Report of the Working Group to Study the Issues Related to Gold Imports and Gold Loans by NBFCs

(Draft for seeking public comments)

RESERVE BANK OF INDIA
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Report of the Working Group to Study the Issues Related to Gold Imports and Gold Loans by NBFCs in India

Reserve Bank of India

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RESERVE BANK OF INDIA
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परामर्शदाता
Adviser

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Dr. Subir Gokarn
Deputy Governor
Reserve Bank of India
Mumbai

Sir:

Working Group to Study the Issues Related to
Gold and Gold Loans by NBFCs in India

We, hereby submit the Report of the 'Working Group to Study the Issues Related to Gold and Gold Loans by NBFCs in India', constituted vide Memorandum dated April 4, 2012 to review the issues related to gold and the functioning of gold loan NBFCs and make appropriate recommendations.

We sincerely thank the Bank for entrusting this responsibility to us.

With kind regards,

Yours sincerely,

(K.U.B.Rao)
Chairman

(S.M.N.Swamy) Member	(Vivek Deep) Member	(Ashok Sahoo) Member
(Ravishankar) Member	(G.Jagan Mohan) Member	(S.K.Pable) Member
(Rohit Das) Member	(A.Karunagaran) Member Secretary	

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Reserve Bank of India

Working Group to Study the Issues Related to Gold Imports and Gold Loans by NBFCs in India

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List of Select Abbreviations

AFCs	Asset Finance Companies
AGLOC	Association of Gold Loan Companies
ALM	Asset Liability Management
AMC	Asset Management Company
AMFI	Association of Mutual Funds in India
AML	Anti-Money Laundering
ARCH	Autoregressive Conditional Heteroskedasticity
ARDL	Autoregressive Distributed Lag
AUM	Assets Under Management
BR	Banking Regulation
BSE	Bombay Stock Exchange
CAD	Current Account Deficit
CAFRAL	Centre for Advanced Financial Research and Learning
CAGR	Compound Annual Growth Rate
CCAC	Committee on Capital Account Convertibility
CCTV	Closed-circuit television
CFT	Combating Financing of Terrorism
CIP	Carriage Insurance Payment
CMIE	Centre for Monitoring Indian Economy
CP	Commercial Paper
CRAR	Credit to Risk weighted Assets Ratio
CRISIL	Credit Rating and Information Services of India Ltd.
DBOD	Department of Banking Operations and Development
DGC	Digital gold currency
DGCI&S	Directorate General of Commercial Intelligence and Statistics
DNBS	Department of Non-Banking Supervision
ECM	Error Correction Modelling
EOU	Export Oriented Unit
ETFs	Exchange Traded Funds
EXIM	Export Import Bank of India
FATF	Financial Action Task Force
FERA	Foreign Exchange Regulation Act
FIs	Financial Institutions
FPC	Fair Practices Code
GAP	Gold Accumulation Plan
GARCH	Generalized Autoregressive Conditional Heteroskedasticity
GDP	Gross Domestic Product
GOFO	Gold Offered Forward Rate

GSA	**Gold Savings Account**
GSS	**Gold Savings Scheme**
GTD	**Gold Trade Deficit**
HHEC	**Handicrafts and Handloom Exports Corporation of India**
HNIs	**High Networth Individuals**
IDF	**Infrastructure Debt Funds**
IDMD	**Internal Debt Management Department**
IMF	**International Monetary Fund**
KYC	**Know Your Customer**
LBMA	**London Bullion Market Association**
LTV	**Loan to Value**
MCX	**Multi Commodity Exchange**
MFIs	**Micro Finance Institutions**
MGL	**Metal Gold Loans**
MMTC	**Mineral and Metal Trading Corporation**
NAV	**Net Asset Value**
NBFC-ND-SI	**Systematically Important Non-Deposit taking Non-Banking Financial Company**
NBFCs	**Non Banking Financial Companies**
NBFCs-D	**Non-Banking Finance Company - Deposit Taking**
NBFCs-ND	**Non-Deposit Taking Non-Banking Finance Company**
NCDs	**Non Convertible Debentures**
NHFDC	**National Handicapped Finance and Development Corporation**
NPAs	**Non-Performing Assets**
NRIs	**Non Resident Indians**
NSEL	**National Spot Exchange Limited**
NSTFDC	**National Scheduled Tribes Finance and Development Corporation**
OTC	**Over-the-Counter**
PAN	**Permanent Account Number**
PIOs	**Persons of Indian Origin**
POL	**Petroleum, Oil and Lubricants**
RALOO	**revaluation of assets and liabilities of overseas offices**
RBI	**Reserve Bank of India**
RIA	**Right to Information Act**
RNBC	**Residuary Non-Banking Company**
SARFAESI	**Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest**
SBI	**State Bank of India**
SEZ	**Special Economic Zone**
SIPs	**Systematic Investment Plans**

SLR	**Statutory Liquidity Ratio**
STC	**State Trading Corporation**
STP	**Systematic Transfer Plan**
SIP	**Systematic Investment Product**
SWP	**Systematic Withdrawal Plan**
TOR	**Terms of Reference**
WGC	**World Gold Council**

Report of the Working Group to Study the Issues Related to Gold Imports and Gold Loans by NBFCs in India

Executive Summary

The Reserve Bank of India constituted a 'Working Group to Study the Issues Related to Gold and Gold Loans by NBFCs in India' in April 2012. The following are the broad Terms of Reference assigned to the Group:

I. Terms of Reference (ToRs):

1. To analyse the implication of gold imports on external and financial stability;

2. To assess the trends in demand for gold loans and to study how it has influenced gold imports;

3. To study the trends in gold price and to examine whether NBFCs extending gold loans has any role in influencing the gold price;

4. To examine the sources of funds of NBFCs for gold loans, especially their borrowings from the banking system, to make an assessment of systemic implications;

5. To examine the current practices of NBFCs involved in lending against the collateral of gold;

6. To review the extant regulatory norms relating to gold loans and recommend any modifications, if necessary;

7. To assess whether NBFCs adhere to fair practices code including the KYC norms in extending gold loans;

8. To examine the scope for dematerializing gold investments through instruments such as ETFs and gold SIPs; and

9. To examine the extant role of banks in canalising gold and retailing gold coins etc.,

10. To examine any other related issue/s to be referred to the Working Group.

The Working Group examined the above terms of reference and submitted its Report to the Reserve Bank. The broad summary and the major recommendations of the Working Group are furnished below.

II. Motivation for the Study of Issues Related to Gold Imports and Gold Loans:

A. Macro Issues

Large gold imports

India is known to be among the largest importers of gold in the world. The imports of gold by India have been rising unabated in recent years notwithstanding the sustained increase in gold prices. Such large import of gold, when the gold prices are ruling high is one major source of bulging trade deficit. The deterioration in current account deficit (CAD) due to large gold imports has implications for financing the same, which would reduce the foreign exchange reserves and could become a drag on the external debt. In this context, a major concern emerged is the impact of huge gold imports on external stability.

Factors affecting the demand for gold

It is well known that the demand for gold in India is influenced by many social, economic and cultural factors. The price of gold, rural income distribution, quantum of black money, rate of return on alternate financial assets and the general price level are major driving factors for gold demand in India. The performance of gold against other comparable domestic assets over the last few years is suggestive of the shift towards gold in India also. Returns from gold investment have outperformed other comparable assets on three of the last five years.

Trends in gold prices

International gold prices have risen exponentially in the last decade. Since 2000, the international gold prices have grown at compound annual growth rate of 16.3 per cent. The domestic gold prices have moved in tandem with international gold prices in recent years. Volatility in international gold prices in recent quarters is positively skewed implying that it provides fewer large losses and a greater number of larger gains. One of the major components of gold demand in recent years has been investment demand at the global level. Rising gold prices in recent years did not deter the acquisition of gold in India, implying that investment in gold is becoming price inelastic.

Large gold imports led to concerns in the macroeconomic management

The management of demand and supply of gold has important policy implications for fiscal policy and exchange rate management. With domestic production of gold falling to insignificant level, the gold consumption is met entirely through imports. Though it is generally considered that a CAD of 2.5 to 3.0 per cent is sustainable for India, in the more recent years CAD is very high. In 2011-12, external sector resilience has weakened mainly due to higher current account deficit, which in turn was largely on account of worsening trade deficit. Two commodities that led to higher imports were oil and gold. Gold contributed nearly 30 per cent of trade deficit during 2009-10 to 2011-12, which is significantly higher than 20 per cent during 2006-07 to 2008-09. The large gold imports, thus, have led to major concerns in the macroeconomic management.

Gold imports appears to be making India's external sector vulnerable

During 2011-12, high trade deficit caused, *inter alia,* by high gold imports led to worsening of the CAD. Had the gold imports in India grown by 24 per cent (an average of growth in world gold demand during part three years) instead of 39 per cent in 2011-12, the current account deficit would have been lower by approximately US$ 6 billion and CAD-GDP ratio would have been 3.9 per cent instead of 4.2 per cent. Thus, gold imports are putting pressure on the Balance of Payments management. The current trend in quantum of gold imports appears to be making India's external sector vulnerable in terms of rising trade and current account deficits, which in the absence of adequate foreign capital flows, can have implications for maintaining adequate foreign exchange reserves buffer.

B. Micro and Institutional Issues

Developments in gold loan market

While the gold imports surged, concurrently, the gold loan market in India has shown rapid strides. The swift rise in the number of institutions involved, their branch network, volume of business in terms of gold pledged, volume of loans disbursed brought new dimensions to the gold loan market. To accommodate the large demand for such loans, these NBFCs have also increased their reliance on bank and other borrowings on a massive scale. It was apprehended that there could be systemic concerns arising out of huge borrowing of public funds by these companies. Simultaneously, there has been a spurt in the number of complaints received against these NBFCs.

Reasons for sharp expansion in gold loans

There are several reasons for the sharp expansion in gold loans in recent years. NBFCs positioned gold loans as a convenient tool for raising loans. Geographical expansion of gold loan companies facilitated the loan delivery. Flexibility of loan options, liberal Loan to Value Ratio, easy to conform documentation led to expansion of gold loans. The average size of the gold loan increased due to the rapid price increase of the gold and constricted availability of retail and personal loans from banks.

Concerns related to rise in the activity of gold loans

Numerous apprehensions arose due to the rapid rise in the activity of gold loans NBFCs. They are systemic concerns arising out of huge borrowing of public funds by these companies; possibility of 'concentration risk' as more than 90 per cent of the assets are concentrated only in gold jewellery loans; and whether large scale branch expansion ensured strengthening of the safety procedures, corporate governance, internal control processes in the gold loans NBFCs. Some of these NBFCs are soliciting retail public funds styling them as 'debentures' and such instruments are issued for periods less than 90 days besides being made available to investors on tap. Further, the lack of transparency in procedures adopted by these NBFCs for auctioning the pledged gold has become a concern. There are also complaints against NBFCs that proper documentation process was not being followed with implications for the KYC norms. The auction procedures followed by these NBFCs have also led to complaints against them. Spurt in the number of complaints received against these NBFCs about overcharging of interest. These developments have necessitated a comprehensive study of the functioning of the gold loan NBFCs.

Against these macroeconomic concerns and institutional developments, it was considered appropriate by the Reserve Bank to constitute a Working Group to examine the issues related to gold imports and gold loans provided by the NBFCs.

III. Views of the Working Group:

With large gold imports, external stability appears to be an issue

The Working Group is of the view that external stability appears to be an issue with large gold imports. Gold contributed nearly 30 per cent of trade deficit during 2009-10 to 2011-12. Due to falling gold re-exports, India's trade deficit as well as CAD as ratio to GDP worsened by 0.3 percentage points in 2011-12. Projections show that net gold imports as ratio to GDP is likely to be in range of 1.8 per cent to 2.4 per cent in the next few years.

Demand for gold may not be fully amenable to policy changes

Demand for gold appears to be autonomous and a function of several influences and factors in India and may not be strictly amenable to policy changes. Supply of gold, through organised channels can be constricted, but buyers may take recourse to unauthorised channels to buy gold. The share of banks in importing gold has already been on decline over the years. Since it is difficult to vary the demand for gold the policy focus will have to be directed to (i) design and offer gold investors, alternative instruments that may fetch positive returns with a flexibility of liquidity; and (ii) increased unlocking of the hidden value locked in idle gold stocks through increased monetisation of gold. In this context encouraging gold jewellery loans from *Banks* and NBFCs, ensuring customer protection of borrowers and changes in the practices of NBFCs is desirable.

Select Recommendations

(i) Resolution of macro issues

Given this scenario, there is a need to moderate the demand for gold imports. We need to opt for a series of demand reduction measures, supply management measures and measures to increase the monetisation of gold.

a. Demand reduction measures

- Fiscal measures to reduce the gold imports may be revisited. The Working Group, however, recognises that there is a limitation to the fiscal route to curb the demand for gold import as beyond a level raising the import duty may lead to buyers taking recourse to purchases from unauthorised sources of supply. Better documentation of gold sales and purchases leading to a paper trail of transactions is also important.

- There are also existing restrictions on carrying of gold and gold jewellery by incoming Indian community from abroad. If need be, this may also have to be reviewed to make bringing gold into the country less attractive option.

- It is necessary to introduce savings schemes and instruments that can provide real returns. The dominant reason why a person may like to hold his savings in the form of gold is to secure hedge against inflation. Therefore, offering real rate of return considering the high inflation rate prevailing, as an incentive on a financial instrument would better address the issue of excessive clamor for gold imports. Therefore, products analogous to Inflation Indexed Bonds may be considered as alternatives.

- There is a need to consider introducing new gold-backed financial products to reduce the demand for physical gold. Products that may be considered are Modified Gold Deposit Scheme (gold taken as a deposit is recycled for meeting domestic demand and given back at the time of maturity); Gold Accumulation Plan (the product is a saving plan catered to even small buyers of gold in which the gold imports are deferred till the time of actual delivery of gold); Gold Linked Account (the entire transaction takes place outside India and import of gold is not involved); and Gold Pension Product (the customer surrenders gold to the bank on agreement to receive streams of monthly pension till his death). Careful evaluation of the feasibility of introducing each proposed gold-backed product is critical.

- Investor education and financial literacy are critical. With appropriate investor education about the positive aspects of investment in gold-backed financial products, it is possible to reduce the demand for physical gold or we can, at least, postpone the demand for gold to future. There is a possibility to attract investment demand for gold with the spread of financial literacy to entice investment in gold-backed and gold related investment instruments. This can bring down demand for physical gold. The demand from the urban consumers can be diverted towards dematerialised gold investments.

- Imposing export obligation on bulk gold importers is one option. Imposing limits on the volume and value of gold to be imported by canalising agencies/nominated banks in the extreme eventuality is also an option.

- The Group notes that there is a preferential and more favourable treatment for gold as compared to import of any other item. Aligning gold import regulations with the rest of imports will take away significant incentives to gold imports and will go a long way towards reducing gold imports by creating a level playing field between gold imports and other imports.

b. Supply management measures

- It would be worth trying to channel the existing supplies of scrap gold in the country into the financial system, so that the unproductive nature of the gold asset is turned into a financially-productive medium. Presently canalising agencies are used as a unidirectional channel to import and sell gold in the country. The Group wonders whether these can be made bi-directional channels, i.e., they be allowed to buy back the tamper proof gold coins at transparent prices. For this, canalising agencies can have a two way quote with very little margin. This would facilitate the agencies to recycle domestically available gold rather than import and sell gold. When the CAD declines to a sustainable level and as considered appropriate from time to time, Reserve Bank may permit banks to offer two-way quotes. Such of those banks that may opt for both buying and selling gold coins will have to manage the sum of consequential risks. While permitting the banks to offer two-way quotes, Reserve Bank will also have to consider any macroeconomic risks (other than the possible impact on CAD) because of the special nature of gold.

- To put the gold with Indian ETFs to productive use and reduce the demand for gold, we may think about putting a certain part of the total corpus of the fund to be 'loaned' to the permitted categories of bulk gold importers like nominated agencies to import gold. In India, some importers have access to gold borrowings with pre-specified limits and they pay interest for the gold borrowed. The transaction is eventually settled by purchasing gold at the end of the tenor of the loan. Such a step would increase the returns on the ETF investments and the demand for gold imports is postponed and thereby reducing the pressure on stressed balance of payments. Alternatively, ETFs may also be allowed to invest their gold holdings in gold certificates with Banks. If, SEBI examines these proposals, operational modalities can be worked out.

- Introduction of tax incentives on instruments like Gold Bonds or like-variants that can impound domestically available gold can be thought of.

c. Measures to increase the monetisation of gold

- There is a need to liberalise the gold loans by banks and gold loan NBFCs to increase the monetisation of idle gold stock in the country. Gold loans may be given for all productive purposes.

- Setting up of Bullion Corporation may be considered. The proposed Bullion Corporation may function as a Backstop Facility providing liquidity for lending against gold or as a refinancing agency. In addition to functioning as a Backstop Facility, it can also undertake retail transactions in gold through pooling of gold. Besides, the Corporation can be the nodal agency for deciding all policies related to gold and innovation of gold-backed products.

In the ultimate analysis, demand for gold is a function of economic growth, import duty, exchange rate, inflation, interest rates, alternative financial instruments, easy availability of credit and the current account transactions. Any strategy to reduce the demand for gold will have to consider the trends in each one of these parameters to evolve an appropriate gold policy. The crux of the problem is the absence of financial instruments that provide flexible liquidity options, while providing real rate of return to investors. Part of the solution lies in innovating them to provide hedge against inflation to the investors.

(ii) Addressing the micro and institutional issues

Liability management - Need for careful monitoring of the gold loans NBFCs' operations

The rapid growth of the assets, borrowings and branch network of gold loans NBFCs need to be monitored continuously through more frequent review of relevant data for large gold loan NBFCs. There is a need to reduce the interconnectedness with the formal financial system over medium and long run. Keeping in view the declining capital adequacy ratio, there is a need to improve the capital. There is also a need to review the current stipulations pertaining to raising resources through NCDs. The exemption available to secured debentures from the definition of "deposit" may be reviewed. It is necessary to monitor the transactions between gold loans NBFCs and their respective sister concerns and unincorporated bodies.

Customer protection - Need for reviewing of the gold loans NBFCs practices

The practices followed by gold loans NBFCs needs a relook to ensure customer protection. In this regard, there is a need to ensure transparent communication of loan terms. Institution of a customer complaints and grievances redressal system is important. Auction procedures need a relook. Auctions should be conducted at a price closer to the market price. Disclosure standards need review. Monitoring the implementation of the Fair Practices Code is urgent. Standard documentation procedures may be devised. Use of PAN Card for large transactions is desirable. Large transactions of gold loan NBFCs may be through cheque to ensure KYC stipulations. There is a need for an ombudsman to address the grievances of gold loan borrowers.

Prudential norms - Review the regulatory framework pertaining to gold loan NBFCs

Coming to the regulatory norms relating to gold loan NBFCs, the Working Group's assessment is that, as of now, there is no case for conceding complete level playing field for the gold loans NBFCs with the banks. There is a need to review the extant 'loan to value ratio'. There is also a need for a well-defined and standardised concept of the term 'Value' for prescribing appropriate 'Loan to Value Ratio'. Unbridled growth of branches by large gold loans NBFCs needs to be moderated. Rationalisation of interest rate structure of the gold loans NBFCs is a priority. Though leverage of the gold loans NBFCs is not a cause for worry at the present juncture, going forward, there is a need for improving owned funds of the NBFCs.

Gold loans NBFCs do not pose a problem for domestic financial stability currently

As of now, gold loans NBFCs do not pose a problem for domestic financial stability. Going by the past trends, a sudden drop in gold price by 30 to 40 per cent is a remote possibility causing any financial distress to the gold loans NBFCs. Asset quality, NPAs as per cent of total credit exposure and Capital adequacy of gold loans NBFCs are also not a cause for concern at present. The sources of funds of gold loans NBFCs also do not appear to be an immediate cause for anxiety giving rise to 'concentration' credit risk. However, the striking growth of gold loans NBFCs business in recent years warrants that their operations may be closely monitored.

Some empirical findings

The technical work undertaken by the Working Group indicated that gold loans have a causal impact on gold imports substantiating the emergence of a liquidity motive for holding gold. But, it should be clearly recognised that availability of gold loans alone cannot push up gold imports. International gold prices and exchange rate significantly and positively affect the gold prices in India. Probability of volatility in gold prices impacting the gold loan market is low. Increase in gold prices appears to be one factor that increases the gold loans outstanding. However, increase in gold loans extended by NBFCs and banks do not impact significantly the gold prices in India. On the basis of empirical analysis of volatility in gold price, it is difficult to estimate future prices of gold. Going by the past trends, a drop in gold price by 30 to 40 per cent is a remote possibility causing financial distress to the gold loans NBFCs. Banking sector's existing exposure in the form of their individual gold loans appears small and may not have any significant repercussions for the stability of the banking sector at present.

IV. Summing-up:

There is a need to moderate the demand for gold imports, as ensuring external sector's stability is critical. But, it is necessary to recognise that demand for gold is not strictly amenable to policy changes and also is price inelastic due to varied reasons. What is critical is to ensure provision of real returns to investors through various financial savings products. What is also relevant is the need for banks to introduce new gold-backed financial products that may reduce or postpone the demand for gold imports. The Working Group believes that providing real rate of return to investors through alternative instruments holds the key to reducing the excessive demand for gold. Meanwhile, there is also a need to increase monetisation of idle gold stocks in the economy for productive purposes. As of now, there appears to be no close substitute to wean away investors' attention from gold. Investors' awareness and education is important, in this context, to channel the investment to gold-backed financial products. Banks and NBFCs may continue to deliver gold jewellery loans, which monetises the idle gold in the country. The gold loan market has grown well in recent years. It is time for consolidation of the operations of the gold loan NBFCs. The gold loans NBFCs need to transform themselves into institutions free of complaints, have proper documentation and auction procedures, with rationalised interest rate structure and have a branch network that is fully safe and secure. Gold loans NBFCs' linkage with formal financial institutions may be reduced gradually. Such transformation ensures the gold loans NBFCs' future growth more robust, besides making them a contributing segment to the financial inclusion process.

2. Introduction

Background

2.1 Gold has always fascinated the mankind's imagination and influenced their urge to possess the same. Gold occupies a pivotal role in the social and economic life of poor and rich alike. In India, besides the economic and strong social considerations, individuals are highly sentimental about the gold jewellery in their possession, as the gold ornaments are passed on from one generation to another. Acquisition of gold is considered auspicious and necessary for making family ornaments to get a sense of wellbeing in our country. Gold is increasingly considered as an investment that appreciates over years and provides a hedge against inflation. Gold is also considered as a medium that can be pledged easily during difficult times for securing financial accommodation.

2.2 India is known to be the largest importer of gold in the world. The imports of gold by India have been rising unabated in recent years notwithstanding the sustained increase in gold prices. Such large import of gold, when the gold prices are ruling high is one major source of bulging trade deficit. The deterioration in current account deficit (CAD) due to large gold imports has implications for financing the same, which would reduce the foreign exchange reserves and could become a drag on the external debt. In this context, a major concern emerged is the impact of huge gold imports on external stability.

2.3 Concurrently, the gold loan market in India has shown rapid strides. While gold loans were provided by money lenders and pawn brokers for several centuries and availed extensively by people from all walks of life, the more recent years witnessed a transformation of the gold loan business with a decisive shift in the players from unorganized sector to organized sector like the banks and specialised non-bank financial institutions undertaking it in a big way. The rapid rise in the number of institutions involved, their branch network, volume of business in terms of gold pledged, volume of loans disbursed brought new dimensions to the gold loan market. In the post crisis period, personal loans have become costlier with frequent upward revisions in interest rates by banks and financial institutions. Individuals, petty traders, borrowers in the low and middle income group resorted to taking loans by pledging their gold jewellery with banks and gold loan non bank financial companies (NBFCs) to meet their funding requirements. The traditional and ubiquitous pawn brokers are known to charge usurious rate of interest. Therefore, there has been a rapid increase in the number of individuals and business entities seeking gold loans approaching the banks and the gold loan NBFCs in the organised sector to meet their consumption as well as funding needs. As the demand for gold loans increased at a scorching pace in recent years, the gold loans NBFCs have started expanding their operations at a hurried pace through opening of their branches rapidly across the length and breadth of the country. To accommodate the large demand for such loans, these NBFCs have also increased their reliance on bank and other borrowings on a massive scale.

2.4 Viewed against these developments, it was apprehended that there could be systemic concerns arising out of huge borrowing of public funds by these companies. Further, the business model adopted by certain large gold loan companies especially relating to lending against gold could expose them to 'concentration risk' as more than 90 per cent of their assets are concentrated only in gold jewellery loans. Simultaneously, there has been a spurt in the number of complaints received against these NBFCs, about some anti-borrower business practices followed by them. The large scale branch expansion would require strengthening of the safety procedures, corporate governance and internal control processes in the NBFCs. Some of these NBFCs are also accepting retail public funds styling them as 'non convertible debentures' and such instruments are issued for periods less than 90 days besides being made available to investors on tap. The lack of absolute transparency in procedures adopted by these NBFCs for auctioning the pledged gold has been a matter of concern. There are also complaints against NBFCs that in order to quickly dispose the cases relating to gold loans, proper documentation process are not being followed. Such deviations will have implications for the KYC norms. The auction procedures followed by these NBFCs have also led to many complaints against them.

2.5 Against these macroeconomic concerns and institutional developments, it was considered appropriate by the Reserve Bank to constitute a Working Group to Examine the Issues Related to Gold Imports and Gold Loans Provided by the NBFCs. Accordingly, as announced in the Monetary Policy Statement for 2012-13, the Reserve Bank constituted a Working Group to study the relevant issues with the following Members:

Composition of the Working Group

K.U.B.Rao Adviser Department of Economic and Policy Research Reserve Bank of India	Chairman
S.M.N.Swamy General Manager Department of Non Banking Supervision Reserve Bank of India	Member
Ashok Sahoo Director Department of Economic and Policy Research Reserve Bank of India	Member

Vivek Deep — Member
General Manager
Department of Banking Operations and Development
Reserve Bank of India

G.Jagan Mohan — Member
Deputy General Manager
Financial Stability Unit
Reserve Bank of India

S.K.Pable — Member
Deputy General Manager
Department of Non Banking Supervision
Reserve Bank of India

Ravi Shankar — Member
Director
Department of Statistics and Information Management
Reserve Bank of India

A. Karunagaran — Member Secretary
Assistant Adviser
Department of Economic and Policy Research
Reserve Bank of India

2.6 The Working Group co-opted, Rohit P Das, Deputy General Manager, Department of External Investments and Operations, Reserve Bank of India as a Member who assisted the Group on the issue of dematerialsation of gold and introduction of new gold-backed products.

2.7 The following broad Terms of Reference (ToRs) have been assigned to the Group:

Terms of Reference

1. To assess the trends in demand for gold loans and to study how it has influenced gold imports;

2. To analyse the implication of gold imports on external and financial stability;

3. To study the trends in gold price and to examine whether NBFCs extending gold loans has any role in influencing the gold price;

4. To examine the sources of funds of NBFCs for gold loans, especially their borrowings from the banking system, to make an assessment of systemic implications;

5. To examine the current practices of NBFCs involved in lending against the collateral of gold;

6. To review the extant regulatory norms relating to gold loans and recommend any modifications, if necessary;

7. To assess whether NBFCs adhere to fair practices code including the KYC norms in extending gold loans;

8. To examine the scope for dematerializing gold investments through instruments such as ETFs and gold SIPs; and

9. To examine the extant role of banks in canalising gold and retailing gold coins etc.,

10. To examine any other related issue/s to be referred to the Working Group.

Approach adopted by the Working Group

2.8 Considering the diverse nature of the ToRs assigned to the Working Group, it was expected of the Group to study the macro trends pertaining to the gold prices, gold imports and gold loans outstanding to undertake technical work to study the empirical relationship among various relevant variables. Non-availability of authentic and more recent data on gold loan industry was a genuine issue for the Working Group. Relevant data on gold loans outstanding has been collected through questionnaires from all banks and the concerned NBFCs. With regard to the micro-dimensions of the ToRs assigned about the functioning of gold loan NBFCs, the Group has decided to have a candid one-on-one dialogue with all the stake holders like the relevant NBFCs, bankers financing these NBFCs, gold loan borrowers, depositors, rating agencies, financial services providers who conceived some innovative gold-backed products to take their views on board. Therefore, the broad approach followed by the Working Group was eclectic by undertaking technical studies to study the relationship among various related variables and to undertake surveys through intense dialogue with all the stakeholders to firm up the views. Surveys were also undertaken by meeting the borrowers in person in various locations to know the first hand information on the practices of the NBFCs and also to record their grievances.

Secretariat

2.9 The Financial Sector Unit of the Department of Economic and Policy Research functioned as the Secretariat for the Working Group. The Division of Non-banking Financial Studies supported the endeavour.

Structure of the Report

2.10 The Report contains an introductory chapter that provided the background to the setting up of the Working Group and a chapter on Gold loan market in India that provides a broad overview of the current status of gold loan segment. Given the fact that the ToRs have been classified as macro and micro issues, the Report contains separate chapters to deal with various macro and micro issues related to gold imports and external sector vulnerability; role of banks in facilitating gold imports; introduction of gold-backed financial products; gold loans and domestic financial stability; gold prices and influence on the gold loans; demand for gold loans and influence on gold imports; financial performance of gold loan NBFCs; practices followed by gold loan NBFCs; regulatory norms relating to gold loan NBFCs; Fair Practices Code and KYC norms; and other issues. An Executive Summary was also provided summarising the major conclusions and the recommendations of the Group.

Date of completion

2.11 It was decided that the Report of the Working Group may be submitted on or before July 31, 2012. The Working Group, accordingly, submitted the Draft Report on August 3, 2012. Subsequently, the Draft Report was discussed in the Financial Markets Committee of the Reserve Bank of India and the Financial Stability and Development Council's Sub-Committee.

Acknowledgements

2.12 At the outset, the Working Members thank the Top Management of the Reserve Bank of India for giving them this responsibility. Deputy Governor, Dr. Subir Gokarn guided this Group from time to time in its deliberations and provided a broad direction to the Group's efforts. He has also arranged for the association of many external experts, who have provided invaluable guidance by sharing their expertise on various gold-backed products. The Working Group expresses its sincere gratitude to Dr. Subir Gokarn. Executive Director, Shri Deepak Mohanty was not only instrumental in giving this responsibility to the Working Group but also provided very useful insights in examining the macro setting, sequencing of the Report and in arriving at select recommendations. The Group is grateful to Shri Deepak Mohanty. The Group also held useful discussions with Executive Director Shri P. Vijaya Bhaskar on regulatory issues. The Group was benefited from the views of the Financial Markets Committee of the Reserve Bank and the Financial Stability and Development Council Sub-committee, which have discussed the draft Report.

2.13 The Working Group also had the benefit of discussing various issues related to gold loans NBFCs' deposits and debentures with Shri Salim Gangadharan, Regional Director, Reserve Bank, Thiruvanathapuram. Regional Directors of Reserve Bank in Chennai, Bengaluru and Thiruvanathapuram provided meeting facilities in their respective offices and participated in the discussions. Officer In Charge, Reserve Bank, Kochi, Shri C.V. George provided excellent facilities for the Group's meeting with the Association of Gold Loan Companies in Kochi. Ms. Jayanthi Anand and Ms. Dhanya of DEPR in Chennai and Kochi coordinated the Group's meetings very well in their respective centres. Shri K. Raja Krishna Reddy and Shri Nishank Gopinath of DNBS, Bengaluru and Thiruvanathapuram, respectively provided excellent assistance to the Group during and after the meetings in the respective centres. Shri M. Sreeramulu, DNBS, Central Office provided considerable data assistance. Shri Deepak Singhal, CGM-In-Charge, Department of Banking Operations and Development and Mr. Rajesh Jai Kanth, Deputy General Manger, Department of Banking Operations and Development also assisted the Working Group.

2.14 A number of young officers of the Department of Economic and Policy Research (DEPR) enthusiastically volunteered to assist the Working Group. The following officers of the DEPR namely, Dr. Rajeev Jain, Dr. Pallavi Chavan, Ms. Rakhe Balachandran, Dr. Narain Pradhan, Shri Alex Philip, Ms. Shromona Ganguly, Ms. Krittika Banerjee, Shri Pankaj Kumar, Shri S. Suraj, Shri Edwin Prabhu and Shri Anand Shankar have been very actively associated with the technical work and ardently provided secretarial assistance to the Group. In particular, Shri Narain Pradhan and Shri Alex Philip's contribution to the Secretariat was considerable. The Working Group places on record the unstinted and energetic support from all these officers, but for which the Report would not have been completed on time.

2.15 From the gold loan NBFCs, Shri I.Unnikrishnan, Managing Director, Mannapuram Finance was extremely helpful in facilitating continuous dialogue with the Association of Gold Loan Companies (AGLOC). Excellent data and information support was provided by Shri Unnikrishnan. Shri George Alexander Muthoot, Managing Director, Muthoot Finance Ltd., Shri K.R.Bijimon, Chief General Manager, Muthoot Finance Ltd. have also extended their sincere cooperation by providing data support. Shri M.G.George Muthoot, Chairman, Muthoot Finance Ltd. and Shri V.P.Nandakumar, Chairman, Mannapuram Finance have always been accessible for discussions. Shri R.Srinivasan, President, Gold Jewels Pledgers' Association provided useful insights. The Working Group is grateful to all of them.

2.16 The Working Group specially thanks Mr. Ajay Mitra, former Managing Director, World Gold Council, India for the useful insights provided. His colleague Ms. Anuja Trivedi also provided inputs to the Group. Assistance rendered by Dr. V.Easwaran, General Manager, SBI, Dr. Brinda Jagirdar, Chief Economist, SBI and Dr. Vidya Mahambare, Director and Principal Economist, CRISIL is gratefully acknowledged by the Group. A list of individuals and external agencies with whom the Working Group interacted is provided in the Annex.

Section I – Macro Issues

3. Demand for Gold Imports and External Sector Stability

3.1 India has traditionally been a leading consumer of gold in the world. Its domestic production has, of late, fallen to insignificant amounts compared to total demand. Therefore, demand is met almost entirely through imports. Gold price has witnessed a gradual rise during the first half of the 2000s and then at a faster pace in the second half with a major correction of around 25 per cent during the financial crisis in 2008. The price of gold has surged to record highs recently, breaching US$ 1900 per ounce in 2011 for the first time and corrected again. Indian prices too have risen to historic highs. Gold is an internationally traded commodity and the domestic prices are determined by international prices adjusted for transportation costs, customs duty and the exchange rate. The Working Group examined whether consistent rise in gold imports has led to deterioration in the balance of payments position and resulted in external sector vulnerability in India.

I. Demand for gold

Global scenario

3.2 At the global level, the annual demand for gold during the last five years (2008 to 2012), on an average, is estimated to be over 4000 tonnes. During 2011-12, India imported about 1080 tonnes of gold. Apart from traditional demand for household jewellery consumption, industrial use and investment purpose, it has been seen that the central banks tend to accumulate gold and diversify their foreign exchange reserves during the time of financial turbulence. It is evident from the fact that since the second quarter of 2009, central banks have turned from net sellers to net buyers of gold. Prior to this, central banks had been net sellers of gold since 1988. In particular, central banks' demand for gold accelerated sharply in 2011 due to concerns over the credit-worthiness of many advanced countries, as sovereign-debt concerns remained in the spotlight. As at end March 2012, total official gold holdings were about 31,063 tonnes. Recently, many current account surplus countries from Asia, Central Asia and Latin America have preferred buying large quantities of gold to diversify their foreign exchange reserves. More recently, the global demand for gold is underpinned by increased demand in China, continued central bank purchases and inflows into gold related exchange-traded funds (ETFs).

Global gold supply and the demand for gold from India

3.3 Trends in global gold supply and the demand for gold imports from India are portrayed in Table 3.1. While global gold supply is more or less flat, the share of demand for gold imports from India in the global gold supply rose steadily in recent years. When the growth in global gold supply has been weak, the growth rate of Indian demand for gold is strong at double digits in more recent years. The demand for gold in India during the year 2012-13 is expected to be *lower* than the previous year due to higher import duties and subdued economic performance. As per the data available up to October 2012, the import of gold had declined from 589 tonnes in 2011-12 (April-October) to 398 tonnes in 2012-13 (April-October). In value terms, it has declined from Rs 1.40 lakh crore to Rs 1.15 lakh crore. The decline is partly attributable to global economic conditions, slow down in India's growth, impact of increase in customs duty and softening of consumer and investment demand.

Table 3.1: Global Gold Supply and India's Demand for Gold

Year	Global Gold Supply $ (Tonnes)	Gold Demand from India @ (Tonnes)	Growth of Global Gold Supply (%)	Growth of Gold Demand from India (%)
1999	4206	486	...	...
2000	3704	462	-11.9	-4.9
2001	3764	471	1.6	2.0
2002	3667	467	-2.6	-0.9
2003	3953	367	7.8	-21.3
2004	3426	537	-13.3	46.1
2005	4034	792	17.7	47.5
2006	3559	707	-11.8	-10.7
2007	3554	716	-0.1	1.3
2008	3657	679	2.9	-5.1
2009	4146	743	13.4	9.4
2010	4274	871	3.1	17.2
2011	4030	975	-5.7	11.9
2012	4130*	1079*	2.5	10.7

Source: *World Gold Council and Estimations from DGCI&S Data;*
$ Calendar Year; @ Financial year

Trends in demand for gold in India

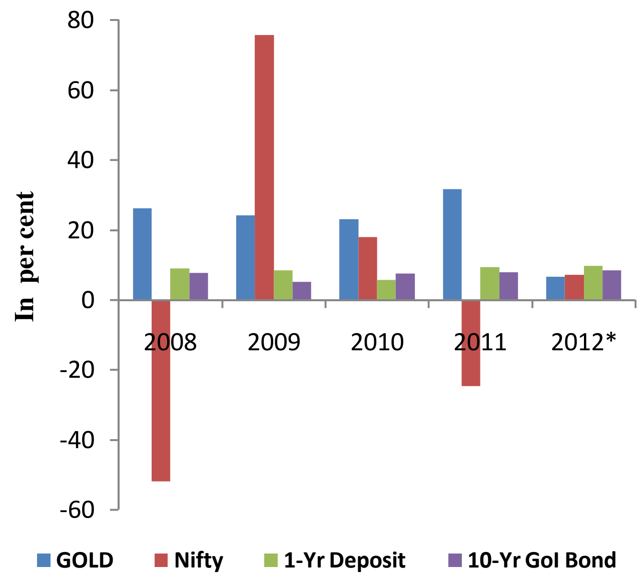
3.4 It is well known that the demand for gold is influenced by many socio, economic and cultural factors. The price of gold, rural income distribution, quantum of black money, rate of return on alternate financial assets and the general price level are major driving factors for gold demand in India. *"The real purchaser of gold is typically a peasant. Close to seventy per cent of gold jewellery is sold in rural areas and most of gold sales are by way of jewellery. To quote Professor Jeffrey A. Franks, holding gold has in fact often in history served, from France to India, as the only way the peasant can protect himself against inflation and the vicissitudes of politics" (Dr. Y.V.Reddy, 1997)".*

3.5 More recently, the uncertainty in real estate and equity markets has made gold an attractive investment and that, in turn, is making gold a convenient option. The economic growth, lack of easy availability of alternative financial products, particularly in the rural areas, has ensured that demand for gold is beyond normal needs for jewellery. Recently, Jagirdar and Jain have estimated that for every 1 per cent increase in income, gold consumption increases by 1.5 per cent, showing that gold consumption is highly income elastic. There are two components of demand for gold. The first category of the demand for gold consists of the 'consumption' demand for making jewellery, medals, electrical components, etc. The second category is the 'asset' demand for gold as an investment. The asset demand for gold is based on a number of factors, such as to serve as a hedge against inflation, as a suitable asset to aid in portfolio diversification and similar objectives. Gold is perceived as 'safe haven' asset, especially, during periods of financial and economic stress. Gold is viewed as a liquid asset and one of the most efficient 'store of value' and hence widely recognized in India as a tool for inter-generational wealth transfer. However, gold jewellery can also serve as a liquid asset which can be pledged for tiding over short term contingencies, which may increase the demand for gold imports.

