Fiscal transparency and sustainability of Small Savings Schemes

A Study for the Fourteenth Finance Commission

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Executive Summary

1. The Central Government offersa risk-free avenue for mobilising savings through Small Savings Schemes (SSS) and the net collections are used as a source of financing the deficits by the Central and State governments. Started as a value added public service to tap the infrastructure of the network of Post Offices, some of the SSS are now also mobilized through banks. The network now spans 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. Being 'Treasury banking operations' of the Central government, these schemes are outside the regulatory jurisdiction of the SEBI and the RBI.

2. As at end of March 2013, the total outstanding deposits mobilised by all scheduled commercial banks aggregated to Rs.7428200 crore (Demand Deposits: Rs.714100 crore, Savings Bank Deposits: Rs.1758200 crore and Term Deposits:Rs.4955900 crore). On the same date, the Central government's liability to the depositors under various SSS was Rs.814545 crore. With SSS liabilities being less than 10 per cent of the deposit liabilities of scheduled commercial banks, the SSS are a small but significant constituent of the financial sector.

3. The funds collected under SSS constitute the liabilities of the Union government accounted for in the Public Accounts of India in respect of which the government acts like a banker or trustee. The National Small Savings Fund (NSSF) was created as part of the Public Accounts wef 1999-2000 under the recommendations of RV Gupta Committees (1998/1999), set up with intent to eventually corporatize the Small Savings operations.

4. Aggregate liability of the Union government to the depositors under various SSS as on 31.03.2013 was Rs.814545 crore against which Rs.517221 crore had been invested through National Small Savings Fund (NSSF) in State Government securities. As much as Rs.69103 crore out of gross collections had been used up in financing accumulated operational deficit of NSSF.

5. Contrary to original intent of the scheme, there has been steady accumulation of operational deficits in NSSF accounts (Rs.69103 crore by 31st March 2013, which is projected to rise to Rs.91275 crore by 31 March 2014 and Rs.112728 crore by 31st March 2015.) NSSF's operational deficit/surplus should have more or less been modest and stable. This amounts to financing expenses of a revenue/recurring nature out of capital raised from SS depositors. So there is a serious sustainability issue with NSSF. Besides, there is also a serious fiscal transparency issue as well since this income deficit is not included in the Centre' Revenue Deficit, NSSF being out of reckoning from the fiscal accounts of government's expenditures and revenues. Had these treasury banking

operations been subject to transparent and prudential regulations, such build-up of accumulated operational deficit would have been red-flagged by regulators long back.

6. The proportionate share of States' liabilities to the Union Government in the States' total liabilities has been declining in recent years. It has come down from 43.6% (27.8% share of securities issued to National Small Savings Fund and 15.8% share of Loans and Advances) at the end of 2004-05 to 26.3%(19.7% share of securities issued to National Small Savings Fund and 6.6%share of Loans and Advances) at the end of 2013-14 (as per Budget Estimates). Thus, States are increasingly relying on open market loans to finance their deficits. While at aggregate level the relative share of NSSF liabilities in the total liabilities is declining, disaggregated data shows that it is still quite significant for some States. At the end of 2011-12 (for which data is publicly available), the NSSF debt constituted 29.6 per cent of total outstanding liabilities of all State/UT Governments (Rs.1751,786 crore). 100% debt of NCT of Delhi is on account of share in net Small Savings collections. Maharashtra and West Bengal, the share of NSSF in their total fiscal liabilities is next highest at 40 per cent. (State/UT-wise break up is given in**Annexure V**).This shows that some States have had significant dependence on SSS resources to bridge their fiscal deficits. The pace of accretion to SSS liabilities has slowed down in recent years. The governments' dependence on the market for financing their deficits has been increasingly as part of conscious reform policy.

7. With increasing expansion of financial inclusion, the SSS have been coming into direct competition with commercial banking both in urban and rural areas. By offering higher returns and tax concessions, the SSS had been queering the pitch for commercial banks especially in urban areas. To address this long outstanding concern, the yields on SSS is being gradually aligned with market rates on other comparable instruments under a reform process initiated in 1999. As an outcome of this marketization trend coupled with redemption pressure under the discontinued scheme of KisanVikasPatra since December 2011 and accumulated income deficit in NSSF accounts, net resource generation by NSSF for financing governments' deficits has dropped to a record low in last two years. Decline in small savings collections will cause financing problems for the governments to the extent the depositors exiting small savings do not re-channelise their savings into formal capital market.

8. Since December 2011, States have an option to borrow from NSSF upto 50 per cent or 100 per cent of net collection within that State, and the option is to be exercised annually. There is a case for prospectively allowing individual States a third option of 0% subscription to NSSF debt. Of course, there are serious legacy issues – particularly the high level of accumulated operational deficit in the management of SSS – that need to be addressed.

9. Recent trends suggest that the share of liabilities on account of securities issued by NSSF in the States' debt profile has been declining and that of Market Loans has been increasing. Increasing borrowing cost of market loans has almost wiped out the difference between cost of NSSF securities and Market Loans for many States. In fact, the marginal cost of Market Loans for many States in 2013-14 was higher than that of NSSF debt. For most States, the marginal cost of Market loans is significantly higher than the average cost of NSSF debt, making any refinancing of NSSF debt unviable.

10. The distortionary effect of SSS on financial sector have been substantially contained by rationalising the returns on SSS and benchmarking them with market-driven rates of government paper. The results have started to show up in declining trend in fresh collections under short/medium term SSS.

11. It is a welcome sign that the Union government is rebalancing SSS to promote long-term savings and not competing with commercial banks in short/medium term maturity segment. However, a concern is raised in some quarters that this alignment of returns on SSS with 'market rate' is basically meant for avoiding unhealthy competition in urban areas. The 'market rate' is 'urban market rate'. The alignment is perhaps inadvertently and adversely affecting SSS mobilization in rural areas, where para-banking channels having serious regulatory concerns are active. With increasing financial inclusion aided by Direct Cash Transfer Schemes, one can hope that even rural areas would have access to well-regulated banking services and the issue of market rates of returns on SSS impacting SSS collections is likely to become less relevant. It is not possible for the Government to segment the market for SSS and get out of urban areas because it would be extremely cumbersome for the system to verify genuine domicile of potential depositor or to keep changing with expansion of financial inclusion by other players in the financial sector.

12. There are serious issues of fiscal sustainability, fiscal transparency and impact on market connected with SSS. The 13th Finance Commission had recommended a comprehensive review of SSS and connected fiscal sustainability issues. Accordingly, a committee chaired by Mrs ShyamlaGopinath, Deputy Governor RBI was appointed and several measures have already been initiated wef December 2011 following acceptance of the recommendations of the Committee. This include further marketization of SSS, viz., narrowing down gap in the tenor of SSS with gilts of comparable tenor, and also to correct maturity mismatch between liability to the depositors and the maturity of investments. However, serious mismatch between the cost of resource mobilization and yield on investments has serious implications on fiscal transparency and sustainability that are yet to be fully addressed.

13. From a fiscal sustainability viewpoint, the cause of concern is continuing and increasing mismatch between the income [interest] and expenses [interest to depositors,

commission to banks/agents and ‘remuneration’ to D/o Posts] of NSSF. This income deficit, which should have normally been part of Centre’s Revenue Deficit is presently not included because of the accounting arrangement of NSSF’s operations within the Public Account. While the returns to the depositors are more and more market driven, a similar alignment between costs and returns in the investment policy of NSSF is also desirable. The well-intentioned recommendations of the 13th Finance Commission to provide relief to the States in interest rates on their borrowing from NSSF has further dented the income-expense gap in NSSF. The Central government did not seem to demur perhaps because NSSF deficit being ‘off-budget’does not show up in Centre’s Revenue/Fiscal Deficit monitored under the Fiscal Responsibility and Budget Management Act but it is not consistent with the intent of the Act.

14. A survey of past work by various Commissions/Committees is given in Chapter 1 and certain key issues are identified for exploration in Chapter 2. It is noted that the NSSF operations involve mixing up of several functions (a) Sovereign Debt management function involving financing through involuntary borrowings (b) Banking function that is not ‘fit and proper’ in terms of prudential norms applicable to commercial banking (c) Financial Intermediation function by sovereign that is outside the fiscal accounts (d) Inter-governmental transfer function in a manner that frustrates sub-national fiscal rules and prevents full exposure of States to the market. (e) Savings promotion function. TheNSSF operations dilute and frustrate fiscal rules.Prudent Fiscal Management of sub-national governments must be guided by exposing them (a) Market Discipline and (b) Fiscal Rules. Financial Intermediation function by the Central government dilutes market discipline and autonomous flows through prescriptive mandatory lending by NSSF to States frustrates the discipline of Fiscal Rules. Further, NSSF operations outside the fiscal accounts and outside full scale regulation by a Financial Sector regulator are also inconsistent with prudential norms of fiscal management.

15. It is observed that the NSSF operations are neither transparent nor self-sustaining. The increasing income deficit in NSSF is *de facto* undisclosed Revenue Deficit of the Central Government outside the regulatory framework of the FRBM Act.

16. Following four issues are discussed in detail:-

- Management of NSSF’s income deficit
- Feasibility and Implications of delinking States from Small Savings
- New institutional mechanism for management of Small Savings Schemes
- Transparency in NSSF’s operations: Accounting and Reporting issues
- Need for continuing with Treasury Banking operations

Recommendations

Dealing with accumulated income-expense gap in NSSF

17. Some measures have been taken by the Government based on the ShyamlaGopinath Committee report (2011) to address the issue of asset-liability mismatch in NSSF but these measures are too little, too late, certainly not commensurate with the size of the accumulated deficit to be liquidated. Accelerated measures like recapitalisation of NSSF by apportioning accumulated deficit among proxy shareholders of this un-corporatised, quasi-Bank, namely NSSF, are required. NSSF may be viewed as an uncorporatized Bank of which the Central and the State governments are co-promoters.

18. In the absence of a defined shareholding pattern, it is somewhat difficult to decide the best course to ensure equitable burden sharing between the Centre and States, especially when it comes to sharing the losses sitting on the NSSF's balance sheet. However, it is imperative that the capital loss in NSSF is made good and brought down to prudential, normative limits.Recouping the capital loss in NSSF primarily needs measures to improve NSSF's income much more than measures of expense control because NSSF investments have consciously been made below cost.

19. One rather legalistic view could be that recapitalisation of NSSF (bridging the accumulated income deficit in NSSF) is entirely theUnion government's responsibility and the States have nothing to do with it. However, the political economy of small savings is actually different. We feel that such an approach is inconsistent with the fact that at least some State have actively resisted Union government efforts to align yields on SSS to market with concomitant risk of reduced inflows into it. In reality, the Union government cannot ignore the States' views while unilaterally withdrawing from Small Savings Schemes. In 2001, the Union government had opted for 100% NSSF onlending to States and one of the prmary driver of the move was that the Union government was not keen to continue high cost SSS.

20. Hence, it should be collectively decided that a sizeable part of accumulated income deficit of NSSF should be apportioned amongst Central and State governments, based on some acceptable formula, preferably recommended by the 14th Finance Commission whereunder the Central and State governments, as deemed shareholders of this deemed bank, share the income and deficit in proportion to a well-defined, normative shareholding pattern. Akin to the process of vertical and horizontal devolution of Central taxes/duties, the Commission may consider prescribing a formula for fixing the share of each government in the annual and accumulated loss/profit. For example, a baseline scenario may be 50% deficit being allocated to the Central government and balance 50% to the States. Each State's inter se share may be fixed on the basis of moving average of State-wise gross collections under various Small Savings Schemes.

The share may be fixed annually on 1st April based on previous 10 or 20 years average gross SS collection in the State. There should be a ceiling on maximum permissible deficit (incremental or accumulated) beyond which the mandatory contributions (in the nature of reverse income transfer from the deemed promoter to the deemed corporate) from respective governments should be mandatorily called for. Relative contribution of the Centre and the States in the build-up of the accumulated loss of NSSF can be worked out since inception of NSSF if comprehensive data on investment and reinvestment from time to time is made available.

21. Following three alternative ways to apportion relative responsibility to fund NSSF's accumulated operational deficit may be considered:

    i. Take the sharing pattern as given and compute what would have been the yield to NSSF had NSSF resources been invested on identical terms for both the Centre and the States.
    ii. Compute the yield to NSSF had a fixed pattern of sharing (say 50:50) and identical terms of lending been followed since inception of NSSF.
    iii. Assuming a 50:50 sharing pattern between the Centre and the States since inception of NSSF, an identical tenor of securities (10 years or 25 years), identical moratorium on repayment (0 or 5 years) retro-compute identical coupon rate calibrated to bring operational deficit to zero say by end 2009-10,(before discontinuation of KVP). Re recalibration of coupon rate thereafter once in three years may then be considered.

22. In all the three scenarios, Union government would be entitled to charged interest for use of its cash balance by NSSF at prevailing WMA rate. Likewise, Union government would be obliged to pay interest to NSSF at WMA rate for using its surplus cash. For this exercise, cash surplus beyond a threshold would need to be notionally treated as automatically invested in Central and State securities.

23. The interest rate on securities issued by the Central and State governments to NSSF should be enhanced for accelerated liquidation of deficit in a time frame of 5 to 7 years. In the past, NSSF's implied investment contracts with the States have been retrospectively revised to reduce the interest rate. Therefore, in principle there cannot be any objection to retrospective enhancement as well. Should that be a practical problem, the States wishing to prepay any NSSF debt may be charged appropriate prepayment premium.

24. The cash balances of NSSF and Union government should be segregated and any to and fro cash transfer should attract an expense equivalent to the WMA rate fixed by the RBI.

25. Since there is a great deal of uncertainty about corporatization of NSSF operations, the above arrangement would *de facto* corporatize the NSSF's management, while leaving operations being carried on in business as usual mode.

Investment from NSSF – Delinking States from mandatory subscription to NSSF debt

26. Taking advantage of the present scenario, when NSSF's significance as a resource for financing States' fiscal deficit has considerably declined in recent years, it is desirable to delink the States from NSSF prospectively even as the legacy issues are sorted out separately. Delinking of States can begin at the margin and in a voluntary manner, prospectively. The States have an option to either take 50% or 100% of net SS collections in the State. What needs to be done is to dilute the prescriptive NSSF lending (50% or 100% of net collection in that State) by adding an option of 0% to individual States.

27. The States may also be allowed to retire their outstanding NSSF debt but it would be appropriate for NSSF to charge a prepayment premium that would help finance NSSF's accumulated income deficit. The present average cost of NSSF debt of States is about 9.1 per cent while the marginal cost of market loans of States raised in 2013 has risen to ~ 9.4 per cent. State's market debt is generally costlier than the comparable Union's market debt.Interest rates on State market loans, already on increase may further go up if States' market borrowing is scaled up to refinance NSSF debt. Hence, refinancing of NSSF debt may not be feasible for most States. However, this is something to be left to individual States and the market to deal with. It is upto the States to decide whether to tap cash balances or go for cheaper market borrowings to retire higher cost NSSF debt. Some States may actually be in a position to avail this option.

28. While States may be delinked from mandatory participation in NSSF investments, it would be useful to provide for NSSF participating in State Debt floatation so that the States may choose NSSF at their option. Given the current trends of redemption pressure under closed schemes, NSSF may not be in a position to generate significant investible resources for some time. There would understandably be some practical problems but there is no harm in retaining this as an avenue of investment for NSSF. While States would not be obliged to take NSSF 'loans', they would have an option to tap these resources if the Union government offers acceptable pricing, absorbing the differential cost itself.

29. In case the States are allowed to withdraw from Small Savings (all States en bloc or option to individual States to withdraw) and NSSF is restructured to be entirely a resource for theUnion government, it is quite likely that the Union government may not continue competition with commercial banks through high cost Small Savings and limit the scope of SSS to provide a social service to small savers, say by allowing Post Office

savings bank accounts to be operated in areas where access to formal banking is not available. For, this is now going to be on the agenda of all banks through Financial Inclusion programme. After the States get delinked from NSSF, and the NSSF resources are totally at the disposal of the Union government, it is desirable that it is treated as part of normal budgetary resources, part of financing the fiscal deficit. Permitting discretionary 'investments' without Parliamentary approval is not desirable. Direct financing of public policy-driven investments/capital expenditures such as lending to IIFCL outside the fiscal accounts of the government is inconsistent with acceptable fiscal accounting. Inclusion of any non-government entity as investment destination of NSSF would be against the integrity of fiscal accounts.

