**THE ROLE OF CONTRACTUAL SAVINGS IN PAKISTAN’S ECONOMY[[1]](#footnote-2)**

**Ishrat Husain**

Pakistan, in my humble view, is an ideal candidate for promoting Contractual Savings institutions. With extremely low and almost stagnant national savings rate hovering around 15 percent of GDP the investment needs of the country for higher income generation are met either by relying upon foreign savings largely in form of external borrowing or deficit financing from the banking system. However, both of these are not feasible options anymore. Debt/GDP ratio has reached the maximum of 60 percent permissible under the Fiscal Responsibility Act. Debt servicing claimed about Rs.1 billion of the budgetary resources in 2011-12 – almost one third of the total expenditure. Borrowing from the State Bank of Pakistan is highly inflationary in nature and needs to be discouraged.

Let me illustrate the gravity of the situation facing us. In theory, it implies that with an average national savings rate of 15 percent we can invest up to this amount. An Incremental Capital Output ratio of 3.5 puts the upper limit on our GNP growth rate of 4.2 percent annually. With a population growth rate of 2 percent this would translate into an annual per capita growth rate of 2.2 percent. At this rate we would double our per capita income in 32 years. Poverty Reduction would remain elusive and we will be left behind other developing countries who are growing much faster than us. Now suppose that our national savings rate rises to 20 percent. Under the same assumptions we can attain per capita growth rate of 3.7 percent annually and reach the doubling of per capita incomes within 19 years. You can notice as to how much difference it makes by simply raising our national savings rate by 5 percentage points. This improvement is by no means spectacular but at least better than what we are facing today. Just to give you the contrast, India’s national savings rate is slightly higher than 30 percent of GDP which enables them to grow at 7 to 8 percent every year. If this speed is maintained they will become the third largest economy in the world by 2025.

You will naturally ask me the logical next question. How can our national savings rate be raised? One way of course is by reducing public dis-savings. If the fiscal deficit and public sector corporation losses are reduced by 5 percentage points from the current 7 to 8 percent of GDP this gap between savings and investment will disappear and we can resume the path for 5 to 6 percent annual GDP growth rate. But this does not appear feasible at this stage and we have to therefore fall upon other ways of bridging this gap.

We all know that we do not have any social safety nets in this country – Social Security, Medical Insurance, Unemployment benefits, Housing Schemes for the retirees except in a few isolated cases such as the Armed Forces. Most households do therefore have to save for their post retirement lives. Extended families, under the pressures of urban living and changing social norms, are giving rise to nuclear families. Therefore the dependence on sons in the old age as insurance is also becoming less reliable. Many households therefore resort to real estate, gold and precious metals, foreign assets as vehicles for long term post retirement savings as well as hedge against inflation. These forms of savings do not help the country in financing its investment needs. International experience shows that the CSIs have become an effective mechanism for channeling savings for the old age and using them to finance an expansion in the supply of productive capital. Thus, we have a hidden source of untapped supply of long term savings that can be channelized by Contractual Savings Institutions (CSIs) and converted into financial assets.

Why is this channelization not taking place in Pakistan? Why are insurance penetration ratios so low? Why aren’t the Pension Funds, Provident Funds and Endowment Fund big players in mobilizing these savings?

You in this audience have a much better knowledge of these issues than myself because you are practitioners and confront them live every day. I have some thoughts which I would like to share particularly drawn from the international scene.

Before I turn to the international experience from which we can learn some lessons let me look at the demand side. Is there an effective demand for these long-term financial assets in Pakistan? If so, how can this intermediation between long term savings and long term investment demand take place.

