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Government of India
Ministry of Finance

Report of the Committee on Comprehensive Review of National Small Savings Fund

June, 2011

June 7, 2011

To

Shri Pranab Mukherjee
Minister for Finance
Government of India

Sir,

Consequent to the recommendation of the Thirteenth Finance Commission for comprehensive reforms in overall administration of National Small Savings Fund (NSSF), this committee was constituted by Ministry of Finance vide its Order No. 5-2/2010-NS-II dated 8th July, 2010 to recommend on the reforms required in NSSF.

The Committee had eight formal meetings in addition to informal interaction amongst members. The Committee has also consulted Finance Secretaries of States, Department of Posts, State Bank of India and Chief Advisor (Cost), GoI during its deliberations.

We are thankful for this opportunity and are pleased to submit the report of the Committee.

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Reserve Bank of India

Shri Shaktikanta Das
Additional Secretary (Budget),
Ministry of Finance, GoI

Shri R Sridharan
Managing Director,
State Bank of India

Dr. Rajiv Kumar
Secretary General, Federation of Indian
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Shri Anil Bisen
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Shri Sudhir Shrivastava
Principal Secretary (Finance)
Government of Maharashtra

Shri C M Bachhawat
Principal Secretary (Finance)
Government of West Bengal

Committee

Chairperson

Smt. Shyamala Gopinath	Deputy Governor, Reserve Bank of India

Members

Shri Shaktikanta Das	Additional Secretary (Budget), Ministry of Finance, GoI
Shri R Sridharan	Managing Director, State Bank of India
Dr. Rajiv Kumar	Secretary General, Federation of Indian Chambers of Commerce and Industry
Shri Anil Bisen	Economic Advisor, Ministry of Finance, GoI
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Summary of Recommendations

The Central Government on 8th July, 2010 constituted an Expert Committee under the Chairpersonship of Smt. Shyamala Gopinath, Deputy Governor, Reserve Bank of India for comprehensive review of the National Small Savings Fund. The terms of reference of the Committee include review of the existing parameters for the small saving schemes in operation and recommend mechanisms to make them more flexible and market linked; review of the existing terms of the loans extended from the NSSF to the Centre and States and recommend on the changes required in the arrangement of lending the net collection of small savings to Centre and States; review of the other possible investment opportunities for the net collections from small savings and the repayment proceeds of NSSF loans extended to States and Centre; review of the administrative arrangement including the cost of operation; and review of the incentives offered on the small savings investments by the States.

The Key Principles

Number of schemes

The Committee, while conscious of the multiplicity of schemes, recognised that most of the schemes serve the thrift needs of various sections of the population, especially small savers. It has, therefore, recommended closure of only one existing scheme – the Kisan Vikas Patra (KVP) while recommending continuation of all other schemes with suitable modifications.

Benchmark of Small Savings Instruments

Taking into account the various considerations, the Committee agrees with the recommendations of the Reddy and Rakesh Mohan Committees that the secondary market yields on Central government securities of comparable maturities should be the benchmarks for the various small savings instruments (other than savings bank deposits, which do not have a fixed maturity). The rate of interest on savings bank deposits would remain fixed at 4 per cent per annum.

Formula

The Committee recommends that the Government may adopt the formula suggested by the Reddy Committee, as it will allow a quicker pass through from the recent market rates to the administered rates. Accordingly, a one-year reference period would be adopted. As compared with the Rakesh Mohan Committee formula, however, the chosen formula is likely to increase the volatility in the administered rates. The average of the month-end secondary market yields announced by FIMMDA (which the RBI has permitted the commercial banks to use for the valuation of their government securities portfolio) may be used for this purpose. The yields, so obtained, would be rounded off to the nearest 10 basis points. (Thus, if the rate as per the formula is 6.120 per cent, the rounded-off rate would be 6.10 per cent).

The Committee also agrees with the recommendation made by the Rakesh Mohan Committee on placing a cap of 100 basis points so that the administered rates are neither raised nor reduced by more than 100 basis points from one year to the next, even if the average benchmark interest rates rise or fall by more than 100 basis points. This would reduce the year-to-year volatility in the administered rates.

Spread

In the developed economies, the issuer appears to offset the higher transaction costs associated with retail debt instruments by offering a lower rate of interest than that in wholesale markets. Taking into account the interests of the small savers, and in view of the absence of social security among the unorganised sections of the society, as also the liquidity augmenting measures for various instruments suggested by the Committee, the Committee recommends a positive spread of 25 basis points, vis-à-vis government securities of similar maturities with a few exceptions. Being lower than 50 basis points recommended by the earlier Committees, it would also contribute to the viability of NSSF.

Reset Period

On a balance of consideration, the Committee is of the view that the administered rates may be reset on an annual basis which will balance between the objectives of the need for closer alignment of administered interest rate with market rates and the reduction of its volatility arising from more frequent resetting.

Date of Notification of the Rate of Interest

The administered rates may be notified by the Government every year on April 1**,** effective 2012. It is considered necessary to provide for a three month lag between the last day of the reference period and the date when the revised rates would be affected. Accordingly, the reference period for averaging the small savings rate would be the calendar year (as was also recommended by the Reddy Committee). An exception may be made for 2011-12; for example. If the revised rate is announced on July 1, 2011, the reference period of April 2010-March 2011 could be taken.

TDS, CBS and KYC

The rationalisation of instruments is aimed at achieving public policy objectives of catering to the needs of financial security of small savers. The nomenclature of 'small' savings and the higher than market rate of interest makes it imperative to place a ceiling on investments in individual instruments so that the schemes cease to pose a fiscal burden on the Centre and the State Governments even while adequately catering to the interests of the target groups. Ceilings may also be strictly enforced, since these instruments are not subject to TDS. The Committee is not recommending any change on TDS on small savings instruments but is of the view that the issue of TDS on small savings instruments may be considered by the Government while drafting the DTC.

In the absence of the use of core banking solution (CBS) linking all post offices at present, it is possible for individuals to avoid the ceiling on various instruments by parking their savings across more than one branches. In future, since the Department of Posts is undertaking CBS in major post offices, it would be possible to enforce the ceiling for a majority of small savers.

Further, KYC may be enforced strictly to prevent money laundering/generation of black money. The computerization and the introduction of CBS among postal savings bank branches would enable monitoring of the adherence to the investment limits prescribed for various small savings instruments.

Rationalisation of Instruments

The Committee's recommendations on the rationalization of instruments of small savings are as under:

Savings Account Deposits

The Reddy Committee (2001) had recommended that as long as the rate of inflation is more than 3.5 per cent, the rate of interest on postal savings deposits may continue to be 3.5 per cent. Incidentally, the rate of interest on postal savings deposits had been aligned with the savings deposit rate of commercial banks since March 2003. The Reserve Bank has since increased the savings bank deposit interest rate from 3.5 per cent to 4.0 per cent, effective May 3, 2011 since the spread between the bank savings deposit and term deposit rates had widened significantly. The Committee is of the view that the postal savings deposit rate may be similarly raised by 50 bps to keep it in alignment with bank savings deposit rate. Further, the Reserve Bank has advised scheduled commercial banks to pay interest on savings bank accounts on a daily product basis with effect from April 1, 2010. The Committee is of the view that the Government may consider applying the same formula for the calculation of the interest on savings deposits of post offices once the post offices are fully computerised. On the issue of relaxation/removal of the ceiling, the Committee considered the following two options: if the ceiling has to be removed, the interest income may not be exempt from income tax under Section 10 of IT Act. Alternatively, if the income tax exemption is to continue, the current ceiling may be retained. Taking into account the above considerations and the need for harmonisation with the DTC code removing most tax exemptions, the Committee favours the first option.

5 Year Recurring Deposit Scheme

To improve the liquidity of the scheme which is needed more by the smaller savers, the Committee is in favour of a reduction in the lock-in period of the scheme from 3 years to 1 year. The penalty on premature withdrawal could be fixed at 1% lower rate of interest than time deposits of comparable maturity. The rate of interest could be benchmarked with G-sec yields of 5 year maturity as was recommended by the Reddy Committee. The 4 per cent commission payable to agents makes it an agent driven scheme. Financial literacy programmes should promote postal savings instruments and the commission should be progressively reduced to 1 per cent over a period of up to three years (by a minimum of 100 bps each year).

Time deposits (of 1, 2, 3 and 5 year maturity)

The postal time deposits, designed to promote thrift, may not enjoy similar liquidity as bank deposits. However, the liquidity of postal time deposits could be improved keeping in view the interest of the small savers. Accordingly, if withdrawn within 6-12 months, the Committee recommends that savings bank deposit rate may be paid (as against nil at present). If deposits are withdrawn prematurely after 1 year, a 1 per cent lower rate of interest than time deposits of comparable maturity may be offered.

Monthly Income Scheme (MIS)

Keeping in view the higher interest rate (inclusive of 5% maturity bonus) on MIS *vis-à-vis* market rates, the Committee recommends that the bonus should be abolished and the effective rate of interest be aligned with the market rate. Further, the Committee favours retaining the present ceiling on MIS as it would adequately serve the interests of the small savers. The Committee also favours a reduction in the maturity of MIS to five years with the rate of interest benchmarked to 5 year G-secs.

Senior Citizens' Savings Scheme (SCSS)

The Committee is of the view that SCSS is serving a useful goal as an instrument of social security. At the same time, the bank dominated intermediation of savings under SCSS appears to reflect the rural-urban distribution of the savers under this scheme. As a higher mark-up of 100 basis points over 5-year G-sec security (as against 25-50 basis points proposed for other schemes) is recommended, the Committee is currently not in favour of an upward revision in the investment ceiling, presently fixed at ₹15 lakh and deemed adequate, keeping in view the fiscal implications.

Public Provident Fund (PPF)

The Committee considered the suggestion of the Department of Posts and some of the State Governments of an increase in the annual investment limit on PPF to ₹1 lakh from the current ceiling of ₹70,000 to coincide with the ceiling on Section 80C of the I.T. Act. The Committee noted that in the past, the investment limit on PPF used to be usually revised in tandem with that of the exemption ceiling for Section 80C. In the last instance, however, notwithstanding the upward revision of Section 80C from ₹70,000 to ₹1 lakh, the investment limit under PPF was not raised. Keeping in view the tenor of PPF and the need to reduce the ALM mismatch of NSSF, the Committee recommends an upward revision in the investment limit to ₹1 lakh. The Committee is, however, aware that the current provisions permitting premature withdrawal/taking advance against deposits is not in sync with the objectives of the scheme. More importantly, it is not considered practicable to monitor the end use of the funds withdrawn prematurely. Keeping in view the above considerations, the Committee, therefore, recommends that the rate of interest on advances against deposits may be fixed at 2 percentage points higher than the prevailing interest rate on PPF (as against 1 per cent at present).

Savings Certificates

The Committee noted the observations made on savings certificates, viz., KVP and NSC by the Rakesh Mohan Committee that both these instruments are quite expensive in terms of the effective cost to the Government and should be discontinued. The Committee is, however, of the view that while KVP may be discontinued as it is prone to misuse being a bearer-like instrument, NSC could continue with the following modifications: (i) Two NSC instruments would be available with maturities of 5 years and 10 years; (ii) The interest rates would be benchmarked to 5 year and 10 year government securities; and (iii) income tax exemption under section 80C on accrued interest would not be available. Since income tax exemption under section 80C on deposits under NSC would be available, NSC may not be encashed before maturity. NSC would, however, continue to be eligible as collateral for availing loans from banks, as hitherto.

Benchmark and Spreads for various instruments

The benchmarks for the various instruments are recommended to be as in Table 1. As regards the spread, , the Committee recommends a positive spread of 25 basis points, *vis-à-vis* government securities of similar maturities. Exceptions are recommended only in case of 10-year NSC and SCSS as under.

- The Committee notes that NSC cannot be withdrawn before maturity, which affects its liquidity. Keeping in view the longish tenor of the 10-year NSC and the absence of liquidity, the Committee favours a higher illiquidity premium of 50bps (instead of 25 bps as in the case of other instruments).
- As regards SCSS where the rate of interest is currently fixed at 9 per cent, the Committee recommends a spread of 100 basis points over and above the secondary market yield of government securities of similar maturity.

Table 1: Benchmark for various instruments

S/No.	Instrument	Benchmark
1	Savings Deposit	No benchmark - 4% (fixed)
2	5 year Recurring Deposit	5 year G-sec yield
3	1 year Time Deposit	364-day T-Bill (primary market auction cut-off – weighted avg. for issuances during the previous calendar year)
4	2 year Time Deposit	Linear interpolation between 364-day T-Bill and 5 year G-sec
5	3 year Time Deposit	Linear interpolation between 364-day T-Bill and 5 year G-sec
6	5 year Time Deposit	5 year G-sec
7	5 year SCSS	5 year G-sec
8	5 year MIS	5 year G-sec
9	5 year NSC	5 year G-sec
10	10-year NSC	10-year G-sec
11	15-year PPF	10- year G-sec

Note: All yields from the secondary market (except 364-day T-Bill).

Administered Rates for 2011-12

For fiscal 2011-12, administered rates would be broadly in sync with the rates that are arrived at by applying the formula suggested by the Rakesh Mohan Committee (Table 2) as seen from a comparison between columns 12 &13. The Reddy Committee formula, however, suggests a higher rate of interest than that suggested by the Rakesh Mohan Committee.

Table 2: Administered Interest Rates as per Reddy and Rakesh Mohan Formula

Tenor	Annual Average of G-sec Yields for the Calendar Year			Administered Rate as per the Reddy Formula(Col.3/4 + 0.5)		Yield as per Mohan Formula.67*(3/4) + .33*(2/3)		Bench-mark (round off)		Rate (Bench-mark+ Liquidity Spread)		Current Rate	Instrument
	2007	2008	2009	2009-10	2010-11	2009-10	2010-11	2009-10	2010-11	2009-10	2010-11		
1	2	3	4	5	6	7	8	9	10	11	12	13	14
1	7.67	7.79	4.64	8.29	5.14	7.75	5.68	7.75	5.75	8.25	6.25	6.25	TD
2	7.75	7.84	5.49	8.34	5.99	7.81	6.26	7.75	6.25	8.25	6.75	6.50	TD
3	7.80	7.86	6.11	8.36	6.61	7.84	6.69	7.75	6.75	8.25	7.25	7.25	TD
4	7.81	7.87	6.42	8.37	6.92	7.85	6.90	7.75	7.00	8.25	7.50		
5	7.82	7.87	6.64	8.37	7.14	7.85	7.05	7.75	7.00	8.25	7.50	7.50	TD/RD
6	7.85	7.89	6.80	8.39	7.30	7.88	7.16	8.00	7.25	8.50	7.75	8.00	MIS/NSC
7	7.90	7.93	6.99	8.43	7.49	7.92	7.30	8.00	7.25	8.50	7.75		
8	7.92	7.95	7.07	8.45	7.57	7.94	7.36	8.00	7.25	8.50	7.75		
9	7.94	7.89	7.00	8.39	7.50	7.90	7.29	8.00	7.25	8.50	7.75	8.00	KVP
10	7.95	7.86	7.02	8.36	7.52	7.89	7.30	8.00	7.25	8.50	7.75	8.00	PPF

Based on the Committee's recommendation of the adoption of the Reddy Committee formula, 25 bps spread and calculation on calendar year basis, the administered rates are worked out for fiscal 2009-10 to 2011-12. It is seen that the rates would be marginally lower for 1 year and 3 year maturities while higher for 2,5 and 10 year maturities for 2011-12. The rate of interest on the new instrument -10-year NSC would be 8.4 per cent. The rate of interest on SCSS would be 40 basis points lower at 8.6 per cent (Table 3). If the revised rates are announced say, on July 1, 2011, the 3-month lag yields a reference period of April-March in which case the administered rates are worked out as shown in Table 4.

In view of the significantly higher yields during January-March 2011 (as compared with those during the comparable period of the previous year), the administered rates across all maturities work out to be significantly higher (ranging from 20 to 70 bps) than the current administered rates; the extent of increase, is, however, lower than the cap of 100 bps fixed by the Rakesh Mohan Committee.

Table 3: Administered Interest Rates as per the Committee's Formula (calendar year as reference period)

Tenor	Annual Average of G-sec Yields for the Calendar Year			Recommended Administered Rate (col 2/3/4+0.25)			Rounded-off Rate			Current Rate
	2008	2009	2010	2009-10	2010-11	2011-12	2009-10	2010-11	2011-12	
1	2	3	4	5	6	7	8	9	10	11
1	7.83	4.38	5.91	8.08	4.63	6.16	8.1	4.6	6.2	6.25
2	7.87	5.42	6.50	8.12	5.67	6.75	8.1	5.7	6.8	6.50
3	7.89	6.05	6.94	8.14	6.30	7.19	8.1	6.3	7.2	7.25
4	7.89	6.49	7.27	8.14	6.74	7.52	8.1	6.7	7.5	
5	7.90	6.69	7.58	8.15	6.94	7.83	8.2	6.9	7.8	7.50
6	7.93	6.85	7.67	8.18	7.10	7.92	8.2	7.1	7.9	
7	7.95	7.02	7.75	8.20	7.27	8.00	8.2	7.3	8.0	
8	7.96	7.10	7.80	8.21	7.35	8.05	8.2	7.4	8.1	
9	7.91	7.06	7.87	8.16	7.31	8.12	8.2	7.3	8.1	
10	7.92	6.97	7.86	8.17	7.22	8.11	8.2	7.2	8.1	8.00

Table 4: Administered Interest Rates as per the Committee's Formula (April-March as reference period)

Tenor	Annual Average of G-sec Yields for April-March			Recommended Administered Rate (col 2/3/4+0.25)			Rounded-off Rate			Current Rate
	2008-09	2009-10	2010-11	2009-10	2010-11	2011-12	2009-10	2010-11	2011-12	
1	2	3	4	5	6	7	8	9	10	11
1	7.07	4.50	6.51	7.32	4.75	6.76	7.3	4.7	6.8	6.25
2	7.25	5.60	6.95	7.50	5.85	7.20	7.5	5.8	7.2	6.50
3	7.42	6.28	7.23	7.67	6.53	7.48	7.7	6.5	7.5	7.25
4	7.53	6.74	7.48	7.78	6.99	7.73				
5	7.56	6.98	7.74	7.81	7.23	7.99	7.8	7.2	8.0	7.50
6	7.63	7.11	7.81	7.88	7.36	8.06				8.00
7	7.71	7.24	7.86	7.96	7.49	8.11				
8	7.73	7.34	7.89	7.98	7.59	8.14				
9	7.67	7.38	7.93	7.92	7.63	8.18				
10	7.58	7.29	7.92	7.83	7.54	8.17	7.8	7.5	8.2	8.00

Accordingly, in the above example, where the Government announces the administered rates on July 1, 2011, the rates of interest of the various instruments would be as shown in Table 5.

Table 5: Administered Interest Rates for July 1, 2011 to March 31, 2012

Instrument	Current Rate (%)	Proposed Rate (%)
Savings Deposit	3.50	4.0
1 year Time Deposit	6.25	6.8
2 year Time Deposit	6.50	7.2
3 year Time Deposit	7.25	7.5
5 year Time Deposit	7.50	8.0
5 year Recurring Deposit	7.50	8.0
5-year SCSS	9.00	8.7
5 year MIS	8.00 (6 year MIS)	8.0
5 year NSC	8.00 (6 year NSC)	8.0
10 year NSC	New instrument	8.4
PPF	8.00	8.2

Investments of NSSF

Formula for Sharing of Net Collections of Small Savings between the Centre and the States

Since the Centre and the States are expected to have same GFD-GDP/GSDP ratio of 3 per cent as per the fiscal consolidation path chalked out by the 13th FC over the medium term, the Committee recommends an equal share in borrowings from the NSSF between the sovereign and the sub-sovereign. To the extent that the rate of interest on borrowings from NSSF is higher than the market rates, the 50:50 share would ensure an equitable 'burden sharing.' Accordingly, the Committee recommends that the mandatory component for States could be lowered to 50 per cent from 80 per cent at present. The State Governments could exercise the option of either 50 per cent or 100 per cent once at the beginning of each fiscal for administrative convenience. The balance amount could either be taken by the Centre or could be on-lent to other States if they so desire, or could be on-lent for financing infrastructure.

Formula for Sharing of Net Collections between the Centre and the States of the Redemption Proceeds of Securities Issued to the Centre/States

On the terms of reinvestments of the redemption proceeds of SSGS and SCGS, the Committee recommends that the reinvestments may be as per the same terms as for fresh investments so as to improve the viability of NSSF. The total redemption proceeds may be shared between Centre and States in a ratio of 50:50 as for the net collection. The States share may be distributed amongst various States in the ratio of their previous year's gross collections.

Maturity Profile of Investments by NSSF

The Committee is of the view that the special securities issued by the Central and State Governments can have a shorter tenor of 10 years to broadly align with the maturity profile of the small savings instruments. The 5-year moratorium on redemption may be done away with and 1/10th of the amount may be redeemed each year. It is expected that with the continued rule-based fiscal consolidation initiatives taken by the Central and State Governments, lower maturity would not involve refinancing risk.

Simultaneously, State Governments could consider elongating the maturity profile of their market borrowings to 15/20 years, taking into account the risk-cost trade-offs and reissue the SDLs to reduce the illiquidity premium. Since the share of NSSF in GFD financing of State Governments is expected to decline (with the simultaneous increase in the share of the Centre), State Governments would be in a position to increase the weighted average maturity of their outstanding liabilities even with a lower maturity of NSSF.

Periodicity of Reset of interest rates on investments by NSSF

As in the case of interest rates on small savings, the interest rates on securities issued by the Central and State Governments would be announced every year on April 1.

Viability of NSSF

With a view to improving the viability of NSSF, the Committee recommends the following: First, the rate of interest on reinvestments may be brought at par with that of fresh investments. Second, downward resetting of interest rates on the assets side may not be henceforth considered without regard to the viability of the NSSF and/or corresponding reduction of interest rates on the liabilities side. Third, the maturity of instruments on the liabilities side could be aligned with those on the assets side to facilitate back-to-back on-lending by NSSF as was originally suggested by the Reddy Committee. Fourth, the return on SCGS should be brought at par with the return on SSGS and recapitalization of NSSF may be undertaken by Centre to bridge the gap between assets and liabilities of the Fund. Fifth, a reduction in the management cost and in the time lag between receipts of small savings and their investments would contribute to the improved viability of NSSF.

Rate of Interest on Investments by NSSF in SCGS and SSGS

With due consideration to the viability of NSSF, the Committee recommends that the rate of interest on securities issued by the Central / State Governments would be equal to the sum of the weighted average interest cost on the outstanding small savings and the average administrative cost. The Committee has taken into account its recommendations on the revised commission payable to the agents as also the recommendations of a Committee set up by the Government on commission payable to the postal authorities. The Committee is of the view that the average administrative cost would be around 70 bps and, hence, 70bps could be loaded on to the interest cost on small savings to determine the rate of interest on SSGS and SCGS.

Given the likely average liquidity spread of around 30 bps [25 bps in all instruments barring SCSS (100 bps) and 10-year NSC (50bps)], the Group views that the break even rate for investments by NSSF could be around 100 bps over the yield on GoI dated securities. Since the special securities would have a maximum maturity of 10 years, the interest rate on SCGS and SSGS would be around 100 bps over and above the 10-year G-sec. Contextually, the spread between the State Government and Central Government securities issued under the market borrowing programme is placed at around 30 - 80 basis points in the recent years and hence, the rate of interest on SCGS and SSGS would be marginally higher than that of the SDLs. This is unavoidable keeping in view the administrative costs involved and the liquidity spread proposed for the small savers (unlike in advanced economies, where no such spread is offered). The rate of interest on investments by NSSF could be modulated each year to ensure that NSSF is a no-profit no-loss entity.

Alternative Instruments for Investments by NSSF

At present, investments by NSSF are free from default risk and small savings enjoy the implicit guarantee of the Government of India. The Committee refrains from recommending an investment avenue that could involve credit risk to the small savers. At the same time, in view of large infrastructure deficit and the relatively larger maturity of small savings instruments vis-à-vis, instruments, such as bank deposits, small savings could play a crucial role in the financing of infrastructure. In view of the above, the Committee recommends that NSSF could invest in securities issued by infrastructure companies, such as, IIFCL, NHAI and IRFC that are wholly owned by the Government. These securities would be non-marketable. The investments by NSSF in these entities may be carved out from the Centre's portion; this would eliminate uncertainty of loans that States will borrow from NSSF. The resources available from NSSF would substitute for alternative funding sources. The identified entities could be permitted to issue securities for 10/15 year maturity. The rate of interest to be charged by the NSSF on infrastructure bonds could be at a spread of 100 basis points above the secondary market yield on GoI dated security of corresponding maturity to cover the management cost and the cost of maturity transformation.

Administrative Costs of NSSF Operations

Commission Payable by the Centre to Small Savings Agents

At present, the Central Government pays commission at the rate of 4 per cent to small savings agents under Mahila Pradhan Kshetriya Bachat Yojana (MPKBY) on the P.O. recurring deposits scheme, which makes it essentially an agent driven scheme. The Committee is of the view that financial literacy programmes should promote postal savings instruments and the commission could be reduced by a minimum of 100 basis points each year to 1 per cent on PORD scheme within three years. Further, no commission may be payable on PPF and SCSS (as against commission of 1 and 0.5 per cent, respectively paid currently). A commission of 0.5% may be payable for all other schemes (viz., time deposits, MIS and NSC (as against 1 per cent paid currently).

Commission Payable by States to Small Savings Agents

The 13th FC had noted the incentives paid by State Governments in respect of small savings mobilisation and stated that all such incentives that either add to the cost of administration or affect normal market linked subscription should be proactively withdrawn by the States. The Committee agrees with the above recommendations of the 13th FC and notes that agency charges distorts the investment pattern and increases the effective cost of borrowings for NSSF. While many States have already abolished payment of agency commission, the remaining States may reduce the agency charges in a phased manner with the ultimate objective of eliminating it. In order to discourage the State Government from giving any extra incentive, the Committee recommends that the incentive paid by the State Government may be reduced from the incentive paid by Central Government to the agents.

Commission Payable by MoF to Department of Posts

It is felt that the cost of operation and the remuneration to Department of Posts should decline with the introduction of new technology and computerization of post offices. Vide OM dated April 9, 2010, the Central Government has set up an Expert Group to review the rates of agency charges payable to Department of Posts for operation of Small Savings Instruments.

Reducing the Time lag between Receipts and Investments

The Committee recognizes the need to reduce the two to three months' lag between the receipts of small savings and investments by NSSF to at most one month in view of the developments in the technology. Instantaneous release would have reduced cumulative loss of NSSF by ₹6,298 crore. The delay in collection and investment should be brought down to 15 days.

Kerala Treasury Savings Bank Scheme

The Committee examined the Kerala Treasury Savings Bank Scheme which is a legacy from the pre-independence days whereby the Kerala Treasury accepts deposits from the public. The Committee recommends in favour of the phasing out of the Kerala Treasury Savings Deposit Scheme in view of the distortionary impact on the interest rate structure and distortion of the fiscal discipline. Further action in this regard may be taken by Government of India.

Other Issues

The Committee recommends the setting up of a monitoring Group with members drawn from the MoF, RBI, DoP, SBI and other select banks as also select State Governments, to resolve the various pending operational issues. The Monitoring Group would, *inter alia*, address the data discrepancy in the operations of NSSF, establish a mechanism to reduce the time lag between the inflows into NSSF and outflows from NSSF.

Implementation of the Recommendations as a Package

The Committee is of the view that the entire gamut of its recommendations on the rationalisation of the small savings schemes and the cost of management of these schemes together with the terms and avenues for deployment of the receipts of the NSSF need to be implemented as a package in order to ensure the viability of the NSSF. This is because each of the recommendations, looked at in isolation, is not independent in itself. These recommendations need to be viewed in totality and therefore, merit a holistic implementation.

1. Introduction

An important aspect of financial sector reforms over the past two decades has been the deregulation of interest rates. Accordingly, with a view to promoting price discovery, auctions of Central Government's open market borrowings and the State Development Loans (SDLs) were introduced in 1992 and 1999, respectively. Since 2006-07, the entire market borrowings of State Governments are conducted by way of auctions facilitating price discovery. Interest rates of sovereign retail debt instruments, viz., savings bonds and small savings, are administered by the Government and this component continues to have a significant share in the outstanding liabilities of the Government of India. With a view to encouraging retail participation in auctions of central and State Government securities, 5 per cent and 10 per cent, respectively, of the notified amounts in auctions of Central and State Government securities, are reserved for retail participation since 2002 and 2009, respectively.

Savings bonds and small savings instruments serve the objectives of social security and as tools of resource mobilisation. The design of these instruments does not reckon modern sovereign debt management objective of the minimisation of the cost of borrowings subject to a prudent degree of risk. Recent developments indicate that administered rates can be rigid downwards reflecting the predominant importance attached to the social security. This has certain implications. If the administered interest rates are not in sync with the interest rates determined through the price discovery process, it distorts the overall interest rate structure and impedes allocative efficiency. A policy dilemma arises between the need to provide instruments of financial security to the small savers and the debt management objective of the minimisation of cost of borrowings of the Centre and the States on the other. Further, the issue of the sharing of the cost of small savings collections has been an issue of contention between the Centre and the States as noted by the Thirteenth Finance Commission (13th FC) in its report submitted to the Government in December 2009. If small savings are to be regarded primarily as instruments of social security and are not to become cost efficient instruments for public debt management, the need for appropriate targeting of the instruments for the specific social purpose that small savings instruments are required to serve, achieves significance.

1.1. Observations of the 13th Finance Commission

The 13th FC has noted that the States have had various issues with the overall scheme regarding the inflexibility of having to borrow based on availability rather than requirement, asymmetry between the effective interest rates to the States and the Centre and the difference between the cost to the NSSF and the States.

In view of the continued asymmetry in the average rate of interest paid by the States *vis-a-vis* that of the Centre even after the implementation of the recommendations of the NDC sub-committee, the 13th FC felt that there was a case for relief to the States on loans advanced from the NSSF and recommended that the loans contracted till 2006-07 and outstanding at the end of 2009-10 be reset at a common interest rate of 9 per cent per annum in place of 10.5 per cent or 9.5 per cent. The repayment schedule, however, should remain unchanged. The total benefit that would accrue to State Governments is ₹13,517 crore during the award period and would aggregate to ₹ 28,360 crore by the maturity of the last loan coming under purview.

The 13th FC recognised that the above relief recommended by it would only address the interest asymmetry between the Centre and the States. Noting that the issue of high interest rate on these instruments arises because of the administrative mechanism presently in place, it suggested that the structural problems in the existing arrangement need to be reviewed.

States had also raised issues before the 13th FC about the tenor of this loan, extending to 25 years, which has been used to justify the high interest rate and has led to a situation where states are locked with fixed interest debt for a long time. There is a significant mismatch between the maturity period of five to seven years for most small savings instruments and the term of the loan extended from NSSF.

The 13th FC suggested that reforms are required in overall administration of the Fund and the small saving instruments. In brief, the 13th FC has favoured comprehensive reforms in the overall management of NSSF and recommended, against this background, that all aspects of the design and administration of the scheme be examined with the aim of bringing transparency, market linked rates and other, much needed reforms to the scheme.

In addition, the 13th FC observed that some **reforms are also required at the state level**. In the past there has been a practice of giving various **incentives such as cash awards** to officials and other similar measures to promote subscription to small savings instruments. These measures also interfere with normal market dynamics. While most of these incentives, like awards to officials, have outlived their utility, all such incentives that either add to the cost of administration or affect normal market linked subscription, should be proactively withdrawn by the states.

1.2. Action taken by the Government of India on the Recommendations of the 13th FC

The Government accepted the recommendations of the 13th FC in principle and decided to set up a Committee to look into the recommendations of the 13th FC and related issues and recommend on modalities for implementation of the recommendations of 13th FC. The broader objective of setting up the Committee is to recommend on the "much needed reforms to the scheme". Since the recommendations of 13th FC are comprehensive and cover other structural aspects like interest rate mismatch, tenor mismatch and other administrative matters, the Union Cabinet accorded approval for constituting a Committee to work out detailed modalities for implementation of this recommendation. This was reported in Parliament in the explanatory memorandum as to the action taken on the recommendations made by the Thirteenth Finance Commission tabled in both houses of the Parliament on 25th February, 2010.

1.3. Constitution of the Committee and Terms of Reference

Consequent to this decision, Ministry of Finance, vide its Order No. 5-2/2010-NS-II dated 8th July, 2010 constituted this Committee chaired by Smt. Shyamala Gopinath, Deputy Governor, Reserve Bank of India. Other members of the Committee are as under:

1.	Shri Shaktikanta Das	Additional Secretary (Budget), Ministry of Finance, GoI
2.	Shri R Sridharan[1]	Managing Director, State Bank of India
3.	Dr. Rajiv Kumar	Secretary General, Federation of Indian Chambers of Commerce and Industry
4.	Shri Anil Bisen	Economic Advisor, Ministry of Finance, GoI
5.	Shri V K Kanade/ Shri Sudhir Shrivastava	Principal Secretary (Finance), Government of Maharashtra
6.	Shri C M Bachhawat	Principal Secretary (Finance), Government of West Bengal

The terms of reference of the Committee are as under:

a. to review the existing parameters for the small saving schemes in operation, and recommend mechanisms to make them more flexible and market linked;

[1] Shri R Shridharan was nominated in the Committee vide Order No. 5-2/2010-NS-II dated 17.09.2010 replacing Shri J M Garg, Chairman and Managing Director, Corporation Bank on his appointment as Vigilance Commissioner.

b. to review the existing terms of the loans extended from the NSSF to the Centre and States and recommend on the changes required in the arrangement of lending the net collection of small savings to Centre and States;
c. to review and recommend on other possible investment opportunities of the net collection from small savings and the repayment of NSSF loans extended to States and Centre;
d. to review and recommend on the administrative arrangement including the cost of operation; and
e. to review and recommend on the incentives offered on the small saving investments by the States.