New Institutional Mechanism for NSSF management

30. Whether the D/o Postsor NSSF is corporatized into a full-fledged or partial Scheduled Commercial Bank or Company or Trust or Statutory Corporation or not, the need of stronger, statutory institutional mechanismto regulate NSSF management (including investment) can hardly be over-emphasized. The recommendation of the Reddy Committee (2001) to set up a National Small Savings Authority and to enact an umbrella legislation encompassing all aspects of small savings to supersede earlier legislations has found strong endorsement from the Financial Sector Legislative Reforms Commission (2013), which recommended as follows: "*There is a need to consolidate and modernise the laws on small savings. Accordingly, the GSB Act, GSC Act and PPF Act should be replaced with a consolidated law that should, inter alia, contain provisions relating to manner of collection / investment of funds, consumer protection, grievanceredressal and, to the extent relevant, prudential regulation. All functions related to the operation and management of small savings should be performed by an independent entity that should be brought within the limited purview of the financial regulator. However, prudential regulation of the proposed small savings entity should not extend to changing the manner in which the funds held by National Small Savings Fund are invested since that constitutes a fiscal decision.*"

31. The NSSF was set up as a prelude to eventual corporatisation of SSS operations. If corporatization is not possible to take care of full range of SSS management, at least the top-level institutional mechanism managing the NSSF, its accounting and regulation, and its investment policy must be encapsulated in a transparent, FRBM-compliant, preferably legislation-backed 'deemed corporate' structure, even if operations in the field continue as before. Hence, pending resolution of consensus on 'corporatization debate', a new institutional arrangement, short of setting up a new corporate entity, should be put in place under a legislation that imposes the regulatory, accounting and disclosure norms on NSSF. Mindful of costs involved, we emphasize that a new institutional arrangement (like a Management Committee recommended by the Reddy

Committee 2001) , short of setting up a new corporate entity, should be put in place preferably under a legislation that imposes the regulatory, accounting and disclosure norms on NSSF. This can be a management committee with representation from financial regulator.

32. It is noted that the D/o Posts has applied to the RBI for a banking license. In view of serious doubts about the desirability of continuing with treasury banking operations in current mode, we need to ascertain if the government has taken a formal view on the nature of banking functions to be undertaken by the D/o Posts. For reasons brought out above, unless there is a separate corporate entity regulated by the RBI like any other bank, the banking license for D/o Posts should be limited to a 'Deposits Only' banking institution and all surplus capital should be transferred to the Central government's accounts as a general budgetary resource and all investments made out of these resources should be part of fiscal accounts. In case the Post office is allowed to function as a Payments bank, the transparency issue would be sorted out but the sustainability issue would still remain. Will the new bank be self-sustaining or have congenital dependence on Union Budget?

Transparency in NSSF's operations: Accounting and Reporting issues

33. Accounting of accrued interest on SAVINGS CERTIFICATES needs review. Unlike in the case of GPF, the accrued interest is not annually debited to NSSF's income-expenditure account. If such interest is accumulated in a separate head, there would be clearer understanding of NSSF's balance sheet and income-expenditure account. Accrued interest need not be calculated individually for each certificate.Even setting aside a certain fixed percentage of outstanding principal in a separate head would suffice for transparency.

34. The need to preserve transparency in the quasi-corporate structure of NSSF can hardly be over-emphasized. Only a highly condensed summary of NSSF operations is presented as part of voluminous Budget documents. Monthly, Quarterly reporting is absent. NSSF Liability is analysed only in terms of *Savings Deposits, Savings Certificates, Public Provident Fund.* Individual Small Saving Scheme-wise outstanding liability is not disclosed. The disclosures in the Budget documents about NSSF may be expanded to include Scheme-wise liability profile.

35. The NSSF's recurring operational loss is simply hidden Revenue Deficit. Had pre-1999 accounting continued, this would have formed part of Union government's Revenue Deficit. This 'off-budget' Revenue Deficit should be disclosed in the Budget documents through a footnote wherever there is a reference to Revenue Deficit, pending formal amendment in the FRBM Act in the definition of 'Revenue Deficit'.

Need for continuing with Treasury Banking operations

36. Capital erosion under SSS has made them into a collective Ponzi structure and raising fresh capital is now an imperative need. However, there is a trade-off between efforts to achieve targeted decline in yield differential on SSS vis-à-vis market rates for comparable products and the efforts to boost gross collection. Alarming reduction in household financial savings in recent years due to combined effect of inflation and diversion to gold had also affected gross collections under SSS. Recent trends suggest that the worst phase is over. Enhancement in investment limit under PPF from Rs.1 lakh to Rs.1.5 lakh in Budget 2014-15 will help as PPF is one of the most buoyant of all SS Schemes.

37. With financial inclusion being pursued as a national programme, there are question marks on the desirability of continuing with treasury banking, especially if it distorts financial market. Given the high administrative costs of Post Offices, government mobilized small savings cannot hope to compete with other players in the financial sector. A moot point is whether it is not opportune time for the Union government to progressively disengage from the short and medium term SSS (mostly through Post offices) and serve the public policy purpose (of helping small savers, depositors, investors) by enhancing sovereign protection through a more comprehensive deposit guarantee.

38. The following are the options for way forward:-
    - NSSF may continue as it is.
    - NSSF may continue with the options given to the States to prepay the outstanding dues at any time from now and also have the option to avail of their share in the future as their discretion on a year to year basis.
    - NSSF may continue purely as a Union government scheme in the future, without any future involvement of the States. The States' involvement in the future will be only repayment as per schedule or prepayment. This will also give all options for the union Government to restructure in the future.
    - NSSF is wound up and the States' outstanding debt obligations to the NSSF be treated as debt to the Government of India on existing terms and conditions.

39. Continuance of SSS per se is closely linked to the resolution of legacy issues of dealing with the accumulated income deficit in NSSF as well as restructuring of States' existing debt to NSSF. Continuing the States' existing debt to NSSF on existing terms and conditions till it is liquidated in normal course is the natural option. Alternatively, the States' debt to NSSF can be converted into States' debt to the Union government, which may be restructured into a long term, fixed interest loan, with bullet repayment of

equated principal redemption at the option of the State government. This will ensure the operation of the fiscal rules implicit in the FRBM Act and will also give relief to the Sates. The interest rate may be set broadly in alignment with the inflation objectives of the Union government and the RBI.

Chapter 1 Background Information

Introduction

1. The Central Government operates Small Savings Schemes (SSS) 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. Through these treasury banking operations, the Government competes with Commercial Banks and other financial sector market intermediaries for tapping household savings for financing deficits in the Union and State budgets. 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 scheduled commercial banks.

2. The Central Government has played the role of financial intermediary in collection of small savings and their sharing with the State Governments. The amount mobilised through the small saving schemes is accounted under the Public Account of the Central Government. The net amount (gross collections minus repayments) is shared between the Union government and the States and forms part of the borrowed funds for partially financing the fiscal deficit of both Union government and States. The outstanding amount under small savings collection constitutes the liabilities of the Central Government. The net collections in small savings schemes and Public Provident Fund were being shared with the States in the form of long term loans for financing the State Plan. This sharing arrangement was put in place to encourage the States to join the Union government in a cooperative effort in mobilising savings. Prior to April 1, 1987, two-thirds of the net collections in a State were passed on as long term loans to that State. The share of States was 75% from April 1, 1987, enhanced to 80% of the net collections from April 1, 2000, 100% w.e.f. April 2002 and 80-100% at the individual State's discretion w.e.f. April 2007. Since December 2011, States have an option to borrow from NSSF upto50 per cent or 100 per cent of net collection within that State, and the option is to be exercised annually.

3. 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. SSS instruments are as good as sovereign borrowing as an investment avenue as also a means of providing social benefit to the small savers. The small savings instruments also compete with retail sovereign retail debt instruments as the individuals are being attracted to the gilt

market though participation as a non-competitive bidder in the auction of marketable government securities. 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 (popularly known as RBI relief bonds).

4. Small savings rates are a key benchmark in the retail section of the debt market as they offer a risk free avenue with tax incentives. High yields on small savings schemes coupled with persisting high fiscal deficits contribute to high real interest rate in the economy for everyone besides severely straining public finances. Higher yields compared to zero risk on these borrowers, leading the latter to offer higher rates while inviting deposits. In turn, the high deposit rates set the floor for the higher lending rates. Adjustment in the interest rates on various small savings schemes and PPF became necessary so as to align them with the overall interest rate structure in the economy.

5. With the rationalisation1 of interest rates on various small savings schemes since 1st January 1999, the rates of interest on the amounts transferred to various State/UTs Governments against net small savings collections were reduced concomitantly. The interest rate on 'loans' to States from NSSF have been successively reduced from 14.5 per cent to 14.0 percent wef January 4, 1999, 13.5 percent wef April 1,1999, 12.5 per cent wef April 1, 2000, 11.0 per cent wef April 1, 2001, 10.5 per cent wef April 1, 2002, 9.5 per cent wef April 1, 2003.[2]

6. SSS have contributed to a promotion of culture of thrift and financial inclusion in unbanked areas. With structural transformation of the Indian economy, increasing penetration of banks, including RRBs, in the semi-urban and rural areas, there is now increasing substitutability between bank deposits and small savings instruments and increasing need to align yield on the later to the market.

7. Aggressive push being given to financial inclusion predicated by need to introduce direct cash transfer of subsidies and benefits to beneficiary accounts further brings the commercial banking and treasury banking into increasing conflict. Enhanced provision of social security through alternative channels such as old age pension, NREGA, etc. and increasing exposure to 'market discipline' in government borrowing under the rule-based fiscal consolidation by the Union government and the State Governments provide added impetus to a relook at the SSS instruments to get aligned with marketable instruments enabling price discovery. Other considerations that drive reforms of SSS

[1]On the basis of RV Gupta Committee (1998)

[2]Consequent to the NDC sub-committee recommendations, the interest rate on pre-2002-03 NSSF loans to States was reset to 10.5 per cent. Subsequently, the 13th Finance Commission recommended that the NSSF 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.

instruments are improving tax compliance, plugging loopholes enabling tax evasion, checking money laundering, observance of investment limitsthrough modern Information Technology (CBS network etc), modern debt management with a view to reduce cost of borrowings while containing risks.

8. Broadly, three types of small saving schemes are in operation. These are postal deposits (akin to fixed term and recurring bank deposits), saving certificates and social security schemes like PPF and retirement schemes. The legislative framework governing the various schemes as also the salient features of the small savings schemes are given in **Annexure I, Annexure II, III, IV and V** give, trends in gross and net SS collections, trends in Asset Liability mismatch in NSSF, trends in Income and Expenditure of NSSF and State-wise break-up up of outstanding NSSF debt as on 31st March 2012. The annual rate of growth of small savings exhibited a sharp volatility reflecting the changing public preference about the relative attractiveness of alternative savings instruments, mainly commercial bank deposits.

9. We elaborate below how the implementation of NSSF mechanism has not been backed by a strong institutional mechanism and there are serious issues of fiscal sustainability, fiscal transparency and impact on market.

Previous Studies by official Committees/Working Groups

10. The whole system of these schemes has been subject matter of study by several Commissions, Committees and Working Groups appointed by the Government of India and the Reserve Bank from time to time, suo moto or at the instance of the Finance Commission. Follow up action these reports has led to significant changes in the SSS system. These are: Rangarajan Committee (1991), RV Gupta Committees (1998, 1999), Expenditure Reforms Commission (2000),Dave Committees (1999, 2000), Mathur Study Group (2000), Shome Advisory Group on Tax Policy and Tax Administration (2001), OASIS Reports (1999, 2000), Sehgal Report (2001), Reddy Committee (2001), Informal Task Force of RBI (2003),Rakesh MohanCommittee (2004), Vajpayee Committee (2005), National Development Council Sub-Committee (2007), Thirteenth Finance Commission(2009), ShyamlaGopinath Committee (2011) and Financial Sector Legislative Reforms Commission (March 2013).

11. These studies have gone into the issues like feasibility of setting up a body corporate for managing small saving funds, aspects of interest rates, tax treatment, pension problems, the macro-economic implications of the fiscal burden of these schemes etc., equitable sharing of the burden of administering the schemes between the Union government and the States and need of a single, comprehensive law to regulate the SSS management and came out with issue-specific suggestions.

12. Of all the changes in the way the SSS are managed, the most fundamental restructuring from fiscal management viewpoint was carried out w.e.f. financial year 1999-2000 on the recommendations of the 'RV Gupta Committee-II' by creating the National Small Savings Fund(NSSF), mimicking an un-corporatized bank operating as part of the PUBLIC ACCOUNTS OF INDIA. (vide**Annexure VI**).

13. The decisions taken by the Central Government about interest rates on investments by NSSF and NSSF's investment portfolio, suo moto (2003 and 2007) or pursuant to recommendations by the NDC Sub-Committee (2005) or the 13th Finance Commission (2010) have been most important development on fiscal management aspect of NSSF since its creation in 1999.

14. The latest in the series of deliberations on the operational aspect of SSS management by various Commissions/Committees/Groups is the report of the ShyamlaGopinath Committee (2011). It focussed on the National Small Savings Schemes in general and National Small Savings Fund in particular. The Committee was set up on the basis of accepted recommendations of the 13th Finance Commission and tasked for a comprehensive review on all aspects of the Fund' management. This paper draws heavily from this report as well as the RV Gupta Committee report (1999) and Y V Reddy Committee (2001) in highlighting the outstanding issues of management of SSS.

RV Gupta Committee (1998, 1999)

15. The RV Gupta Committee (1998) deliberated *inter alia* on the issue whether the Small savings operations may be entrusted to a Corporate Body and identified some accounting problems as an impediment to corporatization. Accordingly, in another report in 1999, the Committee recommended creating a National Small Savings Fund (NSSF) in the Public Account of the Central Government.

16. Accepting this recommendation, an important change in the accounting system was brought about with effect from the fiscal year 1999-2000. Until 1998-99, the States' share in net small savings collection was passed on to the States by the Union government in the form of non-Plan loans at interest rates prescribed by the Central Government. Under these arrangements, loans against small savings provided to States by the Union government represented Union government's expenditure and formed part of Union government's gross fiscal deficit.

17. Under the changed accounting system, all small savings collections are credited to this Fund and net amount is invested in the special securities of Central and State Government according to the norms decided by the Central Government from time to time. The debt servicing of these government securities is an income of the Fund, while the expenditure of the Fund comprises the interest payments to the subscribers of the small savings schemes and cost of management of small savings. The amount released

to States is treated as investment in special securities to be redeemed from the sixth year over a period of 20 years. Following the change in accounting practice, the outstanding amount of balances under small savings amounting to Rs.1,76,221 crore at end-March 1999 was converted into NSSF's investment in Central Government securities and is treated as a part of the PUBLIC DEBT of the Central Government.

18. Creation of NSSF w.e.f. 1999-2000 is the most fundamental restructuring of SSS management from fiscal management viewpoint. **Annexure VI** gives a more detailed note on NSSF.

Expenditure Reforms Commission (ERC) 2000: Downsizing National Small Savings Organization, review of interest rates and incentives to promote small savings

19. The Expenditure Reforms Commission (2000) was perhaps the first major forum to take a hard look at the management of Small Savings Schemes with a view to effect in economy in public expenditure. In its third Report, ERC made the following observations/recommendations:

- With the State governments having a major stake in small savings collections and also having built up large networks for promoting the schemes, it is no longer necessary to continue the National Savings Organisation in its present form with a vast network of field offices with a total staff strength of 1191. It should be drastically downsized.

- The practice of appointment of agents and payment of commission to them by Government of India should be discontinued leaving it to States.

- Attention should be on promotion of genuine small savings. Institutional investments should be disallowed. (There were instances when the Unit Trust of India would invest a few hundred crore in particular States based on incentives offered by States. The UTI alone had invested about Rs.3870 crore between 1989-90 and 1995-96.)

- Government abolished Indira VikasPatra (a bearer instrument held by nameless investors just like currency notes) as it was suspected to have been widely abused3. KisanVikasPatra is also reportedly open to abuse. One cannot claim that it is directed towards small farmers when the instrument is available in a denomination of Rs.50,000. Moreover, in this scheme there is no provision for deduction of tax at source.

