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Re launching NSS: Old Products, New Motives.

Controversy-

The government of Pakistan has lifted a six year old ban on corporate investments excluding Banks and Insurance companies in the National Saving Schemes. The restriction was originally imposed in the year 2000 with the view of encouraging the growth of the domestic debt market. The move has caused great anxiety and uncertainty in leading financial circles and different opinions exist as to the motives of the government and the impact this move will have on financial markets of Pakistan. Predictions ranging from a complete destruction of the financial system to a relatively neutral impact of this move because of relatively lower NSS rates have been made.

Contention-

Our contention is that to make any prediction regarding the impact of this move, just analyzing the situation with the perspective of interest rate differential is unlikely to be accurate. The interest rate is illusionary and principal protection is the key in this case.

Risk-

We are assuming a rational investor in the context of this paper as the primary attempt of this paper is to dissect the impact of allowing corporate investors to invest in the National Saving Schemes. The corporate investor is generally a savvy investor knowing fully well the workings of the financial markets.

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The Winds of Change

A list of changes made recently to the National Saving Schemes is as follows.

- The Government has lifted the ban on institutional investment in National Savings Schemes and now the following institutions can also invest in the NSS.
 - a. Non-profit bodies.
 - b. Registered Charities.
 - c. Public Sector Enterprises excluding Banks.
 - d. Private Educational & Health Institutions.
 - e. Employees Old Age Benefit Institutions (EOBIs).
 - f. Private Corporate Sector registered with the SECP excluding Banks.
 - g. Non-Bank Financial Institutions (NBFIs) excluding Insurance Companies.

- The lock-up period of one month in case of Defence Savings Certificates, Special Savings Certificates and Special Savings Account has been removed. Hence, the investor can now encash the certificates or withdraw the deposits any time after the date of investment.

- To support the frequent transactions in case of Savings Account, the limit of two withdrawals in a week's time has been increased to three times a week.

The Reforms

The last six years or so have been a great era for the financial sector of Pakistan. Significant achievements have been made under the management of Mr. Shaukat Aziz first as the finance minister, and then as the PM of Pakistan. And one of the most profound achievements was to go at length in fixing the biggest drag down of our financial system, the National Saving Schemes. Some critical steps taken with regards to the National Savings Scheme (NSS) were:

- The preferential tax benefit given to NSS instruments, vis-à-vis debt instruments issued by financial and corporate institutions was eliminated. The current exemption on withholding tax is up to the amount of 150,000 which is not relevant to the corporate sector.

- Critical success was achieved in aligning the yields on the NSS instruments to the market level. As per its commitments to the International Monetary Fund, the government moved to adjust the NSS rates, in order to align the rates with market rates on comparable government instruments and by 2004 was reasonably successful in doing so, as illustrated in table 1.

Table 1
Profit Rates on Major NSS and PIB.

	National Savings Schemes			Pakistan Investment Bonds		
	DSC	SSC	RIC	10 Year	5 Year	3 Year
H1-FY00	15.97	14.33	16.00	--	--	--
H2-FY00	15.01	12.33	14.00	--	--	--
H1-FY01	14.01	11.17	12.48	--	--	--
H2-FY01	14.01	11.17	12.48	13.99	12.98	12.46
H1-FY02	15.01	12.37	12.48	12.46	12.07	11.59
H2-FY02	14.13	12.37	12.48	10.62	9.77	8.78
H1-FY03	11.61	10.47	10.56	8.14	7.34	6.66
H2-FY03	10.03	8.67	9.12	4.81	3.64	2.94
H1-FY04	8.50	7.67	7.68	6.20	5.04	4.02
H2-FY04	7.96	7.16	6.96	6.79	5.07	3.98

Source: State Bank of Pakistan Annual Report FY 04

So the pertinent question to ask is, when till yesterday the government was touting its progress in liberalizing the financial system, then why would it now decide to reverse a policy that has been so successful in the past?

Government Envious of Commercial Banks' Profitability?

Commercial bank's profits have soared over the last couple of years. This has come on the basis of rising spreads between the rates on bank deposits and commercial loan rates. The banking spread is averaging persistently more than 7 percent and the warnings delivered so eloquently by the Ministry of Finance seemed to have fallen on deaf ears. So was the government finally tired of delivering empty tirades against the banks and has done something concrete to give relief to the depositors.