While making its recommendations, the Committee was also expected to consider the following:

a. The importance of small savings in the overall savings in the economy especially its contribution in promoting savings amongst small investors.
b. The need of NSSF to be a viable fund ensuring the expenditure in form of interest payment to investors and administrative costs are met by the return on investment made from the net collections of small savings.
c. The overall debt levels of the Centre and States and the fiscal targets prescribed by 13th FC.

The Budget Division, DEA, MoF and IDMD, RBI jointly provided secretarial assistance to the Committee.

1.4. Previous Committees

In order to address various issues relating to administered interest rates, small savings, PF, etc., several Committees/Working Groups were set up by the Government of India and the Reserve Bank from time to time. Various Committees/task forces/Commissions in the past have deliberated on the issues related to small savings. These include: Rangarajan Committee (1991), RV Gupta Committees (1998 & 1999), Dave Committees (1999, 2000), Reddy Committee (2001), informal task force of RBI (2003), Rakesh Mohan Committee (2004), Vajpayee Committee (2005), NDC Sub-committee chaired by Hon’ble FM (2007) and the Thirteenth Finance Commission (2009). The details of the recommendations of the earlier Committees are available in the Report of the Reddy Committee (2001). The recommendations and the status of the implementation of Reddy and Rakesh Mohan Committees are given in Annex 8.

1.5. Meetings and Deliberations

The Committee held eight meetings. In its 1st meeting held on July 23, 2010 at New Delhi, the Chairperson flagged the importance of striking a balance between the need to safeguard the interests of the small investor and the viability of the NSSF. A presentation was made by Deputy Secretary (Budget) highlighting the small saving schemes, National Small Savings Fund (NSSF) and the recommendations of the Thirteenth Finance Commission with regard to NSSF. The Terms of Reference of the Committee and the possible approach was discussed. To assess the utility of the schemes and their role in overall financial inclusion, members suggested that the gross collection organized geographically between, metro, urban, semi-urban and rural areas needs to be examined. The Chairperson directed that Department of Posts and Banks should be asked to provide this data. It was decided, inter alia, to study (i) the public Policy purpose expected to be served by each scheme, (ii) cross-country practices on small savings schemes to study, inter alia, the rationale, benchmark, costs, and implications for the fisc and public debt management (iii) seek information from the Department of Posts on collection under various schemes geographically organized to assess their utility within the overall objective of financial inclusion and to invite representatives from State of Bank India and Department of Posts to make a presentation in the next meeting on the small saving schemes and the public policy objective served by them, (iv) devise a questionnaire for response from the State Governments on the sharing formula of the NSSF, and other issues (v) explore possibilities of delinking of the releases to the States from the collection in that State and lending based on the requirement, and (vi) also explore other investment avenues for net small savings collections.

In its second meeting held at RBI, Mumbai, on September 6, 2010, as decided in the 1st meeting, Department of Posts and SBI were invited to present the overview on NSSF schemes. There were also presentations on the rationalization of the scheme as also on the cross-country experience on retail debt including postal savings by RBI officials. On September 24, 2010, a meeting was held between the Chairperson and the MoF - RBI Secretariat to discuss, inter alia, the questionnaire and the structure of the Report.

In its third meeting held on September 30, 2010, the Committee was informed that the questionnaire had been forwarded to all the State Governments soliciting their response by October 15, 2010. It was also decided to invite all the States to obtain feedback on the questionnaire and to enable the Group to find a common ground among the various stakeholders on matters related to NSSF. The draft Structure of the Report was discussed and approved by the Group and it was decided to initiate the process of drafting the Report to enable a structured discussion on the recommendations in the next meeting among the members and the officials of the Secretariat. The Expert Group headed by Chief Advisor (Cost) for making recommendations on the remuneration payable to Department of Posts for operation of Small Savings Schemes also made a presentation, which, inter-alia, described the approach being followed by the Group in determining the principles that would govern the amount of remuneration and issues related to the cost of managing the NSSF, such as agency commission payable to DoP and to agents.

As a follow up of the decision taken in the third meeting, the Committee solicited the views of the Southern and the Western States in its fourth meeting held on October 22, 2010 at RBI Chennai and the Northern, Eastern and North Eastern States in its fifth meeting held on November 25, 2010 at RBI, New Delhi. These views as also the views of the Department of Posts were taken into cognizance for finalising the recommendations.

In its sixth meeting held in Mumbai on December 28, 2010, seventh meeting held in Mumbai on April 13, 2011 and eighth meeting held in New Delhi on May 27, 2011, the Committee deliberated upon, and finalised the recommendations.

The Committee is grateful to Dr. K.C.Chakrabarty and Dr. Subir Gokarn, Deputy Governors of the Reserve Bank of India for sharing their views on an earlier version of the draft Report. The Committee profoundly thanks the senior RBI officials – Dr.Janak Raj, Shri B.M.Misra, Shri A.B.Chakraborty and Shri S. Chatterjee for their invaluable contributions.

1.6. Acknowledgements

The Committee would like to place on record its deep appreciation of the excellent secretarial support provided by a team of officials from the Budget Division. The Committee would also like to place on record its deep appreciation for the outstanding professional contribution and analytical inputs of Shri A.K.Mitra, Assistant Adviser, Reserve Bank of India and Shri Ritvik Pandey, Deputy Secretary, Department of Economic Affairs, Ministry of Finance, Government of India, in the preparation of the Report.

The Committee acknowledges, with thanks, the arrangements made for its meetings and the hospitality extended by the team of officials led by the Chief General Manager, Internal Debt Management Department at the RBI Central Office, Mumbai and the Regional Director, New Delhi office, RBI.

1.7. Plan of the Report

The Report has eight Sections and summary of recommendations. Section 2 analyses the small savings schemes and the National Small Savings Fund. Critical issues arising from the description are indicated in Section 3. Section 4 covers the recommendations on the rationalisation of small savings schemes. Section 5 discusses the benchmark, spread and periodicity of reset of administered interest rates on small savings. Section 6 details the Committee's recommendations on the sharing of the net collections of small savings between the Centre and the States as also the alternative avenues for investment after meeting the funding requirements of the Centre and the States of the residual amount. Section 7 deals with the recommendations on the management cost of NSSF. Section 8 details the recommendation on the Kerala Treasury Savings Deposit Scheme, which is similar to NSSF.

2.
Small Savings Schemes and NSSF

Small Saving schemes have been always an important source of household savings in India. Although these instruments are technically not Government Securities and do not have any explicit Government guarantee, their legacy has given them characteristic of being equivalent to that of a Sovereign liability. These schemes have been extremely popular amongst a large number of small investors in India who seek to invest in a secure instrument. At the same time, these instruments have been treated as a means of providing social benefit to the small savers.

2.1. Small Savings Schemes and their Public Policy Objectives

2.1.1. Historical Background

Small Savings Schemes date back to 1882 when Post Office Savings Bank was started in the country. Post Office Savings Bank was designated as Government Savings Bank vide Section 3(B) of Government Savings Bank Act 1873 and the main objective of this scheme was to encourage habit of savings in all segments of society and to bring the small savings into the mainstream economy for building the nation.

The Government formulates a basket of small savings schemes to meet the varying needs of different groups of small investors. In respect of each scheme, statutory rules are framed by the Central Government indicating the various details including the rate of interest and the maturity period. The schemes are operated through the countrywide network of about 1.5 lakh post offices, more than 8,000 branches of the public sector banks and select private sector banks and more than 5 lakh small savings agents. About 90 per cent of postal branches are located in rural areas. While post offices run all the schemes, the Scheme of Public Provident Fund and Senior Citizens Savings Scheme are also operated through the banks. The legislative framework governing the various schemes as also the salient features of the small savings instruments are given in Annex 1 & Annex 2. Being liabilities of the Central Government, the schemes are perceived to be devoid of any risk and a surrogate for social security among the public.

Apart from small savings, there are two other components of sovereign retail debt. These are savings bonds, which are non marketable, while the other component is carved out from the issuances of marketable Government securities. At present, the only non marketable sovereign retail debt instrument is the 8% taxable savings bonds, 2003.

2.1.2. Evaluation of Small Savings Schemes and Public Policy Served by Them

Small savings instruments can be classified under three heads. These are: (i) postal deposits [comprising savings account, recurring deposits, time deposits of varying maturities and monthly income scheme(MIS)]; (ii) savings certificates [(National Small Savings Certificate VIII (NSC) and Kisan Vikas Patra (KVP)]; and (iii) social security schemes [(public provident fund (PPF) and Senior Citizens' Savings Scheme(SCSS)]. The two most popular instruments are MIS and KVP together accounting for nearly a half of the total outstandings as at end-March 2010. A quarter of the outstanding small savings is accounted for by social security schemes (PPF and SCSS). Postal deposits and NSC together account for the balance 25 per cent. At 16.3 per cent, the share of postal deposits that directly compete with that of bank deposits is not very significant. There appears to be urban bias in ownership of social security schemes. While PPF with post offices amounted to ₹26,096 crore as at end-March 2010, PPF with SBI amounted to ₹1,56,582 crore. Of the outstanding amount in PPF with SBI, 87 per cent is in urban and metropolitan areas.

The importance of small savings instruments in the promotion of financial savings and provision of social security appears to have changed with the structural transformation of the Indian economy; increasing geographical penetration and perceived safety of the financial sector, particularly following the Bank Nationalisation; provision of social safety nets through the introduction of various schemes, such as old age pension, NREGA, etc.; the implementation of the rule-based fiscal consolidation by the Centre as also the State Governments; the development of marketable instruments enabling price discovery; and the implementation of modern debt management practices with the objective of reduction of costs of borrowings while containing risks.

Table 6: Interest Rates on select instruments

(In per cent)

Tenor	Small Savings Scheme	Interest Rate on Small Savings Schemes
	Savings Deposit	3.50
1 Year	Time Deposit	6.40#
2 Years	Time Deposit	6.66#
3 Years	Time Deposit	7.45#
5 Years	Time Deposit	7.71
5 Years	Recurring Deposit	
5 Years	SCSS	9.31
6 Years	MIS	8.82#
6 Years	NSC	8.16
8 Years 7 months	KVP	8.41#
15 years	PPF	8.00

Effective Rates. There is no tax benefit in these instruments

Note

1. Interest on savings deposits (unlike bank deposits) is fully exempt from tax under Section 10 (11).
2. Time deposits of 1, 2, 3 & 5 year maturities and carrying interest rates of 6.25, 6.50, 7.25 and 7.50 per cent, respectively, are compounded quarterly.
3. Savings up to ₹1,00,000 p.a. in 5 year time deposits is deductible from income chargeable to income tax under Sec 80C. Interest income is taxable.
4. Interest rate of 9% pa is available on SCSS, subject to TDS. Initial deposit qualifies for Section 80C.
5. NSC carries an interest rate of 8.00 per cent and is yearly. Interest accrued on NSC every year is deemed to have been reinvested under the scheme and therefore, enjoys rebate under Section 80C.
6. Savings up to ₹70,000 p.a. in PPF is deductible from income chargeable to income tax under Sec 80C. Interest on PPF is fully exempt from tax under Section 10 (11).
7. MIS offers rate of interest of 8% and a bonus of 5% at the time of maturity.

2.1.3. Trend in Small Savings Collections

The annual rate of growth of small savings exhibited a sharp volatility reflecting the changing public preference reflecting the relative attractiveness of alternative savings instruments, mainly commercial bank deposits (Table 7). The trend of net small saving collection over a period of last twenty years can be seen in Figure 1. The composition of the net collection can be seen in Figure 2.

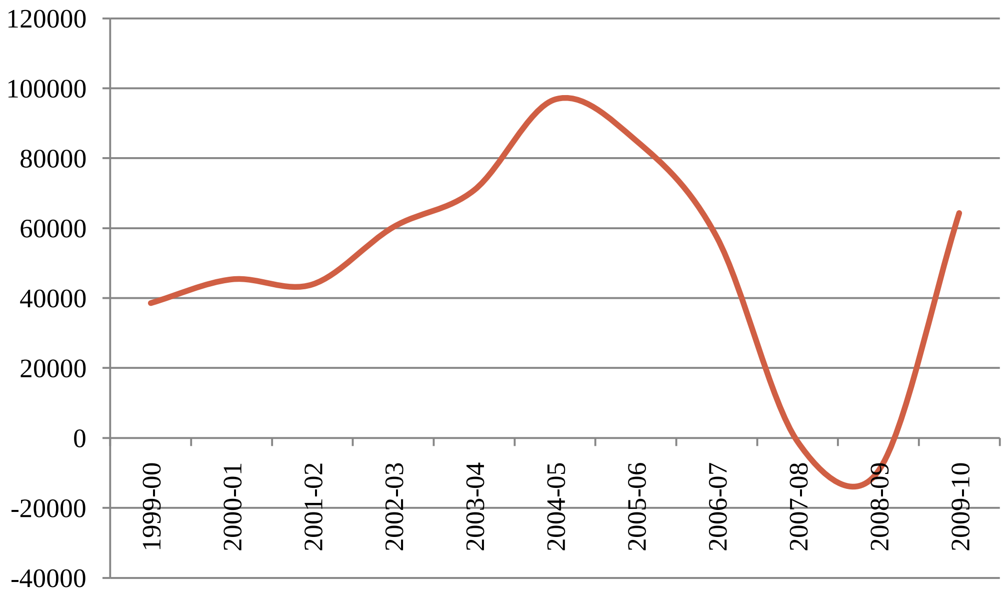
2.1.4. Domestic Household Financial Savings

The promotion of long-term and contractual household financial saving was one of the tools to accelerate the pace of economic growth in the Planning era that began in 1951. The penetration of postal offices in unbanked rural areas provides exclusivity to small savings instruments in the ownership of financial instruments of the households inhabiting these areas.

Table 7: Growth in Small Savings Deposits vis-à-vis Bank deposits

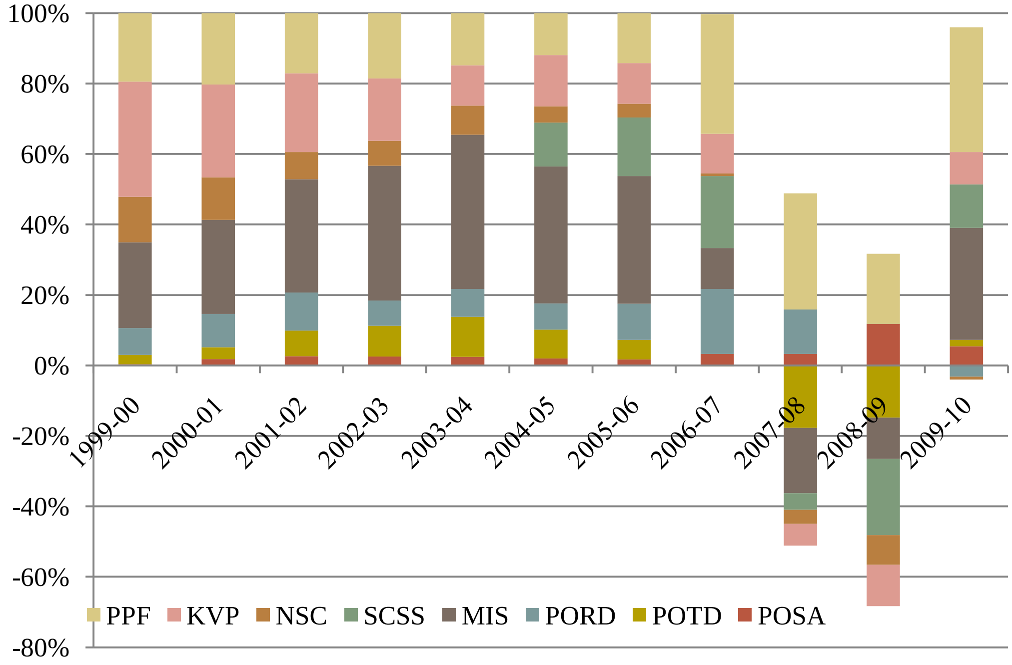
Year	Outstanding Aggregate Bank Deposits (₹ Crore)	Growth Rate in Bank Deposits (Per cent)	Outstanding Small Savings Collections (₹ Crore)	Growth Rate in Small Savings Deposits (Per Cent)
1	**2**	**3**	**4**	**5**
1999-00	8,13,345		2,14,791	
2000-01	9,62,618	18.4	2,60,149	21.1
2001-02	11,03,360	14.6	3,04,057	16.9
2002-03	12,80,853	16.1	3,64,390	19.8
2003-04	15,04,416	17.5	4,35,241	19.4
2004-05	17,00,198	13.0	5,32,029	22.2
2005-06	21,09,049	24.0	6,17,116	16.0
2006-07	26,11,933	23.8	6,74,611	9.3
2007-08	31,96,939	22.4	6,73,589	-0.2
2008-09	38,34,110	19.9	6,64,137	-1.4
2009-10	44,92,826	17.2	7,28,447	8.8
2010-11 (RE)			7,93,447	8.2

Figure 1: Trends in small saving collections over last twenty years



The share of small savings as a percentage of net financial savings of households increased sharply from 7.9 per cent in 1996-97 to 22.3 per cent in 2004-05. Thereafter, the share declined and even turned negative during 2007-08 and 2008-09 as the alternative savings instruments became relatively more attractive. The share was only marginally positive during 2009-10 (RE) and is expected to increase modestly in 2010-11 (BE). Since 2005-06, the rate of growth of small savings was lower than that of aggregate deposits of commercial banks.

Figure 2: Composition of Small Saving Collection



2.1.5. Geographical Spread of Small Savings

The sharp rise and fall in the small savings collections and its share in financial savings, changes in the geographical coverage and investor profile of small savings are in part a reflection of the structural transformation of the Indian economy and the increasing maturity, perceived security and widening coverage of the formal financial system. First, there has been a structural transformation of the Indian economy with the share of agriculture declining to around 1/6th of the GDP from around ½ in the 1950s. Second, there has been an increasing penetration of banks, including RRBs, in the semi-urban and rural areas after Bank Nationalisation and there is now a greater degree of substitutability between bank deposits and small savings instruments. Hence, the investor base of small savings in the rural areas does not appear to be as segmented as it was in the past.

2.1.6. Social Security to the "Small Saver"

The basic philosophy of small savings is to provide a secure avenue for savings by individuals in both rural and urban areas. Over 80 per cent of the 1,50,000 post offices are located in rural areas, many of which are in unbanked areas, implying that small savings is the only instrument available for formal financial savings in the remote areas. Presumably, reflecting this philosophy of small savings as an instrument of social security, the Government did not alter the interest rates in response to the sharp volatility in market rates after March 2003. Small savings instruments are, however, not efficient instruments of providing subvention in the form of higher interest rates in view of the difficulty in identifying and targeting the ‘small’ savers. Fiscal prudence suggests direct targeting of subsidy exclusively to the socially needy.

2.1.7. Postal Savings and Other Retail Debt: A Cross-Country Experience

Cross-country studies on retail participation in the financing of the government’s fiscal deficit are in the following three forms of instruments: (i) marketable government securities issued predominantly through the auction route; (ii) non-marketable retail debt instruments marketed through various channels of distribution, including post offices; and (iii) postal savings instruments. Among these instruments, retail participation in marketable government securities is not significant and this segment is dominated by the whole sale institutional investors.

In several advanced economies, the policy on retail debt is primarily guided by the objectives of sovereign debt management, viz. minimisation of cost over the medium to long-term subject to a prudent degree of risk. Accordingly, the sale of retail instruments is evaluated primarily in terms of economic cost effectiveness. Retail debt instruments serve to broaden the participation of investors in sovereign debt instruments and thereby contribute to the reduction of cost of borrowings. The interest rates on sovereign retail debt in some of the major advanced economies are market linked but fixed at a rate lower than that of the marketable debt instruments. The policy on retail debt in a majority of developed economies is, however, markedly different from that of emerging market economies. Other countries, including many emerging market and developing economies, also take into account social goals such as social security, financial education and to encouraging savings and may appropriately determine the interest rates to serve these objectives. The cross-country differences in the approaches stem , *inter alia*, from the different approaches and perspectives to sovereign debt management, technological development, availability of alternative instruments for social security, fiscal situation, financial literacy and savings habit of the population.

In the US, there are two kinds of retail debt instruments – nominal bonds (EE) and inflation linked (I) bond. In respect of EE bonds issued after 2005, the rate of interest (coupon) is fixed for the entire maturity up to 30 years. The saver is thus forced to bear the risk of subsequent change in the rate of interest since there is no market where he can liquidate the instrument. The savers can, however, encash the bond after a year with a penalty equivalent to 3 months interest and after five years without any prepayment penalty. The Treasury issues a new series of EE bonds every six months with a new rate of interest. While the new EE bond series - issued from 2005 - are fixed rate instruments, the rate of interest on the EE bonds issued before 2005 is reset every six months at a marginally lower rate than that of the yield of a 5 year G-sec. Hence, the interest rate risk which was borne by the issuer pre-2005 has been since shifted to the retail investor. In the US, retail debt constituted only a small proportion of the outstanding liabilities of the

Central Government. The share of retail debt declined from 3 per cent in the early 1990s to 1.5 per cent in 2010.

Another important development in the US is that paper based instruments would no longer be available to the public from 2011, beginning with government employees from October 1, 2010 and the entire new retail debt would be exclusively in demat form. Subscription to instruments in demat form presumes financial literacy, awareness and availability of internet facilities that may not be available to a wide section of the society in the emerging market economies

In countries, such as UK and South Africa, while paper based products continue to exist, the government's attempt is to reduce transactions costs by the introduction of web based transactions in retail debt and also by letting departmental stores to sell retail debt instruments. In the UK different instruments are distributed through the post offices and the internet; the former yielding a lower rate of return in the UK presumably to offset the higher operational costs.

In the UK, retail debt instruments are also sold through the post offices whereas in the US, post offices have ceased to act as agents of the Treasury since 1967. Interestingly, the most popular retail debt instrument in the UK is a monthly lottery where the pooled retail savings collected in a month is distributed among the winners currently yielding an effective annual rate of interest of 1.5 per cent. In the UK, retail debt had been losing its sheen in the absence of technological innovations. The introduction of the web enabled technology was motivated by the need to reduce transaction costs to the Government and the retail investor.

Like the US, UK, South Africa and Japan offer inflation linked savings instruments. As in the case of TIPS, I bonds in US do not offer protection of the nominal value of the principal in the event of deflation; in the UK, on the other hand, IIBs and inflation protected retail debt instrument offer guaranteed protection to the principal.

Among the Asian countries, postal savings is an extremely important component of mobilising retail savings. Japan, like India, offers both postal savings products as also float retail debt instruments. Japan's savings bank is twice the size of its biggest commercial bank – Bank of Tokyo Mitsubishi. In Japan, Germany and China, post banks operate almost like a bank taking credit risk on its asset portfolio. Credit operations appear to reflect quasi fiscal operations in the form of extension of micro credit and rural credit. The post banks, like other banks, are regulated by the financial sector regulator in these countries. In Japan having debt-GDP ratio over 200 per cent, Japan's postal savings bank is a major subscriber of JGBs and has contributed significantly to Japan's debt sustainability.

In some pockets of Africa, postal savings continues to be the sole formal institution for public savings in far flung rural areas; the other alternative being parking savings with the community leader in payment of a fee for his services!

In India, participation in retail debt instruments is available in three forms: (i) participation as a non-competitive bidder in the auction of marketable government securities, (ii) subscription to retail debt instruments, such as 8 per cent taxable bonds (popularly known as RBI relief bonds) and (iii) postal savings instruments. The mandate of this Committee pertains to the small savings instruments issued under NSSF.

Details of cross-country experience are indicated in Annex 11**.**

2.2. Constitution of NSSF

Prior to April 1999, deposits and withdrawals by subscribers were made from the public account and interest payments to subscribers and interest receipts from the States were recorded in the revenue account of the Consolidated Fund of India (Annex 3). Disbursement of loans against small savings made to the States and repayment of such loans were recorded in the capital account of the Consolidated Fund of India. All the payments against the cost of operating the fund were also debited from the Consolidated Fund.

The Government of India set up a Committee during January, 1999 "to work out the modalities of transfer of the work of small savings to an organisation outside the Government of India" (Chairman: R. V. Gupta).

The *Committee on Small Savings* (Chairman: Shri. R.V. Gupta), which submitted its report in February 1999, examined and identified the following lacunae in the prevailing accounting procedure of the small savings: (i) There was no formal transfer of funds collected under small savings in the Public Account to the Consolidated Fund. (ii) Loans to the States/Union Territories were made out of the Consolidated Fund without corresponding receipts. (iii) Transactions in small savings could not be segregated for the purpose of analysing their financial viability.(iv) The on-lending to States from the small savings collections was treated as part of Central Government's expenditure and added to Central Government's fiscal deficit. Therefore, other things remaining the same, an increase in small savings collections led to an increase in fiscal deficit.

In the light of the above, the Committee recommended creation of a separate Fund called the National Small Savings Fund (NSSF) within the Public Account. The Committee observed that segregating all transactions pertaining to the small savings schemes under the umbrella of the NSSF would lend transparency to the accounting system and thus, pave the way for correction. It would also facilitate informed decisions regarding a) amending the terms of government securities issued to the Fund, b) increasing/ reducing the interest rate on small savings schemes and c) the cost of management. Furthermore, it would formalise the Central Government's use of small savings collections accruing in the Public Account to finance its fiscal deficit. Further, NSSF was expected to lend transparency to the accounting system, enable an easy examination of the income and expenditure of small savings process, bring into sharp focus the asset-liability mismatch and pave the way for correction.

The Government accepted the recommendation and the NSSF came into existence on April 1, 1999. The Fund is administered by the Government of India, Ministry of Finance (DEA) under National Small Savings Fund (Custody and Investment) Rules, 2001, framed by the President under Article 283(1) of the Constitution.

The objective of NSSF is to de-link small savings transactions from the Consolidated Fund of India and ensure their operation in a transparent and self-sustaining manner. Since NSSF operates in the public account, its transactions do not impact the fiscal deficit of the Centre directly. As an instrument in the public account, the balances under NSSF are direct liabilities and constitute a part of the outstanding liabilities of the Centre. The NSSF flows affect the cash position of the Central Government. Details of operation of NSSF are indicated in Annex 3.

After the constitution of NSSF, one of the major developments relating to the NSSF was the recommendation of the Sub-Committee of the National Development Council. After the Fund was in operation for six years, many of the States had expressed concerns about the terms and conditions of the loans being extended from NSSF. The Sub-Committee examined the issues and gave certain relief to the States. Details of the recommendations of the Sub-Committee of the National Development Council are indicated in Annex 9.

2.3. Balance Sheet of NSSF

All deposits under small savings schemes are credited to NSSF and all withdrawals by the depositors are made out of accumulations in the Fund. The collections under the small saving schemes net of the withdrawals are the sources of funds for the NSSF (Table 8).

2.3.1. Investments by NSSF in Central and State Government Securities and in IIFCL

NSSF invests the net collections of small savings in the special State Government securities (SSGS) as per the sharing formula decided by the Government of India. The remaining amount is invested in special Central Government securities (SCGS) with the same terms as that for the States. These securities are issued for a period of 25 years, including a moratorium of five years on the principal amount. Hence repayments commence from the sixth year onwards with one twentieth of the principal becoming payable every year. The special securities carry a rate of interest fixed by GoI from time to time. The rate of interest has remained unchanged at 9.5 per cent per annum since April 1, 2003. The NSSF is also permitted to invest in securities issued by IIFCL. An amount of ₹1,500 crore was invested in a 15 year paper issued by IIFCL at 9% with bullet redemption in 2007-08.

2.3.2. Reinvestment by NSSF in Central Government Securities

The amounts collected in the fund through redemption of the securities mentioned above are reinvested in 20-year Central Government securities at prevailing market rate of government securities of comparable maturity. The rate of interest in the 20 year securities ranged from 5.95 – 8.21 per cent which was significantly lower than that charged on the fresh investments on special securities issued by the Centre/States (Figure 3).

Table 8: Sources and Application of Funds of NSSF

	2006-07	2007-08	2008-09	2009-10	2010-11 (RE)	2011-12 (BE)
SOURCES OF FUNDS						
OPENING BALANCE	**617117**	**674611**	**673589**	**664137**	**728447**	**799387**
1. Savings Deposits	121701	105286	121272	185797	207340	201400
Less - Disbursement	*-91755*	*-115078*	*-130490*	*-152119*	*-147300*	*-147300*
Net	29946	-9792	-9218	33679	60040	54100
2. Savings Certificates	34535	21366	22391	31685	29800	29800
Less - Disbursement	*-25521*	*-25175*	*-27555*	*-25832*	*-25800*	*-25800*
Net	9014	-3809	-5164	5854	4000	4000
3. Public Provident Fund	25945	21057	14847	33449	16800	16800
Less - Disbursement	*-7411*	*-8478*	*-9916*	*-8672*	*-9900*	*-9900*
Net	18535	12579	4930	24777	6900	6900
Net collections during the year	**57495**	**-1023**	**-9451**	**64309**	**70940**	**65000**
CLOSING BALANCE	**674611**	**673589**	**664137**	**728447**	**799387**	**864387**
APPLICATION OF FUNDS						
OPENING BALANCE	**594920**	**658665**	**654191**	**654053**	**691514**	**753454**
1. Investment in Central Govt. Securities against outstanding balance as on 31.3.1999	0	0	0	0	0	0
Less - Repayment	*0*	*-10000*	*0*	*0*	*0*	*0*
Net	0	-10000	0	0	0	0
2. Investment in Central Govt. Securities	0	0	0	2500	11640	13550
Less - Repayment	*-865*	*-1302*	*-1302*	*-1302*	*-1302*	*-1302*
Net	-865	-1302	-1302	1198	10338	12248
3. Investment in State Govt. Securities	63746	12194	8410	34862	59300	53800
Less - Repayment	*-2984*	*-6866*	*-7246*	*-10656*	*-15141*	*-19632*
Net	60762	5328	1164	24206	44159	34168
4.Reinvestment in Central Govt. Securities	3849	0	0	12058	7443	11935
Less - Repayment	*0*	*0*	*0*	*0*	*0*	*0*
Net	3849	0	0	12058	7443	11935
5. Investment in India Infrastructure Finance Co. Ltd.	0	1500	0	0	0	0
Less - Repayment	*0*	*0*	*0*	*0*	*0*	*0*
Net	0	1500	0	0	0	0
Net Investment during the year	**63746**	**-4474**	**-138**	**37462**	**61940**	**58350**
CLOSING BALANCE	**658665**	**654191**	**654053**	**691514**	**753454**	**811804**
Liabilities over Assets	**15946**	**19398**	**10085**	**36932**	**45932**	**52582**

2.3.3. Prepayment of NSSF Loans

In pursuance of the recommendation of the NDC Sub-Committee, the State/UT Governments were allowed to pre-pay a part of their liabilities towards NSSF. The

Governments of Tamil Nadu (₹ 1126.67 crore), Orissa (₹ 199.72 crore) and the NCT of Delhi (₹ 752.90 crore) prepaid to NSSF; the sums were reinvested in CGSS at market rates leading to a net interest loss to NSSF.

