

## Special Section 2: Minimum Rate of Return on Savings Deposits – Implications for the Banking Sector

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### Background

The banking sector's robust financial performance in recent years is perceived to have been based on, among other factors, the large interest rate spreads earned by them. The fact that they have not shared their fortunes with the ordinary depositor, who is generally bound to place his funds with them for the sake of security, transactional access to savings etc, has been the subject of constant and widespread debate.

SBP in its capacity as the regulator and supervisor of a banking sector which is owned and operated by the private sector as largely a market based system, took cognizance of banks' deficient role in promoting savings, and as a first step, engaged in an ongoing dialogue with banks where it urged and encouraged them to increase the rate of return on their liability products. SBP's larger focus in this process of moral suasion was also to foster better competition, efficiency and stability in the industry. Factors such as the visible improvement in the measures of concentration as well as various indices constructed on the basis of the relative size and number of banks, and the presence of a reasonable degree of market contestability, are all suggestive of positive developments in the industry driven by the implementation of various policies.<sup>1</sup>

However, the historical dominance of a few large banks with substantive market power, access to low cost funds due to their extended branch network, age-old captive clients and related economies of scale and scope have posed as an impediment, albeit with a decreasing degree over time, for achieving an efficient price setting mechanism in the banking sector, especially for deposits. Even though mid-sized and smaller banks have made visible efforts to capture market share by offering attractive rates of return, their share in overall deposit mobilization of the banking sector remains relatively small.

To exacerbate matters, the Profit-Loss Sharing (PLS) mechanism of determining rates of return on PLS savings deposits entails that the final return to be received by the depositors remains at best indicative and thus uncertain until the date of final declaration of half-yearly profits by banks, leaving it largely at their discretion to adjust it on the basis of their targeted cost of funds (**Box 1**).

When the process of moral suasion didn't produce the desired results over an extended period of time, and the distortion in the process of efficient price discovery continued to pose a problem, SBP introduced a minimum rate of return of 5.0 percent per annum on all categories of savings/PLS savings deposits with effect from 1<sup>st</sup> June 2008.<sup>2</sup> It has now been more than a year that the minimum rate has been in place, and this short note studies the impact of this policy intervention on the returns to depositors, the banking sector's cost of deposits and Net Interest Margin (NIM) by taking into account data for CY08, and in some instance, monthly data upto June-09.

### Impact Analysis of the Policy Intervention

In analyzing the impact of the policy intervention, a starting point would be an assessment of the composition of bank deposits, given that the minimum rate of return is prescribed for the category of savings deposits only. As shown in **Figure 1**, savings and fixed deposits at end-CY08 constitute 32.7 percent and 34.8 percent of total deposits respectively. Trends also indicate a certain degree of substitution of savings deposits with time deposits since CY04.

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<sup>1</sup> Details in Chapter 1, Financial Stability Review 2006, Chapter 4 Financial Stability Review 2007-08, Ansari (2008), Akmal and Saleem (2009), and Khan (2009).

<sup>2</sup> BPRD Circular No. 7 dated May 30, 2008.