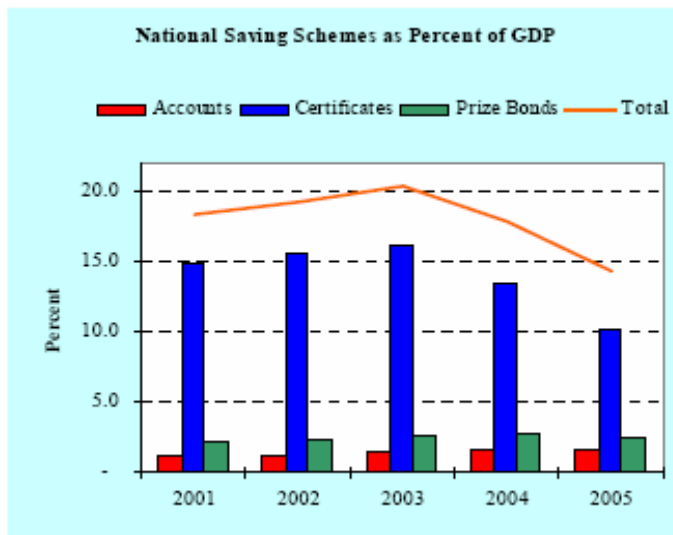
In our opinion this is unlikely to be the motivation behind the government's move. Although this move may drive deposit rates up due to liquidity shortage from the system, the primary target for the government move is the corporate sector for which the banking sector is already offering deposit rates of around 11 to 12 percent for a six months deposit. So the sector is clearly not in the need of any mega relief effort of the government. The small investors who might be offered lower rates on their

deposits already have exclusive access to the much more lucrative Behbood scheme which offers rates around 11.5 percent.

NSS vs. PIBs

Ever since the rationalization of interest rates on the National Saving Schemes there has been a steady outflow of money from the NSS. At the time this was done with the perspective of replacing this with a market oriented long term instrument i.e. the 10 year tenure Pakistan Investment Bonds (PIBs). In the period of low interest rates that prevailed in the years of 2002 and 03 this objective was achieved to some extent. The Government, in order to cash in on the low interest rates altered its borrowing pattern away from the NSS and towards PIBs. The following figure depicts this shift, as in 2003 the NSS as a percentage of GDP declined. The State Bank issued upwards of 150 billion rupees worth of Pakistan Investment Bonds (PIBs).

Figure 1



Source: State Bank of Pakistan Annual Report FY 05

This period of 2002-04 can be classified as one of high economic activity era. Banks were making substantial trading profits due to the increasing prices of their existing stocks of PIBs in a falling interest rate environment. This provided an opportunity for the State Bank to sell huge amounts of long term debt at relatively lower rates. Everyone was happy as long as the rates kept falling. The State Bank was securing funds for the government at low rates and the commercial banks were making money selling their high coupon bonds at higher values because of the falling interest rates.


Well sooner or later all good things have to come to an end. When the interest rates scenario changed and the monetary tightening begun, the commercial banks got stuck

with low coupon PIBs. Because of the rising interest rates, their market value shrank and it forced the banks to park these PIBs in their held to maturity (HTM) account. By doing this they managed to avoid a hit on their profit and loss account (P&L) but this step also meant that the primary dealer's enthusiasm to pick up fresh PIBs issues declined dramatically. They were reluctant to pick up the PIBs for the same reason that they were lapping up every issue the State Bank was throwing their way when the interest rates were falling. With interest rates falling, every subsequent interest rate cut raised the value of all previous PIB issues. Consequently, this meant that in a rising scenario every interest rate hike decreased the value of the existing issues. Thus it made no sense for the primary dealers to park PIB issues when they knew that they would be losing money on them.