Figure 3: Return on Investments by NSSF

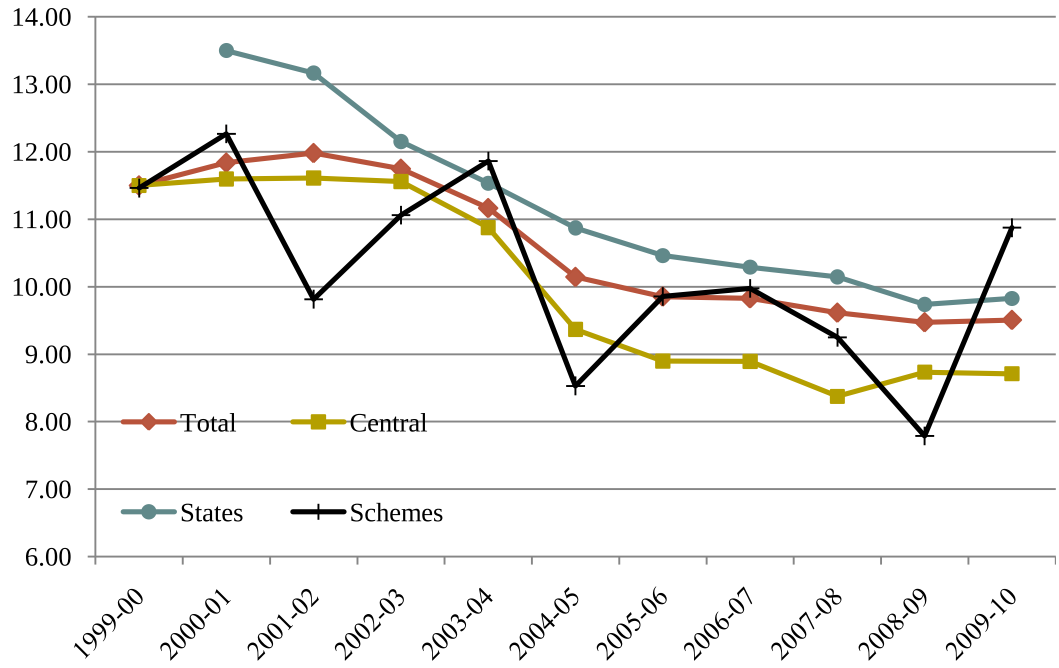
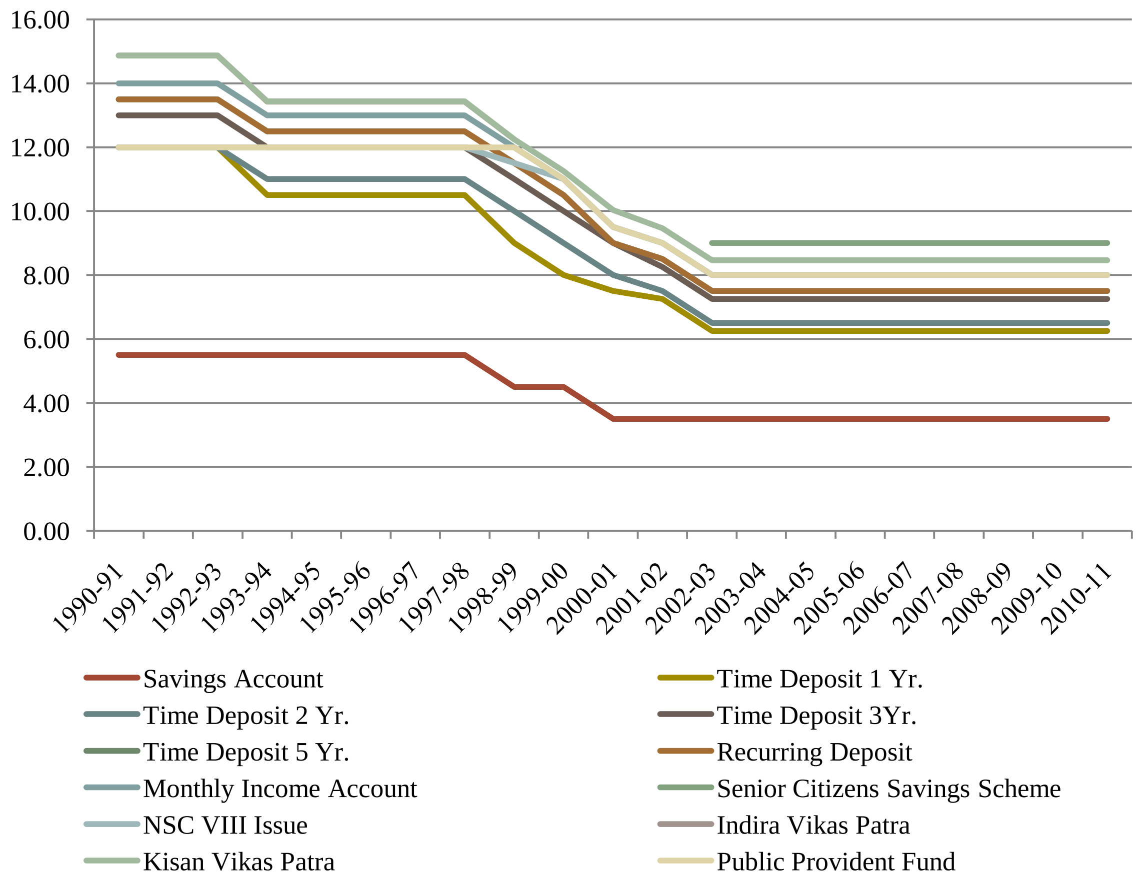


Figure 4: Small Saving Rates



2.3.4. Gap in Assets and Liabilities of NSSF

Over the years, due to the loss on the income and the expenditure account, there has been an excess of liability over assets built up over the years. By the end of 2009-10, this gap has increased to ₹ 36932.38 crore. This gap would further reduce the returns on investment and further impact the income of the Fund. Ultimately, Government of India may have to fill the negative gap between the assets and liabilities. Correcting the anomalies in the NSSF structure would, therefore, need to be integral while recommending on the structure of the small savings schemes and the nature of investments of the funds.

2.4. Income of NSSF

The income of NSSF comprises of the interest receipts on the investments in Central, State Government and other securities. While the interest rate on the investments on the Central and State share of net small saving collection is as per the rates fixed from time to time, the interest rate on the reinvestment of redeemed amounts are at market rate for 20 year Government Securities. The effective rates on Central and State Government securities have come down over a period of time. There is also a rate differential between the effective rate to the Centre and that to States mainly due to the reinvestment of the redemption amount in 20 year SCGS. The trend of effective rates of returns on these investments can be seen in Figure 3.

2.5. Expenditure of NSSF

The expenditure of NSSF comprises interest payments to the subscribers of Small Savings and PPF Schemes and the cost of operating the schemes, also called management cost. The expenditure of the Fund can be seen in the Annex 7 which shows that the expenditure of the Fund has been higher than the income on a consistent basis and the accrued loss till the end of 2009-10 has been ₹ 39518.22 crore.

2.5.1. Interest Expenditure

The rate of interest on small savings exhibited a secular decline up to 2002-03 broadly in sync with the interest rate movements in the economy (Figure 4). The effective interest rate for the interest paid on small savings scheme[2] has varied over time as shown in the Figure 5. The spikes and troughs are mainly due to misclassification of certain payouts as interest payments that have been corrected in the subsequent years.

2.5.2. Management Cost

The management costs of running the NSSF comprises payment of remuneration/agency charges to Department of Post for management / operation of Small Savings and PPF, payment of commission to various categories of agents; and cost of printing of Savings Certificates, cheque books, etc.

[2] Equivalent to the interest paid in that year divided by the closing stock of last year

Management costs aggregate to 0.6-0.8 per cent of the outstanding liabilities Table 10.

Table 9: Income and Expenditure of NSSF

	2006-07	2007-08	2008-09	2009-10	2010-11 RE	2011-12 BE
A. INCOME OF NSSF:						
Central Government Securities prior 1.4.99	8775	7725	7725	7725	7725	6780
Special Central Government Securities after 1.4.99	3154	3041	2720	2720	2797	3742
Special State Government Securities after 1.4.99	40264	45864	44544	45055	43892	48163
Special Central Govt. Securities (Redemption)	6177	6535	6613	6452	7744	9270
Other Receipts	86	154	356	218	225	230
Total Income	**58456**	**63319**	**61958**	**62170**	**62383**	**68184**
B. EXPENDITURE OF NSSF						
B-1. Interest Payments :						
Savings Deposits	26729	29892	33842	36533	31696	33033
Savings Certificates	22365	19380	21240	18506	21474	22527
Public Provident Fund	12458	13130	-2619	17174	12800	13440
Total Interest Payments	**61552**	**62402**	**52463**	**72213**	**65970**	**69000**
B-2. Management Cost:						
Payment of agency charges to Department of Posts	2490	2476	2802	3133	3215	3518
Payment of agency charges to Public Sector Banks	0	0	0	0	1	1
Payment of agency commission to agents	1983	2048	1430	2180	2400	2200
Cost of Printing	12	18	15	20	22	22
Total *Management Cost*	**4486**	**4542**	**4247**	**5332**	**5637**	**5740**
Total Expenditure	**66037**	**66944**	**56710**	**77545**	**71607**	**74740**
Net Income(-)/Expenditure(+) in the year	-7582	-3626	5248	-15375	-9224	-6556

2.5.3. Lag between Receipts and Investments by NSSF

There is a lag of two to three months between the receipts on small savings and investments by NSSF that led to a forgoing of cumulative interest income amounting to ₹6,298 crore.

2.5.4. Viability of NSSF

NSSF has a negative mismatch between its income and expenditure. While the interest rates on the loans extended from the net collection of small savings are higher than the effective interest rates on the small savings schemes, the interest rate on the reinvestments of redemption proceeds are low. This is one of the reasons for the losses in the NSSF. The resetting of the interest rates on SSGS and SCGS without a corresponding decline in the interest rates on the liabilities (small savings) side also contributed to the negative spread. The negative spread would further widen following the implementation of the recommendation of the Thirteenth Finance Commission of the resetting of interest rates on SSGS at 9.0 per cent.

Figure 5: Effective Small Savings Interest Rate (per cent)

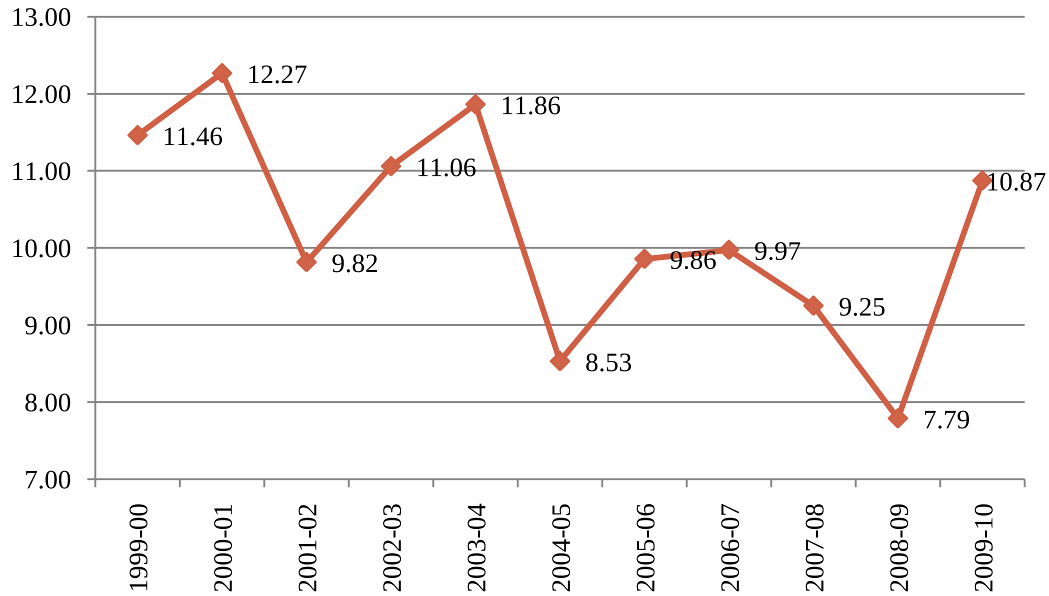


Table 10: Average Cost of small savings3

	Outstanding	Interest Expenditure		Management Cost		Total cost
		Amount	(%)	Amount	(%)	(%)
1999-00	176221	20198	11.5	1749	1.0	12.5
2000-01	214791	26347	12.3	2295	1.1	13.3
2001-02	260149	25534	9.8	2451	0.9	10.8
2002-03	304057	33627	11.1	2663	0.9	11.9
2003-04	364390	43223	11.9	3132	0.9	12.7
2004-05	435242	37125	8.5	3413	0.8	9.3
2005-06	532030	52442	9.9	4316	0.8	10.7
2006-07	617117	61552	10.0	4486	0.7	10.7
2007-08	674611	62402	9.3	4542	0.7	9.9
2008-09	673589	52463	7.8	4247	0.6	8.4
2009-10	664137	72213	10.9	5332	0.8	11.7
2010-11 RE	728447	65970	9.1	5637	0.8	9.8
2011-12 BE	799387	69000	8.6	5740	0.7	9.3

There is a significant ALM mismatch between the tenor of assets and liabilities of NSSF. The average duration of the small savings schemes is around 6 years whereas the on-lending to States is for 25 years, thereby involving a maturity transformation by the Central Government. The Centre loads the cost of maturity transformation and the management cost to the interest cost on small savings. Interestingly, the significant ALM mismatch between the tenor of assets and liabilities of NSSF had a *positive* impact on the viability of NSSF balance sheet in a secular declining interest rate environment since 1999-2000 as the liabilities were repriced at prevailing lower rates at a faster pace than the assets.

[3] Computed as a ratio of interest paid to small savers by the NSSF to the preceding year's outstanding liabilities of the NSSF.

The details of Income and Expenditure since 1999-2000 to 2009-10 are indicated in Annex 7. As may be seen from these figures, while the income is enough to meet the interest expenditure, it is not sufficient to cover the administrative costs. For 2010-11 BE, the average interest rate on small savings was 8.6 per cent. Coupled with the high management cost of 0.7 per cent, the average total cost amounted to 9.3 per cent Table 10. While the average rate of interest on the outstanding SSGS was 9.79 per cent, which was marginally higher than the average cost of 9.3 per cent, the average rate of interest on the outstanding SCGS at 8.81 per cent was significantly lower than the average cost on the outstanding small savings. Thus, the main reason why NSSF has a negative spread is attributable to the reinvestment of the redemption amount in SCGS at the market rate of interest and high management cost. In this regard, the interest relief on SSGS following the implementation of the recommendations of the 13th FC, effective 2010-11, would further affect the viability of the NSSF.

2.6. Other Aspects

2.6.1. Taxation Issues – Designing of Small Savings instruments in post DTC Environment

One of the important factors contributing to the popularity of small savings instruments such as MIS, KVP and NSC VIII appears to be the effective rate of return in the absence of TDS (in all small savings instruments barring SCSS). In the recent years, however, the cost of tax evasion appears to have increased on account of the prescription of KYC and PAN (the latter in respect of transactions amounting to ₹50,000 and above); the progressive computerization of all post office branches by 2014, is expected to further increase the cost of tax evasion. Over the years, the wider coverage of instruments, other than small savings, that qualify for tax exemption (including 5 year bank deposits, educational and housing loans, etc.) has progressively reduced the incentive for holding postal instruments for the purpose of tax avoidance. In view of the above, the role of small savings instruments in the provision of tax haven to investors appears to be declining over time.

In the recent years, the availability of alternative tax savings instruments (e.g. 5 year term deposit with banks, housing loan, education loan, etc.) and the unchanged nominal Section 80 C ceiling of ₹1 lakh have reduced the attractiveness of small savings instruments for claiming tax exemption under Section 80C. The introduction of DTC is expected to further bring about rationalisation of the tax adjusted return of the various instruments.

2.6.2. Implications of Administered Rates on Small Savings on Transmission of Monetary Policy

The fixed rate of interest on small savings provides certainty to the small saver on the (nominal) rate of return. The spread of bank branches across India has increased the substitution effect between small savings and bank deposits. Banks had earlier indicated that they were unable to lower their deposit rates further in line with monetary policy rate changes. This implies that when demand for credit is low or the monetary policy stance is accommodative, small savings rate emerge as a floor for bank deposits, at times, nullifying the monetary policy signals.

2.6.3. KYC and Financial Inclusion

KYC is an important element in ensuing, inter alia, that small savings instruments serve only the small saver. Excessive emphasis on KYC can, however, have implications for financial inclusion. In this regard, the Department of Posts has addressed the KYC issue. Individuals are required to state their PAN number only if a transaction exceeds ₹50,000/-. The completion of computerisation of post office branches, which is currently under way, by 2014, would facilitate adherence to KYC as also address tax evasion.

2.7. Conclusion

In sum, the basic philosophy of small savings is to provide a secure avenue for saving by individuals and promote long-term savings. Unlike in developed countries, where despite a large bouquet of instruments, including inflation indexed bonds for retail participants, retail debt accounts for a small share of the outstanding liabilities of the government, small savings accounted for a significant proportion of GFD financing in India (till 2006-07). Notwithstanding the sharp deceleration in small savings collections in the recent years, the outstanding small savings are budgeted at 20% per cent of the outstanding liabilities of the Centre as at end March 2012. Second, the cost of borrowings from NSSF at 9.5 per cent is not constantly in tune with the prevailing market rates. Third, asset liability mismatch became manifest in 2007-08 when assets had to be liquidated to infuse cash amounting to ₹10,000 crore into NSSF for meeting repayment obligations leading to further mismatch between its assets and liabilities. If repayments continued to be greater than fresh collections, it could have grave consequences for the NSSF balance sheet. Were NSSF to become unsustainable, the ultimate fiscal costs would devolve on the Centre. Fourth, while the importance of tax incentives has diminished in the recent years, evasion of tax in respect of interest income from small savings instruments has the potential of causing loss of revenue to the Central Government. In 2001, the Reddy Committee had recognised the emerging issues and had indicated '*an urgent need for reforms in this sector with a view to putting in place a suitable mechanism for the productive use of these resources for the long term gain of all stakeholders. Ideally, there should be a progressive reduction in the number of such instruments besides removal of distortions arising out of tax treatment, so that they become a modest source of financing Government deficit in future.*'

3.
Critical Evaluation of Issues

The points analysed in the previous section raise various important issues about the Small Saving Schemes and NSSF that need to be addressed by the Committee. The first issue pertains to the interest rates on small saving schemes and the importance of these rates being aligned with market rates. The second issue pertains to the investments of NSSF in State and Central Government Securities. While a higher return is required to sustain the Fund, these have adverse impact on the cost of financing the fiscal deficit for Centre and States, leading to higher interest rates and adversely impacts the fiscal consolidation process. The third issue pertains to the cost of administration of the schemes. Together, these aspects impact the overall viability of the Fund and are some of the considerations referred to this committee.

3.1. Interest on Small Saving Schemes

As shown in Figure 4, the small saving rates were aligned with market rates over a period of four to five years particularly after the recommendations of the Reddy Committee. However, after 2002-03 rate on small saving schemes has not seen any change, although, market rates have seen significant variations during these years. This has thrown the small savings rates out of sync with market rates.

This phenomenon may be seen in Figure 6 and Figure 7 for 1 year and 5 year maturity. These mismatches have led to corresponding volatility in small saving collection in these years. In years 2003-04 and 2004-05, when market rates declined and small saving rates remained unchanged, small saving collections went up. Conversely, in 2007-08 and 2008-09, when market rates went up, collections went down and net collections went negative. This leads to a situation where, when market rates are low, States are loaded with high cost NSSF loans and when market rates are high, NSSF loans as a source of financing FD dries up completely. It is therefore, very essential to align these rates with market rates.

3.2. Finances of NSSF and Fiscal Implications for the Centre

It was noted in the previous Section that there is a negative mismatch between the receipts and expenditure of NSSF as the return on assets were lowered even as the return on the liabilities remained unchanged.

Figure 6: Small saving and market rates - 1 year

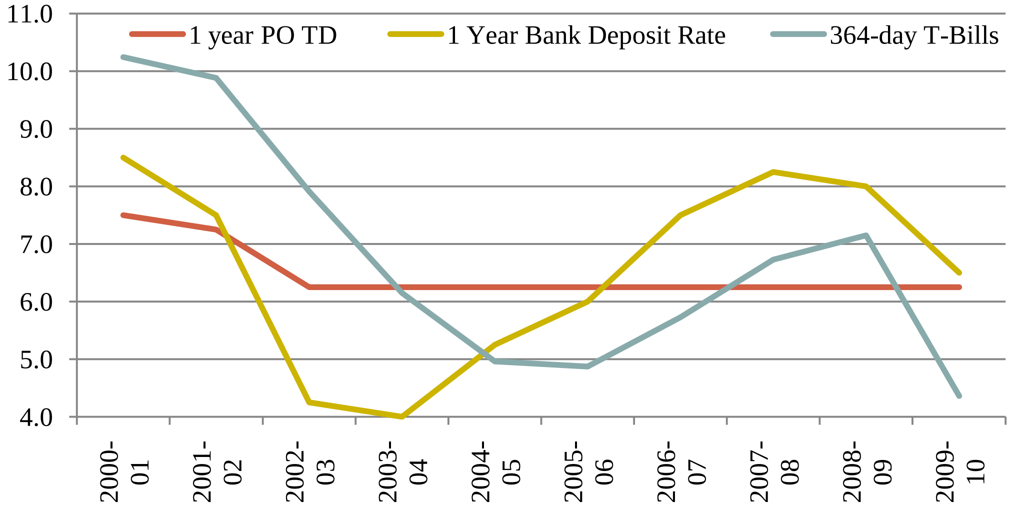
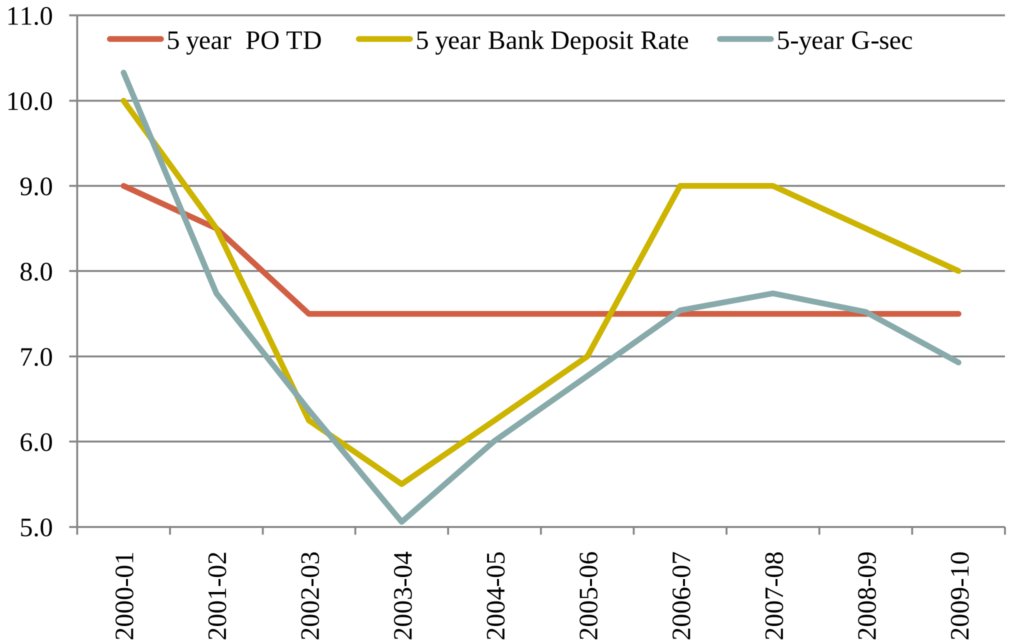


Figure 7: Small saving and market rates - 5 years



The weighted average rate of interest on Special Central Government Securities (SCGS) declined from 11.5 per cent as on April 1, 1999 to 8.81 per cent as on March 31, 2011 (Table 11) on account of the following:

i) Reduction in the interest rate on SCGS issued against the initial outstanding balances of small savings as on March 31, 1999 from 11.5 per cent to 10.5 per cent with effect from 1 March 2003, in line with general softening of market interest rates.

ii) Use of debt swap receipts from States to partly redeem the SCGS issued against the initial outstanding balances and to replace them with fresh securities at lower market rates of interest of 5.95-7.00 per cent yielding a further interest rate relief of 3.50-4.55 percentage points to the Centre. An amount of ₹92,652 crore was redeemed between 2002-03 and 2004-05.

iii) The redemption of high-interest bearing SCGS against outstanding balances for a sum of ₹ 10,000 crore in 2007-08 in order to infuse cash into the NSSF consequent upon negative cash balance in the Fund due to a fall in net small savings collections

Table 11: Interest Rate on Outstanding Investments in Special Central Government Securities (As on March 31, 2010)

	Amount (₹ crore)	Rate of Interest (per cent)	Maturity (years)
1999-2000	73,569	10.50	On call basis
	6,734	13.50	25
2000-01	6,653	12.50	25
2001-02	7,441	11.00	25
2003-04	13,766	7.00	20
	32,602	6.00	20
	13,609	5.95	20
2004-05	22,665	6.96	20
	10,010	7.00	20
2005-06	888	7.50	20
	908	7.60	20
2006-07	2,016	8.17	20
	1,833	7.88	20
2007-08	6,000	7.64	20
2008-09	6,058	8.21	20
2009-10	2,500	9.50	25
2010-11	11,640	9.50	25
	7,443	8.40	20
Total	**2,25,033**	**8.81**	

3.3. Costs for State Governments

The rate of interest on Special State Government securities (SSGS) declined from 13.5 per cent in respect of loans issued during 1999-2000 to 9.5 per cent since 2003-04. In addition, in respect of SSGS contracted during 1999-2000 to 2001-02 (at rates ranging from 11.0-13.5 per cent), the rate of interest has been reset at 10.5% effective April 1, 2007 following the recommendation of the NDC Sub-Committee (Table 12). Consequently, the weighted average rate of interest on the outstanding investments of NSSF as at end-March 2010 stood at 9.79 per cent.[4] State-wise details of investments in SSGS are given in Annex 5**.**

3.4. Role of NSSF in Financing GFD of State Governments

The financing pattern of GFD has undergone significant changes since the 1990s (Table 13). The share of loans from the Centre declined substantially since April 1, 1999 reflecting the change in the accounting framework in respect of small savings and turned negative subsequently on account of the debt swap scheme (DSS) during 2002-03 to 2004-05 and the abolition of the disintermediation role of the Centre after the implementation of the recommendations of the 12th FC since 2005-06. The securities issued to the National Small Savings Fund (NSSF) emerged as the predominant source of GFD financing during 1999-2000 to 2006-07. The developments related to the creation of NSSF and the accounting practices are detailed in Annex 3.

Table 12: Interest Rate on Outstanding Investments by NSSF in SSGS

	NSSF's Investments in SSGS (₹ crore)	Interest Rate on SSGS (%)			Weighted Avg. Rate of Interest on SDLs (%)
		Initial rate	NDC Sub-Committee	13th FC	
1999-00	18,856	13.5	10.5	9.0	11.89
2000-01	24,949	12.5	10.5	9.0	10.99
2001-02	28,015	11	10.5	9.0	9.20
2002-03	44,422	10.5	10.5	9.0	7.49
2003-04	60,878	9.5	9.5	9.0	6.13
2004-05	83,305	9.5	9.5	9.0	6.45
2005-06	89,836	9.5	9.5	9.0	7.63
2006-07	63,746	9.5	9.5	9.0	8.10
2007-08	12,194	9.5	9.5	9.5	8.25
2008-09	8,410	9.5	9.5	9.5	7.87
2009-10	34,862	9.5	9.5	9.5	8.11
2010-11	59,300	9.5	9.5	9.5	
Total	**528,772**	**10.11**	**9.79**	**9.05**	

The increase in the share of open market borrowings in GFD reflected the debt swap scheme (DSS) initiated by the Government of India during 2002-03 to 2004-05 and the net outflow in the small savings collections during 2008-09 and 2009-10 resulting from substitution of savings in favour of bank deposits among

[4] Had the NDC sub-committee not reset the rate of interest effective April 1, 2007, the weighted average rate of interest would have been 10.11 per cent as at end-March 2010.

households due to rise in market rates against the backdrop of unchanged small savings rates since March 2003. In between, during 2005-06 and 2006-07, the share of market borrowings had declined sharply reflecting the large scale autonomous NSSF inflows when the market rates had declined sharply.

3.4.1. Centre's FRBM and automaticity in Extant NSSF Transfers

After constitution of NSSF, the share of Centre was fixed at 20 per cent. Following the implementation of the recommendation of the Reddy Committee (2001), the entire net collections of small savings was transferred to the State Governments during 2002-03 to 2006-07. Effective April 2007, at the request of State Governments, the NDC Sub-Committee reduced the share of States' borrowings from NSSF and simultaneously increased the share of the Centre to a maximum of 20 per cent. The rate of interest payable by the Centre is the same as that fixed for the State Governments at 9.5%. The amount repaid/prepaid by the State Governments is also reinvested by NSSF in SCGS at market rates. The uncertainty in the amount and timing of investments by the NSSF in SCGS has implications for cash and debt management of the Central Government.

Table 13: GFD Financing of State Governments (per cent)

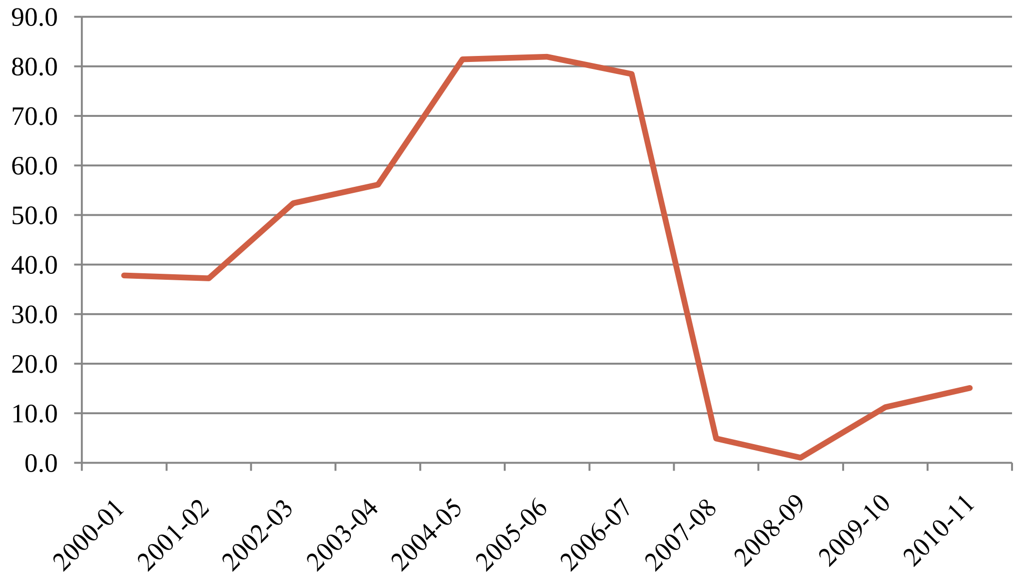
	1990-95	1995-00	2000-05	2005-06	2006-07	2007-08	2008-09	2009-10 (RE)	2010-11 (BE)
Market Borrowings	16.0	15.4	26.4	17.0	16.9	71.5	77.3	57.2	66.9
NSSF	..	9.5	40.2	81.9	72.3	7.8	1.1	8.8	6.1
Loans from Centre	49.2	35.7	4.3	0.0	-11.5	-1.2	-0.6	2.3	3.5
Loans from Banks/FIs	-7.1	11.3	4.0	4.5	1.3	8.5	4.2	3.8	4.1
Others	41.9	28.1	25.1	-3.4	21.0	13.4	18.0	27.9	19.4
Gross Fiscal Deficit	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

3.4.2. State FRL and automaticity in Extant NSSF Transfers

Small savings are an autonomous (passive) and volatile source of financing of GFD of State Governments. The share of NSSF in the financing of GFD varied from 1% (2008-09) to 81.9% (2005-06).

As on March 31, 2009, the outstanding investments by NSSF in the special securities issued by State Governments amounted to ₹ 4,31,938 crore which accounted for about 30 per cent of the outstanding liabilities of the State Governments. Four states, viz. Maharashtra, West Bengal, Gujarat and Uttar Pradesh, accounted for 52 per cent of the total outstanding securities issued to NSSF as on 31 March 2009.

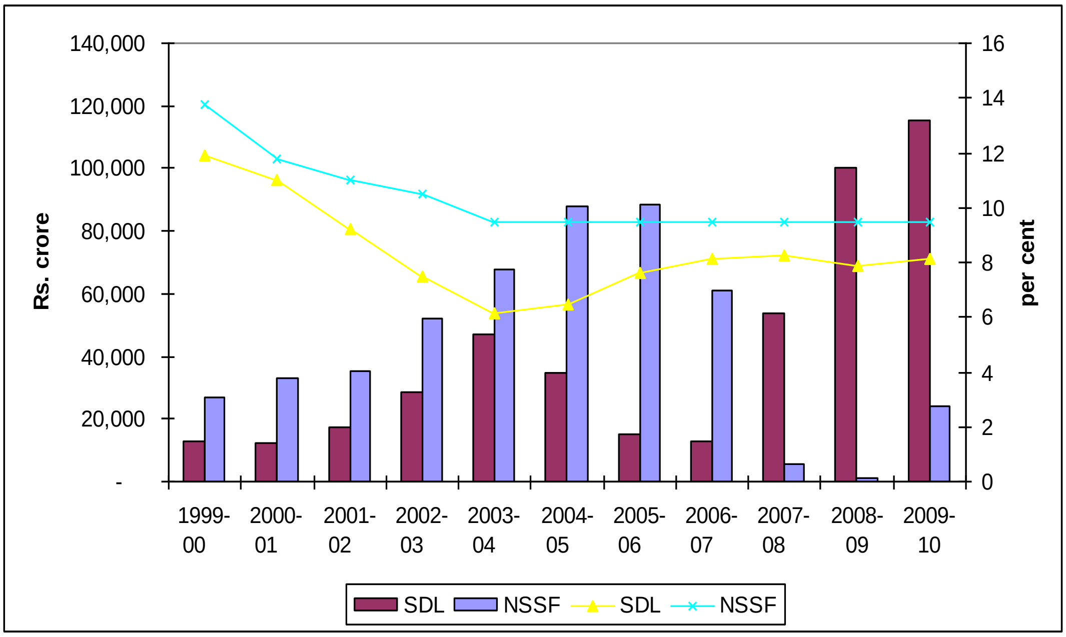
Figure 8: Share of NSSF in GFD Financing of State Governments (per cent)



As per the extant practice, after meeting the redemption of small savings and management cost incurred by NSSF, a pre-decided proportion of net small savings collected within a State is on-lent to that State Government. When the fiscal situation of State Governments deteriorated sharply during the second half of the 1990s following the implementation of the recommendations of the 5th Pay Commission, small savings were a preferred instrument to bridge the fiscal gap. The Reddy Committee (2001) recommended that the entire net small savings collections be transferred to the State Governments (as against 75 per cent earlier) so that the State Governments mandatorily prepay their high cost liabilities to the Centre. The Union Government accepted this recommendation and permitted the State Governments to utilise 20, 30 and 40 per cent of their net small savings collections during 2002-03, 2003-04 and 2004-05, respectively, to prepay a part of their high cost liabilities (₹92,652 crore) owed to the Centre.