**Box 1: Profit on PLS Deposits and Banking Spreads**

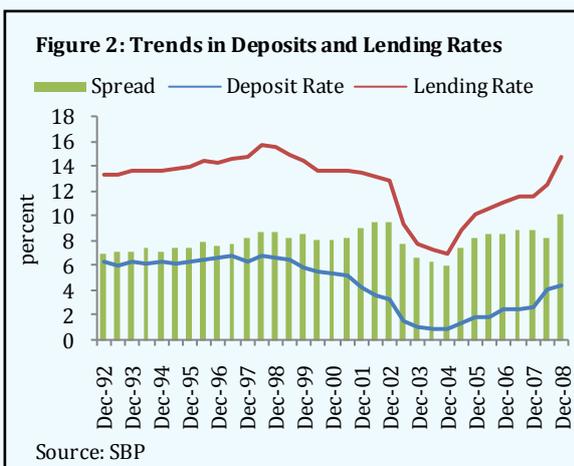
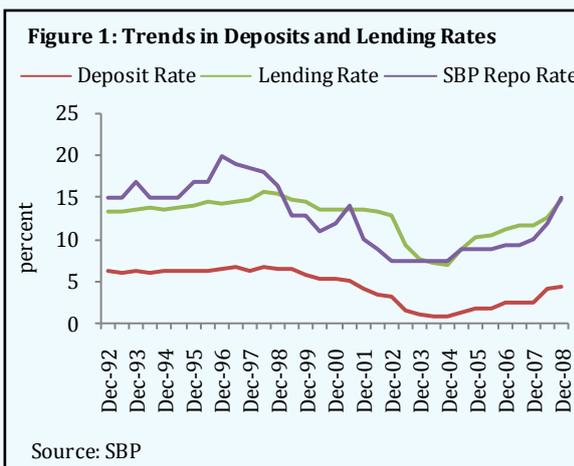
History of PLS deposits dates back to the early 1980s. In 1984, the government announced the elimination of interest ('Riba') from fresh domestic operations of the banking system. In compliance with this decision, SBP issued a directive in June 1984 which barred all banks from accepting interest bearing deposits, with the exception of deposits received in current accounts as well as foreign currency deposits.<sup>1</sup> Banks were required to raise deposits on which the rate of return was calculated on the basis of the profits and losses incurred by them, and hence the term 'PLS Deposits' was coined. SBP also issued detailed directives for the determination of profit rates on various types of PLS deposits. Banks were advised to declare profit rates on PLS deposits on a half yearly basis (30<sup>th</sup> June and 31<sup>st</sup> December of each calendar year), after obtaining clearance from SBP on the rates of profit proposed to be declared. In this mechanism, the income earned from funds employed on non-interest basis was to be distributed according to pre-assigned weights to all PLS liabilities including PLS deposits, PLS borrowing and equity.<sup>2</sup> The distributable income and weighted average liabilities were used to calculate the annual rate of return on PLS liabilities on the completion of six months. Banks were required to provide a certificate from an external auditor to authenticate the validity of the information given to SBP.<sup>3</sup> Subsequently, the requirement of SBP clearance prior to declaring rates of profits was abolished in June 1989.<sup>4</sup>

With the advent of financial liberalization reforms in the early 1990s, SBP's directives on PLS deposits were further amended from time to time with the objective of enhancing banks' discretion in determining returns on deposits. At the initial stage, banks were allowed to change the prescribed weights on PLS liabilities up to a maximum of 15 percent, and also to accept current deposit on PLS basis such that a weightage of 0.5 was assigned to these deposits. Removal of the ceiling on lending rates (with the exception of the rate on Export Finance Scheme and Financing for Locally Manufacturing Machinery) in March 1995<sup>5</sup> was followed by the withdrawal of SBP instructions on payment of returns to investors and depositors in June 1998.<sup>6</sup> Specifically, banks were allowed to determine the returns payable on funds mobilized from investors and depositors, while prior approval of SBP for declaring profit rates was already dispensed with in 1989. The only restriction maintained was for banks to comply with the principles of Sharia.

These liberalization measures have had a profound impact on the interest rate structure of the financial sector. Both lending and deposit rates have become more responsive to changes in the SBP policy rate (Figure 1). Prior to June-1998, there was hardly any link between the discount rate and deposits rates. Simple calculations reveal that deposits rates moved in a narrow band of 72 bps from Dec-92 to Jun-98, i.e. upto the end of the era of regulated interest rates. The range for lending rate and SBP repo rates over the same period was 232 and 500 bps respectively. A similar change in the SBP Repo subsequent to the implementation of liberalization reforms was accompanied with 319 and 468 bps changes in deposits and lending rates respectively. This increased integration of both lending and deposit rates with the SBP policy rate have had far reaching implications for the transmission mechanism of monetary policy.

A key development concurrent with the liberalization of the interest rate regime was the gradual increase of banking spread, i.e. the gap between lending and deposit rates. While banking spread has been high in the past as visible from Figure 2, increase in banking spreads from 2005 onwards was widely criticized due to two reasons: i.e. unprecedented profits earned by banks during the period, accompanied with all time low rates return on deposits. Both these factors jointly suggest that the recent financial gains in the banking sector were not shared with the depositors, who are the major source of funding for the banking system. But this only partly explains the phenomenon of wider spreads.