Table 2

Issue Date	Total Amt.	Accepted Amount	Amount Out Standing	Target Amt.	Cut off Yield
18/06/2002	11,580.50	4,815.50	82,309.35	5,000.00	10.8568
21/08/2002	23,965.20	7,955.00	90,264.35	5,000.00	9.6020
24/10/2002	28,439.00	12,233.20	102,497.55	12,000.00	9.3239
31/12/2002	4,068.50	988.50	103,486.05	1,000.00	5.5699
26/03/2003	5,655.00	1,150.00	104,636.05	1,000.00	4.0295
30/06/2003	75,181.50	25,562.20	130,198.25	25,000.00	5.6704
6/10/2003	20,216.50	5,941.50	136,139.75	13,000.00	6.2511
6/10/2003	21,000.00	11,000.00	147,139.75	8,000.00	6.2299
6/10/2003	16,125.00	8,075.00	155,214.75	5,000.00	6.2269
29/04/2004	23,675.00	15,015.00	170,229.75	15,000.00	6.4903
29/04/2004	10,388.00	9,988.00	180,217.75	10,000.00	7.3698
18/08/2004	1,450.00	-	180,217.75	1,000.00	Rejected
12/11/2004	825.00	-	180,217.75	1,000.00	Rejected
28/03/2005	494.00	-	180,217.75	1,000.00	Rejected
19/05/2006	5,590.00	3,240.00	183,457.75	2,000.00	9.8746

So as witnessed in Table 2, the year 2004 onwards the liquidity went out of the market. We believe the primary reason for this was that the State Bank was unwilling to let market establish the rate for 10 year PIBs. If the primary dealers were unwilling to pick up the offered issue at the rate State Bank wanted them to, the proper move would have been to de-link the 10 year rates from those of the shorter term instruments and let a market establish the rate for long end of the yield curve. In order to attract the primary dealers and make them willing to lock in their money in the current issues, they need to be compensated for the anticipated rise in the interest rates. This would have meant significantly higher interest rates on the PIBs as compared to the Treasury bills and thus an upward sloping yield curve.



But the State Bank in order not to increase borrowing costs kept rejecting the PIB bids, which led it to increase its borrowing in the short end of the curve to meet the government's liquidity demand. As a result of this, the government ended up borrowing undesirable sums of money from the short term debt market. We believe the current move to allow corporate sector access to the NSS is an attempt to correct this trend.

NSS Matters.


If nothing else, this recent development dictates that the Ministry of Finance still believes and views NSS as the most significant source of government funding. And with good reason it seems, as even during the period when corporate sector was barred from purchasing NSS, the outstanding balance stood at One Trillion rupees. Where else could the government turn to for a more reliable source of long term funds, after the failure of the State Bank to ensure a consistent stream of PIB issues, thus forcing the government to skew its borrowing pattern in favor of short term borrowing to meet its non tax revenue needs. And what better way to rescue the situation than to take matters into their own hands. After all many bureaucrats would still have fond memories of the good old NSS days.

And why shouldn't they view NSS as their savior. As mentioned before, NSS still has a hugely significant amount of money invested in it. And people always seem willing to invest more, given the proper incentive and that too at reasonable interest rates. So reversing the policy on NSS and allowing the corporate sector to invest in it is probably an attempt to raise cheap money through the NSS for the government from our well intentioned bureaucracy.

Why Invest in NSS? The Investor Side of the Story.

The question to ask in the current context is that why would an educated, savvy corporate investor decide to invest in the NSS. One big reason to invest into NSS is that it is the risk free choice. For bureaucrats sitting in big government run organizations, it is a simple choice. Investing into NSS is unlikely to get you into trouble and it is the move least likely to get you fired as the investment is guaranteed by the government. So diversification factor alone would guarantee a significant amount of investment into the NSS by these organizations.

But apart from the diversification argument why would the commercial banks feel so threatened by the revival of the NSS? Commercial Banks had begun offering deposit rates around 12% on six months deposits competing for big corporate customers, and this rate would only go up now that NSS has stepped into the fray. Why investors getting 12 % on a six month deposit would invest their funds for a 10% return on a 10 year term?



Part of the interest rate differential is explained away by the credit spread on the instrument being offered by the banks. Since there is a risk of default on any non government debt, the investor has to be compensated for that. A fair measure of the credit spread for a well rated bank would be the difference between the six month KIBOR and the six month T bill rate.

$$\begin{aligned}\text{Credit Spread}^1 &= 10.49 - 8.8142 \\ &= 1.6758 \%\end{aligned}$$

So even after accounting for the credit spread, investing into the products being offered by the commercial banks lets the investor earn a healthy spread of 0.3242%. But this analysis is misleading as it only considers the return being offered on the competing products without going into detail of the structure of the products.