On the demand side, the Development Finance Institutions (DFIs) such as PICIC, IDBP, Bankers Equity, ICP, Equity Participation Fund, RDFC and others used to provide long term financing mainly from the lines of Credit of international financial institutions, SBP or the Government. This model of Government owned, non-professional managed DFIs highly leveraged using non-commercial credit criteria has miserably failed not only in Pakistan but in a large number of developing countries. Private commercial banks which are now universal banks are in theory supposed to provide long term financing. But they are constrained by the limits of maturity transformation. They raise short term deposits and their capacity to lend for long term tenor is linked with the stable rollover of these deposits. It is not realistic to expect that the commercial banks will act as the leader in supply of long term investible funds. On the other hand, long gestation investment projects in power, natural gas, pipelines, terminals, roads and highways, bridges, ports and berths, airports, pipelines, railways, engineering goods manufacturing, petro-chemicals, refineries, exploration and development, housing, commercial buildings, technology parks, industrial estates, export processing zones require large sums of 10 to 15 year tenor funding. In countries all over the world, the Debt Capital Markets and Equity Capital Markets are the main source of this financing. Where do these market get supply of funds? Besides, retail investors the bulk of the funds come from institutional investors of all kind and type. CSIs are one of the most natural buyer of these assets as they have an appetite that matches the maturity structure of the bonds and capital appreciation of equities.

Let us examine the situation on the international scene. Contractual savings institutions, i.e. insurance companies, pension funds, provident funds, endowment funds have played an important role in countries such as Singapore, Malaysia, Chile, etc. For example, Singapore has been successful in building apartments and houses for its population by deploying these contractual savings. There was a mandatory participation in funded pension schemes and the CSIs in Singapore controlled resources equal to 78 percent of GDP as far back as 1987 – up from 28 percent a decade ago. In contrast, the assets of insurance companies and pension funds in the U.S. were 67 percent. Malaysia, which followed the Singapore example, also raised the total assets in CSIs to 48 percent of GDP by 1987 from 18 percent in 1980.

In Chile, the privatization of pension fund management and its control on personal pension plans played a dominant role in doubling the national savings rate. The assets under the personal pension plans that was introduced in 1981 expanded from a mere 1 percent of GDP to 26 percent by 1990.

How have these countries been successful while others including Pakistan have not done so well? Empirical studies have shown that the growth of contractual savings depends on three factors: the coverage of the sector; the level of annual contributions and the rate of investment returns. Assume that a country sets up a funded pension scheme for all its employed workers – public sector, private sector, small businesses, self employed, farmers, etc. Further assume that labor incomes represent 60 percent of national income. A mandatory scheme covering 33 percent of the labor force with an annual contribution rate of 10 percent would accumulate funds equal to 2 percent of national income annually. If the rate of return on fund balances is equal to the rate of growth of GNP, the pension schemes would accumulate 20 percent of GNP over the next 10 years. In Singapore and Malaysia the fast growth in the resources of CSIs were caused by an expansion in coverage, a rise in contribution rates and the growth in wages. In Singapore, the effective contribution rate amounts to 32 percent. If the national savings rate in Year 2011 was 15 percent of GNP at this rate of accumulation it would more than double by the year 2020.

What do the CSIs do with these contributions which they have raised? Most institutions place the largest part of their funds in government, corporate and mortgage bonds and in long term loans.

In Singapore and Malaysia, the national provident funds invest over 90 percent of their funds in government securities that earn a slightly positive real rate of return. Singapore has accumulated a substantial pool of foreign exchange reserves by investing in foreign assets on behalf of Singaporean households. In Chile, the pension funds invest 80 percent of their resources in debt instruments including 40 percent in State securities. Investment in corporate equities were 20 percent of total assets.

In each of these countries the growth of contractual savings has taken place because of a favorable enabling environment . There are many elements of this environment but as an ex regulator with some experience of the banking sector I thought I would focus my attention on the role of regulator and the Government. I therefore turn to the question:

What should the regulators and the Government do?

The basic aim of a regulator is to prevent undue concentration of investment risks in particular types of securities, sectors or companies. Investment regulations should therefore place maximum limits on permissible holdings but avoid imposing minimum requirements or direct investments in particular securities or in favor of particular sectors.

The pension funds should be invested prudently and limits on the amount of pension reserves that can be invested in the securities, property of the sponsoring employer and the stipulation of diversification requirements should be similar to those applicable to the technical reserves of insurance companies.