[3] Also, the government was often faced with investors' difficult-to-verify claims for soiled/lost certificates

- There is also need for restructuring the tax incentives under the various schemes.
- Equally necessary is to examine whether interest rates offered under the scheme, are far out of alignment with the interest rate regime prevailing in the market.
- All these aspects need to be urgently studied by the government and necessary corrective actions taken before the next financial year.

20. Acting on the Report steps were taken to downsize NSSO and stop institutional investments. ERC had almost recommended scrapping of KisanVikasPatra KVP scheme, a move that finally materialized after categorical recommendation on its discontinuation by the ShyamlaGopinath Committee (2011).

Reddy Committee (2001): Need to align yields on SSS with market and the States' need of budgetary resources

21. Based on the ERC recommendation an Expert Committee was constituted by the Ministry of Finance under the Chairmanship of Dr. Y.V. Reddy, Deputy Governor, Reserve Bank of India to Review the System of Administered Interest Rates and other Related Issues.

22. One of the focus area of the committee was aligning/benchmarking yields on SSS instruments with market rates. The committee made out a detailed case for this. (Owing to the significant impact the SSS have on financial sector in general and the banking system in particular, the Reserve Bank of India has been an important stakeholder and prominent influence driving the changes in the tenor on Small savings instruments. The RBI-led deliberations of these fora have focussed on the various issues relating to 'administered interest rates' on Small Savings Schemes and the government-administered Provident Funds. The primary concern has been that the yield on these financial products/services should not be so high as to adversely impact the banks and other financial sector players. The end-use of funds raised through SSS and connected fiscal management aspects of SSS have generally been influenced by the States through the NDC and the Finance Commission.)

23. The basic philosophy of small savings is to provide a secure avenue for saving by individuals and promote long-term savings. In principle, small savings should inculcate the habit of thrift among the people and therefore, be restricted to individuals. Whether they cater to the needs of small savers/investors as they are purported to be needs to be seen. While some deposit schemes appear to be serving the purpose of only raising revenues by providing tax benefits besides other incentives, some long-term schemes in the nature of Provident and Pension Funds serve the purpose of old age security. Small saving instruments at administered interest rates have now emerged as an important method for garnering resources to finance fiscal deficit at both the Union government

and State levels. This increase in scale has given rise to several problems. First, these are high cost borrowings for the Government. Secondly, their use to finance revenue deficits is non-transparent. Thirdly, repayments are made from fresh mobilisations and thereby the ponzi nature of the scheme persists on an enduring basis. Fourthly, tax incentives provided to the small savers have resulted in loss of revenue to the Central Government and also distorted the term structure of interest rates. Fifthly, there is a serious problem of sustainability of small saving schemes as there is absence of a definite asset profile corresponding to the increasing liabilities. In view of these, there is 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.

24. The average cost of funds for banks ranges high between 7 and 9 per cent, which is, *inter alia*, due to high reserve requirements. On top of it, the spread between the deposit rate and lending rate in India is also high compared to most of the developed countries. This could be attributed to following reasons:

    - The intermediation cost in India is relatively large. The non-interest operating cost of funds among the public sector banks is around 3 per cent.
    - Relatively high overhang of non-performing assets (NPAs) puts pressure on the lending rates.
    - Although banks are given freedom to offer variable interest rates on deposits, there is a general preference for fixed interest rates in the system. This practice reduces flexibility on the part of the banks to reduce their lending rates, as the rates on the existing stock of deposits cannot be lowered.
    - There is a persistent and large volume of market borrowing requirements by the Government giving an upward bias to the entire interest rate structure.
    - The internal business savings of the corporate sector is low, keeping the debt-equity ratio high.
    - The risk premium over risk-free rate with respect to corporate lending has also gone up due to prescription of the prudential regulations and uncertainties arising out of corporate restructuring and the uncertain recovery climate.
    - The administered interest rates on small savings, which makes the structure of interest rates inflexible downward.

25. These are some of the structural issues, which need to be addressed so as to improve the overall efficiency of the financial system and thereby reduce the spread in the interest rates between savers and investors. The feasibility and scope for reduction in lending rates are circumscribed by these factors and inhibit lowering the cost of funds for investors affecting economic growth.

26. The issues relating to small saving schemes are quite complex due to the changing perceptions about the role of small saving schemes and the conflicting interests of various stakeholders. The SSS were introduced at a time when the banking and capital markets were relatively underdeveloped and, therefore, were largely confined to rural and a few urban areas. Thus, people looked upon the government as a reliable trustee or banker with whom they could lodge their hard-earned savings. While the same fiduciary bonding is still intact, the banking and capital market have developed significantly over a period of time with a wider coverage.

27. Financial savings play a major role in promoting growth. Therefore, financial saving in general and long-term and contractual savings in particular, should be encouraged keeping in view the long-term investment requirements of the economy. The retail savers should have assurance of relatively risk free real return for savers with special emphasis on old age security.

28. In this background, lowering the cost of funds to investors (lending rates of banks) depends on the following factors:

    - The borrowing requirements of Central and State government have to be brought down to a sustainable level that otherwise puts an upward pressure on interest rates.

    - Governments' access to and dependence on captive sources of financing their fiscal deficit have to be reduced to augment the availability of resources in the competitive debt market.

    - In the long-term, it is necessary to ensure that the funds mobilised are earmarked for productive purposes, the returns on such funds are linked to efficient portfolio allocation, there is transparency in end-use of mobilized savings and unacceptable diversion of funds does not erode confidence of savers.

29. Government administers interest rates on a number of instruments, such as, General Provident Fund (GPF), Employees' Provident Fund (EPF), various pension schemes, small savings including Public Provident Fund (PPF) etc. The share of small savings as percentage of net financial savings of households has gone up sharply from 7.9 per cent in 1996-97 to 12.9 per cent in 1997-98 and to 13.8 per cent in 1998-99.

30. The interest rates on SSS, which were initially conceived to offer reasonable returns to savers, had turned out to be floor rate for deposits of banks and financial institutions. Therefore, Reddy Committee (2001) had recommended that the returns on SSS need to be rationalised in the larger interest of developing an efficient financial market.

31. While recommending measures for rationalisation of schemes, new range of products, revised tax treatment and benchmarking, the Committee kept in view the need to sustain the flow of savings at the macro level for maintaining stable conditions for growth. In other words, there was a difficult balancing requirement to reduce returns on SSS but not so much or so fast as to drastically bring down SSS collections because SSS had become an important source of financing Central and States' fiscal deficit, more so for States.

32. In view of this balancing requirement, Reddy Committee (2001) observed that the small savings and other administered rates also should be *eventually* (emphasis added) aligned with market rates with the financial system moving towards complete deregulation of interest rates but in the transition, possibly some form of Government intervention may continue. Enabling conditions, however, need to be created so that the interest rates on small savings may be made flexible and appropriately aligned with the market rates.

33. Elaborating this line of thinking further, the Reddy Committee noted that a flexible system of fixing interest rates based on sound normative principles is desirable and there should be institutional arrangements to periodically review and rationalise the range of products and introduce schemes appropriate to small savers on a continuing basis.

34. Besides recommending changes in the interest rates payable to SSS depositors, the Reddy Committee also underscored the need to rationalise tax concessions attached to various SSS instruments as the concessions also create distortions in the market. The basic purpose of small saving schemes should be to inculcate the habit of thrift among the common people, particularly in the rural and semi-urban areas. These instruments also provide safe avenues for small savers who are, by and large, not taxpayers. However, Government offers various fiscal incentives to attract more savings from the urban areas as well. Various tax incentives have not only discriminated between tax-paying and non-tax paying savers, but also created distortions in the yield structure of the small saving instruments *vis-à-vis* other debt instruments. Further, the effective cost of resources mobilised under small saving schemes has turned out to be very high for the Central and State Governments. As such, tax-incentives appear to be available on a variety of other debt instruments as well and the *ad hoc* nature of tax treatment on financial instruments has distorted the price discovery and resource allocation processes. It is, therefore, considered necessary that the tax treatment applicable to

small savings be reviewed keeping in view the whole tax structure of financial instruments.In principle, while tax incentives should be available and are justifiable to promote long-term savings under social security schemes, other financial instruments should be tax neutral to promote allocative efficiency.

Progress made in aligning returns on Small Savings with that on other products / services offered by the non-government Financial Sector

35. Between 1999 and 2001, the revision of interest rates was based on the recommendation of the R.V. Gupta Committee (September, 1998), which recommended benchmarking of the rates of interest on small savings schemes against the rates of interest prevalent on similar instruments/schemes offered by banks and financial institutions.

36. The Finance Minister in his budget speech (2001-02) had noted that since 1998, the difference between the interest rates on contractual savings and the consumer price inflation had risen to 6 to 8 per cent, as against the 3 per cent difference between 1980 and 1998. Based on this reading of the situation, he reduced the interest rate from 11 to 9.5 per cent and proposed to appoint an Expert panel. Accordingly, Reddy Committee was set up.

37. After emphatic reiteration of the need of alignment of small saving interest rates with the market rates by the Reddy Committee (2001) due to its impacts returns to investors, market rates, small saving collections, cost of finances for the Union government and States and the composition of financing of fiscal deficit, interest rates payable to the depositors under SSS were reduced to bring them closer to market rates. The second major exercise of aligning SSS returns with market returns was undertaken in 2011 on the recommendation of ShyamlaGopinath Committee. The committee noted that 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. These mismatches had led to corresponding volatility in small saving collections. 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, SS 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 was, therefore, very essential to once again align SSS yields with market yields.

Reddy Committee (2001): 100% back-to-back transfer of net collections to States

38. The proposed scheme of transferring the entire net small savings collections to States on a back-to-back basis concurrently will need to address the problem of overhang resulting from the mismatches between the terms of repayments by the States and repayments to the investors of small savings. Under the existing transfer mechanism, the States are required to pay back the loans given to them by the Union government against small saving collections in 25 years (including a moratorium of 5 years). This leads to mismatch between loan repayment by the States and repayment to the investors of small savings as the maturity of small saving investment is much shorter. For instance, during 1999-2000, out of gross collections of Rs.75,542 crore, repayments to investors of as much as Rs.36,889 crore (about 49 per cent) were made. The net amount of Rs.38,653 crore was distributed between the Union government and the States. While the share of States was Rs.26,937 crore in 1999-2000, the repayments made by the States to the Union government against the small savings loans were only at Rs.2,475 crore.

39. Reddy Committee(2001) found the transfer of the entire net proceeds of net small savings to States on a back-to-back basis feasible within the existing accounting arrangement. However, the Committee recognised broad implications for the Union government and the States. First, the Union government would not get any funds from small saving collections and to that extent, its borrowing requirements from other sources would increase. Second, to start with, States would get more funds from small saving collections and to that extent their borrowing requirements from other sources may decrease. Third, a back-to-back arrangement would imply a much shorter repayment period for States than the period up to 25 years under the present system of loans from the Union government. In order to mitigate the immediate resource shortfall to the Union government, a transitional arrangement for compensatory additional market borrowing may be necessary. On the other hand, as the States will get additional loans against small saving collections, the States should mandatorily prepay their outstanding loans to the Union government. In doing so, States would be effectively replacing the outstanding high cost loans by low cost borrowings in a softening/stable interest rate scenario. Similarly, in case the net collection available for distribution among States come down because of growing repayments, States may also require some sort of additional borrowing to maintain their resource position. This transitional arrangement may be provided for the Union government and States to raise additional market borrowings to the extent of resource shortfall arising out of switching over to the new system of transferring small savings to States. Accordingly, the Committee suggested new arrangement for transfer of the entire net proceeds of small savings to States with thefollowing features:

(a) Complete decentralisation would be detrimental to the interests of the State Governments as the resultant risks in investment decision could have an adverse effect on the overall mobilisation of such savings.

(b) Therefore, the NSSF must continue as the conduit for mobilisation of small savings as well as repayment to the investors. Keeping in view the limited access to the market borrowing programme by the State Governments and the inelastic nature of the sources of revenue available to the States, the entire net proceeds from small savings collected after March 31, 2002 should be transferred to the State Governments.

(c) The Central and State Governments should jointly repay the outstanding small saving liabilities as of March 2002, apportioned in accordance with their respective shares.

(d) As the Central Government would have no share from the fresh collections after March 2002, the market borrowing programme of the Central Government may be enhanced to the extent of its annual liabilities.

(e) Similarly, if during 2002-03 and later the net collection available for distribution among the States comes down because of growing repayments, each State Government may be allowed additional market borrowings to maintain its budgeted resources.

(f) Utilising the additional resources in full (on account of 100 per cent transfer of the net proceeds from small savings), the State Governments should mandatorily prepay their liabilities to the Central Government ahead of the schedule, as it would be beneficial for them to replace their high cost liabilities of the past with low cost borrowings in a softening/stable interest rate environment.

(g) In case, some State Governments 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.

(h) The Central Government will have to deduct a portion of gross collection to cover actual operational expenses, before transferring the net collections.

40. The last stipulation, viz., "The Central Government will have to deduct a portion of gross collection to cover actual operational expenses", which was nothing but a continuation of status quo ante, could have been reformulated – it is felt in retrospect – to stop a continuing practice of using capital to cover operating losses. Today this has become the most serious problem facing NSSF. An important pitfall of continuing 'sharing' NET SS collections with the States is that it over-simplifies the investment policy and basically

encourages use of capital inflows to finance income deficit. All the Commissions and Committees including the one that recommended creation of NSSF, have consistently underlined the need of ensuring their operation in a "transparent and *self-sustaining* manner" (emphasis added in the recommendation of the 13th Finance Commission)".However, neither transparency nor self-sustainability is manifest in the operation of NSSF.

National Development Council sub-committee (2005)

41. In 2005, a sub-committee of the NationalDevelopment Council was set up to examine thevarious issues raised by the States. Based on its recommendations, the following changes weremade in the scheme:i) The States were not compelled to take 100per cent of the net collections under Small Savings and were permitted to go down to 80 per cent, with the remainder being takenby the Union government.ii) The rate of interest payable on NSSFsecurities issued during the years 1999-2000 to 2001-02 was reduced from 13.5 percent, 12.5 per cent and 11 per cent perannum respectively, to 10.5 per cent perannum with effect from 1 April 2007. (iii) The States were allowed to pre-pay a partof their liabilities to NSSF (this was availedof only by Tamil Nadu and Orissa withpre-paid sums of Rs.1126 crore and Rs. 200crore respectively during 2007-08).