Following the completion of the debt swap scheme and with most states embarking on a rule-based fiscal consolidation after the implementation of the recommendations of the Twelfth Finance Commission (2004), the excess NSSF inflows led to a secular build-up of surplus cash balances. While States became empowered to access the market at a low spread (*vis-à-vis* secondary market yield of Central Government security of similar maturity) reflecting their fiscal consolidation initiatives, they could not access the market in a significant manner during 2004-05 to 2006-07 with overall GFD capped by FRL targets (Figure 9). As the return from the investments in the intermediate Treasury Bills (ITBs) and/or auction Treasury Bills is lower than the cost of borrowing NSSF funds, the involuntary large surplus cash balances involve a negative carry which has implications for revenue and fiscal balances of the State Governments.

Figure 9: A Comparison between the Quantum and Cost of Borrowings from NSSF and the Market



Conversely, when market interest rates ruled higher than small savings rates during 2007-08 to 2009-10, the subscriptions to small savings instruments dipped and flows from NSSF dried up necessitating additional market borrowings by State Governments. The autonomous flows have implications for fiscal marksmanship and preparation of auction calendar for market borrowings. Net inflows for many states even turned negative during 2007-08 and 2008-09 and were modestly positive during 2009-10.

Market borrowings perforce act as a residual in the GFD financing which renders cash and debt management operations difficult. The preparation of an advance release calendar with indicative amounts of periodic open market borrowings for the benefit of investors is wrought with uncertainty in the presence of a large component of volatile autonomous inflows. For e.g., for fiscal 2007-08, NSSF inflows turned out to be significantly lower than that initially estimated and State Governments were permitted to raise additional open market borrowings under Article 293(3) in lieu of NSSF flows towards the end of the fiscal, thereby leading to the bunching up of borrowings, particularly, during March. The period also coincides with the pick-up in seasonal credit demand and advance tax outflows. The resultant tightening of liquidity caused a spike in yields and increased the cost of borrowings of State Governments.

3.5. Cost of Operations of Small Savings Schemes

Cost of operation of NSSF contains two major items, namely, payment of agency charges to Department of Posts and commission to small saving agents. While the agency charges are payable on a per account per year basis, the agency commission is paid on the amount collected under the small saving schemes. The details of the cost of operation over the years may be seen in Table 14.

Table 14: Cost of Operation of NSSF (₹ crore)

	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Department of Posts	1861	2318	2490	2476	2802	3133
Public Sector Banks	8	11	0	0	0	0
Agency commission	1529	1972	1983	2048	1430	2180
Cost of Printing	15	15	12	18	15	20
Total	**3413**	**4316**	**4486**	**4542**	**4247**	**5332**

While the payment of commission to agents is highly correlated to the gross collection in a particular year, the same is not true for the payment of agency charges to DoP. This is mainly because these charges are payable on number of accounts being maintained and thus, even if gross collection is low, agency charges are payable. Secondly, since the number of postal saving accounts is large as compared to the net collection from these accounts, there is a low correlation between agency charges paid and gross collection. For viability of NSSF, it is very critical that the cost of operations of NSSF is kept under control.

3.6. Viability of NSSF

Despite the high interest rate on the investment of net small saving collection in SCGS and SSGS, since the overall rate of return on assets is lower than the total cost including the interest cost and the cost of operation, the NSSF has been incurring losses in the past. The trends in the losses in the income and expenditure account of NSSF may be seen in Figure 10. It may be seen that, in many of the years, although the interest expenditure is lower than the interest receipts, after adding the cost of operations, the total expenditure is higher than the interest receipts.

Since the cash deficit in the income and expenditure account had to be funded by less assets over liabilities, over period of years, NSSF has accumulated liabilities in excess of assets. This can be seen in Figure 11. Years in which the excess of liabilities over assets has come down are those when the NSSF has drawn over the cash balances of GoI. Ideally speaking, this is a liability of NSSF towards GoI but the same is not shown in the accounts of NSSF. These are like advances that NSSF has drawn from GoI with zero costs.

Over years, since the asset base has been eroding, this is another factor for the loss in the Fund. Coupled with low return, since the asset base is lower than the liabilities, the income in absolute terms is even lower. Over the years, this has become a vicious cycle and even if the average interest rate on small savings combined with the effective cost of operation becomes marginally lower than the rate of return on assets, the Fund will still incur losses. These factors, combined together affect the viability of the Fund.

Figure 10: Income and Expenditure of NSSF (₹ crore)

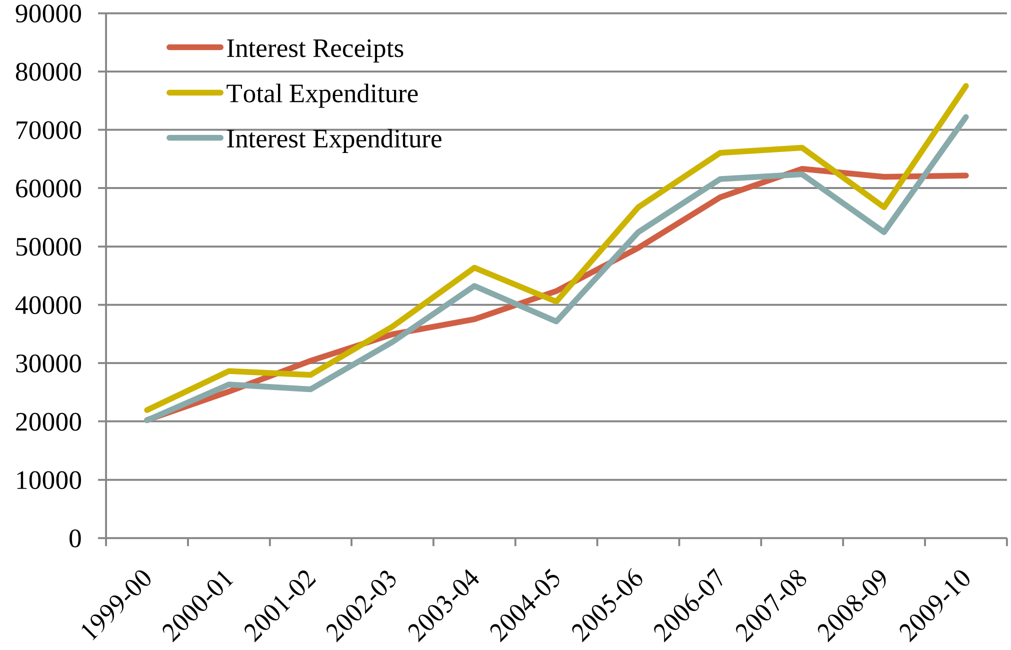
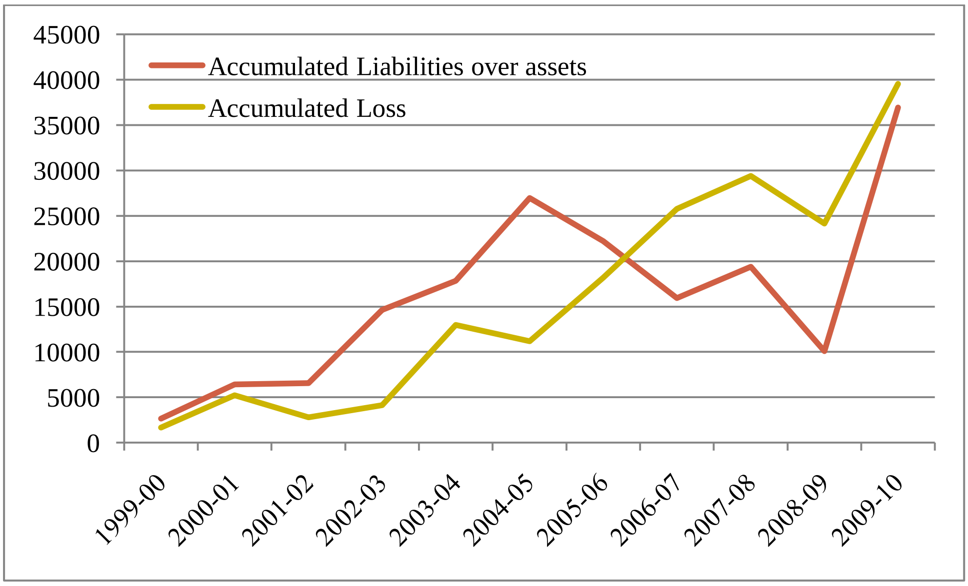


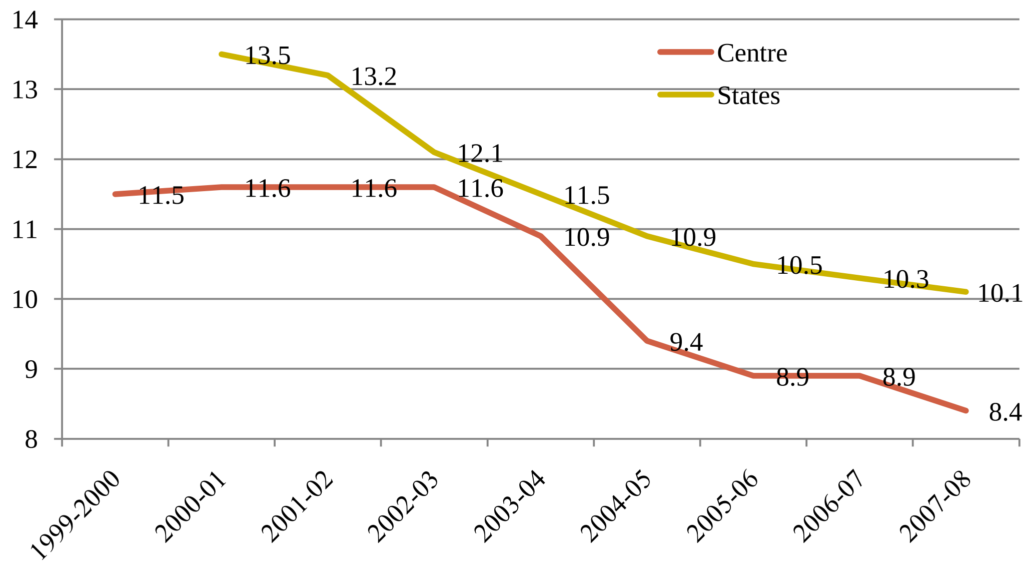
Figure 11: Finances of NSSF



3.7. Issues addressed by the NDC and the 13th FC and their Implications

Despite the relief provided by the NDC Sub-committee (detailed earlier), there continued to remain an asymmetry between the effective rate of interest payable by the Centre and by the States (Figure 12). Further, after narrowing from 1.9 percentage points in 2000-01 to 0.5 percentage points in 2002-03, the gap between the effective rates of interest paid by the States and the Centre increased to 1.7 percentage points in 2007-08 mainly reflecting the reinvestment of the redemption proceeds of the State Governments at market rates (Table 11). Hence, the 13th FC felt that there is a case for interest rate relief to State governments on loans advanced from the NSSF.

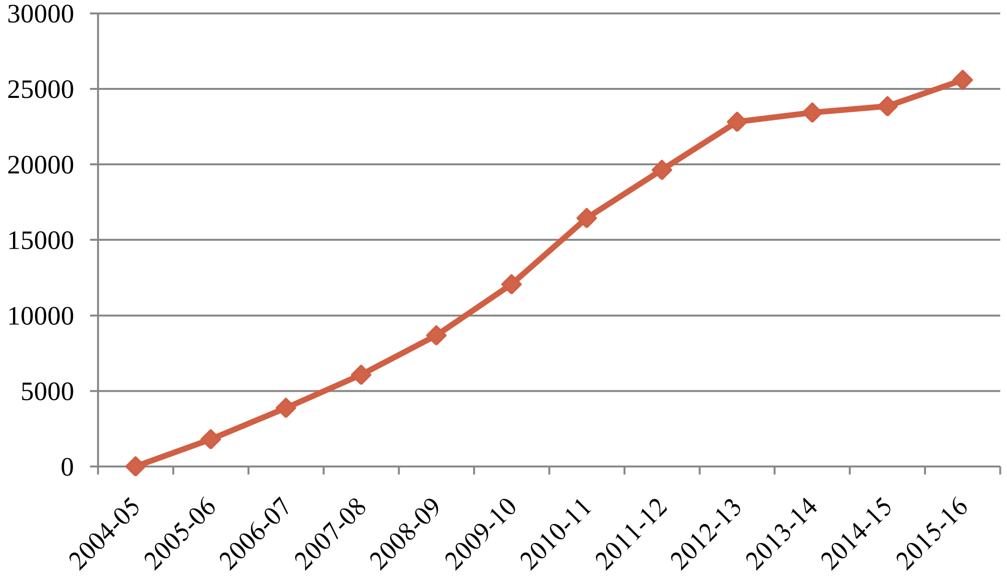
Figure 12: Effective Rates of Interest of NSSF Loans (in per cent)



The 13th FC recommended that the loans contracted till 2006-07 and outstanding as at the end of 2009-10 be reset at a common interest rate of 9 per cent per annum in place of 10.5 per cent or 9.5 per cent. The repayment schedule, however, should remain unchanged (Figure 13). The total benefit that would accrue to States was placed at ₹ 13,517 crore during the award period and would aggregate to ₹ 28,360 crore by the maturity of the last loan coming under purview. As a result of the implementation of the recommendations of the 13th FC, the rate of interest on SSGS would decline to 9.05 per cent, closer to the interest rate of 8.81 per cent paid by the Centre (Table 11). This would, however, further impact on the viability of NSSF by increasing the extent of mismatch between the average rate of return on receipts and average rate of expenditure on NSSF.

One option to reduce the tenor mismatch between the assets and the liabilities of NSSF would be accelerate the reinvestments in SCGS through a reduction in the maturity of SSGS and fresh investments in SCGS. In this regard, the Reddy Committee (2001) had noted that a back-to-back arrangement necessitating reduction in the maturity of the loan from 5-25 years to 6 years though '*desirable, may not be advisable at this stage*' owing to the deterioration in States' fiscal situation. The alternative proposed by the Reddy Committee was to elongate the maturity structure of the existing small savings instruments towards the medium-to-long-term. The States should be encouraged to adopt a back-to-back arrangement so that the overhang problem does not arise for the fresh flows.

Figure 13: NSSF Repayment Schedule (₹ crore)



4.
Rationalisation of Small Savings

The rationalisation of the various small savings instruments would need to take into account the following: (i) the need to avoid a multiplicity of overlapping instruments serving the same public policy objective of promotion of savings among ‘small’ savers; (ii) ensuring viability of NSSF through a reduction or elimination of ALM mismatch and the cost of administration of NSSF; (iii) synchronization of fiscal incentives in the form of tax exemption within the overall taxation framework as enshrined in the Direct Tax Code (DTC) which would be implemented from April 2012; and (iv) making interest rates consistent with the overall interest rate structure of the economy to ensure smooth working of the transmission mechanism of monetary policy. Further, since small savings instruments are, after all, instruments for financing the fiscal deficit of the government, availability of more efficient instruments of borrowings would have implications for the continuation of the existing small savings instruments.

4.1. Savings Deposits

4.1.1. Savings Account

The rate of interest on postal savings deposits is currently identical with that of commercial banks administered by the Reserve Bank. There are, however, certain factors that affect the effective rate of return of the two instruments. First, the interest income on postal savings deposits is tax free unlike savings deposits with banks. Second, savings deposit in an individual’s account with a post office branch is subject to a ceiling of ₹1 lakh (₹ 2 lakh for a joint account). Aggregate savings deposits is equivalent to only 2.7 per cent of the savings deposits of commercial banks and do not appear to compete with the latter. Third, modern day commercial banking offers a significant ease of carrying out transactions unlike post offices. Fourth, anecdotal evidence suggests that postal savings are largely used for transactions purposes by the weaker sections and those residing in unbanked areas. The Reddy Committee (2001) had recommended that as long as the rate of inflation is more than 3.5 per cent, the rate of interest on postal savings deposits may continue to be 3.5 per cent. **The Committee endorses the principle enunciated by the Reddy Committee and recommends that with Reserve Bank increasing the saving bank deposit rate to 4%, the interest rate on Postal Saving Account may also be increased to 4%.** The Government may also consider applying the formula of the weighted average of daily balance over the reference period prescribed by the RBI for commercial banks for the calculation of the interest on savings deposits of post offices. A few State Governments have suggested an increase in the ceiling on savings deposits. DoP has also suggested removal of the ceiling (as in the case with banks) that will enable the post offices to credit the maturity proceeds of saving instruments in their savings bank account. **The Committee considered the following two options: if the ceiling has to be removed, the interest income may not be exempt from income tax under Section 10 of IT Act. Alternatively, if the income tax exemption is to continue, the current ceiling may be retained. Taking into account the above considerations and the need for harmonisation with the DTC code removing most tax exemptions, the Committee ruled in favour of the first option.**

4.1.2. 5 Year Recurring Deposit Scheme

The aim of the scheme is to encourage the smallest saver to make monthly savings as the minimum monthly payment is ₹10. The effective rate of interest (7.7% per annum) is almost the same as that prescribed for 5 year time deposits of post offices. The scheme is not liquid as premature closure of the account is available only after 3 years and only savings bank rate of interest (3.5% p.a.) is paid. The scheme requires to have market aligned rates with higher liquidity to meet the needs of the small savers.

To improve the liquidity of the scheme which is, perhaps, needed more by the smaller savers to take care of unforeseen contingencies, the Committee recommends a reduction in the lock-in period of the scheme from 3 years to 1 year. For premature withdrawal, a 1% lower rate of interest than postal time deposits of comparable maturity may be paid to the small savers.

The effective tenure of RD accounts would work out to less than 3 years since the entire amount of deposit is not made while opening of account. Thus, ideally the interest rates on RD should be benchmarked to 3 year maturity instrument. However, since this scheme promotes habit of thrift amongst small savers, **the Committee recommends that the interest rates on recurring deposits should be benchmarked to 5 year G-sec.**

However, this high level of interest to the subscribers should be coupled with a reduction in the commission payable to the agents. The 4 per cent commission payable to agents makes it an agent driven scheme and increases the administrative cost of the scheme. By reducing the commission payable and benchmarking the scheme to G-Sec rate of higher maturity, Government would be passing on the benefit from reduction of commission to the subscribers as higher returns. **Financial literacy programmes should promote postal savings instruments and it is recommended that the rate of commission be reduced to 1 per cent over a period of three years with one percent reduction every year.**

Recently, DoP has sent a proposal to MoF for the launching of two new schemes, one of which is titled 'Post Office Female Flexi Recurring Deposit Scheme' (meant for working women - particularly workers under MG-NREGA). The Committee is of the view that an increase in liquidity of the scheme as recommended above would adequately address the needs of this segment of the society without affecting the viability of NSSF.

DoP has also suggested a change in the formula for the calculation of interest on premature withdrawal from RD account from compound rate of interest to simple rate of interest. The Committee is of the view that it would accentuate the illiquidity in the scheme and favoured the continuation of the current practice in the calculation of interest.

A few State Governments have suggested RD of 1,2 and 3 years. RD of lower maturity would increase the ALM mismatch for NSSF. The Committee felt that the increase in liquidity of the scheme as recommended above would obviate the need for the introduction of lower maturity instruments.

4.1.3. Time deposits (of 1, 2, 3 and 5 year maturity)

Postal time deposits have recorded modest growth despite the absence of a ceiling on their investments and account for only a modest share in the outstanding small savings. Currently, the effective rates of interest on these instruments are broadly in sync with the rates arrived at from the formula suggested by the Rakesh Mohan Committee (Table 2). These instruments are not as liquid as bank deposits: in the 1st six months, account cannot be closed; after six months (and before one year), accounts can be closed but without receiving any interest; and after 1 year at a interest rate 2% less than the original rate. The deposits under the scheme can, however, be pledged as a security with banks for availing loans. Interest income is taxable as in the case of bank deposits though no TDS applies in case of postal deposits. The investment under the 5 year time deposits (up to ₹1 lakh) qualify for Sec 80 C benefit. Keeping in view the modest amount of outstanding postal time deposits and modest annual accretions in the recent years, these do not appear to meaningfully compete with bank deposits.

Committee recommends that the interest rates on 1 year time deposit may be benchmarked to 364 day T-Bills and that on 5-year TD may be benchmarked to 5-year G-Sec. The interest rate on 2-year and 3-year TD may be determined through linear interpolation between the interest on 1 year and 5 year maturity instruments. The Committee was of the view that postal time deposits, designed to promote thrift, may not enjoy similar liquidity as bank deposits. However, the liquidity of postal time deposits could be improved keeping in view the interest of the small savers. Accordingly, if withdrawn within 6-12 months, the **Committee recommends that savings bank deposit rate may be paid (as against nil at present). If deposits are withdrawn after 1 year, interest rate of 1% less than the interest rate on equivalent maturity instrument may be paid.**

The Committee broadly agrees with the suggestion of a few State Governments on the introduction of longer term instrument of 10 years which is considered later. On the grounds of ALM and the need for rationalisation of instruments, respectively, the Committee did not favour the introduction of term deposits of less than 1 year as also of 4 year maturity proposed by the DoP.

4.1.4. Monthly Income Scheme (MIS)

MIS provides monthly income and yields an effective annual rate of interest of 8.82 per cent (inclusive of 5% maturity bonus) and is popular among those subscribers seeking regular additional income. Since the effective rate of interest on MIS has been higher than the market rates, the ceiling on investment of ₹4.5 lakh per individual limits the fiscal costs. Whereas the term deposit rates of post offices are broadly aligned with the market rates, the effective rate of interest on MIS is significantly higher than the bank deposit rate and the G-sec yields of comparable maturities. MIS can be prematurely encashed after deduction of 2% from the principal after one year and before 3 years and at 1% after 3 years. Notwithstanding the liquidity risk, MIS is a relatively popular instrument in view of the higher than market rate of return.

The current term of six years of MIS is a non standard term and Committee recommends that the term should be reduced to five years. The interest rates on MIS should be benchmarked to 5-year G-Sec rates. The Committee recommends that the bonus should be abolished.

A few State Governments have suggested an upward revision in the ceiling of individual/joint holding to ₹10 /20 lakh from ₹4.5/9 lakh at present. DoP has suggested the removal of ceiling on MIS. The Committee felt that the upward revision in the ceiling, or removal of the ceiling need not considered at this stage as it meets the requirement of small savers.

A State Government also suggested that there should not be any maturity period for MIS. The implementation of this proposal will have implications for ALM of NSSF. The Committee viewed that the suggestion of MIS without maturity could be acceded to only if interest rates on MIS is floating, linked to 364-day T-Bills and with annual reset and with a 1 year lock-in period for the scheme. For the present, the Committee does not recommend any change.

4.1.5. Senior Citizens' Savings Scheme (SCSS)

SCSS was introduced in 2004 against the backdrop of a sharp fall in market interest rates. The objective of SCSS is to provide social security to the senior citizens in the form of a higher than market rate of return of 9 per cent per annum on a quarterly basis. A ceiling of ₹15 lakh was fixed in view of the fiscal implications, which has not since been revised. The interest income is taxable. SCSS is the only small saving scheme where the interest income is subject to TDS. Pre-mature closure of the scheme is available after one year on deduction of 1.5% interest and after 2 years on deduction of 1% interest. The Committee is of the view that SCSS is serving a useful social goal. At the same time, the bank dominated intermediation of savings under SCSS appears to reflect the rural-urban distribution of the savers under this scheme. The Government could consider popularising this scheme in rural areas by media publicity.

The Committee recommends that this instrument should be benchmarked to 5-year G-Sec with a higher spread as compared to the other schemes because of the social objective that it serves (details of spread explained in section 5.2.2). There is a proposal to either increase the term of this scheme or have an option to subscribe for ten years. As of now, the scheme provides for renewal for three more years and the subscriber also has the option of investing again on maturity. There is little merit in an option for a lock-in of 10 years for senior citizens. The Committee also sees no merit in revising the ceiling in the scheme as it serves the purpose of small investors.

4.2. Public Provident Fund (PPF)

The PPF Scheme was introduced primarily for non-government employees, self-employed personnel to encourage savings and provide income tax benefits. Employees, who contribute to other provident fund accounts, have also been allowed to open PPF accounts. A subscriber can utilize his account as a pension account if a certain sum is deposited into it every year regularly. The rate of interest is 8% per annum (compounded yearly). The scheme has the longest tenure of 15 years, which can be extended on 5 years basis thereafter, without any limit. Deposits qualify for deduction from income under Sec. 80C of IT Act. Interest income is completely tax-free. The scheme does not permit any withdrawal for the first six years after which limited withdrawal is permitted without any penalty. The scheme also provides loan facility after one year of opening of account but before completion of 5 years, after which normal withdrawals can be availed.

The annual investment is subject to a ceiling of ₹70,000. In the past, this ceiling has been in-sync with the limit of deduction under Section 80C of IT Act. However, when the limit under IT Act was revised to ₹ 1 lakh, this ceiling was not revised. **In accordance with the views of the Department of Posts and most of the State Governments, the Committee recommends an increase in the limit to ₹1 lakh to coincide with the ceiling on Section 80C.**

Keeping in view the liquidity that the scheme provides, the Committee is of the view that the interest rate on the scheme may be benchmarked to 10-year G-Sec rate. Further, keeping in view the financial emergencies that households are subject to, withdrawal may be allowed to continue. Loans against PPF may not be permitted during the first 3 years.

The Committee is, however, aware that the current provisions permitting premature withdrawal/taking advance against deposits is not in sync with the objectives of the scheme. More importantly, it is not considered practicable to monitor the end use of the funds withdrawn prematurely. Keeping in view the above considerations, the Committee recommends **that the rate of interest on advances against deposits may be fixed at 2 percentage points higher than the prevailing interest rate on PPF (as against 1 per cent at present).**

4.3. Savings Certificates

There are two types of savings certificates under operation, viz. National Savings Certificate (NSC) and Kisan Vikas Patra (KVP). These instruments have higher maturities than term deposits and the effective rates of interest at 8.16 per cent and 8.41 per cent, respectively, are also higher than the market rates of interest on G-sec of comparable maturities mainly in view of the flattening of the yield curve. While KVP does not enjoy any tax benefit, subscription of NSC up to ₹1 lakh qualifies for deduction from taxable income under Section 80C. The interest income accruing annually under NSC is also deemed to be reinvested and qualify for deduction under Section 80C. The effective rate of interest on NSC is thus significantly higher than 8.16 per cent, depending on the individual's tax bracket.

The continued popularity of both KVP and NSC among the urban population who are not all small savers could be prompted by an incentive to avoid tax. As compared to NSC, KVP is more popular as it is a bearer-like certificate due to its ease of transfer. It also has an in built liquidity due to the regulated premature closure facility offered in the scheme. The absence of TDS and ceiling on investment, tax benefits on NSC and higher than market rate of return have posed considerable fiscal costs to the Government. The deposits under both KVP and NSC can be pledged as a security with financial intermediaries, including banks[5]. The Rakesh Mohan Committee had recommended that both these instruments are quite expensive in terms of the effective cost to the Government and felt that these instruments should be discontinued to ensure an equitable and harmonious tax treatment across the full spectrum of medium term savings schemes. The Committee endorses this recommendation. **In view of the recent developments on AML/CFT front, the Committee recommends that KVP should be discontinued.**

[5] For example, the Bank of Baroda provides loan against NSC/KVP/Relief Bonds at 12 per cent [i.e. 3.5% above base rate (of 8.5%) or 0.5% over NSC/KVP rate, whichever is higher] while the rate of interest on overdraft is 12.5%.

As far as NSC is concerned, currently the term of the certificate is 6 years. This is again a non standard term and was fixed when interest rate was such that the amount invested in NSC would double in six years. Over the years, interest rates were lowered, but have been for the same maturity of 6 years. **It is recommended that the maturity period of NSC should be aligned to 5 year and the instrument should be benchmarked to 5-year G-sec.**

Since the Committee recommends abolition of KVP, which offered a slightly longer term instrument, after its abolition, the Committee recommends introduction of another NSC with maturity period of 10 years. This instrument should benchmarked to 10-year G-Sec. Since the investors money will be locked up for 10 years with very limited liquidity that the scheme offers, the illiquidity premium in terms of spread over the benchmark instrument may be fixed at a higher level than other schemes (details of spread explained in section 5.2.2). Both these instruments will continue to be eligible as collateral for availing loans from banks.

4.4. Common Issues

The tax administration for the small savings instruments would need to be made more efficient to ensure tax compliance. Further, in the absence of the use of core banking solution (CBS) linking all post offices, it is possible for individuals to avoid the ceiling on various instruments by parking their savings across more than one branches. Since the Department of Posts is undertaking CBS in major post offices, it would be possible to enforce the ceiling for a majority of small savers.

Summing up, the rationalisation of instruments is aimed at achieving public policy objectives of catering to the needs of financial security of small savers. The nomenclature of ‘small’ savings and the higher than market rate of interest makes it imperative to place a ceiling on investments in individual instruments so that the schemes cease to pose a fiscal burden on the Centre and the State Governments even while adequately catering to the interests of the target groups. **All instruments (other than those that are specially designed to serve as tax saving instruments) may be subject to TDS. Also, KYC may be enforced strictly to prevent money laundering/generation of black money. Similarly, the computerization and the introduction of CBS among postal savings bank branches would enable monitoring of the adherence to the investment limits prescribed for various small savings instruments.**

5.

Interest Rates on Small Savings Schemes

The issue of the alignment of small saving interest rates with the market rates has been elaborated in section 3.1. This issue is important as it impacts returns to investors, market rates, small saving collections, cost of finances for the Centre and States and the composition of financing of fiscal deficit. Due to these reasons, the issue of benchmarking small saving rates with market rates is extremely important.

5.1. Benchmark of Small Savings Instruments

5.1.1. Recommendations of Previous Committees

Committees in the past have suggested measures to benchmark the rates on various small savings instruments with market rates. In 1999, the R.V. Gupta Committee suggested that interest rates offered by banks and financial institutions might be considered for benchmarking some of the small savings schemes. The Committee on Administered Rates on Small Savings (Chairman: Dr.Y.V. Reddy, 2001) favoured the market determined yields on government securities as the benchmark. The Union Budget 2002-03 accepted the recommendation and announced the non-discretionary automatic linking of small savings rates to government securities on an annual basis[6]. Subsequently, in 2004, another Committee (Chairman: Dr. Rakesh Mohan) also recommended the yields on government securities to be the benchmark for government securities. Accordingly, the Government revised the rates of interest on small savings every year during January-March of 1999-2003 to align with the market rates but no further revision was carried out after March 2003. Recently, both the Thirteenth Finance Commission (2009) and the Report of the State Finance Secretaries on

[6] It was announced in the Union Budget of February 28, 2002 that "*Administered interest rates will now be benchmarked to the average annual yields of government securities of equivalent maturities in the secondary market. Accordingly, most administered interest rates are being reduced by 50 basis points from March 1, 2002. Such adjustments will henceforth be made annually on a non-discretionary automatic basis*."

Fiscal Responsibility Legislation: The Next Phase (Chairman: Dr. D.K.Srivastava) (2009) also made similar recommendations on the choice of government securities as the benchmark.

5.1.2. Meetings with State Finance Secretaries

In the meetings of the Committee held on October 22, 2010 at Chennai and November 25, 2010 at Delhi with the State Finance Secretaries, a few State Governments preferred bank deposit rates as the benchmark for small savings rates since bank deposits are the closest substitutes for small savings. It may, however, be noted that bank deposits, unlike small savings (or government securities), are not free from credit risk. Second, bank deposits are usually concentrated at the shorter end of the maturity spectrum and banks do not appear to actively solicit longer maturity borrowings. This is reflected in the lower deposit rates often offered by the banks on longer maturity bank deposits. On the other hand, since the public policy of NSSF is to promote thrift, the interest rates on small savings should vary directly with maturity. Third, various banks, reflecting the bank specific ALM also give additional interest rates on particular maturities; e.g. deposits for 555 days, 390 days, 1,000 days, etc. Hence, it may be operationally difficult to use bank deposit rates as benchmark for small savings. Fourth, unlike bank deposits which fund the demand for credit from both the corporate and the sovereign, small savings almost exclusively cater to the demand for credit by the sovereign (or quasi-sovereign entities such as IIFCL), and therefore, bank deposit rates cannot be the appropriate benchmark for the pricing of small savings instruments.

5.1.3. Principles for Benchmarking

A transparent and market based indicator that exclusively reflects the opportunity cost of small savings borrowings by the sovereign is a preferred benchmark for the following reasons.

First, debt management demands that the instruments of borrowings be designed so as to reduce the cost of borrowings to the issuer. If there is an identical retail investor base for marketable debt instruments as also small savings, the difference in the tax and risk (market and liquidity) adjusted effective rate of interest on various instruments issued by the same issuer should be in sync in order to prevent any arbitrage between these instruments. In countries where cost minimization is the principal objective of sovereign debt management, interest rate on non marketable retail debt is linked to that of the marketable government securities. Debt management, therefore, involves a choice of an appropriate mix of products so that in equilibrium, the risk adjusted cost of borrowing is similar for all market and non market instruments issued by the Centre as also the risk adjusted rate of return earned by the whole sale and retail investors.

Second, a yield curve based on Central Government dated securities can be generated across the maturity spectrum spanning 30 years for Central Government dated securities.

Third, to the extent that yields on government securities provide a forward looking view on inflation, government securities as a benchmark for retail debt instruments can assure security against inflation.

Fourth, retail participation in Central and State government securities issued through the auction route is actively solicited from 2002 and 2009, respectively. One of the plausible factors that could be responsible for the lukewarm response by the retail investors appears to be the lower rate of tax adjusted return on investments in government securities vis-à-vis small savings. Pricing of instruments of small savings should reckon the need for improving retail market participation in government securities.

Fifth, as per international practice, government securities serve as the benchmark for retail sovereign debt instruments in view of the cost minimization objective of sovereign debt management.