Returns on gold vis a vis other assets

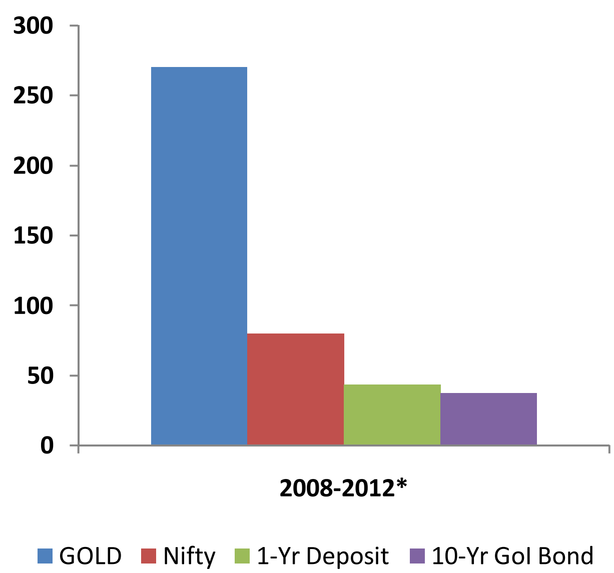
3.6 The performance of gold against other comparable domestic assets over the last few years is suggestive of the shift towards safe assets in India also. Gold has outperformed other comparable assets on three of the last five years. In fact, there has not been a period with negative returns for gold (Chart 3.1). Also, in the last five years, the cumulative returns of gold are higher than other assets by a big margin (Chart 3.2). According to the World Gold Council, India's investment demand for gold constituted US$ 3 billion out of US$ 11.2 billion in Q4 2011-12 (55.6 tonnes out of 152.0 tonnes). Chart 3.2.1 and Table 3.2 depicts the average annualized growth of monthly gold price and Wholesale Price Index (WPI), over the period March 2001 to March 2012. During the period, the growth in gold price (redline) is higher than the annualized inflation rate (WPI), which clearly indicates the preference to purchase gold as an inflation hedge. The Group recognises that several studies have empirically validated that gold can be regarded as a long-run inflation hedge. Absence of any close substitute to gold as an investment asset with the liquidity gold can offer is one major reason why gold has become a preferred asset. In addition, bulk of the gold transactions is generally on cash basis and without much of documentation has also made gold as an endeared asset to acquire and store. There are no tax hassles on gold transactions in the informal market. Financial products like bank deposits are subject to tax deduction at source. This feature too might be incentivising diversion of domestic savings towards non-financial products like gold and real estate. Such de-financialisation is undesirable to the financial system.

Chart 3.1: Annual Returns of Various Domestic Assets in Recent Years



Source: Bloomberg. Note: * Pertains to the period January to May 2012

Chart 3.2: Cumulative Returns of Domestic Assets (January 2008 – May 2012)



Source: Bloomberg. Note: * Pertains to the period January to May 2012

Chart 3.2.1: Annual Average Growth of Gold Price and WPI

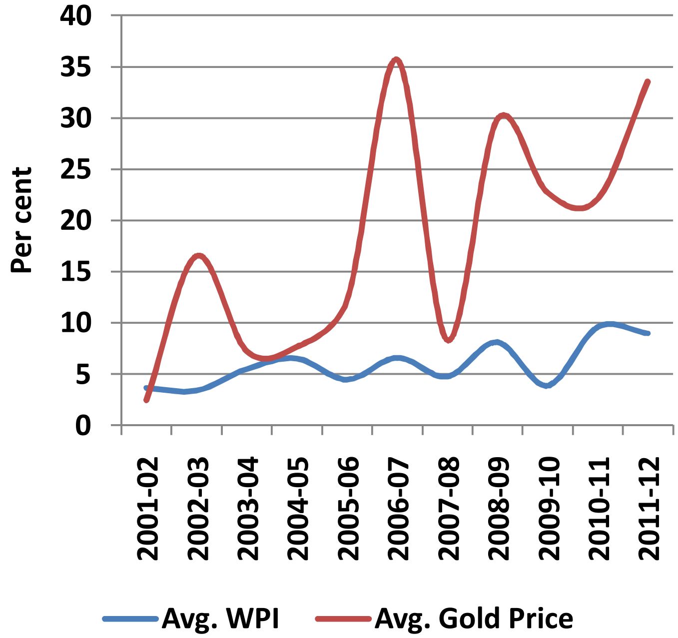
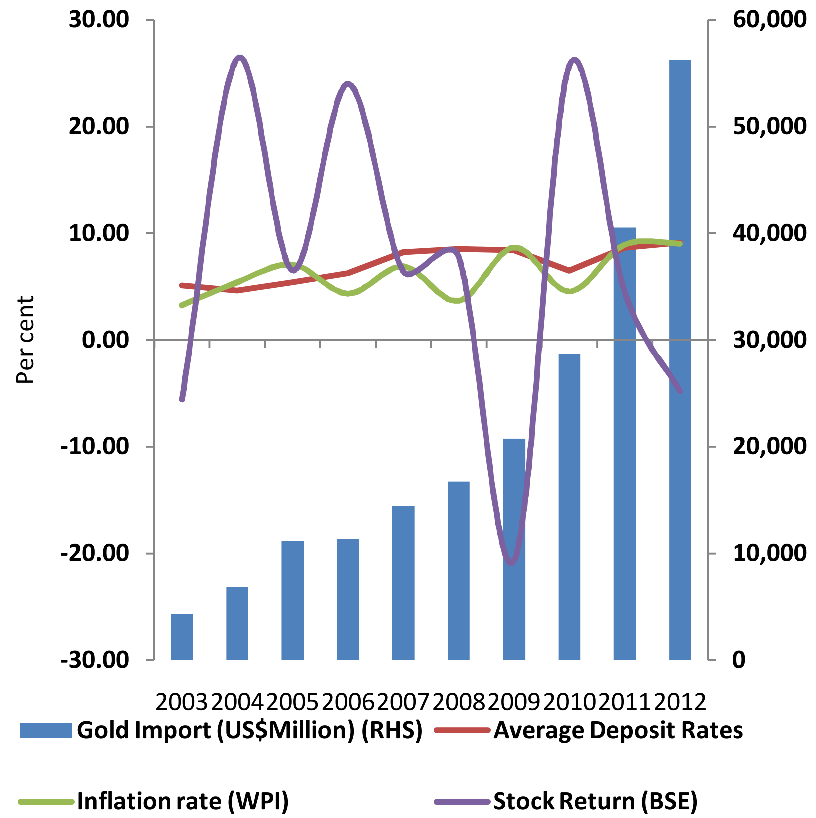


Table 3.2: Annualized Monthly Average Growth in Gold Price and WPI		
Period	**Avg. WPI Growth**	**Avg. Gold Price Growth**
2001-02	3.64	2.44
2002-03	3.38	16.51
2003-04	5.48	7.24
2004-05	6.51	7.63
2005-06	4.44	12.17
Average of 2001-02 to 2005-06	***4.69***	***9.20***
2006-07	6.59	35.68
2007-08	4.74	8.30
2008-09	8.09	29.83
2009-10	3.86	22.69
2010-11	9.57	22.08
Average of 2006-07 to 2010-11	***6.57***	***23.72***
2011-12	8.96	33.54

3.7 Moreover, relatively lower volatility of gold prices in recent years has reinforced the conception of gold as a stable asset. The volatility of the domestic gold prices has been less than that of equities (Nifty Index) in the last five years. The easy availability of the gold products given the low financial awareness in the country as well as its potential for value appreciation, when compared to financial instruments like equities, bank deposits and mutual funds in India encourages both low and high networth individuals to accumulate gold. Also, the fact that central banks worldover have started raising the composition of gold in their foreign exchange reserves[1] reinforced the belief, that it is a prudent investment. Apart from these reasons, two factors specific to India, driving demand for gold imports, need to be stressed. Firstly, India enjoys a strong position as an exporter of gems and jewellery due to its skilled and competitive labour. Thus, a significant proportion of gold imports is undertaken with a view to convert it into value added products like jewellery and export it back to the rest of the world. Secondly, in recent years, utility of gold jewellery in securing credit has been reinforced to a great extent by the marketing efforts of gold loan companies. This has strengthened the liquidity motive for holding gold, which could be pledged by households as collateral, to tide over temporary mismatches in liquidity.

Chart 3.3: Movements in Key Indicators and Gold Imports (Annual 2003-2012)

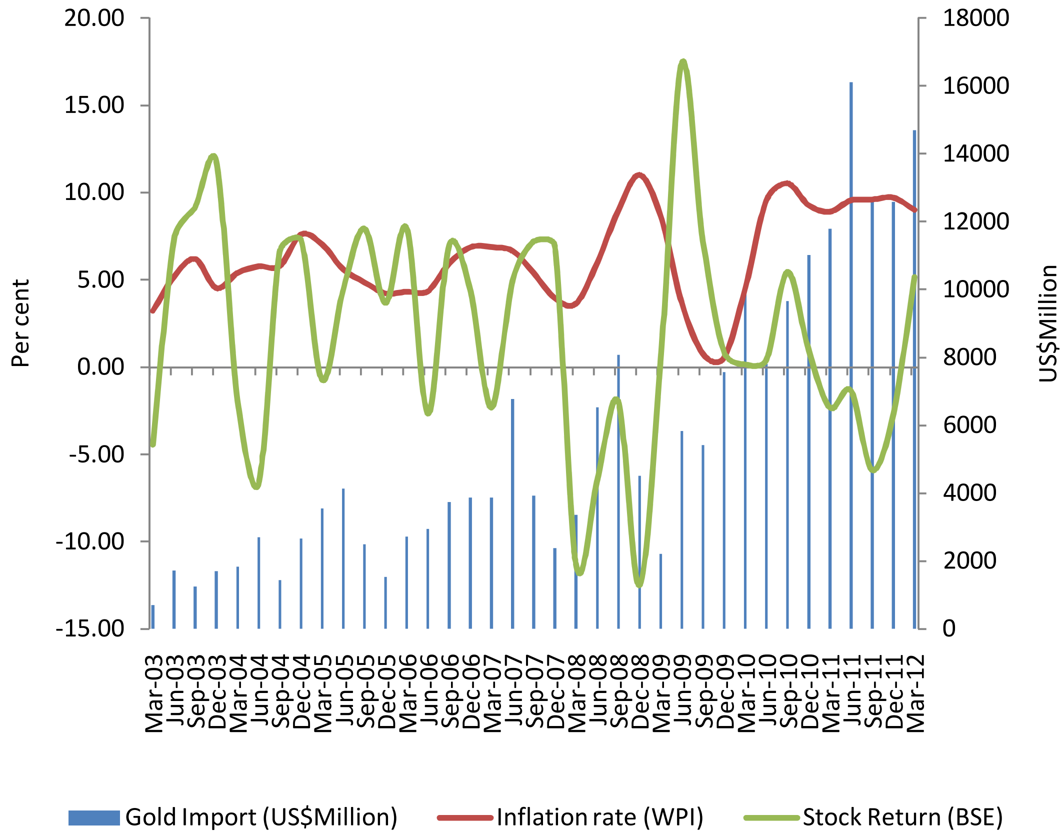


3.8 From 2006 to 2012 (except for the year 2010), the stock market returns and the gold imports show negative relationship. Inflation rate (WPI-All Commodities)

[1] Central banks which were net sellers of gold until 2010 have become net buyers of the commodity today.

and average term deposits rates (1-3 years) of scheduled commercial banks does not show any relationship with the gold imports (**Chart 3.3)**.

Chart 3.4 Movements in Key Indicators and Gold Imports (Quarterly March 2003-March 2012)



3.9 The quarterly gold imports and inflation rate show some positive correlation from December 2009 onwards. The gold imports and stock market return also, in general, show negative correlation in the recent period show some kind of seasonality **(Chart 3.4)**.

II. Gold imports and external sector

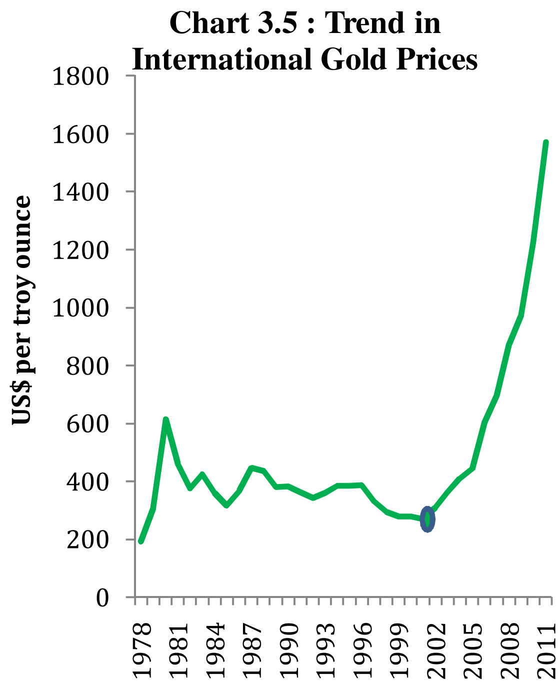
Table 3.3: Trends in Gold Imports		
Year	**Import of Gold in Rs. Crore**	**Growth Rate (%)**
1999-00	17991	…
2000-01	18829	4.7
2001-02	19889	5.6
2002-03	18608	-6.4
2003-04	29946	60.9
2004-05	47348	58.1
2005-06	47951	1.3
2006-07	65440	36.5
2007-08	67330	2.9
2008-09	95324	41.6
2009-10	135878	42.5
2010-11	184742	36.0
2011-12	269563	45.9

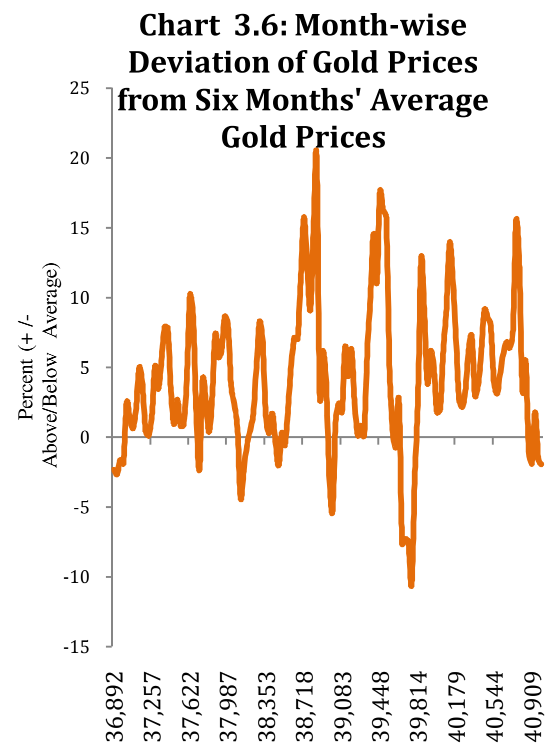
***Source:* DGCI&S**

3.10 The large gold imports have led to major concerns in the macroeconomic management Table 3.3. The management of demand and supply of gold has important policy implications for fiscal policy and exchange rate management. With domestic production falling to insignificant level, the consumption is met entirely through imports. Based on the data from DGCI&S, India's gold imports are estimated at US$ 57.5 billion during 2011-12, an increase of 49.2 per cent over 2010-11. In Q4 of FY2011-12, India imported US$ 16.2 billion worth of gold. Global demand for gold of US$ 46.6 billion was also up 9 per cent from US$ 42.8 billion during this time. As per the World Gold Council data, in terms of physical demand, India's demand at 207.6 tonnes in Q4 of 2011-12 was, however, down 29 per cent from 290.6 tonnes. Total demand was down 11 per cent from 960 tonnes to 858 tonnes during the period. Gold imports constitute more than 10 per cent of total imports and about a third of India's trade deficit today.

Trends in gold prices

3.11 As shown in Chart 3.5 international gold prices have risen exponentially in the last decade. In fact, the Quandt-Andrews unknown breakpoint test indentifies the structural break in international gold prices (in US dollar) to have occurred in 2000. Since 2000, the international gold prices have grown at compound annual growth rate of 16.3 per cent. One of the major components of gold demand in recent years has been investment demand at the global level. More importantly, volatility in international gold prices in recent quarters is positively skewed implying that it provides fewer large losses and a greater number of larger gains. Chart 3.6 also confirms that frequency of monthly average gold price, remaining above the previous six months' average, was high during January 2000 to April 2012. Such behavior of gold prices assumes importance for building up of positive expectations by gold investors.





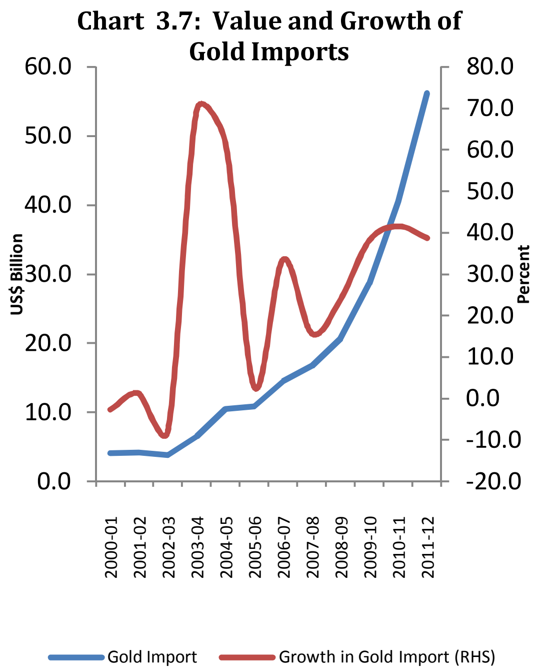
Source: World Gold Council

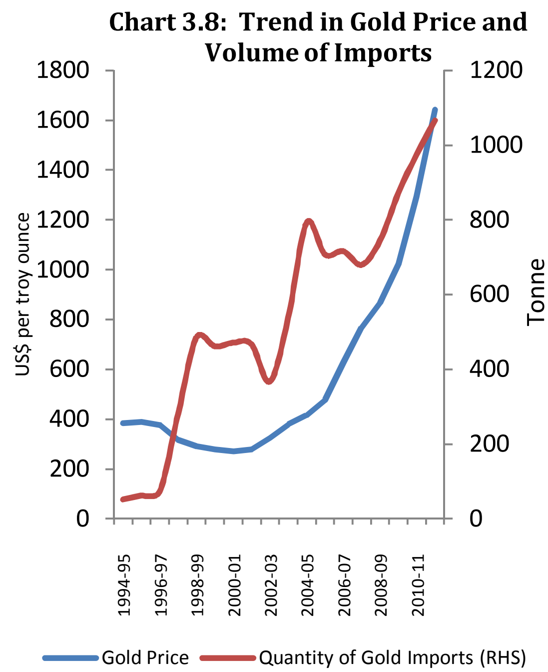
3.12 As regards the underlying factors for explaining international gold prices, studies suggest that the international gold price is a complex phenomenon affected by economic and political environment. While in the short-run, trend in gold prices could be due to inter-commodity substitution on account of movement in their relative prices, in the long-run, gold can be used as an instrument to hedge against inflation. History shows that during periods of financial turbulence, gold becomes an attractive asset class for investment. More recently, after the 2008-09 financial crisis, the demand for gold as collateral has also increased as it does not involve credit risk and its price generally exhibits counter-cyclical behavior. Similarly, transparent pricing of gold as compared to other assets may also be another positive factor for its demand.

Trends in imports of gold

3.13 There has been a sharp increase in India's gold imports in the recent past, which has raised concerns about its implications for trade deficit. As per DGCI&S data, the imports of gold increased from US$ 40.5 billion during 2010-11 to about US$ 56.2

billion during 2011-12 (**Chart 3.7**). The rise in India's import of gold has been on account of both price and quantum factors. International gold prices on average rose by 27.2 per cent in US dollar terms (34.0 per cent in INR terms) during 2011-12 as compared with 26.4 per cent in US dollar terms (21.6 per cent in INR terms) cent during 2010-11. As far as quantum of gold import is concerned, it is estimated to have increased by 9.2 per cent in 2011-12 (12.0 per cent in 2010-11). As shown in **Chart 3.8**, volume of gold import has surged in recent years despite sharp increase in gold prices. It implies that gold imports of India are relatively price inelastic.





Source: DGCI&S and World Gold Council

3.14 Uptrend in gold imports is particularly evident during the post-global financial crisis period. Growth in demand for gold in India (39 per cent) has also remained higher than that at global level (24 per cent) in previous three years (Chart 3.9)[2]. Similarly, increasing preference for gold is reflected in a steep rise in gold import–GDP ratio in the past few years. Since 2009-10, gold import-GDP ratio has remained significantly above the trend (Chart 3.10). It needs to be noted that India exports a certain portion of its gold imports in the form of re-exports of gold jewelry, etc. However, gold re-exports as a percentage of total gold imports has declined from around 41 per cent to 29 per cent, which may be a concern for India's trade balance (Chart 3.11). This implies that a higher percentage of imported gold is now domestically used, deploying foreign exchange that could have been earned with gold re-exports. Furthermore, the import content in the form of raw material of gold in total gems and jewelry exports is estimated to be 16 per cent (an average of 2005-06

[2] Demand for gold at global level is on calendar year basis.

to 2009-10). This underscores that a large portion of gold imports is not used for creating exports. Increasing domestic consumption of gold import is clearly a concern for external sector sustainability.

Chart 3.9: Growth in Gold demand: Global vis-a-vis India

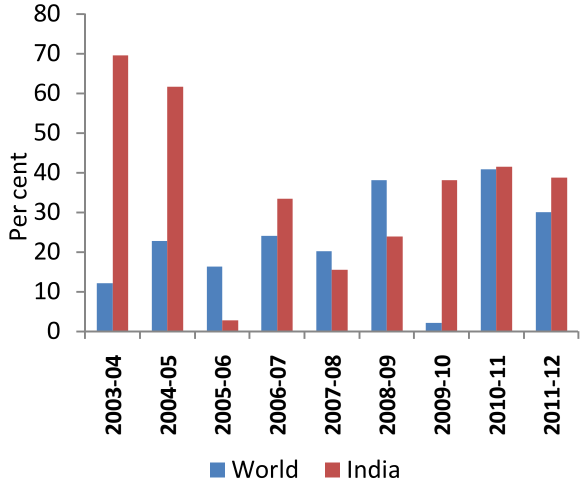


Chart 3.10: Gold Import as a Ratio to GDP

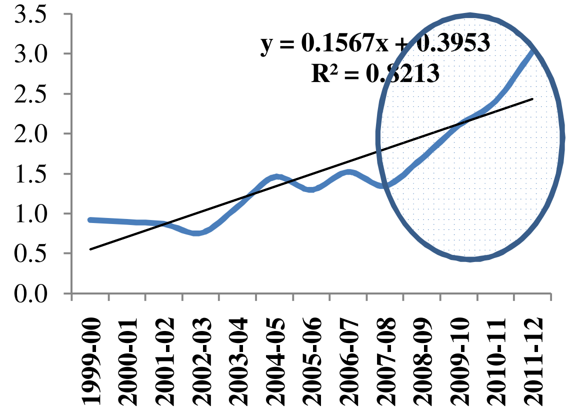


Chart 3.11: Share of Export of Gold Jewellery in Total Gold Imports

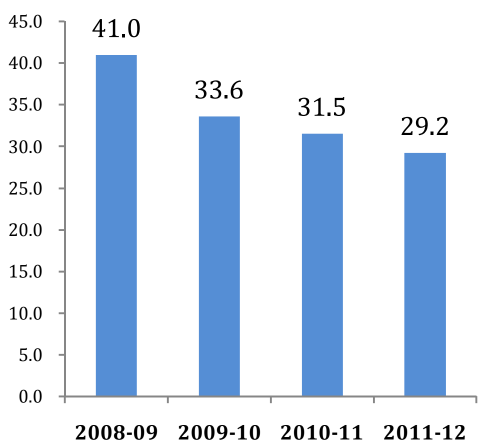
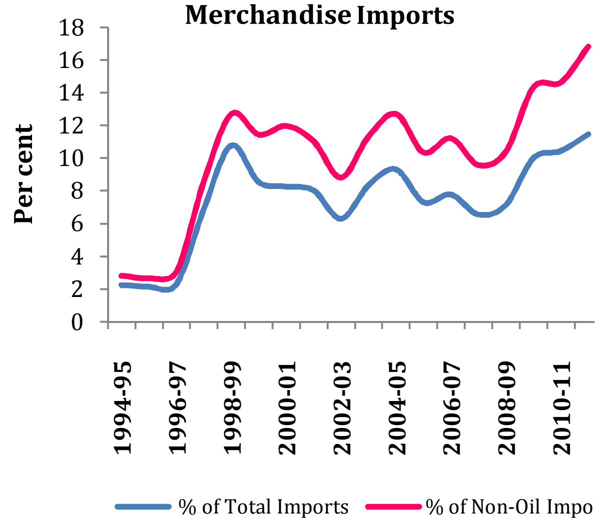


Chart 3.12: Share of Gold Imports in Merchandise Imports



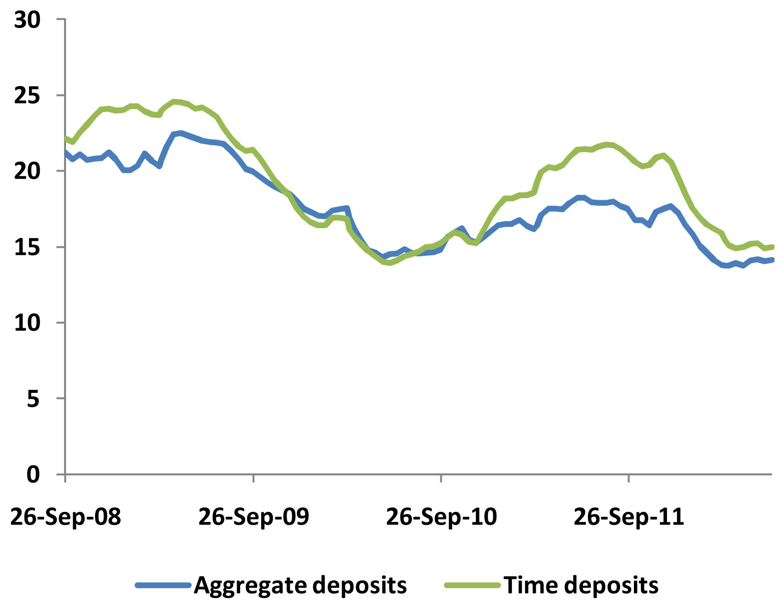
Source: DGCI&S and Gems and Jewellery Exports Promotion Council

What explains the spike in gold imports in the recent years?

3.15 As mentioned earlier, the volume of gold imports by India surged despite sharp increase in gold prices. Some possible explanations for the steep increase in demand for gold were considered by the Working group.

3.16 The Group's discussions with the gold market experts revealed that when the global financial crisis erupted in 2008, the investors were standing at the margin and disinclined to invest in various assets including gold for some quarters in 2008 and 2009 as there was gloom and uncertainty from the crisis related developments. This has led to postponing of the demand for gold investment by investors as they cling on to bank deposits (**Chart 3.13**). But, from the mid 2009 onwards investors have started re-entering the gold market in a big way and the gold imports started rising. The pent up demand for gold resulted in large gold imports thereafter.

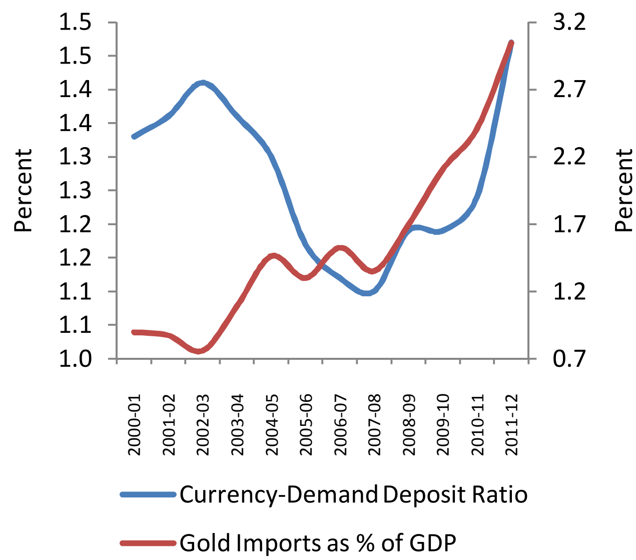
Chart 3.13: Three-year moving average rate of growth in bank deposits



3.17 Another reason for the increasing imports of gold by India was the sustained increase in gold prices in India. The gold prices have increased markedly over the period April 2008 to March 2012. Investors have reaped the benefit of attractive returns as the gold prices were increasing, that led to further investment in gold, giving impetus to further rise in gold prices. Rising prices of gold and imports of gold mutually reinforced each other. Investors seized the opportunity of investing in gold at temporary falls in gold prices.

3.18 Further, it is interesting to take note of the trends in currency with public as ratio to demand deposits (CP-DD) observed since 2008-09. CP-DD ratio, which showed declining trend from 1.4 per cent in 2003-04 to 1.1 per cent in 2007-08, began to increase in 2008-09 and reached 1.5 per cent in 2011-12 (Chart 3.14). It implies that public's preference for cash holding increased significantly during these years. Furthermore, average growth in currency with public was 18.0 per during 2008-09 to 2010-11, significantly higher than 15.4 per cent during 2005-06 to 2007-08. High CP-DD ratio in recent years might be partly reflecting increase in high value cash transactions and a part of that perhaps took place for gold purchases in recent years. Gold deals in the grey market are said to be cash-based. The possibility of large informal transactions involving huge money in recent years flowing into gold cannot be ruled out, though; this cannot be verified and authenticated by the Working Group.

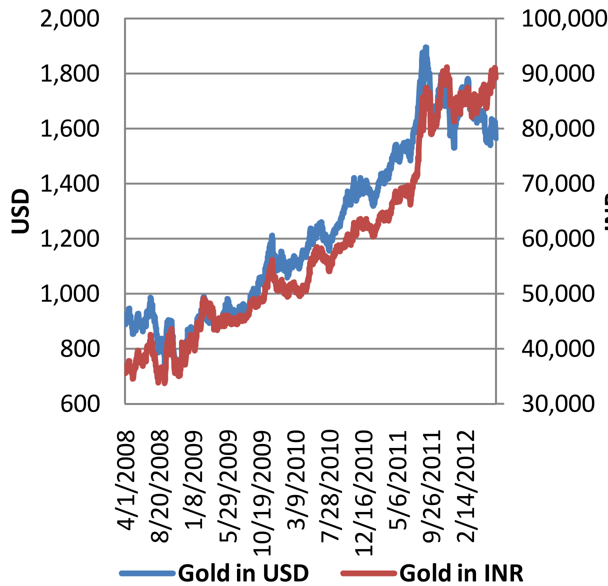
Chart 3.14: Trend in Currency - Demand Deposit Ratio and Gold Imports-GDP Ratio



Impact of exchange rate depreciation on gold prices in India

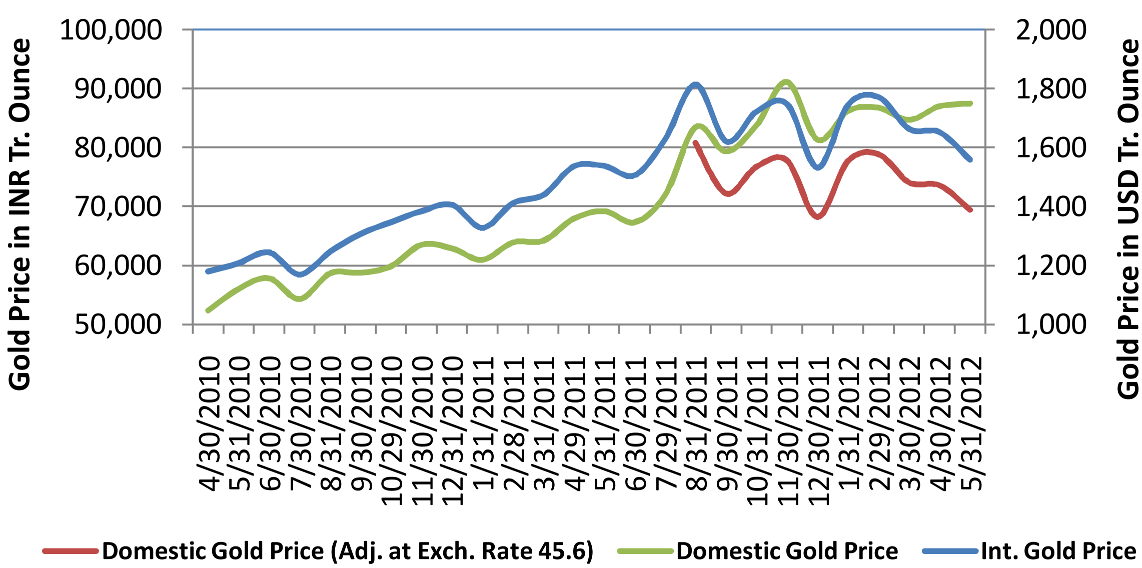
3.19 In the more recent months, the international price of gold in Indian Rupees and US Dollar show divergence, especially from August 2011 mainly due to depreciation of Rupee against Dollar (Chart 3.15).

Chart 3.15: Gold Price in USD and INR



3.20 To explain the effect of depreciation, we have assumed the exchange rate at 45.6 (which was the actual rate at end August 2011) and calculated the monthly price in recent period starting from August 2011. The real domestic price of gold in the absence of exchange rate depreciation would have been Rs.69,000 per troy ounce instead of actual price of Rs.88,000 at end-June 2012 (Chart 3.16). This indicates the impact of depreciation of Rupee against Dollar on domestic price of gold.

Chart 3.16: International and Domestic Gold Prices



3.21 Therefore, in addition to the known core demand for gold jewellery and investment, a host of other factors could have played the role in the spike witnessed in the gold imports in the recent years. Some of the factors are not recurring in nature and, therefore, may not further increase the demand for gold in medium term and the gold imports should, hopefully, revert to the trend growth in medium term.

III. Gold imports and Current Account Sustainability

3.22 It is generally considered that a CAD of 2.5 to 3.0 per cent is sustainable for India. In 2011-12, external sector resilience has weakened mainly due to higher current account deficit, which in turn was largely on account of worsening trade deficit Chart 3.12. The trade deficit increased on account of a host of global and domestic factors, which led to moderate growth in merchandise exports and higher growth in imports. Two commodities that led to higher imports were POL and gold. Gold contributed nearly 30 per cent of trade deficit during 2009-10 to 2011-12, which is significantly higher than 20 per cent during 2006-07 to 2008-09. Analysis shows that trade deficit without net gold imports would have been 2.1 percentage points of GDP lower than that recorded during 2011-12 (Chart 3.17). Accordingly, it would have reduced the CAD to the same extent in 2011-12. It is also estimated that had the export content of gold import been maintained at 41.0 per cent (as was in 2008-09), in subsequent years, the trade deficit as a percentage to GDP would have been 9.7 per cent in 2011-12, instead of historic high of 10 per cent. In other words, due to falling gold re-exports, India's trade deficit as well as CAD as ratio to GDP worsened by 0.3 percentage points in 2011-12 (Chart 3.18). The impact of gold imports on Current Account is portrayed in Table 3.4.

Chart 3.17: India's Trade Deficit with and without Gold Imports

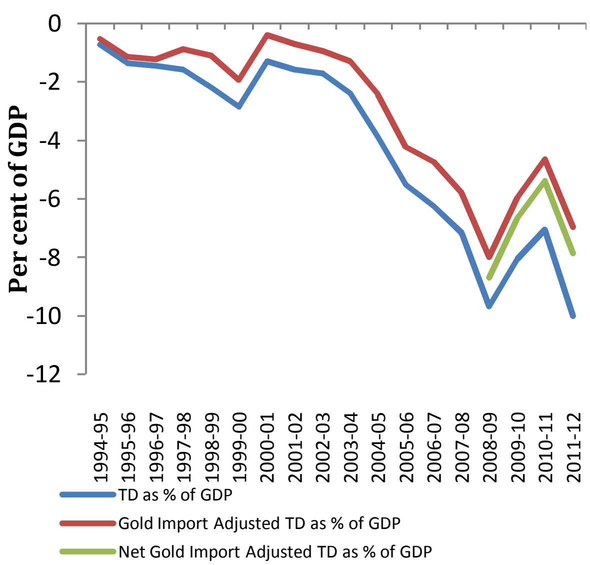
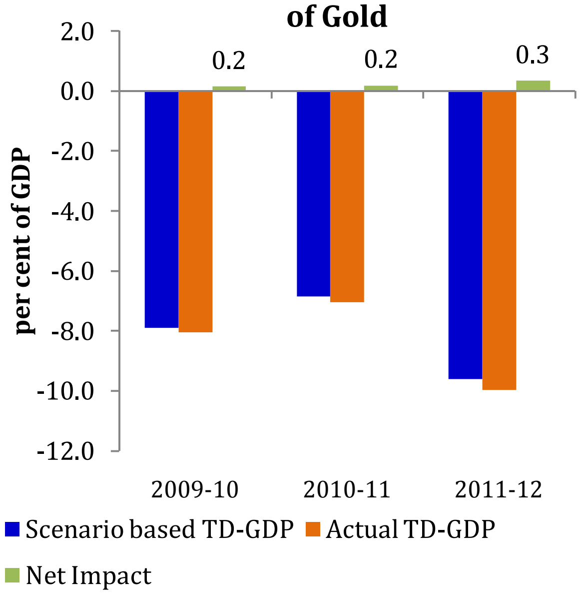


Chart 3.18: Net Impact on Trade Deficit due to Domestic Demand of Gold



Source: DGCI&S

Table 3.4: Gold Imports and Current Account Balance					
Items/Year	**2007-08**	**2008-09**	**2009-10**	**2010-11**	**2011-12**
1. Current Account Deficit (US $ billion)	**-15.7**	**-27.9**	**-38.2**	**-46.0**	**-78.2**
2. Current Account Balance as a Ratio of GDP (%)	**-1.3**	**-2.3**	**-2.8**	**-2.7**	**-4.2**
3. Gold Imports (in $ billion)	**16.7**	**20.7**	**28.6**	**40.5**	**56.2**
4. Gold Exports* (in $ billion)	**3.0**	**4.2**	**4.3**	**6.1**	**7.0**
5. Gold Imports (Net Value in $ billion: 3-4)	**13.7**	**16.5**	**24.3**	**34.4**	**49.2**
6. Gold Imports as % of GDP	**1.3**	**1.7**	**2.1**	**2.4**	**3.0**
7. Net Gold Imports as % of GDP	**1.1**	**1.3**	**1.8**	**2.0**	**2.7**
8. Gold Imports as a ratio of CAB	**106.4**	**74.2**	**74.9**	**88.0**	**71.9**
9. Net Gold Imports as ratio of CAB	**87.3**	**59.1**	**63.6**	**74.8**	**62.9**

*: Imputed Figure consists of 15% of exports of 'Gems and Jewellery'

Impact of gold imports on India's external sector stability

3.23 Gold has been imported mainly through designated banks and MMTC. During 2009-10, 2010-11 and 2011-12, gold imports through designated banks amounted to 547 tonnes, 634 tonnes and 603 tonnes respectively. During 2011-12, gold imports through banks are estimated to be around 56 per cent of total gold imports.

