household sector. The savings of the insurance sector arising strictly out of its life insurance business, net of transfers to government, accrue to the policy holder and, therefore, are included in the estimates of savings of the household sector.

Currently, schemes in the public sector include : (1) Civil Services Pension Schemes; (2) General Provident Fund (GPF) and (3) Gratuity Scheme, whereas schemes in the private sector consist of : (1) Employees Old Age Benefit Institution (EOBI); (2) Provident Fund Schemes; (3) Gratuity Schemes and; (4) Pension (Superannuation) Schemes. Further, there is a need to develop private pension funds, a brief analysis of which is given below.

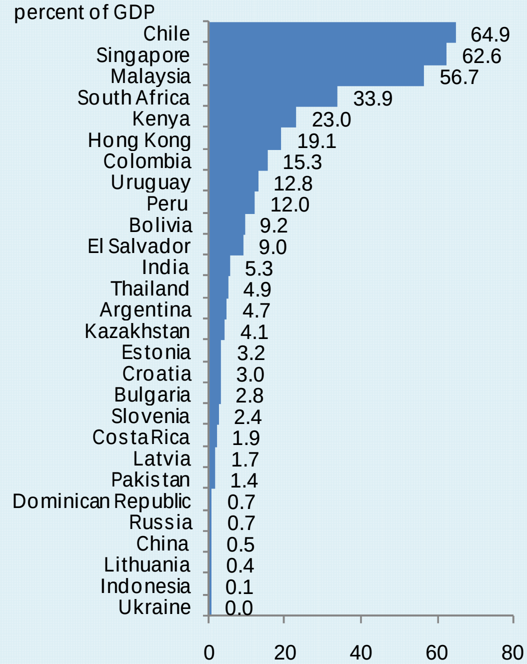
4.5.1 Pension funds: Pakistan and the Global Picture

Private pension funds have witnessed a tremendous upsurge across the developed and emerging countries during the last decade.[9] Total pension fund assets in OECD countries build up to US $17.9 trillion in 2005, compared to US $13 trillion in 2001, and recorded an annual growth rate of 8.70 percent during this time period.[10] Similarly, there are projections of a sizeable increase in the Asian private pension fund market by 2015. For instance, China's pension savings market is expected to grow from US $7.6 billion to US $125 billion, India's from US $4.5 billion to US $150bn and Korea's from US $29 billion to US $250 billion.[11]

With the exception of Chile and Singapore, which started pension funds in 1981 and 1950 respectively, a large majority of countries, including UK and USA, opted for private pension plans as recently as only a decade ago. Some other countries such as Argentina introduced pension reforms in 1994, and China in 1997, encouraged by the success of the Chilean pension reforms. In 2005, the size of the private pension funds relative to GDP was 98.9 percent in USA, 117.4 percent in Switzerland, while it was 5.8 percent in France and 2.8 percent in Italy.[12] On the other hand, available data (**Figure 4.8)** suggests a relatively small pension asset accumulation in emerging economies in comparison with the OECD countries, USA and UK. However, with the increased focus on pension reforms, it is expected that their pension funds base will expand significantly over the coming years.

Figure 4.8: Pension Fund Assets in 2005

percent of GDP



Source: OECD, Global Pension Statistics

The case of Pakistan is not very different from most of the emerging countries where private pension fund assets constituted just 1.4 percent of GDP in 2005. Presently, the pension schemes exist predominantly in the government sector, which operate on the defined-benefit (unfunded/pay as you go basis) system, while such schemes are available on a limited basis in the private sector. The public sector pension schemes entail huge fiscal costs, and give rise to sustainability issues for the government. Although the private sector also has a number of pension schemes but they exist in the form of gratuity and provident funds offered by various employers. Furthermore, normally this form of accumulation of savings is used by the respective employees to either pay off their liabilities or for other consumption purposes when they switch jobs, for

[9] Pension funds are independent legal entities which gather pools of assets constituted by employer and employee contributions. These funds also establish pension plans for financing pension benefits for their members.
[10] Pension Market in Focus, October 2006, Issue 3. Available at http://www.oecd.org/daf/pensions.
[11] Details in 'Investment & Pensions in Asia', available at http://www.ipe.com/asia/.
[12] Countries like UK, US and majority of the East and Central European countries introduced private pension plans a decade ago, however countries like France and Italy have a predominant reliance on public pension plans and their private plans constitute a meager percentage in terms of GDP.