In developing countries the absence of strong and transparent capital markets, the shallowness and lack of credibility of the domestic financial markets and lack of familiarity of pension members with those markets dictate that stringent investment rules should be prescribed and followed. Exposure limits of different forms have to be laid out to ensure that excessive risks are not taken with the savings of the pensioners. Of course, this involves trade-offs in form of lower returns because the Pension Funds cannot take advantage of the boom in the equities market by exceeding the binding limits. However, as the pension funds gain experience and mature, the professional investment managers become skilled and proficient and internal controls are established most of the concerns with which the regulators are preoccupied can be addressed. Gradual liberalization and revision in investment rules should be allowed then.

One of the arguments against fully funded pension funds is that they become captive source of financing the government deficits. This is what is happening to even bank deposits today in Pakistan. So fiscal discipline and reduced demand from the government and the public sector are sine quo non for the growth of professionally managed CSIs. Private pension funds would otherwise have very little incentives to invest wisely.

Next ,development of Corporate Bond Markets should take precedence over other initiatives related to capital market development. In Chile also, the privately managed pensions funds invested most of their assets in fixed income instruments. Financial innovation and efficiency will also follow in a competitive environment. Institutional investors can play a role in modernizing the securities market by exerting pressures for better accounting and auditing standards, more meaningful and timely disclosure of information to investors.

Third, the SECP has to work hard to rebuild the confidence of small retail investors by introducing transparency, full disclosure and separating ownership from management of the debt and equity capital markets. Vigilance and strong oversight by the regulator accompanied by strong enforcement and penal actions against those indulging in malpractices would provide a powerful signal in re-building this trust.

Fourth, the insurance and takaful industry has suffered due to benign neglect in absence of a strong champion and promoter in the government or the regulatory agency. It is time to consider setting up an independent Regulatory Authority for Insurance Industry which should act both as a watchdog for and promoter. There is a fine balance to strike but it seems the only practical way out if we have to exploit the huge potential of insurance and takaful in Pakistan.

Finally, the Government of Pakistan has to move away its own civil and Military pension scheme from Pay as you go to Fully funded schemes. The huge contingent liabilities that are being built up as the number of retirees is rising, longevity is increasing and the pay scales are being substantially raised would create serious fiscal difficulties in the future. By moving to Defined Contributions and Funded schemes there will be some initial investment required but it will taper off in the future. Government Pension Fund can play a critical role in the growth of Contractual Savings Institution in Pakistan.

CSIs can promote a greater dispersion of corporate ownership, better oversight and monitoring of performance and overall improved corporate governance. CALPER – the California Public Employees Retirement Fund – is now a powerful force in altering the behavior of the companies in which they have invested. The broader issues of Corporate Social Responsibility, Environmental Sustainability and Equity are also attracting attention of the large funds. This can happen in Pakistan if the CSIs attain economies of scale and therefore a clout in resource allocation.

Let me conclude my remarks by quoting my address of July 29, 2004 in which I had set out a vision for Pakistan’s financial services industry. This vision envisaged a continuum on the domestic front with well functioning capital markets at one end, the banking system in the middle and micro-finance institutions at the other end. Capital markets will cater to the needs of well established, highly reputed, credit worthy large issues of capital trusted by both the retail and institutional investors and to whom they are willing to provide their savings at competitive prices. The CSIs in Pakistan are highly segmented, narrowly focused and making sub-optimal returns on the assets they manage. It is the joint responsibility of the Government, regulators and the industry to mobilize and manage these savings in an optional and professional manner. As we further develop and manage private pension funds, provident funds and endowment funds the overall domestic savings rate in the country will rise. That vision remains valid even today and needs to be translated into a strategy with goals and milestones. The strategy needs to be executed with continuous monitoring and fine tuning.

I would request the members of your Association to play a leadership role in developing a consensus on this strategy and take it forward to the implementation stage.

1. A paper presented at the Pakistan Insurance and Takaful Conference 2011 held at Karachi on Sep 6, 2011. [↑](#footnote-ref-2)