3.24 According to the research by the World Gold Council, the future gold purchase intent in India has remained stable in recent years despite sharp increase in prices. According to CMIE, due to the launch of gold related mutual funds and ETFs, the demand for gold as an investment option is likely to remain high and is projected to grow by at least 3 per cent per annum up to 2020-21. CMIE's estimate appears to be conservative, given the fact that import of gold grew by more than 12.0 per annum during 2009-10 to 2011-12.

3.25 In order to examine the impact of gold imports on India's external sector performance in general and trade deficit in particular, five alternative scenarios are assumed based on growth in quantity of gold imports, international gold prices and export content of imports. For estimating India's Nominal GDP in terms of US dollar, IMF's projections of growth for GDP at current prices (in US$) have been used. Other assumptions under various scenarios are given in Table 3.5.

Table 3.5: Assumptions under Five Scenarios		
Annual Growth in Quantum of Gold Imports (%)	International Gold Prices (US$ per troy ounce)	Export (gold jewellery) content of gold (% of Gold Imports)
3	1645.2	29.2
3	1750.0	29.2
5	1645.2	29.2
5	1750.0	29.2
10	1750.0	29.2

3.26 Under the first scenario, wherein the gold import growth remains at 3 per cent per annum and the average international gold prices remain at US$ 1645 per troy ounce (average of 2011-12) , total quantity is estimated to reach 1,158 tonnes by 2014-15 and the total value of import would be around US$ 61.2 billion. Under this scenario, contribution of net imports of gold to the trade and CAD (as ratio to GDP) would be around 1.8 percentage points in 2014-15 (Table 3.6).

Table 3.6: Scenario 1- Imp Gold Qty Gr. 3% p.a, Int. gold price = US$ 1645.2 per troy ounce, Export content of Import=29.2%

	Gold Import		Gold Export	Gold Trade Deficit (GTD)	GTD as % of GDP
Year	Qty (Tonnes)	Value (US$ Million)	Value (US$ Million)	Value (US$ Million)	
2011-12	1,059.7	55,962.3*	16,520.7	-39,441.6	-2.1
2012-13	1,091.5	57,732.3	16,857.8	-40,874.5	-2.0
2013-14	1,124.2	59,464.3	17,363.6	-42,100.7	-1.9
2014-15	1,157.9	61,248.2	17,884.5	-43,363.7	-1.8

*: Data has been later revised to US$ 56249 Million by DGCI&S.

Table 3.7: Scenario 2- Imp Gold Qty Gr.3% p.a, Int. gold price = US$ 1750 per troy ounce, Export content of Import=29.2%

	Gold Import		Gold Export	Gold Trade Deficit	GTD as % of GDP
Year	Qty (Tonnes)	Value (US$ Million)	Value (US$ Million)	Value (US$ Million)	
2011-12	1059.7	55962.3	16520.7	-39441.6	-2.1
2012-13	1112.7	61409.9	17931.7	-43478.2	-2.2
2013-14	1168.3	63252.2	18469.6	-44782.5	-2.1
2014-15	1226.7	65149.7	19023.7	-46126.0	-1.9

3.27 Under scenario 2, wherein growth of 3 per cent in gold imports and higher international gold prices are assumed, the gold trade deficit as ratio of GDP turns out to be 2.1 per cent in 2012-13 which declines to 1.9 per cent by 2014-15 and the same impact will be reflected in overall trade and current account deficit (Table 3.7).

Table 3.8: Scenario 3 - Imp Gold Qty Gr.5% p.a, Int. gold price = US$ 1645.2 per troy ounce, Export content of Import=29.2%					
	Gold Import		Gold Export	Gold Trade Deficit	GTD as % of GDP
Year	Qty (Tonnes)	Value (US$ Million)	Value (US$ Million)	Value (US$ Million)	
2011-12	1,059.7	55,962.3	16,520.7	-39,441.6	-2.1
2012-13	1,112.7	58,853.3	17,185.2	-41,668.1	-2.1
2013-14	1,168.3	61,796.0	18,044.4	-43,751.6	-2.0
2014-15	1,226.7	64,885.8	18,946.6	-45,939.1	-1.9

3.28 Under the third scenario, wherein higher growth of 5 per cent in gold imports along with international gold price at US$ 1645.2 per troy ounce is assumed, it is estimated that gold trade deficit as ratio to GDP will be remain at 2.1 per cent in 2012-13 which declines to 1.9 per cent by 2014-15 (Table 3.8). However, under the fourth scenario, wherein higher growth of 5 per cent in gold import along with higher international gold prices are assumed, the trade deficit to GDP ratio would be around 2.2 per cent in 2012-13 and 2.0 per cent in 2014-15 (Table 3.9).

3.29 Under a scenario of gold imports growing by 10 per cent and international gold prices remaining on average at US$ 1750 per troy ounce in the next few years, it is estimated that gold trade deficit of 2.4 per cent of GDP would be reflected in trade and current account deficit in 2012-13 (Table 3.10).

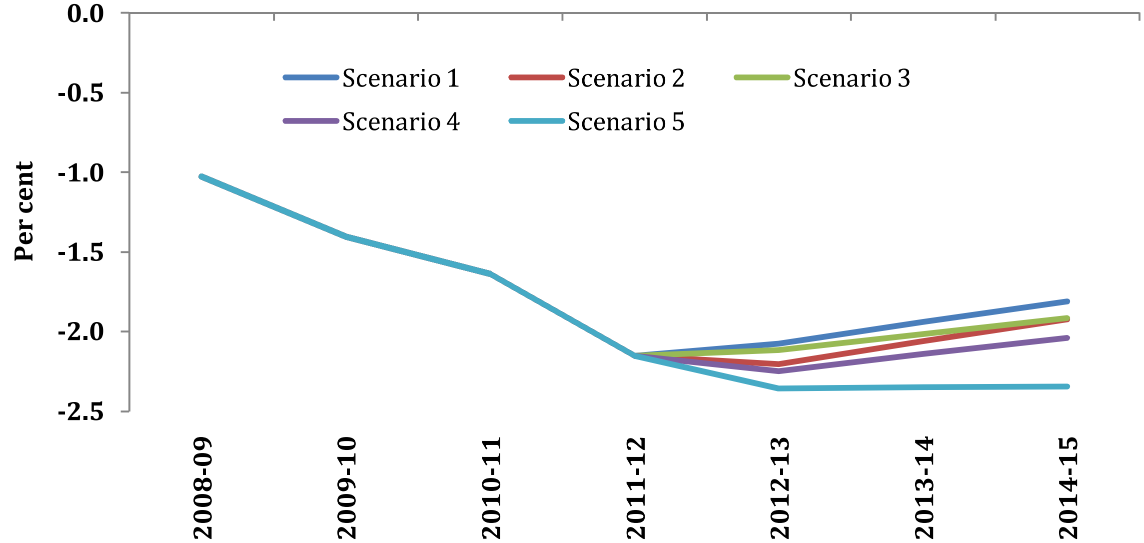
Table 3.9: Scenario 4 - Imp Gold Qty Gr.5% p.a, Int. gold price = US$ 1750 per troy ounce, Export content of Import=29.2%					
	Gold Import		Gold Export	Gold Trade Deficit	GTD as % of GDP
Year	Qty (Tonnes)	Value (US$ Million)	Value (US$ Million)	Value (US$ Million)	
2011-12	1,059.7	55,962.3	16,520.7	-39,441.6	-2.1
2012-13	1,112.7	62,602.3	18,279.9	-44,322.4	-2.2
2013-14	1,168.3	65,732.4	19,193.9	-46,538.5	-2.1
2014-15	1,226.7	69,019.0	20,153.6	-48,865.5	-2.0

Table 3.10: Scenario 5 - Imp Gold Qty Gr.10% p.a, Int. gold price = US$ 1750 per troy ounce, Export content of Import=29.2%					
	Gold Import		Gold Export	Gold Trade Deficit	GTD as % of GDP
Year	Qty (Tonnes)	Value (US$ Million)	Value (US$ Million)	Value (US$ Million)	
2011-12	1059.7	55962.3	16520.7	-39441.6	-2.1
2012-13	1165.6	65583.4	19150.3	-46433.0	-2.4
2013-14	1282.2	72141.7	21065.4	-51076.3	-2.4
2014-15	1410.4	79355.9	23171.9	-56183.9	-2.3

3.30 Above analysis shows that under various scenarios for gold import growth and international gold prices, the net gold imports as ratio to GDP is likely to be in range of 1.8 per cent to 2.4 per cent in next few years. To this extent, India's trade deficit and current account deficit will be adversely affected. Unless gold imports are converted into re-exports or volume of gold import does not moderate, increasing quantum of gold imports not only stresses India's CAD but would also be a drag on India's foreign exchange reserves.

3.31 In sum, during 2011-12, high trade deficit caused, *inter alia,* by high gold imports led to worsening of CAD. Had the gold imports in India grown by 24 per cent (an average of growth in world gold demand during part three years) instead of 39 per cent in 2011-12, the current account deficit would have been lower by approximately US$ 6 billion and CAD-GDP ratio would have been 3.9 per cent instead of 4.2 per cent. Even though capital flows were higher in 2011-12, they remained lower than required to finance high CAD. Consequently, there was a drawdown of forex reserves to the extent of US$ 12.8 billion. Drawdown of forex reserves has important implications for external sector vulnerability indicators, viz., import cover, ratio of reserves to external debt, in particular short-term debt which market players monitor closely. It may be noted that due to current account stress, partly emanating from high gold imports and insufficient capital inflows, various measures were taken to facilitate external flows through FII in corporate bonds and government securities, ECBs, NRI deposits, particularly in H2 of 2011-12. Since recourse to such flows pose implications for external debt (an increase of around US$ 22 billion in H2), there is a need to curb the stress in external sector emanating from current account, which to some extent has been caused by rise in gold imports in recent years. In a situation, when global economic and financial environment does not seem to be supportive of either export growth and foreign capital flows, such unproductive imports may prove to be costly in terms of loss of foreign exchange reserves. It is concluded that even if conservative assumptions under scenario 1 remain valid, the extent of gold trade deficit estimated for 2012-13 does not seem augur well for current account sustainability, which is generally considered to be 3 per cent of GDP. Stress in India's trade account has already been discernible in 2011-12 as net gold imports were as high as 2.1 per cent of GDP (Chart 3.19).

Chart 3.19: Gold Trade Deficit as % of GDP Under Various Scenarios



Source: Working Group's calculations

3.32 The Reserve Bank has developed an external vulnerability index[3] which takes into account various measures of solvency ratios designed to reflect the vulnerability of the Indian financial system to external risks. Since gold imports contribute significantly to current account deficit, it can be, by deduction, said to cause the country's external vulnerability to go up.

Recent Policy Measures

3.33 Recognising the implications of high imports of precious metals, gold in particular, the central government undertook certain measures in recent months. In January 2012, the import duty on gold was changed to 2 per cent of value from the flat duty of Rs. 300 per 10 gm while the same for silver was changed to 6 per cent from earlier duty of Rs. 1,500 per kg in January 2012. Recently, the Union Budget 2012-13 has proposed to increase basic customs duty on standard gold bars; gold coins of purity exceeding 99.5 per cent and platinum from 2 per cent to 4 per cent and on non-standard gold from 5 per cent to 10 per cent. Despite these measures, gold imports in Q4 of 2011-12 were higher than Q3 *albeit* growth in import of gold was negative in April 2012 probably reflecting the impact of gold jewellers' strike.

3.34 Given the high growth in demand for gold loans in the recent past, the Reserve bank announced certain measures which include the following:

[3] The External Vulnerability Index is based on a set of external solvency indicators designed to reflect the vulnerability of the Indian financial system to external crises. It consists of Current payments/Current receipts, Average monthly imports/Foreign exchange reserves, Share of short term debt in total debt, debt stock/GDP ratio, CAD/ GDP and Debt service ratio.

- Loan-to-Value (LTV) ratio not exceeding 60 per cent for loans against collateral of gold jewellery and a minimum Tier 1 capital of 12 per cent by April 1, 2014. It has also been stipulated that NBFCs should not grant any advance against bullion/primary gold and gold coins.

- Banks should reduce their regulatory exposure ceiling in a single NBFC, having gold loans to the extent of 50 per cent or more of its total financial assets, from the existing 10 per cent to 7.5 per cent of bank's capital funds. However, exposure ceiling may go up by 5 per cent, *i.e*., up to 12.5 per cent of bank's capital funds if the additional exposure is on account of funds on-lent by NBFCs to the infrastructure sector; and banks should have an internal sub-limit on their aggregate exposure to all such NBFCs, having gold loans to the extent of 50 per cent or more of their total financial assets, taken together.

3.35 Even though the impact of these measures on gold imports is yet to be seen in the period ahead, some moderation is evident in value of gold and silver imports during April-October 2012. However, the need is to continually monitor the trend in gold imports and undertake necessary steps, if warranted. Given the global economic growth conditions, there seems to be little scope for increase in the export content of gold imports, at least in the short-term. Therefore, measures to control gold imports seem to be more relevant.

IV. Conclusion

3.36 The large and growing demand for gold in India is putting a burden on India's current account balance. Domestic gold production is negligible and the resultant gold imports directly contribute to the widening of the current account deficit. Notwithstanding increasing prices of gold, the volumes of gold purchases are induced by the prospects of getting good appreciation. The gold imports appear to be price inelastic in India. In a country with over one billion population, with social customs warranting purchase of gold for specific occasions, irrespective of the price, there will be a core component of demand for gold imports. Emergence of a new class of investors who has appetite for investment in gold for real returns also adds to the demand and thereby to imports. In short, the current trend in quantum of gold imports appears to be making India's external sector vulnerable in terms of rising trade and current account deficits which, in the absence of adequate foreign capital flows, can have implications for maintaining adequate foreign exchange reserves buffer. While we coped up with such large imports, so far, if this trend continues the gold imports will have adverse implications for the external sector management, as export performance is not robust.

V. Recommendations:

There is a need to moderate the demand for gold imports

3.37 Large and sustained gold imports are a strain on the external sector's stability. Given the precarious global economic situation and its impact on the Indian exports, there is a clear need to reduce the CAD considerably. Due to falling gold re-exports, India's trade deficit as well as CAD as ratio to GDP worsened by 0.3 percentage points in 2011-12. Viewed from the fact that India has a large appetite for gold, it is desirable that the economy needs to moderate the demand for gold imports to bring down the CAD to a more sustainable level. Any strategy to reduce the demand for gold should have a combination of demand reduction measures, supply management steps and monetisation of gold. In this context, the Working Group has the following suggestions to make.

A. Demand reduction measures:

Fiscal measures to reduce the gold imports

3.38 Currently, there is a system of imposing import duty on *ad valorem* basis on gold imports. Recognising the implications of high imports of gold, the Government undertook certain fiscal measures in recent months to curb demand for gold as indicated in para 3.33 of this Report. Despite the measure, gold imports in Q4 of 2011-12 were higher than Q3. Growth in import of gold, however, was negative in April 2012 probably reflecting the impact of gold jewellers' strike. This move was intended to address the issue of reducing dollar outflows due to gold imports, which are hurting the current account. However, looking at the pattern of gold consumption in India and quantum of gold imports, raising the import duties did not seem to have had the desired impact on bringing down gold demand. If considered necessary and appropriate, further hike in the import duties may have to be contemplated to dissuade gold imports. But, due to the limitation of the fiscal route to curb the demand for gold imports, beyond a threshold, we cannot raise the import duty as it may lead to buyers taking recourse to purchases from unauthorised sources of supply. There are restrictions on carrying of gold and gold jewellery by incoming Indian community from abroad. If need be, this may also have to be reviewed to ensure that bringing gold into the country less attractive option. One major reason for investors to go after gold acquisition is that there are no significant hassles with reference to documenting the buying and selling transactions in gold leaving a paper trail to track the sales and purchases of gold and its ownership. No one really knows how much gold the other individual possess. Similarly, there is no need for paying any capital gains tax on the deals and no irritants like tax deducted at source for the sales and purchases of gold. Though the current rules stipulate that PAN card number has to be given beyond a limit for ornament purchases, many jewelry shops flout that norm. There is a strong need for plugging these loopholes to increase transparency in gold deals.

There is a need to design innovative financial instruments that can provide real returns

3.39 The real attraction for gold is clear and simple. High returns, high liquidity and no tax and documentation related hassles. If interest earned on various financial savings instruments is attractive and positive, a part of the demand for gold will be automatically diverted to the financial instruments. Demand for gold will come down commensurately with the availability of alternative instruments for investment with real rates of return. The fact that major portion of individuals' savings are channeling into physical assets, such as, gold and real estate indicates that there is vast scope for the banking system to take advantage of these opportunities. Growing demand for gold in the country especially in the rural side is an indication that households with high levels of savings are in need of instruments that are very easily accessible and equally attractive to gold in terms of return as well as liquidity. Banking sector should come forward to tap this huge untapped source of funds from being diverted to buy gold. It is necessary to introduce savings schemes and instruments that can provide real returns with high liquidity. However, the Group concedes that provision of real rates of return on savings presupposes prevalence of a low-inflation environment on a sustained basis. The schemes to be conceived should also ensure liquidity of the savings comparable to gold or gold jewellery. The dominant reason why a person may like to hold his savings in the form of gold is to hedge against inflation. Therefore, offering a real rate of interest considering the high inflation rate prevailing as an incentive on a financial instrument would better address the issue of excessive clamor for gold imports. Therefore, it is considered desirable that products analogous to Inflation Indexed Bonds may be considered as alternatives.

Investor education and literacy is important to convert rural and urban demand for physical gold into investment in gold related instruments

3.40 Investor education and financial literacy are critical in an environment where the people live in rural areas are not aware of the availability of gold-backed financial products or not having accessibility to invest in such gold-related products. In India the investment demand for gold has been lower when compared with the demand for gold for consumption purpose. The availability of and awareness about gold-backed financial instruments in India is very limited, especially in rural areas. However, this trend seems to be changing in recent years, with slowly picking up the investment demand for gold. With appropriate investor education about the positive aspects of investment in gold-backed financial products, it is possible to reduce the demand for physical gold or we can, at least, postpone the demand for gold to future. There is a possibility to attract investment demand for gold with the spread of financial literacy to entice investment in gold-backed and gold related investment instruments. This may bring down demand for physical gold. Steps need to be taken to enhance awareness of potential physical gold buyers to the alternatives available with good returns and liquidity.

There is a need to introduce new gold-backed financial products to reduce the demand for physical gold

3.41 There is a need to consider introducing new gold-backed financial products to reduce the demand for physical gold. Products that may be considered are Modified Gold Deposit Scheme (gold taken as a deposit is recycled for meeting domestic demand and given back at the time of maturity); Gold Accumulation Plan (the product is a saving plan catered to even small buyers of gold in which the gold imports are deferred till the time of actual delivery of gold); Gold Linked Account (the entire transaction takes place outside India and import of gold is not involved); and Gold Pension Product (the customer surrenders gold to the bank on agreement to receive streams of monthly pension till his death). Careful evaluation of the feasibility of introducing each proposed gold-backed product is critical.

Limits on the volume and value of gold to be imported by canalising agencies and nominated banks

3.42 The canalising agencies like MMTC, STC and the nominated banks are playing a major role in canalising gold imports into the country. The imports through banking channel are about 56 per cent of total gold imports. These imports are largely for selling gold to jewellery manufacturers and at retail level. Setting value or quantum limits for canalising agencies and banks to import gold can also reduce the demand for gold. Such limits can be reviewed periodically. However, the Group recognises the fact that choking supply channels cannot be an appropriate way to reduce the demand unless under compelling circumstances. We need to address the excessive demand issue.

Imposing export obligation on importers

3.43 It may be noted that the share of gold re-exported with value addition from the country as a proportion to gold imported is declining steadily (Chart 3.11 page 28 of the Report). In this context, such of those entities importing bulk gold through banking and non-banking channels can be asked to an export obligation based on a certain percentage of imports of the gold.

B. Supply-related measures:

Recycling of domestic gold

3.44 Temples in India holds large quantities of gold jewellery offered by devotees to the deities. There is also significant amount of scrap gold in the country. Some estimates say that scrap gold that comes into the system is nearly 300 tonnes per annum. It would be worth trying to channel the existing supplies of scrap gold in the country into the financial system, so that the unproductive nature of the gold asset is turned into a financially-productive medium. Presently canalising agencies are used as a unidirectional channel to import and sell gold and gold coins in the country. The Group wonders whether these canalising agencies can be made bi-directional channels, i.e., they be allowed to buy back the tamper proof gold coins at transparent prices. For this, canalising agencies and nominated banks can offer a two way quote with very little margin. This would facilitate the agencies to recycle domestically available gold rather than import and sell gold. This would also be more attractive because the price fetched by the customer from the agencies is relatively higher with less loss when compared with any the price offered seller of gold coins to jewellery shops. This step has the potential to reduce the demand for gold imports by facilitating availability of domestically idling gold stocks. It may, however, be recognised that the rationale for allowing banks to buyback gold coins would be with the expectation that this may reduce the import of gold through recycling of domestic gold. The Working Group is conscious of the fact that the opposite outcome is also a possibility as the availability of two-way quotes may increase the attractiveness of gold purchase and hence the demand for gold. Therefore, under the current situation of high current account deficit, status quo of giving only a sale quote for gold coins by the nominated banks may be considered. Subsequently, when the CAD declines to a sustainable level and as considered appropriate from time to time, Reserve Bank may permit banks to offer two-way quotes. Such of those banks that may opt for both buying and selling gold coins will have to manage the sum of consequential risks, which may not be different from other trading risks. While permitting the banks to offer two-way quotes, Reserve Bank will also have to consider any macroeconomic risks (other than the possible impact on CAD) because of the special nature of gold.

Introduction of tax incentives on instruments that can impound gold

3.45 Gold Bonds and Gold Deposits Schemes that may encourage gold holders to deposit their idle gold holdings with banks can be designed with in-built tax incentives by Government. This would encourage investors to invest in gold bonds. The impounded gold through gold bonds can be used to reduce the demand for gold imports. There can be a lock in period. This would impound domestic gold in various forms, such as jewels, ornaments and coins. While making this suggestion, the Group is conscious of the fact that currently only around 3 per cent of the population has income above the minimum limit chargeable to tax under Income Tax Act. With the majority of the gold buyers hailing from rural areas, a view prevails that the rural people are even otherwise not subjected to income tax and therefore fiscal incentive route may not be effective. However, the Group makes this suggestion keeping in view High Networth Individuals who are holding idle gold who may opt for the instruments with fiscal sops to diversify their portfolios.

C. Measures to increase the monetisation of gold

Banks may be encouraged to expand their gold jewellery loan portfolio

3.46 There is great scope for expanding financial inclusion in extending gold jewellery loans. If banks continue to increase their gold jewellery loans portfolio, the reliance of economically weaker sections of the society on money lenders and pawn brokers will come down considerably. Banks may make the gold jewellery product more flexible and encourage people to avail this fully collaterilised loan for all types of productive purposes. This greatly facilitates monetisation of huge stocks of gold in the country. Given the superior quality of gold as collateral, the prudential norms like risk weights and provisioning on gold loans may be softer than other loans.

Setting up of a bullion corporation

3.47 It may be recalled that in the Union Budget of February 1992, it was announced an intention to set up a gold bank, which would undertake various types of operations in gold. The Group believes that there is a need to revisit the earlier debate on setting up of Gold Corporation or Gold Bank in India. The purpose of the suggested gold corporation can be as a 'backstop facility' to provide refinance to institutions lending against the collateral of gold or besides being a backstop facility, it can also undertake retailing functions in gold including pooling of idle gold in the system. On the other extreme, the gold corporation may be empowered with wide-ranging activities related to the entire spectrum of gold policies. The gold corporation can make official purchases and sales of gold. It may issue gold bonds and collect the gold stocks. The objectives of such gold corporation can also be to mobilising domestic non-official gold holdings; channelise them into a centralised pool over a period of time and to deploy them in a productive manner in the best interests of growth and development of the country. The corporation can be authorized to buy and sell gold on their behalf and on behalf of their clients. The suggested gold corporation may be empowered to handle the country's gold reserves. In sum, the gold bank may be given powers to import, export, trade, lend and borrow gold and deal in gold derivatives. Its role should be that of an intermediary in gold transactions, providing liquidity to holders of gold. The proposed gold bank may take care of the liquidity needs of gold holders. As the central banks world over have been fortifying their reserves by enhancing the share of gold, it is logical to expect that the suggested gold corporation can be nurtured under the Reserve Bank's umbrella. The modalities to setup the Gold Bank can be examined by the Reserve Bank through preparation of a concept paper.

3.48 In the ultimate analysis, demand for gold is a function of economic growth, prevailing import duty, exchange rate, inflation, interest rates, availability of alternative financial instruments and investment options, easy availability of credit and the magnitude of current account transactions. Any strategy to reduce the demand for gold will have to consider the feasibility of bringing necessary changes in each one of these parameters to evolve an appropriate gold policy. The crux of the problem is the absence of financial instruments that provide flexible liquidity options, while providing real rate of return to investors. Part of the solution lies in innovating them to provide hedge against inflation to the investors.

4. Role of Banks in Gold Imports and Retailing Gold Coins

4.1 Gold is canalised into the country by authorised agencies like the Minerals and Metals Trading Corporation, State Trading Corporation and nominated commercial banks. Banks have been playing significant role in importing gold into the country and retailing gold coins through their branches. Approximately 56 per cent of the gold imported into the country was canalised by the nominated banks. The role of banks in gold is multi-fold. Banks provide loans against the collateral of gold jewellery; they canalise gold for the purpose of providing gold to the gold jewellery industry and also sell retail gold in coins through their branch network. However, banks are not authorised to finance purchase of gold. In this context, there are concerns that whether the import deals of banks in gold and sale of gold by banks through imports to individuals is feeding into the appetite for gold. Therefore, whether the large scale participation of banking sector in the gold imports and related activities is fueling the demand for gold is a question needs to be reviewed.

4.2 In this context, the Working Group examined the present status of gold imports by the commercial banks and merits and adverse implications of such large scale gold imports by the banks.

I. Background

Conscious liberalisation of gold imports

4.3 Before 1992, gold used to be brought into the country through unauthorised channels due to high domestic demand and low domestic production along with a ban on import of gold under the then existing Gold Control Act, 1968. Government of India started liberalizing import of gold from 1992. Under the liberalised policy for gold import, Government of India permitted import of gold by certain nominated agencies viz. Minerals and Metals Trading Corporation, Handicrafts and Handlooms Export Corporation, State Trading Corporation, State Bank of India and other agencies authorised by Reserve Bank of India.

The Standing Committee on Gold and Precious Metals

4.4 The Standing Committee on Gold and Precious Metals was set up by the Reserve Bank in 1993 for evolving an integrated national gold policy. The Committee was subsequently reconstituted and included representatives from Ministry of Commerce, Ministry of Finance. The reconstituted Committee recommended that the import-export policy may be modified to incorporate a provision to allow banks authorized by the Reserve Bank to import gold on consignment or outright purchase basis subject to terms, conditions and prudential regulations prescribed by the Reserve Bank. It recommended that gold imported through banks may also be permitted to be utilised for domestic consumption. The Committee listed the following merits in import of gold through banks: Imports would be undertaken by regulated and supervised entities. In fact all over the world, the bullion trade is largely in the hands of banks and FIs specializing in this area; the quality of the gold, which is a critical factor in trading, consumption and exports can be assured; there would be proper accounting of the sales undertaken by banks and will ensure transparency of prices and facilitate regulation over the trade, per se; the gold market, as in the case of forex market, can develop along sound lines acquiring a good reputation. In times to come, India could emerge as a leading bullion centre in this part of the world; and relationship and association with the international bullion banks would ensure competitive pricing and banks having such specialisation would be keen to enter this area of activity in India.

Views of the Committee on Capital Account Convertibility

4.5 The Committee on Capital Account Convertibility (CCAC Chairman: Shri S.S.Tarapore) in its Report had recommended in 1997 that it was essential to liberalise the policy on gold, while simultaneously taking steps to develop a transparent and well regulated market in gold, which would be integrated with other financial markets. The main ingredients of the change in the policy on gold should be: removal of restrictions on import and export of gold, which would curb smuggling and hoarding; development of gold-related financial instruments; development of markets for physical and financial gold; and encouragement of banks and non-banks to participate in gold market.

Grant of authorisation to agencies by the Reserve Bank

4.6 Accordingly, on August 16, 1997, action required to grant authorisation to agencies by the Reserve Bank for import of gold / silver / platinum inter-alia states under provisions of Section 6(1) (a) of the Banking Regulation Act, was initiated, which facilitated banks dealings in bullion and specie. The term "bullion" was not specifically defined in the Banking Regulation Act. Reserve Bank's Legal Department examined and advised that the term bullion would include gold and silver as bullion means metal in bulk before coining or value by weight and specie means coin money. Similarly, Para 4A.4 of the extant Foreign Trade Policy (2009-14) includes agencies authorised by the Reserve Bank among the list of nominated agencies authorised to import gold. However, the Reserve Bank do have the powers and prerogative not to grant authorisation or renewal of authorisation to the banks for importing gold notwithstanding Section 6(1) (a) of the Banking Regulation Act, 1949, allowing banks to deal in bullion and specie or the above provisions of Foreign Trade Policy enabling RBI to authorize nominated agencies for gold import. Further, the prohibition of trading in goods under Section 8 of BR Act also does not apply to "bullion and specie.

Current eligibility criteria for banks to apply for authorisation as nominated agency for import of gold

4.7 The current eligibility criteria as per the Press Release dated March 1, 2006, inter-alia, include the following: the applicant entity should be a scheduled commercial bank; it should have unimpaired total capital of Rs.300 crore; its ratio of total capital to risk-weighted assets for business in India should be at least 9 per cent; it should have fairly advanced risk-management system in place; it should have excellent track record both in terms of business reputation history of compliance vis-à-vis legal and regulatory norms/requirements; and it should have previous experience or familiarity in respect of gold-related business activities.

II. Gold Import Schemes

4.8 In terms of FED's Master Circular dated July 1, 2011 on import of Gold by Nominated Banks/Agencies; Gold can be imported in the following ways:

A. Import of Gold on loan basis

(i) By nominated agencies / authorised banks for on lending to exporters of jewellery

(ii) By EOUs and units in SEZ in the gem and jewellery sector for manufacturing and export of jewellery

(iii) The maximum tenor of gold loan would be as per current Foreign Trade Policy (2009-14), which is 270 days at present.

B. Direct Import of Gold

AD Category-I bank can open Letters of Credit and allow remittances on behalf of EOUs, units in SEZs in the gem and jewellery sector and the nominated agencies / banks for direct import of gold.

C. Import of Gold on Consignment basis

Gold may be imported by the nominated banks/agencies on consignment basis wherein the ownership of the goods will rest with the supplier and the importer (consignee) will be acting as an agent of the supplier (consignor). Remittances towards the cost of import shall be made as and when sales take place as per the provisions of agreement entered into between the overseas supplier (consignor) and nominated agency/bank (consignee).

D. *Import of gold on unfixed price basis*

The nominated agency/authorised bank may import gold on outright purchase basis subject to the condition that although ownership of the gold shall be passed on to the importer at the time of import itself, the price of gold shall be fixed later/ as and when the importer sells the gold to the users (11 days as per the FCRA, 1952 / cf.DBOD.IBS.669/23.67.001/2002-03 dated October 7, 2002).

4.9 Bulk of the gold is imported on consignment basis, because it does not lead to any price risk to the Nominated Agencies. Nominated Agencies including banks authorised by the Reserve Bank, import gold for supplying to exporters of jewellery and domestic jewellery manufacturers and also for sale of gold TT bars/and coins to the retail customers. The Group is of the view that under the current import regulations (refer to FEMA Master Circular), there is a preferential and more favourable treatment for gold as compared to import of any other item, including essential imports. As explained above, import of gold is permitted: i) on consignment basis ii) on unfixed price basis and iii) metal loan basis. This preferential treatment makes gold imports free from both price and currency risks for consignors as effectively it amounts to their short selling of gold in India and simultaneously covering their short position abroad, with both the risks being borne by end-buyers of jewellery and gold ETFs. This is not the case with other items, say, coal, edible oils etc, which are imported on direct import basis.

III. Measures taken for regulating bank and NBFC finance for purchase of gold and loans against security of Gold

Bank finance for the purchase of gold

4.10 In terms of guidelines contained in circular DBOD.Leg.BC.74/c.124 (P)-78 dated June 1, 1978, banks were advised to ensure that *no* advances should be granted against gold bullion to dealers and traders in gold if in their assessment such advances are likely to be utilised for purposes of financing gold purchases at the auctions and or speculative holding of stocks of bullion. There were no restrictions on extending working capital finance and packing credit to exporters of gold jewellery. Although there is no explicit prohibition on bank finance for the purchase of gold jewellery/coins, banks are generally not financing acquisition of gold, except, a few banks.

Bank lending against collateral security of gold

4.11 Banks were advised vide Reserve Bank circular DBOD.No.Leg.BC.95/C.124 (P)-78 dated July 22, 1978 not to grant or renew any loan against gold bullion. As regards granting of loan against gold jewellery and ornaments, in terms of various circulars dated December 20, 1976, October 15, 1981, November 22, 1994 and November 2, 2005, banks were advised that such loans may be granted subject to the condition that they are not used for speculative purposes. While granting loan against jewellery, banks were advised to consider the advantages of hallmarked jewellery and decide on the margin and rates of interest thereon. Loans against other gold ornaments and jewellery were to be discouraged. Loans against the collateral security of gold ornaments could be granted for consumption purposes up to rupees one thousand. Subsequently, this ceiling was raised to rupees twenty five thousand and later *removed* vide circular DBOD.No.BC.138/21.01.023/94 dated November 22, 1994. Banks were permitted to stipulate such ceiling as considered appropriate.

4.12 As regards loans against pledge of specially minted gold coins, through clarification dated April 5, 2011, banks were advised that specially minted gold coins sold by banks/other banks cannot be treated as 'bullion' or 'primary gold' and hence there is no objection to banks granting loans against such coins. However, these loans may be covered under the policy framed by the bank's Board, in terms of the circular dated November 22, 1994*(ibid)* and banks should ensure that the end use of the funds is for approved, non-speculative purposes.

Lending Against Gold Jewellery by NBFCs:

4.13 It was observed that NBFCs, predominantly engaged in lending against the collateral of gold jewellery had recorded exponential growth in recent years both in terms of size of their balance sheet and physical presence. Based on the number of complaints received against such companies, it is apparent that the mammoth expansion had taken place at the cost of sound internal controls. Several undesirable features such as poor KYC compliance, poor storage facilities for gold accepted as collateral, increased incidences of frauds and robberies, opaque auction procedures all pointed towards rising operational risk as well as consumer protection issues in such companies. These concerns along with the inherent concentration risk that such NBFCs face, their exposure to adverse movement of gold prices and increased dependence on public funds including bank finance and non-convertible debentures issued to retail investors have prompted RBI to issue certain measures vide circular DNBS.CC.PD.No.265/03.10.01/2011-12 March 21, 2012. These measures have already been highlighted elsewhere in this Report.

III. Present status of gold imports by banks and the case for continuation of banks as canalising institutions

4.14 Banks deal with gold transactions routinely in many countries. In India, at present, there are 36 Nominated Banks authorised by RBI for importing gold. Of these, only 27 banks actually imported gold. Fourteen banks imported more than one tonne of gold during the financial year 2011-12. Bank of Nova Scotia had the largest share (39 per cent) of the total gold imported by all the Nominated Banks during 2011-12. During 2011-12, about 59.0 per cent of the gold was imported through the banks. These imports cater to the bulk requirements of the jewellery manufacturers. Banks have been meeting the requirements of re-exports of gold in the form of jewellery. We need to be careful about singling out banks for imposing curbs on gold imports and the Group is of the view that this measure may not serve the purpose. Nominated banks are the major suppliers of gold to the domestic jewellery manufacturers and the exporters of jewellery. Therefore, they along with Government nominated agencies as MMTC, HHEC and STC are able to meet the high domestic demand of gold. It is difficult to relate the imports of gold by banks are leading to higher imports of gold in India. The demand for gold is governed by numerous factors as elucidated elsewhere in this Report including the demand from the jewellery manufacturers, the demand for which is seemingly inelastic. Therefore, if banks do not import gold, then demand for gold imported by the Government nominated agencies could show a proportionate and large increase. The intended purpose of reducing the demand for gold may not be served. If RBI asks banks to desist import of gold, the unmet demand would be met through higher import of gold by the Government nominated agencies or possibly by unauthorised channels.

4.15 The quantity and value of gold imported along with its break-up between gold bars and coins for last three financial years (April-March) were as shown in Table 1. It may be seen that the share of gold imported by banks as a proportion to the total gold imports is gradually coming down. However, the share of gold coins has been inching up. But, it may be stated that gold coins imported by banks form a negligible portion of the total gold imported (Table 4.1).

Table 4.1: Import of gold by the Nominated Banks*

Financial Year	Imports of bars by the Nominated Banks (Tonnes)	Import of Coins by the Nominated Banks (Tonnes)	Total Imports by the Nominated Banks (Tonnes)*	Total Imports of Gold (Tonnes) **	Total Imports by the Nominated Banks as a per cent of Total Gold Imports	Gold coins imported by banks as a per cent of Total Gold Imports of Nominated Banks	Gold coins imported by banks as a per cent of Total Gold Imports
2009-10	541	6	547	851	64.3	1.1	0.7
2010-11	625	9	634	970	65.4	1.4	0.9
2011-12	580	23	603	1079	55.9	3.8	2.1

* **Data for the nominated banks compiled by Reserve Bank (DBOD) from their monthly statements.**

** **DGCI&S Data**

IV. Sale of gold coins by banks to individuals

4.16 A related concern is whether there is a case for banks to sell retail gold in the form of coins and medallions from the branch network? Whether, we should stop such retailing selling of gold? Since there is a demand for gold coins and medallions of different denominations by the members of public as a channel for investment and hedge against inflation, banks import gold coins. Since there has not been any macroeconomic concern, so far, we have allowed banks to import gold coins also along with gold bars. If required, we may stop import of gold coins by the nominated banks and their distribution through the branch network of the nominated banks. It would need to be appreciated that demand from domestic users of gold will not go away simply because banks are not in the fray. This demand is fuelled by more attractive returns on investments in gold as an asset class as compared to other asset classes on account of economic conditions in the country and has nothing to do with which or how many agencies are allowed to import gold. It would be important to note that unless the Foreign Trade Policy decides to levy higher duties and otherwise take steps to discourage gold consumption, especially among domestic users, the number of agencies for importing gold may not make much difference.