The killer blow that NSS deals to the competing products comes in the form of amenities given to the investor. NSS allows the investor the provision of early encashment without any penalties, if so desired by the investor. This early encashment provision being offered with NSS guarantees principal protection for the investor. It allows the investor to redeem the investment at par in case of any adverse movement of the interest rates.

In other words, NSS offers investor principal protection in the true meaning of the word. Not only is the government guaranteeing the interest payments and return of the principal, it has also offered immunity to adverse interest rates changes to the investor. The government is not just offering the 10% return on Defence Saving Certificates but also an implicit put option is being sold to the investors as part of the package. This put option allows the investors to redeem their investment at par at the time of their choosing.

This option protects the NSS instruments from the bane of PIBs existence, rising interest rates. So whereas in a rising interest rate scenario every interest rate hike meant that the value of the existing issues of PIBs fell, such a scenario will not impact the NSS investors as they will be able to put their investment to the government at par and reinvest at the higher interest rates. As a result the competing 10 year PIB will only be acceptable to the investors at a much higher yield as compared to the NSS certificate of a similar tenure, because the risk of value erosion is present with the PIBs but not with the NSS.

$$\text{Adjusted Return on NSS} = 10\% + \text{value of the put option}$$

¹ This use of the credit spread is theoretically incorrect as it is comparing credit spreads of different tenures. But in the absence of 10 year KIBOR and a liquid 10 year PIB issue in recent times we are using the six month credit spread as an approximation.



As the analysis shows that the rate of return on NSS is not just 10%, but it is 10% plus the value of the put option that the government is providing to the depositor in form of their ability to liquidate their investment at par. Pricing of a put option on such an investment is beyond the scope of this paper. But even assuming a conservative put price of 1 % in terms of return completely changes the whole picture and puts PIBs out of competition. Even the higher priced deposit rates of around 12% being given by the commercial banks would come under serious competition.


All that glows is not gold.

Raising long term funds through the NSS is problematic for a variety of reasons. Firstly, the unpredictability of cash flows arising from early encashment provisions makes NSS an undependable source of long term funds. Moreover, in case of NSS the government fails to predetermine the amount of funds to be raised as opposed to the case of PIB's where in the auction the government can raise the desired amount on the market determined rate. This makes it difficult to fulfill government's long term borrowing need from the NSS alone.

Secondly, the fact that the NSS accounting systems assess all investments at face value instead of using accrual accounting, presents misleading figures. For example, if the government borrows Rs.100,000 at 10% through Defence Savings Certificates that follows a bullet structure where the lump sum payment is due only at maturity, the liability will be presented in NSS accounting systems at its face value of Rs. 100,000 only until maturity, instead of the actual value of Rs. 260, 000 had accrual accounting been used. Since Defence Savings Certificates constitutes a large part of NSS, this creates a significant misconception in terms of actual cost.

Lastly, NSS instead of the PIBs would give an illusion of lower cost borrowing to the government, as the interest rates on NSS deposits would be lower. But an analysis in terms of put option shows that the actual costs of mobilizing NSS deposits is much higher than these rates indicate. A simple example to illustrate this is given below.

The government borrows 100 billion rupees at 10 percent through NSS. The interest rates rise by 100 basis points and the total quantum of funds go up to 110 billion rupees. For the funds in NSS the rate change would be applicable to the whole 110 billion rupees, as the depositors have the option to withdraw the 100 billion and put it back at 11 percent. So the government would probably be paying 11 percent on the entire 110 billion rupees. For similar PIBs the situation would have been different in absence of the put option on the PIBs. The government would have had to pay 11 percent only on the new 10 billion and the old stock of 100 billion would still pay interest at 10 percent.



So the decline in cost of government borrowing is illusory and may be only temporary at best. This move towards NSS looks good on the balance sheet but until one reads the fine print it is difficult to be cognizant of the entire costs. And this is just considering the impact on government borrowing costs; we are yet to consider the wide ranging side effects of popularizing NSS.