A detailed analysis of banking spreads indicates that administrative expenses, non-interest income, provisions against NPLs, degree of competition in the industry, interest rate volatility, ownership structure, reserve



requirements on deposits, structure and composition of deposits, sectoral distribution of the loan portfolio (which drives income generation) and the level of overall economic activities in the economy are all important determinants of banking spread. Efforts to create customers awareness, attempts to rationalize bank charges in the industry, proposal of revisiting the status of PLS deposits, efforts to promote competition and instilling greater disclosure (transparency) requirements are some of the policy suggestions to correct this distortion.<sup>7</sup>

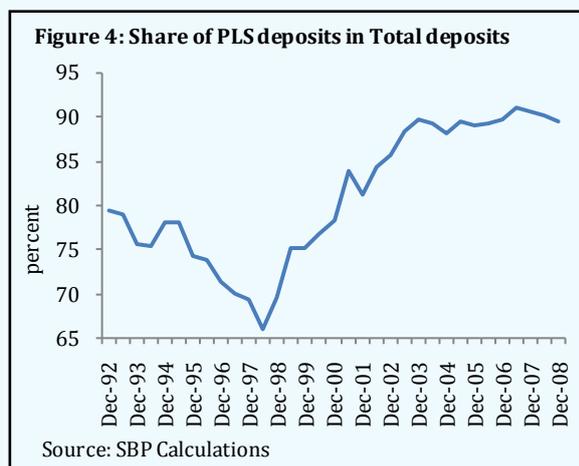
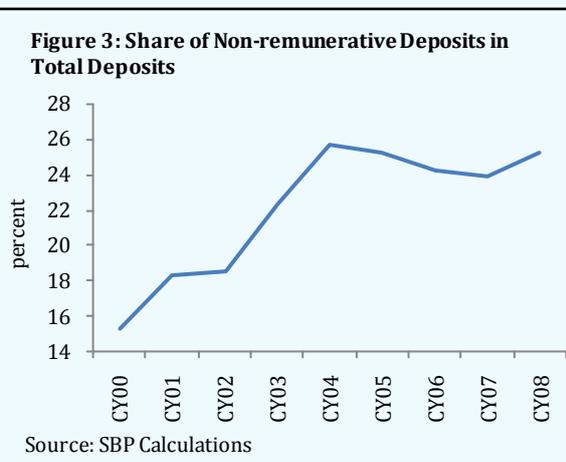
Notwithstanding, the all time low returns to depositors are also attributed to the historically low interest rates which prevailed in the economy from 2002 until 2004. Not surprisingly, lending rates also dipped to the lowest level during this period such that rates were in single digit for the first time since 1975.

A notable development in the recent past is the visible change in the structure of bank deposits. The share of non-remunerative deposits in total deposits has substantially increased since the year 2000 (**Figure 3**). As of end Dec-08, 25.3 percent of total bank deposits were non-remunerative. Inclusion of these deposits in calculating the rate of return suppresses the average rate of returns on overall deposits, for instance by 164 bps in the second half of CY08. Another important development in the deposit structure is the substantial increase in the share of PLS deposits in total deposits. As of end Dec-08, the share of PLS deposits in total deposits was 89.6 percent as against 65.9 percent in 1998 (**Figure 4**). This increase is primarily attributed to two distinct factors. First, the sharp increase in the share of PLS deposits in the late 1990s was due to the freezing of foreign currency deposits in 1998, which are categorized as interest bearing deposits. Second, the gradual increase in subsequent years is primarily attributed to the establishment of Islamic banking Institutions parallel to conventional banks, which served to increase the overall proportion of PLS deposits.

It is important to note that the PLS nature of bank deposits create uncertainty about the final rate of returns to be received by the depositors. Details on the inception of PLS deposits clearly indicates that the PLS mechanism was introduced in a bid towards Islamization of the banking system, whereas practical experience suggests that it provides banks the flexibility to revise their announced indicative deposit rates, at the time of the final declaration of the rate.