V. Gold jewellery loans by commercial banks

4.17 Banks, in general, extended gold loans as part of the agricultural and priority sector loans till recent past. In order to restrict the flow of funds from banks to NBFCs actively engaged in gold loan business, it was decided that gold loan portfolio buyouts and lending to gold loan NBFCs by banks will no more be eligible to be counted as priority sector lending. Banks did not go out of the way to promote this segment of the business like the way the NBFCs are pursuing. The major reason being that the security of maintaining the gold ornaments, ensuring the good quality of ornaments by appointing assayers/ valuers at all branches is found difficult. But the bankers candidly submitted that there is great scope for financial inclusion in extending gold loans and admitted that they lost a significant business opportunity to the NBFCs.

4.18 For most of the public sector banks, the gold loan portfolio is very small in proportion of their total financial assets. For instance one public sector bank which has an outstanding gold loan portfolio of over Rs. 19,000 crores, the gold loan portfolio is just around 0.03 per cent of its loan book. Even for other commercial banks, gold loan portfolio is not very large as this is only a smaller segment of loan market due to banks' much diversified portfolio. Gold loans are, by and large, extended to agriculturists and rural households to the tune of 80 per cent by public sector banks and the remaining 20 per cent is for all other activities, including small traders, individuals for social and education purposes.

4.19 According to bankers, despite the gold price is on the increase, they take a bit conservative approach towards valuing gold ornaments pledged. At best, they follow a loan to value (LTV) ratio of 70 to 75 per cent, sometimes up to 80 per cent. There is no standard model followed in valuing the gold by bankers. The price used to arrive at the value of ornaments/ jewelleries is also not uniform. Some banks take just week's daily closing price and some banks chose to take 15 days average price or even the particular day's price. The average size of individual gold loans are in the range of Rs.50,000 to Rs.80,000. However, some private banks also lends to the high ticket loans that goes up to as high as Rs. 3 lakhs in urban areas. There were instances of increasing the loans up to Rs. 10 lakhs on case to case basis.

VI. Incentive applicable to Metal Gold Loans – Exemption from Base Rate Stipulations

4.20 Another issue that was referred to the Working Group for examination was whether there is a case for exempting Metal Gold Loans (MGL) disbursed by the nominated commercial banks from the 'base rate' linked lending rates.

Metal Gold Loans

4.21 MGL is a loan segment of the Indian banking sector through which banks get exposed to gold apart from lending against gold. A unique feature of MGL is that it is a commodity loan extended in terms of metal, *i.e.,* gold, unlike other loans and advances of the banking sector. Presently, the Reserve Bank of India has nominated fourteen commercial banks to engage in the MGL business. There have been some representations to the Reserve Bank that MGL should be excluded from the purview of the base rate guidelines, as it is a commodity loan and as such it is different from regular rupee loan. The Working Group examined the issue of applicability of base rate guidelines on MGLs in detail and the observations of the Working Group in this regard are presented below.

4.22 MGL is a commodity loan extended by the banking sector in terms of gold to the domestic jewelers. It is a short-term loan with maximum maturity up to 180 days for domestic jewellery manufacturers and 270 days for exporters. There are two types of MGL prevalent in the Indian market, *viz*., overdraft facility and fixed rate MGL. Under overdraft facility, borrowers can repay the MGL at any time within the maximum period permitted by the Reserve Bank. Under the fixed rate MGL, the rate of interest and tenure of MGL is fixed. The rate of interest on MGL is calculated in terms of metal but the repayment is made in rupee terms. Under the overdraft facility, interest is charged only for the actual loan period, while under the fixed rate MGL, interest is charged for the full sanctioned loan period. The repayment of interest is in monthly installments but usually the principal is repaid as a one-time payment at the then prevailing price of gold. However, part prepayment of principal is also allowed in banks before the closure of the gold loan account. The portion of gold loan allowed to be repaid before the closure of the gold loan account varies from bank to bank.

4.23 The gold for extending MGL is acquired on consignment basis from the international suppliers of gold by banks. Immediately after the receipt of the metal, the carriage insurance payment (CIP) is remitted to the overseas suppliers of gold. This is generally one or two USD per Troy ounce of gold. CIP rates are pre-fixed before indenting of gold with overseas suppliers. The price of gold is remitted to the overseas suppliers only after the sales take place. This settlement is done at the then prevailing price of gold and hence unlike lending against gold, in case of MGL, banks are not at risk arising from fluctuations in gold prices. Further, the settlement is also done at the then prevailing foreign exchange rate with the international suppliers of gold.

Present rate of interest on MGL

4.24 Presently, MGL interest rates are linked to the international gold lease rate. The international gold lease rate is determined on the basis of the Gold Offered Forward Rate (GOFO), which is set by the Market Making Members (contributors) of the London Bullion Market Association. GOFO is the rate at which contributors are prepared to lend gold on a swap against US dollars. The international gold interest rate, *i.e.*, the interest rate charged by overseas suppliers of gold to Indian banks is presently in the range 1.75 per cent to 2.75 per cent. The interest rate on MGL charged to the domestic jewelers is linked to the international gold interest rate as per the Reserve Bank circular dated September 5, 2005. After adding the costs incurred by banks and a small margin, the rate at which this gold is supplied to the domestic jewellery manufacturers is in the range 5.25 per cent to 6.50 per cent.

MGL and Base Rate: Crux of the Issue

4.25 The base rate system was introduced for the Indian banking sector with effect from July 1, 2010, which replaced the erstwhile BPLR system. This was aimed at enhancing the transparency of lending rates on the one hand and improving the monetary policy transmission to lending rates on the other. In this context, the guidelines on base rate prevented lending below base rate by banks. The only exceptions were DRI advances, loans to banks' own employees and loans to banks' depositors against their own deposits. The present range of base rate is 10.00 per cent to 10.75 per cent for public sector banks, and 10.00 per cent to 11.25 per cent for private sector banks. The present range of base rate for foreign banks is 6.25 per cent to 11.85 per cent. As mentioned earlier, the rate of interest on MGLs is in the range 5.25 per cent to 6.50 per cent. Thus, as far as the base rate of public sector banks and private sector banks are concerned, the interest rate on MGLs is less than the base rate. As far as the base rate of foreign banks is concerned, the interest rate on MGLs is only slightly higher than the lowest base rate of foreign banks. This means that even after the introduction of base rate, MGLs by and large continue to be a sub-base rate lending. Whether this can be allowed is an issue worth discussion in detail.

Rationale for the Implementation of Base Rate

4.26 One important objective for the introduction of base rate system was to bring in transparency in lending rates besides facilitating better monetary policy transmission. With the proliferation of sub-BPLR loans, the erstwhile system of Bench Mark Prime Lending rate had almost become meaningless. Thus, with the implementation of the base rate, the sub-base rate lending was prohibited by the Reserve Bank except for a few categories of loans. Further, agricultural loans, where interest subvention is available, subsidized loans under the scheme Jawaharlal Nehru

National Solar Mission, where refinancing from the Central Government is available, subsidized loans to beneficiaries under schemes of the National Scheduled Tribes Finance and Development Corporation (NSTFDC), where refinance is available from NSTFDC, and subsidized loans under various schemes of National Handicapped Finance and Development Corporation (NHFDC), where refinance is available from NHFDC are also exempted from the base rate. However, interest rate charged on the part not covered under refinance should not be below Base Rate.

Arguments for Applicability of Base Rate on MGL

4.27 The exemptions permitted in the base rate system reveals two points. First, one important consideration for allowing sub-base rate lending in certain loan segments was the benefit accruing to the deprived sections of the society due to such exemption given to DRI advances. Beneficiaries of MGLs are jewelers, who are not considered as a deprived section in the economy. Second, such loans are excluded from base rate where refinancing is available either from Government or from some other organization. In such cases also, the guidelines specify that the interest rate charged on the part not covered by refinance should not be below base rate. In the case of MGL no such refinance is available. Third, commodity loans are treated like regular rupee loan for all practical purposes including reporting in the balance sheet. MGL is revalued at RALOO (revaluation of assets and liabilities of overseas offices) rate and reported in the balance sheet as part of loans and advances. Analogous to regular rupee loan, MGL may also increase the economic activity in the economy. Further, gold borrowed for extending MGL is also a part of the demand and time liabilities of banks and gets reported in the Section 42 Returns. Thus, for better monetary policy transmission, it is desirable that interest rate on MGL has to be linked to the base rate. Based on the above arguments, *prima facie*, the Working Group is convinced that there is little justification for excluding these loans from the base rate system. However, the Working Group has also considered the arguments against the applicability of the base rate on MGL as explained below.

Arguments against Applicability of Base Rate on MGL

4.28 The Working Group did consider the arguments against applicability of base rate on MGL. There is a view citing that banks are getting gold at a very low international interest rate. Thus, if this gold is supplied at a base rate linked rate, it would lead to overpricing of MGLs. However, the implication of such an overpricing would be a reduction in the demand for MGLs from the banking sector in the medium to long-term. Thus, the overall gold import may be affected. Second, such overpricing of MGL may lead to higher margins for the banking sector from MGL segment. Thus, banks stand benefitted in the short-term as compared with the beneficiaries. Third, at present, MGL forms a very small section of the total loans and advances. Thus, the issue may be an insignificant one from the point of view of the entire banking sector. Another argument in favour of exempting MGLs from the base rate system is the employment intensiveness of the jewellery manufacturing sector. Overpricing of

MGLs from the banking sector may adversely affect the business of this employment intensive sector. However, it may be recalled that with the introduction of base rate, all lending rates stand deregulated including interest rates on small loans up to rupees two lakhs. Thus, loans at concessional rates to one particular employment intensive sector may lead to discrimination of sectors by commercial banks.

VII. Recommendations:

Banks may continue their role as nominated agencies in gold imports

4.29 No doubt, banks are playing a significant role in canalising gold into the country to meet the huge demand for the same. Bulk of this gold is supplied to the jewellery manufacturers and a part of the jewellery manufactured is re-exported. The Working Group is of the view that banking sector, as a formal channel, has been playing an important role in the gold imports and gold supply catering to the huge demand for gold. Their discontinuation from this role may not materially alter the demand for gold. India with a one billion plus population, where in the individuals, to fulfill the social customs have to necessarily buy gold will continue to feed the demand for gold. Going by the fact that banks are importing around 56 per cent of the total gold imports, it may not be practicable for the remaining agencies to take over their role immediately and ensure steady supply and distribution of gold. This may possibly give rise to the participation of unauthorsied channels entering the gold supply chain as the demand for gold will not come down.

4.30 Besides, involving the banks in the supply chain management has the advantage of tracking the gold supply sources and the users of the gold. Further, the exchequer will continue to garner the assured revenue if the transactions are routed through the banking channel. The Working Group envisages that it would be difficult to displace the role for banks in gold imports. As regards gold retailing by banks, it is a small portion of gold that is retailed through banks and it virtually makes no difference whether banks are selling the coins or not. These days, even post offices are retailing the gold.

Bank finance to purchase gold may be prohibited

4.31 The need to contain the demand for gold imports is critical in a country, with insatiable demand for the yellow metal. If a concerted action plan to moderate the demand for gold has to be conceived, the following ***options*** to reduce the role of bank finance in gold deals could be considered.

Options:

i. Import of gold coins by banks could be prohibited but share of these items being very low it would not have any perceptible impact on CAD. Therefore, banks may be allowed to retail these gold products;

ii. Differential pricing of banking services and finance for gold imports such as stipulation of high cash margin on opening of LCs for import of gold and imposition of surcharge on interest on gold metal loans to domestic jewellery manufacturers;

iii. We may reiterate our earlier guidelines explicitly prohibiting the banks from extending advances for *purchase of* gold bullion/primary gold/jewellery/coins/ingots/gold ETF/gold MF units with the exception of providing working capital finance to jewellers;

iv. However, the Working Group is of the view that there need not be any curb or limits on advances against gold jewellery and gold coins for productive purposes subject to internal policies to be formulated by banks, including appropriate LTV, while ensuring that the advance is not used for speculative purposes and or for purchase of gold;

v. Designing and introducing innovative gold-backed financial instruments including a reverse mortgage type of product for gold to liquidate large stocks of idle gold may be considered by banks as discussed in this Report.

4.32 Above measures are considered appropriate so as to not to allow bank finance to fuel demand for fresh purchases of gold. The Working Group recognises that a policy discouraging advances against gold jewellery and gold coins by banks may adversely affect the gold holders' genuine needs and may cause hardship. More importantly, such policy will prevent existing gold stocks from being monetised. The Group is of the considered view that it is desirable to liquidate large amounts of idle gold and use the hidden value in the idle stock of gold for mobilising resources for productive purposes. While banks can be generous in providing finance against gold as collateral, the Reserve Bank may caution banks on this and advise them to formulate Board approved policies covering KYC, amount of collateral and loan, LTV, monitoring the end use of the loan proceeds etc., for loans against gold coins and jewellery. Any restrictions on the loans against gold jewellery by individuals may lead to people going back to pawn brokers and money lenders to borrow. This may be against the spirit of our pursuit to secure financial inclusion. Therefore, the Working Group is **not** in favour of considering any limit on loans against gold jewellery by individuals. The Group reiterates that, putting curbs on loans against existing gold jewellery/gold coins for genuine needs by individuals would cause hardship as well as prevent existing gold stocks from being monetised. The steps suggested above may serve as a signal service to indicate that banks need to deny finance to purchase of gold while providing generous loans against the collateral of existing gold.

Banks may expand their gold jewellery loan portfolio

4.33 There is great scope for expanding financial inclusion in extending gold jewellery loans. If banks continue to increase their gold jewellery loans portfolio, the reliance of economically weaker sections of the society on money lenders and pawn brokers will come down considerably. Banks may make the gold jewellery product more flexible and encourage people to avail this fully collaterilised loan. Banks can also devise customised gold-lending facilities on the lines of gold loan NBFCs, which are providing many variants in the gold loans. This greatly facilitates monetisation of huge stocks of gold in the country.

There is no strong case to exempt Metal Gold Loans from the base rate stipulations

4.34 MGL is a very small segment of the loan portfolio of the Indian banking sector. Under MGL, banks act as importers of gold on the one hand and sellers of gold on the other. As price settlement takes place, at the time of the actual sales at the then prevailing price, there is no risk arising from the fluctuations in the price of gold. Based on the assessment done, the Working Group is of the view that there is no strong case to exempt MGL from the base rate stipulations. There are three reasons for making this recommendation. First, exemption of MGL from the base rate may adversely affect the monetary policy transmission, second, the beneficiaries of these loans are not deprived sections of the society and third, refinance is not available on MGL from any organization.

Aligning gold import regulations with the rest of imports

4.35 The Group notes that there is a preferential and more favourable treatment for gold as compared to import of any other item. Aligning gold import regulations (as discussed in par 4.9) with the rest of imports will take away significant incentives to gold imports and will go a long way towards reducing gold imports by creating a level playing field between gold imports and other imports.

5. Dematerialisation of Gold – Scope for Introduction in India

5.1 Annual investment in gold is substantial at around over Rs.300000 crores in India at present. In the context of a need for diverting a part of the investment into gold-backed financial products conceiving and introducing gold-backed financial products that may reduce the demand for physical gold or postpone the demand for physical gold is important. The Working Group reviewed various types of gold-backed financial instruments that are available for investors at the global level and considered introducing some such products in India.

I. Gold Backed Instruments: Global Trends

5.2 Investing in gold, although remained to be a century old phenomenon, investing in innovative gold backed instruments seems to be of recent origin. The recent financial turmoil and widespread fears over inflation have pushed gold prices sharply higher to near all time highs. In fact, the price of gold has surged from about US$800/oz. in 2008 to their current level of US$1,650. Given the continuation of easy money policies by central banks around the world as well as the potential for more turmoil in the financial space in view of remerging euro area sovereign debt crisis, it appears that many investors took position in gold. Interestingly, in the Financial Markets, the traded amount of 'paper linked to gold' exceeds by far the actual supply of physical gold: the volume on the London Bullion Market Association (LBMA) OTC market and the major Futures and Options Exchanges was over 92 times that of the underlying Physical Market (Table 5.1).

Table 5.1: Gold Futures and OTC Market Vs Physical Market for Gold (Million ounces)

Instrument	2001	2007	2008	2009	2010
Physical market	114.3	127.0	115.8	120.4	120.8
Futures & Options ET vol.	1203.1	4609.8	6133.4	5327. 2	6438.8
LBMA (OTC) clearing volume	5288.8	5130.3	5605.5	5165.3	4727.7
Total	**6606.2**	**9867.1**	**11864.7**	**10613.9**	**11287.3**

Source: The CPM Gold Yearbook 2011.

A. Gold Related Investment Instruments available at the Global Level

5.3 Globally, the developed world, in particular, gold has always been seen as an investment instrument more than the ornamental value. The ornamental or jewellery forms of gold are relatively of lower caratage. Those who held gold for investment purpose were holding gold with higher caratage. The pattern of demand for gold in Indian context is also on the lines of what was observed at the global level, in the sense that, in recent years, the investment demand for gold in the forms of gold coins, gold bars and gold-backed securities such as ETFs are increasing (Chart 1 and2).

Gold Exchange Traded Funds (Gold ETFs)

5.4 Gold ETFs basically offer investors a means of participating in the gold bullion market without the hassle of taking physical delivery of gold and to buy and sell that participation through trading of a security on Stock Exchange. It is aimed to provide returns, closely correspond to the returns provided by physical gold. Most of the gold ETFs provide in the denomination of each unit approximately equal to the price of one gram of gold. ETFs provide investors with a secure way to participate in the gold bullion market without the necessity of taking physical delivery of gold. By increasing investors' understanding on the role of gold within a balanced investment portfolio, these ETFs have become important in the portfolio of institutions and individuals of all size. Globally, gold ETFs are very popular. According to Barclays Global Investors, worldwide ETF assets were estimated at around $789.04 billion at the end of the second quarter of 2009.'Gold Shares' are also 'exchange traded securities' that give the holder an undivided beneficial ownership interest in a trust, the primary asset of which is allocated gold.

Quanto Gold

5.5 This product is issued and denominated in gold's trading currency (XAU), however, investors need not have to have a separate metal account meant for this. This can be invested in USD, CHF or EUR, which will be converted into gold trading currency prior to issuance. At maturity, the investors can choose to receive their investment in gold trading currency or in the specified currencies. When redeemed in the currency, the investors are subject to the positive or negative performance of gold trading currency (XAU) *vs* the underlying currency. During its life cycle, the product is exposed to market fluctuations.

Stocks of Gold Mining Companies

5.6 Investors abroad also prefer to invest in gold stocks, these stocks are mostly of mining and exploration companies. These are stated to offer advantages that other securities on the market cannot match. A number of these individual companies have strong dividend options as well as high liquidity for traders of all kinds, because of the inherent advantage of increasing gold price. However, the risk factors are very similar to the ordinary stocks of any company, excepting that the price of gold is on the increase and that benefits can be reaped by way of dividends.

Electronic Currencies

5.7 Digital gold currency (DGC) is a form of electronic money based on ounces of gold. It is a kind of representative money, like a US paper gold certificate (1873 to 1933), exchangeable for gold on demand. This gives the investor scope to gain in terms of gold prices in the form of digital/electronic currencies linked to gold bullion in allocated or unallocated storage. It offers a simple and cost-effective way of buying and selling gold, and also to use it as money. Any amount of gold can be purchased, and these currencies allow gold to be used to send online payments worldwide. There can be instant transfer of gold ownership. Digital gold currencies are issued by a number of companies, each of which provides a system that enables users to pay each other in units that hold the same value as gold bullion. The issuer will redeem the digital currency obligation with physical metal. Just as the exchange rates of national currencies fluctuate against each other, the exchange rates of DGCs fluctuate against national currencies, which are reflected by the price of gold in a particular currency. This creates exchange risk for any account holder, in the same way one would experience exchange risk by holding a bank account in a foreign currency. Since gold has historically been the refuge of choice in times of inflation or economic hardship, the purchasing power of gold becomes stronger during times of negative sentiment in the markets. Due to this speculative interference, there are times when purchasing power has also declined.

Gold Options

5.8 While a future is generally bound by obligation to honor the contract, an option specifies a contract between two parties for a future transaction on an asset at a reference/strike price, where the buyer by paying a small price or premium gains the right, but not the obligation, to engage in that transaction, while the seller incurs the corresponding obligation to fulfill the transaction. More specifically, options give the holder the right, but not the obligation, to buy ('call' option) or sell ('put' option) a specified quantity of gold, at a predetermined price, by an agreed date. Buying gold options can give the holder substantial leverage. Conveniently, where the strike price is not achieved in the market, there is no obligation to exercise the option. That means the holder's loss is limited only to the premium paid for the option. The cost of such an option depends on a number of factors, including the current spot price of gold, interest rates, anticipated or implied volatility, time to expiry, and of course the pre-agreed or 'strike price'.

Gold Swaps

5.9 Gold swaps by producers have become an increasingly prevalent aspect of the gold market and forward prices have been cited as a particularly important determinant of gold prices. Gold swaps are attractive because they do not directly depress gold prices. In swaps, essentially two counterparties agree to exchange one stream of cash flows against another stream. Swaps can provide liquidity to the market for gold loans if they are converted into loans by the dealers concerned. And they can subsequently affect supply to bullion markets if the loans are drawn down and sold by producers.

Warrants

5.10 The warrants give the buyer a right to buy gold at a specific price on a specific day in the future, on payment of premium. Similar to futures, warrants are generally leveraged to the price of the underlying asset gold. Gearing can also be on a one-for-one basis. In the past, gold warrants mostly applied to shares of gold mining companies.

B. Gold Systematic Investment Products

Gold Accumulation Product (GAP)

5.11 Internationally, this product has been successfully operational. GAP is basically a SIP intended to offer an opportunity to the investors to accumulate/ save gold in smaller denomination such as 1 gram of gold on a regular periodicity say monthly or quarterly and sometimes worked out mutually by the bank and the investors. At the end of the scheme, the investor is given the option of taking the physical delivery of gold or the cash equivalent based on the transparent gold price announced on daily basis. In Japan, banks distribute the products, so far, around 6,00,000 customers stated to have joined the scheme. Interestingly a significant portion of investors are women. Around 50 per cent of the investors showed interest in taking physical delivery of gold. GAP is basically meant for small ticket gold buying aspirants. In China, within a short period of introduction, the scheme is stated to have attracted 1 million investors. The scheme charges around 2.5 per cent upfront commission and a markup of 2 to 3 per cent above market price. The advantages are that the quality of gold is assured, even very small size investors can afford to buy gold. Ease and transparent operation and no storage cost involved. Going by the experience of these countries, it was not necessary to hold the entire investment in physical form by the bank or custodian. They can keep a portion (20 to 30 per cent) invested in other financial instruments and that extent can be hedged with little extra cost.

Gold-linked Bonds and Structured Notes

5.12 Gold-linked bonds are available from the world's largest bullion dealers and investment banks. These products provide investors with a combination of exposure to gold price fluctuations, a yield and principal protection. Structured notes tend to allocate part of the sum invested to purchasing put/call options. The balance goes into traditional fixed income products, such as the money market, to generate a yield. Depending on the structure, they can offer capital protection and a varying degree of participation in price fluctuations. The structure of the note will vary according to prevailing market conditions and personal investor preferences.

Gold Certificates

5.13 Gold certificates offer investors a mode of holding gold without taking physical delivery. These certificates represent ownership of a certain quantity of gold bullion or gold coins. The paper confirms an individual's ownership, while the bank holds the metal on the client's behalf. Investors are able to avoid the cost and hassle of storage and security issues of the physical gold, while also gets liquidity as even portions of such holdings can be sold. Gold certificates continue to be issued by several German and Swiss banks, as well as by gold pool programs in Australia and the US. There are some issues such as possibilities of duplicating or counterfeiting the certificates, deliberate over-issue, good forgeries, bad administration, cancellation of old classes of certificates and their replacement, failure to destroy old certificates surrendered, etc. However, with the use of modern technology it is easy to publish every day an accessible list of all gold owners with an interest in a specific vaulted store.

II. Gold-backed Investment Products: A Review of Presently available Options in India

Gold ETFs in India

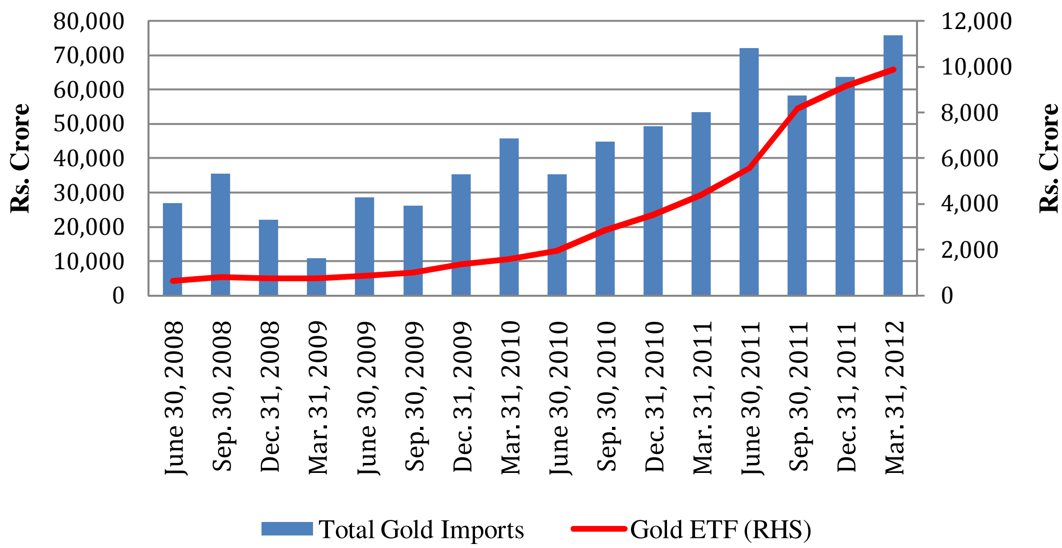
5.14 In recent years, Indian investors are showing increasing interest in gold exchange-traded funds (ETFs). Presently, the retail investors in India have an option to buy gold in smaller units, like one gram, without the requirement of its storage and safety related issues. So, ETFs and other dematerialized forms of gold have become a preferred asset class for gold investments in India. The minimum quantity required for delivery has been reduced to 10 grams of gold. Currently, there are 14 companies offering gold ETFs in India, ETFs are traded on the stock exchange and are similar to a share of a company (Table 5.2). According to the Association of Mutual Funds in India (AMFI), assets under management (AUMs) under gold ETFs have more than doubled to Rs 9,886 crore as on March 31, 2012, from Rs 4,400 crore reported in March 2011, showing a year-on-year growth of 124 per cent. Also, the share of gold ETFs to total AUMs rose to two per cent from one per cent last year. Experts attributed the sharp growth in AUMs of gold ETFs to the increased awareness among retail investors about the convenience of holding gold in dematerial format as well as more companies offering gold ETF schemes for investments. As per the prescribed norms, the ETFs in India have to maintain 100 per cent gold reserves corresponding to the full value of the investments they secured, which implies that the gold ETFs add to the demand for gold. However, it may be noted that the ETF corpus at a macro level is smaller, though growing at a robust pace. Besides, SEBI appears to be of the view that Gold ETFs need to maintain 100 per cent gold reserves to sustain investor confidence in the scheme. Besides, if the ETFs are not holding the 100 per cent reserves there will be implications for acquiring gold at a higher price when redemptions are due in gold or incur cost of rolling hedging contracts at regular intervals. As of now, the gold ETFs are not very significant contributors to the gold demand nor is the corpus of gold ETFs large enough to tighten their operational practices rigorously.

Table 5.2: Gold ETFs in India

	Names	**Date of operation**
1	Gold BeES	March 2007
2	UTI Gold ETF	April 2007
3	Kotak Gold ETF	July 2007
4	Reliance Gold ETF	November 2007
5	Quantum Gold ETF	February 2008
6	SBI Gold ETF	May 2009
7	Religare Gold ETF	March 2010
8	HDFC Gold ETF	July 2010
9	ICICI Gold ETF	August 2010
10	Axis Gold ETF	November 2010
11	MOSt Share Gold ETF	May 2011
12	Birla Sun Life Gold ETF	March 2011
13	IDBI Gold ETF	November 2011
14	Canara Robecco Gold ETF	March 2012

5.15 The assets under management (AUM) with the gold ETFs in India have showed a clear sharp upward trend. This explains that the investors' preference for gold for purely investment purpose is on the increase and such a trend will likely to have bearing on India's import of gold (Chart 5.1). The confidence of the investors on this product is the outcome of maintaining 100 per cent gold reserve, which as mentioned already is adding to the demand for gold. In some of the other countries, the ETFs hold only a fraction of the value of assets in gold. In India SEBI is of the opinion that ETFs have to invariably maintain 100 per cent reserves. To put the gold with Indian ETFs to productive use and reduce the demand for gold, we can think about putting a certain part of the total corpus of the fund to be 'loaned' to bulk gold importers like nominated agencies to import gold. As is known, some importers have access to gold borrowings with pre-specified limits and they pay interest for the gold borrowed. The transaction is eventually settled by purchasing gold during or at the end of the tenor of the loan. Such a step would increase the returns on the ETF investments and the demand for gold imports is at least postponed and thereby reducing the pressure on balance of payments. Alternatively, ETFs may also be allowed to invest their gold holdings in gold certificates with Banks. SEBI may examine these proposals.

Chart 5.1: Gold Imports and Gold ETFs (AUM)



Source: Association of Mutual Funds in India

Gold Fund-of-Funds

5.16 Gold Fund-of-Funds (FoFs) is a mutual fund investing in the units of other mutual funds specialised in investing in Gold ETFs. Gold FoFs offers open ended schemes that invest predominantly in the units of Gold ETFs. The schemes seek to provide returns that closely correspond to returns provided by Gold EFTs. The investors can invest in Gold FoFs just like any other mutual fund scheme without the hassles of opening a demat account, with an opportunity to take exposure into Gold as an asset class in a more convenient way. There is no physical delivery of gold involved in these schemes. Most of the schemes offer either growth and income options or both options similar to normal mutual funds.

Gold Futures

5.17 Gold futures contracts are binding commitments to make or take delivery of a specified quantity and purity of gold, on a prescribed date, at an agreed price. Since the futures price will generally change daily, the difference in the prior agreed-upon price and the daily futures price is settled daily also. The exchange squares off the daily loss or profit to the parties. Loss or profit arises from changes in actual prices in comparison to agreed futures prices. These transactions also involve a brokerage cost. This can yield significant trading profits, and it can also cause equally significant losses in the event of an adverse movement in the gold price. The key determining factor in futures prices is the market's perception of what the carrying costs ought to be at a given time. These include the interest cost of borrowing gold plus insurance and storage charges. Traders deal in futures contracts on regulated commodity exchanges.

Gold Forward Contracts

5.18 Forward contracts are similar to futures differing only in the nature of operations and risks. Forwards are agreements to exchange an underlying asset, in this case gold, at an agreed price, at a future date. They can be used to either manage risk or for speculative purposes. Although forward contracts being over-the-counter products offer greater flexibility of a private agreement, they still pose a level of counterparty risk. Futures contracts carry the guarantee of the exchange on which they trade and are therefore risk free. The owner of a futures contract can sell to third parties at any point before maturity, making these instruments more liquid than forward contracts (whose obligations cannot be transferred).

III. Gold Systematic Investment Products (SIPs): Presently available Options in India

5.19 A systematic investment product (SIP) is a way to invest regularly and is basically a long-term disciplined investment technique, which allows an investor to accumulate gold silver and other commodities in small amounts regularly. The idea is to set apart a sum every month or quarter as per investor’s choice, and use that to buy investment products, regardless of its price. People like such a system because it helps them save regularly and build up an investment. In line with the growing commodity investment demand more particularly in gold and silver introducing SIP is aimed at to cultivate a regular savings habit among investors to accumulate commodity in small amount. SIP is the preferred route of investment by the retail investors in equity and mutual funds. The SIP offers a convenient way to diversify investment portfolio and reap the returns of gold from a long-term perspective. The investor could hold gold-linked paper assets or could lend out the physical gold on the market. Therefore SIPs can be flexibly structured to take the savings in physical gold or cash equivalent as per the transparent gold price minus the applicable charges.

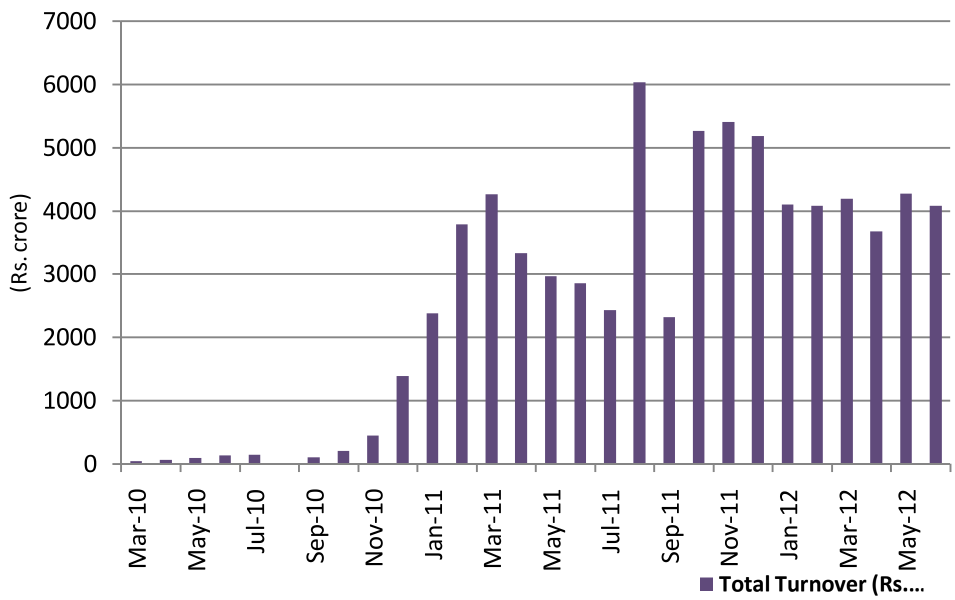
Gold Savings Fund

5.20 This is relatively new product for Indian market, it was introduced recently in February 2011 and only a few players have launched this product, viz., Kotak Mahindra and Reliance Mutual Funds. Therefore it has a limited penetration in the market. As at the end of March 2011, Reliance Mutual Fund had total investors of 200000 valuing Rs. 400 crore, which is less than 1 per cent of the household investment. This is a fund-of-funds scheme with the primary objective to provide investment returns that closely correspond to returns of the underlying Gold linked fund(s). In September 2011, ICICI Prudential has come up with Gold Savings fund. ICICI prudential regular gold savings fund is an open ended fund-of-funds which primarily invests in its own ICICI Gold ETF and can invest in oversees gold ETFs in future. It mainly targets retail investors. NRIs and Person of Indian Origin (PIOs) can also invest in the fund. Apart from SIP, the fund allows STP (Systematic Transfer Plan) and SWP (Systematic withdrawal Plan). The fund also offers the three options as far as the mode of investment is concerned like Growth Option: Mainly intended for long term investors. NAV reflects the gains of investments in gold for the whole period of investment; Dividend Payout option: Profit from investment in gold would be returned to the investors regularly; and Dividend Reinvestment option: The declared dividend would be reinvested in the same gold fund scheme units. Since it is an open ended fund the units are not traded on stock exchanges like gold ETFs. So investors need not have demat accounts. Other banks are also showing interest in launching similar products.

Accumulation of Gold in Dematerialised Form

5.21 India is emerging as one of the largest marketplace for trading in precious metals and base metals in the world (commodity online). While investing in commodities and trading in futures market are attracting increasing participation across the country, a new form of commodities investment has sprouted up in India: e-trading in spot gold, silver, copper and other commodities. Volumes in India’s four online national commodities exchanges are increasing. The National Spot Exchange (NSEL) has initiated Systematic Investment Plan (SIP) e-Series products to make it more investor friendly and to promote saving and investment among the retail investors. The product has all the features of Gold Accumulation Plan (GAP) which an investor desires and compare to other asset class. Despite positive and healthy return on commodities investment, investors stay away mainly due to hassles of managing physical delivery. E-gold from NSEL is backed by physical delivery and are stored in the exchange's secured warehouses /vaults, while trading takes place in demat form. An investor can buy/sell in these investment products after opening a demat account with any of NSEL's empanelled Depository Participants. Among the different e-Series products the, e-Gold has given a healthy annualized return of over 30 per cent. Since launch it is giving a net return of 65 per cent in last two years, while e-silver has given a net return of 110 per cent.

Chart 5.2: e-Gold Turnover on NSEL



Within a short span of two years the volume of trade in E-Gold has increased manifold (Chart 5.2). This is larger even compared with the largest gold-ETF in India. This indicates that there is greater demand from the retail investors in India for gold related SIP which has the feature of conversion into physical gold as well as can be maintained in dematerialised form. Even this has implications on India's gold imports.

Monetisation of Gold - Loans Against Gold (LAG)

5.22 The most prominent mode that monetises gold is the gold jewellery loan segment. As Indians privately own huge quantities of gold jewelleries, the loan against gold was an age old business. The orientation of the gold loan products is completely different from the other products. The importance of these products is that gold loan segment unlocks the hidden economic value of the existing stock of physical gold, which is otherwise lying idle. It is a very useful concept of converting the physical savings into money. In India, a large number of banks and NBFCs are extending loans against the used gold jewels and ornaments at a specific loan to value ratio (LTV).

Gold Deposit Scheme

5.23 In the Gold Deposit Scheme, the individuals can monetise their existing stock of physical gold, jewels or gold coins through depositing with the bank and earning return in grammage on them. In general, the schemes were with a term of 5 to 10 years. This met with limited success on account of (i) high melting costs (including due to low caratage) and (ii) also had very high ticket sizes. Further, as the schemes are based on the gold content of the jewelleries, the customer will not get back his jewelleries in its original form but only the gold. Therefore, this type of scheme was met with limited acceptability in the Indian context, as people have emotional and sentimental attachments with their gold jewels which are lying with them for generations. The SBI has this type of scheme in operation for some years. It is aimed at mobilizing the idle gold in the country and put it into productive use, and to provide an opportunity to earn interest in grammage on the idle gold holdings, with safety, liquidity and tax benefits. The gold procured will be melted, assayed and converted into gold bars for lending to jewellers. The holders can also avail loans in case of exigencies against Gold Deposit Certificate from any branch of SBI. The minimum deposit size is 500 grams of gold in gross weight. There is no upper limit for such deposits. Gold Deposits are available for maturity periods of 3, 4 or 5 years. Interest is calculated in Gold Currency (XAU) based on principal quantity of deposit and applicable rate of interest. A provisional receipt will be issued to the depositors by the Designated Branch.