5.1.4. Recommendation

Taking into account the above considerations, the Committee agrees with the recommendations of the Reddy and Rakesh Mohan Committees that the secondary market yields on Central government securities of comparable maturities should be the benchmarks for the various small savings instruments (other than savings bank deposits, which do not have a fixed maturity). The rate of interest on savings bank deposits should remain fixed at 4 per cent per annum in line with RBI's policy. The benchmark for the various instruments are recommended to be as under:

S/No.	Instrument	Benchmark[7]
1	Savings Deposit	No benchmark - 4% (fixed)
2	5 year Recurring Deposit	5 year G-sec yield
3	1 year Time Deposit	364-day T-Bill (primary market auction cut-off – weighted avg. for issuances during the previous calendar year)
4	2 year Time Deposit	Linear interpolation between 364-day T-Bill and 5 year G-sec
5	3 year Time Deposit	Linear interpolation between 364-day T-Bill and 5 year G-sec
6	5 year Time Deposit	5 year G-sec
7	5 year SCSS	5 year G-sec
8	5 year MIS	5 year G-sec
9	5 year NSC	5 year G-sec
10	10-year NSC	10-year G-sec
11	15-year PPF	10- year G-sec

[7] All yields from the secondary market (except 364-day T-Bill)

5.2. Fixation of the Formula, Spread and Reset Period on Administered Rates vis-à-vis Yields on Government Securities

5.2.1. Formula

The previous Committees have taken different approaches in recommending the formula for benchmarking. Reddy Committee recommended benchmarking to annual average of the month-end secondary market yields announced by FIMMDA. Rakesh Mohan Committee felt that this leads to unnecessary volatility in the small saving rates which may not be desirable for small savers. It recommended that weighted average of two years' yields should be taken with the 0.67 weight given to the last year average and 0.33 weight given to the earlier year's average. The application of these two formulas for last two years can be seen in Table 15.

Table 15: Administered Interest Rates as per Reddy and Rakesh Mohan Formula

Tenor	Annual Average of G-sec Yields for the Calendar Year			Administered Rate as per the Reddy Formula(Col.3/4 + 0.5)		Yield as per Mohan Formula.67*(3/4) + .33*(2/3)		Bench-mark (round off)		Rate (Bench-mark+ Liquidity Spread)		Current Rate	Instrument
	2007	2008	2009	2009-10	2010-11	2009-10	2010-11	2009-10	2010-11	2009-10	2010-11		
1	2	3	4	5	6	7	8	9	10	11	12	13	14
1	7.67	7.79	4.64	8.29	5.14	7.75	5.68	7.75	5.75	8.25	6.25	6.25	TD
2	7.75	7.84	5.49	8.34	5.99	7.81	6.26	7.75	6.25	8.25	6.75	6.50	TD
3	7.80	7.86	6.11	8.36	6.61	7.84	6.69	7.75	6.75	8.25	7.25	7.25	TD
4	7.81	7.87	6.42	8.37	6.92	7.85	6.90	7.75	7.00	8.25	7.50		
5	7.82	7.87	6.64	8.37	7.14	7.85	7.05	7.75	7.00	8.25	7.50	7.50	TD/RD
6	7.85	7.89	6.80	8.39	7.30	7.88	7.16	8.00	7.25	8.50	7.75	8.00	MIS/NSC
7	7.90	7.93	6.99	8.43	7.49	7.92	7.30	8.00	7.25	8.50	7.75		
8	7.92	7.95	7.07	8.45	7.57	7.94	7.36	8.00	7.25	8.50	7.75		
9	7.94	7.89	7.00	8.39	7.50	7.90	7.29	8.00	7.25	8.50	7.75	8.00	KVP
10	7.95	7.86	7.02	8.36	7.52	7.89	7.30	8.00	7.25	8.50	7.75	8.00	PPF
11	7.99	7.95	7.24	8.45	7.74	7.96	7.48	8.00	7.50	8.50	8.00		
12	8.03	8.03	7.43	8.53	7.93	8.03	7.62	8.00	7.50	8.50	8.00		
13	8.07	8.14	7.57	8.64	8.07	8.12	7.76	8.00	7.75	8.50	8.25		
14	8.10	8.20	7.60	8.70	8.10	8.17	7.80	8.25	7.75	8.75	8.25		
15	8.13	8.23	7.63	8.73	8.13	8.20	7.83	8.25	7.75	8.75	8.25		

While Rakesh Mohan Committee formula gives more stability to rates, it adds a lag to the response in small saving rates towards market rates. It can be seen that the sensitivity of small saving collections to the rates is very high and thus such a delay in response should be avoided.

The Committee recommends that the Government may adopt the formula suggested by the Reddy Committee, as it will allow a quicker pass through from the recent market rates to the administered rates. Accordingly, a one-year reference period would be adopted. As compared with the Rakesh Mohan Committee formula, however, the chosen formula is likely to increase the volatility in the administered rates. The average of the month-end secondary market yields announced by FIMMDA (which the RBI has permitted the commercial banks to use for the valuation of their government securities portfolio) may be used for this purpose. The yields, so obtained, would be rounded off to the nearest 10 basis points. (Thus, if the rate as per the formula is 6.120 per cent, the rounded-off rate would be 6.10 per cent).

The Committee also agrees with the recommendation made by the Rakesh Mohan Committee on placing a cap of 100 basis points so that the administered rates are neither raised nor reduced by more than 100 basis points from one year to the next, even if the average benchmark interest rates rise or fall by more than 100 basis points. This would reduce the year-to-year volatility in the administered rates.

5.2.2. Spread

In the developed economies, the issuer appears to offset the higher transaction costs associated with retail debt instruments by offering a lower rate of interest than that in wholesale markets. **Taking into account the interests of the small savers, and in view of the absence of social security among the unorganised sections of the society, the Committee recommends a positive spread of 25 basis points, *vis-à-vis* government securities of similar maturities.** This would be consistent with the differential of about 25 basis points between the yields of the on-the-run and off-the-run government securities. A lower spread of 25 basis points *vis-à-vis* the spread of 50 basis points recommended by the Rakesh Mohan Committee would also contribute to the viability of NSSF.

As regards SCSS where the rate of interest is currently fixed at 9 per cent, the Committee recommends a spread of 100 basis points over and above the secondary market yield of government securities of similar maturity. Similarly, for 10-year NSC recommended by the Committee, it is desirable to have a marginally higher spread. The Committee recommends that for this instrument a spread of 50 basis points above the benchmark may be give.

5.2.3. Reset Period

Both the Reddy and Rakesh Mohan Committees had recommended an annual reset period for the rate of interest on government securities. Resetting of interest rates on a more frequent (say, half yearly, or even quarterly) basis is generally expected to increase the alignment of administered rates with the market rates. In the US, for example, interest rates on retail debt is reset every six months (May 1 and November 1) based on G-sec yields. On the downside, frequent resetting is likely to increase the volatility of the administered rates which could be detrimental to the interests of the small savers. As noted earlier, the Government has not reset the administered rates since March 2003 notwithstanding the volatile swings in market rates. **Accordingly, on a balance of consideration, the Committee recommends that the administered rates may be reset on an annual basis which will balance between the objectives of the need for closer alignment of administered interest rate with market rates and the reduction of its volatility.**

5.2.4. Date of Notification of the Rate of Interest

The administered rates may be notified by the Government every year on April 1, effective 2012. It is considered necessary to provide for a three month lag between the last day of the reference period and the date when the revised rates would be affected. Accordingly, **the reference period for averaging the small savings rate would be the calendar year** (as was also recommended by the Reddy Committee). **An exception may be made for 2011-12; for example, if the revised rate is announced on July 1, 2011, the reference period of April 2010-March 2011 could be taken**.

Table 16: Administered Interest Rates as per the Committee's Formula (calendar year as reference period)

Tenor	Annual Average of G-sec Yields for the Calendar Year			Recommended Administered Rate (col 2/3/4+0.25)			Rounded-off Rate			Current Rate
	2008	2009	2010	2009-10	2010-11	2011-12	2009-10	2010-11	2011-12	
1	2	3	4	5	6	7	8	9	10	11
1	7.83	4.38	5.91	8.08	4.63	6.16	8.1	4.6	6.2	6.25
2	7.87	5.42	6.50	8.12	5.67	6.75	8.1	5.7	6.8	6.50
3	7.89	6.05	6.94	8.14	6.30	7.19	8.1	6.3	7.2	7.25
4	7.89	6.49	7.27	8.14	6.74	7.52	8.1	6.7	7.5	
5	7.90	6.69	7.58	8.15	6.94	7.83	8.2	6.9	7.8	7.50
6	7.93	6.85	7.67	8.18	7.10	7.92	8.2	7.1	7.9	
7	7.95	7.02	7.75	8.20	7.27	8.00	8.2	7.3	8.0	
8	7.96	7.10	7.80	8.21	7.35	8.05	8.2	7.4	8.1	
9	7.91	7.06	7.87	8.16	7.31	8.12	8.2	7.3	8.1	
10	7.92	6.97	7.86	8.17	7.22	8.11	8.2	7.2	8.1	8.00
11	8.03	7.13	7.92	8.28	7.38	8.17	8.3	7.4	8.2	
12	8.13	7.27	7.99	8.38	7.52	8.24	8.4	7.5	8.2	
13	8.23	7.40	8.05	8.48	7.65	8.30	8.5	7.6	8.3	
14	8.34	7.53	8.12	8.59	7.78	8.37	8.6	7.8	8.4	
15	8.39	7.66	8.19	8.64	7.91	8.44	8.6	7.9	8.4	

5.2.5. Administered Rates for 2011-12

Based on the Committee's recommendation of the adoption of the Reddy Committee formula, 25 bps spread and calculation on calendar year basis, the administered rates are worked out for fiscal 2009-10 to 2011-12. It is seen that the rates would be marginally lower for 1 year and 3 year maturities while higher for 2, 5 and 10 year maturities for 2011-12. The rate of interest on the new instrument -10-year NSC would be 8.4 per cent. The rate of interest on SCSS would be 40 basis points lower at 8.6 per cent (Table 16). If the revised rates are announced say, on July 1, 2011, the 3-month lag yields a reference period of April-March in which case the administered rates are worked out as in Table 17.

In view of the significantly higher yields during January-March 2011 (as compared with those during the comparable period of the previous year), the administered rates across all maturities work out to be significantly higher (ranging from 20 to 70 bps) than the current administered rates; the extent of increase, is, however, lower than the cap of 100 bps fixed by the Rakesh Mohan Committee.

Table 17: Administered Interest Rates as per the Committee's Formula (April-March as reference period)

Tenor	Annual Average of G-sec Yields for April-March			Recommended Administered Rate (col 2/3/4+0.25)			Rounded-off Rate			Current Rate
	2008-09	2009-10	2010-11	2009-10	2010-11	2011-12	2009-10	2010-11	2011-12	
1	2	3	4	5	6	7	8	9	10	11
1	7.07	4.50	6.51	7.32	4.75	6.76	7.3	4.7	6.8	6.25
2	7.25	5.60	6.95	7.50	5.85	7.20	7.5	5.8	7.2	6.50
3	7.42	6.28	7.23	7.67	6.53	7.48	7.7	6.5	7.5	7.25
4	7.53	6.74	7.48	7.78	6.99	7.73				
5	7.56	6.98	7.74	7.81	7.23	7.99	7.8	7.2	8.0	7.50
6	7.63	7.11	7.81	7.88	7.36	8.06				8.00
7	7.71	7.24	7.86	7.96	7.49	8.11				
8	7.73	7.34	7.89	7.98	7.59	8.14				
9	7.67	7.38	7.93	7.92	7.63	8.18				
10	7.58	7.29	7.92	7.83	7.54	8.17	7.8	7.5	8.2	8.00
11	7.70	7.43	7.98	7.95	7.68	8.23				
12	7.83	7.54	8.05	8.08	7.79	8.30				
13	7.97	7.65	8.11	8.22	7.90	8.36				
14	8.09	7.75	8.18	8.34	8.00	8.43				
15	8.22	7.86	8.24	8.47	8.11	8.49				

Accordingly, in the above example, where the Government announces the administered rates on July 1, 2011, the rates of interest of the various instruments would be as in Table 18.

Table 18: Administered Interest Rates for July 1, 2011 to March 31, 2012

Instrument	Current Rate (%)	Proposed Rate (%)
Savings Deposit	3.50	4.0
1 year Time Deposit	6.25	6.8
2 year Time Deposit	6.50	7.2
3 year Time Deposit	7.25	7.5
5 year Time Deposit	7.50	8.0
5 year Recurring Deposit	7.50	8.0
5-year SCSS	9.00	8.7
5 year MIS	8.00 (6 year MIS)	8.0
5 year NSC	8.00 (6 year NSC)	8.0
10 year NSC	New instrument	8.4
PPF	8.00	8.2

5.3. New Instruments

The Committee considered the introduction of the following instruments:

5.3.1. Floating Rate Instruments

Fixed rate instruments dominate small savings schemes. PPF is the only floating rate product given its longer maturity and the yearly contribution.

Many countries, such as Japan and South Africa, have introduced floating rate retail debt instruments. The Reddy Committee had suggested introduction of floating rate instruments. In India, most savers continue to prefer the certainty of the contracted nominal rate of interest and, therefore, floating rate products introduced by commercial banks have not been very successful. For the issuer, introduction of floating rate instruments involves a cost in terms of the budgetary uncertainty on the interest outgo. In view of the above, **the Committee does not favour introduction of a new floating rate instrument at present**.

5.3.2. Inflation Indexed Instruments

Many countries, such as US, UK, Japan and South Africa, offer inflation indexed retail bonds to the savers. In India, an Expert Group on 'Protection of Interests of Small Investors and New Avenues for Safe Investment of their Savings' (Chairman: Shri G.N.Bajpai) in a report submitted to the Government in January 2005 had recommended a new scheme called "Senior Citizens Inflation Protection Savings Scheme" which will ensure to the senior citizens a real rate of return of 200 basis points above the annual average rate of inflation, as measured by WPI (Base: 1993-94) of the preceding calendar year. The following are noted: (i) the measure of inflation being WPI rather than consumer price index and (ii) arbitrary nature of the determination of the real rate of interest.

In India, the year-on-year WPI and CPI inflation diverge significantly on an annual basis. WPI inflation indexed instrument may not offer adequate protection to the small savers on a year to year basis although over a period of time, the divergence between WPI and CPI inflation may not be very significant. Hence, CPI-IW, which is easily understood as it is the basis for calculation of DA of Central and State Government employees, could be used. It is also expected that this segment would provide the dominant investor base for retail inflation linked product.

Second, in the absence of a mechanism for price discovery, the fixation of the real rate of return on implicit sovereign debt would be arbitrary. In countries, such as, South Africa and Japan that issue inflation indexed retail debt, the real rate of return on retail debt is arrived at on the basis of the price discovered in the preceding auction(s). Accordingly, the Committee is of the view that the retail capital indexed savings instrument can be introduced once inflation indexed bonds (IIB) are auctioned in the G-sec market. In India, it has been proposed to auction the WPI based inflation indexed bonds in the G-sec market, which would contribute to price discovery for the real rate of return. The same real rate of return could be added to the CPI-IW based inflation rate to derive the nominal rate of interest on inflation linked small savings instrument. The Committee is of the view that the introduction of the instrument for small savers could be considered depending on the market response to the IIB auctions and after conducting a survey to gauge the likely demand for such products among the retail savers.

5.3.3. Scheme for Girl Child

Cross country practice indicates that in countries such as UK, there are schemes that are specially designed for the children (Annex 11). DoP has sent a proposal to MoF for starting of a new scheme called Post Office Minor Girl Child Development Account (meant for welfare of girl child). The Committee is of the view that the girl child may not always be the actual ultimate beneficiary given the socio-economic status of the girl child. Hence Committee does not recommend introduction of such a new scheme.

6.
Investments of NSSF

As explained earlier, the investments of NSSF are mainly in SCGS and SSGS. A very small amount has been invested in 15 year security of IIFCL in 2007-08. While investments of net collection of small saving schemes in SCGS and SSGS are done on the basis of formula decided by NDC Sub-Committee, the investment of redemption proceeds of these securities are done in SCGS of 20 year maturity at prevailing market rates.

6.1. Present Arrangement – Criteria for Sharing

As per the present arrangement of the sharing of the NSSF funds, States have the option to take either 80 per cent or 100% of their respective net collections during a year. Among the 17 general category States, 11 States (viz., Bihar, Chhattisgarh, Goa, Haryana, Jharkhand, Karnataka, Maharashtra, Orissa, Punjab, Rajasthan and Tamil Nadu) have opted for 80 per cent share in their net small savings collections whereas the remaining six States (viz., Andhra Pradesh, Gujarat, Kerala, Madhya Pradesh, Uttar Pradesh and West Bengal) opted for 100 per cent share. As regards the special category States, nine States (viz., Arunachal Pradesh, Assam, Himachal Pradesh, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim and Uttaranchal) opted for 100 per cent share and the remaining two States (viz., J&K and Tripura) have opted for 80 per cent share.

It is on expected lines that a majority of the general category States and special category States have opted for 80 per cent and 100 per cent shares, respectively. The exercise of the option by State Governments also broadly corresponds to their individual cash balance position (except for a few States such as Assam, Gujarat and J&K). Interestingly, none of the States had changed its option from 80% to 100% or *vice versa* between 2007-08 and 2009-10. It may be concluded that of the 28 States, 15 States (viz., six from general category and nine from special category) that have opted for 100 per cent share appear to be comfortable with the current arrangement. The remaining 13 States may like to opt for a share of NSSF that is lower than 80 per cent with a view to substituting NSSF with cheaper market borrowings or reducing surplus cash balances.

In the meetings with State Finance Secretaries and in their response to the questionnaire sent by the Secretariat to the Committee, it was noted that States do not share a uniform view about the merits of market borrowings vis-à-vis NSSF borrowings. Many States were of the view that the small savings pose a fiscal burden on sub-national Governments. These States prefer market borrowings because it appears to be cheaper. The State Governments can exercise discretion on the quantum and the timing of borrowings, which is not possible under NSSF. A few State Governments viewed that since small savings are necessary as a public policy instrument though not necessarily as a debt management tool, the fiscal burden arising from the high cost NSSF borrowings be equitably shared between the Centre and the States. On the other hand, there are a few States that appeared to be relatively indifferent between NSSF and market borrowings. These States were of the view that the average maturity of their NSSF borrowings at 15.5 years is higher than that of open market borrowings. While open market borrowings have a lower maturity of 10 years and involve bullet repayments, exposing States to refinancing risk, NSSF involves a phased repayment. The interest rate of special securities issued to the NSSF is a certainty, whereas the coupon on open market borrowings is not known in advance and can differ across issues and States, depending on the liquidity situation, absorptive capacity of the market and State specific rating. Depending on the State specific risk-cost-redemption profile, some States could prefer a greater resort to open market borrowings, while some other States may prefer small savings.

The Committee also observed that the lowering of the administered interest rates on SSGS issued to NSSF from time to time can generate uncertainties about the choice between NSSF and Open Market Borrowings (OMB)/SDLs. While the original rate of interest on SSGS was significantly higher than the rate of interest on OMBs/SDLs during 1999-00 to 2001-02, the revised rate of interest as recommended by the 13th FC would make SSGS a cheaper option *vis-a-vis* OMBs/SDLs over the residual maturity period (Table 12). The Committee also considered the recommendations made by the pervious Committees on the issue of the sharing of NSSF borrowings in the past. The Reddy Committee (2001) had recommended that (i) the entire net proceeds from small savings should be transferred to the States; and (ii) in case some States do not wish to have a share in small savings, they may be given the choice to opt out of the scheme. The net proceeds from such States may form a corpus with the NSSF to be used for investment in Central or other State Government securities. The Technical Group on Borrowings by State Governments (Chairperson: Smt. S. Gopinath, 2005) preferred limited flexibility to the States and suggested that at least 80 per cent of the net small savings collections may be transferred to the State Governments. The Committee also suggested an alternative formula in terms of a minimum proportion of GFD to be financed through NSSF. The NDC Sub-Committee (2007) adopted the first alternative proposed by the Technical group.

6.1.1. Investment of Net Collection of Small Saving Schemes

As per the fiscal consolidation path chalked out by the 13th FC, the GFD of the States is expected to reach 3% in 2013-14 and remain at that level thereafter. Since the Centre and the States are expected to have same GFD-GDP/GSDP ratio over the medium term, the **Committee recommends an equal share of NSSF borrowings between the sovereign and the sub-sovereign**. To the extent that the rate of interest on borrowings from NSSF is higher than the market rates, the 50:50 share would ensure equitable 'burden sharing.' **Hence, the Committee recommends that the mandatory component for States could be lowered to 50 per cent from 80 per cent at present**. The option could be exercised once at the beginning of each fiscal for administrative convenience. **The balance amount could either be taken by the Centre or could be on-lent to other States if they so desire, or could be on-lent for financing infrastructure**.

6.1.2. Investment of redemption proceeds

The past Committees have not deliberated on the terms of utilisation of the redemption proceeds of SSGS and SCGS. At present, the NSSF invests the redemption proceeds in Central Government securities in 20 year SCGS at the prevailing market rates, which is lower than the rate of interest on fresh investments by NSSF. This is one of the most important reasons of non-viability of NSSF. Since there does not seem to be any rationale for the difference between the term of investments and reinvestments, **it is recommended that the reinvestments may be as per the same terms as for fresh investments so as to improve the viability of NSSF. The reinvested amount should also be shared between the Centre and the States on 50:50 basis as in the case of fresh investments.**

For this arrangement, the Committee considered three options. The first option is to invest the amount realised from redemption of a particular entity into securities of the same entity. Thus, the redemption proceeds of SCGS can be invested back into SCGS and redemption proceeds of SSGS of a State can be invested in SSGS of the same state. This option is very neat and simple but not as equitable as that for net collection and also involves legacy issues. The second option is that the entire redemption proceeds in a year are pooled together and are invested in SCGS and SSGA in the ratio of 50:50. The inter se distribution of SSGS amongst various states can be fixed in the ratio of their repayment of that year (which is known from before). This option is equitable but the investment is not in accordance with the recent trend of small saving collection. The third option is that, like in second option, the entire redemption proceeds in a year are pooled together and are invested in SCGS and SSGS in the ratio of 50:50. **The inter se distribution of SSGS amongst various states can be fixed in the ratio of their gross collection in the previous year.** The Committee recommends the third option.

6.2. Tenor of Issuances by States and Maturity Profile of Investments by NSSF

At present, all investments by NSSF in SSGS have identical maturity / repayment schedule. These loans have an extremely long maturity of 20 years after a moratorium of five years. This term was fixed before constitution of NSSF when these loans were actually extended as plan loans from Centre to States from Consolidated Fund of India. Currently, after the recommendation of disintermediation by Twelfth FC, plan loans from Centre to States have been discontinued but these loans still continue to have same term. Many States have argued against high cost longer maturity NSSF borrowings and favoured a greater flexibility on the fixation of the tenor of instruments. In particular, the lowering of the tenor would also facilitate better matching between assets and liabilities of NSSF.

The Committee recommends that the special securities issued by the Central and State Governments can have a shorter tenor of 10 years to broadly align with the maturity profile of the small savings instruments. The 5-year moratorium on redemption may be done away with and 1/10th of the amount may be redeemed each year. It is expected that with the continued rule-based fiscal consolidation initiatives taken by the Central and State Governments, lower maturity would not involve refinancing risk.

6.3. Periodicity of Reset of interest rates on investments by NSSF

As in the case of small savings, **the interest rates on securities issued by the Central and State Governments should be done on an annual basis based on the average interest paid on small saving schemes.** This can be assessed at the beginning of every financial year on 1st April.

6.4. Rate of Interest on Investments by NSSF

With the small saving rates being market linked and management cost brought down, the only parameter to ensure viability is the interest rate on the SCGS and SSGS. The Committee favours to adopt a cost-plus approach in fixing the interest rates on these securities. **The Committee recommends that the rate of interest on securities issued to the Central / State Governments would be equal to the sum of the weighted average interest cost on the outstanding small savings and the average administrative cost.** The Committee has taken into account its recommendations on the revised commission payable to the agents as also the recommendations of a Committee set up by the Government on commission payable to the postal authorities. **The Committee is of the view that the average administrative cost would be around 70 bps and, hence, 70bps could be loaded on to the interest cost on small savings to determine the rate of interest on SSGS and SCGS.**

Given the likely average liquidity spread of around 30 bps [25 bps in all instruments barring SCSS (100 bps) and 10-year NSC (50bps)], the Group views that the break even rate for investments by NSSF could be around 100 bps over the yield on GoI dated securities. Since the special securities would have a maximum maturity of 10 years, the interest rate on SCGS and SSGS would be around 100 bps over and above the 10-year G-sec. Contextually, the spread between the State Government and Central Government securities issued under the market borrowing programme is placed at around 30 - 80 basis points in the recent years and hence, the rate of interest on SCGS and SSGS would be marginally higher than that of the SDLs. This is unavoidable keeping in view the administrative costs involved and the liquidity spread proposed for the small savers (unlike in advanced economies, where no such spread is offered). The rate of interest on investments by NSSF could be modulated each year to ensure that NSSF is a no-profit no-loss entity.

For fixing the interest rate every year, the total interest paid to the subscribers of small saving schemes during the last financial year as a percent of the outstanding at the beginning of the financial year may be taken as the weighted average interest cost on the outstanding small savings. However, to ensure that this reflects a correct picture of the average interest on small saving instruments, it is extremely essential that the interest payments from NSSF are captured properly in the account. As explained in Section 2.5.1, it has been observed that the interest expenditure does not truly reflect the interest paid to the subscribers on small saving instruments.

6.5. Existing Asset Base

While the formula for fixation of interest rates on investment of NSSF takes care of the future investments of NSSF, the issue of return on existing asset base and the gap between the assets and liabilities in NSSF needs to be addressed. The return on investment in SSGS has been fixed by 13th FC and with the reset recommended by it, the effective return on SSGS would reduce to 9.05% (Table 12). The return on SCGS is still lower at 8.81% as shown in Table 11. As pointed out earlier, this is one of the reasons for lower overall returns on the asset of NSSF. There is a need to restructure this asset base. **The Committee recommends that as in case of SSGS, the SCGS issued till 2006-07 may be reset to 9.0% and the securities issued after 2006-07 may be reset at 9.5%.** This will raise the effective interest on SCGS to 9.07%. This will also bring the effective interest rate on SCGS on par with that of SSGS. For Centre, this will have additional implication of about ₹ 600 crore. This will also help the NSSF in bridging its income-expenditure gap and eventually asset liability-mismatch.

To address the issue of excess liabilities over assets, the Committee recommends that the Centre may take up recapitalisation of NSSF, especially when the NSSF is in need of cash to discharge its liabilities. There is an urgent need to bridge this gap to ensure that a viable return on of investment ensures viability of the Fund.

6.6. Viability of NSSF

NSSF has a negative mismatch between its income and expenditure. This is due to two reasons. Firstly, the asset base of the Fund is lower than the liabilities that it has to discharge since in the past years, due to continuous loss on income and expenditure account, a part of net collection has been used to finance the cash deficit. Secondly, on the lower asset base than the liability, the return on assets is lower than the cost of liabilities.

The weighted average rate of interest on the cost of small savings stood at 9.05 per cent in 2010-11 RE which was marginally lower than the weighted average rate of interest of 9.79 per cent on SSGS (Table 12). The loss incurred by NSSF is attributed to the reinvestments by NSSF of the redemption proceeds (of its investments in SSGS/SCGS) in SCGS at market rates which resulted in a lower weighted average rate of interest on SCGS at 8.81 per cent. The resetting of the interest rates on SSGS and SCGS without a corresponding decline in the interest rates on the liabilities (small savings) side also contributed to the negative spread. The negative spread would further widen following the implementation of the recommendation of the Thirteenth Finance Commission of the resetting of interest rates on SSGS at 9.0 per cent. Interestingly, the significant ALM mismatch between the tenor of assets and liabilities of NSSF had a *positive* impact on the viability of NSSF balance sheet in a secular declining interest rate environment since 1999-2000 as the liabilities were repriced at prevailing lower rates at a faster pace than the assets.

With a view to improving the viability of NSSF, the Committee recommends the following. First, the rate of interest on reinvestments may be brought at par with that of fresh investments. **Second**, downward resetting of interest rates on the assets side without corresponding reduction of interest rates on the liabilities side has implications for the viability of NSSF. It is necessary that the viability of NSSF is taken into account while recommending on the reduction of interest rate on the assets side. **Third**, the maturity of instruments on the liabilities side could be aligned with those on the assets side to facilitate back-to-back on-lending by NSSF. **Fourth**, the rate of interest on SCGS should be reset to bring the average return on par with that on SSGS. In addition, Centre may also undertake recapitalisation of NSSF to bridge excess of liability over assets. **Fifth**, a reduction in the management cost and in the time lag between receipts of small savings and their investments would contribute to the improved viability of NSSF as discussed in Section 7.

6.7. Alternative Instruments for Investments by NSSF

The scope of channeling NSSF funds for infrastructure development was explored in the Union Budget 2007-08 which provided for investments by NSSF in 15 year paper issued by IIFCL at 9 per cent. Even as States remain saddled with large surplus cash balances in view of the FRL ceiling, the economy faces severe '*infrastructure deficit*'. Since States have been disincentivised to breach their FRL ceilings, infrastructure development would necessitate a greater public-private partnership in the near future. In this regard, the following options are considered:

One option could be to devise a dedicated scheme for infrastructure financing. To begin with, the receipts under the existing PPF scheme could be earmarked for financing of infrastructure with a lock-in period of at least ten years. Net inflows under PPF could be on-lent to institutions like NHAI, IIFCL, IRFC, etc. with a mark-up to cover the management cost. This would eliminate the interest rate and the maturity mismatch risk from such schemes. To place greater emphasis on infrastructure financing, the corpus under the long term infrastructure financing component of NSSF could be delinked from the general NSSF funds. The resources could also be on-lent to the State infrastructure agencies, with State Government guarantees. The higher exemption would also compensate the investor for the loss due to revised market based interest structure of the scheme.

The second option could be for post offices to draw upon the Japanese, Chinese and German Post-bank models to recycle part of the NSSF resources. These could be especially targeted at the rural poor in the area of *micro-financing*. This activity could make post offices *micro-financing banking institutions* that would help in the ongoing effort of financial inclusion and uplifting of the rural poor, thereby contributing directly to the developmental effort. In the long-run, post offices could become full-fledged micro-financing institutions, delinked from NSSF. The deposits could be recycled as micro credits, which would help redeem the rural poor from money lenders. However, in India, the post bank model involves risks as such loans may quickly degenerate into NPA.

At present, investments by NSSF are free from default risk and enjoy implicit guarantee of the Government of India. The proposed options, however, involve credit risk. The underlying liabilities being small savings of the public, erosion in the NSSF balance sheet would have implications for the repayment capacity of the Centre of its small savings liabilities and would have to be honoured out of budgetary resources of the Government of India. Hence, a guarantee redemption fund may have to be created out of the accruing NSSF inflows to cover the default risk. This would require an estimation of the default probability to work out the required guarantee corpus. A nominal budgetary contribution could also be a supplement for the purpose. Hence, the Committee is of the view that the feasibility of the above options involving credit risk would depend on the risk bearing capacity of NSSF to absorb NPAs and the fiscal sustainability of the Central and State Governments. Also, post offices would need to develop expertise to perform micro financing activities, which may not be feasible over the medium term.

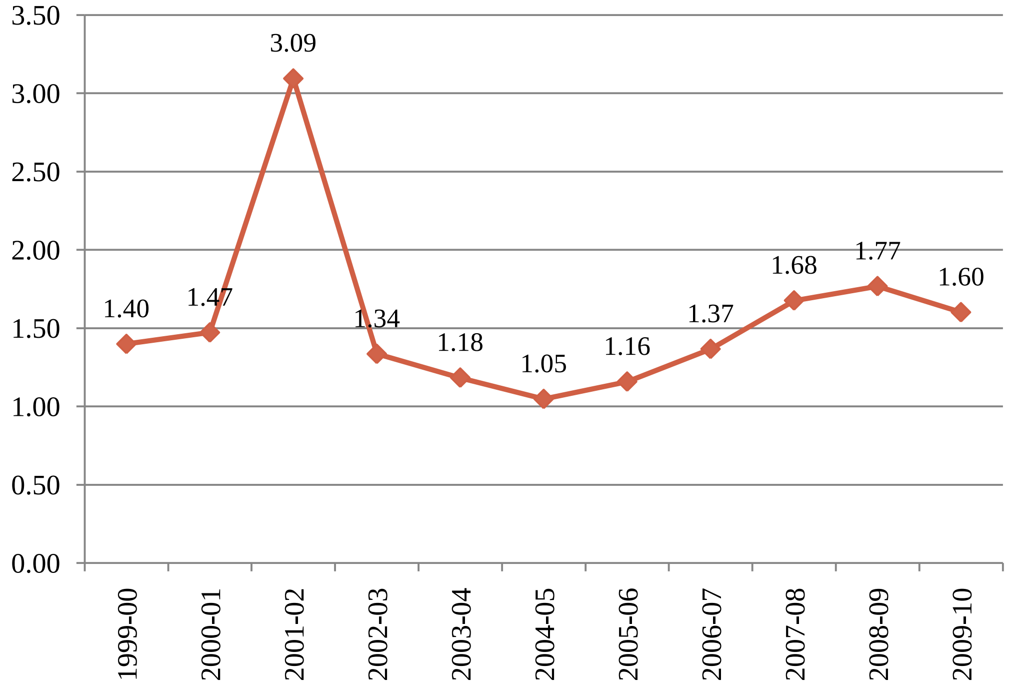
At present, as indicated above, investments by NSSF are free from default risk and small savings enjoy the implicit guarantee of the Government of India. The Committee desisted from recommending an investment avenue that could involve credit risk to the small savers. At the same time, in view of large infrastructure deficit and the relatively larger maturity of small savings instruments vis-à-vis, instruments, such as bank deposits, small savings could play a crucial role in the financing of infrastructure. In view of the above, **the Committee recommends that NSSF could invest in securities issued by infrastructure companies, such as, IIFCL, NHAI and IRFC that are wholly owned by the Government.** These securities would be non-marketable and NSSF would hold these till maturity. The resources available from NSSF would substitute for alternative funding sources.