The Federal Shariat Court (FSC) declared the PLS mark-up based procedure un-Islamic in November 1991. The verdict was also endorsed by the Supreme Court of Pakistan on December 12, 1999. The emergence of Islamic Banking in parallel to conventional banking from 2002 onwards clearly indicates that bank depositors can now choose between conventional commercial banking and Islamic banking, and also highlights the need for revisiting the status of PLS contracts in practice by conventional banks.<sup>8</sup>

Finally, the introduction of minimum rate on savings deposits (including PLS savings deposits) is in direct conflict with the notion of the PLS deposits–shariah compliant liability products do not carry a pre-determined minimum rate of return.



<sup>1</sup> BCD Circular No. 13 dated June 20<sup>th</sup>, 1984.

<sup>2</sup> BCD Circular No. 34 dated November 16, 1984.

<sup>3</sup> BCD Circular No. 10 dated February 20, 1985.

<sup>4</sup> BPRD Circular No 8 dated June 20, 1989.

<sup>5</sup> BPRD Circulars No. 4&5 dated March 26, 1995.

<sup>6</sup> BPRD Circular No. 14 dated June 16, 1998.

<sup>7</sup> For details, please see SBP FSR 2006.

<sup>8</sup> The Financial Stability Department had also suggested a number of policy recommendations on the subject in Chapter 1 of SBP FSR 2006.

This shift in deposit composition is primarily attributed to: (1) SBP’s policy incentives for banks to mobilize long term deposits,<sup>3</sup> and (2) efforts initiated by banks themselves to mobilize time deposits to narrow maturity mismatches between their assets and liabilities. Notably, this gradual increase in the share of time deposits is also likely to positively impact the average return on deposits.

The composition of deposits indicates that SBP’s directive was aimed to increase the return on savings deposits which constitute 32.7 percent of the total deposits of the banking sector at end CY08. Bank level information suggests that 3 of the 5 big banks are likely to have been more adversely affected by this policy measure, as savings deposits constitute more than 40 percent of their total deposits, and they consistently hold a higher share of savings deposits compared to the rest of the banking industry (**Figure 2**).

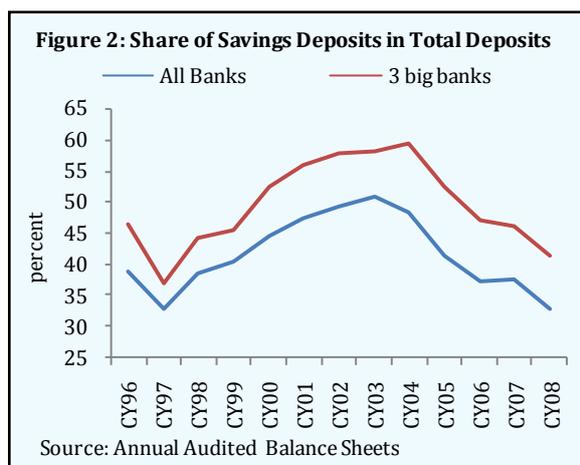
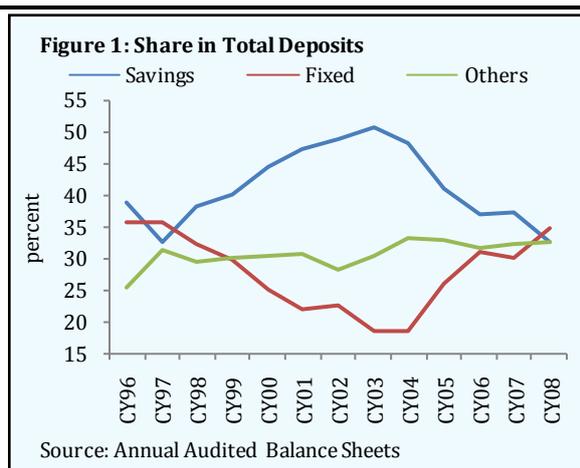
Simple calculations under the assumption of ceteris paribus suggest that a 100 bps change in the return on savings deposits is likely to affect the average cost of deposits to the tune of 33 bps for the banking sector, in line with the deposit composition as of end December 2008.