IV. Evaluation of Proposals for Introducing New Gold-backed Instruments in India

5.24 The Working Group is of the opinion that in order to unlock the huge economic value lies with the idle gold in the country, there is an imperative need to conceive and introduce innovative gold-backed products in India. Although, there have been several initiatives in the past to mobilize the gold resources of the country for productive purposes, these efforts have met with limited success only. With the development of financialisation of commodities at the global level, there are many types of gold-backed products that are available in the global markets. Taking cues from these products, the Working Group is of the view that some of these products may be customised to suit the requirements of Indian investors. The Working Group recognises the fact that bulk of the privately held gold in India is possessed by rural community who are illiterate and semi-literate. Therefore, any attempt in introducing new SIPs in Indian market need to be properly devised keeping in view the specific target group of investors along with proper investor education about those products. Otherwise, the success of the products cannot be assured. There could be issues to be addressed from the extant regulatory environment, legal provisions, operational constraints and risk management while considering new gold-backed products.

5.25 Besides surveying the available products in the global and Indian markets, the Working Group also had the benefit of eliciting the views of external experts from various organisations that are dealing directly or indirectly with gold and gold related financial products like the World Gold Council, CITI Bank, Jamal Mecklai Financial Consultants, McKinsey and Company, Yes Bank and Scotia Bank. The senior representatives of these organisations shared their perceptions about various innovative products backed by gold both in physical form and demat for the benefit of the Group. The Working Group evaluated the features of the products, considered their positive characteristics and highlighted the issues that may have to be addressed to consider the introduction of these products India. The products are listed here.

5.26 Modified Gold Deposit Scheme

Product Description: This product aims to mobilize privately held stock of gold in the country and putting them to productive use.

Product Features: Customers have to deposit their gold with authorized banks which melt, assay and refine into standard bar forms. Banks can sell the gold collected and invest the proceeds to more productive use such as infrastructure financing and other high return investments. Correspondingly, the customers are given returns in grammage to generate interest in the scheme. Deposit mobilization can be in the form of gold jewels, coins and bars without restrictions on weight. Maturity period can be for 3-5 years or can be flexible to the bank and customer's choice. Lock-in period will be one year. The banks can use gold futures to hedge their position. Clients are allowed for prepayment before the lock in period with some annual penalty. Redemption can be in cash settlement, gold bars and coins.

Issues: Most of the changes proposed are permitted by the existing guidelines on the product. The extant guidelines permit banks to accept gold (bars, coins, jewellery, etc.) in scrap form. Banks may deploy gold mobilised under the scheme to provide gold loans to domestic jewellery industry, gold loans to jewellery exporters and outright sale of gold domestically or sale of gold to other nominated banks (subject to compliance with gold open position limits approved by RBI). Banks can determine the lock-in period; the banks have the freedom to fix interest rates in light of their own costing considerations; and to hedge their price exposure overseas. Further, there is no prescription of any minimum ticket size.

5.27 Gold Accumulation Plan (GAP)

Product Description: The GAP involves a modified procedure of sale of coins/bars for the banks. It combines 'saving by the customers' and 'sale for the banks' wherein the physical delivery of gold is done later according to the customer's demand. Though bank owes the responsibility of delivery of physical gold to the customers in short notice, it needs to buy gold and stock up for future delivery. The plan gives sufficient leeway for the banks not to buy all the requirement of gold in physical form at once and stock up. It needs to hold only a part of gold in physical form to meet the immediate delivery requirements and the remaining part of gold can be either leased/ lent to jewellers. A part of the funds mobilised also can be invested in other financial instruments. That portion of the funds, which are not in the gold form, need to be necessarily hedged. The cost of hedging has to be borne by the bank because bank needs to maintain only a portion of AUM in physical gold.

Product Features: The depositors of GAP schemes can deposit cash at fixed periodicity or at flexible times with facility for small ticket sizes. The banks offering the GAP will purchase gold with the aggregate cash deposited on a daily basis. Banks back 80 per cent of assets under the management with physical gold and hedge the remaining position. The gold purchased can be held with custodians or lent to jewellers. On redemption, there can be cash or physical settlement of gold. The benefits expected are that the scheme can help to tap flow into physical gold that are typically for savings/ investments. The consumers can save on significant transaction costs while commercial players can benefit from tapping into a growing demand for gold. The product will unlock a part of the resources, which can be used for investments in the productive sector.

Issues: Regulatory approvals are required to permit GAP products to be launched by banks. Gold price risk must be managed using market-based hedging mechanism. The demand for physical gold through such schemes can increase. With the GAP, increase in demand can translate into higher demand for gold imports. Hedging in international markets is permitted and may be used to cover the price risk. However, in the medium term efforts towards deepening the domestic market would be beneficial as it reduces/ eliminates the forex outflow on account of hedging costs.

5.28 Gold Certificate

Product Description: Gold Certificate will provide an opportunity to the customer to purchase in rupees, a certificate representing the value of a particular quantity of gold. Gold certificates would target two key segments (i) people buying gold for purely investment purposes, who may or may not want gold jewelleries, ETF and gold coins and bullion and (ii) people who are buying gold for delayed consumption.

Product Features: The bank will issue a non-transferable, non-negotiable certificate for the quantity of gold with a maturity of 1-5 years. The lock-in period will be from six months to one year. Funds to be mobilised are rupee deposits. Rate of interest can be can be decided by the issuing institutions. The deployment of funds can be for funding bank's loan book or outright local sale of gold to jewellers or other nominated agencies. The certificates may be assigned as collateral security for rupee loans. Cash settlement on the prevailing price or physical settlement can be allowed. An incentive scheme could be built in to the product where cash delivery gets higher returns than physical gold delivery. The expected benefits from the certificates are that the customer will be able to have an exposure to gold without having to worry about its purity, safe keeping and insurance. Gold certificates would postpone gold imports for the tenure of the certificate. Gold imports will be reduced to the extent that cash settlement is opted for.

Issues: As has been the case with some other products, regulatory approvals are required to permit the Gold Certificate products to be launched by commercial banks. Concerns with regard to safe keeping and insurance will remain issue of bankers. Hedging in international markets is permitted and may be used to cover the price risk.

5.29 e-Gold Plan through Banking Channel

Product Description: The National Spot Exchange (NSEL) has initiated Systematic Investment Plan (SIP) e-Series products to make it more investor friendly and to promote saving and investment among the retail investors. This is an existing product to be routed through the banks.

Product Features: The e-gold product has all the features of Gold Accumulation Plan (GAP). This product can be routed through the banking channel. Trading lot for e-gold is 1 gram. E-gold from NSEL is backed by physical delivery and are stored in the exchange's secured warehouses/ vaults, while trading takes place in demat form. E-gold is targeted at retail investors, who want to invest small amounts in gold. Banks can play an intermediary between the NSEL and investors. On behalf of the customers the banks can place order with the NSEL to buy whatever the grammage of gold and maintain the record in the form of a pass book issued to customers by bank. As and when the customers require gold in a standard weight as done by the NSEL, the customer can get it redeemed in physical form from the bank. Customers are avoided from opening a separate account and the hassle of buying and selling on line. Bank intervention will help to prevent the NSEL from opening large numbers of individual accounts. Unlike in other products, banks need not have to hedge for the gold price volatility and also need not have to hold the entire stock of gold. Banks can charge nominal fees. Securing regulatory approval may be easier than other proposals, as banks are not exposed to extra risks such as price or exchange risks.

5.30 Paper Gold/Gold Savings Account (GSA)

Product Description: Paper gold is an entry on paper, representing a quantity of gold, say, in multiples of 1 gm. This is different from the gold bonds issued in India at different points of times in the past, which represented securitized gold (where bonds were issued against physical deposit of gold).

Product Features: Paper gold has every quality of holding physical gold except that it is in paper but can be converted into physical gold at a short notice. The instrument would be held in a GSA with a bank who is licensed to trade / hold stocks of gold. A depositor/ investor holding the account can operate similar to the savings account and can buy gold at the displayed price, and get the account credited with equivalent of physical gold in grammage (of certified quality).The depositor cannot sell the physical gold back to the bank. But prior to taking delivery of physical gold the customer can encash the gold in his credit. The two-way quote will be displayed everyday by the bank. The quantity sold will be debited to the GSA along with payment of cash / transfer of sale proceeds to rupee savings account. Thus, the GSA will have only debit and credit entries in terms of grammage of gold, with indication of the unit price at which the gold is bought and sold back by the depositor. The bank will need to display daily bid-ask prices for gold (similar to its currency quotes) and will be obliged to return the gold to the depositor as and when she chooses to close the account or receive physical gold corresponding to the credit balance. Every branch of the bank can have the account being operated, but the stock of physical gold need not be preserved at all the branches. At best, the specified branches of the bank can hold the physical gold. Not all the holders of gold account will convert their paper gold into physical gold at the same time. Therefore, the bank can keep some 80 per cent in physical form or it can be less at any point of time and by closely studying the conversion pattern, remaining it can hedge in the market. From the macroeconomic management point of view, the scheme is more promising because there will not be an immediate burden on the balance of payments as imports of gold can be postponed.

Issues: This may not require any apparent legislative changes in Banking Regulation Act. The scheme does not involve in buying back from the customers from outside. In case, if the product designed to provide for buy back gold from customers, then the guidelines needs appropriate changes with separate examination. The product involves risk similar to the GAP. This product requires banks to bear the gold price risk. Therefore, hedging is involved with attendant costs. Therefore, approval from the regulator is involved. From the macroeconomic perspective, introduction of this product will only have a deferred impact on the creation of demand for gold leading to additional demand on gold imports. The demand for physical gold will, however, be deferred.

5.31 Gold Securities

Product Description: Banks to issue Gold Securities at the initial market price and assure delivery of a fixed quantity of gold on maturity date. The traded price on any date will reflect both supply and demand as well as market view, and the price would finally converge with the spot price on due date. If the paper is held till maturity, the holder is able to fix the price for gold deliverable by the bank. It is nothing but dematerialized tradable securities.

Product Features: Gold Securities, as an OTC product, could be used by exporters and traders to manage their inventory more efficiently, with assured supply of gold at fixed price. These securities, which would be more like a debt market paper than a derivative, could also be considered as an approved security for repo facility, which would enable the development of an inter-bank and inter-institutional market.

Issues: There is a need to examine the extant regulations for considering this product as it not only involves issue of the securities by the bank; it also involves trading in these securities and therefore regulatory authorities need to examine in more details.

5.32 Gold Linked Account

Product Description: This is a non-interest bearing account, which holds gold investments and provides the client flexibility to buy and sell gold just like any other foreign currency. This product is in line with gold ETFs in giving the depositor exposure to gold, while giving him the flexibility to time his entry or exit into the market. The essential difference is that the gold is purchased / kept in custody / sold in London and the physical gold is not imported into India, which can make a fundamental difference to the entire scheme as is explained above. Investors purchase gold account by depositing equivalent currency. Bank purchases equivalent amount of gold on International Commodity Exchanges. Exposure could also be hedged on International Commodity Exchanges through Futures which would reduce net forex outflow. On liquidation, investors receive the mark to market value of gold. The physical settlement of gold is not involved. Gold investment can be pledged to obtain loan or overdraft, at pre-determined LTV ratios.

Product Features: This product offers the facility to trade in gold in an efficient manner. Liquidity helps clients in timing entry and/or exit from the investment. Usage of gold linked account ensures return of foreign exchange to the economy on redemption. These products, if offered by banks, would widen the reach and distribution of the product beyond current reach and distribution of gold ETFs in the country. Given that gold is held abroad and not imported into India, there could be saving of costs as well as offering better bid-ask rates than currently available for Gold ETFs.

Some Issues: Regulatory approvals are required to permit the said product to be launched by banks. The payment by the depositor will be made in USD while the depositor will receive USD upon sale. The implications of the same from the

FEMA angle have to be examined. However, it is advisable to restructure the product to ensure payment/ receipts in rupees.

5.33 Gold linked Dual Account

Product Description: Gold Linked Dual Account is a structured investment product, which provides exposure to one or more currency or gold. The product entails providing interest higher than traditional time deposits, subject to the reference/ base currency not falling below the pre-determined strike price. An Investor can choose a base currency, i.e., gold price and another currency in which high interest payout will be made. In case, the gold price appreciates, investor will stand to receive the pre-determined interest rate and in case the gold price depreciates below the strike price, investment amount will be converted into gold at the strike price, thereby leading to erosion of principal. As the product involves in buying appropriate derivative to hedge, regulatory approvals are required to permit the said product to be launched by banks.

Product Features: Investor can choose two reference instruments from an array of currencies (AUD/EUR/USD) or gold, one used as the base and the other as an alternative. (In the Indian context this could be Rupee and XAU). Bank purchases an option from the customer to convert his maturity amount at a pre-determined price, in case the underlying falls below the strike price on the maturity date. Upon maturity, investor receives principal and interest amount in either base or alternative reference instrument at the pre-determined conversion / strike price of the investment. Customer receives the option premium in form of higher rate of interest. Bank manages the exposure on the option by hedging the same in the commodity markets. It might also keep open positions, within approved limits. The product has a risk of principal erosion in a condition where the alternative reference asset (gold) falls below the pre-determined strike price.

This product may offer higher Interest Rates than time deposits. There is opportunity to diversify into gold at a pre-determined strike price. The product has the flexibility of wide range of strike prices to suit risk appetite. There is risk of erosion in the principal in case the underlying/ base currency (gold) moves below the strike price.

Issues: Regulatory approvals required to permit the said product to be launched by banks. Banks may be exposed to gold price or volatility risks.

5.34 Gold-backed Pension Product

Product Description: The scheme seeks to mobilize existing stocks of gold and then distributing the gold equivalent returns to the customers in the form of a pension over next 20-25 years. The product envisages payment of returns in the form of monthly pension.

Product Features: Households shall deposit their idle gold with banks. Instead of a one shot payback after 3-5 years, customers are given parts of the gold equivalent returns in the form of a monthly pension scheme over next 20-25 years. This would require an active back-end management of funds/ availing of annuity schemes by the banks with insurance companies. Expected benefits are that the customer can place the idle gold for earning effective returns. The scheme could lead to a drop in gold imports to the extent of gold deposits mobilized. Given the longer product gestation period, impact on gold imports would be higher.

Issues: The scheme needs to be worked out explaining as to how it will generate returns adjusting inflation over 20-25 years. The scheme appears to be based on the assumption that gold returns will exceed inflation over the 20-25 year horizon. If this scenario does not materialize, there would be concerns regarding the viability of the scheme. The scheme involves longer period and availing of Annuity Plans in insurance companies, therefore, could involve costs. A pension-like product should ideally generate a steady stream of income over a long period of time. Therefore, introduction of this product needs closer examination of all relevant issues. From a bank's point of view, the risk of erosion in the principal value to the extent of negative price movement cannot be ignored.

5.35 Securitisation of Gold Loans

Product Description: Presently, gold loans extended by the banks and NBFCs are for a shorter period of one year and mostly all loans are of bullet payment types. This can be extended for a maximum period of 3 years. Like any other securtisation process, here the gold loans are securitised.

Product Features: The lending institutions such as banks and NBFCs in particular can securitise the gold loans sell to other investors. This relieves the NBFCs blocking their entire funds as also creates more number of instruments for liquidity in the market. The orginator of securities continue to have the onus of recovering the loans. Moreover, the gold loans default rate is very minimal, which will ensure good performance of securities as well. Institutions, individuals including the HNIs can be investors in these securitised product.

The issuing institutions can release the assets for raising further resources for on-lending purpose. So there is scope for expansion of balance sheet. For the investors in these securities, since it is backed by gold jewels it is expected that the securities will be more liquid and can be attempted to be traded. Moreover the gold loans are the least delinquent. For the market, in general, there will be more number of instruments available for investments making the market also more liquid. Of course, there are issues to be addressed.

Issues: The existing regulations relating to securitisation issued by the Department of Banking Operations and Development (DBOD) can be made applicable with modifications to suit the requirements of gold loans to be securitised. Adequate caveats needs to build into the existing regulatory framework in this regard.

5.36 A bird's eye view of the above instruments is furnished in the Table 5.3 below.

Table 5.3: Broad Classification of Gold-backed Financial Instruments

Product	Likely impact on Gold Import
Instruments that may possibly reduce the demand for gold imports	
Modified Gold Deposits Scheme	The gold taken as deposit is recycled for domestic demand and given back only at the time of maturity.
Gold-backed Pension Plan	Here the customer surrenders his gold to the bank on agreement to receive streams of monthly pension till his death. The bank can sell these ornaments or convert them into coins for resale.
Gold Linked Account	Since the entire transaction takes place outside India, the import of gold is not involved.
Securitisation of Gold Loans	The question of increase in import of gold does not arise. It only involves securitizing the existing gold loan portfolio.
Possibility of Deferred Imports	
e-Gold Scheme through banking channel	This product is like ETF but buying and selling of gold units are done with a difference of routing through banks. Here also if the buyer intends to sell the gold savings there is no imports but if the delivery in taken in gold then deferred

	imports.
Gold Accumulation Plan (GAP)	As the product is a saving plan catered to even small buyers of gold, the increased imports deferred till the time of actual delivery of gold. If option is exercised to take cash, no import of gold required.
Instruments that may or may not reduce gold imports	
Paper Gold /Gold Savings Account	This product is a saving scheme similar to GAP, but delivery takes place for physical gold at a later stage without option to take cash. In case the customer opts for cash then there is reduction of imports.
Gold Certificate Scheme	May or may not reduce the imports as it depends upon the choice exercised by customer at the time of maturity of the certificate.
Gold Dual Account	Investor can choose a base currency, i.e., gold price and another currency in which high interest payout will be made. In case, the gold price appreciates, investor will stand to receive the pre-determined interest rate and in case the gold price depreciates below the strike price, investment amount will be converted into gold at the strike

V. Recommendations:

5.37 The Working Group is of the view that given the large stock of gold in India and the requirement to unlock the hidden economic value in the idle gold stock, there is a need as also scope for introducing new gold-backed products. Various options available for consideration to introducing new gold-backed products in the Indian markets may be considered.

5.38 The Working Group has identified, based on extensive discussions with experts and broadly classified the gold-backed products that can be considered for the Indian investors into five categories. They are:

a) Products, which seek to ***monetise*** a portion of the privately held stock of gold (Modified Gold Deposit Scheme);

b) Products, which aim to ***financialise the incremental demand*** for gold by facilitating systematic investment in gold (Gold Accumulation Plan, Gold Certificate, e-Gold Plan through Banking Channel, Paper Gold);

c) Products, which allow ***active management of customer's gold portfolio*** by providing flexibility for buying/ selling gold on the lines of ETFs (Gold linked Account and Gold Securities);

d) ***Derivative products,*** which enable customers to take positions depending upon their view on gold prices (Gold linked Dual Account and Gold Securitisation); and

e) Gold **Pension** Product.

5.39 The Working Group is of the view that, to begin with, products like Gold Accumulation Plan, Gold Linked Account, Modified Gold Deposit and Gold Pension Product may be considered for introduction in India.

5.40 However, introduction of these products in India presupposes a thorough review under the extant regulations. Further, in the evolving situation of market development and with the objective of deferring the import burden on the country's balance of payment, we may require to review the extant regulations to accommodate certain new products. These products will, if designed properly, help to monetise a portion of the privately held stock of gold as well as financialise the incremental demand for gold. The impact of these products on the volume of gold imports will, however, depend on the interplay of various factors, which could either lead to increase in gold demand or a reduction in gold imports. The banks may take considered view of each of the gold-backed products discussed by the Working Group subject to a careful study of the features of each of the products, regulatory clearances required, cost aspects, appetite for the product and ability to manage the related risks by the banks. The connected legal aspects also require a re-look. Investor education assumes critical importance for the success of each of these products. In sum, there is a need and scope to consider new gold-backed products after careful evaluation of each product by relevant regulatory departments and regulators. The products identified by the Working Group are indicative in nature and banks may consider designing more financial products and customising them as per the investors' requirements and appetite.

5.41 The Working Group is conscious of the fact that mere introduction of these products will not automatically reduces the demand for gold in a significant manner, as the factors that contribute to the demand for gold are many and diverse. Introduction of these gold-backed financial products may reduce the demand at margin in the initial stages. Only, when these products prove that they can offer returns that are higher than the existing financial products and are comparable with the returns on gold then the prospects for these products will be good. The Working Group recognises that besides offering better returns gold is also highly liquid. Therefore, the products to be considered should provide adequate liquidity as well to become more popular. The objective of considering these gold-backed products is more to offer a diversified gold-backed savings menu and divert the attention of the saver from physical gold in a phased manner.

5.41 To gainfully use the gold reserves with Indian ETFs and reduce the demand for gold, we may think about putting a certain part of the total corpus of the fund to be 'loaned' to the permitted categories of bulk gold importers like nominated agencies to import gold. In India, some importers have access to gold borrowings with pre-specified limits and they pay interest for the gold borrowed. The transaction is eventually settled by purchasing gold at the end of the tenor of the loan. Such a step would increase the returns on the ETF investments and the demand for gold imports is postponed and thereby reducing the pressure on stressed balance of payments. Alternatively, ETFs may also be allowed to invest their gold holdings in gold certificates with Banks. If, SEBI examines these proposals, operational modalities can be worked out.

Section II – Micro Issues – Gold Loan NBFCs

6. Gold Loan Market in India – An Overview

6.1 Possession of gold has been a symbol of prosperity in India and is considered a safest form of investment that provides hedge against inflation. Gold has always been a highly coveted product not only in the form of jewellery, gold bars or bullion, but also has the ready acceptability as collateral for the lenders because of its high liquidity character. According to an estimate of World Gold Council, about 10 per cent of world's gold is in India's possession. Accumulated Gold stock in India is around 18,000 to 19,000 tonnes as per independent estimates. During 2002-2012, annual gold demand has remained relatively stable at around between 700 to 900 tonnes despite the rise in prices from Rs. 13,333 to Rs. 86,958 per troy ounce (as on May 25, 2012). In India, the demand for gold has not been adversely impacted by rising prices.

I. Genesis of Gold Loan Market in India

6.2 In India, it is believed that most of the gold is held by people in rural areas and in many cases this is the only asset they have in their possession though in small quantity. All the while, rural Indians know that if his crop fails or his family is sick, he can raise cash in a moment from the goldsmith or may be pawnbrokers and moneylenders, because the rural India lags in availing banking facilities. Therefore, even the pattern of saving in India differs for various income groups. While richer sections diversify their portfolio according to risk-return equation, the poor rely more on commodities like gold as well as silver. The jewellery bought in times of prosperity has been pawned or sold for cash in periods of distress or need. Over the years, some portion of this is being used as collateral for borrowing in the informal market, though estimates is not available. It is a common practice in India that gold is pawned, bought back and re-pawned to manage day-to-day needs of the poor and middle class. The pledging of gold ornaments and other gold assets to local pawnbrokers and money lenders to avail loans has been prevalent in the Indian society over ages. Due to the increased holding of gold as an asset among large section of people as also the borrowing practices against gold in the informal sector have encouraged some loan companies to provide loans against the collateral of used gold jewelleries for years and over a period to emerge as 'specialised gold loan companies'.

6.3 Some independent estimates indicate that rural India accounts for about 65 per cent of total gold stock in the country. At times of emergency, gold ensures a loan almost instantaneously for the poor and without any documentation process. Most of the loans are for meeting unforeseen contingencies and may be categorized as personal. Further, growth in middle income classes and increase in the earning capacity of women, a core customer group for gold is expected to further boost the demand of gold. The demand for gold has a regional bias with southern Indian states accounting for around 40 per cent of the annual demand, followed by the west (25 per cent), north (20-25 per cent) and east (10-15 per cent). Accordingly, even the gold loan market has also developed on the same lines where a large portion of market is concentrated in southern India. India continues to be one of the largest gold markets in the world. The attraction towards gold in India stems from varied historical and cultural factors and its perceived safety in times of economic stress.

6.4 Since 1990, with the repeal of Gold Control Act, Indians have been allowed to hold gold bars. In the year 1993, the provisions of Foreign Exchange Regulation Act (FERA) relating to gold were repealed and imports were allowed by NRIs and since 1997 gold imports were brought under Open General License. All these gave fillip for the development of not only the gold market but also the gold loans market. With a view to bring the gold holdings to the core financial market, several gold based financial products have been made available to retail consumers in the Indian market from time to time. Recently, Exchange Traded Gold Funds (ETF) has also been allowed in the Indian markets, which have received a positive response from investors.

II. Structure of the Players in Gold Loan Market

6.5 Borrowing against gold is one of the popular instruments based on physical pledge of gold and it has been working well with Indian rural household's mindset, which typically views gold as an important saving instrument that is liquid and can be converted into cash instantly to meet any urgent needs. The market is very well established in the Southern states of India, which accounts for the highest accumulated gold stock. Further, traditionally gold holders in Southern India are more open to accept and exercise the option of pledging gold as compared to other regions in the country which are reluctant to pledge jewellery or ornaments for borrowing money.

6.6 The major players in the organised gold loans market in India are commercial banks, cooperative banks and gold loan NBFCs known as non deposit taking, systemically important NBFCs (NBFCs ND SI). The data on outstanding gold jewellery loans from the banks and the major gold loan NBFCs is furnished in the Table below.

6.7 In addition to a growing organised gold loans market, there is a large long-operated, un-organised gold loans market which is believed to be several times the size of organised gold loans market. There are no official estimates available on the size of this market, which is marked with the presence of numerous pawnbrokers, moneylenders and land lords operating at a local level. These players are quite active in rural areas of India and provide loans against jewellery to families in need at interest rates in excess of 30 percent. These operators have a strong understanding of the local customer base and offer an advantage of immediate liquidity to customers in need, with extreme flexible hours of accessibility, without requirements of any elaborate formalities and documentation. However, these players are completely un-regulated leaving the customers vulnerable to exploitation at the hands of these moneylenders and pawn-brokers.

6.8 Seizing the vast untapped potential available for lending against gold, the organised players such as NBFCs became more aggressive in the gold loans market and a significant part of the gold loans likely to have shifted from the un-organised lenders to the organised lenders, thus fuelling a strong growth in the organised market. Further, the growth would be even higher if the customer attitude towards gold pledging becomes more positive aided by positive government regulations and aggressive promotion by banks, finance companies and other formal financial institutions. South India continues to account for 80-85 per cent of the gold loans market in India. Despite attempts by banks to expand in certain pockets of Northern and Western India, historically, the market has remained concentrated in Southern India. However this trend is changing gradually, as witnessed in the strong expansion of branches of the leading gold loans providing NBFCs in Northern and Western India.

III. Key Drivers of Gold Loan Market in India

6.9 The prevalence of high level of rural indebtedness, easy availability of gold loans at extreme flexible terms, relative constriction of personal and retail loans by banks and changing attitude of customers to avail gold loans have contributed to the sharp growth in the gold loans outstanding. It was also realized that there is potential to expand gold loans market to the Northern and Western regions of India, provided the branch network is expanded and the loans are available easily with flexible options. Several large finance companies started expanding their branches in these regions and the response appears to be favourable. The gold loans NBFCs and banks operate in the gold loans segment have different approaches and philosophy which can be seen in the margins and profitability for different category of lenders. Gold loans NBFCs view gold loans as their most focussed business and, therefore, have built their service offerings through good investment. They have been commanding premium yields and high profitability. But, banks view gold loans for agriculture as a safer means to meet their priority sector lending targets, which typically offer low returns with high defaults. Further, even for non agriculture gold loans, their target clientele is more organised segment, given that they are unable to offer the level of flexibility and rapid disbursals as compared to specialised NBFCs.

IV. Trends in Gold Loans Outstanding

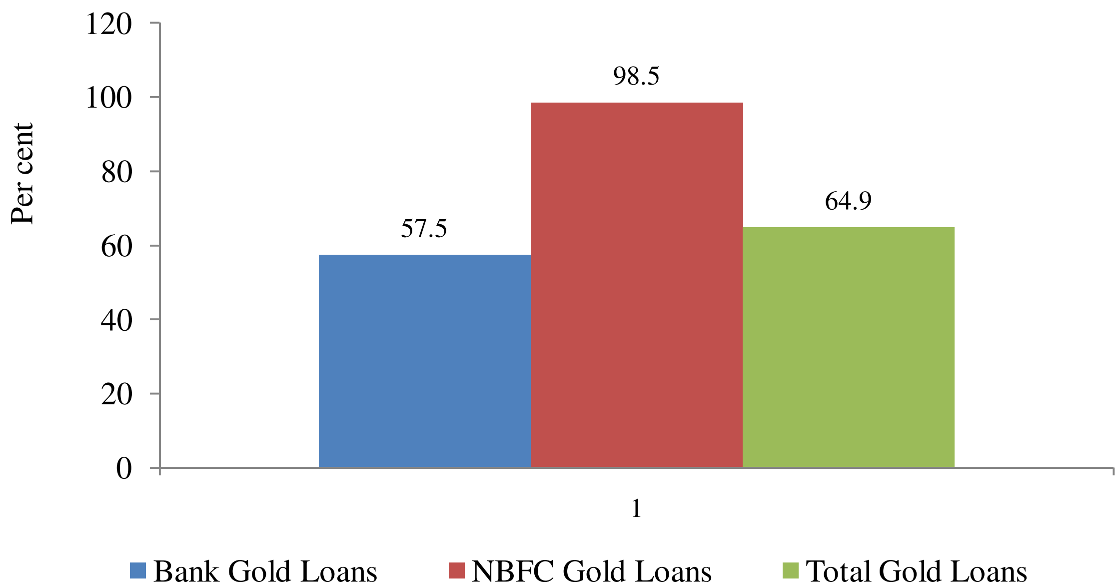
6.10 Gold as an asset is liquid and can be readily exchanged for cash even in the informal market. With the gold market getting more organized within a formal setup, in recent years there has been rapid growth in the gold loans market particularly in gold loans disbursed by Banks and NBFCs (Table 6.1). Both demand and supply side factors have played important roles in bringing about this growth. From the demand side, holders of gold were able to get cash in *lieu* of their gold in a formal setup and at higher loan to value ratios at relatively less rate of interest with better terms when compared with the informal segment. From the supply side, banks and NBFCs were able to disburse loans against collateral whose value was stable even in times of financial turmoil.

Table 6.1: Annual Growth Rate of Gold Loans Outstanding (Per cent)			
Year	**Bank Gold Loans**	**NBFC Gold Loans**	**Total Gold Loans**
2008-09	**54.2**	**41.4**	**52.5**
2009-10	**47.7**	**169.3**	**62.6**
2010-11	**52.1**	**126.7**	**67.2**
2011-12	**77.6**	**80.0**	**78.3**

Source: Working Group calculations based on data from Commercial Banks and five major Gold Loans NBFCs.

6.11 On a Compound Annual Growth Rate Basis (CAGR), all segments of the gold loan market have witnessed growth of over 55 per cent between March 2008 and March 2012 (Chart 6.1).

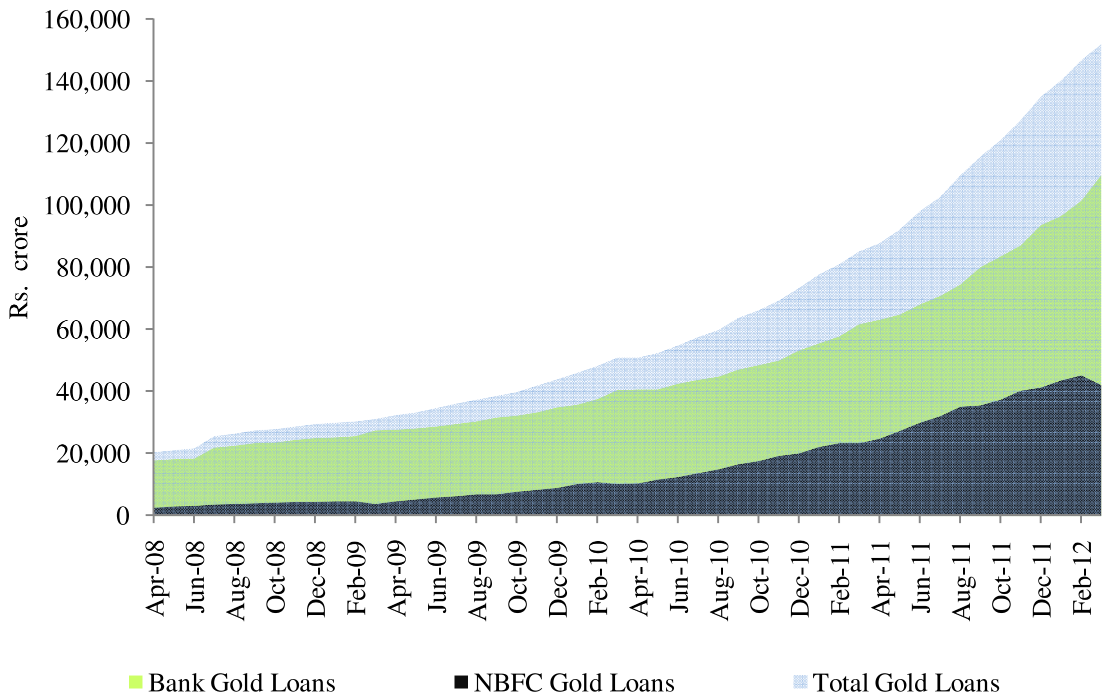
Chart 6.1: Compound Annual Growth Rate of Gold Loans Outstanding 2008-2012



Source: Working Group calculations based on data from Commercial Banks and major Gold Loans NBFCs.

6.12 An analysis of the annual growth rates of the total gold loans disbursed reveals that the growth rate of gold loans disbursed by banks has witnessed an increasing trend during March 2008 and March 2012. Growth in gold loans by NBFCs has fallen over the years but it remains higher than the growth of gold loans disbursed by banks. With the small base effect waning over the years, the growth of gold loans disbursed by NBFCs has fallen in more recent years. However, consumer interest in gold loans by NBFCs still remains high and can be gauged from the fact that currently it is still growing at a rapid pace of about 80 per cent. Gold loans disbursed by banks and NBFCs have moved in tandem and are highly correlated. Total gold loans outstanding have progressively grown (Chart 6.2).

Chart 6.2: Gold Loans Outstanding In India



Source: Working Group calculations based on data from Commercial Banks and major Gold Loans NBFCs.

V. Trends in Borrowings Outstanding by Gold Loans NBFCs

6.13 NBFCs lending against gold, source their funds from the banks as well as from other non-banks sources. But, a sizable portion of their borrowings account from the banking system. Since, the primary business of these NBFCs is lending against gold, any drastic fall in the gold market leading to sharp correction in the gold price may potentially have a disturbing effect on the banking system.

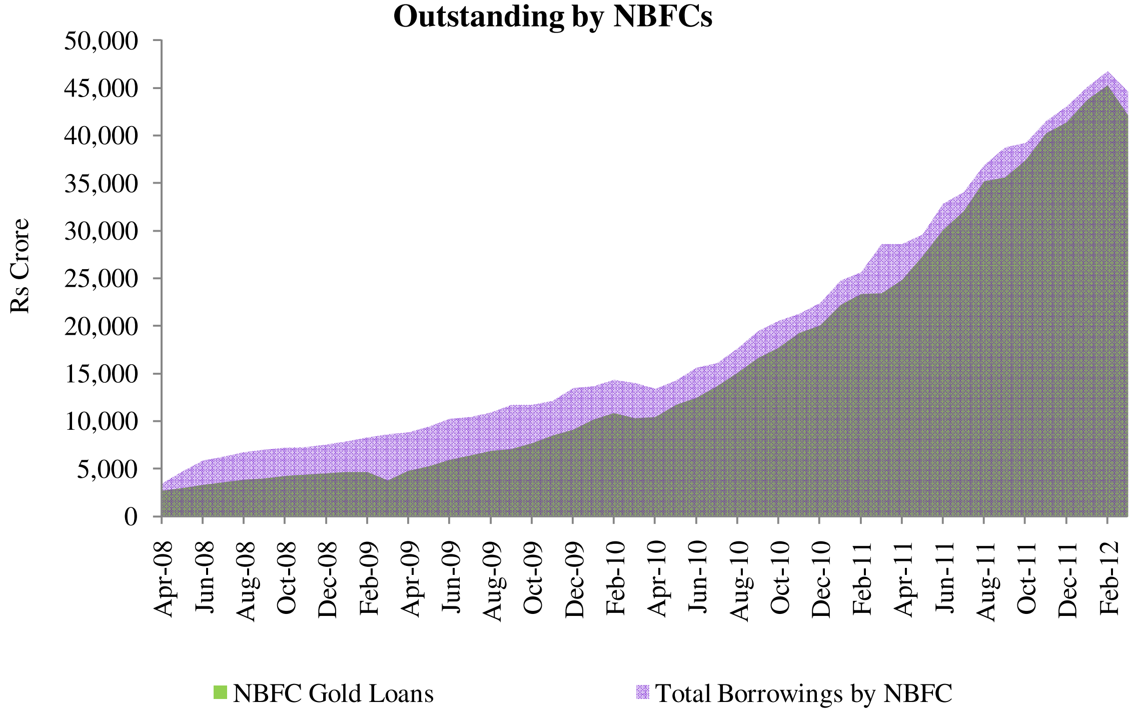
6.14 Growth rate of bank borrowings by NBFCs has fallen in 2011-12 when compared to the previous years. However, bank borrowings by NBFCs continue to grow at a high pace of 54.3 per cent. In line with the fall in growth of bank borrowings by NBFCs, growth in non-bank borrowings by NBFCs and hence growth in total borrowings by NBFCs are also falling but continue to grow at a fast pace (Table 6.2).

Table 6.2: Annual Growth Rate of Borrowings Outstanding by Gold Loans NBFCs (Per Cent)			
Year	**Borrowings from Banks by Gold Loans NBFCs**	**Borrowings from Other Sources by NBFCs**	**Total Borrowings by NBFC**
2008-09	**224.9**	**101.8**	**146.7**
2009-10	**88.7**	**39.4**	**63.1**
2010-11	**118.7**	**84.8**	**103.6**
2011-12	**54.3**	**58.5**	**56.0**

Source: Working Group calculations based on data from Commercial Banks and major Gold Loans NBFCs.

6.15 Gold loans disbursed by NBFCs and total borrowings by NBFCs move in the same direction to a very large extent. NBFCs are highly leveraged (Chart 6.3). This trend needs to be examined further as high leverage could potentially be destabilizing.

Chart 6.3: Gold Loans Outstanding and Total Borrowings Outstanding by NBFCs



Source: Working Group calculations based on data from Commercial Banks and major Gold Loans NBFCs.

6.16 Total borrowings outstanding by NBFCs and total gold loans outstanding by both banks and NBFCs have moved in the same direction with very high correlation perhaps indicating that demand for gold loans has been high and lucrative prompting the NBFCs to mobilize more funds *via* borrowings (Chart 6.4). Growth in gold loans outstanding by NBFCs has been higher than that of bank borrowings outstanding by NBFCs (Chart 6.5). Similarly, non-bank borrowings outstanding have grown but at rates lesser than the growth in gold loans outstanding by NBFCs (Chart 6.6). Total borrowings by NBFCs (including from banks and other sources) have increased substantially over the years (Chart 6.7).