The identified entities could be permitted to issue securities for 10/15 year maturity. These securities could be either of the nature of bullet bonds or redemption bonds. If the securities are bullet bonds, it may be preferable to match the investments by NSSF with the inflows from the only available longer term savings instrument, viz., PPF. If, however, these securities are amortization bonds as in the case of special securities issued to the State governments, the entire pool of small savings could be used as the source of funds for the infrastructure bonds. The rate of interest to be charged by the NSSF could be at least a spread of 100 basis points above the secondary market yield on GoI dated security of corresponding maturity to cover the management cost and the cost of maturity transformation. In addition, the Centre could also charge a guarantee commission wherever Government guarantee is given. The Government may consider giving guarantee to these securities, in which event, NSSF would not incur any credit risk. Accordingly, credit risk is not priced in. If however, Government guarantee is not available, credit risk would have to be priced in.

7.
Cost of Operations

The operational costs of running the NSSF comprises payment of remuneration/agency charges to Department of Post for management / operation of Small Savings and PPF, payment of remuneration / agency charges to banks for operation of PPF and SCSS, payment of commission to various categories of agents; and cost of printing of Savings Certificates, cheque books, etc. Besides, there are costs arising from the lags between receipts of small savings and investments in government securities.

Figure 14: Management Cost to Department of Posts (per cent of Gross Collections)



7.1. Remuneration to Department of Post

Department of Posts are paid remuneration by Ministry of Finance for managing the small savings and PPF schemes on agency basis (Figure 14). The remuneration is calculated on the basis of the estimated number of accounts/certificates issued/discharged by applying rates per account/certificate.

The small saving schemes of are mainly operated through the network of over 1.55 lakh post offices. Department of Posts is paid agency charges/remuneration from NSSF on per account/per certificate basis for deposit accounts and various categories of savings certificates.

An Expert Group (November 1994), headed by the then Chief Advisor (Costs) had recommended the rates of remuneration to be paid Department of Posts, taking 3.6 transactions per account per year. These recommendations were later modified on the request of Department of Posts and the number of per accounts transactions was enhanced to 4.8. The rates of remuneration continue to be calculated on this basis since 1-4-1993. The Expert Group had also recommended an escalation of 10% every year over the rates of previous year, which was allowed till 2001-02 based on the overall growth in Government establishment expenditure.

However, in 2002-03 a view was taken that the 10% yearly increase in the rates of remuneration was on a higher side when compared with the rate of inflation. This was also since the growth in overall Government establishment expenditure declined due to various economy measures undertaken by the Government as a part of overall fiscal reforms. Simultaneously, the rate per account was bifurcated into ‘salary’ and ‘non-salary’ components. While the escalation in the salary component was allowed at the same percentage as that allowed to various Departments for the fixation of ceilings of non-plan expenditure, in the case of ‘non-salary component’ the escalation was linked to the rate of inflation.

Statement showing details of remuneration paid since 2004 -05 and the rates are given in Table 19

Table 19: Payment of Remuneration to DOP and the Rates

Year	Amount (₹ crore)	Rates per Account / certificate (₹)		
		SB	IVP	SC
2004-05	1,861	106.97	8.02	30.19
2005-06	2,318	111.12	8.33	31.36
2006-07	2,490	114.46	8.58	32.3
2007-08	2,476	117.89	8.84	33.27
2008-09	2,802	123.33	9.24	34.8
2009-10	3,133	129.49	9.7	36.54
2010-11 (RE)	3,215	135.96	10.19	38.37
2011-12 (BE)	3,518	142.76	10.69	40.29

7.2. Expert Group to Review the Agency Charges to Department of Post

As explained, the agency charges are being fixed on the basis of the parameters fixed by the Expert Group constituted in 1993, after giving an annual increase every year. Considering the fact that many of the parameters worked out by the previous Group have become outdated, the Government has has constituted an Expert Group on 9.4.2010 under the Chairmanship of Addl. Chief Adviser (Cost), Department of Expenditure, for review of rates of agency charges payable to Department of Posts.

The Group consists of members from Department of Posts, Department of Economic Affairs, NSI and Finance Secretaries of 3 State Governments. The main TOR of the Expert Group, inter alia include examination of basis of payment of remuneration, recommending formula for sharing of management cost between Centre and State, recommending suitable measures for improving efficiency of Post Offices and to recommend whether any powers for relaxation of rules of small savings schemes can be delegated to Department of Posts.

The cost of administration per account of DoP depends on three factors, viz cost per employee per minute, average time taken per transaction and average number of transactions per account. Various developments during these years are expected to impact on these parameters and consequently, cost of operation.

Firstly, with more and more computerisation of Post Offices and efficiency improvement in Post Offices, the average time per transaction is expected to have come down. It is also expected that DoP would undertake further process reengineering to make handling of transactions more efficiently, which would not only, reduce cost of transaction but also quality of service to the subscribers. The savings from these efficiency improvements should be properly factored in to ensure that the cost of operations come down. This is also important because the Government has invested in computerisation and modernisation of Post Offices and it should get a return in the form of cost savings.

Secondly, there have been two Pay Commissions after the previous expert group has given its recommendations. The impact of pay revision would increase the cost of employee per unit time. While an increase per year in the rate per account is being given, it may not have fully captured the impact of the pay rise due to Pay Commissions' recommendations.

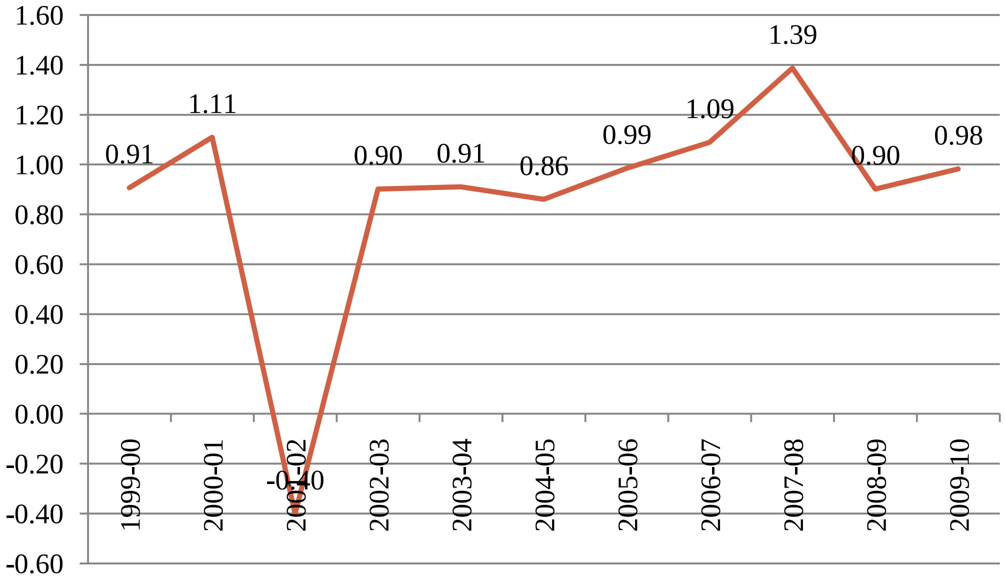
Average number of transactions per account may not undergo major change as the structure of the schemes has remained more or less same. Unlike regular bank accounts, since the transactions under each of small savings are governed more by the structure of the scheme rather than the behaviour of the account holder, the change on number of transaction per account would be limited. However, due to overall financial inclusion, the number of transactions per account would have gone up for postal saving accounts. This would have some limited impact on this parameter.

However, it is essential to ensure that the overall cost of management should come down as percentage of the outstanding. This is critical because the formula for fixing the rate on investments of NSSF would make the Fund unviable if the total cost of operations exceed 0.7% of the total outstanding.

7.3. Commission payable to Small Savings Agents

Small savings collections are mobilised through a wide network of agents. There are three types of agencies *viz.*, (a) Standardised Agency System (SAS), (b) Mahila Pradhan Kshetria Bachat Yojana (MPKBY) and (c) Public Provident Fund Agents (PPFA). These agents are remunerated from the NSSF on the basis of gross small savings collections (Figure 15).

Figure 15: Agency Charges Paid from NSSF (Per cent of Annual Gross Collections)



State Governments have, in the past, noted the employment generated by small savings schemes. In the past, State Governments used to also remunerate the agents. Most of the State Governments have now abolished agency commission at their end. The details of commission paid at source to the agents are provided in Table 13

Various Committees in the past have recommended on the agency commission payable to the agents and the DoP. In 1998, the R.V.Gupta Committee had recommended that the commission to the agents may be payable at a flat rate of 1%. The Gupta Committee (1998) indicated that the remuneration to DoP would constitute 1.7% of gross deposits and may be reduced to 1% within 5 years. The Reddy Committee (2001) had recommended that the existing rates of commission paid to the agents may continue.

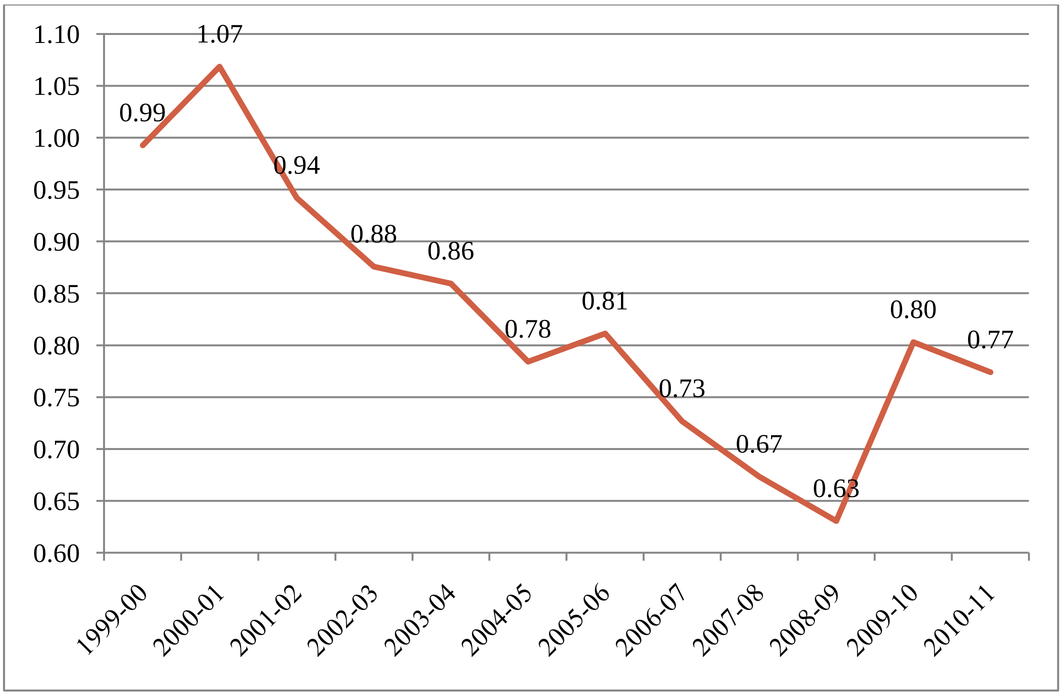
Table 20: Agency Commission of small savings schemes

Agents	Schemes operated	Commission given by the Central Government (per cent)
1.Standardised Agency System (SAS)	a. Kisan Vikas Patra	1
	b. Post Office Monthly income scheme	1
	c. Post Office Time Deposits	1
	d. National Savings Certificates	1
	e. National Savings Scheme	1
	f. Senior Citizens Savings Scheme	0.5
2.Mahila Pradhan Kshetria Bachat Yojana (MPKBY)	Post Office Recurring Deposit Scheme	4
3.Public Provident Fund Agents (PPFA)	Public Provident Fund	1

Table 21: Details of Commission paid to the Agents

Year	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11 (RE)	2011-12 (BE)
Amount (₹ crore)	1,972	1,983	2,048	1,430	2,180	2,400	2,200

Figure 16: Total Management Cost (per cent of outstanding small savings)



The Working Group of State Finance Secretaries on State FRL: The Next Phase (2009) had recommended that the spread between the rate of interest charged by the NSSF to the States and the rate of interest on small savings paid by NSSF may be brought down to around 75 bps from around 150 bps a present.

The 13th FC has noted the following: "*Some **reforms are also required at the state level**. In the past there has been a practice of giving various **incentives such as cash awards** to officials and other similar measures to promote subscription to small savings instruments. These measures also interfere with normal market dynamics. While most of these incentives, like awards to officials, have outlived their utility, all such incentives that either add to the cost of administration or affect normal market linked subscription, should be proactively withdrawn by the states*. "

The Committee agrees with the above recommendations of the 13th FC and noted that agency charges distorts the investment pattern and increases the effective cost of borrowings for NSSF. While most of the States have already abolished payment of agency commission, the Centre may also reduce the agency charges over a phased manner with the ultimate objective of establishing a near parity between the costs of borrowings from NSSF vis-à-vis market borrowings.

The Committee therefore recommends that under PPF, the commission should be abolished. Under PPF, 90% of the transactions are happening through banks and for banks commission is not payable for any other scheme of theirs. The Committee feels that 4% commission under MPKBY is very high and is affecting the viability of NSSF. The Committee recognises that the RD scheme requires considerable effort on part of agents in mobilising monthly deposits. However, 4% commission is distortionary and expensive. The committee recommends that this should be brought down to 1% in a phased manner in a period of three years with a 1% reduction every year. Under SAS, while the commission for senior citizen saving scehme is 0.5%, it is 1% on other scheme. The Committee recommends that while commission should be abolished on Senior Citizen Saving Scheme, on other schemes, it should be brought down to 0.5%.

7.3.1. Agents' Commission paid by States

Although most of the State Governments have already abolished the commission being paid by them, some states are still paying commission to agents in their state. This creates distortion in operation of the scheme and needs to be discouraged, as recommended by 13th FC. **In order to ensure that the State Governments do not give any extra incentive to the Agents, the Committee recommends that the incentive paid to the State Government may be reduced from the incentive payable by the Central Government to the Agents.**

7.4. Reducing the lag between Receipts and Investments

There is about two to three months' lag between the receipts of small savings and investments by NSSF. In the interregnum, the balances are held in the public account of the Government. While the balances are available to the Government for financing of the deficit, it represents interest income foregone by the NSSF. Instantaneous release would reduce cumulative loss by ₹ 6,298 crore. **The Committee recognizes the need to reduce the lag to fifteen days in view of the developments in the technology. Accordingly, the Committee recommends that further action in this regard may be taken by Government.**

7.5. Other Issues

There are certain issues relating to management of the NSSF, that the Committee came across during its analysis, which need close coordination between various agencies if they need to be properly addressed. Two critical areas that form part of recommendations of this Committee are proper capturing of interest paid to subscribers and time lag between and the receipts of small savings and investments by NSSF. There are other operational issues that are critical for efficient operation of NSSF.

The Committee recommends the setting up of a monitoring Group with members drawn from the MoF, RBI, DoP, SBI and other select banks as also select State Governments, to resolve the various operational issues. The Monitoring Group would, *inter alia*, address the data discrepancy in the operations of NSSF, establish a mechanism to reduce the time lag between the inflows into NSSF.

8.
Kerala Treasury Savings Bank Scheme

The Committee has examined the Kerala Treasury Savings Bank Scheme. The Committee notes that the Scheme of acceptance of public deposits by the Kerala State Treasury is a legacy from the pre-independence days and its continuation was one of the conditions of the state's accession into the Indian Union in 1947. The Government Savings Bank Act, 1873 which was enacted by the Government of India to make statutory provisions in respect of Government Savings banks extends to the whole of India *except* the deposits made in Anchal Savings Bank of the erstwhile State of Travancore-Cochin. As at end-March 2010, the outstanding treasury deposits at ₹6,500 crore constituted 10.3 per cent of the outstanding liabilities of the State Government (₹63,269.68 crore). Apart from utilizing the receipts under the Kerala Treasury Savings Bank Scheme for financing its GFD, Kerala also borrows from NSSF like any other State Government.

Recently, the Government of Kerala has proposed to introduce ATM facility for its savings bank account holders under its Kerala Treasury Savings Bank Scheme. The matter has been examined in depth in the Reserve Bank of India. In this regard, the considered view of the Reserve Bank is that it may not be prudent to incentivize the deposit mobilisation under the scheme for the reasons furnished below.

It is noted that the Kerala Treasury Savings Bank Scheme distorts the fiscal discipline imposed on the State Government including the WMA/OD scheme. Second, the State Government is paying a higher rate of interest on its savings deposits and fixed deposits as compared to the commercial bank deposits of comparable maturities resulting in an unfair advantage over the banks whose savings rate is regulated by the Reserve Bank. Third, the scheme is tantamount to a parallel NSSF at the State level with additional administrative cost incurred by the State Government. Taking into account the administrative cost, the cost of borrowings is likely to be higher than that of State Development Loans floated by the State Government. Fourth, the scheme is akin to a savings bank run by a State

Government without adequate regulation and supervision. Fifth, the extension of ATM facility with co-branding arrangement with the SBI/SBT, as suggested by the State Government, has the potential of multiplying deposit mobilisation even from outside Kerala. Sixth, the scheme has ramifications for customer service in the absence of regulation.

In view of the above, the Reserve Bank is not in favour of permitting the State Government to issue ATMs to the savings bank account holders cobranded with/ through the banks. The Reserve Bank is of the view that the Kerala Savings Bank Scheme may be phased out since the scheme has outlived its purpose with the introduction of NSSF of which the Kerala Government is also a beneficiary.

The Reserve Bank has requested the Committee to examine the issue in its entirety and consider recommending the phase-out of the scheme. **The Committee has examined the issue and recommends in favour of the phasing out of the Kerala treasury Savings Deposit Scheme in view of the distortionary impact on the interest rate structure and distortion of the fiscal discipline.**

Annexes

Annex 1: Small Saving Schemes: Legislative Framework

Broadly, small savings schemes can be classified under three broad heads, viz., savings accounts/deposits, saving certificates and provident fund scheme. The small saving schemes can be classified under the Acts that govern them, viz., Government Savings Banks Act, 1873, Government Savings Certificates Act 1959 and Public Provident Fund Act 1968. Every scheme is formulated by the process of framing a rule/scheme under the relevant Act.

The Government Savings Banks Act, 1873

The Act was enacted to make statutory provisions in respect of Government Savings Banks. The Act was notified on 28th January, 1873 and extends to the whole of India except the deposits made in Anchal Savings bank of the State of Travancore Cochin and any law in force in the said State immediately before commencement of the Part B States (Laws) Act, 1951, relating to such deposits. Various small savings (deposit**)** schemes of the Government have been formulated under the Act. At present, the following schemes are in operation through the agency of post offices and designated bank branches throughout the country:

	Scheme/Rules	Implementing Agency
1.	Post Office Savings Account (POSA)	Post Offices
2.	Post Office Time Deposit(POTD) – 1year, 2 years, 3 years and 5 years	Post Offices
3.	Post Office Recurring Deposit (PORD)	Post Offices
4.	Post Office (Monthly Income Account)	Post Offices
5.	Senior Citizens Savings Scheme(SCSS)	Post Offices and Designated branches of public sector banks and few public sector banks

Apart from the above current schemes, a number of other schemes/rules had also been framed under the provisions of the Act. Fresh deposits under such schemes have since been discontinued as a result of reviews carried out from time to time, the related rules are, however, still in existence viz: National Savings Scheme, National Savings Scheme, Post Office Cumulative Time Deposit, etc. The depositors / investors are not bound to withdraw their deposits under the schemes even after the specified maturity periods, deposits as well as past claims under the discontinued schemes continues to exist / be raised for indefinite periods even a number of years after discontinuance of fresh deposits. The rules governing the schemes have, therefore, to be kept alive and hence, not repealed.

Government Savings Certificates Act, 1959

The Act was enacted to enable the Government to make statutory rules for making provisions for issue and administering the various categories of Savings Certificates issued by the Central Government from time to time. The Act came into force from the 1st August, 1960. The two Certificate schemes/rules, presently in force, are:-

	Scheme/Rules	Implementing Agency
1.	Kisan Vikas Patra (KVP)	Post Offices
2.	National Savings Certificate (VIII Issue)	Post Offices

Statutory rules/regulations governing a number of savings certificates viz: Indira Vikas Patra, National Savings Certificates (I to VII-Issues), National Savings Certificates (Old Series), National Plan Certificates, National Plan Savings Certificates, National Defence Certificates, National Savings Annuity Certificates, National Development Bonds, Social Security Certificates, etc., were also framed under this Act. These schemes/certificates have since been discontinued after reviews from time to time and similar to the Savings Deposit Schemes, the rules are still in existence in order to take care of the remaining un-discharged certificates, claims/issues arising therefore, if any.

Public Provident Fund Act, 1968

This Act was enacted to constitute / introduce a Public Provident Fund for the benefit of general public, specifically for the people in business or professions, workers in un-organised sector, who are not the beneficiaries of any of the other provident funds like General Provident Fund (GPF), Employees Provident Fund (EPF), Contributory Provident Fund (CPF). The Act came into existence with effect from the 15th June, 1968 and the Public Provident Fund (PPF) Scheme, 1968, framed and operationalised there-under through the agencies of designated post offices as well as designated branches of the public sector banks throughout the country, is open to all the citizens, whether or not benefited by any other provident fund scheme.

The Savings Bank General Rules, 1981, contain various provisions which are common in respect of all the above Savings Deposits Schemes and as such applicable to all these schemes except the Senior Citizens Savings Scheme, 2004, the rules governing to which are self-contained/comprehensive.

The schemes are promoted at national level by the National Savings Institute and at State/Regional level by State and UT Governments/Administrations. Extension agents have been appointed to mobilise deposits at the doorstep of the individual investors.

Annex 2: Small Savings Schemes – Salient Features

SCHEME	Interest Payable, Rates, Periodicity etc.	Investment Limits and Denominations	Salient features including Tax Rebate
Post Office Savings Account	3.5% per annum on individual/ joint accounts.	Minimum INR 50/-. Maximum INR 1,00,000/- for an individual account. INR 2,00,000/- for joint account.	Cheque facility available. Interest Tax Free.
5-YearPost Office Recurring Deposit Account	On maturity INR 10/- account fetches INR 728.90/-. Can be continued for another 5 years on year to year basis. Rate of interest 7.5% (quarterly compounded).	Minimum INR 10/- per month or any amount in multiples of INR 5/-. No maximum limit.	One withdrawal upto 50% of the balance allowed after one year. Loan of 50% of balance: after 12 months, 12 deposits) Premature withdrawal: after 3 years (3.5% savings deposit rate is paid) 6 & 12 months advance deposits earn rebate.
Post Office Time Deposit Account	Interest payable annually but calculated quarterly. Period Rate 1 yr. 6.25% 2 yr. 6.50% 3 yr. 7.25% 5 yr. 7.50%	Minimum INR 200/- and in multiple thereof. No maximum limit.	2,3 & 5 year account can be closed after 1 year at discount. Account can also be closed after six months but before one year without interest. The investment under 5 year deposit scheme qualifies for the benefit of Section 80C of the Income Tax Act, 1961 from 1.4.2007.
Post Office Monthly Income Account	8% per annum payable i.e. INR 80/- will be paid every month on a deposit of INR 12000/-.	In multiples of INR 1500/- Maximum INR 4.5 lakhs in single account and INR 9 lakhs in joint account.	Maturity period is 6 years. Can be prematurely encashed after one year but before 3 years at the discount of 2% of the deposit and after 3 years at the discount of 1% of the deposit. (Discount means deduction from the deposit.) A bonus of 5% on principal amount is admissible on maturity in respect of MIS accounts opened on or after 8.12.07.
15year Public Provident Fund Account	8% per annum (compounded yearly).	Minimum INR. 500/- Maximum INR. 70,000/- in a financial year. Deposits can be made in lumpsum or in 12 instalments.	Deposits qualify for deduction from income under Sec. 80C of IT Act. Interest is completely tax-free. Withdrawal is permissible every year from 7th financial year Loan facility available from 3rd Financial year. No attachment under court decree order.

SCHEME	Interest Payable, Rates, Periodicity etc.	Investment Limits and Denominations	Salient features including Tax Rebate
KisanVikas Patra	Money doubles in 8 years & 7 months. Facility for premature encashment. Rate of interest 8.4% (compounded yearly)	No limit on investment. Available in denominations of INR. 100/-, INR. 500/-, INR. 1000/-, INR. 5000/-, INR. 10,000/-, in all Post Offices and INR. 50,000/- in all Head Post Offices.	A single holder type certificate may be issued to an adult for himself or on behalf of a minor or to a minor, can also be purchased jointly by two adults.
National Savings Certificate (VIII issue)	8% Interest compounded six monthly but payable at maturity. INR. 100/- grows to INR 160.10 after 6 years.	Minimum INR. 100/- No maximum limit available in denominations of INR. 100/-, 500/- , 1000/-, 5000/- & INR. 10,000/-.	A single holder type certificate can be purchased by an adult for himself or on behalf of a minor or to a minor. Deposits quality for tax rebate under Sec. 80C of IT Act. The interest accruing annually but deemed to be reinvested will also qualify for deduction under Section 80C of IT Act.
Senior Citizens Savings Scheme	9% per annum, payable from the date of deposit of 31st March/30th Sept/31st December in the first instance & thereafter, interest shall be payable on 31st March, 30th June, 30th Sept and 31st December.	There shall be only one deposit in the account in multiple of INR.1000/- maximum not exceeding rupees fifteen lakh.	Maturity period is 5 years. A depositor may operate more than a account in individual capacity or jointly with spouse. Age should be 60 years or more, and 55 years or more but less than 60 years who has retired on superannuation or otherwise on the date of opening of account subject to the condition that the account is opened within one month of receipt of retirement benefits. Premature closure is allowed after one year on deduction of 1.5% interest & after 2 years 1% interest. TDS is deducted at source on interest if the interest amount is more than INR 10,000/- p.a. The investment under this scheme qualify for the benefit of Section 80C of the Income Tax Act, 1961 from 1.4.2007.

General Features of Small Savings Schemes: A Summary

Small Savings Schemes have been specially designed for the small investors and have evolved to serve this objective.

Risk-Free Investment: Investments under these schemes are fully secured as these schemes carry implicit guarantee of the Government of India.

Easy access, availability and liquidity: The schemes are designed keeping in view the needs of the investors.

- Small amount of money can be deposited on a monthly basis in Post Office Recurring Deposit Scheme (PORD)-

- Post Office Savings Account (POSA) is an easy to operate account with tax-free interest and withdrawals. There are convenient linkages for crediting monthly incomes of an investor into POSA and for debiting into PORD.
- Retired persons and senior citizens have the option to deposit their money in Senior Citizens Savings Scheme at a higher rate of interest.
- Post Office Monthly Income Account Scheme (POMIA), which is a very useful scheme for those needing a fixed monthly return.
- Kisan Vikas Patra (KVP) is a very popular cash certificate of doubling the cash with documentation.
- The salaried investors rely heavily on investments in National Savings Certificates-VIII Issue (NSC-VIII Issue) and Public Provident Fund (PPF) and these instruments carry Income Tax rebate/exemption benefits.
- The entire basket of small savings schemes for the investors is available round the year all over the country.

Tax Benefits on Small Saving Schemes

The small savings schemes enjoy income tax exemptions/rebate under different sections of the Income Tax Act. Following are the benefits under these schemes:

i. Deposits under National Savings Certificate (NSC-VIII Issue), Public Provident Fund (PPF), 5-Year Post Office Time Deposit Account and Senior Citizen Savings Scheme, enjoy income tax deduction under Section 80C of the Income Tax Act 1961.

ii. Interest accrued on NSC every year is deemed to have been reinvested under the scheme and therefore, enjoys rebate under Section 80C; whereas interest on PPF is fully exempt from tax under Section 10 (11).

iii. Interest earned on Post Office Savings Account enjoys tax exemption under Section 10(15).

iv. There is no tax deduction at source (TDS) on withdrawals under any of the small savings schemes except Senior Citizens Savings Scheme 2004.

Annex 3: National Small Savings Fund (NSSF)

The net collections under the small saving schemes are onward lent to the Centre and States for financing their fiscal deficit, in general and specifically for financing their annual plans. The loan carries a 25 year term with a moratorium of 5 years and interest rates fixed from time to time.

Developments leading to creation of NSSF

Prior to 1.4.1999, the deposits and withdrawals (of principal) of the Small Savings and Public Provident Fund Schemes were accounted for under Major Heads: 8001-Savings Deposits, 8002-Savings Certificates & 8006-Public Provident Fund in the Public Account of India whereas the items of income (i.e. interest received on long term loans granted to State Governments against their share of net collections) and expenditure viz: interest payments to subscribers, payment of agency charges to DOP and Banks, payment of commission to agents, cost of printing of savings certificates, cheque books etc. were accounted for under various heads in the Consolidated Fund of India. The long term loans granted to States & U.Ts. (with legislature) Governments was treated as non-plan expenditure of the Central Government and booked under Major Heads: 7601 & 7602 in the Consolidated Fund of India thereby increasing the fiscal deficit of the Central Government.

Interest received on Special GoI Securities against outstanding balances in various small savings and PPF schemes as on 31.3.1999 (by debiting MH: 2049-Interest Payments in CFI); interest received on Special GoI Securities issued against share of net collections from 1.4.1999 onwards (by debiting MH: 2049-Interest Payments in CFI); and interest received on Special Securities of various States/U.T(with legislature) Governments from 1.4.2000 onwards form the income of the NSSF.

A high level committee was set up by the Government under the Chairmanship of Shri R. V. Gupta, former Deputy Governor of RBI to review various parameters of small savings schemes. The Committee after considering the issue "of operation of small savings through a separate body corporate" in its Report (September, 1998) *inter-alia* stated that the question of the viability of a separate organisation for small savings as well as the effect on collections would need to be gone into in detail. The Committee recommended that this issue be examined in all its ramifications before a final decision is taken.

Accepting the above recommendation, the Government set up another Committee during January, 1999 "to work out the modalities of transfer of the work of small savings to an organisation outside the Government of India" under the Chairmanship of Shri R. V. Gupta, former Dy. Governor, RBI. The Committee after examining the issue in detail, in its Report (February, 1999) recommended establishment of a "National Small Savings Fund" (NSSF) in the Public Account of India to book all the transactions relating to small savings schemes under one umbrella of NSSF in order to lend transparency to the accounting system, to enable an easy examination of the income and expenditure of small savings process, to bring into sharp focus the asset-liability mismatch and to pave the way for correction, to facilitate better informed decisions regarding amending the terms of government securities or increasing/reducing the interest on small savings schemes or the cost of management etc.

The Government accepted the recommendation and the "National Small Savings Fund"(NSSF) came into existence since: 1.4.1999. The Fund is administered by the Government of India, Ministry of Finance (DEA) under National Small Savings Fund (Custody and Investment) Rules, 2001, framed by the President under Article 283(1) of the Constitution.

Initial Assets and Liabilities of the Fund

On implementation of the new system of accounting under the National Small Savings Fund since 1.4.1999, the past loans to State Governments and outstanding balances standing at the credit of the account holders and holders of certificates under various small savings schemes at the close of the 31st March, 1999 were treated as under :

The outstanding balances (₹ 1,76,220.92 Crore) at the credit of the account holders and holders of certificates under small savings schemes at the close of the year 1998-99, have been treated as investment in the special securities of the Central Government, issued against outstanding balances as on 31.3.1999.

The repayment of loans granted to States & Union Territory (With Legislature) Governments (up to 31.3.1999) and payment of the amounts of interest thereon shall continue to be made to the Central Government as the whole liability of the outstanding balances as on 31.3.1999 has been borne by the GOI in the shape of investment in special securities.

Current Arrangement

With effect from 1.4.1999, all the above-said transactions were booked under the umbrella of the new sub sector “National Small Savings Fund” in the Public Account of India. The sums released to various State /U.Ts.(with legislature) Governments were treated as investment of NSSF in their Special Securities. Similarly, the share of Centre in the net collections is now treated as investment of NSSF in Special Securities of the Central Government. The amount of outstanding balances (of ₹ 1,76,220.92 Crore) standing at the credit of the holders of accounts / certificates in various small savings and PPF schemes as on 31.3.99 also stands invested in “Special Securities of the Central Government against outstanding balances”.

