Venturing into retail, Household saving behavior and the role of Financial Literac

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Financial literacy, in simpler terms is learning the art of managing your finances. Every household faces these challenges largely due to the lack of knowledge on how to manage one's personal expenses and reduce liabilities. Individuals are confronted with ever more complex financial decisions such as anticipation of future income, keeping track of your assets, setting short, medium and long term financial goals, steering clear from unwanted debt and planning for retirement. Understanding the key factors of financial planning is the beginning of one's journey into financial freedom but becoming financially literate does not happen overnight! The most important step is the realization of one's attitudes about money and taking responsibility of changing the financial situation one is in. The path to financial wellness is not to be achieved by reading a book or following a HOW TO guide of financial freedom, it is to be acquired by education and through your own experiences.

An individual must undertake the role of being a financial planner/CFO of the house. Deployment of savings into long term beneficial avenues which can combat the ongoing inflation in the country and understanding stock market are the first few steps taken after the audit of expenses has begun at home.

As we all know that saving is vital to any country's economic health, both at the household and national levels. For households, saving builds resilience against recession and unforeseen circumstances and creates wealth that can ensure citizens an adequate income upon retirement. A bank, under the net of security not only robs the investment's potential to grow beyond the inflation number in the country, but also limits your options to obtain higher returns and a secure future. Therefore, the need of making smart investment choice arises which comes from understanding markets and trends.

For any nation, saving provides a vital engine for long-term economic prosperity and stability. It is said, that the savings behavior adopted by any economy is the key determinant of whether it is to be classified as a developed or a developing economy. A developed economy has a lower cost of living, which enables households to save a higher portion of their income. On the other hand, a developing economy offers low average income and higher cost of living which restricts the amount a household can save. By being smart about your investments, individuals will also be more likely to save and to encourage the financial system to develop products that truly respond to their needs, and that should have positive effects on both individual's wealth and economic growth of the country.

Incidentally, developed nations have witnessed increased numbers in household savings; whereas Pakistan's saving rate has further declined this year to 12% of the GDP from 15% last year. Many factors such as the scarcity of basic education, the desire to have a high standard of living, religious beliefs, lack of understanding of investment options such as Mutual Funds and failure to plan for retirement have greatly contributed to this decline.

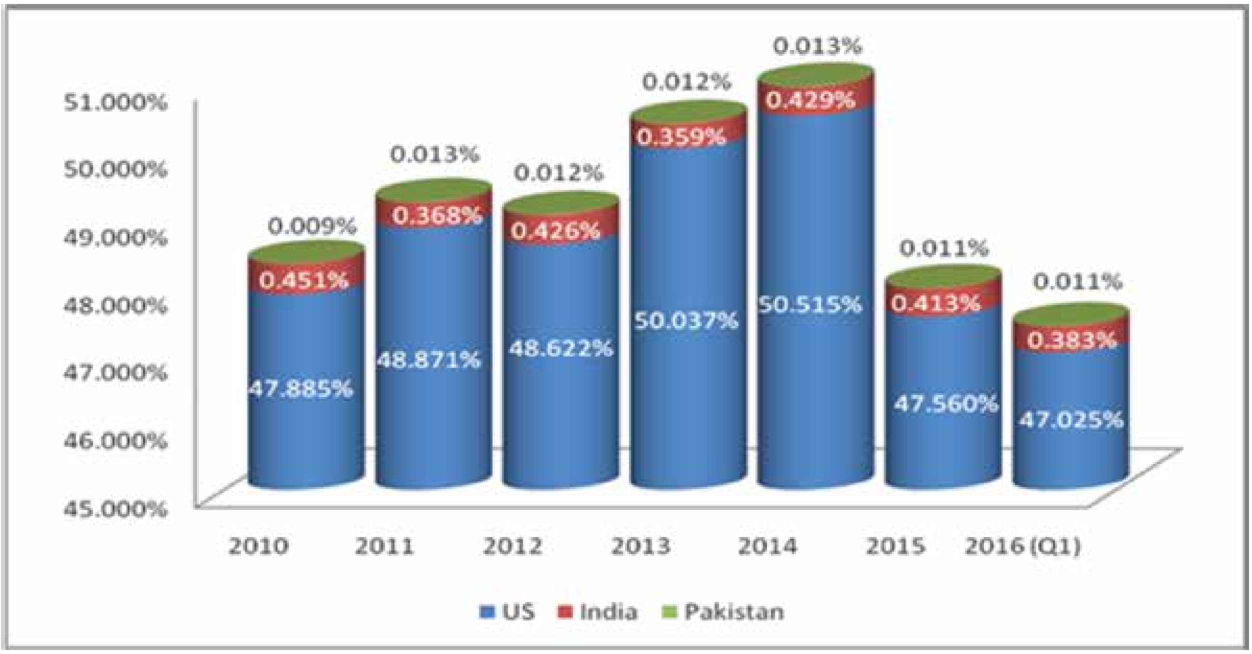
According to the recent survey by World Bank Group, Pakistan has around 31% of its population which is involuntarily financially excluded, and over 80% do not even have a savings account. With a huge rural population (~68%), increasing pace of urbanization in the country and growing middle class, Pakistan offers huge potential for the financial institutions endeavoring to translate higher proportions of public savings into investments. To capitalize on the opportunity, financial institutions are looking at various measures to bring the nonparticipating population under the umbrella and one such example is the branchless banking service that banks are now introducing.