In terms of actual results, annual audited data of banks indicates that the cost of deposits increased by 82 bps to 5.1 percent during CY08. If this entire increase is assumed to arise from the increased rate of return on savings deposits by ignoring the effect of confounding factors, it translates to an increase of 251 bps in the returns on savings deposits. However this is obviously not the case; factors such as the 500 bps cumulative increase in the SBP policy rate during the year, significant increase in the share of fixed deposits in the overall deposits base, stiff competition from National Savings Schemes which pushed banks to offer more attractive returns, and banks’ vigorous efforts to mobilize incremental deposits in the wake of liquidity strains observed in Q4-CY08, also contributed to the high cost of deposits during the year. Moreover, this change in the cost of deposits is less than the 143 bps increase in the average return on advances and 118 bps increase in the returns on earning assets during the year. These developments indicate that banks were generally able to pass on the impact of the policy intervention to the borrowers. This fact is also evident from the increase in both the average spread and NIM of the banking sector by 27 bps and 29 bps respectively (**Table 1**).<sup>4</sup>

Bank-wise information indicates that the cost of deposits for the big 5 banks increased in the range of 60 to 129 bps during the year. While all of these banks were able to enhance their return on earning assets, the extent of increase was different for each (**Table 1**). Similarly,

<sup>3</sup> Cash Reserve Requirements and Statutory reserve Requirement on time liabilities were abolished with effect from 4<sup>th</sup> Aug-07 and 18<sup>th</sup> Oct-08 respectively.

<sup>4</sup> NIM is the net interest income as a percent of average earning assets, while the average spread is the difference between average returns on earning assets and average cost of funds.



bank-wise information on the entire banking sector reveals that 25 out of 36 commercial banks witnessed an increase in their NIM, which again leads to the conclusion that the impact of the minimum rate was passed on to the borrowers to a greater extent.

**Table 1: Increase in Cost of Deposits and NIM of the Banking Sector\***

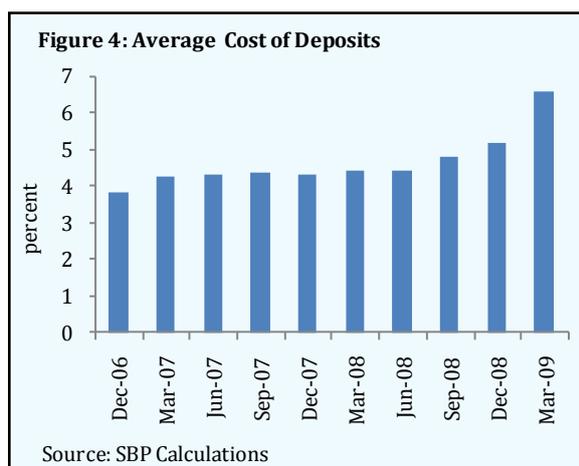
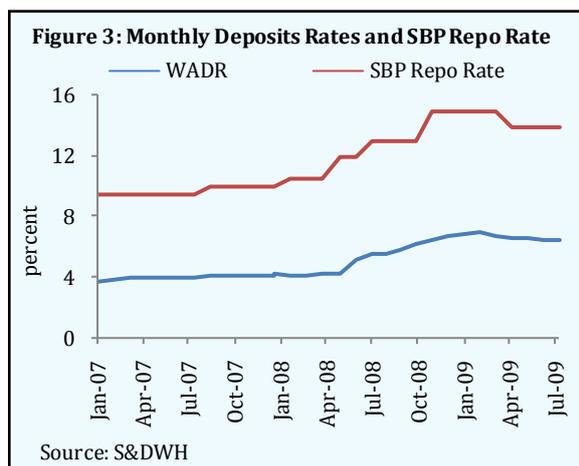
bps changes during CY08