instance.[13] The possibility of bankruptcy of the firm and dependency on the same employer under a defined benefits pension scheme makes the gains attainment more risky. Thus, the majority of the self employed and other private sector retirees, those who are not covered through government and private pension schemes, depend on the joint family system which allows them to live with their children in their old age even when they do not have retirement savings. However, given the cultural change and rising life expectancy, the current system does not seem feasible in the long run.[14]

In order to tackle the problem of low coverage of pension schemes, other than those offered by the government and some private sector employees, there is a need to create an adequate mechanism of social safety nets in the shape of a structured, robust and sustainable pension system in the country, which will be helpful in smoothing consumption patterns. With this objective in mind, SECP introduced the Voluntary Pension System (VPS) Rules in January 2005. VPS is expected to cater to the long term needs of the larger segment of both employed and self-employed individuals and the informal sector without access to occupational pension plans. In the long run, it will not only help to provide

Box 4.2: Characteristics of the Voluntary Pension System (VPS), 2005

- Under VPS, asset management companies and life insurance companies can obtain licenses to act as pension fund managers. SECP has so far approved 4 Asset management and life insurance companies for managing these pension funds. The life insurance companies are allowed to offer VPS annuities.
- All Pakistani nationals over the age of 18 years with a valid National Tax Number (NTN) who are not employed in any position entitling them to benefits under any approved occupational pensions scheme are eligible to contribute to the pension fund authorized under these rules.
- An individual will contribute a maximum amount of 20 percent of his/her net income with any of the approved private pension funds. Employers may also contribute to their employee's VPS account. In all cases, the total combined (employee and employer) annual contribution is limited to 50 percent of the worker's net taxable income and must not exceed Rs. 500,000.
- The contributors' investments and gains are tax-free unless the amount is withdrawn. This provides an incentive to keep the money in the fund for a long period of time.
- The contributor has control on his money in terms of contributions and investments in any of the approved pension funds according to his risk preferences.
- Unlike the gratuity fund and provident fund, the savings of contributors will remain intact even when they switch jobs.
- VPS rules restrict front-end and investment management fees.

Source: www.secp.gov.pk

consistent cash flows for such people in their post-retirement lives but will also help in generating long term savings from the economically active segment of the society. Moreover, investments of these pension fund assets will serve to increase the depth of the capital markets and provide capital for sustained economic growth in the coming years. The main characteristics of VPS are summarized in **Box 4.2**.

With the introduction of initial products under VPS, SECP is now focusing on the establishment of a robust system of occupational savings which would enable employers to develop appropriate employee benefit structures. SECP has also initiated a survey of existing occupational savings schemes including pension, gratuity and provident funds to collate information on their respective size and characteristics. Additionally, SECP is also working with the Asian Development Bank (ADB) on developing a comprehensive system of occupational savings and retirement benefits which may replace the existing Pay-As-You-Go schemes in the public sector.

[13] http://www.secp.gov.pk/Pensions_Overview.htm.

[14] Due to declining fertility and mortality rates in Pakistan, the share of the population of ages 65 and above will be 4.8 percent in 2025 and 8.4 percent in 2050. Please see details in Technical Note, Pension Reform and ADB Interventions, Asian Development Bank, December 2006.

The asset size of the private pension funds and the recent introduction of VPS by SECP indicate that these developments are still at an evolutionary stage. However, in order to encourage privately managed pension schemes such as VPS, there is a need for strong regulation and supervision of the pension funds, and for rules and regulations governing the activities of the pension funds investment managers and custodian banks. Appropriately designed risk management systems for the diversification of the associated investment portfolios will also be needed. In addition, it is also important to focus on the implementation of financial education programs meant to increase the knowledge and awareness of the young population on issues related to financing their future stream of income under these pension plans and to improve literacy of overall financial issues. The other determinants of expansion in coverage are strong and balanced economic growth and consistent tax incentives over the coming years.[15] Going forward, the role of SECP, private fund managers, social organizations and the media would remain crucial in driving pension fund reforms.

[15] Please see further details on increasing coverage among the poorest segments of the population in Chile, in "Summary of Record of the OECD/IOPS Conference on Private Pensions in Latin America", at http://www.oecd.org/dataoecd/31/49/37394040.pdf.