Given the banks' business model, the return that account holder gets is almost always lower than the prevailing inflation rate in the country, and Banks' charge a higher rate from the borrowers, but while only a fraction of it is passed on to the depositors, pocketing the difference. The better alternative for the nonparticipating population is therefore the Mutual Funds which offer the investors an exposure to the capital markets, and provides market based returns. This also allows them to benefit from the expertise of the experienced fund managers limiting the risk of financial loss. Mutual Funds, in dictionary terms, are a collective investment scheme which pools together the money from the investors and invests further into a diverse portfolio of multiple asset classes, backed by professional management. The portfolio consists of a careful, researched selection of investments aiming for the maximum returns. It is pertinent to mention that Mutual Funds offer a variety of plans each tailored to meet the risk and return appetite of the investor. This customization is seldom offered by the banks. Mutual Fund schemes offers various products and services catering to a broader client base due to its diversified investments options and liquidity. A good Mutual Fund reflects how an industry or other sectors are doing. Mutual Funds values change on daily basis which reflects the value of the assets in the fund's portfolio. The economy is much slower moving, so that wide variations in a fund do not necessarily mean that sector is gyrating as much. However, if a Mutual Fund price declines over time, then it is a good bet that the sector it tracks is also growing more slowly.

In the US and India, huge investments have been witnessed in Mutual Funds as compared to bank deposits. However, Pakistan has seen the exact opposite where preferences have been given to saving in bank accounts despite Mutual Funds out performing in most asset classes and providing inflation adjusted higher returns. The popularity of Mutual Funds in Pakistan has been inconsequential where the value of entire industry is estimated to be USD 4.3bn which is 1.6% of GDP. On the other hand, India, our immediate neighbor with much in common, where every fourth house hold feels safe to entrust their savings with Mutual Funds resulting in an industry worth of USD 184bn which is over 9% of its GDP.

Globally Mutual Funds industry has Assets under Managements AUM worth over US $41 trillion of which USA contributes $19 trillion or 47%. India stands at $159 billion or aprox. 0.4%, whereas Pakistan AUM's are estimated to be $4.6 billion which is 0.01% of the Global Mutual Fund Industry and is approximately 5% of total bank deposits of our country. Indian Mutual Funds are approximately 13% of their country's bank deposits. The global Mutual Fund industry grew by 30% in 2014 -15, while Pakistan Mutual Fund industry grew by 8% in the same period which depicts potential for growth.

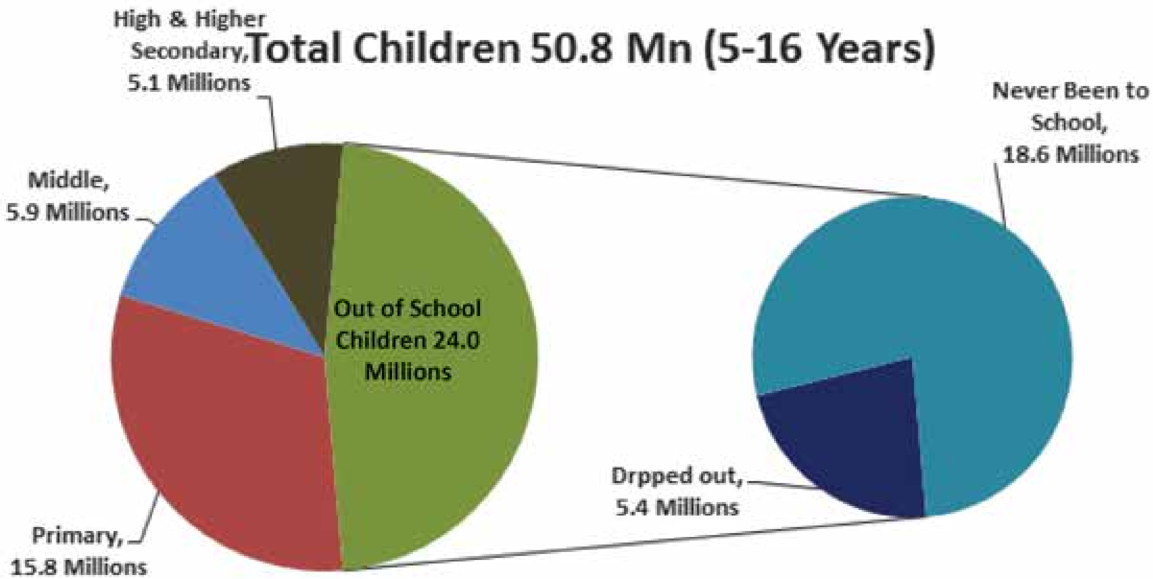
According to the recent report by Bloomberg, Pakistani Stock Exchange (PSX) has gained 20% YTD making it the best performer in Asia and with Pakistan's recent induction in the MSCI index it is expected to bring in USD 475 million of inflows into our market by the middle of the next year which makes Pakistani stock market a place to be. However, despite the outperformance of PSX in the Asian markets and its potential, the total size of the equity funds managed by Pakistan's Mutual Fund Industry as at 1st qtr CY16 is USD 1.5 billion as compared to India where the total size of Equity Funds are at 49.36 billion and USA at $9.97 trillion which amounts to more than half of their total assets under management, shows trust by the investors in high return products. Factors like the century old "Speculation" phenomena, daily highs and lows also known as volatility, weak systems and misplaced regulations, heavy taxation on investments and most importantly lack of investor education programs are collectively a hindrance in attracting new investors towards equities and in turn the growth of Mutual Funds is being affected.