	Cost of deposits	Return on advances	Return on E Assets	NIM	Average Spread
NBP	78	113	80	-2	7
ABL	129	224	168	19	22
HBL	79	142	124	31	35
MCB	88	191	123	45	41
UBL	60	118	63	-16	-16
All Banks	82	143	118	29	27

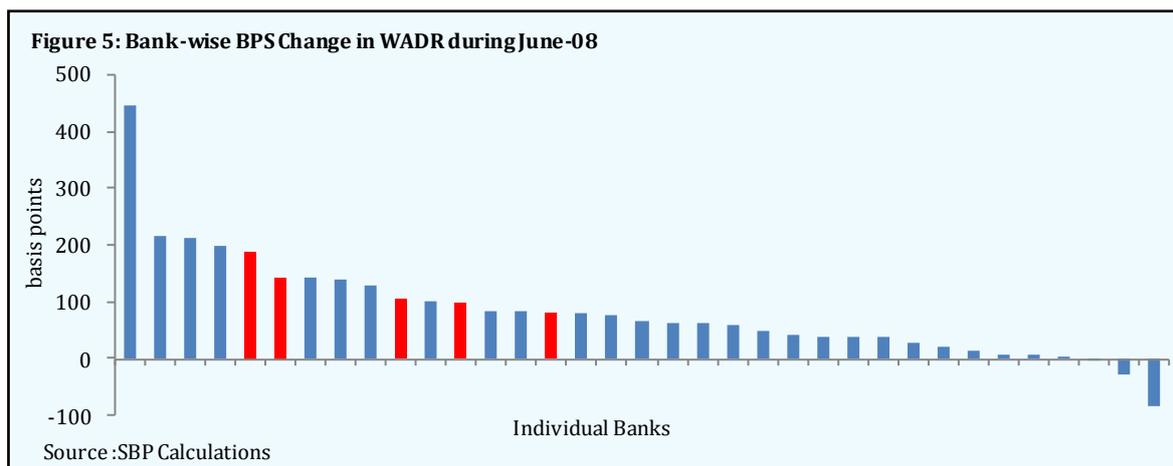
\*SBP calculations, based on annual audited balance sheet data

While the annual data for 2008 clearly shows that the cost of deposits increased due to a host of factors including the introduction of the minimum rate of return on savings deposits, the magnitude of the increase does not necessarily reflect the full impact of the policy change, which was effective for only 7 months of the year. To investigate the specific impact of the minimum rate of return, monthly and quarterly data of the banking sector is scrutinized next.

Following the introduction of the minimum rate of return from the beginning of June-08, the monthly weighted average deposit rate increased by 97 bps during the month (**Figure 3**). If this entire increase is attributed to savings deposits, it implies that the return on savings deposits increased by 232 bps based on the available monthly data. This is, however, not the case, given that the deposit rates were expected to increase in June in response to the upward revision in SBP’s benchmark policy rate in May 2008. This is substantiated by the increase of 41 bps in the weighted average lending rate during the same period. Base effect and the relatively lower degree of pass-through of the movements in the bench-mark policy rate to deposit rates suggest that the increase in the weighted average deposit rate would have been less than 41 bps, had SBP not introduced the minimum rate on savings deposits. One can argue therefore that at least (97-41) 56 bps increase in the weighted average deposit rate can be attributed to the policy intervention. This translates to an increase of 134 bps in the return on PLS savings deposits. The impact of the policy measure is also visible from the gradually increasing average cost of bank deposits. Specifically, the average cost of deposits has increased by 219 bps since June-08 (**Figure 4**).