13th Finance Commission 2009: Interest relief to States on NSSF loans and need for comprehensive review of SSS

42. The following observations and recommendations of the 13th Finance Commission are relevant to the discussion in hand:

    i. *The States have for long been complaining about high cost of NSSF loans even though the Centre has been contending that even the supposed high costs do not fully cover the cost of funds (interest paid to depositors plus commissions paid to agents plus remuneration to D/o Posts/Banks etc as management cost plus rollover cost involved in borrowing short and lending long on fixed interest rates plus reliefs given by the Finance Commissions plus tax revenue foregone). This Centre-State quibbling has been a long outstanding affair. Many State pleaded ThFC to include NSSF loans in the Debt Consolidation and Relief Facility (DCRF) at an interest rate of 7.5 per cent. Some states sought a reduction in the difference between the interest rates on open market loans and NSSF loans. It has also been suggested that the interest rate should not be more than 50 basis points higher than the average cost of funds. Some States have suggested that it should be linked to the Central Government Securities (G-Sec) rate to eliminate the anomalies in interest rates for all time. All these suggestions ignore the cost of raising NSSF funds.*

    ii. *Even though the interest rates have come down over this period, the States have had variousissues with the overall scheme regarding theinflexibility of having to*

borrow based on availability rather than requirement, asymmetry betweeneffective interest rates to the states and the Centreand the difference between cost to the NSSF andinterest rates. High cash balances with some States can be partially attributed to high inflows from NSSF(vide para 7.124 ibid). The primary reason for accumulation of cash balances is borrowing more than the fiscal deficit. With reduced fiscal deficits, it is essential that States follow the practice of borrowing on requirement rather than on availability. Amongst different sources of debt, the only source of borrowing on which States have free control is the open market loans. Most of the negotiated loans and external aid (received through Central Government on back to back terms) are tied to projects, and thus, do not have much flexibility. Parameters controlling inflows from NSSF are autonomous in nature, beyond the control of States. Hence, the blame for excess borrowing should actually lie with market loans and time lag in information that can help reduce the size of an open market floatation or even cancel it.

iii. *The NSSF loans are the costliest debt in the States' portfolio. Within the outstanding debt stock of NSSF loans at the end of 2009-10 (Rs. 4.3 lakh crore), Rs. 4.1 lakh crore pertained to loans contracted till 2006-07. On this portion of the debt stock, ThFC recommended that interest rate be reduced to 9 per cent, subject to the States passing FRBM Acts. (vide Para 9.106 of 13th FC report). The remaining stock of Rs. 20,000 crore carries an interest rate of 9.5 per cent, implying an effective rate of 9.02 per cent on the entire stock of NSSF loans. ThFC used this rate to estimate interest payments on the NSSF loans. ThFC also observed that gross collection under NSSF had dropped in recent years and net collection for 2008-09 had been negative. Keeping in view the recommended institutional reforms for NSSF, ThFC assumed that there would be no net addition to the debt stock of NSSF for the base year and the projection period. The underlying logic for providing interest relief on NSSF loans to the States by ThFC was that (vide para 6.36 ibid) the States had to pay a higher effective rate of interest on NSSF loans as compared to the Centre. Total relief on this account amounts to Rs. 13,517 crore. The Centre has to compensate this amount to the NSSF. (vide para 7.69 ibid)*

iv. *"On debt management, States have protested that they are saddled with high cost debt. It has been pointed out that while States take 80 per cent of the high-cost NSSF loans, the Centre takes 80 per cent4 of the aggregate open market*

[4] It may be recalled that the Centre had started passing on 100% net SS collections to States w.e.f. April 2002 after accepting the recommendations of the Reddy Committee(2001). The mandatory 100% transfer of net SS collection was reduced to 80% on the recommendations of the NDC Sub-Committee w.e.f. April 2007.

loans, which are low-cost. Some states have argued that the ratio of the shares of the Centre and states should be similar for all sources of borrowings." Para9.13).

v. *Both the Centre and the states have seen the interest cost of their respective NSSF debts declineover the years. However, the average interest ratepaid by the states has been higher than that of theCentre from the commencement of NSSF in1999-2000. This is primarily because the states havebeen paying interest only on securities issuedagainst collections on current small savings from 1April 1999, whereas the Centre is also payinginterest on securities against the depositsoutstanding on that date, which, at 11.5 per cent,was lower than the rate of interest on transfersduring 1999-2000 and 2000-01. The gap betweenthe average interest paid by the states and theCentre on their respective NSSF debt had narrowedfrom 1.9 percentage points in 2000-01 to 0.5percentage points in 2002-03, but thereafter,increased to 1.7 percentage points in 2007-08.*

vi. *This widening after 2002-03 has arisen dueto the following decisions taken by the Centre:i) Reduction in interest rate on central specialsecurities issued against outstandingbalances on central liabilities from 11.5 percent to 10.5 per cent with effect from 1March 2003, in line with general softeningof market interest rates.ii) Use of debt swap receipts from states topartly redeem the central special securitiesissued against the initial outstandingbalances and to replace them with freshsecurities at lower market rates of interest.The total amount redeemed between2002-03 and 2004-05 was Rs. 92,652 crore.iii) Further redemption of high-interest centralspecial securities against outstandingbalances for a sum of Rs. 10,000 crore in2007-08 in order to infuse cash into theNSSF consequent upon negative cashbalance in the Fund due to a drastic declinein net small savings collections.*

vii. *Consequent to the NDC sub-committeerecommendations, the interest rate on pre-2002-03loans was reset to 10.5 per cent and the collectionsfrom NSSF are being shared by Centre to the extentof 20 per cent. However, the asymmetry hascontinued in favour of the Centre even after theimplementation of the recommendations of theNational Development Council sub-committee.Therefore, we feel that there is a case for relief tothe states on loans advanced from the NSSF.9.106 Since the collections, from 2007-08onwards, have been flowing to the Centre as well,we have decided to consider relief on loanscontracted till 2006-07. The state-wise position ofloans contracted till 2006-07 and outstandingestimated as at the end of 2009-10 can be seen inAnnex 9.4. Keeping in view the existing effective rateof interest for the Centre, the fact that now theCentre too is using 20 per cent of the collectionsand the*

recent trends in flows to NSSF, werecommend that the loans contracted till 2006-07and outstanding at the end of 2009-10 be reset at acommon interest rate of 9 per cent per annum inplace of 10.5 per cent or 9.5 per cent. The repaymentschedule, however, should remain unchanged.9.107 The total benefit that would accrue to states,estimated on the basis of outstanding at the end of2009-10, is Rs. 13,517 crore during our awardperiod. State-wise details of estimates of the benefitare given in Annex 9.4. The benefit shall continueto accrue even beyond the award period and isestimated to reach Rs. 28,360 crore by the maturityof the last loan coming under purview.9.108 While the relief recommended above onlyaddresses the interest asymmetry between theCentre and states, the structural problems in theexisting arrangement need to be reviewed. Theissue of high interest rate on these instrumentsarises because of the administrative mechanismpresently in place.

viii. *A rise in the difference between the interestrates paid on small savings instruments and themarket rate causes an increase in subscription tothese instruments, thereby increasing flows of NSSFloans to states. With overall borrowings capped byFRBM targets, the states cannot take recourse toopen market borrowings. This has already beenwitnessed during 2003-04 and 2004-05. Thus,states may not be able to benefit from the lowerinterest rates, even when market rates go down, asthey are saddled with high inflows from high-costNSSF loans. Conversely, when market interest ratesincrease, the subscriptions to small savingsinstruments dip and flows from NSSF dry up. Thishas been witnessed in 2006-07 and 2007-08 whennet flows for many states even became negative.*

ix. *States have also raised issues about thetenor of this loan, extending to 25 years, which hasbeen used to justify the high interest rate and hasled to a situation where states are locked with fixedinterest debt for a long time with no option of resetand pre-payment. There is a significant mismatchbetween the maturity period of five to seven yearsfor most small savings instruments and the termof the loan extended from NSSF.*

x. *These issues highlight the need for morecomprehensive reforms in the overall administrationof the National Small Savings Fund. Variouscommittees constituted in the past to look into theseissues have made far-reaching recommendationsOne of the important recommendations has beenlinking of interest rate on small savings instrumentsto the prevailing G-sec rates, which we endorse. Werecommend, against this background, that all aspectsof the design and administration of the scheme beexamined with the aim of bringing transparency,market linked rates and other, much neededreforms to the*

scheme.9.112 Some reforms are also required at the statelevel. In the past there has been a practice of givingvarious incentives such as cash awards to officialsand other similar measures to promote subscriptionto small savings instruments. These measures alsointerfere with normal market dynamics. While mostof these incentives, like awards to officials, haveoutlived their utility, all such incentives that eitheradd to the cost of administration or affect normalmarket linked subscription, should be proactivelywithdrawn by the states.

xi. *States resented 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.*

xii. *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 Rs.13,517 crore during the award period and would aggregate to Rs.28,360 crore by the maturity of the last loan coming under purview.*

xiii. *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.*

xiv. *The tenor of this loan, extending to 25 years, 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.*

xv. *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.*

xvi. 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.

xvii. NSSF was created in the public account of India with effect from 1 April 1999 "with the main objective of de-linking small savings transactions from the Consolidated Fund of India and ensuring their operation in a transparent and self-sustaining manner.

ShyamlaGopinath Committee 2011: Increase in interest rates to Small Savings depositors, reduction in maturity mismatch in onlending

43. On ThFC recommendation for comprehensive reforms in the overall administration of NSSF, a Committee headed by SmtShyamalaGopinath was constituted by the Ministry of Finance in July 2010 for a comprehensive review of SSS and to suggest required reforms in the NSSF, keeping in view the following:

    - The importance of small savings in the overall savings in the economy especially its contribution in promoting savings amongst small investors.
    - 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.
    - The overall debt levels of the Centre and States and the fiscal targets prescribed by 13th FC.

44. The Committee, which submitted its report in June 2011, made following recommendations relating to small savings instruments and investments made by the NSSF:

    - An increase in the rate of interest on postal savings deposits to align with commercial bank savings deposit rate
    - Measures to improve liquidity which is needed more by small savers on recurring and time deposit schemes

- Abolition of the maturity bonus on Monthly Income Scheme (MIS) keeping in view the higher interest rate (inclusive of 5 per cent maturity bonus) on MIS vis-à- vis market rates
- An increase in the annual investment limit on Public Provident Fund (PPF) from Rs.70,000 to Rs.100,000 to coincide with the ceiling on Section 80C of the I.T. Act
- Withdrawal of income tax benefit under Section 80C for accrued interest on National Savings Certificate
- Discontinuance of KisanVikasPatra (KVP) which is prone to misuse being a bearer like instrument
- Introduction of a longer maturity instrument.
- benchmarking the interest rate payable on the small savings instruments (other than savings bank deposits which do not have fixed maturity) to the secondary market yields on Central government securities of comparable maturities (a one-year reference period – taking the average of the month-end secondary market yields in the preceding calendar year – could be adopted; with inter-year movement of interest rate limited to a maximum of 100 basis points (bps) on either direction.)
- A positive spread of 25 bps, vis-à-vis government securities of similar maturities (as against 50 bps recommended by the earlier Committees), which would contribute to the viability of the NSSF.
- Annual reset of the administered rates to achieve a balance between the objectives of the need for closer alignment of administered interest rate with market rates and the reduction of its volatility.
- Equal sharing in borrowings from the NSSF between the sovereign and the sub-sovereign for equitable burden-sharing as the rate of interest on the NSSF is higher than market rates. (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. After the States exercise their options, the balance amount, if any, could either be taken by the Centre or could be on lent to other States if they so desire, or could be on-lent to finance infrastructure to companies, such as IIFCL, NHAI and IRFC that are wholly owned by Government.)
- Reduction in the maturity period of special securities issued by the Central and State governments to NSSF from 25 years to 10 years to address the asset-liability maturity mismatch of NSSF. (With the rule-based fiscal consolidation initiatives, lower maturity may not involve refinancing risk.)

- Doing away with the 5-year moratorium on redemption of NSSF securitiesaway with and one-tenth of the amount to be redeemed each year. (Simultaneously, State governments could consider elongating the maturity profile of their market borrowings to 15-20 years, taking into account the risk-cost tradeoffs and reissue the SDLs to reduce the illiquidity premium. Since the share of the NSSF in financing of the fiscal deficits of State governments is expected to decline (with a 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 the NSSF.)

- Doing away with flat rates of interest charged on NSSF securities and instead annual reset based on a cost-plus formula (The Committee recommended that the rate of interest on NSSF 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. These interest rates would be announced annually every year on April 1. The reinvestments may be on the same terms as for fresh investments and should be shared between the Centre and the States on equal basis. This was felt appropriate as the present practice of the NSSF's reinvestments of its redemption proceeds in 20- year special Central government securities (SCGS) at the prevailing market rates is not viable as these rates are lower than the interest rate on fresh investments by the NSSF. The negative gap between the outstanding assets and liabilities of the NSSF may be funded by the Central government. To address the issue of excess liabilities over assets, the Centre may take up recapitalisation of the NSSF, especially when the NSSF is in need of cash to discharge its liabilities. It felt that these measures would contribute to the viability of the NSSF.

45. The following decisions were taken by the Government in November 2011:

- Reduction in the maturity period for MIS and NSC from 6 years to 5 years.

- Introduction of a new NSC instrument with maturity period of 10 years.

- Discontinuation of KisanVikasPatras (KVPs).

- Increase in the annual ceiling on investment under Public Provident Fund (PPF) Scheme from Rs.70,000 to Rs.100,000.

- Increase in the interest rate on loans obtained from PPF to 2 per cent per annum from the existing 1 per cent per annum.

- Improving the liquidity of Post Office Time Deposits by allowing pre-mature withdrawal.

- Increase in the rate of interest paid under the Post Office Savings Account (POSA) from 3.5 per cent to 4 per cent per annum.
- Alignment of the rate of interest on small savings schemes with interest rates on government securities of similar maturity, with a spread of 25 basis points (bps) (except for the new NSC instrument of 10-year maturity where spread would be 50 basis points and the Senior Citizens Savings Scheme where spread would be 100 bps); notification of interest rates on small savings schemes every financial year before April 1 of that year.
- With effect from December 1, 2011, the rate of interest on various small savings schemes for current financial year, on the basis of the built-in interest compounding/payment schemes, has been raised by 0.2-1.45 per cent. The interest rates are since then being adjusted wef every 1st April.
- Reduction in the minimum share of States in net small savings collections in a year, for investment in State governments Securities, from 80 per cent to 50 per cent with the remaining amount being invested in Central government securities or lent to other willing States or in securities issued by infrastructure companies/agencies that are wholly owned by Central government.
- Reinvestment of the yearly repayment of NSSF loans made by Centre and States by the NSSF in Central and State government securities in the ratio of 50:50.
- Reduction in the period of repayment of NSSF loans by the Centre and the States to 10 years, with no moratorium.
- Continuation of the prevailing rate of 9.5 per cent on investments from NSSF for the current financial year but the revised interest rate to be notified from April 1, 2012.
- Introduction of half-yearly payment of interest by the Centre and the States.
- Resetting of interest rate on existing investments from the NSSF in Central government securities till 2006-07 at 9 percent and on those from 2007-08 until 2010-11 at 9.5 per cent.

Financial Sector Legislative Reforms Commission (FSLRC) 2013: Need of consolidated law and independent management entity under limited purview of the financial regulator, investor protection provisions etc.

46. The Financial Sector Legislative Reforms Commission was set up for review of all laws impacting the financial sector. The Commission had set up a Working Group on Insurance, Retirement financing and Small Savings, chaired by Shri Dhirendra Swarup,

Member Secretary of the Commission. On the basis of the Working Group report, the Commission has made the following recommendations((March 2013):

- There is a need to consolidate and modernise the laws on small savings. Accordingly, the GSB Act, GSC Act and PPF Act should be replaced with a consolidated law that should, inter alia, contain provisions relating to manner of collection / investment of funds, consumer protection, grievanceredressal and, to the extent relevant, prudential regulation.
- All functions related to the operation and management of small savings should be performed by an independent entity that should be brought within the limited purview of the financial regulator. However, prudential regulation of the proposed small savings entity should not extend to changing the manner in which the funds held by National Small Savings Fund are invested since that constitutes a fiscal decision. (emphasis added)
- To address concerns that corporatisation of the scheme would lead to loss of public confidence, it should be ensured that upon the transfer of the management of small savings to an independent entity, the law effecting such transfer should explicitly clarify that these schemes are guaranteed by the government.
- Requisite changes may be made in the laws governing small savings to include provisions on investor protection, compensation and grievance redressal.
- To minimise operational risks on account of agent defaults and to protect the interests of investors, the law should lay down the framework for the licensing, qualifications and training of agents.