Mutual Funds were launched for catering to the retail segment of the population but huge investments were received from the corporate sector because of the tax advantage on investments in Mutual Funds. The corporate entities were drawn towards Mutual Funds to avail this tax arbitrage which provided Mutual Funds opportunity to spend more on marketing its products and expanding its reach to the masses and growing retail base, however it was short lived. In 2013, Government started taxing the industry without clear understanding of its mechanics. Mutual Funds are pass through vehicles and the return the fund makes is passed on to the investors after deduction of Management fee and operational expenses. The average management fee that a Mutual Fund charges is 1.25% with which AMC's covers all operating costs leaving little or nothing behind for the establishment of skilled and trained sales teams, expanding its branch network to increase distribution and educating the masses through marketing of its products countrywide unlike in the case of banks that are currently working on 5-6% spreads.

Without the proper tax regime and the need to further incentivizing the masses to encourage savings and investing in Mutual Funds, this industry will soon collapse.

As narrated earlier, an individual in our country isn't financially literate or investment savvy to understand the dynamics of portfolio management. Educational campaigns thus become an essential part to bring about the overall change in this depleting savings culture although it is a long and time consuming process. Education is a constitutional right of every Pakistani however this article remains to be a black and white piece that has been decorated on the constitution while 47% of 50.8 Million children between the ages of 5 and 16 are still out of school in our country. Although the numbers are clearly frightening and highlight the low priority in endowed by Government on education, our pursuit of promoting financial literacy can still be channelized and begin at schools. Despite it being a long cumbersome process, to give it a jump start, courses formulated to impart financial knowledge can be introduced at elementary levels thus creating awareness. Government needs to initiate programs on financial education on a grass root level. Corporations can also make it mandatory to organize financial education seminars for their staff to help individuals make saving and investment decisions and equip them with tools to deal effectively with advisors and financial intermediaries. According to the *research in the United States workers increase their participation in 401(k) retirement savings plans funded by employee and employer contributions when employers offer financial education programs, whether in the form of brochures or seminars. Mortgage counseling before people take on their loan has been found to be effective in reducing the risk of default. Consumers who attend one-on-one counseling sessions on their personal finances have lower debt and fewer delinquencies. More work is clearly needed to develop ways of measuring the success of fnancial education programs, and governments need to invest time and money in evaluating them.



Regulators also need to play a vital role by endorsing and sharing the benefits of investing through Mutual Funds, and help formulate investor friendly policies to assist Mutual Funds expand their reach to the masses. In addition, strong management teams, vigilant risk and audit departments to minimize risks, strong distribution channels to be able to reach maximum number of individuals are some of the areas where Mutual Fund industry itself would have to play a huge part.

We are cognizant of the fact that promoting financial literacy is a difficult and likely costly task, and more research is required to determine when and how to most efficiently invest in consumer financial literacy. It is also clear that it is necessary to enhance financial knowledge if consumers are to do a better job navigating the complexities of the modern financial environment. Saving for retirement is becoming more challenging but also more critical for younger consumers, requiring ever-greater levels of financial sophistication. To incentivize and encourage savings, government introduced many product like VPS, combined with the tax benefits that can be availed by investing in these schemes, a huge majority of the general public is still unaware of the advantages.

This marks an epic failure on our part.

It is thus urgent to develop, evaluate, and target effective programs to those who can put this necessary financial knowledge to work. Achieving a pro-saving, pro-growth policy set within the boundaries of a private sector system will require government, employers and financial services providers to work together and better understand the range of possible outcomes. Public policy should, at a minimum, maintain incentives at the existing levels and ideally increase them and focus on households facing large savings gap.

Increased household savings not only gives families greater financial security, but helps the national economy create sustainable prosperity for its people.

**Reference to USA Study: http://www.oecd.org/finance/financial-education/37087833.pdf*