Bank-wise information on monthly WADR reveals that all banks (with the exception of 3) witnessed an increase in their respective deposit rates during Jun-08 (**Figure 5**). As



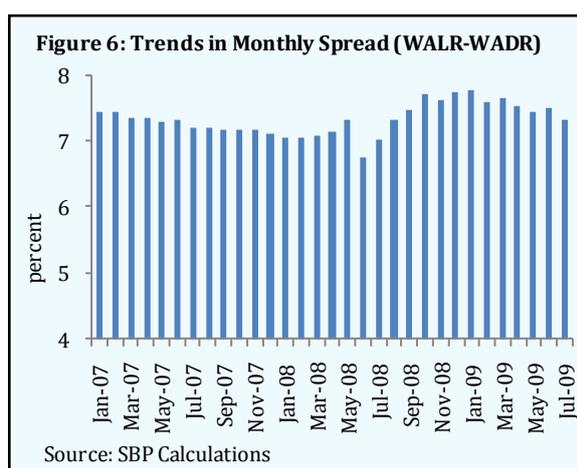
expected, four out of the 5 big banks had their WADR increase by more than the banking sector average of 97 bps. Two small-sized domestic banks whose WADR declined, were already paying high returns to depositors. Notably, both banks were among the top 5 banks with the highest WADR. The distribution of banks according to May-08 WADR indicates that 10 banks had their respective WADR above 7.0 percent prior to the introduction of the minimum rate (**Table 2**). These banks were the least affected by the introduction of the floor on the return on savings deposits. A comparison of banks with an already high WADR prior to the policy intervention and those with a low increase in their WADR subsequently, reinforces this assertion as 4 commercial banks are found to be common in both lists. This analysis is indicative of the fact that an increase in the overall WADR and average cost of deposits is bound to be suppressed to some extent due to the presence of these banks.

**Table 2: Banks' distribution according to WADR, May 08**

WADR	No. of Banks
< 3.0	7
3.01 < 5.0	11
5.01 < 7.00	11
>7.01	10

Source: SBP

Notably, despite the visible increase in both the monthly WADR and the average cost of deposits, the banking spread continued to move in a narrow range of 100 bps without showing any significant decline (except for one month when it dipped to 6.8 percent (**Figure 6**). The dip in the spread during Jun-08 seems to indicate the time lag involved in the adjustment of lending rates in response to the policy intervention. On the other hand, deposits rates were set to rise immediately. Trends in the banking spread suggest that banks were generally able to raise their lending rates to a greater extent in a bid to pass on the impact of the minimum rate of return on their respective cost structure, towards the borrowers. Additionally, peculiar circumstances in recent times, characterized by the enormous government borrowing requirements and the higher risk premium charged by banks with the re-emergence of credit risk due to the cyclical downturn in economic activities also helped banks to pass on the impact of the 5.0 percent floor to the borrowers. In subsequent months, a cumulative increase of 300 bps in the SBP policy rate again provided banks with



an opportunity to further hike up their respective lending rates. Notwithstanding these developments, the continued absence of an efficiently functioning domestic bond market also helps banks in passing on the impact of any change in the policy rate towards their borrowers.<sup>5</sup>

### **The Way forward**

The analysis suggests that the introduction of a minimum return on savings deposits did lead to an increase in returns to the depositors. However, banks were generally able to pass on a major proportion of this increase in cost to the borrowers. With the reversal in the monetary stance signaled by the 200 bps reduction in the benchmark policy rate in two steps since April 2009, the interest rates have started to decline. Monthly WALR and WADR have declined by 87 bps and 52 bps respectively during Jan-Jul CY09 from their respective peak level. Trends in interest rates indicates that banks had largely factored in the impact of the Monetary Policy Announcement in August 2009, as all the market rates witnessed some decline in July 2009, though the 100 bps cut in the SBP policy rate was lower than the market expectations. Given the declining interest rate scenario, the SBP might need to revisit its minimum threshold of 5.0 percent on all savings deposits rates at it was imposed when the SBP policy rate was 12.0 percent. The current SBP policy rate is only 50 bps higher than the level prevalent at 1<sup>st</sup> June CY08; the effective date of implementation of the minimum rate.

It is important not to lose sight of the fact that interest rates were liberalized in Pakistan as part of a broader reform agenda and an intervention of this type in a market based mechanism should be seen to be temporary and not a permanent policy measure. That said, the following section explores the three most likely options available to SBP in an environment of monetary easing, and the possible implications of these options.