Regular Budget 2014-15

47. While presenting the regular Budget 2014-15, the Finance Minister made the following announcements in the Budget speech concerningSmall Savings: *"To address the concerns of decline in savings rate and improving returns for small savers, I propose to revitalize small savings. My Government attaches utmost importance to the welfare of Girl Child. A special small savings instrument to cater to the requirements of educating and marriage of the Girl Child will be introduced. A National Savings Certificate with insurance cover will also be launched to provide additional benefits for the small saver. In the PPF Scheme, annual ceiling will be enhanced to Rs.1.5 lakh p.a. from Rs.1 lakh at present. (Para 136-138) KissanVikasPatra (KVP) was a very popular instrument among small savers. I plan to reintroduce the instrument to encourage people, who may have banked and unbanked savings to invest in this instrument. (Para 27)*

Chapter 2: Issues of Fiscal Transparency and Sustainability

Introduction

40. Small Savings scheme represent Treasury banking functions of the government, which had great relevance when commercial banking was not widespread. 'Universal Financial Inclusion' is now high on agenda and is likely to become a reality in near future with the implementation of the Prime Minister's Jan DhanYojna. Hence, the rationale of Union government competing with commercial banks and other financial sector intermediaries for attracting household savings may become a debatable proposition. However, given the huge stock of outstanding liabilities of the government on this account, it is unlikely for the government to altogether give up taking new business.The reformist agenda to align the tenor of small savings instruments with others in the market so that there is a level playing field for all capital market intermediaries is likely to continue. In the past, small savings had indeed queered the pitch for commercial banks. Now the relative share of SSS has contracted. As at end of March 2013, the total outstanding deposits mobilised by all scheduled commercial banks aggregated to Rs.7428200 crore (Demand Deposits: Rs.714100 crore, Savings Bank Deposits: Rs.1758200 crore and Term Deposits: Rs.4955900 crore). On the same date, the Central government's liability to the depositors under various SSS was Rs.814545 crore. With SSS liabilities being less than 10 per cent of the deposit liabilities of scheduled commercial banks, the SSS are a small but significant constituent of the financial sector. As the year-wise trends given in Annexure VII show, there has been a deceleration in the year-on-year growth rate in the collections under Small Savings Schemes vis-à-vis the growth rate in the mobilization of deposits by the scheduled commercial banks (SCB) from 2005-06 onwards. Earlier, the relative trend was just the reverse. The SCB deposits grew 4.37 times by the end of 2012-13 over the outstanding SCB deposits at the end of FY2004-05. During the same period, the outstanding Small Savings collections grew by just 1.53 times. (Discontinuation of KisanVikasPatra scheme on the recommendation of the ShyamlaGopinath Committee (2011) is just one of the contributory factor to this outcome.

48. As a measure of social safety and financial security to the citizens, the government is expected to provide to them at least one risk-free avenue for investment of their savings. The treasury banking operations through Small Savings Schemes have traditionally served this broader public policy objective. However, with increasing financial inclusion and spread of commercial banking and other financial services, as also the way the schemes are being managed for quite some time, there is an

imperative need to have a hard look at its fundamentals. NSSF operations involve mixing up of several functions (a) Sovereign Debt management function involving financing through involuntary borrowings (b) Banking function that is not 'fit and proper' in terms of prudential norms applicable to commercial banking (c) Financial Intermediation function by sovereign that is outside the fiscal accounts (d) Inter-governmental transfer function in a manner that frustrates sub-national fiscal rules and prevents full exposure of States to the market. (e) Savings promotion function.

49. NSSF operations are inconsistent with basic principles of prudential fiscal management and inter-governmental transfers. Prudent Fiscal Management of sub-national governments must be guided by (a) Market Discipline and (b) Fiscal Rules. NSSF frustrates both. NSSF operations dilute and frustrate fiscal rules. When debt ceilings are fixed for States under fiscal rules, the autonomous inflows through Small Savings route results in bursting of debt ceilings and accumulation of cash balances with States. Prudential principles require that the sovereign should not intermediate between the market and sub-national governments.

50. Financial Sector reforms require that any agency accepting 'Public Deposits' must be subjected to regulation by Financial Sector regulator. As a proxy bank, NSSF at present would be considered a sick bank and would not qualify for a banking license for not meeting the 'fit and proper' criterion.

51. The Reddy Committee (2001) had further cautioned that it will not be in public interest to allow continuance of ponzi schemes on a longer-term basis and hence the Committee felt that at some point of time, the ponzi nature of the Small Savings scheme should definitely stop. The Committee had, therefore, suggested that States should be encouraged to adopt a back-to-back arrangement at the earliest so that the overhang problem would not arise for the fresh flows. In the opinion of the Committee, the timeframe for the same may be spread over six years from 2002.

52. Several aspects of SSS management have been covered by various Expert Bodies with thrust on marketization since 1999 in so far as interface with depositors is concerned and management of NSSF. As noted above, the 13th Finance Commission had reiterated the basic premise on which NSSF was created in 1999: "*NSSF was created in the public account of India with effect from 1 April 1999 with the main objective of de-linking small savings transactions from the Consolidated Fund of India and ensuring their operation in a* ***transparent andself-sustaining*** *(emphasis added) manner."* **However, NSSF operations are neither transparent nor self-sustaining. The increasing income deficit in NSSF is *de facto* undisclosed Revenue Deficit of the Central Government outside the regulatory framework of the FRBM Act.**

53. In this paper, we are focussing not so much on the structure of SS schemes and other aspects of interface with depositors but on NSSF's management. There are serious issues concerning transparency and sustainability of NSSF's operations and its investment policy.

- Management of NSSF's income deficit
- Review of Investment Policy of NSSF: Feasibility and Implications of delinking States from Small Savings
- New institutional mechanism for management of Small Savings Schemes
- Transparency in NSSF's operations: Accounting and Reporting issues
- Need for continuing with Treasury Banking operations

Management of NSSF's income deficit

54. NSSF may be viewed as an uncorporatized Bank of which the Union and the State governments are co-promoters. The problem is that in the absence of a defined shareholding pattern, it is somewhat difficult to decide as to how do we ensure equitable burden sharing between the Union government and States, especially when it comes to sharing the losses sitting on the NSSF's balance sheet.

55. Since the burden-sharing responsibilities are not well-defined and the Union government claims to be providing the guarantee to the depositors and financing all residual losses, there has been a mismatch between the rate of return to NSSF on investments made in the Union and State government securities. Despite the relief provided by the NDC Sub-committee, there continued to remain an asymmetry between the effective rate of interest payable by the Union and by the States to NSSF, as shown below.

56. 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 Union government increased to 1.7 percentage points in 2007-08 mainly reflecting the reinvestment of the redemption proceeds of the State Governments at market rates.

57. Hence, the 13th FC felt that there is a case for interest rate relief to State governments on loans advanced from the NSSF. The Commission 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. The total benefit that would accrue to States was placed at Rs.13,517 crore during the award period and would aggregate to Rs.28,360 crore by the maturity of the last loan coming under purview. As may be seen from para 42 above, in recommending a reduction in interest rate payable

by States on NSSF loans, the 13th Finance Commission was guided by a manifest Centre-State asymmetry in the management of NSSF. As the Commission noted "*while States take 80 per cent of the high-cost NSSF loans, the Centre takes 80 per cent5 of the aggregate open market loans, which are low-cost".*

58. The States' demand of source-neutrality on government borrowing programme is a fair point*per se* but one that glosses over the basic issue of equitable burden sharing on total cost of resource mobilization. As a result of the implementation of the recommendations of the 13th FC, the rate of interest on State Government securities would decline to 9.05 per cent, closer to the interest rate of 8.81 per cent paid by the Union government. 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. It is indeed perplexing that the 13th Finance Commission chose to reduce the interest rate payable by States on NSSF loans in a bid to ensure "equitable sharing of NSSF burden" whereas the equitable burden-sharing should have been ensured instead by asking the Union government to pay more interest to NSSF and by asking the States to share the burden of accumulated income deficit of NSSF. Reduction of interest rate for States on the plea that the interest rate payable by the Centre is lower ignored the burden of unrecovered administrative cost and accumulated income deficit. This sort of equitable burden-sharing turned out to be equitable 'loot' of the NSSF by the Centre and the States!!

59. Discussions about inequity in pushing more SS funds to States ignore that the burden of cost of SSS mobilization inequitably falls more on the Union and the Union has been subsidizing the cost of SSS collection or rather brushing it under Public Accounts, post-1999 creation of NSSF. The harsh reality that the cost of raising NSSF funds was higher than 9 per cent was overlooked and postponed for another commission/committee to be reviewed and corrected. Bleeding of NSSF by its promoters should discontinue in the interest of adherence to prudent fiscal management even though the present accounting arrangement helps to keep this accumulated operating income deficit outside the reckoning of revenue and fiscal deficits of the Centre and the States.

60. The States' desire to move away from NSSF is understandable when cheaper market loans are available cost of NSSF funds and open market loans cannot be compared because of the very large and diversified resource base and efficient banking infrastructure that acts as intermediary, relatively unburdened by the public policy objectives.

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[5]It may be recalled that the Centre had started passing on 100% net SS collections to States w.e.f. April 2002 after accepting the recommendations of the Reddy Committee(2001). The mandatory 100% transfer of net SS collection was reduced to 80% on the recommendations of the NDC Sub-Committee w.e.f. April 2007.

61. Not only in the context of Small Savings but also in the context of external assistance, there has been a long outstanding grudge and perception that the Centre's budgetary intermediation of these resources for the States is actually a source of profit for the Central government. On external assistance, the Central government has been pleading that there is no evidence of profit-making in the process of averaging and pooling of external assistance from different sources, in different foreign currencies, of different types of assistance(grants, soft loans, commercial loans) and lending in Indian currency for fixed interest rates and maturities insulating the States from forex rate variation risk. However, though nothing was proved either way, the States' protest grew so loud that the 12th Finance Commission was persuaded to recommend back-to-back transfer of external assistance to States alongwith forex risk. It was perhaps the same sense that guided the Reddy Committee (2001) to recommend transfer of 100% net SS collections on back-to-back basis to States. It is not surprising that in the past Centre's attempts to scale down high cost Small Saving operations have been resisted by the States and it was in this context that the Centre had pushed for a back-to-back, 100% on-lending of NSSF funds to States in 2001. The underlying message seemed to be this: Left to itself, the Central government would discontinue all SSS but since the SSS are being continued at the insistence of the States, let the States take 100% net collections.

62. An additional consideration of recommending 100% onlending to States in 2001 was that the conditions were then favorable to States to enhance their borrowing from NSSF. At that time, NSSF was the cheapest source of borrowing for the States and the States were allowed to use the enhanced borrowing from NSSF to pre-pay their higher cost loans taken from the Central government. It is ironical that a measure clearly taken in the interest of States was subsequently whittled down as soon as the arrangement became burdensome to States and the NDC Sub-Committee was pursuaded to reduce the mandatory sharing of 100% net collections to 80% w.e.f. April 2007. In fiscal management, this sort of cherry-picking and adherence to an arramagement only so long as it is conveneient is not uncommon..

63. In 2001, the Centre approved transfer of 100% of net Small Saving collections to States and allowed the States to use the enhanced transfer to prepay costlier non-NSSF debt at a time when NSSF debt was cheaper. 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. Accordingly, the States sought relief by way of reduction in the burden of then costlier NSSF debt. On National Development Council's recommendation, certain

decisions [6] were taken (2006) wef April 2007. The share of States in NSSF's investible resources was reduced to 80 per cent wef April 2007. The interest rate on NSSF debt contracted during 1999-00 to 2001-02 was reduced and reset to 10.5% per annum with effect from 1-4-2007 from 13.5%, 12.5% and 11% per annum. Three States/UT were allowed to prepay NSSF debt of 2079.29 crore (without any prepayment premium).

64. The impact of NDC's recommendations on the cost of NSSF debt to States meant reduction in average cost of NSSF debt from 10.11 per cent to 9.79 per cent on debt stock outstanding as on 31st March 2011. It got further reduced to 9.05 per cent due to further relief provided on the recommendations of the 13th Finance Commission (by reducing the interest further to 9% p.a. on all NSSF debt contracted till 2006-07). Since then, there has been no accretion to NSSF debt of States/UTs in aggregate. Thus, the present average cost of NSSF debt is about 9 per cent while the marginal cost of market loans of States raised in 2013 has risen above 9.5 per cent.

65. Thus, changes in the NSSF debt flows and cost made in 2001, 2007 and 2009 were all made in favour of the States even though these measures accentuated NSSF's viability. To set the record complete, the Central government also reduced the interest payable on Union government securities to NSSF while financing cash deficit and leaving the operational deficit of NSSF to be financed out of NSSF's capital. These decisions whether in favour of the Centre or the States/UTs have all undeniably increased accumulated income deficit of NSSF and reduced the Fund's viability.

66. Ironically, the 13th Finance Commission left the issue of NSSF's viability hanging, to be studied and addressed by another committee to be appointed by the government. While it suited immediate concerns of both Centre and States, it possibly delayed action

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[6] 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 National Development Council in its meeting held on 9th December 2006 endorsed the recommendations of the NDC Sub-Committee and the Government has accepted these recommendations and 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 Governments availing this facility are: Tamil Nadu (Rs.1126.67 crore), Orissa (Rs.199.72 crore) and the NCT of Delhi (Rs.752.90 crore)

being taken to redress continued undermining of the core principles of fiscal sustainability and transparency. We shall revert to this topic in the concluding part of our paper.

Viability of NSSF: Steadily rising Asset-Liability Mismatch is a cause of concern

67. The importance of striking a balance between the need to safeguard the interests of the small investor and the viability of the NSSF can hardly be over-emphasised. Aggregate accumulated liability of the Union government to the depositors under various SSS[7] as on 31.03.2013 was Rs.814545 crore against which Rs.517221 crore had been invested through National Small Savings Fund (NSSF) in State Government securities. As much as Rs.69103 crore out of gross collections had been used up in financing accumulated operational deficit of NSSF. Contrary to original intent of the scheme, there has been steady accumulation of operational deficits in NSSF accounts (Rs.69103 crore by 31st March 2013, which is projected to rise to Rs.91275 crore by 31 March 2014 and Rs.112728 crore by 31st March 2015.) NSSF's operational deficit/surplus should have more or less been modest and stable. This amounts to financing expenses of a revenue/recurring nature out of capital raised from SS depositors. So there is a serious sustainability issue with NSSF. Besides, there is also a serious fiscal transparency issue as well since this income deficit is not included in the Centre' Revenue Deficit, NSSF being out of reckoning from the fiscal accounts of government's expenditures and revenues. Had these treasury banking operations been subject to transparent and prudential regulations, such build-up of accumulated operational deficit would have been red-flagged by regulators long back.

68. The income-expenditure gap would reduce the returns on investment and further impact the income of the Fund. 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. A closer look at the accumulated income deficit in NSSF and its implications would be in order. The details of Income and Expenditure since 1999-2000 are given in **Annexure IV.**

69. Main reasons identified by the ShyamlaGopinath Committee why NSSF has a negative spread were the reinvestment of the redemption amount in Special Central Government Securities at the market rate of interest and high management cost. It was noted that interest relief (Reduction in interest rates on a huge block of SSGS portfolio to 9.0 per cent.) on Special State Government Securities following the implementation of the

[7]These liabilities are recorded under three Major Heads, viz Savings Deposit, Savings Certificate, and Public Provident Funds in the Public Accounts of India, all bracketed under NSSF.

recommendations of the 13th FC, effective 2010-11, would further affect the viability of the NSSF.

70. Other important factors affecting incomes/expenses of NSSF relate to the time cost of money, as indicated below.

    i. 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 Rs.6,298 crore.

    ii. There used to be a significant Asset-Liability 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 used to be for 25 years prior to 2011 when it was reduced to 10 years. The Centre is supposed to load the cost of maturity transformation and the management cost to the interest cost on small savings.

71. 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. 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. Interest relief to States provided by the 13th FC further increased the income deficit in NSSF.

72. **Rate of Interest on Investments by NSSF : Reforms under ShyamlaGopinath Committee (2011)** 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 ShyamlaGopinath Committee favoured adoption of a cost-plus approach in fixing the interest rates on these securities and recommended 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 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 Union government 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.

73. The Committee drew attention to the problem of accounting of interest payable to the depositors so as to make a proper assessment of the average interest on small saving instruments. Presently, there is no system of setting aside interest accrued on certificates, though payable on maturity, creating distortions in income-expenditure account of NSSF.

74. **Cost of SSS Operations: Expenditure of NSSF:** When discussing accumulated income deficit of NSSF, it may be useful to put the magnifying glass on the NSSF's expenses, the cost of operating SSS. The operational costs of running administration of the SSS/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. 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 trends expenditure of the Fund can be seen in the **Annexure IV** which shows that the expenditure of the Fund has been higher than the income on a consistent basis.

75. **Management Cost** of NSSF contains two major items, namely, 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. While the agency charges are payable on a per account per year / per certificate basis, the agency commission is paid on the amount collected under the small saving schemes. 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. For viability of NSSF, it is very critical that the cost of operations of NSSF is kept under control. The details of the cost of operation over the years may be seen in **Annexure IV.**

76. **Agency charges payable to Department of Posts for operation of Small Savings Instruments** The small saving schemes of are mainly operated through the network of over 1.55 lakh post offices. Department of Posts are paid agency charges/remuneration by Ministry of Finance from NSSF for managing the small savings and PPF schemes on agency basis. The remuneration is calculated on the basis of the estimated number of accounts/certificates issued/discharged by applying rates per account/certificate.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.It can be seen that the agency charges paid to the Department of Posts are per necessity ad hoc, administrative arrangements

77. Agency charges are payable on number of accounts being maintained and thus, even if gross collection is low, agency charges are payable. 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.