Chart 2.4abcd: NBFCs Borrowings Outstanding and Gold Loans

Chart 6.4: Total Gold Loans and Total Borrowings by NBFCs

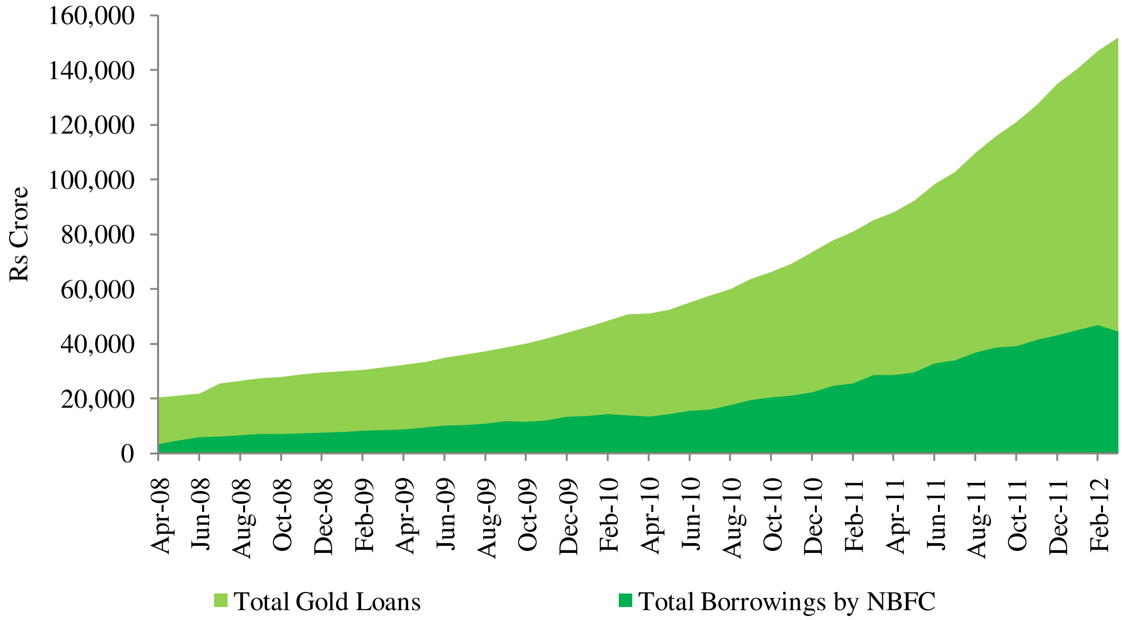


Chart 6.5: Bank Borrowing and Gold Loans by NBFCs

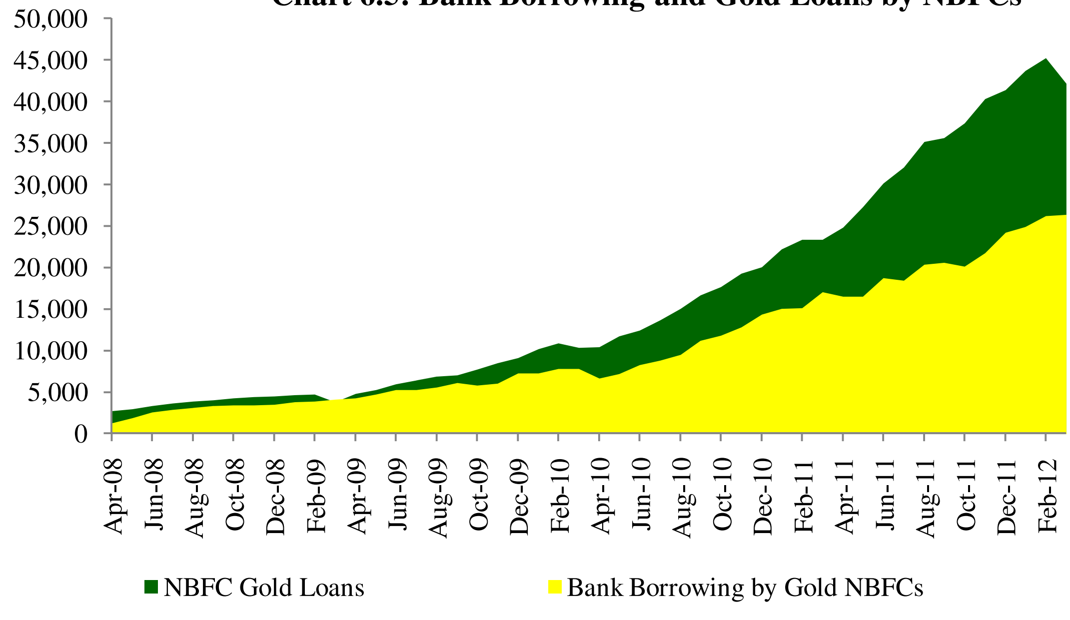


Chart 6.6: Gold Loans and Non Bank Borrowings by NBFCs

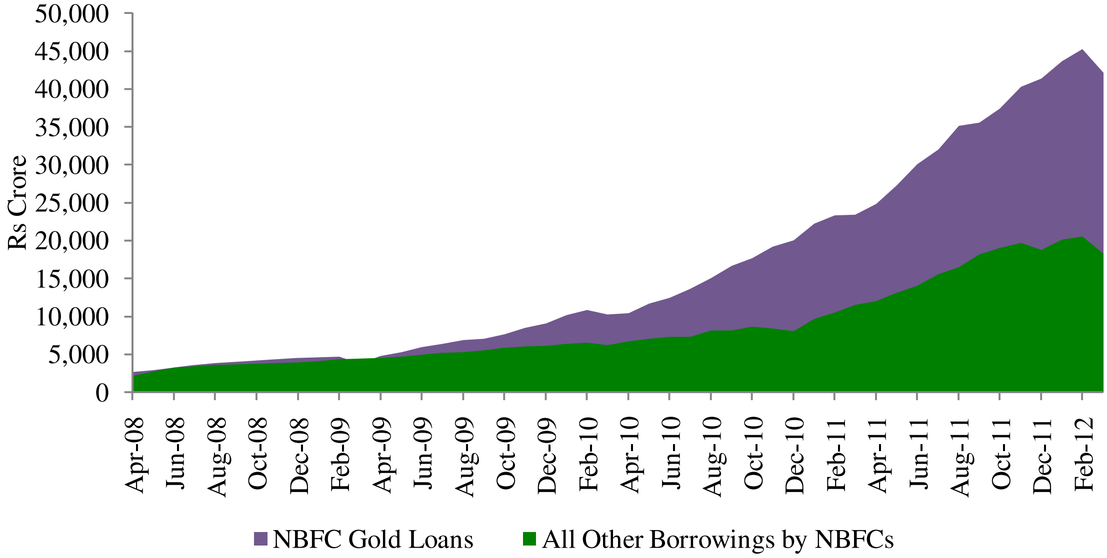
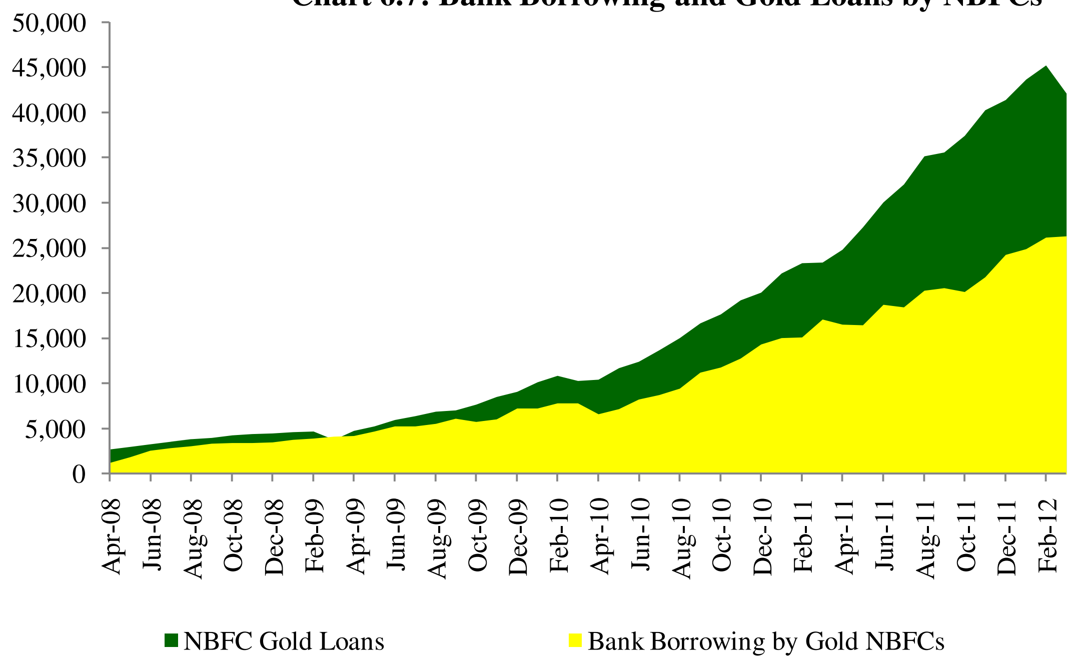


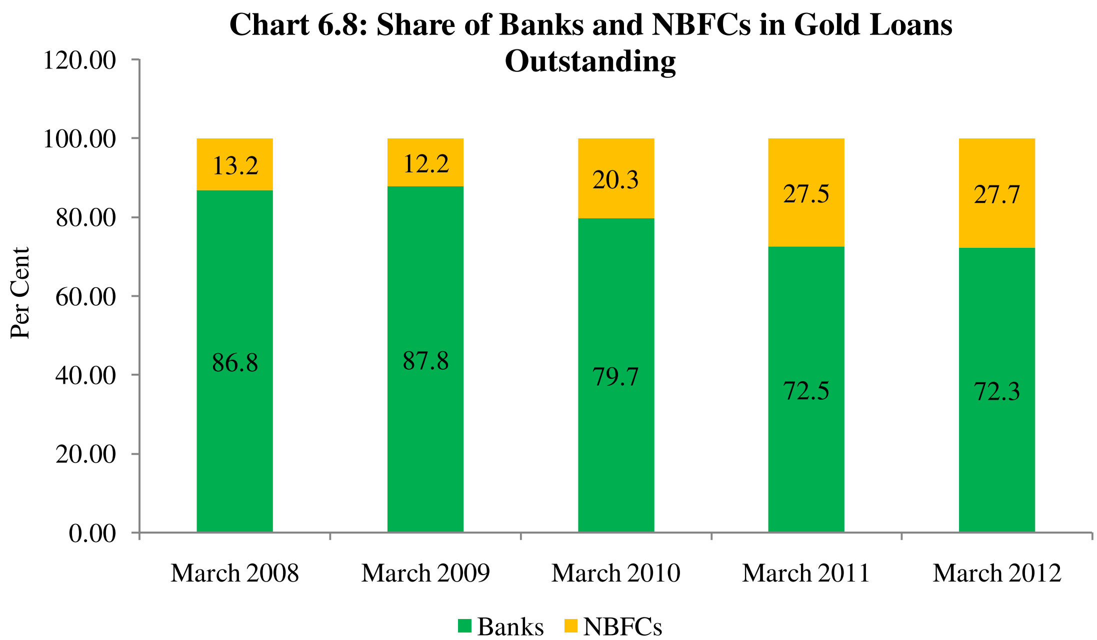
Chart 6.7: Bank Borrowing and Gold Loans by NBFCs



Source: Working Group calculations based on data from Commercial Banks and major Gold Loans NBFCs.

VI. Share of Banks and NBFCs in the Gold Loan Market

6.17 Gold loans disbursed by NBFCs have witnessed rapid growth in the recent past. Therefore, there is a general feeling that NBFCs account for the majority of gold loans disbursed. However, contrary to popular belief, share of banks in total gold loans is highest at 72.3 per cent at end March 2012. Although banks continue to retain the dominant share in the gold loan market, the share of NBFCs has been steadily increasing over the years. Share of gold loans disbursed by NBFCs in total gold loans was 13. 2 per cent as at end March 2008 more than doubled to 27.7 per cent as at end March 2012 (Chart 6.8).



Source: Working Group calculations based on data from Commercial Banks and major Gold Loans NBFCs.

6.18 To sum up, in India, the demand for gold has not been adversely impacted by rising gold prices in recent years. Borrowing by pledging of gold is popular with the Indian rural households. The major players in the organised gold loans market are commercial banks, cooperative banks and gold loan NBFCs. The prevalence of high level of rural indebtedness, easy and availability of gold loans in flexible terms, relative constriction of personal and retail loans by banks have led to the sharp increase in the gold loans outstanding in recent years. Total gold loan market witnessed robust growth in recent years. Growth in gold loans outstanding by banks and NBFCs continue to be robust with strong double digit growth. Though the gold loans disbursed by NBFCs have witnessed rapid growth in the recent years the share of banks in total gold loans is larger than the share of NBFCs. The growth rate of gold loans disbursed by NBFCs remains higher than the growth of gold loans disbursed by banks, with slight moderation in the latest year. Gold loan NBFCs source their funds from the banks as well as from other non-banks sources like NCDs. Growth of gold loan NBFCs' borrowings from the banking system and total borrowing by NBFCs, though decelerated in 2011-12 continue to grow at a high pace.

7. Recent Trends in Gold Loans and Influence on Gold Imports

7.1 In the recent years gold loans given by NBFCs and banks have grown sharply. Concurrently, the gold prices and gold imports were also on increase (Table 7.1). The Working Group examined whether the recent surge in gold imports by India was in any way influenced by the steady growth in gold loans by the Commercial Banks and NBFCs.

Table 7.1: Growth rates of gold loans, gold prices and gold imports (per cent)

Parameter	2009-10	2010-11	2011-12
Gold Loans by NBFCs	170	126	80
Gold Loans by Banks	48	52	78
Gold prices	8	28	32
Value of Gold imports in Rupees	49	36	46

Source: Working Group calculations and World Gold Council and DGCI & S

I. Factors influencing the demand for gold loans in India

7.2 The demand for gold loans is influenced by many factors. As the gold loans are granted against the gold ornaments deposited by the borrower, the size of the stock of gold jewellery, available with the borrowers is a crucial parameter. The needs of the borrower coinciding with various purposes like cropping season, academic year, festivals, Medical purposes etc, are also critical in determining the demand for gold loans. While banks would typically give around 75 per cent of the gold value as loan, NBFCs give loans up to 60 per cent of the value of the pledged gold, in case of high-purity gold jewellery, under the extant norms. Hence, the prevailing loan-to-value ratio is a factor that can affect the demand for gold loans. Finally, alternative sources of borrowing and the interest rate charged, which depends on the tenure and amount of loan is a crucial factor in affecting the demand and supply of gold loans.

7.3 As a financial instrument, gold loans have promoted the suitability of gold as a collateral drawing upon its ability to secure loans against itself quickly to address temporary surges in consumption. As substitutes for gold to serve as collateral for addressing short run liquidity needs are virtually absent, the cross section of population who faces borrowing constraints will have incentives to consume more gold jewellery (hence rising gold imports) which could be used as collateral during periods of distress. Thus the emergence of a liquidity motive for holding gold assets needs to be reckoned with in the light of high growth in gold loans in recent years. This is particularly relevant given the fact that rising gold prices enable borrowers to receive higher loan realisations and hence induce increase in gold loans outstanding. This chain of causation can be self sustaining as long as gold prices exhibit a long term increasing trend.

II. Gold loan market growth and gold import linkage

7.4 As gold loans are issued solely on the basis of gold jewellery as collateral, the high growth rates observed for gold loans in recent years could be reflecting the emergence of a liquidity motive apart from the conventional saving motive to acquire gold. The strengthening of liquidity motive over time could result in increased demand for gold loans. The rapid growth in gold loans in recent years indicates unleashing the latent demand for liquidity from significant proportion of the population who faced severe borrowing constraints in the past. This could also be viewed as an offshoot of the huge rise in gold price along with liberal loan to value ratios that existed till the recent past. The prospects of gold value appreciation together with easy and flexible availability of gold loans increase the demand for gold and thereby to gold imports.

7.5 It is known that the gold demand in India is influenced strongly by the feature of gold as an attractive investment option. The recent gold loan growth phase coincided with the rise in growth of imports of gold, which grew, despite the rise in gold prices. A quiet swing in savings from financial products to assets, showing propensity for further growth, is visible in the Indian economy. There were apprehensions that liberal loan to value ratio and consistent rise in gold prices could result in an incentive for individuals, to consider investment in gold jewellery as an arbitrage opportunity, by pledging the purchased jewellery and use the proceeds to buy gold jewellery to take advantage of future appreciation. Thus, gold loans and demand for gold (jewellery) can theoretically become mutually reinforcing in the long term. However, it is not logical to attach much relevance to this possibility, as bulk of the gold loans is taken by a cross section of the population, facing strong borrowing constraints. Also the adjustment of making charges of 20 per cent and a margin of 20 to 25 per cent on the value of gold jewellery along with the interest charges of about 24 per cent on the loan, make this possibility unnecessary. In other words, the arbitrage opportunity is negligible and may even be negative to have such mutual reinforcement between gold loans and gold imports in the short run. Against this setting, the Working Group, focused on the question whether gold loans, which can be a proxy for demand for short term liquidity has any impact on the surge witnessed in gold imports, in recent years.

Whether increase in gold loans outstanding influence the demand for gold imports? – Empirical Exercise

7.6 Gold loans are offered by both banks and NBFCs. The total gold loans outstanding are quite sizeable today. An empirical exercise, based on monthly data available for 2008-09 to 2011-12 is undertaken to examine the possible determinants of gold demand in India. The empirical analysis suggests that such loans outstanding have an impact on quantum of gold imports and there exists positive correlation between total gold loans outstanding and gold imports at levels (Exhibit 7A.1).

Granger Causality Test

7.7 The Working Group probed further, to assess, whether there is any long term relationship between the gold loans outstanding and gold imports. The Granger Causality Test was conducted for the period April 2008 to March 2012. The results indicate that total gold loans as well as gold loans by NBFCs outstanding, both expressed in real terms, can explain the variation in volume of gold imports in recent years.

OLS Estimates

7.8 In order to further examine the possible determinants of gold imports in India, The Working Group deployed OLS Estimation. The gold demand in recent years has been explained by increase in rising gold prices and increasing level of gold loans by banks and NBFCs. *One per cent change in gold loans leads to 0.3 per cent change in volume of gold imports.* The empirical findings seem to be indicating the role of gold loans in inducing gold imports in India. It may be noted that gold loans by banks and NBFCs continued to rise in spite of RBI removing the priority sector status from gold loan companies. The positive coefficient of gold price confirms the recent rise in gold imports despite the sharp increase in gold price, which is in contrast to the negative sign found in some earlier studies. Therefore, increasing international gold prices seem to be building up the expectations of newly emerged class of gold investors, thereby leading to higher gold demand.

III. Conclusion

7.9 The key conclusion that can be drawn from the econometric analysis for the period 2008-09 to 2011-12 was that gold loans have a causal impact on gold imports, thus, substantiating the emergence of a liquidity motive for holding gold, which could be pledged by households as collateral to tide over temporary mismatches in liquidity. This relationship is valid when either gold loans by NBFCs or total gold loans outstanding (including banks) are considered. Possible rationale for this relationship could be that when the gold prices were generally increasing, with a liberal loan to value ratio, people are generally induced to invest in gold due to the prospects of gold value appreciation and the possibility to raise a loan in case of need.

7.10 It would be, however, erroneous to conclude that easy availability of gold loans alone is driving the gold imports. Econometric modelling may not fully capture the precise relationship among related economic variables. Therefore, a caution is warranted in interpreting the empirical findings. Gold loans are offered against gold jewellery by NBFCs. In the case of banks, bullion can be offered as collateral, but it is not a large component of total loans, according to discussions with commercial banks. In other words, gold loan outstanding is generally a function of available jewellery in the country. No borrower is likely to have bought jewellery with the express intention of pledging it. As gold loans are issued on the basis of gold jewellery as collateral, the high growth rates observed for gold loans in recent years could be reflecting the emergence of a liquidity motive to acquire gold jewellery. The strengthening of liquidity motive over time could result in increased demand for gold Imports. While analysing the relationship between gold loans outstanding and gold imports, the Working Group was guided by the need to factor in the emergence of a liquidity motive by including gold loans as an argument in the estimated import demand function for gold. However, the Working Group recognises the fact that demand for gold and gold consumption in India is a function of several other factors as explained elsewhere in this Report. Therefore, the role of gold loans in inducing gold imports is limited.

7A.Technical Note - Gold Loans and Influence on Gold Imports

Correlation Analysis

Exhibit 7A.1: Correlation analysis between gold loans and gold imports (Variables in logs)

Correlation (Levels)		
Sample (adjusted): 2008 April to 2012 March Included observations: 48 after adjustments Standard errors in ( ) & t-statistics in [ ]		
Variables#	LRGLTOT	LRGM
LRGLTOT	1 ----- -----	
LRGM	0.41 (3.02)* [0.004]	1 ----- -----

Note: LRGLTOT and LRGM indicates natural log of Total gold loans outstanding and gold imports expressed in real terms respectively. Also,*,**,*** represents significance at 1 per cent, 5 per cent and 10 per cent level, respectively.

Long term relationship between the gold loans outstanding and gold imports

7A.1 In considering the relationship between gold loans outstanding and gold imports, the chosen lag length is arrived at by employing the information criteria approach. The value of gold loans outstanding and value of gold imports are converted into real terms by deflating it by general price level (Whole sale price index) and domestic price of gold, respectively.

7A.2 The granger causality tests presented in Exhibit 7A.2 **and** Exhibit 7A.3 rejects the null hypothesis of 'no causality in granger sense' in favour of the alternate hypothesis namely, both total gold loans as well as gold loans outstanding by NBFCs granger cause gold imports. However the reverse is not supported by granger causality tests.

$$\boldsymbol{LRGLTOT = \sum_{m=1}^{1} LRGLTOT_{t-m} + \sum_{m=1}^{1} LRGM_{t-m} + u_1} \quad \text{........ } \mathbf{(1)}$$
$$\boldsymbol{LRGM = \sum_{m=1}^{1} LRGLTOT_{t-m} + \sum_{m=1}^{1} LRGM_{t-m} + u_2} \quad \text{........ } \mathbf{(2)}$$

Exhibit 7A.2 : Pair wise Granger Causality Tests – Total Gold loans and Gold imports both expressed in real terms (Variables in logs and adjusted for seasonality)			
Sample: April 2008 to March 2012 Lags: 1			
Null Hypothesis:	Obs	F-Statistic	Prob.
LRGLTOT does not Granger Cause LRGM		6.67	0.01**
LRGM does not Granger Cause LRGLTOT	47	0.0045	0.95

Note: LRGLTOT and LRGM indicates natural log of Total gold loans outstanding and gold imports expressed in real terms respectively. Also,*,**,*** represents significance at 1 per cent, 5 per cent and 10 per cent level, respectively.

$$\boldsymbol{LRGLNB = \sum_{m=1}^{2} LRGLNB_{t-m} + \sum_{m=1}^{2} LRGM_{t-m} + u_3} \qquad \text{........ (3)}$$
$$\boldsymbol{LRGM = \sum_{m=1}^{2} LRGLNB_{t-m} + \sum_{m=1}^{2} LRGM_{t-m} + u_4} \qquad \text{........ (4)}$$

Exhibit 7A.3: Pair wise Granger Causality Tests- Gold Loans by NBFCs and Gold imports both expressed in real terms (Variables in logs and adjusted for seasonality)			
Sample: April 2008 to March 2012 Lags: 2			
Null Hypothesis:	Obs	F-Statistic	Prob.
LRGLNB does not Granger Cause LRGM	46	3.53	0.03**
LRGM does not Granger Cause LRGLNB		0.51	0.60

Note: LRGLNB and LRGM indicates natural log of Total gold loans by NBFCs outstanding and gold imports expressed in real terms respectively. Also,*,**,*** represents significance at 1 per cent, 5 per cent and 10 per cent level, respectively.

7A.3 These tests indicate that there is unidirectional causality with the causality running from gold loans to gold imports, both of which are in real terms and adjusted for seasonality. This is not surprising given the fact that gold loans are impacted by the stock of gold holdings and by the flow of gold imports.

7A.4 Though granger causality cannot be used to determine parameter estimates in 17 the presence of stationarity, it can serve as an effective guide to identifying relationships between variables. Moreover, as argued by Sims (1980), the differencing procedure suggested by Box-Jenkins methodology could be 'throwing away' information concerning co movements in the data such as possibility of co-integrating relationships.

7A.5 In order to derive quantitative estimates regarding the causal impact of gold loans on gold imports, following simultaneous equation system, modelling demand and supply of gold, is employed. Within this framework, it is possible to test the proposition whether volume of gold imports are influenced by gold loans outstanding, expressed in real terms and to arrive at a quantitative estimate of the impact.

$$GM^D = \propto_0 + \propto_1 \ GPW + \propto_2 GL + \propto_3 GXJ + \propto_4 \ USD + \propto_5 SNX(-2) + u_5 \ \ldots\ldots\ (5)$$
$$GM^s = \propto_0 + \propto_1 \ GPW + \propto_2 GX + \propto_3 USD + \ u_6 \qquad \ldots\ldots\ (6)$$

7A.6 The demand for gold imports (GM^D) is a function of world gold price proxied by the London price (GPW), gold loans [GL=Gold loans outstanding by NBFCs (RGLNB) or Total gold loans outstanding (RGLTOT)] proxying demand for short run liquidity, bilateral India U.S. exchange rate (USD), lagged values of alternate assets proxied by Sensex (SNX) and gold jewellery exports to control for foreign demand for Indian jewellery. The supply of gold imports (GM^S) is determined by gold exports of its major gold exporting countries (GX) as well as world gold price. The monthly data on exports of gold from South Africa, Australia, United States and Peru have been aggregated to serve as proxy for the supply of gold exports. As India is a major consumer of gold, the Group assumed that Indian imports of gold and world gold price are simultaneously determined within the model and hence endogenous. All other variables in the two equation system, which are exogenous are employed as instruments in their levels and lag forms, to derive estimates for the factors influencing demand for gold imports. The impact of total gold loans (RGLTOT) as well as gold loans by NBFCs outstanding (RGLNB) on imports is presented in Table 8. The t- statistics provided in **Exhibit 7A.4** within brackets are based on heteroskedasticity and autocorrelation consistent Newey-West standard errors.

Exhibit 7A.4: Gold Loans and Gold Imports -Two Stage Least Squares estimates (Variables in logs and adjusted for seasonality) HAC estimates

Dependent Variable :RGM		Dependent Variable :RGM	
C	34.19* (2.42)	C	34.76* (2.51)
RGLNB	1.19** (2.10)	RGLTOT	2.24** (2.43)
GPW	-2.78*** (-1.72)	GPW	-3.38*** (-1.91)
RGXJ	0.31 (0.80)	RGXJ	0.19 (0.42)
USD	-1.27 (-0.45)	USD	-2.85 (-1.21)
SNX(-2)	-0.02 (-0.03)	SNX(-2)	-0.03 (-0.05)
Adj R^2	0.37	Adj R^2	0.43
D.W	1.98	D.W	1.99

Note: *,**,*** represents significance at 1 per cent, 5 per cent and 10 per cent level, respectively.

OLS Estimates

7A.7 In order to further examine the possible determinants of gold imports in India, the following specification was also estimated based on monthly data available for 2008-09 to 2011-12.

$$GD_t = \alpha + \beta_1 DLnGP_t + \beta_2 LnGL_t + \beta_3 DLnWPI_t + \beta_4 RBD_t$$

7A.7 Here the dependent variable GD represents quantum of India's gold demand where as independent variables include (i) international gold prices in rupees (DLnGP), (ii) gold loans by banks and NBFCs (LnGL), (iii) Inflation Rate (DLnWPI) and (iv) deposit rate offered by banks (RBD). Gold price, in terms of rupee, reflects the movement in the international gold price as well as INR exchange rate. Other long-term factors which affect gold demand could be (i) increase in per capita income level, (ii) changing consumption pattern, (iii) urbanisation, etc. However, these variables are not included in the present model as it is estimated based on monthly data available for four years.

7A.8 It is expected that gold loans offered by banks may be generating demand for gold imports. With the gold schemes becoming popular, even the perception of households may have changed to use gold not only as an addition to wealth but also as collateral to borrow funds from banks and non-banking financial intermediaries. Theoretically, gold prices should have depressing effect on gold demand. However, upward bias in movement of gold prices can build up positive expectations among investor for short-term gains. Therefore, a positive sign of coefficient of variable representing rate of change in gold price cannot be ruled out. Change in inflation rate is used to examine whether gold is being used as a hedge against inflation which has been observed in other countries, particularly advanced countries. For capturing the impact of return on other available investment avenues on gold demand, the deposit rate of banks has been used as a variable.

7A.9 Respective coefficients of gold prices and gold loans have shown expected signs and are statistically significant **Exhibit 7A.5**. In the case of seasonally adjusted WPI, the sign of the coefficient was expected but is not statistically significant. Likewise, results show that increase in deposit rate has dampening effect on gold imports but again the coefficient is not statistically significant.

Exhibit 7A.5: Determinants of India's Gold Imports				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	2.8	0.8	3.3	0.0
D(LOG(GPR))	2.9	1.2	2.5	0.0
LOG(DOSGL)	0.3	0.1	3.4	0.0
DLOG(WPISA)	3.3	12.0	0.3	0.8
DR	-0.1	0.1	-1.0	0.3
R-squared	0.30	F-statistic		4.5
Adjusted R-squared	0.23	Durbin-Watson stat		2.0

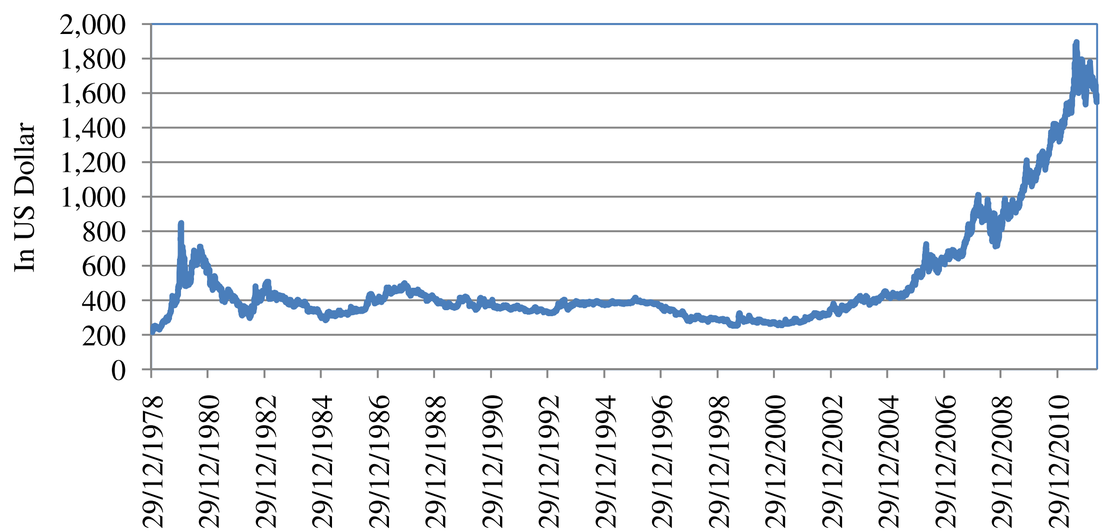
8. Recent Trends in Gold Loans and Impact on Gold Prices

8.1 The recent years have witnessed consistent rise in price of gold. Simultaneously, the gold loans outstanding with the NBFCs focussing on gold loans and that of commercial banks have also grown rapidly. There is a need to study the trends in gold prices and gold loans outstanding to understand, whether there is any link between them. The Working Group has undertaken an analysis of the trends in gold prices and examined whether NBFCs extending gold loans has any role in influencing the gold prices or *vice versa*. In this context, the Working Group has also examined the volatility in gold prices in India to make an assessment of its impact on the NBFCs focussing on gold loan business.

I. Trends in Gold Price

8.2 The consistent rise in gold price besides other contributing socio-economic factors, during the last 11 years has positioned gold as an attractive investment option. Further, the lack of penetration of organised banking in rural areas compels the households to divert their savings to gold. In recent years, global financial markets volatility and concerns over sovereign debt in the Euro zone prompted investments in gold which led to sharp increase in gold prices (Chart 8.1). With the introduction of QE 3, there are expectations that gold prices are embarked on an up leg during the remaining months of 2012.

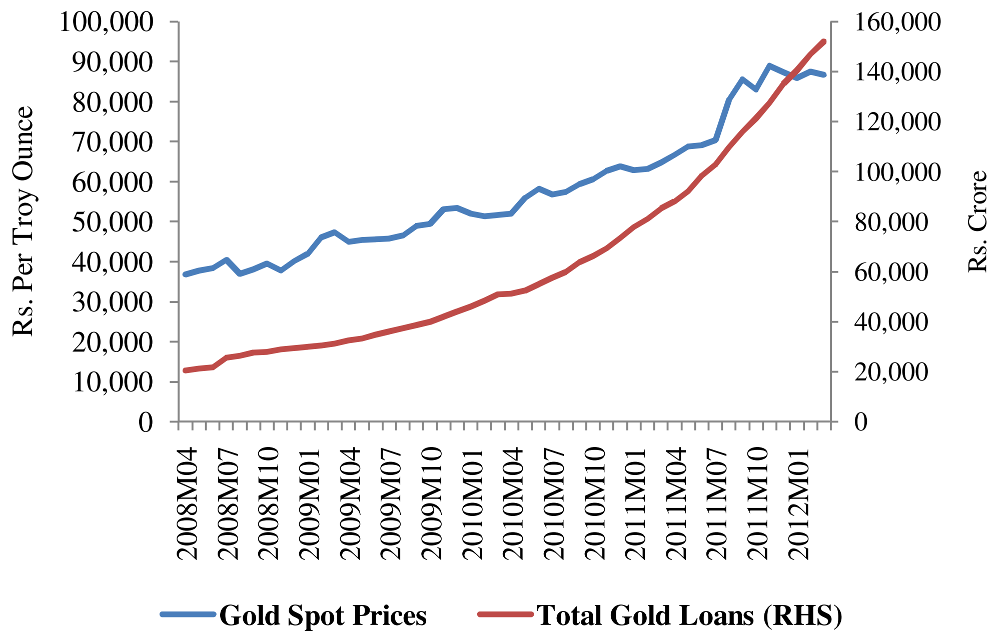
Chart 8.1: Gold Price in US Dollar - London Fix Price



***Source*:** World Gold Council

8.3 There was significant growth in gold loan market concurrent with the rise in gold prices during 2008-2012. The major reasons for the strong growth in Gold loans include aggressive structuring of gold loan products by the NBFCs to suit the needs of the customer, the ease of obtaining loans on account of meagre documentation involved in the process and higher loan to value (LTV) ratio maintained by NBFCs while providing gold loans. Commercial banks, taking a cue from the strategies adopted by NBFCs, have also been aggressively marketing their gold loan products, though with lower interest rates. Apart from these factors, the sharp rise in gold prices, in recent years, also could have contributed to the growth in gold loans. The association between domestic gold prices and total gold loans outstanding, in India, is apparent from Chart 8.2.

Chart 8.2: Movements in gold prices and gold loans by NBFCs and Banks



Source: World Gold Council

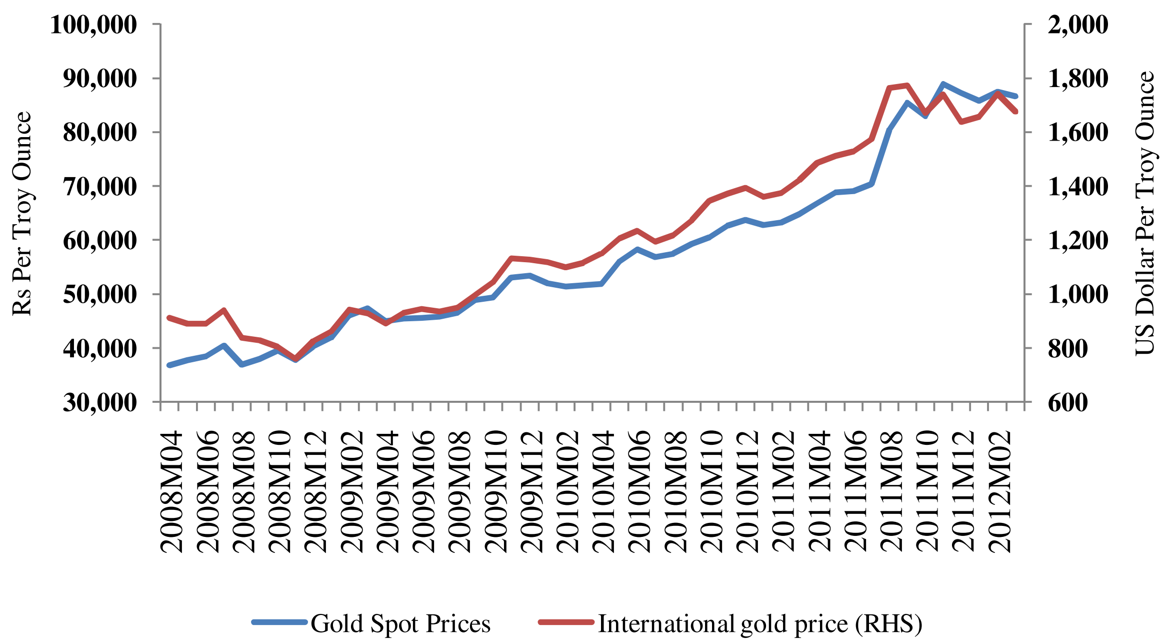
8.4 The gold prices as well as gold loans extended by both NBFCs and Banks have increased markedly over the period April 2008 to March 2012. While total gold loans increased by 65 per cent, the price of gold grew by 24 per cent, on a compounded annual average growth rate basis. This indicates a more rapid rise in gold loans extended by NBFCs and Banks as compared to the increase in gold prices.

II. Determinants of gold prices in India

8.5 As a financial asset, gold is unique in the sense that it possesses benefits of both use value and asset value. Though gold has strong use value, providing utility to the consumer in the socio- cultural environment of which he is part of, it also possess asset value, which latent during normal economic conditions, increases sharply during crisis period. The following factors, *viz*., (i) flow of supply and demand for gold, (ii) inflation, (iii) U.S. Dollar exchange rate, (iv) interest rate, (v) financial stress, (vi) political instability, and (vii) official sector activity (behaviour of central banks and other parts of official sector) play critical role in determination of international price of gold.

8.6 With the deregulation of gold imports in India, almost entire import of gold has been taking place through official channel leading to the integration of domestic and international gold prices. In recent years, the domestic gold price has moved in tandem with international gold prices (Chart 8.3).

Chart 8.3: Movements in Indian gold prices and International gold prices



***Source*:** World Gold Council

8.7 Since international gold prices have direct linkage to prospects of economic growth in general and its relative strength *vis-a-vis* US Dollar (USD) and Euro, these factors exerts influence on gold prices in India. In addition to external factors, investment in gold is traditionally viewed as a saving instrument in India. Thus domestic factors, including weak investor sentiments leading to a shift towards safe assets like gold has played a role in the recent rally. However it needs to be stressed that gold prices in India cannot be viewed in isolation to its global trends.