### ***No Change in the Minimum Rate***

If SBP opts to maintain the minimum rate of 5.0 percent on all savings deposits in case of a further decline in its policy rate, it entails a number of policy implications. In this case, the depositors will benefit the most, in that they will receive the same return on deposits despite the significant decline in overall interest rates. This is likely to have a positive impact on deposit growth, and hence banks' liquidity position. It may be added here that the chain of reaction is based on the assumption of a positive correlation between the return on deposits and deposits growth.

In order to contain their overall cost of funding in a declining interest rate scenario, banks would have the following options:

- To resist a reduction in their lending rates in line with changes in the SBP policy rate. However this is a less likely outcome. Monthly average of the 6-month KIBOR has already seen a reduction of 364 bps from its peak level to 12.0 percent in August CY09. This implies that a reduction in the benchmark rate has already been factored in by the market. However, the decline in the WALR is much lower than the decline in the 6-month KIBOR. Given the comparatively higher relevance of WALR for the cost of borrowing of the private sector, any hesitation on part of banks to lower their lending rates due to the minimum rate of return will weaken the transmission mechanism of monetary policy. Hence the desired impact of the policy change may become difficult to achieve.
- To alter their lending rates in line with the SBP policy rate, but to also simultaneously increase the service charges on various financial services, especially for the PLS deposits for which the banks have full discretion to do so. Given the recent increase

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<sup>5</sup> As discussed in Chapter 3 "Development of a Debt Market in Pakistan", SBP Financial Stability Review 2006.

in bank charges from July 1, 2009, this issue has already generated debate on the role of banks in the economy. While not interfering with the transmission mechanism of monetary policy, this option will result in higher charges for regular financial services. The SBP may then have to intervene on this front also. A recently issued BPRD Circular letter<sup>6</sup> also indicates that SBP has abolished charges for collection of fees from students of educational institutions, and has prescribed maximum charges for issuance of demand drafts/pay orders and other financial instruments in favor of educational institutions.

- They may be unable to reduce their deposit rates in line with declining interest rates due to the increased competition for deposit mobilization, especially given the higher rates offered by CDNS on NSS instruments and the consequent disintermediation observed in the recent past. Notably, this situation is more pervasive in mobilizing long term deposits.

### ***Downward Revision in Minimum Rate***

In this case, the SBP will have to decide on the magnitude of the rate cut. The policy decision will give rise to a number of questions pertaining to issues such as the mechanism of reducing the minimum rate to *x* percent, the real rate of return to depositors, etc. Keeping these issues in view it can be suggested that SBP should work out a transparent mechanism for determining the minimum rate on PLS deposits. A quick fix can be to link the minimum rate with the rate on the newly introduced overnight repo (end-of-day) standing facility.

### ***Eliminating the Minimum Rate***

While the existing regulations on the calculation of returns on PLS deposits are suggested to be revised, SBP can also consider the removal of the administered measure of prescribing a floor on the return on deposits. In this case, the focus should be to create a transparent market-based mechanism of remunerating deposits. In doing so, SBP may prescribe the minimum terms and conditions that should be applied in determining an adequate level of returns on deposits.

### **Conclusion**

The floor on the return on savings deposits was imposed to overcome a distortion in the banking system caused by a failure of market forces in achieving an efficient price discovery mechanism. This distortion will continue to exist until the notion of PLS deposits, whose mechanism of profit determination works to the advantage of banks, is done away with in the conventional banking system. Depositors now have a choice between a shariah-compliant mode of banking and a banking system based on the age-old system of 'interest'. Simply labelling a deposit 'PLS' does not make it shariah-compliant and it is high time that this factor is recognized and dealt with. The very fact that SBP was able to implement a 'fixed' rate of return on all savings deposits including PLS deposits is a clear indication of their non-shariah compliant status. Additionally now that banks face stiff competition from NSS instruments which have mobilized funds to the tune of Rs. 267.0 billion during FY09, they are faced with rationalizing the rates of return on not just time deposits but also savings deposits to prevent the flight of deposits to higher and risk-free returns. SBP can hence consider the option of eliminating the minimum fixed rate of return at an appropriate time in the near future.

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<sup>6</sup> BPRD Circular Letter No 21, dated August 10, 2009.

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