78. 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. The following developments during these years are expected to impact on these parameters and consequently, cost of operation.

i. 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.

ii. 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 havegone up for postal saving accounts. This would have some limited impact on this parameter.

iii. With increasing computerisation 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.

79. **Commission payable to Small Savings Agents**[8]Major revision in commission structure was effected in November 2011 on the recommendation of ShymlaGopinathCommittee(2011). 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 KshetriaBachatYojana (MPKBY) and (c) Public Provident Fund Agents (PPFA). These agents are remunerated from the NSSF on the

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[8]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.

basis of gross small savings collections. Extension services are provided by agents appointed under Standardised Agency Scheme, Mahila Pradhan and PPF Agents scheme. 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.

80. Prior to December 2011, 1 % Commission was being given on KisanVikasPatra, Post Office Monthly income scheme, Post Office Time Deposits, National Savings Certificates, National Savings Scheme and0.5 per cent on Senior Citizens Savings Scheme under Standardised Agency System (SAS). Under Mahila Pradhan KshetriaBachatYojana (MPKBY), agents' commission on Post Office Recurring Deposit Scheme was 4% and under Public Provident Fund Agents (PPFA) on Public Provident Fund collections, commission was 1%.

81. ShyamlaGopinath Committee (2011) noted that agency charges distort 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 recommended that 4% MPKBY commission was distortionary and expensive should be brought down to 1% in a phased manner in a period of three years with a 1% reduction every year. The committee also recommended that commission should be abolished on PPF and Senior Citizen Saving Scheme as these were largely bank-driven schemes and banks do not get commission for any other scheme of theirs. MPKBY commission On other schemes, the Committee recommended that the commission should be reduced from 1% to 0.5%. Further, in a major template-change, the Committee recommended that the incentive paid to the State Government may be reduced from the incentive payable by the Central Government to the Agents, in order to ensure that the State Governments do not give any extra incentive to the Agents.[9]

Measures to improve Viability of NSSF

82. The income-expense gap in NSSF was a modest Rs.1681 crore in the first year of NSSF (1999-2000) and it was expected that NSSF would be managed in a self-sustaining manner and marginal surplus and deficit year-by-year could be acceptable in the nature

[9] 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*.

of temporary overdraft. However, as per Budget Estimates 2014-15, the accumulated income-expense gap in NSSF is set to rise to nearly Rs.112728 crore by 31 March 2015, accelerated measures are needed to bring down the accumulated income deficit in NSSF, to say below Rs.5000 crore. The capital loss must be made good and brought down to prudential, normative limits. Following three measures are recommended for consideration:

83. 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. Years in which the excess of liabilities over assets has come down are those when the NSSF has drawn over the cash balances of Union government. This is indeed a liability of NSSF towards Union government but the same is not shown in the accounts of NSSF. These are like advances that NSSF has drawn from Union government with zero costs. This cost should be loaded on NSSF' expenses at least at the WMA rate at which the Union government pays interest to the RBI.

84. Coupled with low return on NSSF investments, the income in absolute terms is even lower since the asset base is lower than the liabilities. 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 therate of return on assets, the Fund will still incur losses. "These factors, combined together affect the viability of the Fund", avers ShyamlaGopinathCommittee(2011), a gross understatement of the distortion we face! The Committeedeliberated on ways to reduce the asset-liability mismatch. 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.

85. With a view to improving the viability of NSSF, the Committee recommended the following measures:

- The rate of interest on reinvestments may be brought at par with that of fresh investments.
- 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. Hence, the viability of NSSF should be taken into account while recommending on the reduction of interest rate on the assets side.
- 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.
- 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.
- A reduction in the management cost and in the time lag between receipts of small savings and their investments.

86. The above measures would definitely help improve the viability of NSSF and reduce the Asset Liability mismatch. However,these measures are too little, too late, and certainly not commensurate with the size of the accumulated deficit to be liquidated. Accelerated measures like recapitalisation of NSSF by apportioning accumulated deficit among proxy shareholders of this un-corporatised, quasi-Bank, namely NSSF, are required. NSSF may be viewed as an uncorporatized Bank of which the Central and the State governments are co-promoters.

87. In the absence of a defined shareholding pattern, it is somewhat difficult to decide the best course to ensure equitable burden sharing between the Centre and States, especially when it comes to sharing the losses sitting on the NSSF's balance sheet. However, it is imperative that the capital loss in NSSF is made good and brought down to prudential, normative limits. Recouping the capital loss in NSSF primarily needs measures to improve NSSF's income much more than measures of expense control because NSSF investments have consciously been made below cost.

88. One rather legalistic view could be that recapitalisation of NSSF (bridging the accumulated income deficit in NSSF) is entirely the Union government's responsibility and the States have nothing to do with it. However, the political economy of small savings is actually different. We feel that such an approach is inconsistent with the fact that at least some State have actively resisted Union government efforts to align yields on SSS to market with concomitant risk of reduced inflows into it. In reality, the Union government cannot ignore the States' views while unilaterally withdrawing from Small

Savings Schemes. In 2001, the Union government had opted for 100% NSSF onlending to States and one of the prmary driver of the move was that the Union government was not keen to continue high cost SSS.

89. Hence, Whether NSSF is corporatized or not, it should be collectively decidedto put in place a formal mechanism – preferably under the award of the 14th Finance Commission –under which a sizeable part of accumulated income deficit of NSSF is apportioned among proxy shareholders of this un-corporatised, quasi-Bank, namely NSSF, viz., the Union and State governments, based on some acceptable formula, preferably recommended by the 14th Finance Commission whereunder the Central and State governments, as deemed shareholders of this deemed bank, share the income and deficit in proportion to a well-defined, normative shareholding pattern. Akin to the process of vertical and horizontal devolution of Central taxes/duties, the Commission may consider prescribing a formula for fixing the share of each government in the annual and accumulated loss/profit. For example, a baseline scenario may be 50% deficit being allocated to the Central government and balance 50% to the States. Each State's inter se share may be fixed on the basis of moving average of State-wise gross collections under various Small Savings Schemes. The share may be fixed annually on 1st April based on previous 10 or 20 years average gross SS collection in the State. There should be a ceiling on maximum permissible deficit (incremental or accumulated) beyond which the mandatory contributions (in the nature of reverse income transfer from the deemed promoter to the deemed corporate) from respective governments should be mandatorily called for. Relative contribution of the Centre and the States in the build-up of the accumulated loss of NSSF can be worked out since inception of NSSF if comprehensive data on investment and reinvestment from time to time is made available.

90. Following three alternative ways to apportion relative responsibility to fund NSSF's accumulated operational deficit may be considered:

91. Following three alternative ways to apportion relative responsibility to fund NSSF's accumulated operational deficit may be considered:

i. Take the sharing pattern as given and compute what would have been the yield to NSSF had NSSF resources been invested on identical terms for both the Centre and the States.
ii. Compute the yield to NSSF had a fixed pattern of sharing (say 50:50) and identical terms of lending been followed since inception of NSSF.
iii. Assuming a 50:50 sharing pattern between the Centre and the States since inception of NSSF, an identical tenor of securities (10 years or 25 years), identical moratorium on repayment (0 or 5 years) retro-compute identical coupon rate calibrated to bring operational deficit to zero say by end 2009-10,(before

discontinuation of KVP). Re recalibration of coupon rate thereafter once in three years may then be considered.

41. In all the three scenarios, Union government would be entitled to charged interest for use of its cash balance by NSSF at prevailing WMA rate. Likewise, Union government would be obliged to pay interest to NSSF at WMA rate for using its surplus cash. For this exercise, cash surplus beyond a threshold would need to be notionally treated as automatically invested in Central and State securities.

42. Since there is a great deal of uncertainty about corporatization, the above arrangement would de facto corporatize the NSSF's management, while leaving operations being carried on in business as usual mode.

43. The interest rate on securities issued by the Central and State governments to NSSF should be enhanced for accelerated liquidation of deficit in a time frame of 5 to 7 years. In the past, NSSF's implied investment contracts with the States have been retrospectively revised to reduce the interest rate. Therefore, in principle there cannot be any objection to retrospective enhancement as well. Should that be a practical problem, the States wishing to prepay any NSSF debt may be charged appropriate prepayment premium.

92. The cash balances of NSSF and Union government should be segregated and any to and fro cash transfer should attract an expense equivalent to the WMA rate fixed by the RBI.

93. Since there is a great deal of uncertainty about corporatization, the above arrangement would *de facto* corporatize the NSSF's management, while leaving operations being carried on in business as usual mode.

Alternative Instruments for Investments by NSSF

94. 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. The issue of diversifying the investment destinations of NSSF was further deliberated by ShyamlaGopinathCommittee(2011).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.Since 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. Hence, the Committee recommended 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 Union government 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.

95. In this context, the author wishes to place below a different viewpoint disfavouring diversification of NSSF's investment portfolio. This is on account of involved compromise with budgetary principles. That the NSSF creation lead to reduction in Centre's revenue and fiscal deficit was indeed one of the considerations for creating NSSF. (Revenue deficit was not contemplated as NSSF was supposed to be operated in a self-sustaining manner.) However, the primary consideration was to prepare for NSSF's eventual corporatization. It was never the original intention that this convenient cherry picking would end at NSSF creation to simply window dress the Centre's revenue and fiscal deficit. NSSF creation was a prelude to some sort of corporatization of Small Savings operations. Therefore, in case it is a clear determination of the government that the Small Savings operations are not going to be corporatized, then it is only fair to revert back to pre-1999 situation. Otherwise, there is continuing compromise with basic principles and inconsistencies in budgetary practices.

96. So long as the NSSF invests only in State Government securities, there is some justification to exclude such investments from Centre's fiscal deficit because the NSSF liabilities get included in general government debt and NSSF financing forms part of State' fiscal deficit and hence of general government's fiscal deficit. Even this justification gets diluted when NSSF starts lending to non-government entities like IIFCL. Apart from the difference in accounting, there is no difference in substance between the Central Government transferring resources by way of loans out of the proceeds of market loans or small savings or General Provident fund accretion. All involve an act of financial intermediation and, therefore, if at all financial intermediation has to be excluded from fiscal deficit calculation, then that should apply to all loans and advances under proper authority. It is easy to see that there is no logic in treating the following two differently.

(a) Investment in Public Sector Banks as part of Plan expenditure of the Central Government.

(b) NSSF investments in IIFCL, which is not treated as Central Government expenditure at all and hence does not get reckoned in Centre's fiscal deficit.

97. Hence, it is felt that the States should not be delinked from NSSF and in fact NSSF investment should be only in the Central and State Governments so long as NSSF continues to be part of the Central Government's accounts. The States may be delinked only after NSSF is corporatized or after necessary legislation on NSSF management is enacted with necessary amendments in the FRBM Act redefining Central government lending.

98. Opening a channel of lending that is neither subjected to Centre's budgetary discipline nor to the normal lending regulations/ prudential norms by the Reserve Bank of India prescribing lending policy, lending rates, capital adequacy, reserve requirements, imposed by the Reserve Bank of India is not desirable. Delinking States allowing NSSF to invest in non-State entities could open the floodgates of quasi fiscal activities and the Central Government would be tempted to push its public policy induced lending programme through NSSF even at the risk of exposing NSSF to non-performing assets and on top all of this, doing it 'below the line' as the term goes in accounting parlance away from the discipline of FRBM Act on fiscal deficit. The market distortion potential of such loosely regulated, discretionary lending by the Central Government cannot be overlooked.

Feasibility and Implications of delinking the States from mandatory subscription to NSSF debt

99. Prior to April 1, 1987, two-thirds of the net collections in a State were passed on as long term loans to that State. The share of States was increased to 75% from April 1, 1987, enhanced to 80% of the net collections from April 1, 2000, 100% w.e.f. April 2002 and 80-100% at the individual State's discretion w.e.f. April 2007. Until 2006-07, NSSF investments have been only in the Central and State Government securities. In a paradigm shift in the investment policy of NSSF, a Rs.1500 crore, 15 Year, 9% Loan (2023) was extended from NSSF to the India Infrastructure Finance Company Limited.

100. The transfer of the entire net proceeds of small savings collections to the States was effected on the recommendation of the Reddy Committee. That decision was partially rolled back with 100% mandatory transfer reduced to 80% wef 2007-08. Actually, the Reddy Committee was asked to examine not just transfer of 100% net SS collections to State but also such transfer on back-to-back basis. The back-to-back onlending by NSSF (for each type of scheme having a certain maturity?) has not materialised so far and maturity mismatch continues to exists (albeit at lower level now, post November 2011 decision to reduce NSSF securities tenure from 25 years to 10 years). It would be useful to dwell upon the circumstances that led to contemplation of such a move. One cannot resist drawing analogy from the back-to-back intermediation of external assistance

started wef 2005-06 on the recommendation of the 12th Finance Commission. The Commission was persuaded to recommend it on the basis of perception and pleading that the averaging and pooling of external assistance from different sources in different currencies and conversion into fixed interest, fixed term rupee loans to State by the Centre benefitted the Centre, though there has been no conclusive documentary proof of such alleged profiteering by the Centre. The move to resort to back-to-back onlending by NSSF to states was also meant to similar allay States' concerns about perceived profiteering by the Centre from SS operations.

101. Consequent upon acceptance of the ShyamlaGopinath Committee recommendations, the States were given the option to take either 50 per cent or 100 per cent of net Small Savings collections in the State wef December 2011. 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.

102. As mentioned above, equitable burden sharing by the Centre and the States on the full cost of SS operations continues to be absent. In this background, it is worthwhile to examine whether the States can e or should be delinked from SS operations? NSSF lending to IIFCL has opened up alternative investment avenues for NSSF. Theoretically, States can be delinked from Small Savings and NSSF can expand the scope of alternative investments but the following caveats need careful consideration:

103. So far Centre and States have collaborated to raise and share these resources. It has been a joint effort and to that extent both the Central and State Governments are both the promoters/co-owners as well as client-borrowers of this quasi bank named NSSF. While the States can opt out as client-borrowers, they cannot shed their responsibility as co-promoters/co-owners of this bank, especially in relation to meeting the accumulated income deficit/capital shortfall. Therefore, the Centre and States must jointly work towards cleaning up of the balance sheet of NSSF – irrespective of whether it is formally corporatized or not, an issue separately discussed below .The 14th Finance Commission may consider recommending a formula for working out the share of each State in funding the accumulated income deficit in the NSSF.

104. Taking advantage of the present scenario, when NSSF's significance as a resource for financing States' fiscal deficit has considerably declined in recent years, it is desirable to delink the States from NSSF prospectively even as the legacy issues are sorted out separately. Delinking of States can begin at the margin and in a voluntary manner, prospectively. The States have an option to either take 50% or 100% of net SS collections in the State. What needs to be done is to dilute the prescriptive NSSF lending (50% or 100% of net collection in that State) by adding an option of 0% to individual States.

105. The States may also be allowed to retire their outstanding NSSF debt but it would be appropriate for NSSF to charge a prepayment premium that would help finance NSSF's accumulated income deficit. The present average cost of NSSF debt of States is about 9.1 per cent while the marginal cost of market loans of States raised in 2013 has risen to ~ 9.4 per cent. State's market debt is generally costlier than the comparable Union's market debt.Interest rates on State market loans, already on increase may further go up if States' market borrowing is scaled up to refinance NSSF debt. Hence, refinancing of NSSF debt may not be feasible for most States. However, this is something to be left to individual States and the market to deal with. It is upto the States to decide whether to tap cash balances or go for cheaper market borrowings to retire higher cost NSSF debt. Some States may actually be in a position to avail this option.

106. While States may be delinked from mandatory participation in NSSF investments, it would be useful to provide for NSSF participating in State Debt floatation so that the States may choose NSSF at their option. Given the current trends of redemption pressure under closed schemes, NSSF may not be in a position to generate significant investible resources for some time. There would understandably be some practical problems but there is no harm in retaining this as an avenue of investment for NSSF. While States would not be obliged to take NSSF 'loans', they would have an option to tap these resources if the Union government offers acceptable pricing, absorbing the differential cost itself.