8.8 Apart from international prices, a critical factor that could impact gold prices in India is the USD/INR bilateral exchange rate. For instance, as the Rupee depreciates/appreciates, domestic gold prices should increase/decrease as bulk of Indian consumption of gold is met through imports. Also, the prices of alternative assets could play a part in the decision to invest in gold. Although the most important alternative asset price relevant to an Indian household looking for saving options will be housing or fixed deposits in banks, they are primarily a long term saving choice. In the short run, a comparable savings alternative would be investment in equity. Unlike housing but similar to gold, investments in equities can be acquired in tranches and hence does not require a long planning horizon. Therefore, downturns in equity market, could trigger a shift to safety and hence in the short run, there could be increase in gold demand in the domestic market leading to a rise in domestic gold prices. Though equity participation of Indian households is low, relative to global standards, movements in equity prices can proxy positive or negative expectations, regarding future, and hence can be an ideal candidate variable for characterising features like shift to safer assets during times of crisis. Apart from its short term utility to arrive at an acceptable risk return combination through portfolio rebalancing, investment in gold can also stem from a desire to hedge against inflation. Since, gold is considered as an inflation hedge in the long-run the level of inflation can affect the gold prices. If the level of inflation is high, gold consumption may increase leading to higher gold prices in India.

III. Whether the NBFCs extending gold loans have any role in influencing the gold price? - Empirical analysis

8.9 Given the phenomenal increase in the gold loans extended by NBFCs and Banks in the recent period, there has been some concern that whether the NBFCs extending gold loans has any role in influencing the gold price. The ease of obtaining loans on account of meagre documentation, higher loan to value maintained by the NBFCs, effective structuring of gold loan products tailored to the suit customers' needs and rapid appreciation of gold value would have enhanced the attractiveness of gold loans, among the significant cross section of population, who faced severe borrowing constraints in the past. Naturally since gold loans requires gold ornaments as collateral for sanctioning loans, its increasing popularity as a new financial instrument is bound to increase the demand for gold ornaments among Indian households in order to address possible liquidity mismatches in future. Against this background, the Working Group examined whether gold prices influence gold loans and vice versa.

Whether gold prices influence gold loans? – Relationship between gold loans by NBFCs outstanding and gold price

8.10 The Working Group undertook the pair-wise granger causality test to ascertain the relationship between gold loans by NBFCs and domestic price of gold. The hypothesis that gold loans by NBFCs can affect gold prices is not supported by granger causality test in bivariate framework.

8.11 In order to study the relationship between the gold prices and the gold loan outstanding with banks and NBFCs in multivariate framework, the Working Group used autoregressive distributed lag (ARDL) cointegration model as proposed by

Pesaran *et al* (1996). The Group used monthly data from April 2008 to March 2012 with 48 observations. The variables are: (i) domestic gold prices, (ii) gold loans extended by banks and NBFCs, (iii) inflation, (iv) average exchange rate (INR/USD), (v) international gold price and (vi) stock prices (BSE Sensex). The simple correlation among variables shows the strong correlation exist among gold prices in India, international gold prices and gold loans extended by NBFCs and banks (Appendix Table 8AT.1). However there is only moderate correlation among domestic gold prices, inflation and stock prices.

8.12 The ARDL cointegration test between domestic gold prices, international gold prices, total gold loans, exchange rate and stock index shows that there is cointegrating relationship among the variables (Appendix Table 8AT.2).

IV. Gold prices and exchange rate

8.13 The exercise results (as explained in Para 8A.8) establish a strong linkage between domestic and international gold prices and exchange rate in the short-run.

The empirical findings can be summarised as follows:

8.14 There is a cointegrating relationship among gold price in India, international gold prices, gold loans, exchange rate and stock index revealing a long run relationship among these variables. In the long run and short run, increase in gold loans extended by NBFCs and banks does not impact significantly the gold prices in India. The error correction term is large and significant, implying that any long run disequilibrium will be corrected significantly in the next month.

8.15 Thus, the broad conclusion that emanates from the analysis is that the increase in gold prices appears to be leading to increase in gold loans outstanding. The economic rationale for this relationship is that, as mentioned earlier, when the gold prices were generally increasing, with a liberal loan to value ratio, people are generally induced to invest in gold due to the prospects of gold value appreciation and the possibility to raise a loan in case of need. But, the gold loans extended by the NBFCs and the banks do not impact gold prices in India both in the long run and short run. Possible explanation for this relationship is that gold loans are raised for the purpose of consumption as well as productive purposes. Gold prices in India are a function of international gold prices, exchange rate, domestic demand etc.

V. Volatility in Gold Price

8.16 The Working Group has also studied the volatility aspect of gold prices to make an assessment of a possibility and the extent of gold price crash and see the resultant impact on the balance sheet of gold loan NBFCs.

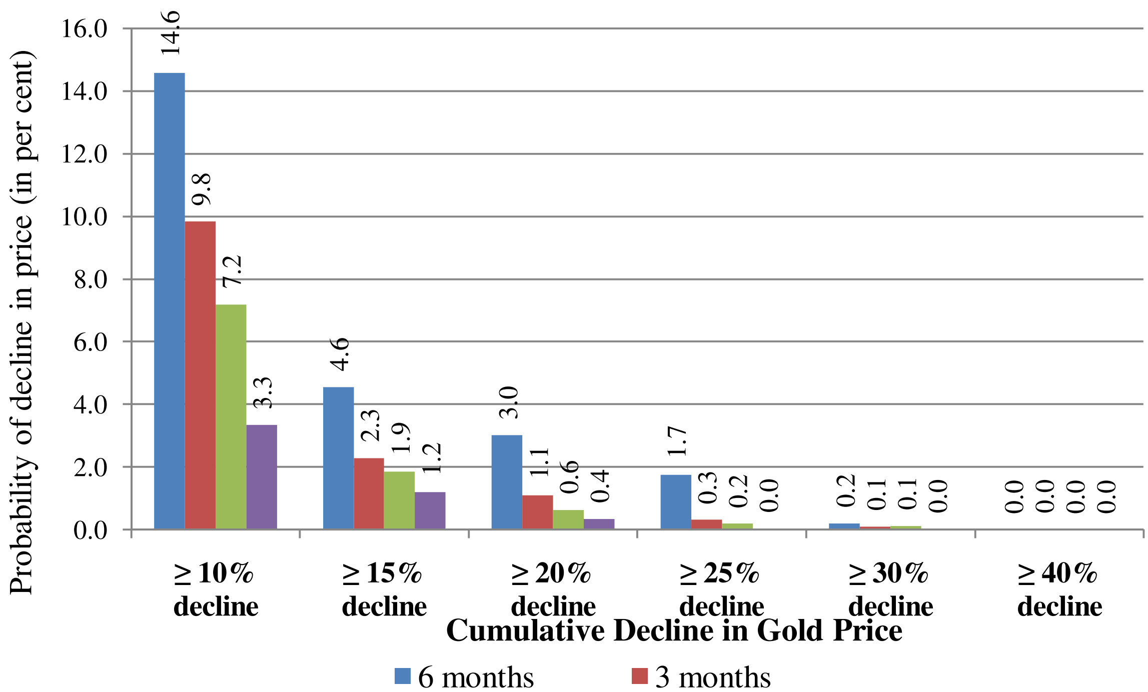
8.17 The Working Group investigated the applicability of generalized autoregressive conditional heteroskedasticity (GARCH) in the context of explaining volatility in gold prices. It is hypothesised that the nominal value of gold may go up in the event of an increase in its price, consequently, the borrower may be at less advantageous position in terms of LTV ratio. On the other hand, in the event of decline in gold price, it may pose problem for gold-loan NBFCs and financial system as a whole due to their inter-connectedness. In this scenario, the Working Group has assessed the volatility in price of gold and appropriateness of the LTV at 60 per cent from regulatory perspective.

8.18 As per the results, the Mean Absolute Percent Error having more than 100 per cent indicates that the model forecasts are unable to account for much of the variability of the out-of-sample part of the data. This is to be expected, as forecasting changes in gold price, like the changes in the prices of any other assets is difficult. Due to forecasting difficulties, the Working Group has assessed the historical volatility in terms of probability of decline in gold price.

VI. Probability of gold price decline – Possible impact on NBFCs - Alternative specifications

8.19 As sound forecasting of the volatility in gold prices appears to be technically infeasible, the Working Group studied the historical patterns of major gold price declines over past thirty years. In order to assess the conceivable future decline in gold prices, the Working Group identified episodes of price declines over periods of 6 months, 3 months, 2 months and one month basis and derived a frequency distribution. From the frequency distribution, the probability of occurrence of major and minor declines is measured. Based on a CRISIL's methodology, the Working Group also calculated the probability of gold price decline in four baskets (6-months, 3-months, 2-months and 1 month basis) using World Gold Council's long-run daily price of gold in US Dollar from January 1979 to April 2012. It is evident from the analysis of the past data that there is no probability of a drop in gold price of more than 40 per cent and even the possibility of 30 per cent or more fall is very rare in all the four baskets. However, based on past episodes a likelihood of decline in gold price of 10 per cent or above could be in the range of 14.6 per cent to 3.3 per cent over the time horizons considered. Similarly, the possibility of decline in gold price of more than 20 per cent or above could be in the range of 0.4 per cent to 3.0 per cent (Chart 8.4).

Chart 8.4: Probability of decline in gold price
(Based on Daily Price in US $ (London Fix) –January 1979 to April 2012)



Source: Working Group's calculations based on World Gold Council's data

VII. Conclusion:

8.20 In other words, the analysis suggests that there is only a minuscule probability associated with gold price reductions of 30 per cent or more in the short run. However, a 10 per cent decline in gold prices is a likely possibility during a six month period. The Reserve Bank's stipulation that all gold loan NBFCs shall maintain an LTV ratio, not exceeding 60 per cent for loans granted against the collateral of gold jewellery, would ensure that these NBFCs maintain reasonable risk cover against such loans. This measure will ensure that there is no shock is built into the financial system in the long-run as a result of concentration risk inherent in gold loan business.

8.21 Besides, it needs to be noted that even when there is a fall in the gold prices, the loss to be booked depends on the value of jewels that may have to be auctioned and not on the value of entire collateral the gold loans NBFCs hold. Normally, the jewellery that may go for auction is in the range of 2 to 3 per cent of the entire collateral held per annum. It is also pertinent to recognise that the gold price decline takes place over months and the average repayment period of the gold loans NBFCs is between 3 to 6 months.

8A.Technical Note - Gold Loans and Impact on Gold Prices

Whether gold prices influence gold loans? – Relationship between gold loans by NBFCs outstanding and gold price

8A.1 The Working Group undertook the pair-wise granger causality test to ascertain the relationship between gold loans by NBFCs and domestic price of gold. Though granger causality cannot be used to determine parameter estimates in the presence of stationarity, it can serve as an effective guide to identifying relationships between variables. Moreover, as argued by Sims (1980), the differencing procedure suggested by Box-Jenkins methodology could be 'throwing away' information concerning co movements in the data such as possibility of co-integrating relationships. As various information criterion point towards either a lag of 6 or 12, the pair-wise granger causality tests are conducted incorporating both lags. The granger causality test indicates unidirectional causality with the direction of causality running from domestic gold prices to gold loans by NBFCs for both the lags (**Exhibit** 8A.1 and 8A.2).

$$LRGLNB = \sum_{m=1}^{6} LRGLNB_{t-m} + \sum_{m=1}^{6} LGP_{t-m} + u_1 \qquad \ldots\ldots \ (5.1)$$
$$LGP = \sum_{m=1}^{6} LRGLNB_{t-m} + \sum_{m=1}^{6} LGP_{t-m} + u_2 \qquad \ldots\ldots \ (5.2)$$

Exhibit 8A.**1 : Pair-wise Granger Causality Tests- Gold loans by NBFC's expressed in real terms and Gold prices**			
Pair-wise Granger Causality Tests Lags: 6			
Null Hypothesis:	Observations	F-Statistic	Prob.
LRGLNB does not Granger Cause LGP	42	1.69	0.15
LGP does not Granger Cause LGLNB		3.93	0.005*

Note : LGP and LRGLNB indicate natural log of domestic price of gold and gold loans by NBFCs expressed in real terms, respectively. Also, * represents significance at 1 per cent, level.

$$LRGLNB = \sum_{m=1}^{12} LRGLNB_{t-m} + \sum_{m=1}^{12} LGP_{t-m} + u_3 \qquad \ldots\ldots\ldots \ (5.3)$$
$$LGP = \sum_{m=1}^{12} LRGLNB_{t-m} + \sum_{m=1}^{12} LGP_{t-m} + u_4 \qquad \ldots\ldots\ldots \ (5.4)$$

Exhibit 8A.**2: Pair-wise Granger Causality Tests- Gold loans by NBFC's expressed in real terms and Gold prices**			
Sample: 2008 April 2012 March Lags: 12			
Null Hypothesis:	Observations	F-Statistic	Prob.
LRGLNB does not Granger Cause LGP	36	1.59	0.23
LGP does not Granger Cause LRGLNB		3.22	0.03**

Note: LGP and LRGLNB indicate natural log of domestic price of gold and gold loans by NBFCs expressed in real terms, respectively. Also, ** represents significance at, 5 per cent level.

8A.2 The hypothesis that gold loans by NBFCs can affect gold prices is not supported by granger causality test in bivariate framework.

8A..3 In order to study the relationship between the gold prices and the gold loan outstanding with banks and NBFCs in multivariate framework, the Working Group used autoregressive distributed lag (ARDL) cointegration model as proposed by Pesaran *et al* (1996). The Group used monthly data from April 2008 to March 2012 with 48 observations. The variables are: (i) domestic gold prices, (ii) gold loans extended by banks and NBFCs, (iii) inflation, (iv) average exchange rate (INR/USD), (v) international gold price and (vi) stock prices (BSE Sensex). The simple correlation among variables shows the strong correlation exist among gold prices in India, international gold prices and gold loans extended by NBFCs and banks (Appendix Table 5.1). However there is only moderate correlations among domestic gold prices, inflation and stock prices.

8A.4 Before estimating the long-run relationship, all the variables are tested for their unit root properties. All the variables are in log form. The unit root test results using Augmented Dickey-fuller test shows that all the variables (Gold prices in India, international gold prices, exchange rate, Stock Index) except inflation show unit root properties. Inflation shows no unit root, thus indicating $I(0)$ property (Appendix Table 5.2). Further differencing, all the variables show no unit root, thereby showing $I(1)$ property. Given the nature of $I(1)$ and $I(0)$ variables in the model, Working Group used ARDL cointegration tests to examine the long-run relationships between domestic gold prices (Y_t), international gold prices (X_t), exchange rate (W_t), inflation rate (I_t), gold loans extended by NBFCs and Banks (G_t) and stock prices (W_t). The results indicated that inflation did not show the desired impact and was dropped from the empirical analysis.

8A.5 The ARDL cointegration model can be estimated in three steps. In the first step, we test the presence of cointegrating relationship on the following model:

$$\Delta Y_t = \theta_1 Y_{t-1} + \theta_2 X_{t-1} + \theta_3 Z_{t-1} + \theta_4 G_{t-1} + \theta_5 W_{t-1} + \sum_{i=1}^{k} \partial_i \Delta Y_{t-i} + \sum_{i=0}^{k} \varphi_i \Delta X_{t-i} + \sum_{i=0}^{k} \rho_i \Delta Z_{t-i} + \sum_{i=0}^{k} \tau_i \Delta G_{t-i} + \sum_{i=0}^{k} \lambda i \Delta W_{t-i} + \xi t \quad \text{---------(5.5)}$$

Where, Δ is the first difference operator.

8A.6 If the calculated F-statistic exceeds the critical values, we reject the null hypothesis of no cointegration. Otherwise, no meaningful long-run relationship can be formed from between these variables. Once we have cointegration relationship, the second step is to estimate the long run equation specified as

$$Y_t = \sum_{i=1}^{k} \partial_i Y_{t-1} + \sum_{i=0}^{k} \varphi_i X_{t-1} + \sum_{i=0}^{k} \rho_i Z_{t-1} + \sum_{i=0}^{k} \tau_i W_{t-1} + \sum_{i=0}^{k} \lambda i G_{t-i} + \xi t \quad \text{-------(5.6)}$$

In the third step, we estimate the short run relationship specified as

$$\Delta \ln Y_t = \sum_{i=1}^{k} \partial_i \Delta \ln Y_{t-i} + \sum_{i=0}^{k} \varphi_i \Delta X_{t-i} + \sum_{i=0}^{k} \rho_i \Delta Z_{t-i} + \sum_{i=0}^{k} \tau_i \Delta W_{t-i} + \sum_{i=0}^{k} \tau_i \Delta G_{t-i} + ECMt\text{-}1 + \mu i \quad \text{-------(5.7)}$$

8A.7 The ARDL cointegration test between the domestic gold prices, international gold prices, total gold loans, exchange rate and stock index show that there is cointegrating relationship among the variables (Appendix Table 8AT.3). The diagnostic tests show that there are no serious problems with serial correlation, functional form, heteroskedasticity but showed non-normal distribution (Appendix Table 8AT.4).

Gold prices and exchange rate

8A.8 The long run estimation shows that both international gold prices and exchange rate significantly and positively affect the gold prices in India (Table 8A.3). The total gold loans and stock market did not have a statistically significant effect on the gold prices in India. The short-run relationship (*i.e.* month-over-month changes) between domestic gold prices, international gold prices, exchange rate and stock index is established through the Error Correction Modelling (ECM) framework. The ECM results show that in the short-run the international gold prices and exchange rate affect positively and significantly the gold prices in India (**Exhibit** 8A.4). However, the total gold loans do not have significant effect on the gold prices in India. The error correction term, which shows the degree of correction in the long run disequilibrium, shows that any minor deviation, if any, gets corrected shortly as reflected through the high and significant coefficient of the error term. Thus, these results establish a strong linkage between domestic and international gold prices and exchange rate in the short-run.

Exhibit 8A**.3: Long Run Equation Results of ARDL (1, 1, 1)**

Dependent Variable: Log Gold Prices in India

Variable	**Coefficient**	**Prob**
Log International Gold Price	1.17*	0.00
Log Gold Loan	-0.06	0.16
Log Exchange Rate	0.96*	0.00
Log Stock	-0.04	0.21

* indicates significance at 1 % level.

Exhibit 8A**.4: Short Run ECM results**

Dependent Variable: Change in log Gold Prices

Regressor	Coefficient	Prob.
D(Log International Gold Price)	0.86*	0.00
D(Log Gold Loans)	-0.03	0.09
D(Log Exchange Rate)	0.46*	0.00
D(Log Stock)	-0.10*	0.00
ECM(-1)	-0.48*	0.00

* indicates significance at 1 % level.

Volatility in Gold Price

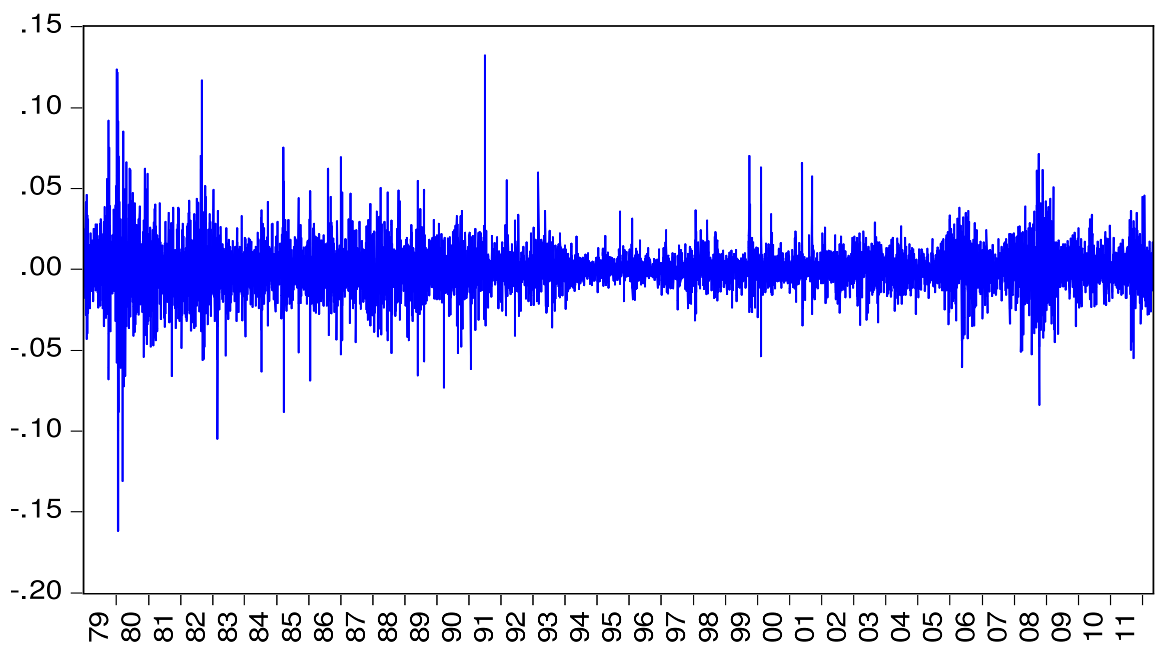
8A.9 The Working Group has also studied the volatility aspect of gold prices to make an assessment of a possibility and the extent of gold price crash and see the resultant impact on the balance sheet of gold loan NBFCs.

8A.10 The Working Group investigated the applicability of generalized autoregressive conditional heteroskedasticity (GARCH) in the context of explaining volatility in gold prices. It is hypothesised that the nominal value of gold may go up in the event of an increase in its price, consequently, the borrower may be at less advantageous position in terms of LTV ratio. On the other hand, in the event of decline in gold price, it may pose problem for gold-loan NBFCs and financial system as a whole due to their inter-connectedness. In this scenario, the Working Group has assessed the volatility in price of gold and appropriateness of the LTV at 60 per cent from regulatory perspective.

Methodology for Explaining Volatility

8A.11 In case of gold price, the series exhibits periods of unusually high volatility followed by more tranquillity. Simple plotting of the gold price data in differenced form demonstrates different sets of volatility, so the possibility of ARCH effect is quite high (Chart 8A.5). The autoregressive conditional heteroskedasticity (ARCH) developed by Engle (1982) and the generalised ARCH (GARCH) developed by Bollerslev (1986) are two methods, the Group has followed for modelling volatility in gold price in Indian Rupee over the period 1979-2012 based on daily data (5-day week) from the World Gold Council.

Chart 8A.5: Log Difference of gold price



Data Source: World Gold Council

8A.12 The simple model is as follows:

$$\gamma_t = a + \beta' X_t + u_t \qquad \text{... (5.8)}$$

8A.13 One way of allowing for this model is to have the variance depend on one lagged period of the squared error terms as follows:

$$\sigma_t^2 = \gamma_0 + \gamma_1 u_{t-1}^2 \qquad \text{... (5.9)}$$

which is the basic ARCH(1) process. One of the main reasons to consider the GARCH extension is that by allowing past volatilities to affect the present volatility, a more parsimonious model may result. According to Engle (1995), ARCH specification looked more like a moving average specification than an autoregression. The Working Group have followed the GARCH (1,1) process to model the gold price in Rupee terms.

8A.14 To test whether there are ARCH effects in the residuals of this model, the Group has used Breusch-Pagan-Godfrey ARCH test (**Exhibit** 8A.5).

Exhibit 8A**.5: Heteroskedasticity Test: Breusch-Pagan-Godfrey**

F-statistic	40.5366	Prob. F(2,8696)	0.0000
Obs*R-squared	80.3520	Prob. Chi-Square(2)	0.0000
Scaled explained SS	567.9150	Prob. Chi-Square(2)	0.0000

8A.15 The LM Statistic as represented by obs*R^2 is higher at 80.35 and has a probability limit of 0.000 suggesting the rejection of null hypothesis and indicates that an ARCH model will provide better results. The simplest form of GARCH(p,q) model is the GARCH(1,1) model for which the variance equation has the form:

$$Y_t = a + \beta' X_t + u_t \qquad \text{... (5.10)}$$

8A.16 The coefficients on both the lagged squared residual and lagged conditional variance terms in the conditional variance equation are highly statistically significant (**Exhibit** 8A.6). The sum of the coefficients on the lagged squared error (0.10) and lagged conditional variance (0.89) is very close to unity (approximately 0.99). This implies that shocks to the conditional variance will be highly persistent. The individual conditional variance coefficients as expected (C is very small at 0.00000164) . The GARCH Variance series GARCH(1,1) is presented in Chart 8A.5.

Exhibit 8A**.6: Gold price volatility**

Dependent Variable: LGOLD_PRICE
Sample (adjusted): 1/03/1979 5/07/2012
GARCH = C(3) + C(4)*RESID(-1)^2 + C(5)*GARCH(-1)

Variable	Coefficient	Std. Error	z-Statistic	Prob.
C	-0.001707	0.001235	-1.382140	0.1669
LGP(-1)	1.000199	0.000131	7.823	0.0000
Variance Equation				
C	1.64E-06	1.18E-07	13.89839	0.0000
RESID(-1)^2	0.104114	0.003325	31.31087	0.0000
GARCH(-1)	0.894404	0.002935	30.7359	0.0000

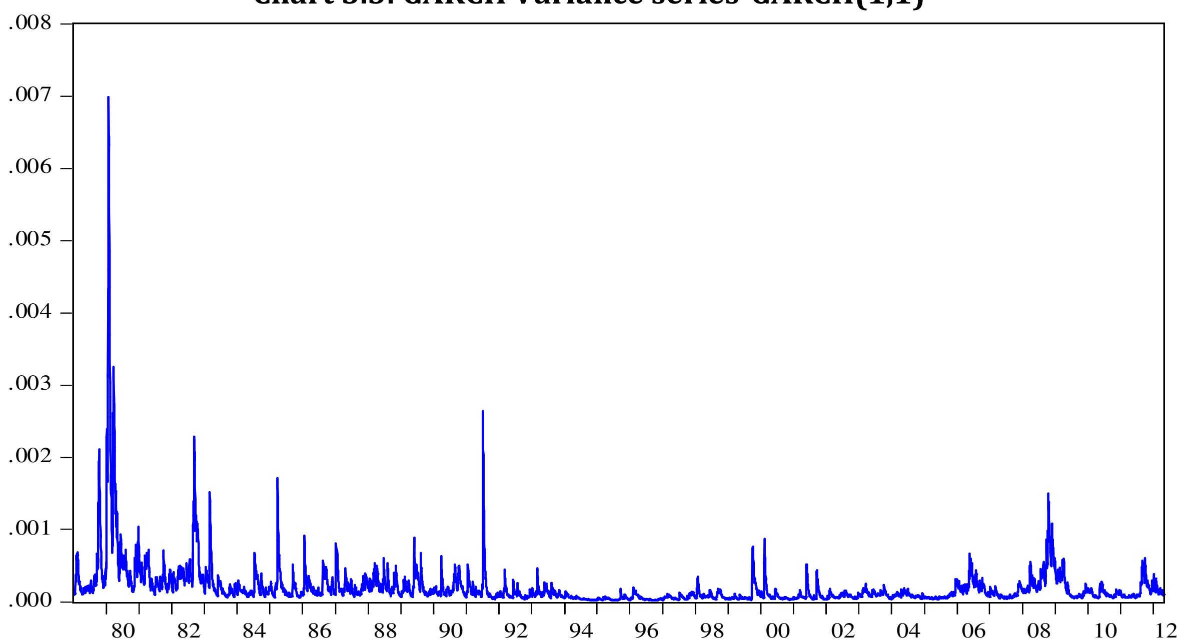
Note: LGP indicates natural logarithm of gold price.

It took 7 iterations to reach convergence in estimating above model. The model can be written as:

$$LGP_t = -0.0017 + 1.0002\, LGP_{t-1} + u_t \dots\dots..(5.11)$$
$$\quad (-1.38) \qquad (7.82)$$

$$h_t = 0.00000164 + 0.894\, h_{t-1} + 0.104\, u_{t-1}^2 + v_t \dots\dots(5.12)$$
$$(13.89) \qquad (30.73) \qquad (31.31)$$

Chart 5.5: GARCH Variance series-GARCH(1,1)



8A.17 As GARCH(1,1) requires high frequency data at daily frequency, our analysis is restricted to univariate GARCH method. Since, explanatory variables of gold prices are not available at daily frequency, multi-variate GARCH techniques are not applicable. As is the case with any financial asset, forecasting changes in gold prices ,is beset with issues relating to uncertainty in tracing the path of its many explanatory variables. Since this issues can be addressed only through multivariate techniques for which data at the required frequency is not available, the Working Group made use of alternative methodologies to arrive at probability of decline in gold prices.

Appendix Table 8AT.1: Correlation Structure among the factors influencing Gold prices in India

Covariance Analysis: Ordinary
Date: 06/01/12 Time: 18:38
Sample: 2008M04 2012M03
Included observations: 48

Correlation Probability	INDGOLDPRICE	INTGOLDPRICE	INF	EXCH	GOLDLOANS	STOCK
INDGOLDPRICE	1.00 -----					
INTGOLDPRICE	0.98 0.00	1.00 -----				
INF	0.42 0.003	0.52 0.0002	1.00 -----			
EXCH	0.35 0.02	0.17 0.24	-0.37 0.009	1.00 -----		
GOLDLOANS	0.98 0.00	0.96 0.0000	0.44 0.0015	0.33 0.02	1.00 -----	
STOCK	0.51 0.0002	0.62 0.0000	0.49 0.0004	-0.39 0.006	0.48 0.0005	1.00 -----

Appendix Table 8AT.2: Test for Stationarity

	Augmented Dickey Fuller Test	
	Intercept	**Intercept**
Variables in Levels		
Log Gold Prices in India	-0.23 (0.93)	-3.00 (0.14)
Log International Gold Price	-0.13 (0.94)	-3.41 (0.06)
Log Gold Loans	0.98 (0.99)	-0.99 (0.93)
Log Stock Index	-1.19 (0.67)	-1.88 (0.65)
Log Exchange Rate	-1.89 (0.34)	-1.92 (0.63)
Inflation (WPI)	-2.99* (0.04)	-4.30* (0.01)
Variables in Levels		
D(Log Gold Prices in India)	-4.75* (0.00)	
D(Log International Gold Price)	-5.09* (0.00)	
D(Log Gold Loans)	-6.30* (0.00)	
D(Log Stock Index)	-5.05* (0.00)	
D(Log NEER)	-6.35* (0.00)	

* indicates significance at 5 per cent level.

Appendix Table 8AT.3: ARDL (1,1,1) Cointegration test results

Test Statistic	Value	Lags	Significance level (%)	Bounds Critical Value	
				Lower	Upper
F-Statistic	5.38	1	5%	2.43	3.74

Appendix Table 8AT.4: Diagnostic test results for ARDL (1,1,1) Cointegration

Test Statistics	Lagrange Multiplier Test Value
Serial Correlation CHSQ(12)	9.59 (0.65)
Functional Form CHSQ(1)	0.33 (0.56)
Normality CHSQ(1)	171.50 (0.00)
Heteroskedasticity CHSQ(1)	0.25 (0.62)

9. Liability Management – An Assessment of Financial Performance of Gold Loan NBFCs-ND-SI

9.1 The high rate of growth witnessed in the volume of business of the Systemically Important Non-Deposit Taking NBFCs (NBFCs-ND-SI), which are primarily engaged in the business of lending against the collateral of gold jewellery (hereafter referred to as gold loan NBFCs) during the recent years warranted an analysis of the financial performance as well as soundness of these companies. Further, though all these companies are based in Kerala, their business is spread across the country through a large network of branches having implications for the entire financial system. This also underlined the need for analyzing the performance of these companies in the larger interest of the entire financial system. Accordingly, in this Chapter, an analysis of the financial performance of gold loan NBFCs during the period March 2008 to March 2012 is presented.

I. Analysis of the financial performance of gold loan NBFCs

9.2 The Reserve Bank seeks data on important financial parameters from all Non-Deposit taking systemically important NBFCs (with asset size of Rs.100 crore and above) for off-site surveillance on a monthly basis. The basic data for this analysis has been extracted from these on-line monthly returns submitted by the gold loan NBFCs to the Department of Non-Banking Supervision, Reserve Bank of India. The data are presented at aggregate level for six gold loan NBFCs which are predominantly into gold loan business (Annex-9.I).

Growth of Gold Loan NBFCs vis-à-vis NBFCs-ND-SI Sector

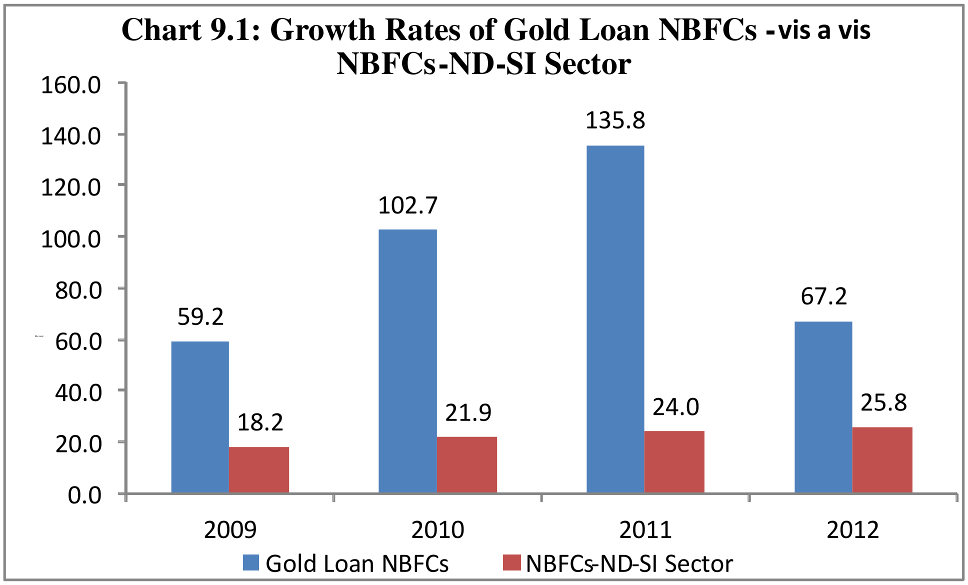
9.3 The gold loan NBFCs witnessed very high rate of growth of balance sheet during the recent years. It is pertinent to note that the growth rate of gold loan NBFCs was always higher than the growth rate of NBFCs-ND-SI sector as a whole during the last four years. However, there was a moderation in the growth rate of gold loan NBFCs during 2011-12 as compared with the previous year (Table 9.1 and Chart 9.1).

Table 9.1: Assets of Gold Loan NBFCs *vis-à-vis* NBFCs-ND-SI Sector

(As at end-March) (Rs.crore)

Item	2008	2009	2010	2011	2012
Total Assets of NBFCs-ND-SI sector	408705	482907	588806	730366	918904
Total Assets of Gold Loan NBFCs	3577	5694	11538	27206	45479

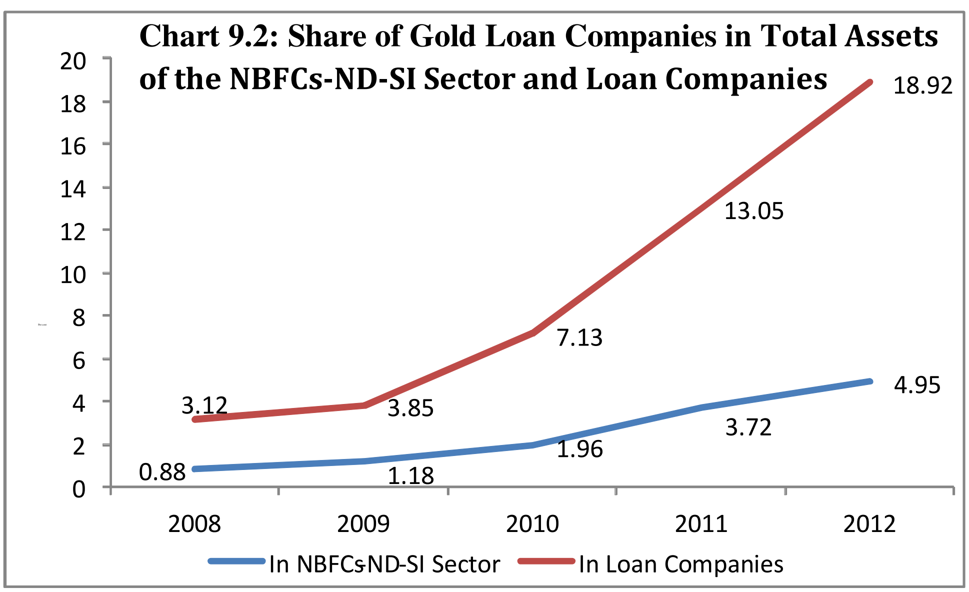
Source: Reserve Bank of India, DNBS Data Base



Source: Reserve Bank of India, DNBS Data Base

Share of Gold Loan NBFCs in the NBFCs-ND-SI Sector

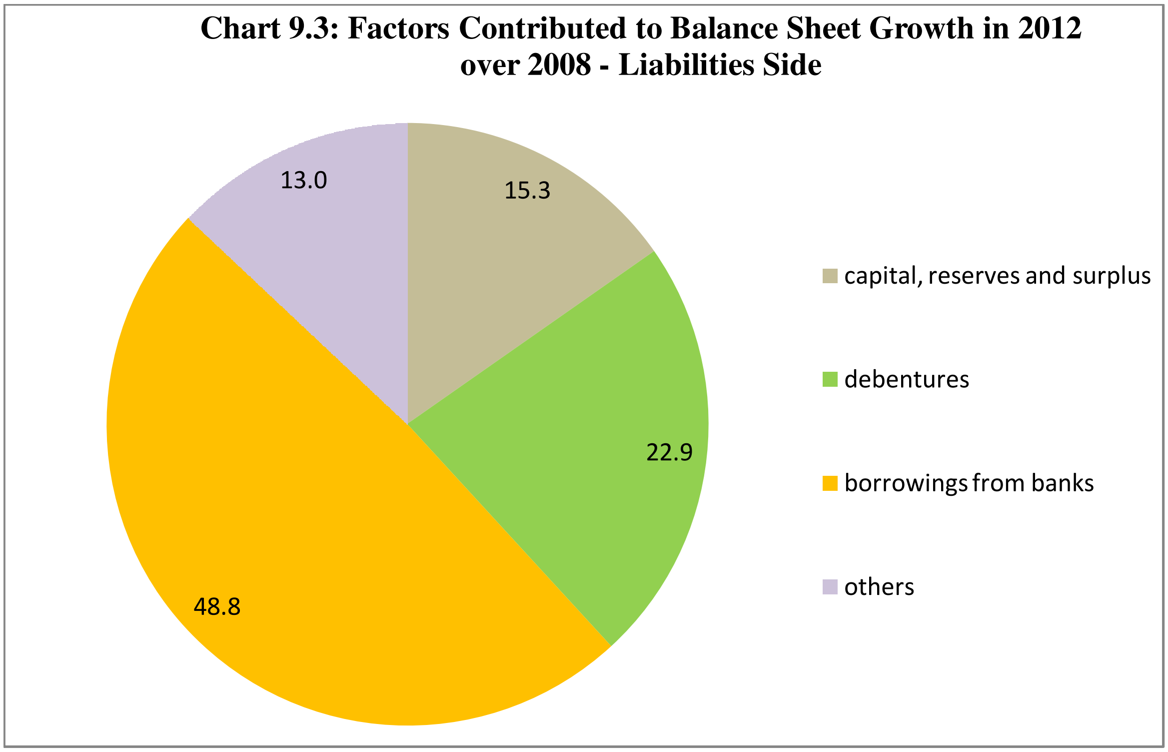
9.4 As the assets of gold loan NBFCs were growing at a very high rate as compared to the growth of the assets of the NBFCs-ND-SI sector during the period from 2009 to 2012, the share of assets of gold loan NBFCs in the total assets of NBFCs-ND-SI sector witnessed consistent increase during the same period. As at end-March 2012, the gold loan NBFCs accounted for almost five per cent of the total assets of the NBFCs-ND-SI sector. Further, assets of gold loan NBFCs constituted around 19 per cent of the total assets of loan companies as at end-March 2012 (Chart 9.2).