The Collateral Damage: Innocent Victims of War

The move to allow corporate sector access to the NSS has caused anxiety right through the financial sector. And the anxiety is not without justification. As explained before, NSS offers tough competition to the financial sector. But the problem we and the banking sector have with the NSS is not that it is offering competition, but that it is offering unfair competition. The financial sector cannot compete with a product which offers inherent and complete principal protection. So unless the policy on NSS is revised, the current move should generate significant movement of corporate funds from the financial sector to the NSS.

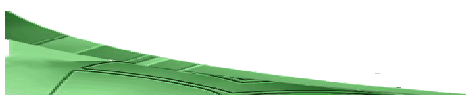
The impact of NSS on the banking deposits is uncertain, but what is not uncertain is the quick but silent death of the PIBs. The long term bonds only in its nascent stages look already set to be the first casualty of the government's love with the NSS. With State Bank's determination of keeping the return on PIB's linked to the T Bill rates and not to allow market pricing of the PIBs, it is difficult to see how the PIBs can survive. And the recent trend of ridiculously low interest in the PIBs looks set to continue.

Also with the death of PIBs, we can say goodbye to determining the long end of the yield curve anytime soon. NSS instruments cannot be used to construct the yield curve because of the presence of the put option, pricing which is a science in itself. The ten year and onwards part of the yield curve is both theoretically and practically very important as it is used to price long term investments. Investments not just into the financial sector like long term bonds and equities, but also the expected cash flows from big capital spending projects on which the return is long term, are discounted using this rate. In our opinion the biggest loss caused by this whole saga to the Pakistani economy maybe the uncertainty caused by the lack of a valid long term interest rate.

Going forward we do not expect the government to backtrack on the current policy change of allowing corporate investment into NSS. And it does not necessarily have to backtrack in order to correct the current mess. Indeed NSS has its role to play as a viable savings institution with a long history and deep outreach to the public saving. NSS should be there, competing with the rest of the financial sector for the savings of



the public helping in achieving a more efficient saving culture. What has to change in our humble opinion is the unfair advantage that the NSS has over the rest of the financial sector in the form of principal protection. The best step for the government to take now would be to withdraw the policy of allowing redemption at zero penalties and link the return on NSS to the PIB rates existing in the market. This would allow the financial sector to compete with NSS ensuring a viable saving culture in Pakistan.



Economic Snapshot

Fiscal year 06														
	Units	Aug	Sep	Oct	Nov	Dec	Jan	Feb	March	April	May	June	July	Aug
<u>Inflation</u>														
Headline Inflation	%	8.41	8.53	8.27	7.89	8.51	8.76	8.05	6.91	6.16	7.12	7.65	7.63	8.93
Core inflation	%	7.55	7.58	7.81	7.59	7.36	7.34	7.00	6.67	6.43	6.58	6.29	6.28	6.20
Food inflation	%	7.82	7.52	6.41	5.84	8.1	8.17	7.48	5.42	3.64	5.59	7.78	7.44	11.08
Non-food inflation	%	8.83	8.25	9.61	9.38	8.8	9.18	8.44	7.98	8.01	8.21	7.55	7.77	7.43
<u>T-bill (Wgt Avg)</u>														
3 month	%	7.99	8.10	8.10	bid rej	8.09	8.10	8.10	8.10	8.10	8.10	8.29	8.32	8.63
6 month	%	8.12	8.14	8.14	bid rej	8.25	8.29	8.29	8.29	8.29	8.29	8.45	8.49	8.81
12 month	%	8.78	8.79	8.77	8.79	8.77	8.75	8.78	8.79	8.79	8.79	8.79	8.79	9.00
<u>External Sector</u>														
Export	Mln US\$	1,360	1,318	1,317	1,205	1,451	1,252	1,287	1,536	1,432	1,498	1,512	1350	1383
Import	Mln US\$	2,056	2,037	2,021	2,024	1,929	2,037	1,854	2,269	1,664	2,299	2,626	2370	2292
Trade balance	Mln US\$	(696)	(719)	(704)	(819)	(478)	(785)	(567)	(733)	(232)	(801)	(1114)	(1020)	(909)
Remittances	Mln US\$	348	341	373	309	336	391	339	444	401	507	464	376	435
Forex reserves	Mln US\$	12,124	12,000	11,715	11,341	11,669	11,505	11,516	12,487	13,021	13,003	13,137	12,725	12,631



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