107. In case the States are allowed to withdraw from Small Savings (all States en bloc or option to individual States to withdraw) and NSSF is restructured to be entirely a resource for Union government, it is quite likely that Union government may not continue competition with commercial banks through high cost Small Savings and limit the scope of SSS to provide a social service to small savers, say by allowing Post Office savings bank accounts to be operated in areas where access to formal banking is not available. For, this is now going to be on the agenda of all banks through Financial Inclusion programme. After the States get delinked from NSSF, and the NSSF resources are totally at the disposal of Union government, it is desirable that it is treated as part of normal budgetary resources, part of financing the fiscal deficit. Permitting discretionary 'investments' without Parliamentary approval is not desirable. Direct financing of public policy-driven investments/capital expenditures such as lending to IIFCL outside the fiscal accounts of the government is inconsistent with acceptable fiscal accounting. Inclusion of any non-government entity as investment destination of NSSF would be against the integrity of fiscal accounts.

New institutional mechanism for management of Small Savings Schemes

108. The idea to corporatize Small Savings operations was first articulated by Shri Yashwant Sinha, Minister of Finance in the Budget Speech for the Budget 1991-92. (Para 16 and 19)[10]. As the reforms priorities changed, this was put on the backburner. Corporatization of NSSF or Treasury banking operations into a full-fledged Postal Savings Bank or at least statutory regulation of NSSF management in accordance with prudential regulatory norms consistent with FRBM Act is an idea whose time has come.

109. It may be recalled that the primary objective of setting up the RV Gupta Committee-I (Sept 1998) was to examine the feasibility of hiving off the Small Savings operations into a body corporate and virtually draw a blueprint for creation of a Postal Savings Bank. The operation of small savings through a separate body corporate had been considered earlier by the Rangarajan Committee in Part II of its report submitted in March, 1991, which had recommended that while the existing pattern of administering the small savings schemes may continue, a separate body may be set up as a subsidiary of RBI for operations in regard to 'National Savings Schemes, 1987'.

110. In the Inter State Council meeting held in December, 1998 in New Delhi, the Finance Minister agreed to consider the transfer of work of small savings to an organisation outside the Government of India. The RV Gupta Committee-II (1999) recommending the creation of NSSF was in a way the first step towards corporatization of SS operations. NSSF embodies a proxy bank whose balance sheet gets consolidated in the annual

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[10]Para16 Budget Speech 91-92. "No provision has been made for additional instalments of dearness allowance that may become payable next year. I am requesting all Ministries and Departments to absorb this additional liability within their budgeted outlay by effecting suitable economies. The provision for payment of loans to States, on account of their share of small savings, is placed at Rs. 4,500 crores next year against Rs. 6,770 crores in the Revised Estimates for the current year. This reduction is due to the proposed transfer of the National Savings Scheme to the Bharat Bachat Bank, to be set up soon."

Para 19 Budget Speech 91-92 . "In the sphere of receipts, at the existing rates of taxation, gross tax revenue is estimated at Rs.65,354 crores next year, compared to the revised estimate of Rs.58,916 crores in the current year. The payments to States of their share of taxes is placed at Rs.15,900 crores next year as against Rs.14,535 crores in the current year. Thus, the net revenue receipts of the Centre, including non-tax revenue, are estimated to increase from Rs.57,381 crores in 1990-91 to Rs.63,584 crores in 1991-92. Under capital receipts, market borrowings are placed at Rs.7,500 crores next year which is lower than Rs.8,000 crores in the current year. Budgetary receipts from net collections of small savings are estimated at Rs.6,000 crores in 1991-92 as compared with Rs.8,000 crores in 1990-91 on account of the transfer of the National Savings Scheme to the new Bharat Bachat Bank, proposed to be set up. External assistance excluding grants but net of repayments is expected to be Rs.4,000 crores in the next year as against Rs.3,984 crores in the current year."

accounts of the central Government. Time has come to now take the next step and corporatize NSSF.

111. R V Gupta Committee had 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. 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.

112. NSSF was a well-meaning move towards corporatization and transparency. Unfortunately, one set of non-transparency has been removed (scattered information about various Revenue and Capital transactions consolidated at one place) but has led to another set of more serious non-transparency about the real fiscal imbalances. Prior to setting up of NSSF w.e.f. 1.4.1999, all the payments against the cost of operating the fund were also debited from the Consolidated Fund and thus any operating deficit – income expenditure mismatch in this operation of mobilising resources and partially onlending to States – directly affected the Revenue Deficit of the Central Government. Onlending to States and recoveries of such loans against SS collctions affected the Fiscal Deficit of the Central Government. The RV Gupta Committee's vision of operation of NSSF in a transparent and self-sustaining manner stands blurred at the altar of short-term expediency.

113. The issue of corporatization of Small Savings operations has eluded consensus since 1991 when the idea was first mooted. Recently, the Department of Posts has applied for a new banking license from the RBI and DoP has a plan to establish a corporate arm.

114. The following are the points in against corporatization:

- The RBI as the banking regulator would find it difficult to regulate 100% government-owned banks *de facto* operating in 'departmental' mode though 'corporatized' on paper. It would take a long time before 'at arms' length' corporate governance with firewalled promoter-client interface can be put in place. There are doubts whether the Banking subsidiary of the D/o Posts can function under RBI without creating conflict situations.

- There are serious doubts whether the banking arm of the D/o Posts, carrying huge social burden, can function even as a no-profit-no-loss S.25 company. Apprehension is that it would be born sick and remain sick. In fact, in the corporatized model, the costs of operations may actually increase!

- The costs for corporatized treasury banking may increase if itneeds to maintain SLR and CRR on the deposits. Presently, there are no reserve requirements. Also, the costs of unlimited Union government guarantee presently enjoyed by SS investors may also need to be factored into. Under normal banking, only limited guarantee under the DICGC only applies.
- There are doubts whether the banking arm subjected to market discipline and competition would be able to compete with established corporate players in the banking sector and more importantly with the aggressive banking expansion being pursued by private sector banks. It may quickly lose its current customer base.
- Depending on how the corporatization pans out and what all does it include in its scope, there is likelihood of a scenario of parallel run/competition of departmental and corporate functioning of two arms of the D/o Posts. The Banking arm weans away profitable niche of its current/upcoming business portfolio of financial services (eg, disbursements under various government schemes) and leave the departmental remnant further in red.
- The need to undertake "Lending" as a new activity will pose a huge HR challenge, requiring new skills and environment.
- Creation of higher wage island in the banking arm can be disruptive to HR management for D/o Posts.
- With increasing financial inclusion, competition for branch expansion and using several different Business Correspondent models, this will be a daunting HR challenge for DoP. After all, in many rural areas, augmenting the Post Office network may not be cost effective and if one were to fall back on the very departmental or extra-departmental employees running the Post Offices, the HR conflicts are very much foreseeable.
- Should the banking arm of DoP fail, the consequences would be wider and serious.
- 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.

115. The following are the points in favour of corporatization:

    i. With ready access to a vast network of Post offices, DoP has a strategic advantage and it can meaningfully contribute to the financial inclusion agenda of the government.

ii. With financial inclusion being a top priority, there is enough room for DoP to enter the financial sector as a corporate player without either hurting itself or disrupting the market.

iii. Corporatization will improve fiscal transparency. Transparent 'Subsidy' in compensation of social burden is better than running non-transparent operations like NSSF.

iv. With rapid spread of information technology being pursued by DoP, the operational costs are expected to come down.

v. DoP corporatization is a necessity, with traditional postal services facing fundamental business process re-engineering.

vi. There are encouraging success stories of corporatization of treasury banking abroad. China Postal Savings Bank began operations in March 2007 and 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, China‗s central bank, to support national investment plans.Initially, it may be a deposit-only institution, a half-bank. China and Japan have had massive treasury banking operations which are now corporatized. Japan‗s savings bank is twice the size of its biggest commercial bank, Bank of Tokyo Mitsubishi. 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.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.

116. The Reddy Committee (2001) had perceptively observed that the present system of direct management of long-term funds by the public sector and fixing administered rates of interest with all tax advantages would not be sustainable in the medium-term. Most of these funds, in future, are expected to be privately managed with larger and diversified investment portfolios. The medium-term objective of the Central Government should be to spell out a well conceived investment policy to facilitate switching over to fully funded long-term saving schemes managed independently and professionally and aimed at promoting growth and meeting genuine investment demands in the economy. The PPF may be integrated into the Pension Funds system that emerges along the lines of action taken towards the reform of GPF, EPF and other old age security schemes. The continuation of administered regime of interest rates on small saving schemes should, therefore, remain temporary and any benchmarking of

these rates should also be treated as an interim measure**.** On new management structure for NSSF, the Committee recommended as follows:

"A National Small Savings Authority (NSSA) may be constituted at the Centre to administer the NSSF with regard to all fresh flows. To formulate policy in respect of small saving schemes, the NSSA would have an Executive Committee consisting of representatives of the Ministry of Finance, Government of India, some State Governments and a permanent invitee from the RBI in advisory capacity. A nominee of the Controller General of Accounts may also be included in the Executive Committee. The NSSA may compile data on small savings on a monthly basis and disseminate them regularly. The NSSA may prepare statement showing sources and uses of funds on a regular basis (monthly or so) for close monitoring of flow of funds relating to small savings. The NSSA would have an Executive Committee consisting of representatives of Ministry of Finance, Government of India, some State Governments and a permanent invitee (not a member) from the RBI in advisory capacity. A nominee from the office of the Controller General of Accounts may also be included in the Executive Committee to facilitate close monitoring of the method of administering interest rate on deposit, collections reported by various operating agencies, the transfer of Fund to State Governments as well as preparation of accounts of the Fund from time to time. (Paras 80-84)"

117. The above recommendation to set up a National Small Savings Authority read with another recommendation by Reddy Committee (2001) to enact an umbrella legislation encompassing all aspects of small savings to supersede earlier legislations could have been a prelude to running this proxy bank through a proxy Board of Directors representing stakeholders but this did not happen. It was a call for new 'Institutional Arrangements'. Whether the D/o Postsor NSSF is corporatized into a full-fledged or partial Scheduled Commercial Bank or Company or Trust or Statutory Corporation or not, the need of stronger statutory regulation of NSSF can hardly be over-emphasized. These recommendations of the Reddy Committee (2001) have not been accepted/acted so far and found strong echo and endorsement from the Financial Sector Legislative Reforms Commission (2013), which recommended as follows: "*There is a need to consolidate and modernise the laws on small savings. Accordingly, the GSB Act, GSC Act and PPF Act should be replaced with a consolidated law that should, inter alia, contain provisions relating to manner of collection / investment of funds, consumer protection, grievanceredressal and, to the extent relevant, prudential regulation. All functions related to the operation and management of small savings should be performed by an independent entity that should be brought within the limited purview of the financial regulator. However, prudential regulation of the proposed small savings entity should not extend to changing the manner in which the funds held by National Small Savings Fund are invested since that constitutes a fiscal decision."*

118. Whenever we are faced with a serious problem, it is often useful to go back to the basics. In the case of present discussion on the viability and future of NSSF, it is recommended to go back to the deliberations and background for creation of NSSF. It can be seen that the NSSF was set up as a prelude to eventual corporatisation of SSS operations. If corporatization is not possible to take care of full range of SSS management, at least the top-level institutional mechanism managing the NSSF, its accounting and regulation, and its investment policy must be encapsulated in a transparent, FRBM-compliant, preferably legislation-backed 'deemed corporate' structure, even if operations in the field continue as before. Hence, pending resolution of consensus on 'corporatization debate', a new institutional arrangement, short of setting up a new corporate entity, should be put in place under a legislation that imposes the regulatory, accounting and disclosure norms on NSSF. The recommendations of the Reddy Committee (2001) on creation of NSSA and Financial Sector Legislative Reforms Commission (2013) on NSSF management (including its investments) under legislative regulation are relevant.

119. It is noted that the D/o Posts has applied to the RBI for a banking license. NSSF operations are inconsistent with basic principles of prudential fiscal management and inter-governmental transfers.NSSF operations dilute and frustrate fiscal rules.Prudent Fiscal Management of sub-national governments must be guided by exposing them (a) Market Discipline and (b) Fiscal Rules. Financial Intermediation function by the Central government dilutes market discipline and autonomous flows through prescriptive mandatory lending by NSSF to States frustrates the discipline of Fiscal Rules. Further, NSSF operations outside the fiscal accounts and outside full scale regulation by a Financial Sector regulator are also inconsistent with prudential norms of fiscal management. In view of serious doubts about the desirability of continuing with treasury banking operations in current mode, we need to ascertain if the government has taken a formal view on the nature of banking functions to be undertaken by the D/o Posts. For reasons brought out above, unless there is a separate corporate entity regulated by the RBI like any other bank, the banking license for D/o Posts should be limited to a 'Deposits Only' banking institution and all surplus capital should be transferred to the Central government's accounts as a general budgetary resource. All investments should be part of fiscal accounts.In case the Post office is allowed to function as a Payments bank, the transparency issue would be sorted out but the sustainability issue would still remain. Will the new bank be self-sustaining or have congenital dependence on Union Budget?

Transparency in NSSF's operations: Accounting and Reporting issues

120. Accounting of accrued interest on Savings Certificates needs review. Unlike in the case of GPF, the accrued interest is not annually debited to NSSF's income-expenditure account. If such interest is accumulated in a separate head, there would be clearer understanding of NSSF's balance sheet and income-expenditure account. Accrued interest need not be calculated individually for each certificate.Even setting aside a certain fixed percentage of outstanding principal in a separate head would suffice for transparency.

121. The need to preserve transparency in the quasi-corporate structure of NSSF can hardly be over-emphasized. Only a highly condensed summary of NSSF operations is presented as part of voluminous Budget documents. Monthly, Quarterly reporting is absent. NSSF Liability is analysed only in terms of *Savings Deposits, Savings Certificates, Public Provident Fund.* Individual Small Saving Scheme-wise outstanding liability is not disclosed. The disclosures in the Budget documents about NSSF may be expanded to include Scheme-wise liability profile.

122. The NSSF's recurring operational loss is simply hidden Revenue Deficit. Had pre-1999 accounting continued, this would have formed part of Centre's Revenue Deficit. Hence, there is a serious issue of compromise with principles of Fiscal Transparency and with the FRBM Act. This 'off-budget' Revenue Deficit should be disclosed in the Budget documents through a footnote wherever there is a reference to Revenue Deficit, pending formal amendment in the FRBM Act in the definition of 'Revenue Deficit' and 'Effective Revenue Deficit'.

Need for continuing with Treasury Banking operations

123. Capital erosion under SSS has made them into a collective Ponzi structure and raising fresh capital is now an imperative need. However, there is a trade-off between efforts to achieve targeted decline in yield differential on SSS vis-à-vis market rates for comparable products and the efforts to boost gross collection. Alarming reduction in household financial savings in recent years due to combined effect of inflation and diversion to gold had also affected gross collections under SSS. Recent trends suggest that the worst phase is over and we may expect collections to improve. Enhancement in investment limit under PPF from Rs.1 lakh to Rs.1.5 lakh in Budget 2014-15 will help as PPF is one of the most buoyant of all SS Schemes.

124. With financial inclusion being pursued as a national programme, there are question marks on the desirability of continuing with treasury banking, especially if it distorts financial market. Given the high administrative costs of Post Offices, government

mobilized small savings cannot hope to compete with other players in the financial sector. A moot point is whether it is not opportune time for the Union government to progressively disengage from the short and medium term SSS (mostly through Post offices) and serve the public policy purpose (of helping small savers, depositors, investors) by enhancing sovereign protection through a more comprehensive deposit guarantee.

125. NachiketMor Committee[11] has proposed a roadmap for enhancing financial inclusion and advocated convergence of banks and NBFCs, noting the regulatory similarities between them in terms of capital adequacy rules on credit risks, risk-weighting of assets, provisioning and non-performing asset (NPA) norms and the applicability of fair practices code. They have pictured a scenario where NBFCs operate not merely as 'shadow banks' but as an integral part of the large banking system. This is based on the principle of neutrality in lines of the Usha Thorat Committee recommendations. In this backdrop, it is easy to see that the Treasury banking operations through SSS not only distort financial sector but are outside the common regulatory framework which is against the principle of regulatory neutrality.