Finances of the NSSF

The Deposits & withdrawals (of principal) relating to the Small Savings and Public Provident Fund schemes are booked /accounted for in NSSF in the Public Account of India as under

i. Savings Deposit Schemes under Major Head : 8001
ii. Savings Certificates under Major Head : 8002
iii. Public Provident Fund under Major Head : 8006

The amounts released against net collections in these schemes / invested in the Special States' and Central Government Securities are debited to Major Head: 8007-Investments of NSSF. All the Items of Income and Expenditure relating to small savings and PPF schemes are accounted for under Major Head: 8008-Income and Expenditure of NSSF

Annex 4: Small Saving Collections over the years

	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Gross Colections											
Post Office Savings Account	11117	12279	14077	17611	21926	25417	31432	35958	43161	53528	68047
Time Deposit 1 Yr.	1192	2171	3907	6166	9438	12129	15359	16157	12007	11183	13842
Time Deposit 2 Yr.	273	222	415	1024	1054	1378	1175	727	443	407	517
Time Deposit 3Yr.	122	299	653	958	1783	2161	2281	1911	968	1005	1612
Time Deposit 5 Yr.	1232	1000	1470	2135	4064	4761	1712	1005	625	657	1069
Recurring Deposit	8422	10097	11794	13993	16645	20135	23488	26333	27681	28443	30353
Monthly Income Account	11960	16359	18788	27642	38854	48692	47272	26460	17026	23850	54302
Senior Citizens Savings Scheme	0	0	0	0	0	12283	14986	12854	3038	1935	15738
Other Deposit Schemes	331	1042	615	605	510	573	319	295	327	264	317
NSC VIII Issue	7451	8588	7841	9587	11398	10247	10540	8971	6285	7080	10518
Kisan Vikas Patra	22397	24474	20283	23234	27797	23601	29281	23495	14975	15708	21167
Other Certificate Schemes	1275	-114	-149	369	-28	-130	-11	2069	104	-397	0
Public Provident Fund	9658	12053	10747	14795	15490	16484	22313	25945	21057	14847	33449
Total	**75431**	**88471**	**90442**	**118118**	**148929**	**177730**	**200148**	**182181**	**147697**	**158510**	**250931**
Net Collection											
Post Office Savings Account	145	852	1215	1549	1774	1933	1489	1775	1224	2869	3768
Time Deposit 1 Yr.	306	995	1791	2394	3503	3035	3503	1370	-3272	-63	3555
Time Deposit 2 Yr.	135	43	152	783	619	368	122	-531	-661	-217	118
Time Deposit 3Yr.	81	200	559	798	1461	1416	1142	-49	-1167	-922	91
Time Deposit 5 Yr.	496	342	837	1372	2876	3176	50	-956	-1674	-2469	-2457
Recurring Deposit	3021	4430	4952	4437	5879	7330	8897	10040	4843	-31	-2254
Monthly Income Account	9556	12585	14775	23581	32471	38188	31502	6363	-7049	-2798	22189
Senior Citizens Savings Scheme	0	0	0	0	0	12233	14380	11152	-1823	-5355	8649
Other Deposit Schemes	-227	572	132	226	108	99	-104	782	-213	-230	20
NSC VIII Issue	5083	5651	3556	4319	6107	4518	3390	372	-1525	-2079	-533
Kisan Vikas Patra	12848	12402	10288	10924	8513	14351	10068	6160	-2360	-2891	6416
Other Certificate Schemes	-512	-2248	-2208	-1489	-3477	-1540	-1663	2482	76	-193	-30
Public Provident Fund	7643	9548	7859	11441	11026	11682	12309	18535	12579	4930	24777
Total	**38575**	**45372**	**43908**	**60334**	**70859**	**96788**	**85085**	**57495**	**-1022**	**-9451**	**64309**

Annex 5: Statewise Investments in SSGS over the years

	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Andhra Pradesh	1141	1787	1145	2661	3578	4872	4914	4144	387	323	1531
Arunachal Pradesh	13	11	11	18	36	41	239	128	27	24	54
Assam	300	528	389	742	1196	834	629	127	72	115	163
Bihar	1464	1605	1310	1575	2069	2300	2494	2113	847	793	1852
Chhatisgarh	0	117	316	551	676	896	981	765	81	68	253
Goa	83	99	131	200	474	453	618	537	114	49	175
Gujarat	2595	3428	3793	5082	6477	8788	8459	5775	915	671	3829
Haryana	742	796	881	1307	1708	2129	1861	1176	172	107	806
Himachal Pradesh	69	129	276	376	577	788	813	680	158	103	468
Jammu & Kashmir	195	317	162	388	497	572	591	454	62	43	127
Jharkhand	0	154	625	1025	1376	1593	1634	1331	169	178	863
Karnataka	1114	1180	1285	1978	2733	4266	4327	2593	388	114	661
Kerala	571	440	463	832	1947	2795	2678	2228	180	13	72
Madhya Pradesh	994	992	803	1589	2429	2766	3035	2121	246	71	810
Maharashtra	4120	4660	5472	7945	9061	15753	15733	9277	2188	1538	4314
Manipur	19	23	25	10	19	34	127	227	203	203	2
Meghalaya	13	24	25	33	50	57	56	24	12	11	69
Mizoram	7	14	11	17	27	33	26	8	0	0	12
Nagaland	11	6	8	16	13	25	21	14	1	2	6
Orissa	384	603	496	615	1015	1338	1394	1085	169	161	756
Punjab	1712	2330	1395	2627	3376	3641	3402	2990	729	190	1576
Rajasthan	1705	2204	2638	3398	4126	5043	3652	1940	105	63	144
Sikkim	8	8	15	9	22	32	18	6	0	0	0
Tamil Nadu	1014	1287	1488	2200	3785	5915	6094	4013	534	62	695
Tripura	65	104	51	207	148	199	199	150	16	3	64
Uttar Pradesh	3256	3857	3855	5074	5992	7181	7779	6172	1956	1213	4985
Uttranchal	0	70	356	573	786	968	1026	598	230	189	777
West Bengal	4160	4949	5736	7832	8903	10436	10934	8700	1470	1654	7992
Delhi	1165	1505	1774	3277	4408	3732	5896	4002	746	429	1769
Pondicherry	19	40	84	104	138	212	206	367	16	22	38
GRAND TOTAL	**26937**	**33265**	**35018**	**52261**	**67642**	**87690**	**89836**	**63746**	**12194**	**8410**	**34862**

Annex 6: Sources and Application of Funds in NSSF

(Rs. Crore)

	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11 (RE)	2011-12 (BE)
A. SOURCES OF FUNDS													
OPENING BALANCE	176221	214791	260149	304057	364390	435242	532030	617117	674611	673589	664137	728447	799387
1. Savings Deposits	34650	43469	51723	70133	94273	127529	138025	121701	105286	121272	185797	207340	201400
Less - Disbursement	*-21135*	*-23454*	*-27299*	*-34995*	*-45582*	*-59752*	*-77043*	*-91755*	*-115078*	*-130490*	*-152119*	*-147300*	*-147300*
Net	13514	20015	24424	35138	48691	67777	60982	29946	-9792	-9218	33679	60040	54100
2. Savings Certificates	31127	32946	27972	33190	39166	33718	39810	34535	21366	22391	31685	29800	29800
Less - Disbursement	*-13713*	*-17151*	*-16347*	*-19435*	*-28023*	*-16388*	*-28014*	*-25521*	*-25175*	*-27555*	*-25832*	*-25800*	*-25800*
Net	17414	15795	11625	13754	11143	17329	11796	9014	-3809	-5164	5854	4000	4000
3. Public Provident Fund	9658	12053	10747	14795	15482	16484	22313	25945	21057	14847	33449	16800	16800
Less - Disbursement	*-2016*	*-2506*	*-2888*	*-3354*	*-4464*	*-4802*	*-10005*	*-7411*	*-8478*	*-9916*	*-8672*	*-9900*	*-9900*
Net	7643	9548	7859	11441	11018	11682	12309	18535	12579	4930	24777	6900	6900
Net collections during the year	**38571**	**45357**	**43908**	**60334**	**70851**	**96788**	**85086**	**57495**	**-1023**	**-9451**	**64309**	**70940**	**65000**
CLOSING BALANCE	**214791**	**260149**	**304057**	**364390**	**435242**	**532030**	**617116**	**674611**	**673589**	**664137**	**728447**	**799387**	**864387**
B. APPLICATION OF FUNDS													
OPENING BALANCE		212136	253718	297490	335986	417394	505084	594920	658665	654191	654053	691514	753454
1. Investment in Central Govt. Securities against outstanding balance as on 31.3.1999	176221	0	0	0	0	0	0	0	0	0	0	0	0
Less - Repayment	*0*	*0*	*0*	*-13766*	*-46211*	*-32675*	*0*	*0*	*-10000*	*0*	*0*		
Net	176221	0	0	-13766	-46211	-32675	0	0	-10000	0	0	0	0
2. Investment in Central Govt. Securities	8979	8316	8755	0	0	0	0	0	0	0	2500	11640	13550
Less - Repayment	*0*	*0*	*0*	*0*	*0*	*0*	*-449*	*-865*	*-1302*	*-1302*	*-1302*	*-1302*	*-1302*
Net	8979	8316	8755	0	0	0	-449	-865	-1302	-1302	1198	10338	12248
3. Investment in State Govt. Securities	26937	33265	35018	52261	67642	87690	89836	63746	12194	8410	34862	59300	53800
Less - Repayment	*0*	*0*	*0*	*0*	*0*	*0*	*-1347*	*-2984*	*-6866*	*-7246*	*-10656*	*-15141*	*-19632*
Net	26937	33265	35018	52261	67642	87690	88489	60762	5328	1164	24206	44159	34168
4.Reinvestment in Central Govt. Securities	0	0	0	0	59977	32675	1796	3849	0	0	12058	7443	11935
Less - Repayment	*0*	*0*	*0*	*0*	*0*	*0*	*0*	*0*	*0*	*0*	*0*	*0*	*0*
Net	0	0	0	0	59977	32675	1796	3849	0	0	12058	7443	11935
5. Investment in India Infrastructure Finance Co. Ltd.	0	0	0	0	0	0	0	0	1500	0	0	0	0
Less - Repayment	*0*	*0*	*0*	*0*	*0*	*0*	*0*	*0*	*0*	*0*	*0*	*0*	*0*
Net	0	0	0	0	0	0	0	0	1500	0	0	0	0
Net Investment during the year	**212136**	**41581**	**43773**	**38496**	**81408**	**87690**	**89836**	**63746**	**-4474**	**-138**	**37462**	**61940**	**58350**
CLOSING BALANCE	**212136**	**253718**	**297490**	**335986**	**417394**	**505084**	**594920**	**658665**	**654191**	**654053**	**691514**	**753454**	**811804**

Annex 7: Income and Expenditure of NSSF

(Rs. In crore)

	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11 RE	2011-12 BE
A INCOME OF NSSF:													
INTEREST INCOME :													
1 Central Government Securities prior 1.4.99	20265	20265	20265	20119	15346	11611	8775	8775	7725	7725	7725	7725	6780
2 Special Central Government Securities after 1.4.99	0	1212	2206	3260	3215	3215	3215	3154	3041	2720	2720	2797	3742
3 Special State Government Securities after 1.4.99	0	3636	7926	11569	17009	23389	31678	40264	45864	44544	45055	43892	48163
4 Special Central Central Govt. Securities (Redemption)	0	0	0	0	1942	4124	6008	6177	6535	6613	6452	7744	9270
5 Other Receipts	0	0	0	0	0	0	84	86	154	356	218	225	230
TOTAL (A)	20265	25114	30397	34948	37512	42338	49759	58456	63319	61958	62170	62383	68184
B EXPENDITURE OF NSSF													
B-1 *INTEREST PAYMENTS :*													
1 Savings Deposits	5360	7298	8059	10340	13409	17596	21541	26729	29892	33842	36533	31696	33033
2 Savings Certificates	12591	15569	14802	18675	25684	14999	24940	22365	19380	21240	18506	21474	22527
3 Public Provident Fund	2247	3480	2674	4612	4130	4530	5961	12458	13130	-2619	17174	12800	13440
TOTAL (B-1)	20198	26347	25534	33627	43223	37125	52442	61552	62402	52463	72213	65970	69000
B-2 *MANAGEMENT COST:*													
1 Payment of agency charges to Department of Posts	1055	1302	2799	1577	1763	1861	2318	2490	2476	2802	3133	3215	3518
2 Payment of agency charges to Public Sector Banks	6	7	8	16	7	8	11	0	0	0	0	1	1
3 Payment of agency commission to agents	684	981	-363	1065	1356	1529	1972	1983	2048	1430	2180	2400	2200
4 Cost of Printing	3	4	6	5	6	15	15	12	18	15	20	22	22
TOTAL (B-2)	1749	2295	2451	2663	3132	3413	4316	4486	4542	4247	5332	5637	5740
C Total (B-1) + (B-2)	21947	28642	27984	36290	46354	40538	56758	66037	66944	56710	77545	71607	74740
D Net Income(-)/Expenditure(+) in the year	-1682	-3528	2413	-1342	-8842	1800	-6999	-7582	-3626	5248	-15375	-9224	-6556
Cumulative Income(-)/Expenditure(+)	-1682	-5210	-2797	-4138	-12980	-11180	-18179	-25761	-29386	-24138	-39514	-48738	-55294

Annex 8: Recommendations of the Y.V. Reddy and Rakesh Mohan Committees

The recommendations of the Y.V. Reddy and Rakesh Mohan committees on the various issues covered in the terms of reference of the present committee are as under:

Reddy Committee		Rakesh Committee	
Recommendation	**Status of Implementation**	**Recommendation**	**Status of Implementation**
ToR I: How to make small savings instruments more flexible and market linked?			
Yearly average secondary market yield on G-secs of comparable maturity as the appropriate benchmark with a positive spread of up to 50 bps depending on the maturity and liquidity of the instrument. Periodicity of revision to be on annual basis.	Vide Budget speech 2002-03, GoI accepted the recommendation. The last revision in the rate of interest took place in March 2003 although the yield on GoI dated securities varied markedly over the years.	(i) Continuance of average G-sec yields as the suitable benchmark but for a longer period of previous 2 years with a weight of 0.67 for the later year and 0.37 for the earlier year. (ii) Fixed liquidity spread of 50bps (in view of relative illiquidity and investors profile) over the average benchmark yield (iii) Annual interest rate reset period (iv) To cap inter-year movement of interest rate on small savings fluctuations to a tolerable level of +/- 100 bps. Such a cap on interest rate movement would make the implementation of administered interest rate more feasible. (v) If fluctuation > 200 bps, another committee could be appointed to review the benchmark. (vi) Removal of schemes where investments are primarily motivated to obtain tax benefits.	Not implemented

		Recommended discontinuance of KVP and NSC.	
Savers to have option to choose between floating & fixed rate.	Not implemented		
ToR II: review of the *existing terms of the loans* extended from the NSSF to the Centre and States and recommend on the *changes* required in the arrangement of lending the net collection of small savings to Centre and States			
100% of net proceeds to be transferred to State Governments	Accepted. (*Following recommendation of NDC sub-committee, States have the option to take at least 80% since April 1, 2007*).		
States to have choice to opt out of NSSF scheme. Net proceeds from such States to be used for investment in Central and other State Government securities.	Not implemented		
ToR III: review and recommend on the *other possible investment opportunities* for the net collections from small savings and the repayment proceeds of NSSF loans extended to States and Centre			
Use of NSSF funds for infrastructure funding allowed since 2007			
ToR IV: Review and recommend on the *administrative arrangement* including the cost of operation			
The Central Govt. to deduct a portion of gross collection to cover operational expenses, before transferring the net collections	Previous practice continues.		
ToR V: Review and recommend on the incentives offered on the small savings investments by the States			
The existing rate of commission paid to agents may continue	No change in status quo.		

Annex 9: Recommendations of the National Development Council – Sub Committee

Although subsequent to the creation of the fund, 80 percent of the net collections of small savings schemes were released to States and the remaining 20 per cent was released to the Centre, with the debt swap scheme of the Central Government, where States used NSSF loans to repay Central loans, the sharing formula changed to 100 percent being released to States. From 2005-06 onwards, when the Central loans were consolidated at 7.5 percent, States did not have any requirement for debt swap. In addition, the market interest rates kept moving downwards making NSSF loans unattractive. Due to these developments many States raised various issues related to NSSF.

To look into these issues, a Sub-Committee of the National Development Council (NDC) was set up on 16th September, 2005 under the Chairmanship of Union Finance Minister with Deputy Chairman, Planning Commission, Governor, Reserve Bank of India represented by Deputy Governor, Finance Ministers of Andhra Pradesh, Chhattisgarh, Punjab, Tamil Nadu and West Bengal, Secretary (Expenditure), and Secretary (Economic Affairs), Ministry of Finance as its members to examine the issue of debt outstanding of the States against the National Small Savings Fund (NSSF). The Sub-Committee gave the following recommendations.

i. The small savings collections will be shared between the States and the Centre in the ratio of 80:20 (vis-à-vis the present arrangement of 100 per cent transfer of collections to the State Governments) with the option to the States to take up to 100 per cent of their collections. The revised sharing pattern will be effective from 1st April, 2007.
ii. The interest rates on loans taken by State Governments from NSSF from 1999-2000 to 2002-03 will be reset at 10.5 per cent with effect from 1st April, 2007.
iii. The interest rate on current NSSF loans will continue at 9.5 per cent.
iv. Request of State Governments for additional open market borrowing to enable them to repay non-NSSF loans will be considered on a case to case basis.
v. Requests of State Governments for prepayment of NSSF loans contracted up to 2002 – 2003 will also be considered on a case to case basis within the approved market borrowing ceilings.

The National Development Council in its meeting held under the Chairmanship of the Prime Minister on 9th December 2006 has, inter-alia, endorsed the above recommendations of the NDC Sub-Committee and the Government has accepted these recommendations. Pursuant to above, the Government adopted the following measures, effective April 1, 2007:

i. Allowed the State/UT Governments to opt for a percentage of their share of net small savings collections between 80 percent to 100 percent from the year 2007-08 onwards.
ii. Reduced and reset the rate of interest payable on the special securities issued by the State/UT Governments to the NSSF during the years 1999-00 to 2001-02 from 13.5%, 12.5% and 11% per annum to 10.5% per annum with effect from 1-4-2007.
iii. Allowed the State/UT Governments to pre-pay a part of their liabilities towards NSSF. The requests of the Governments of Tamil Nadu (₹ 1126.67 crore), Orissa (₹ 199.72 crore) and the NCT of Delhi (₹ 752.90 crore) requested for the same and this was agreed to.

Annex 10: Recommendations of the Thirteenth Finance Commission on NSSF

One of the terms of reference of the Thirteenth Finance Commission (13^{th} FC) stated "The Commission shall review the state of the finances of the Union and the States, keeping in view, in particular, the operation of the States' Debt Consolidation and Relief Facility 2005-2010 introduced by the Central Government on the basis of the recommendations of the Twelfth Finance Commission, and suggest measures for maintaining a stable and sustainable fiscal environment consistent with equitable growth". 13^{th} FC, while reviewing the debt position of States, examined the issues related to the NSSF loans.

The Twelfth Finance Commission, while recommending the Debt Relief scheme for the States has consolidated the Central Loans[8] to States at 7.5 percent interest rate but had excluded NSSF loans from the purview of its recommendations. Many States represented to the 13^{th} FC for a relief on NSSF loans.

Observations of 13^{th} FC on NSSF loans to States

The 13^{th} FC observed that there is a difference in the cost of NSSF loans to the Centre and the States. It observed that the differential has narrowed after the implementation of the recommendations of the NDC subcommittee but the difference still exists. As pert their assessment, during 2007-08, while the effective rate of NSSF loans to States was 10.1 percent, for the Centre, it was 8.4 percent. In 2006-07, these rates were 10.3 and 8.9 percent respectively.

13^{th} FC went into the reasons for this differential and observed:

> Both the Centre and the states have seen the interest cost of their respective NSSF debts decline over the years. However, the average interest rate paid by the states has been higher than that of the Centre from the commencement of NSSF in 1999-2000. This is primarily because the states have been paying interest only on securities issued against collections on current small savings from 1 April 1999, whereas the Centre is also paying interest on securities against the deposits outstanding on that date, which, at 11.5 per cent, was lower than the rate of interest on transfers during 1999-2000 and 2000-01. The gap between the average interest paid by the states and the Centre on their respective NSSF debt had narrowed from 1.9 percentage points in 2000-01 to 0.5 percentage points in 2002-03, but thereafter, increased to 1.7 percentage points in 2007-08.
>
> This widening after 2002-03 has arisen due to the following decisions taken by the Centre:
>
> i) Reduction in interest rate on central special securities issued against outstanding balances on central liabilities from 11.5 per

[8] Which also included Small Savings loans released from Centre to States prior to 1999 as they were considered as Central loans to States

cent to 10.5 per cent with effect from 1 March 2003, in line with general softening of market interest rates.

ii) Use of debt swap receipts from states to partly redeem the central special securities issued against the initial outstanding balances and to replace them with fresh securities at lower market rates of interest. The total amount redeemed between 2002-03 and 2004-05 was ₹ 92,652 crore.

iii) Further redemption of high-interest central special securities against outstanding balances for a sum of ₹ 10,000 crore in 2007-08 in order to infuse cash into the NSSF consequent upon negative cash balance in the Fund due to a drastic decline in net small savings collections.

Recommendations of the 13th FC – interest rates

The 13th FC observed that this asymmetry has continued even after the interest rates on past loans have been reset at 10.5 percent as per the recommendations of the NDC subcommittee. To remove this asymmetry, keeping in mind the effective rates to the Centre and the fact that since 2007-08 even Centre is using upto 20 percent of the net collections, the 13th FC recommended that the NSSF loans to the States extended till 2006-07 and outstanding at the end of 2009-10 be rest at 9 percent keeping the repayment schedule unchanged. It also kept the current rates on NSSF loans[9] unchanged.

The Commission made several other recommendations regarding other aspects of the NSSF. The 13th FC, in its report has deliberated on the tenor and the interest rate of the loans extended from NSSF to the Centre/States. It has stated that while the interest rate is one issue, there is also an important issue related to the tenor of these loans and the mismatch between the average tenor of the small savings instruments and the NSSF loans to the States. The report states that this mismatch pushes up the interest rate and some States have recommended against the long tenor and high interest rates.

The 13th FC has also brought out the structural problem relating to the flow into NSSF due to rigidity in its interest rates. When the market rates are low, the States would like to benefit from the low rates and would like to raise more market loans. But due to low market rates, the flow into NSSF increases and since the overall borrowing of the States are capped by their FRBM Act targets, the States are pre-empted from tapping cheap market loans. Contrarily, when the market rates increase and raising loans from the market becomes dearer, NSSF sources dry up as alternative instruments offer better returns. Both ends of the cycle have been witnessed in past during 2003-04 when NSSF collections peaked and 2007-08 when it became net negative. 13th FC has recommended that the only solution to this structural problem is to make interest rates on small saving instruments more flexible and link it to G-Sec rates as has been recommended by may previous Committees on this issue.

[9] Which is at 9.5 percent currently

Annex 11: Savings Bonds and Postal Savings Institutions: A Cross-Country Study

This note has two Sections: one relating to **retail debt** and the other related to **postal savings**. In many countries, retail debt is also mobilised through post offices.

A. RETAIL DEBT

Some countries have a long tradition in issuing retail debt, even though the importance of retail relative to overall debt has been shrinking during the recent years. However, the share of retail debt varies significantly across countries.

Distribution is a key factor featuring the retail debt issuing activity. Differently from wholesale instruments, retail ones are placed also through banks, post offices, internet, or even shops and supermarkets. In increasingly competitive financial markets, this type of direct debt selling has to pay a great deal of attention to product innovation, brand equity, benchmarking, strategic market position, etc. Some product features can only be introduced or developed by a public institution; for example, fiscal incentives (tax credits). Other factors that influence the design of retail public debt products concern the macroeconomic environment, interest rates and the general economic and institutional context.

In several advanced markets the sale of retail instruments is evaluated purely in terms of economic cost effectiveness. Other countries, including many emerging debt markets, take into account also social goals such as financial education and encouraging savings.

Moreover, the introduction of dematerialised products and the use of electronic retail systems require addressing additional technical and economic issues. In this respect governments need also to take into account social and cultural sensibilities, including such issues as the imagined fiscal or collateral value of physical tangibility.

A table on government debt instruments available to retail investors in select countries is presented below

Government Debt Instruments Available to Retail Investors

Countries	Marketable	Non-marketable	
		Savings Bonds	Lottery bonds
Belgium		Yes	
Brazil	Yes		
Bulgaria		Yes	
Canada		Yes	
China		Yes	
Germany	Yes	Yes	
Indonesia		Yes	

Countries	Marketable	Non-marketable Savings Bonds	Lottery bonds
India	Yes	Yes	
Ireland	Yes	Yes	Yes
Italy	Yes	Yes	
Japan		Yes	
Pakistan	Yes	Yes	Yes
South Africa		Yes	
Sweden	Yes	Yes	Yes
UK	Yes	Yes	Yes
US	Yes	Yes	

Source: Euromoney (2007)

It is seen that the terms of retail non-marketable debt instruments in developed economies is currently guided by the same principles of debt management as applicable to wholesale marketable government securities. Emerging markets on the other hand, have multiple objectives of promotion of savings habit, mobilisation of savings for financing economic development, social security, etc.

Table below provides a summary of objectives for offering retail debt programmes in select countries

Country	Objectives of Retail Debt Programme
Belgium	• Diversify investment instruments offered to retail investors • Promote retail investor participation in the bond market
Brazil	• Democratise investment in government bonds • Increase financial literacy of the domestic population • Promote strong national brand • Stimulate the culture of long-term savings • Diversify the investor base • Introduce competition among financial intermediaries in the retail market
Canada	• Raise stable, low-cost funding for the government
India	• Provide means for long-term diversified investments for retail investors • Ensure cost-effective way of raising long-term funds for the government • Provide an investment mechanism for senior citizens and pensioners
Ireland	• Provide investors with alternative savings products
Italy	• Provide alternative investment choice to retail investor
Japan	• Reduce the overall cost of government borrowing • Diversify the investor base • Promote retail participation in the bond market
Pakistan	• Provide the government with additional source of funding • Encourage and mobilise savings by the public • Diversify the investor base • Diversify investment instruments available to retail investors • Develop a secondary market for government bonds

Country	Objectives of Retail Debt Programme
South Africa	• Diversify the investor base, funding instruments, and funding sources • Diversify investment instruments offered to individuals • Promote culture of savings in the population
Sweden	• Borrow at the lowest possible cost, taking into account the risks • Offer individuals secure and diverse investments with low fees • Contribute to fair competition in the financial markets
United Kingdom	• Minimise financing costs over the long term, subject to risks • Diversify investment instruments offered to investors • Provide totally secure place for people to invest • Provide the government with additional source of funding
United States	• Borrow at the lowest possible cost recognising the constraints

(Source: Euromoney, 2007).

Characteristics of retail debt instruments issued by select countries are presented below:

United States

U.S. Savings Bonds were introduced to finance World War I, and were originally called Liberty bonds.

While US public debt increased from US$ 5,773.4 billion to US $ 12,773.1 billion between March 2000 and March 2010, the outstanding US savings bonds increased marginally from US $ 185.3 billion to US $ 190.2 billion over the same period. As a percentage of public debt, the proportion of small savings declined from 3.2% to 1.5%.

Currently, two types of savings bonds are being issued – EE bonds yielding a fixed rate of return and I bonds where the rate of return is inflation linked.

The 'TreasuryDirect' -a financial services website - lets an investor buy and redeem securities directly from the U.S. Department of the Treasury in paperless electronic form. The new TreasuryDirect accounts offer Treasury Bills, Notes, Bonds, Inflation-Protected Securities (TIPS), and Series I and EE Savings Bonds in electronic form in one convenient account.

The Treasury is phasing out the issuance of paper savings bonds through traditional employer-sponsored payroll savings plans. As of September 30, 2010, federal employees will no longer be able to purchase paper savings bonds through payroll deduction. The end date for all other (non-federal) employees is January 1, 2011.

A new program called SmartExchange allows TreasuryDirect account owners to convert their Series E, EE and I paper savings bonds to electronic securities in a special Conversion Linked Account in their online account.

The following are the salient features of the US Savings bonds:

1. EE and I bonds are both available in paper and electronic form.
2. Electronic bonds can be purchased, managed, and redeemed through a personal TreasuryDirect account.
3. The rate of interest on EE bonds **issued between 1997 and April 2005** earn market-based interest rates set at **90% of the average 5-year Treasury securities yields** for the preceding six months. The new interest rate for these bonds, effective as the bonds enter semiannual interest periods from May 2010 through November 2010, is **2.16%.**
4. The fixed interest rate on fresh issues of EE bonds at **1.40%** (issued during May – October 2010) is ***lower*** than that of bonds issued during 1997-2005 (**2.16%**) for the period May – October 2010 and is also lower than that of I bonds (**1.74%** = fixed component of 0.20% + inflation uplift of 1.54%).
5. The Secretary of the Treasury, or the Secretary's designee, determines the rate of return on savings bonds. In case of I-bonds, the fixed rate is established for the life of the bond. The fixed rate will always be greater than or equal to 0.00%. However, the fixed rate is not a guaranteed minimum rate; **the composite rate could possibly be less than the fixed rate in deflationary situations.** The Secretary's determination of fixed rates of return, semiannual inflation rates, composite rates, and savings bonds redemption values is final and conclusive.
6. Since January 2008, the ceiling on annual purchase of savings bonds is US $ 20,000 (US $ 5,000 *4).
7. The detailed features of EE bonds and I bonds are as under:

Feature	EE Bonds purchased on or after May 1, 2005		I Bonds
Form	**Electronic**	**Paper**	**Electronic and Paper**
Issue price	**Sold at face value**	**Sold at half of face value**	**Sold at face value**
Denomination	**Purchase in amounts of $25 or more, to the penny.**	**Purchase in denominations of $50, $75, $100, $200, $500, $1,000, and $5,000, and $10,000.**	**As in EE bonds**
Annual Ceiling	**$5,000 maximum purchase in one**	**$5,000 maximum purchase in one**	**$5,000 maximum purchase in one calendar year,**

	calendar year.	**calendar year.**	**separately for paper and electronic forms**
Interest accrual	**Interest accrues monthly and compounds semiannually and is paid when redeemed. Bonds have an interest-bearing life of 30 years. The EE bond fixed rate applies to the bond's 20-year original maturity.**		
Interest Rate and Benchmark	**Fixed rate up to original maturity of 20 years (1.40% for bonds bought from May 2010 through October 2010)**. • Announced each May and November • Applies to all bonds issued during the six months period beginning with the announcement date. • Remains the same for the life of the bond		The earnings rate combines a 0.20% fixed rate of return (determined as in case of EE bonds) with the 1.54% annualized rate of inflation as measured by the Consumer Price Index for all Urban Consumers (CPI-U). The CPI-U increased from 215.969 to 217.631 from September 2009 through March 2010, a six-month increase of 0.77%.
Resetting of Interest Rate	**Interest rates for new issues are set at half yearly intervals (May 1 and November 1).**		**The 1.74% earnings rate for I bonds bought from May 2010 through October 2010 will apply for the succeeding six months after the issue date.**

Maturity	**Original: 20 years; final: 30 years**		
Lock-in period	**12 months**		
Penalty on Premature redemption	**3 most-recent months' interest to be forfeited if redeemed in the first 5 years. No penalty thereafter.**		
Ownership	**Effective April 2009, individuals and various types of entities including trusts, estates, corporations, partnerships, etc. can have TreasuryDirect accounts.**	**Individuals, corporations, associations, public or private organizations, and fiduciaries**	
Tax Treatment	**The interest earned is subject to federal income tax, which can be deferred until redemption, final maturity, or other taxable disposition, whichever occurs first. Savings bonds are subject to estate, inheritance, gift, or other excise taxes, whether federal or state. Special tax benefits are available to qualified owners of I Bonds under the Education Savings Bond Program.**		

In US, postal savings ceased operations in the 1960s. The share of retail savings in outstanding liabilities has declined since the early 2000s. The Treasury is phasing out issuance of paper savings bonds. The savings bonds issued in post May 2005 period yield fixed and lower rates of return than the market linked floating rate of return available for bonds issued during 1997 – April 2005. The promotion of US savings bonds is in sync with the debt management objective of the minimisation of the cost of borrowings. The Treasury has also sought to reduce transactions costs by progressively encouraging selling of bonds electronically through TreasuryDirect and is phasing out the issuance of paper savings bonds.

United Kingdom

In UK, the objectives of small savings schemes are consistent with the objective of debt management, viz., minimisation of costs rather than mobilisation of savings for economic development. Accordingly, the schemes that involve lower transactions costs (schemes that operate through internet rather than involving manual support at post offices) provide a higher rate of interest. Also, the rate of interest offered on various schemes is proportional to the outstanding size of the deposits of savers. Hence, the objectives of small savings does not appear to be dictated by the objective of the promotion of financial inclusion through provision of safe instruments of savings.

NS&I (National Savings and Investments) is one of the largest savings organisations in the UK, with almost 27 million customers and over £98 billion invested. NS&I is best known for Premium Bonds, held by over 23 million people, but also offer a range of other savings and investments to suit different people's needs, including its Direct Saver and Children's Bonus Bonds. All products offer 100% security, because NS&I is backed by HM Treasury.

NS&I is an Executive Agency of the Chancellor of the Exchequer.

Background

In 1861 UK set up the "Post Office Savings Bank" - a simple savings scheme aiming to encourage ordinary wage earners "to provide for themselves against adversity and ill health". The scheme quickly became very popular, and the deposits found their way from the Post Office to the Exchequer.

This set two principles which have remained in place ever since:

- to provide a totally secure place for people to save, backed by the Government
- to provide the Exchequer with a source of funding (ie public borrowing).

Significant expansion over the next century included the introduction of Savings Certificates during the First World War to help finance the war effort, while Premium Bonds were officially launched for sale on 1 November 1956.

1969 saw the first main structural change - the Post Office Savings Bank became a separate government department accountable to Treasury Ministers, and was renamed National Savings.