126. Urjit Patel Committee[12] has recommended that fixed income financial products (e.g. various maturity plans, Non-convertible debentures, small savings scheme etc.) be treated at par with bank deposits in terms of applicability of TDS and tax benefits. That would motivate people to save into them rather than in gold. This is yet another strong signal from the Mint Road that seeks convergence in various segments of the financial sector. Distortionary Treasury banking must submit to common regulatory framework of the financial sector and wind up if it cannot do so.

127. The following are the options for way forward:-

- NSSF may continue as it is.
- NSSF may continue with the options given to the States to prepay the outstanding dues at any time from now and also have the option to avail of their share in the future as their discretion on a year to year basis.
- NSSFmay continue purely as a Union government scheme in the future, without any future involvement of the States. The States' involvement in the future will be only

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[11]The Report (January 2014) ofa 13 member panel , headed by NachiketMor (called *Committee on Comprehensive Financial Services for Small Businesses and Low Income Households)* set up by the Governor RBI to study various aspects of financial inclusion in India.

[12]The Report (January 2014) of the expert committee appointed by Governor, RBI to examine the current monetary policy framework of the Reserve Bank of India (RBI), headed by Urjit R. Patel, Deputy Governor of the Reserve Bank of India.

repayment as per schedule or prepayment. This will also give all options for the union Government to restructure in the future.

- NSSF is wound up and the States' outstanding debt obligations to the NSSF be treated as debt to the Government of India on existing terms and conditions.

128. Continuance of SSS per se is closely linked to the resolution of legacy issues of dealing with the accumulated income deficit in NSSF as well as restructuring of States' existing debt to NSSF. Continuing the States' existing debt to NSSF on existing terms and conditions till it is liquidated in normal course is the natural option. Alternatively, the States' debt to NSSF can be converted into States' debt to the Union government, which may be restructured into a long term, fixed interest loan, with bullet repayment of equated principal redemption at the option of the State government. This will ensure the operation of the fiscal rules implicit in the FRBM Act and willalso give relief to the Sates. The interest rate may be set broadly in alignment withthe inflation objectives ofthe Union government and the RBI.

Annexure I: Small Saving Schemes: An Overview

This is an updated version of Annex 1 & Annex 2 of the ShyamlaGopinath Committee Report. Para2.1 "Small Savings Schemes and their Public Policy Objectives" of the ShyamlaGopinath Committee Report gives historical background of SSS.

The small savings schemes can be classified under three broad heads, viz., savings accounts/deposits, saving certificates and provident fund scheme. 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.

At present, Post Office Savings Account (POSA), Post Office Time Deposit(POTD) – 1year, 2 years, 3 years and 5 years, Post Office Recurring Deposit (PORD), Post Office (Monthly Income Account) and 5/10 year National Savings Certificates are in operation through the agency of post offices. Senior Citizens Savings Scheme (SCSS) and Public Provident Fund (PPF) are operated through both the Post Offices and designated bank branches throughout the country.

Different small saving schemes are governed by Rules / Schemes made by the Government under the Government Savings Banks Act, 1873, Government Savings Certificates Act 1959 and Public Provident Fund Act 1968. Rules made for discontinued schemes like Indira VikasPatra and KisanVikasPatra (i.e., where fresh investments are not being accepted) continue since 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.

Small Savings Schemes have been specially designed for the small investors and have evolved to provideEasy access, availability and liquidity to investors. Investments under these schemes are fully secured as these schemes carry implicit guarantee of the Government of India.

- 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.

- 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.

Income Tax Benefits on Small Saving Schemes

The investment made in small savings schemes and interest income so earned enjoy certain exemptions/rebate under different sections of the Income Tax Act, detailed below:

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

ii. Interest on PPF is fully exempt from tax under Section 10 (11).

iii. Interest on savings deposits of less than 5 year maturity (unlike bank deposits) is fully exempt from tax under Section 10 (11). Interest income is taxable on 5-year Post Office Time Deposit.

iv. 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).

v. Deposits under National Savings Certificate (NSC-VIII and IXth 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.(Savings up to Rs.100,000 p.a. in specified investments are deductible from income chargeable to income tax under Sec 80C.)

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

Interest Rates and tax incentives on select instruments (with effect from 1st April 2014)

Tenor	Small Savings Scheme	Interest Rate on Small Savings Schemes (per cent per annum)
	Savings Deposit	4.0
1 Year	Time Deposit	8.4 (compounded quarterly)
2 Years	Time Deposit	8.4 (compounded quarterly)
3 Years	Time Deposit	8.4 (compounded quarterly)
5 Years	Time Deposit	8.5 (compounded quarterly)
5 Years	Recurring Deposit	8.4
5 Years	SCSS	9.2 (compounded quarterly)
5 Years	Monthly Income Scheme	8.4
5 Years	NSC (VIIIth Issue)	8.5 (compounded six monthly)
10 Years	NSC (IXth Issue)	8.8 (compounded six monthly)
15 years	PPF	8.7

Notes

1. Where tax benefit is available and is actually availed, the effective yield on the investment is higher than the rates mentioned above.

2. Interest on Time deposits of 1, 2, 3 & 5 year maturities is compounded quarterly. Hence, effective yield is higher.

3. Under SCSS, 9% per annum interest is 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.

Small Savings Schemes – Other Salient Features

- **Post Office Savings Account** individual/ joint accounts permitted. Cheque facility available. Minimum INR 50/-. Maximum INR 1,00,000/- for an individual account. INR 2,00,000/- for joint account.
- **5-YearPost Office Recurring Deposit Account** Minimum INR 10/- per month or any amount in multiples of INR 5/-. No maximum limit. Can be continued for another 5 years on year to year basis. 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** 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.
- **PostOffice Monthly Income Account** In multiples of INR 1500/- Maximum INR 4.5 lakhs in single account and INR 9 lakhs in joint account. Maturity period is 5 years. Can be prematurely encashed after one year at discounted interest rates (Discount means deduction from the deposit.)
- **15-year Public Provident Fund Account** in a financial year.Deposits can be made in lumpsum or in 12 instalments.Withdrawal is permissible every year from 7th financial year Loan facility available from 3rd Financial year@2% interest. No attachment under court decree order. Minimum INR 500/-Maximum INR 150,000/-in a financial year. (The annual investment limit was raised from INR 100,000/-to INR 150,000/-wef FY2014-15 in Budget 2014-15).Deposits can be made in lumpsum or in 12 instalments.Withdrawal is permissible every year from 7th financial year. Loan facility available from 3rd Financial year@2% interest. No attachment under court decree order.
- **National Savings Certificate** 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.
- **Senior Citizens Savings Scheme**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.

Annexure II Trends in Gross and Net SS collections

Year	Gross Collection (Rs.in crore)	Net Collection (Rs.. in crore)
1999-00	75,421	38,561
2000-01	88,468	45,357
2001-02	90,603	44,068
2002-03	1,18,111	60,327
2003-04	1,48,930	70,860
2004-05	1,68,987	88,050
2005-06	2,00,147	85,082
2006-07	1,82,179	57,492
2007-08	1,40,910	-7,822
2008-09	1,58,510	-9,450
2009-10	2,50,931	64,310
2010-11	2,74,721	58,655
2011-12	2,20,948	3,021
2012-2013 (Provisional)	2,25,554	24,600

Annexure III Trends in Asset Liability mismatch in NSSF

Year	**Year-end liabilities of NSSF**	**Year-end investments of NSSF**	**Asset-liability mismatch (cumulative income deficit of NSSF)**	**ALM as % of year-end liabilities**	**Cumulative** Income deficit	Uninvested Cash Balanceaccretion
1999-00	214791	212136	2655	1.2	1681	974
2000-01	260149	253718	6431	2.5	5209	1222
2001-02	304057	297490	6567	2.2	2797	3770
2002-03	364390	335986	28404	7.8	4139	24265
2003-04	435242	417394	17848	4.1	12982	4866
2004-05	532030	505084	26946	5.1	11181	15765
2005-06	617116	594920	22196	3.6	18179	4017
2006-07	674611	658665	15946	2.4	25760	-9814
2007-08	673589	654191	19398	2.9	29385	-9987
2008-09	664137	654053	10084	1.5	24137	-14053
2009-10	728447	691514	36933	5.1	39513	-2580
2010-11	7,87,100	7,34,504	52,596	6.7	52219	377
2011-12	7,90,194	7,26,960	63,234	8.0	55323	7912
2012-13	8,14,545	7,35,530	69,103	9.7	69,103	9913

Annexure IV Trends in Income and Expenditure of NSSF

Year	Income of NSSF	Expenditure of NSSF - Interest	Expenditure of NSSF - Management cost	Income deficit	Cumulative Income deficit
1999-00	20,265	20,198	1,748	1,681	1,681
2000-01	25,113	26,347	2,294	3,528	5,209
2001-02	30,397	25,535	2,450	-2,412	2,797
2002-03	34,948	33,627	2,663	1,342	4,139
2003-04	37,512	43,223	3,132	8,843	12,982
2004-05	42,339	37,125	3,413	-1,801	11,181
2005-06	49,760	52,442	4,316	6,998	18,179
2006-07	58,456	61,552	4,485	7,581	25,760
2007-08	63,319	62,402	4,542	3,625	29,385
2008-09	61,958	52,463	4,247	-5,248	24,137
2009-10	62,170	72,213	5,333	15,376	39,513
2010-11	65,561	72,360	5,907	12,706	52,219
2011-12	69,554	66,622	6,040	3,109	55,328
2012-13	66,536	73,762	6,549	13,775	69103

Annexure V:Outstanding liabilities of States/UTs towards share in Small Savings collections (Rs. in crore as on 31st March 2013)

State/UT	Outstanding (NSSF debt)	% share in total NSSF debt	Total Liabilities@	NSSF debt as % of Total Liabilities@
Maharashtra	79,076	15.27	2,19,626	36.0
West Bengal	77,716	15.01	2,12,749	36.5
Uttar Pradesh@@	56,352	10.88	2,05,882	27.4
Gujarat	48,194	9.31	1,44,409	33.4
Andhra Pradesh	25,946	5.01	1,51,182	17.2
Tamil Nadu	24,802	4.79	1,32,952	18.7
Punjab	21,719	4.19	85,774	25.3
Rajasthan	20,767	4.01	1,03,698	20.0
Karnataka	20,074	3.88	90,966	22.1
Bihar	19,125	3.69	66,820	28.6
Madhya Pradesh@@	16,806	3.25	77,329	21.7
Haryana	11,504	2.22	60,054	19.2
Kerala	11,323	2.19	1,03,561	10.9
Jharkhand	9,784	1.89	28,876	33.9
Odisha	8,597	1.66	37,981	22.6
Uttarakhand	7,404	1.43	23,519	31.5
Assam	6,700	1.29	26,600	25.2
Chhattisgarh	5,378	1.04	14,640	36.7
Himachal Pradesh	5,348	1.03	28,615	18.7
Jammu & Kashmir	3,440	0.66	35,043	9.8
Goa	3,010	0.58	9,688	31.1
Tripura	1,216	0.23	6,873	17.7
Manipur	820	0.16	5,255	15.6
Arunachal Pradesh	670	0.13	3,444	19.5
Meghalaya	563	0.11	4,193	13.4
Mizoram	191	0.04	4,120	4.6
Sikkim	153	0.03	2,602	5.9
Nagaland	123	0.02	5,930	2.1
NCT of Delhi@@@	29,243	5.65	29,243	100.0
Puducherry	1,739	0.34	5,427	32.0
Total - All States/UTs	**5,17,782**	**100**	**19,27,050**	**26.9**

@Total Liabilities include "Public Debt" liabilities in the Consolidated Fund and the liabilities under the section "I – Small Savings, Provident Fund etc" in the Public Accounts of the State. @@ For Uttar Pradesh and Madhya Pradesh, the total liabilities include liabilities yet to be allocated to Uttarakhandand Chhattisgarh.

Annexure VI National Small Savings Fund (NSSF)

Developments leading to creation of National Small Savings Fund (NSSF)

1. 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 (loans to States) 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. 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. The result of the accounting practice prevalent then was that the end-use of SS proceeds and servicing of the liabilities affected Centre's fiscal and revenue deficit. All the payments against the cost of operating the fund were also debited from the Consolidated Fund and thus any operating deficit – income expenditure mismatch in this operation of mobilising resources and partially onlending to States – directly affected the Revenue Deficit of the Central Government.
2. 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) 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.

3. 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.
4. 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

5. 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 (Rs.1,76,220.92 Crore) 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 invested in special GoI securities carrying an interest rate of 11.5% p.a. and repayable on call. 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.
6. 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 Rs.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.
7. Since loans against the deposits outstanding on April 1999 had been extended to State Governments from the Consolidated Fund of India (CFI) prior to creation of NSSF, interest from states on these loans was also credited to CFI and accounted as a non-tax receipt of GoI. These loans were included in the corpus of high-coupon

loans pre-paid by the states under the Debt Swap Scheme as well as in the subsequent debt relief awarded by the Twelfth Finance Commission.

8. National Small Savings Fund (Custody and Investment) Rules, 2001, framed by the President under Article 283(1) of the Constitution, and administered by the Ministry of Finance govern NSSF's operations.

Investment policy of NSSF

9. NSSF invests a part of the net collections of small savings in the special State Government securities (SSGS). The remaining amount is invested in special Central Government securities (SCGS) with the same terms as that for the States.
10. Till 2001-02, the net small savings collections in a State (gross collections minus repayments to depositors) were being shared between the Central and State Governments, with the share of the State Government being progressively increased from 66.66 per cent to 75 per cent from 1 April 1987 and to 80 per cent from April 2000. Based on Reddy Committee report(2001) it was decided that w.e.f. 1 April 2002, the entire net collections in a State were being invested in special securities issued by the concerned State Government. However, w.e.f. from 1 April 2007, the State Governments were permitted to borrow 80 to 100 per cent of net collections in the State from NSSF.
11. The sums received in NSSF on redemption of special securities are re-invested in special Central Government securities. The special securities issued by the Central Government against such redemption amounts used to carry a tenure of 20 years with bullet repayment on maturity and coupon rates benchmarked to average secondary market yields on Central Government securities (G-sec) 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) On acceptance of the ShyamlaGopinath Committee recommendations, the tenor of these securities has been reduced (wef December 2011) to 10 years and it has been stipulated that yearly repayment of NSSF loans made by Centre and States, will be reinvested in Central and State Government securities in the ratio of 50:50. The interest rates on the securities are now aligned closer the general interest rates applicable to special securities issued to NSSF according to a benchmarked formula.
12. Further, w.e.f. 1 April 2007, an enabling provision has been made in the NSSF (Custody and Investment) Rules, 2001 to allow for investment in other instruments. Accordingly, NSSF lent Rs.1500 crore @ 9 per cent per annum (payable annually) to India Infrastructure Finance Company Limited (IIFCL) in 2007-08 for financing infrastructure development. The loan carries a bullet repayment after a period of 15 years.
13. The securities issued by the States to NSSF used to be for a period of 25 years and a moratorium of five years on the repayment of the principal amount. Thus, repayments commenced from the sixth year onwards with one twentieth of the principal becoming payable every year. On acceptance of the ShyamlaGopinath Committee recommendations, the tenor of these securities has been reduced

(wefDecember 2011) to 10 years and the 5 year moratorium on repayment has been lifted. Thus, now one-tenth of the principal is repaid every year. The special securities carry a rate of interest fixed by Government of India from time to time. The rate of interest remained unchanged at 9.5 per cent per annum since April 1, 2003 until reduced to 9 per cent on the recommendation of the 13th Finance Commission. The NSSF is also permitted to invest in securities issued by IIFCL. An amount of Rs.1,500 crore was invested in a 15 year paper issued by IIFCL at 9% with bullet redemption in 2007-08.

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

ANNEXURE VII:Growth in Small Savings collections vis-à-vis deposit mobilisation by Scheduled Commercial Banks

Year	Bank Deposits Outstanding at Year-end (Rs.Crore)	Y-o-Y Growth rate (Per Cent)	Small Savings Collections Outstanding at Year-end (Rs.Crore)	Y-o-Y Growth rate (Per Cent)
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	9.7
2010-11	56,16,432	25.0	7,87,100	8.1
2011-12	64,53,700	14.9	7,90,194	0.4
2012-13	74,28,218	15.1	8,14,545	3.1