The Post Office still play a major role in supporting NS&I's business as a distribution channel for NS&I's products, alongside NS&I website and call centres.

On 1 July 1996 National Savings became an Executive Agency of the Chancellor of the Exchequer. In February 2002 the organisation became known as National Savings and Investments, and later this was shortened to NS&I.

While NS&I remain accountable to HM Treasury, Agency status has given it greater autonomy in day-to-day management.

In 2004, National Savings introduced new Easy Access Savings Account that is based on cash cards, telephone withdrawals and mailed quarterly statements.

The savings instruments offered by NS&I are as under:

Instrument	1. Premium Bond	2. Direct Saver	3. Direct ISA[10]
Objective/ Charateristic	instead of interest payments, investors have the chance to win tax-free prizes. When someone invests in Premium Bonds they are allocated a series of numbers, one for each £1 invested. Prizes range from £25 to £1 million every month	Meant only for individuals who manage their accounts online and by phone. Payment is by using debit card online or by electronic transfer.	Meant only for individuals who manage their accounts online and by phone. Payment is by using debit card online or by electronic transfer.
Minimum Purchase	The minimum purchase is £100 (or £50 when you buy by monthly standing order), which provides 100 Bond numbers and, therefore, 100 chances of winning a prize..	£1	£100
Maximum Purchase	£30,000	£2,000,000	£5,100 per tax year[11]
Number of investors	23 million		
Outstanding Amount	£26 billion		
Interest Rate	Equivalent to 1.5%	Variable. Currently at 1.75% (gross, AER).	2.50% (AER) Equivalent gross rates for basic and higher rate taxpayers at current rates of tax are 3.12% (basic rate), 4.16% (higher rate), 5.00% (additional rate). The Account ceases to qualify for tax-free interest on the death of the holder and interest earned following the date of death is liable to tax.
Interest rate reset		Savings earn interest on a daily basis and is credited to the individual's account annually. The rate of interest is variable and changes from time to time.	Savings earn interest on a daily basis and is credited to the individual's account annually. The rate of interest is variable and changes from time to time.
Taxation	Free of UK Income Tax and Capital Gains Tax and does not need declaration on the tax return	Taxable, paid gross	Tax free
Investor	Anyone aged 16 or over; can also be bought on behalf of under-16s by parents and grand-parents	Anyone aged 16 or over	Anyone aged 16 or over
Withdrawal arrangement	Can be cashed in all or part of the Bonds at any time	No set term, seven days after deposit, no notice, no penalty	No notice, no penalty

[10] ISA: Individual Savings Account
[11] Maximum tax free amount in ISA is £10,200 per fiscal of which £5,100 can be in NS&I Direct ISA.

Instrument	4. Children's Bonus Bonds	5. Income Bonds	6. Investment Account
Objective	To give a child a long term tax-free investment	Provides monthly variable income. Can be applied online, by phone or by post; cash in by post	Passbook savings account with easy access to money. Deposits by cash at post offices and also by cheque only (i.e., Not by phone/online)
Minimum Purchase	£25	£500	£20.
Maximum Purchase	£3,000 per issue per child	£1 million in total	Max £1 million. Can make further deposits of at least £20 at the saver's discretion.
Denomination	Multiple of £25	..	Not applicable
Number of investors			
Outstanding Amount			
Interest Rate	2.5% AER fixed rate for 5 years at a time plus guaranteed bonus	Variable, tiered rate, paid monthly (gross, i.e. without deducting tax) -1.46% AER ('Treasury Rate) for investment up to £25,000 and 1.76% (Treasury Rate + Bonus Rate') for more. Interest is earned on a daily basis at 1/365 of the annual interest rate for each day held (or 1/366 for each day in a calendar leap year)	Tiered – (i) 0.2% (gross rate, i.e. without deducting tax) up to £25,000; (ii) 0.3% for deposit above £25,000
Interest rate reset	After 5 years	No fixed periodicity	Variable. No fixed date
Bonus Payment	Paid when held for minimum 5 years	No	No
Taxation	Tax free for parents and children	Taxable, paid gross	Taxable, paid gross
Investment term	5 years at a time until 21st birthday After that no further interest or bonus will be earned.	No set term. Investment in the Bond is for at least 10 years from the date of investment. On giving six months' notice, the Treasury may redeem the Bond on any interest payment date after this ten year period. Interest will continue to be paid until the redemption date.	No set term.
Investor	Anyone aged 16 or over for anyone under 16	Anyone aged 7 or over; can also be bought on behalf of under-7s. Individuals – single/joint, trustee, bodies (corporate/unincorporate)	Anyone aged 7 or over; can also be opened on behalf of under-7s
Withdrawal arrangement	Can be cashed in early, but no interest earned if cashed in within first year. Interest rate for each year of withdrawal is specified.	No notice and no penalty	No notice and no penalty
Ownership & COntrol	Children's Bonus Bonds are owned by the child, but until their 16th birthday they are controlled by their parent or guardian – regardless of who bought them. Only the parent or guardian can decide to cash in the Bond, but the money still belongs to the child. Once the child is 16, they control the Bond themselves.		

Instrument	7. Easy Access Savings Account	8. Fixed Interest Savings Certificates	9. Index-Linked Savings Certificates
Objective	An application to open an account can be made via the internet, by telephone or by post to NS&I; or in person at any post office which carries out NS&I business.	NS&I Fixed Interest Savings Certificates are lump sum investments that earn guaranteed rates of interest over set periods of time, called 'terms'. They're free of UK Income Tax and Capital Gains Tax. There is no need to declare the interest on the tax return. When on sale, they normally offer a choice of fixed rate terms. There are no Issues currently on sale.	The value of savings stays ahead of any increase in the Retail Prices Index over the investment term. When on sale, they normally offer a choice of terms. There are no Issues currently on sale.
Minimum	£100		
Maximum	£200,000 (£400,000 for joint)		
Denomination			
Number of investors			
Outstanding Amount			
Interest Rate (Gross/AER)	£100 - £9,999 0.30%; £10,000 - £49,999 0.45%; £50,000 + 0.70%		
Interest rate reset	Variable rate, no fixed reset period		
Bonus Payment	No		
Taxation	Taxable		
Investment term			
Investor	Anyone aged 11 or over		
Withdrawal arrangement	Instant access, no penalty. Maximum of £300 can be withdrawn per day at a post office and at ATM by using cash card and PIN (in both places). Withdrawals above £300, or to close one's account, can only be made by electronic transfer to a UK bank or building society account in the saver's name (or in the name of a parent or guardian)		

Italy

The household sector was fundamental to the public debt management strategy of extending portfolio average life and breaking the dependence on the banking system in the late 1970s and mid-1980s. In the first stage, innovative instruments were introduced with longer maturities but linked to floating rates or foreign currencies. To ensure acceptance of these new securities, the government accepted significantly higher costs. For instance, interest rates on short-term securities sold to retail investors were higher than those of long-term bonds sold to the banks. In addition, high commissions were paid to intermediaries to distribute the securities to the final investors and preferential tax treatment was offered to increase the after tax return on these government securities. These policies helped diversify the investor base and lengthen the portfolio average life, both of which substantially reduced refinancing risk. In this first stage the authorities decided to mitigate the exposure to refinancing risk at the expense of increasing the portfolio vulnerability to market rates. It was only in a second stage, after the nineties, with the independence of Bank of Italy and joining the eurozone, that better fundamentals allowed a fully fledged strategy to address the financial risk of the debt portfolio through the development of the domestic debt market.

Source: Euromoney (2007) - Based on Alessandra Campanaro and Dimitri Vittas *"Greco-Roman Lessons for Public Debt Management and Debt Market Development"*. - World Bank Policy Research Working Paper 3414. September, 2004

New Zealand

New Zealand Government Kiwi Bonds (Kiwi Bonds) are retail stock offered directly to the public. They are available only to New Zealand residents.

Interest Rate	Fixed Rate	
Periodicity of payment of Interest	**Quarterly**	
Benchmark	**Interest rates are set periodically by the NZDMO from the moving averages of domestic wholesale rates.**	
Maturity	Six month, 1 year and 2 years	
Min. amount (per issue)	NZ $ 1,000	
Max. amount (per issue	NZ $ 500,000	
Registry	NZDMO	

Japan

Japan offers JGBs exclusively for retail investors (called JGB-R). Currently, JGB-R have 3 maturities (i) floating rate (10-year), (ii) fixed rate (5 year) and (iii) fixed rate (3 year. The details are as under:

Minimum face value unit	10,000 yen		
Maturity	10-year	5-year	3-year
Fixed/Floating	Floating	Fixed	Fixed
Coupon Payment	semiannually	Fixed-rate coupon	Fixed-rate coupon

	variable(Every six months)	(Every six months)	(Every six months
Interest Rate	Reference rate - 0.8%	Reference rate - 0.05%	Reference rate - 0.03%
Benchmark/ Reference Rate	yield at the average price of 10-year fixed-rate bond's auction held in the month prior to the commencement of the interest calculation period.	the yield at the theoretical price calculated on the market price of 5-year fixed rate bonds, on the 2 business days prior to the offering date(auction date of the 10-year fixed rate bonds).	yield at the theoretical price calculated on the market price of 5-year fixed rate bonds, whose remaining maturity is 3 years, on the 2 business days prior to the offering date(the first business day on each month in principle(note))
Guaranteed Minimum Interest Rate	0.05%		
Redemption Before Maturity	The bondholder is able to wholly or partially redeem the bond at any time after the second interest payment period (1 year following issue).	The bondholder is able to wholly or partially redeem the bond at any time after the fourth interest payment period (2 years following issue).	The bondholder is able to wholly or partially redeem the bond at any time after the second interest payment period (1 year following issue).
Exceptional redemption	Redemption before the above mentioned respective interest payment period is possible in the event of death or accident by natural catastrophe of the bondholder.		
Value for redemption before maturity	Face value + a proportionate amount of accrued interest - already paid interest to a value corresponding to the	Face value + a proportionate amount of accrued interest - already paid interest to a value corresponding to 4	Face value + a proportionate amount of accrued interest - already paid interest to a value corresponding to 2

	most recent 2 interest payments (before tax) ×0.8	interest payments (before tax) ×0.8	interest payments (before tax) ×0.8
Frequency of issuance	Quarterly (January, April, July and October)		Monthly

Note: In the case of the 3-year fixed-rate bonds issued in January, April, July and October, the date for deciding reference rate is the 10-year fixed-rate bond's auction date.

South Africa

The National Treasury strives to make RSA Retail Savings Bonds as accessible as possible through which the general public can save their money while earning secured and market related returns on their investments. The National Treasury has on offer 2 different types of RSA Retail Savings Bonds, being the Fixed Rate Retail Savings Bonds and the Inflation Linked Retail Savings Bonds. The salient features of each of the RSA Retail Savings Bonds are set out below:

Instrument	**Fixed rate**	**Inflation Linked**
nature	Fixed Rate Retail Savings Bonds earn a market related fixed Coupon / Interest Rate, priced off the current Government Bond Yield Curve, payable on the Coupon / Interest Payment Dates until the Maturity Date.	Capital is inflation adjusted every six months
Eligibility	All natural persons (of any age group), who are citizens or permanent residents of the Republic in possession of a valid South African identity number, and who operate bank accounts with financial institutions in the Republic, are eligible to purchase RSA Retail Savings Bonds. Persons under the age of 21 must receive parental consent before investing in RSA Retail Savings Bonds,	
Maturity	2,3 and 5 year	3,5 and 10 year
Minimum purchase	ZAR 1,000	ZAR 1,000
Maximum purchase	ZAR 5 000 000	ZAR 1 000 000
Interest dates		31 May, 30 November

Benchmark	Determined by interpolating the equivalent yields of 3-year, 5-year and 10-year Government Bonds which are interpolated on the last day of each month. The Prevailing Coupon / Interest Rate is rounded upwards to the nearest quarter of a percent and are applicable during a calendar month.	Inflation uplift + 6 monthly floating real interest rate (being the difference between nominal interest rates and CPI rates) . which is derived from the Government's Inflation Linked Bonds Yield Curve, as traded on the Bond Exchange of South Africa and calculated separately by the National Treasury for the various terms.
Current Interest Rates (September 2010)	8.50%, 8.75% and 9.00 %	2.25%, 2.50% and 3.00%
Register	• Any branch of the South African Post Office • RSA Retail Savings Bond website - • Directly at the National Treasury • Telephonically	Same
Payment	• Any branch of Pick 'n Pay, Boxer or Score • Any branch of the South African Post Office • Internet Banking • Direct deposit at the bank	Same
Early withdrawal	After twelve months - penalty equal to a percentage of the interest calculated on the amount withdrawn and will be deducted from amount withdrawn. A balance of R1,000.00 (one thousand rand) should remain if the whole investment is not	• Only allowed after 1 year from the date that your payment is received • A penalty is, however payable on the early withdrawn amount effectively equal to one interest payment on the early withdrawal amount.

	withdrawn; or Within the first year, only in extraordinary circumstances.. A penalty will be deducted from the amount payable on such early withdrawal. The penalty shall be a total forfeiture of all interest accrued and/or previously paid on the amount to be withdrawn.	• Allowed to withdraw prior to one year in extra ordinary circumstances, after forfeiting interest received
Other features	• Non-transferable • Non-tradable • Monthly coupon payments for senior citizens only (Pensioners bond) • Capitalisation of interest payments received	• Non-transferable • Non-tradable • No monthly payments • No capitalisation of interest payments received
Statement of Account	The investor receives, on a regular basis, a statement of account setting out his Unique Investor Number, personal particulars; the amount invested in each of the RSA Retail Savings Bonds, interest rates payable and maturity dates of respective investments, the Bank details into which the investor chooses to receive the interest or the capital balance on maturity, and a confirmation of nomination of beneficiary and particulars of nominated beneficiaries.	

B. Postal Savings System

The outstanding advantage in providing financial services through a postal system is the post's ubiquitous character. Financial services can be made available to all by virtue of the broad network of postal facilities. They are usually provided as a public service, including in those cases where the posts act as an agent, providing the services on behalf of another institution or bank, or when the postal system itself is privately owned—a relatively new phenomenon. The essential characteristic distinguishing postal financial services from the private banking sector is the obligation and capacity of the postal system to serve the entire spectrum of the national population, unlike conventional private banks which allocate their institutional resources to service the sectors of the population they deem most profitable. (Scher, 2001, UN).

As per a survey conducted by the UN Department of economic and Social Affairs in 1999, 77 countries had postal savings systems (of which 50 countries responded to the survey). Kazakhstan and Vietnam began postal savings operations in 1999. Vietnam recorded a rapid growth in postal savings resulting from private-sector activity.

Norway and New Zealand resumed postal savings in 2002 after a 13 year break and Finland and Sweden ceased postal savings.

Not only do postal savings systems thrive in many countries, history demonstrates time and again that the use of postal savings systems dramatically increases when the public's distrust of banks rises or when there is an unusual amount of political anxiety or economic insecurity. During the Great Depression of the 1930s postal savings account deposits in the United States rose to $1.2 billion, a nearly eight-fold increase over the $153 million on deposit in 1929 [*In Business*, July 1999]. Japan's banking crisis, which began in the early 1990s, has precipitated enormous growth in postal savings deposits. Political and economic uncertainty in Niger and Togo in the 1980s may have been the reason for a dramatic increase in postal savings deposits. In Niger from 1985 to 1990, there was a 329 per cent increase in deposits; similarly in Togo, from 1984 to 1986, a 45 per cent increase was experienced [*Postal Statistics*, 1980-1997, UPU]. Postal savings deposits in the Republic of Korea have jumped since Korea's financial crisis began at the end of 1997.

Depositor confidence in postal savings is directly related to an implicit, if not explicit, guarantee by the government of the safety of deposits, which is the primary concern of all savers. In Malaysia, the National Savings Bank (NSB), which utilizes the postal infrastructure, prominently displays a sign printed in four languages (Malay, English, Chinese, Tamil) that states: "Your savings are guaranteed by the Government." Even in the Netherlands, which has fully privatized its postal savings system, survey data show that the mistaken belief persists that postal savings are still secured by the Government.

The security of the postal savings system is generally not hard for the government to guarantee as the investment of postal savings funds is usually restricted to government-guaranteed or approved bonds and equities

The higher cost of servicing a higher percentage of small deposits tends to be offset by the smaller number of withdrawals per account, compared to current accounts at commercial banks.

Usually very few, if any, alternatives to postal savings are available for the poorest depositors in developing countries. In some African countries, such as Benin and Mali, in rural areas and among the poor, people are accustomed to paying fees to obtain even a low level of security against loss. That is, savings may be deposited with so-called "money-keepers."

Postal checking and giro accounts, where they exist, are strikingly popular for compelling reasons. They are cheaper for households and small businesses to maintain than commercial bank accounts and provide a secure, affordable means to transfer money. The "informal economy" in many developing and transition countries often relies on giro accounts to make the transfers. Evidencing the utility and economy of the giro accounts system, the use of giro accounts extends beyond national borders. West African and North African countries, along with many European countries, Japan, and the Republic of Korea, have established international giro payment systems by bilateral and multilateral agreements. Cross border remittances by poor migratnts are routed through this system

In recent decades, public sector, universal postal networks have been facing threat from the entry of the private sector in the provision of services formerly provided exclusively exclusively by the posts and from the concomitant separation of different components of public services from the posts according to their susceptibility to private competition. Most affected are rural and low-income areas where post office closures have resulted in the loss of postal savings and other financial services to communities previously served, as well as the loss of postal services.

Postal systems operated under one of 3 governance structures: (i) traditional model centred on a department of government, (ii) government owned corporation and (iii) fully privatized postal operator.

Under the *traditional model*, the postal department operates as a government department within a government determined budget and all revenues from the operations are returned to the treasury. Typically, income derived from postal savings or postal financial services is reported on the basis of gross revenue collected, most often without any analysis of actual transaction costs to determine net profits.

Corporatised model: A Government owned company with objective of rationalisation of operating costs and being responsible for the viability of operations while at the same time responsible for fulfilling public policy objectives. The management adds new profit making services to its operations and creates more efficiency in all areas of operations.

Privatised postal model: The Government (MoF) or the central bank acts only as a regulatory authority and supervisor. Privatised Posts fulfill its mandate as a regulated public utility. There are certain restrictions on financial services offered and, therefore, the entity is called "post bank".

In the survey, 80% of developed countries (mostly continental European countries and not UK) and 20% of EMEs reported offering credit facilities to their clients. Hence, credit function is rarely performed in the erstwhile British colonies.

In case of commercially oriented post banks in developed countries, there has been a demise of the postal savings function and funds are not mobilised for economic development when the post bank operates commercial banking strategies.

Once the ownership of post bank is separated from posts, conflict between goals of post bank/post occurs and the synergy between the two disappears typically. Isolated communities and low income areas were hard hit as post office branches closed. For e.g., in 1990s, the commercial bank strategies replaced savings linked to development. With the loss of revenue, 65% of Finland's Pos closed during 1990-95.

Postal financial services franchise of Duetsche Post accounted for 23.5 per cent of revenue and 18.7% of profits. Netherland Post was 50% owned by ING Barings Bank and also the owner of the Post Bank. In Germany, the major share holding was with the government but Deutsche Post AG operates as a privatized entity. 21% of the shares of Deutsche Post AG are traded in the market.

Postal financial services make possible more intensive use of the postal network, reducing costs through economies of scale in transactions through the postal infrastructure. The privatization process of postal financial services (Scher, 2001) in Finland, Sweden, and the United Kingdom adversely impacted on this symbiosis. In developing countries, also, the separation of the postbank from the posts effectively destroyed synergies that made providing financial and postal services to lower-income and rural populations financially feasible. Many governments in the transition economies have undervalued their postal savings institutions both as financial and social economic assets. This in turn led to opportunistic mergers and sales, subsequent liabilities requiring intervention and bailouts and, worst, the reduction or elimination of services. On the other hand, some private sector operators, such as ING Barings and Deutsche Post AG, realized opportunities in maintaining the postal network and the profitable synergies it has with postal financial services. It, thus, seems that at least some privatized operators rediscovered the synergies from recombining them.

We examine institutions that are being successfully used in a variety of economic and institutional environments in Asia. The focus is on issues which lie at the heart of the concerns in developing countries relating to the mobilization of postal savings: financial product development and promotion, postal savings in rural areas, the credit function and the building of partnerships with other institutions, agency problems and private sector competition, overseas remittances, the investment and intermediation of funds for development, management operations and the utilization of technology.

One may distinguish four types of organization for providing savings services through the postal infrastructure in Asia: 1) the national savings organization, as in Bangladesh and India; 2) the postal savings bureau, as in China, Japan and the Republic of Korea; 3) the linkage of savings to a postal payments system, as proposed in Kazakhstan and other CIS States; and 4) the national savings bank use of the postal infrastructure, as in Malaysia, Sri Lanka and formerly Singapore (postbanks) Individual country cases serve to describe the different types.

Japan

The Japanese postal savings system (JPSS) was established in 1875 for the purpose of offering small volume personal deposit accounts to promote savings among the general population, especially rural communities. Prior to 2001, the JPSS was legally bound to place its funds with the Ministry of Finance's Trust Bureau which managed the funds through the Fiscal Investment and Loan Program (FILP). The Trust Bureau invested a portion of the FILP funds in Japanese government bonds (JGB) and allocated the rest to various government-owned institutions to fulfill public policy objectives. A major force driving postal privatization worldwide is the sizeable amount of accumulated deposits in postal savings programs. This is the case with both the JPSS and the KPS. At its peak in 2000, postal savings deposits amounted to ¥260 trillion (US$2.2 trillion). As of March 31, 2007, the balance of postal savings deposits held by the JPSS amounted to ¥187 trillion (US$1.6 trillion), making it the largest deposit base among Japanese banks at 33.5% of aggregate deposits (Bank of Tokyo Mitsubishi, the 2nd largest Japanese bank - accounted for 18% of the total deposits). By 2001, the Japanese economy had experienced a prolonged period of stagnant growth, and public calls for greater transparency and more fiscal responsibility on the part of the central government were increasing.

Against this backdrop, legislation for the privatization of numerous government-owned institutions including the JPSS was initiated. Pursuant to the new legislation, on October 1, 2007, the Japan Post Bank – along with the Japan Post Insurance, the Japan Post Service, and the Japan Post Network – began operations as a private company under the holding company of Japan Post Holdings Co., Ltd.

Currently, all shares of the four entities are held by the holding company, which, in turn, is wholly owned by the government. During the coming years, shares of the holding company and the two financial entities –namely Japan Post Bank and Japan Post Insurance –will be sold publicly with the aim of fully privatizing these entities by 2017.

Japan Post Bank is operating as a standalone bank and is under the direct supervision of the Japanese Financial Services Agency, which is the main regulator of all financial institutions operating in Japan.

In pursuit of postal privatization, the JPSS faces challenges. The large size of its postal savings deposits and its legacy as a major purchaser of JGB present unique challenges. For instance, because of its size, the newly formed Japan Post Bank is viewed as a potential competitive threat by both large and small regional banks. While commercial banks attempt to manage interest rate risk by diversifying their investment portfolios, the large size of the Japan Post Bank's JGB holdings prevents it from taking similar actions without causing significant market disruptions. As a result, the Japan Post Bank is not in a position to maximize its earnings potential by reinvesting in higher yielding instruments. Other challenges are the recruitment and retention of skilled staff with commercial banking experience, the establishment of effective internal control systems, and the ability to compete with established financial institutions in an already competitive business environment.

Korea

The postal savings program in South Korea can trace its beginnings to the late 19th century. South Korea's first national postal administration was established in 1884 and began collecting postal savings deposits some years later. However, it was not until the passage of the Postal Savings Law in 1962 that the current Korea Post Service (KPS) began to take shape. Until 2003 when the law was amended to give the KPS some flexibility in its investment options, the KPS placed the funds it collected from postal savings deposits in the Government's Public Account. Major growth in the KPS's deposit base came in the wake of the 1997-98 Asian financial crisis. The KPS benefited from a flight to safety by depositors eager to take advantage of the government's guarantee of postal savings deposits. Between 1998 and 2007, the level of postal savings deposits nearly tripled, with the most accelerated growth occurring between 1998 and 2001. The sharp increase in deposit base threatened commercial banks and there was a clamour for privatization to achieve a level playing field. Korea's postal savings deposits is the sixth largest banking entity accounting for 5% of the total deposits. (Kookmin Bank is the largest with 17% market share.). While the size of its accumulated postal savings deposits is significant, deposits held at the KPS represent less than half the market share of each of the top three South Korean domestic banks.

In contrast to the JPSS, the KPS has not privatised its postal savings system, although the push for postal reform has gained some momentum in 2008. There would be challenges common to the postal privatization process, including maintaining the financial viability of other postal business lines without the support of the postal savings business. The limited market presence and lack of a defined customer base in KPS create their own challenges. The KPS must develop its own market niche if it is to remain a profitable entity in the highly competitive South Korean banking market.

It may be noted that the Ministry of Knowledge Economy is the regulatory agency for the KPS.

China

China's postal savings program plays a critical role in the government's goal of more balanced economic development. Compared to its urban areas, China's rural areas remain relatively financially underdeveloped. As a result, many of the plans for China's postal savings program are centered on the need to improve access to credit and other banking services in rural areas.

Like Japan and Korea, China began offering postal savings services in 1919. In China, postal savings was abolished in 1952 when personal savings was subsumed under the People's Bank of China, the central bank. In 1986 postal savings was reintroduced at the initiative of the central bank through the China Postal Savings and Remittance Bureau (CPSRB), which was part of the State Post Bureau in an effort to mobilize savings. It has shown remarkable growth in the 1990s as a repository of rapidly rising personal savings resulting from the opening and development of the private- sector economy.

In the late 1990s, China proposed establishing a stand-alone postal savings bank. In June 2006, the Chinese Banking Regulatory Commission (CBRC) endorsed the establishment of a separate China Postal Savings Bank (CPSB). In March 2007, the CPSB officially began operations with registered capital of RMB 20 billion (US$ 2.7 billion). It is wholly owned by the newly formed China Post Group and is regulated by the CBRC. By creating a stand-alone postal savings bank which is supervised by the country's banking regulator, Chinese authorities have avoided a common criticism of other postal savings programs—namely, that some postal savings programs enjoy special treatment with respect to financial oversight (as in the case of Korea).

Deposits with the CPSB amounted to RMB 1.7 trillion (US$ 233 billion) by end-2007, making the CPSB China's fifth largest bank in terms of customer deposits. CPSRB, like its Japanese and South Korean postal savings counterparts, was not allowed to make loans. Instead, deposits were placed in the People's Bank of China (PBOC), China's central bank, to support national investment plans. In case of China, as in the case of Japan and Korea, the financial viability of mail delivery and post office management remains an ongoing concern in the wake of postal savings reforms. In China, approximately 42% of income of the postal bureau came from the postal savings business line in the early 2000s.

One of the objectives of the CPSB is to encourage postal savings funds flow back to the rural areas. The CPSB launched trial operations of "small loan" products in even provinces starting in mid-2007 and as of January 2008, the bank had offered nearly RMB 87 million (US$ 12 million) of such loans In May 2008, the CPSB began offering a specialized bankcard in Guizhou and Hunan Provinces that is tailored to the banking needs of migrant rural workers, enabling them to deposit and withdraw funds in various cities, and also to remit money to their families at home. This service would be extended to other provinces over time.

While postal privatization remains stalled in Korea and Japan Post Bank's options are constrained by its already large market share, the CPSB is steadily moving ahead with its plans to become a full-service commercial bank. In the long term, the CPSB will likely follow the path of China's other large banks by selling public shares to raise additional capital. It may also seek a foreign strategic investor at some point in the future.

The CPSB is in the process of becoming a full-service bank. It benefits from a lack of legacy nonperforming loans, advice from the CBRC and lessons learnt from China's financial modernization process. The CPSB also benefits from: 1) its vast network; 2) a strong base of stable, long-term savings; and 3) very localized knowledge (often down to the village level). As a result of localized knowledge, the CPSB is expected to be able to cultivate strong customer relationships, particularly in small towns with limited access to other banking services. At the same time, compared with the Agricultural Bank of China, which has historically focused on lending primarily to farmers and companies in rural areas, the CPSB may be less limited in its target client populations and product offerings. For example, the CPSB would like to pursue wealth management and intermediary business markets in the future. In March 2008, the CPSB launched corporate services on a trial basis in its Tianjin branch. Corporate services initially will be confined to deposits and settlements, but eventually will include corporate online banking and other services. The CPSB will expand the program once it has adopted adequate measures to manage associated risks.

The timing of the CPSB's growth plans coincides with a challenging banking environment in China. As the CPSB expands into new business lines, it faces difficulties common not only to other commercial Chinese banks, but also to the Japan Post Bank and Korea Post Service. For example, it will need to continue enhancing its system of internal controls and implement plans to recruit and retain staff with commercial-banking experience. While addressing risk management, personnel and other issues, the CPSB must also develop strategies to compete with more established credit cooperatives and commercial banks.

The CPSB also faces an environment of increasing reserve requirements and resultant credit tightening. As of September 2007, the PBOC allowed the CPSB to follow reserve requirement of 4%, well below the 12% requirement for commercial banks at that time. CPSB is also expected to address rural-urban income inequality and to improve financial services in the country's rural areas. This could have implications for pursuing sound risk management practices.

Pakistan

The rates on Government National Saving Schemes (NSS) have been linked with the yields on market based G-secs of different maturities.[12]

South Africa

The Post Office plays a major role as a distribution channel for retail savings instruments issued by the Treasury.

UK

The concept of postal savings has its origin in UK. Post office savings bank (POSB) was founded in UK in 1861. In 1969, the ownership of postal savings operations was separated from the posts, renamed National Savings and transferred to the treasury with the PO subsequently playing an agency role. The failure to modernize its functioning led to the decline in the business of NS&I in the 1970s and 1980s.

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Annex 12: Expert group to review the rates of agency charges payable to Department of Posts for operation of Small Savings Instruments

Vide OM dated April 9, 2010, the GoI has set up an Expert group to review the rates of agency charges payable to Department of Posts for operation of Small Savings Instruments. The terms of reference of the Committee are as under:

i. To examine the basis of payment of remuneration in its whole perspective taking into account all cost elements including 'at source' commission payments to various categories of agents, SB pairing, computerization, accounts and audit, maintenance of 'silent accounts,' etc. and recommend a suitable formula to adopted for remunerating Department of Posts for their agency functions relating to small savings schemes. While doing so aspects of improving efficiency and optimizing costs, etc may also be factored in.

ii. To examine and recommend the formula for sharing the cost of management of small savings schemes between the Central Government and the State Governments.

iii. To recommend suitable measures for improving the efficiency of post offices relating to small savings work.

iv. To see and recommend if any power of relaxation of rules presently held by Ministry of Finance (Department of Economic Affairs) can be delegated to Department of Posts to save operational cost and to avoid delay in cases related to general public.

v. To examine the reasons for large number of irregularities, such as opening of irregular accounts and issue of NSCs and KVPs to the persons firms, institutions, trust, etc, and to suggest remedial measures to curb such irregularities.

vi. To examine the request of Department of Posts for payment of remuneration on zero deposit/ zero balance Post Office Savings Accounts opened for the beneficiaries of NREGA and other social security schemes (IGNOAPS, IGNSPS and IGNDPS).

Background

- Various small savings schemes are framed by the Central Government under the Government Savings Bank Act, 1873 and The Government Savings Certificates Act, 1959. The Public Provident Fund Scheme has been framed under PPF Act, 1968.
- Small savings scheme are administered through Post offices. The Public Provident Fund and SCSS scheme are also operated through Nationalised and select private sector Banks.
- Extension services are provided by agents appointed under Standardised Agency Scheme, Mahila Pradhan and PPF Agents scheme.

- Department of Posts used to be remunerated for its agency work by the Department of Economic Affairs on per transaction basis. Separate rates were in vogue for Savings Bank deposits (including MIS) and Savings Certificates.
- For the years 1967-68 to 1970-71, Award by Shri Rangachari, the then Accountant General, Post & Telegraph, Rates were fixed with specified rates of escalation per transaction based on increase in DA/HRA or Pay revision.
- For the years 1976-77 to 1980-81, Shri S.M. Patankar, the then Financial Adviser, BPE recommended rates per transaction for Saving Bank and Saving Certificates. Rates from 1979-80 to 1985-86 were re-worked as per Patankar formula based on revised pay scales.
- For the year 1988-89, D. Rajagopalan, the then Chief Adviser (Cost) recommended rates per transaction with an annual increase of 10% over the previous year's rates. Group recommended that the cost of SB/SC operations to be linked up with the overall cost of the Postal Department. Rates were applicable for 5 years from 1.4.88 to 31.3.93.

Basis of Remuneration by the Last Group

- In Nov 1994, Shri C. Ramaswamy, the then Chief Adviser (Cost) recommended a change in the calculation of remuneration from "number of transactions" to "no. of live accounts" as on 31st March every year with escalation of 10% every year and to review after recommendations of 5th Pay Commission are implemented.
- Rate per live account was fixed based on average number of transactions in an account which was calculated as 4.8.
- Up to the year 2000-2001, DEA remunerated the DOP based on the rates fixed as per recommendations of the Expert Committee with 10% escalation in rates every year.
- No review was carried out after implementation of 5th Pay Commission in 1996. From 2001-02, DEA allowed the different rate of escalation since 2001-02. 5% has been allowed as the rates of escalation for the years 2009-10 and 2010-11.
- The Group had also considered the following alternatives
  i. As a percentage of gross or net collection
  ii. As a percentage of common expenses
  iii. Per Transaction rate basis
  iv. Rate per Saving Account per Saving Certificate basis.

These options were not accepted by the Group.