Source: Reserve Bank of India, DNBS Data Base

Factors Contributed to the Balance Sheet Growth of Gold Loan NBFCs

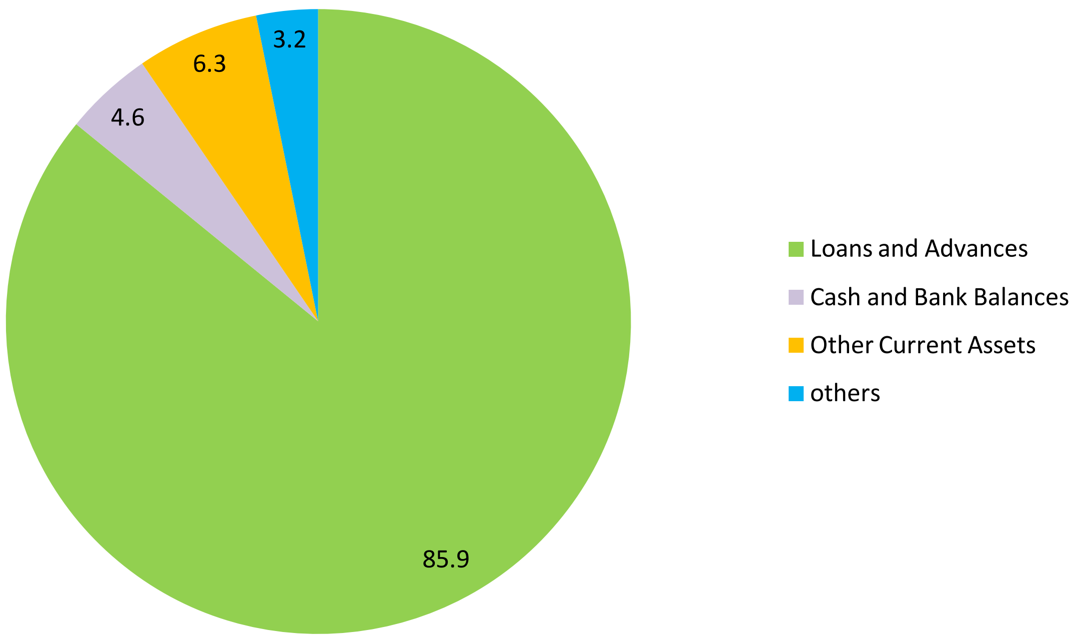
9.5 On the liabilities side, the growth of balance sheet of gold loan NBFCs was mainly contributed by borrowings from banks followed by debentures. On the positive side, the capital funds of gold loan NBFCs also contributed for the growth in balance sheet of gold loan NBFCs during the period under review (Chart 9.3).



Note: Composition of incremental increase in the balance sheet during the period 2008 to 2012 is plotted in the chart. ***Source:*** Reserve Bank of India, DNBS Data Base

9.6 On the assets side, the growth in balance sheet of gold loan NBFCs was mainly contributed by the increase in loans and advances since these companies are mainly into lending against gold jewellery (Chart 9.4).

Chart 9.4: Factors Contributed to Balance Sheet Growth in 2012 over 2008 - Assets Side

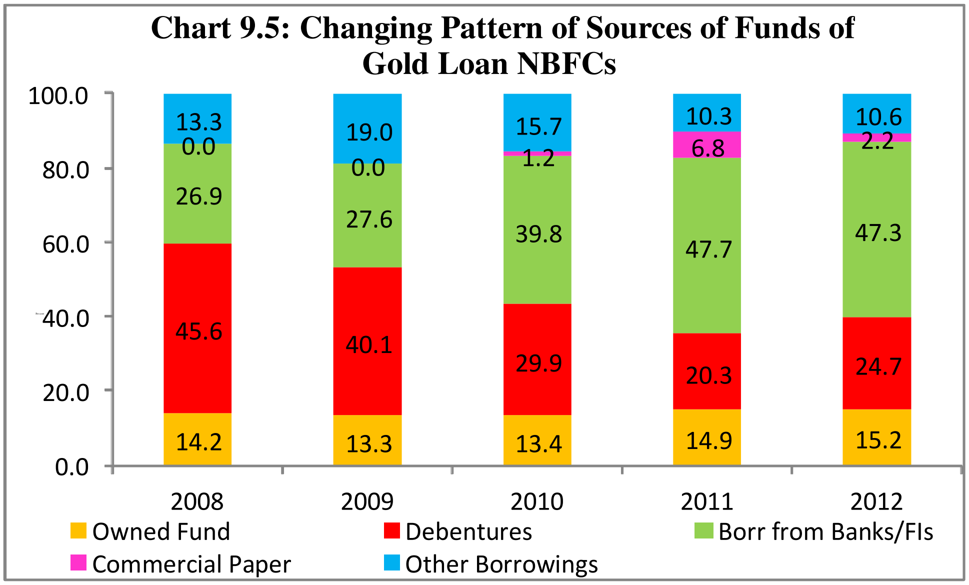


Note: Composition of incremental increase in the balance sheet during the period 2008 to 2012 is plotted in the chart. ***Source:*** Reserve Bank of India, DNBS Data Base

Sources and Uses of Funds of Gold Loan NBFCs

a. Sources of Funds

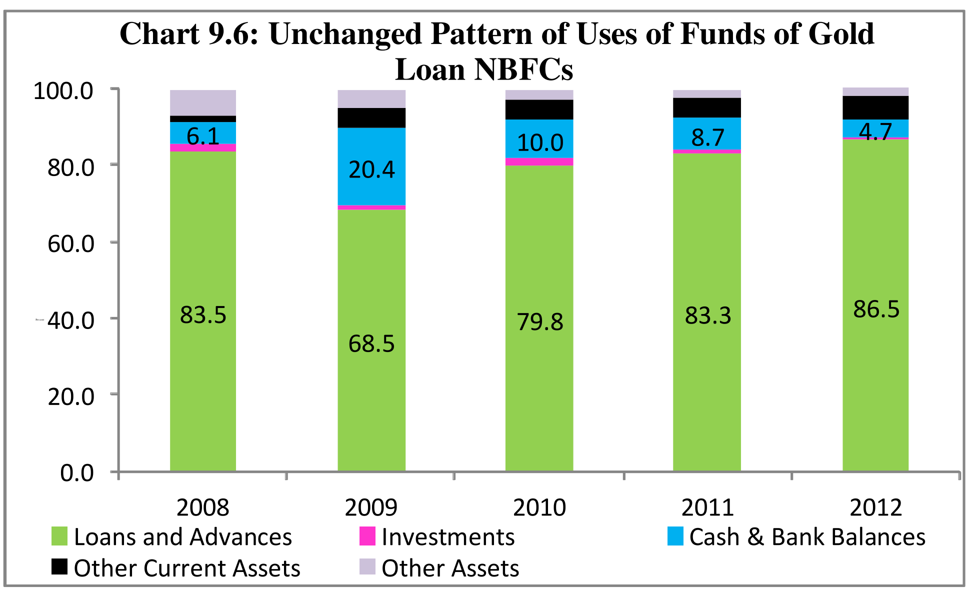
9.7 There was a change in the pattern of sources of funds of gold loan NBFCs during the recent years. Notably, since 2010, borrowings from banks have emerged as the most important source of funds for the gold loan NBFCs. Consequently, there has been a decline in the share of resources raised through debentures since 2010. Yet debentures are the second major source of funds for gold loan NBFCs. During the period under review, the share of owned funds remained more or less at the same level. Another point to be noted in this context is the emergence of commercial paper as a source of fund since 2010 (Chart 9.5).



Source: Reserve Bank of India, DNBS Data Base

b. Uses of Funds

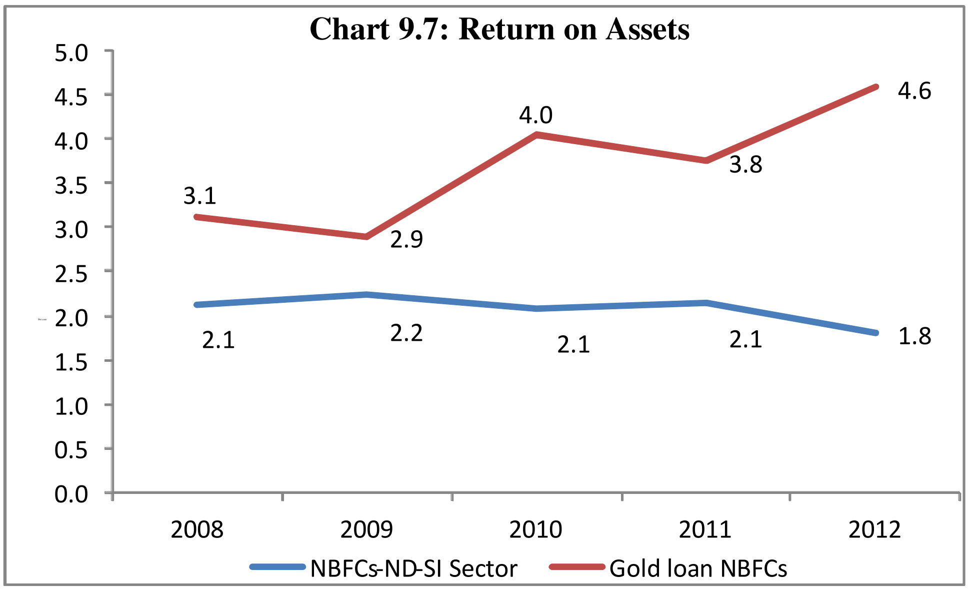
9.8 On the other hand, the pattern of uses of funds of gold loan NBFCs remained almost unchanged during the period under review. The loans and advances continue to be the largest use of fund for the gold loan NBFCs. It may be noted that the gold loan NBFCs deployed very less funds in current assets and other liquid assets such as cash and bank balances (Chart 9.6).



Source: Reserve Bank of India, DNBS Data Base

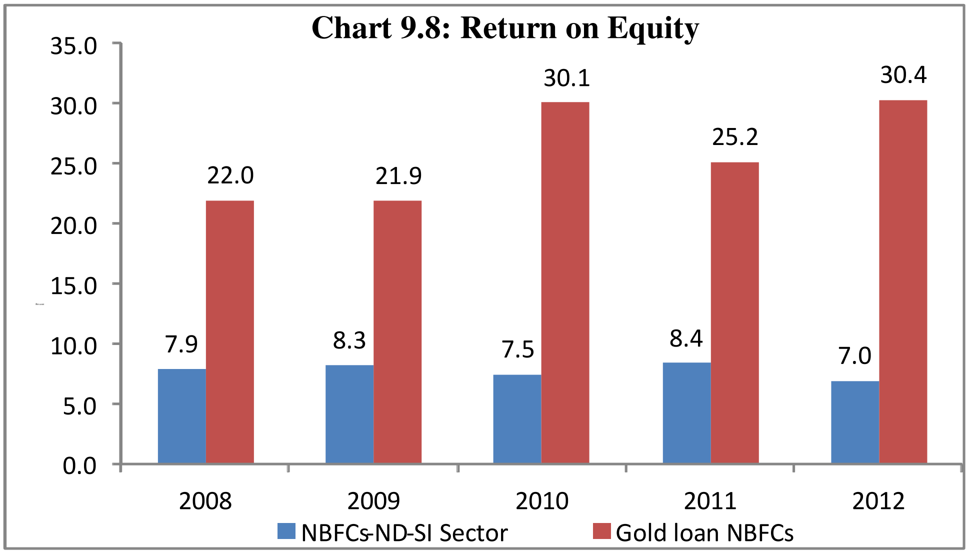
Profitability

9.9 Profitability of gold loan NBFCs has been much above than that of the NBFCs-ND-SI sector as a whole during the period under review. As at end-March 2012, the return on assets of gold loan NBFCs was at 4.6 per cent as against the return on assets of the NBFCs-ND-SI sector as a whole at 1.8 per cent. Further, during the period under study, while the return on assets of the entire NBFCs-ND-SI sector hovered around two per cent, the return on assets of gold loan NBFCs witnessed substantial increase (Chart 9.7).



Source: Reserve Bank of India, DNBS Data Base

9.10 Similarly, the return on equity of the gold loan NBFCs has also been consistently above the NBFCs-ND-SI sector as a whole during the study period. Higher return on equity displays better prospects for resource mobilization of these companies *vis-à-vis* other companies in the NBFCs-ND-SI sector (Chart 9.8).



Source: Reserve Bank of India, DNBS Data Base

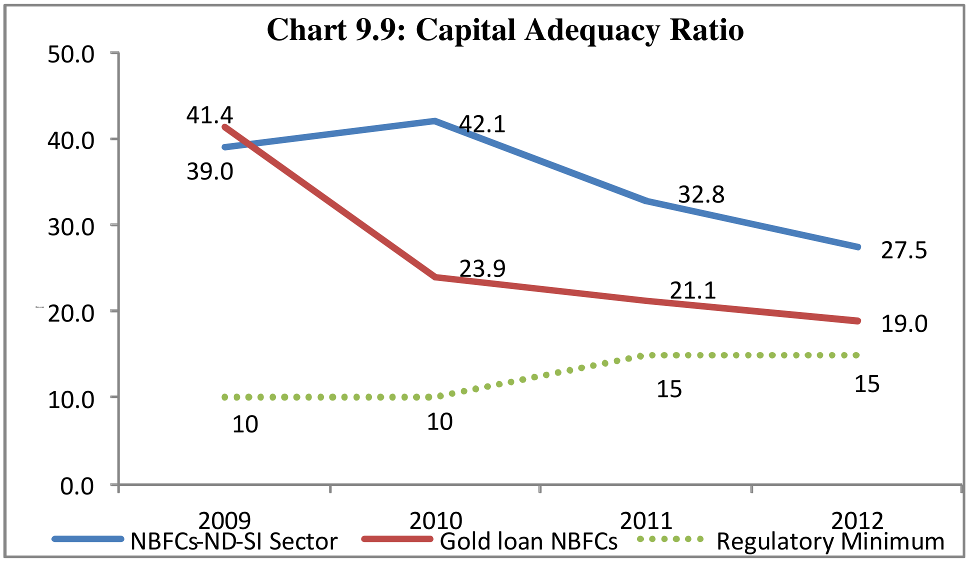
II. Financial Soundness

Capital to Risk Weighted Assets Ratio

9.11 The capital adequacy ratio of both the NBFCs-ND-SI sector as also the gold loan NBFCs witnessed substantial decline during the period under study.[4] Notably, the decline in the capital adequacy ratio of gold loan companies was more than the decline in the capital adequacy ratio of the NBFCs-ND-SI sector as a whole.

9.12 Further, capital adequacy ratio of gold loan NBFCs remained lower than the capital adequacy ratio of the NBFCs-ND-SI sector as whole since 2010. However, on the positive side, the capital adequacy ratio of gold loan NBFCs always remained above the regulatory minimum prescribed by the Reserve Bank (Chart 9.9).

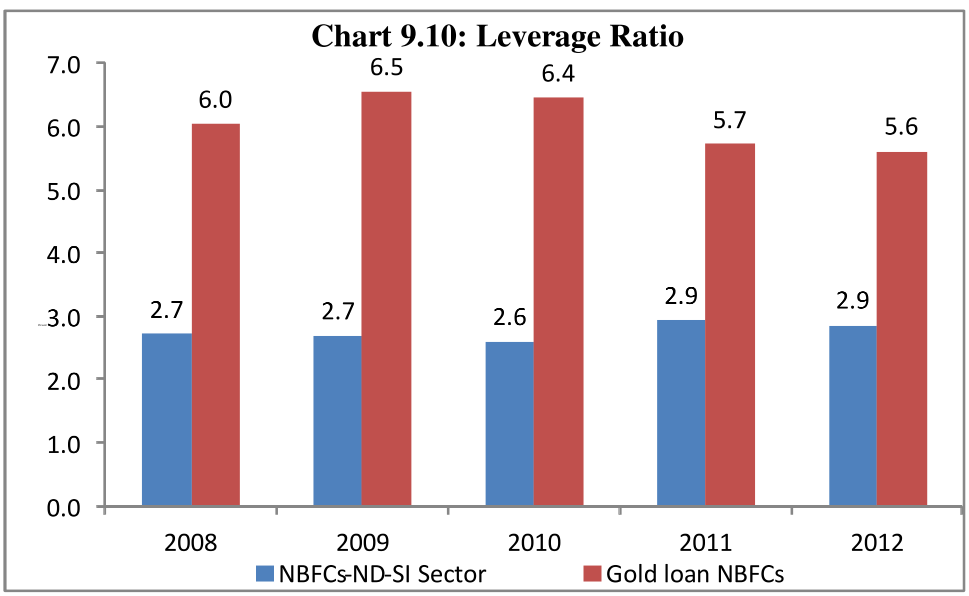
[4] Capital to risk-weighted assets ratio (CRAR) norms were made applicable to NBFCs-ND-SI with effect from April, 2007 (Vide Notification No. DNBS.193 DG (VL) 2007, dated 22-02-2007), in terms of which all NBFCs-ND-SI (including gold loan NBFCs) are required to maintain a minimum capital, consisting of Tier-I and Tier- II capital, of not less than 15 per cent of its aggregate risk-weighted assets (10 per cent up to March 2010).



Source: Reserve Bank of India, DNBS Data Base

Leverage Ratio

9.13 The leverage ratio of gold loan NBFCs has been consistently above than that of the NBFCs-ND-SI sector as a whole during the period under review.[5] However, it is important to note that since 2009, the leverage ratio of gold loan NBFCs witnessed a declining trend, though marginally. Decrease in leverage ratio indicates NBFCs' gradual improvement in owned fund either by infusion of additional capital or retained earnings (Chart 9.10).

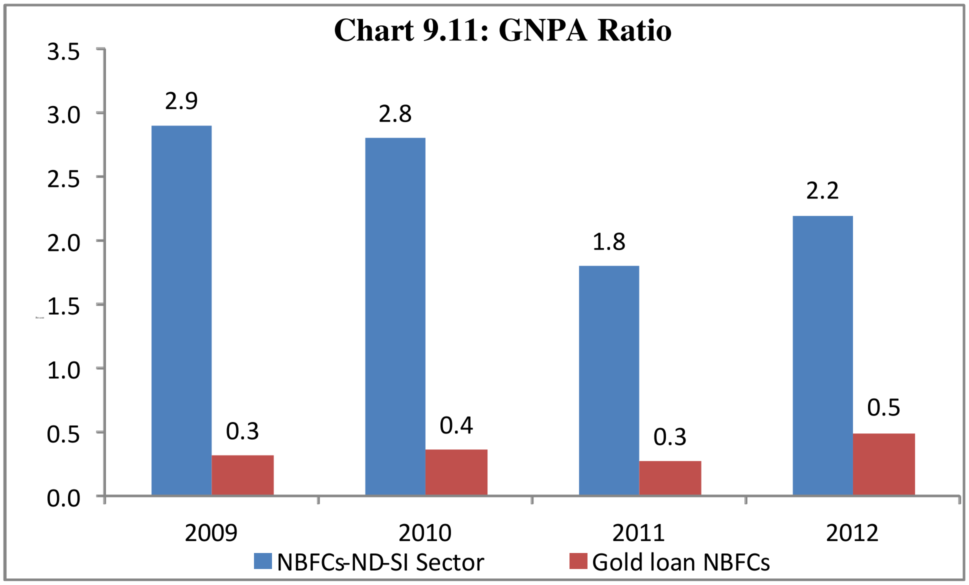


Source: Reserve Bank of India, DNBS Data Base

[5] Leverage ratio of NBFCs has been calculated as outside liabilities to owned fund.

Asset Quality

9.14 As gold loan NBFCs grant loans against security of gold/gold jewellery, gross NPAs to gross advances ratio of gold loan NBFCs was much less than that of the NBFCs-ND-SI sector. However, the GNPA ratio of gold loan NBFCs increased during 2011-12 as compared with the previous years (Chart 9.11).



Source: Reserve Bank of India, DNBS Data Base

III. Assessment of financial performance of the Gold Loan NBFCs:

9.15 As compared with the NBFCs-ND-SI sector as a whole, the gold loan NBFCs displayed better performance in terms of profitability during the period under review. This is evident from a number of performance indicators such as return on assets and return on equity. Though the capital adequacy ratio of gold loan NBFCs always remained above the regulatory minimum prescribed by the Reserve Bank, the ratio witnessed a declining trend during the period under review. Further, the leverage ratio of gold loan NBFCs has been above than that of the NBFCs-ND-SI sector as a whole, though it witnessed a declining trend during the recent years. Asset quality of gold loan NBFCs was always better than that of the NBFCs-ND-SI sector as a whole. The higher profits and lower NPA ratios reported by gold loan NBFCs were mainly due to the secured lending against gold jewellery. Further, the future prospects of these companies in terms of resource mobilization from the market are also positive, as these companies report high return on equity.

9.16 Relatively high leverage as compared with other companies in the NBFCs-ND-SI Sector: Leverage of gold loan companies has been higher than that of NBFCs-ND-SI sector as a whole during the period under study. Though the leverage ratio witnessed a marginally declining trend during the recent years, there may be a further need to limit the leverage of gold loan companies.

9.17 Increasing Share of Gold Loan NBFCs in the NBFCs-ND-SI Sector: As alluded to, earlier, NBFCs-ND-SIs include those companies whose assets are more than Rs. 100 crore. The major gold loan NBFCs fall into the NBFCs-ND-SI sector. Though the share of gold loan NBFCs in the NBFCs-ND-SI sector is still low at around five per cent as at end-March 2012, the consistent increase in the share of gold loan NBFCs in the NBFCs-ND-SI sector deserves attention.

9.18 Concentration of Assets in the Gold Loan Segment*:* Gold loan companies are into lending against the security of gold jewellery. There are instances where the companies lent up to 85 per cent of the value of gold earlier till the loan to value ratio was brought down to 60 per cent recently. One disquieting feature here is the fact that bulk of the gold loan NBFCs' assets are from one activity i.e., gold loan with majority concentration.

9.19 Resources mobilisation by NBFCs: Gold Loan companies have been taking recourse to bank borrowings and issuance of Non-Convertible Debentures (NCDs) for resource mobilisation. While banks are supposed to appraise the NBFCs' credit needs before sanctioning credit facilities, the mobilization of funds by these companies through issue of NCDs to retail customers in the guise of secured debentures raises concerns. The Working Group's Interaction with customers revealed that they are not aware of the difference between a debenture and deposit. However, they affirmed that they placed deposits with the companies and they did not face any difficulty in earning interest and getting back the principal as and when matured/required. Bank's IDMD circular dated June 23, 2010 read with Bank's DNBS circular dated December 30, 2011 governing issue of NCDs up to one year on private placement basis bars companies from issuing NCDs for less than 90 days. It was however observed that the companies were found to be allowing pre-closure well before 90 days and also allow loans against such NCDs. This violates and takes away the spirit of the regulatory intent. Secondly, companies issue NCDs for maturity period of one year and one day to escape the regulatory restrictions of the extant stipulations.

9.20 Profitability and Lending Practices: The profitability of gold loan NBFCs has been unusually high when compared with the NBFCs-ND-SI sector. The growth in profits of was mainly due to increase in the volume of business. However, an interaction with the aggrieved borrowers revealed some questionable practices followed by the gold loan NBFCs could also be partly the source of high profits. Some of the gold loans NBFCs are charging of usurious interest rates, appropriating the pledged gold jewellery and adopting questionable auctioning procedures.

IV. Recommendations

The rapid growth of their assets, borrowings and branch network needs to be monitored continuously

9.21 One of the major concerns of the growth story of the gold loan companies is the pace at which their assets size has grown in volume as well as the expansion of branch network. The rapid growth of their assets, borrowings and branch network needs to be viewed with circumspection and measures to moderate such growth to more sustainable levels are desirable.

Need to reduce the interconnectedness with the formal financial system:

9.22 An analysis of the sources of funds of gold loan NBFCs revealed that their dependence on the banking sector witnessed an increase during the last five years. Borrowings from the banking sector were the biggest source of funds for the gold loan NBFCs. The consistent increase in the dependence of the gold loan NBFCs on the banking sector raises concerns. Gold loan NBFCs should gradually reduce their dependence on the bank finance so as to bring down the interconnectedness with the formal financial system.

Declining capital adequacy ratio – Need to improve the capital.

9.23 The capital adequacy ratio of gold loan NBFCs witnessed a continuous declining trend during period under study. Further, the capital adequacy ratio of gold loan NBFCs was also lower than that of the NBFCs-ND-SI sector as a whole. The decline in the capital adequacy ratio despite increase in capital funds points to the aggressive asset growth that took place during the period under study. The gold loans NBFCs should strive to improve their capital.

Need to review the current stipulations pertaining to raising resources through NCDs

9.24 Some gold loans NBFCs have been circumventing Reserve Bank (IDMD) stipulations on Non-Convertible Debentures (NCDs) and mobilization of funds on retail form bearing ticket size of as less as rupees five thousands from public practically on tap at their branches. This is tantamount to raising 'surrogate deposits' because of exemption they are enjoying under Section 67(3) of Companies Act, 1956 from the stipulation of not more than 49 persons for private placement. If the present exemption available to NBFCs under Section 67 (3) of the Companies Act is removed or basic slab of individual contribution to NCD is prescribed for a minimum investment of Rs.10 lakh or so for private placement, it will deter retail investors to subscribe and confine private placements of NCDs by gold loans NBFCs to institutions and High Net worth Individuals. The issue may be taken up with Government of India for necessary amendments and issuing appropriate directions to companies.

The exemption available to secured debentures from the definition of "deposit" may be reviewed

9.25 While recognizing the need for deepening and broadening the bond market vis-à-vis the safety of retail depositors' and investors' funds in the hands of the NBFCs, it is recommended that the exemption available to secured debentures from the definition of "deposit" may be withdrawn. It is a trade-off in favour of the retail depositors and investors in a non-deposit taking company, which accepts camouflaged public deposits in the form of secured debentures. The deposit acceptance activity may be left to the banking system, where regulatory and supervisory framework is more robust. Similarly, exemption available from the definition of deposit to "Subordinated Debt" also needs to be withdrawn as the retail subscribers do not know the features and implications of subscription to such instruments. Recent regulatory measures on errant NBFCs saw such investors seeking repayment of subordinated debt instruments. Further, companies canvass for such subscriptions camouflaging them as deposits to the retail investors.

Annex- 9.I: Gold Loan NBFC-ND-SI

Item	(Rs. Crore)					Growth (y-o-y)			
	2007-08	2008-09	2009-10	2010-11	2011-12	2008-09	2009-10	2010-11	2011-12
1. Share Capital	128	135	404	633	911	5.4	200.6	56.5	43.9
2. Reserves & Surplus	381	620	1145	3419	5970	62.9	84.7	198.6	74.6
3. Debentures	1632	2284	3453	5532	11199	39.9	51.2	60.2	102.4
4. Bank Borrowings	922	1574	4568	12903	21306	70.7	190.2	182.5	65.1
5. Borrowings from FIs	39	0	20	65	142	-100.0	-	225.0	117.9
6. Inter-Corporate Borr	34	60	173	0	13	77.5	190.6	-99.7	2654.4
7. Commercial Paper	0	0	140	1846	1012	-	-	1217.6	-45.2
8. Other Borrowings	313	778	1024	2107	3674	148.8	31.6	105.7	74.4
9. Current Liabilities	67	146	372	187	454	117.7	153.7	-49.8	143.5
10. Provisions	63	97	239	513	648	55.5	145.8	114.6	26.5
Total Assets/Liabilities	**3577**	**5694**	**11538**	**27206**	**45479**	**59.2**	**102.7**	**135.8**	**67.2**
1. Loans & Advances	2981	3860	9179	22666	39230	29.5	137.8	146.9	73.1
2. HP & Lease Assets	7	38	31	5	0	451.9	-19.6	-84.8	-99.5
3. Investments	71	66	232	169	375	-7.8	253.3	-27.2	122.3
3.1. Govt. Securities	14	1	1	0	0	-92.5	-42.5	-48.8	-100.0
3.2. Equity Shares	6	8	11	21	11	24.8	41.1	100.6	-47.5
3.3. Preference Shares	0	0	0	0	0	-	-	-	-
3.4. Debentures & Bonds	0	0	0	0	0	-	-	-100.0	-
3.5. Units of Mutual Funds	2	4	156	84	264	75.2	4159.6	-46.0	214.0
3.7. Other Investments	45	52	64	63	100	15.7	23.3	-2.3	58.9
4. Cash & Bank Balances	217	1163	1158	2357	2150	436.3	-0.4	103.5	-8.8
5. Other Current Assets	58	292	591	1354	2735	405.1	102.3	129.0	102.0
6. Other Assets	243	274	347	655	989	12.7	26.8	88.9	50.9

Source: Reserve Bank of India, DNBS Data Base

10. Recent Trends in Gold Loans and Domestic Financial Stability

10.1 In the recent years, there has been a strong growth in loans against the collateral of gold disbursed by gold loan NBFCs and banks. It is necessary to make an assessment of the implications of the sharp rise in gold loans for domestic financial stability. The concern about financial stability arises from (a) the linkage between global movements in gold prices (as gold is an essentially imported commodity) and domestic gold demand, (b) gold imports (constituting one of the largest portion of India's import bill) and domestic gold demand, and finally, (c) gold prices and gold loans. Additionally, there are also concerns being raised about the ways of operation of gold loan financing companies, namely gold loan NBFCs, which have given rise to greater concerns about financial stability. The Working Group examined various channels through which gold loans can impact the stability of the Indian financial system in general, banking system in particular, and the extent to which such impact is likely to be felt.

10.2 It is observed that, in India, buyers do not borrow in order to invest in gold. Banks and other financial institutions, which are inherently leveraged, do not invest in gold. This is because while their liabilities have costs, gold as an asset does not earn any revenue, and actually has insurance and storage costs which offset any revenue that can be generated from leasing it out.

10.3 The systemic implications of India's demand for gold imports and the rapid use of jewellery as collateral for loans from NBFCs have been studied by the Working Group. The significance of gold and for that matter any asset is derived from the nature of the holder. It depends on whether the asset is held by a large and disparate group of individuals or by a narrow set of large and leveraged institutions. As more and more of the asset is held by the latter, the systemic impact of a sharp fall in prices of the asset rises. Retail holdings are typically less susceptible to panic sale and hence contribute to greater stability. Institutional nature of holdings amidst low levels of market liquidity, however, makes a financial system more vulnerable to a correction in asset prices. Gold is held as an asset by the household sector and indirectly as collateral by the leverage institutions, namely banks and non-banks. Gold is also held indirectly by leveraged institutions like banks and non-banks as collateral in their loans. LTV ratios in banks are typically around 70 per cent whereas in non-banks they have been brought down to 60 per cent. This nature of exposure of the two segments *viz*. retail (directly as jewellery and coins and Exchange Traded Funds (ETFs)) and institutional (indirectly as collateral) suggests that a sharp correction is unlikely to cause panic. Moreover, the riskier holding, namely, the indirect institutional exposure of banks and non-banks has adequate buffers to contain the impact of a price correction.

10.4 To study various issues in this regard, the Working Group analysed the implications and risks to financial stability through four major channels: (a) by analysing the operations of gold loan NBFCs and banks *each* in a stand-alone manner, (b) by analysing the implications of the gold loans industry as a whole (taking NBFCs and banks together) for financial stability through its linkages with gold prices, (c) by analysing the interlinkages between banks and NBFCs to analyse the risks to financial stability arising out of concentration, and (d) by analysing interlinkages within the NBFCs segment itself to analyse the risks from regulatory arbitrage.

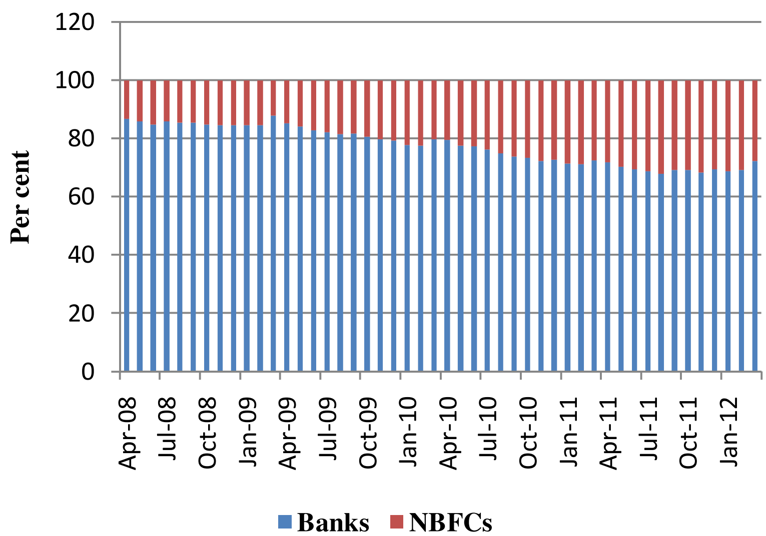
10.5 As a prelude to such analysis, the Working Group identified some relevant basic features of the gold loan industry in the recent years.

I. Basic features of gold loan industry

Dominance of banks in gold loan provision

10.6 Gold loans are provided by the banks (commercial and cooperative) and specialised NBFCs. The Working Group collected the loans outstanding data from all the public sector banks, State Bank of India and Associates, prominent private sector banks and Apex Cooperative Banks. The Group collected the relevant data from the leading gold loan NBFCs as well. Of the total gold loans outstanding at end-March 2012, 72 per cent were provided by banks while the remaining 28 per cent were given by gold loan NBFCs. Banks thus have been the most important supplier of gold loans (Chart 10.1).

Chart 10.1: Shares of banks and NBFCs in total gold loans outstanding



Growing importance of NBFCs in providing gold loans

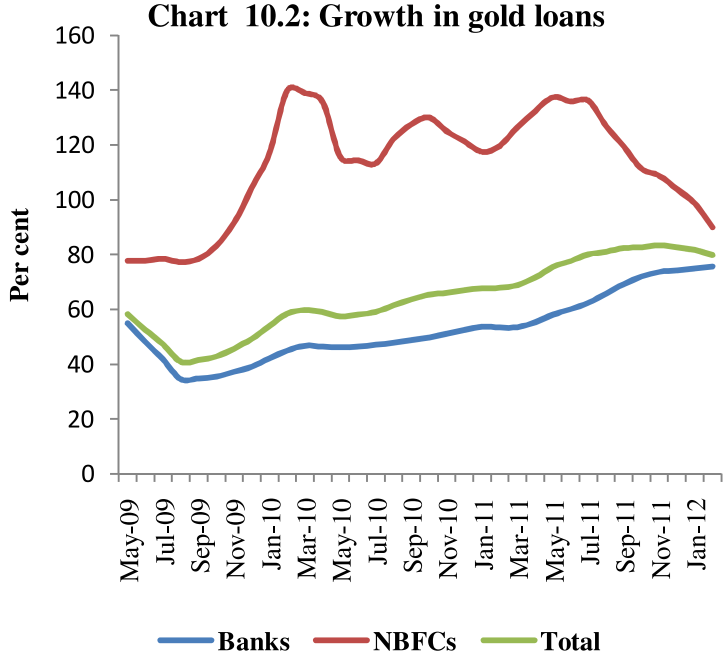
10.7 While the importance of banks has continued unabated, a striking increase in the share of NBFCs in total gold loans is also discernible in the recent years. The share of NBFCs doubled from 13 per cent at end-April 2008 to 27 per cent at end-March 2012. In other words, on average, the share of gold loan NBFCs increased by about 3 percentage points on an annual basis.

Growing demand for gold loans from NBFCs

10.8 In general, there has been a growing demand for gold loans in the recent years. On a year-on-year basis (taking three-year moving average), gold loans in India have grown at strikingly high rates of 60 to 70 per cent per annum in the last four years. The growth of gold loans from NBFCs has been particularly high *albeit* marked by fluctuations. After smoothening, the annual growth of gold loans from NBFCs shot up to significantly high levels of over 140 per cent per annum in 2009-10 and showed fluctuations around a declining trend thereafter. The year 2011-12 saw a steady fall in loans from NBFCs and yet, the rate of growth remained much higher than banks (Chart 10.2).

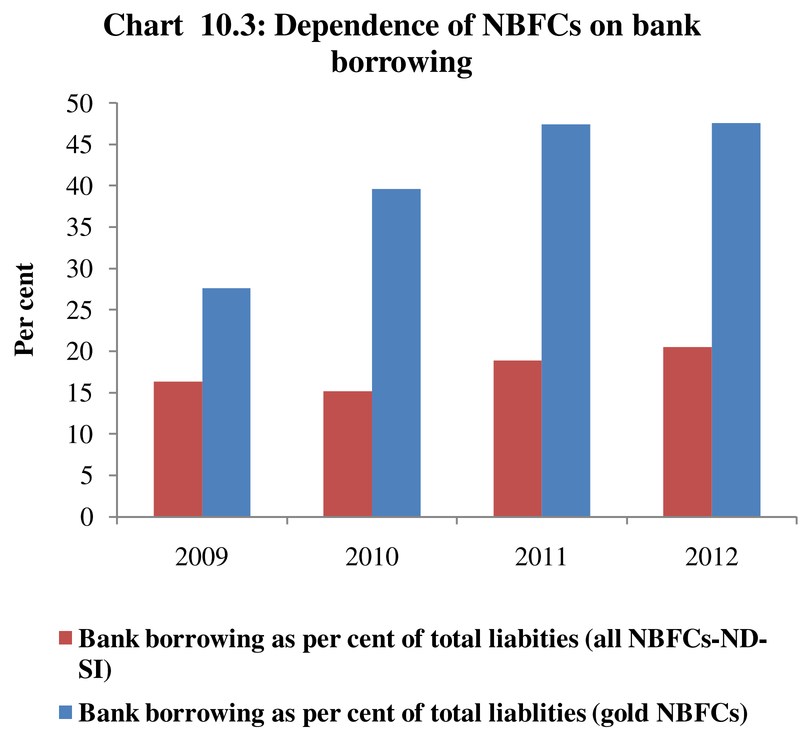
10.9 The year-on-year average growth in gold loans from banks has been on a steady rise in recent years. Since August 2009, when the rate had dipped to 35.0 per cent per annum, it rose steadily to 76.0 per cent by February 2012.

Chart 10.2: Growth in gold loans



Banks as a major source of funds for gold loan NBFCs

10.10 Given that NBFCs-ND-SI (non-deposit taking systemically important) are barred from accepting public deposits, borrowing in general and bank borrowings in particular has been an important source of funds for these NBFCs. At end-March 2012, bank borrowing constituted 20 per cent of total liabilities of NBFCs. Within the NBFCs-ND SI sector, gold loans NBFCs have been particularly more reliant on bank borrowings. Bank borrowing formed nearly half (48 per cent) of total liabilities of these institutions (Chart 10.3). Thus, any analysis of stability concerns related to gold loan NBFCs has to take into account not just their own financial soundness but also their interlinkages with the banking sector.



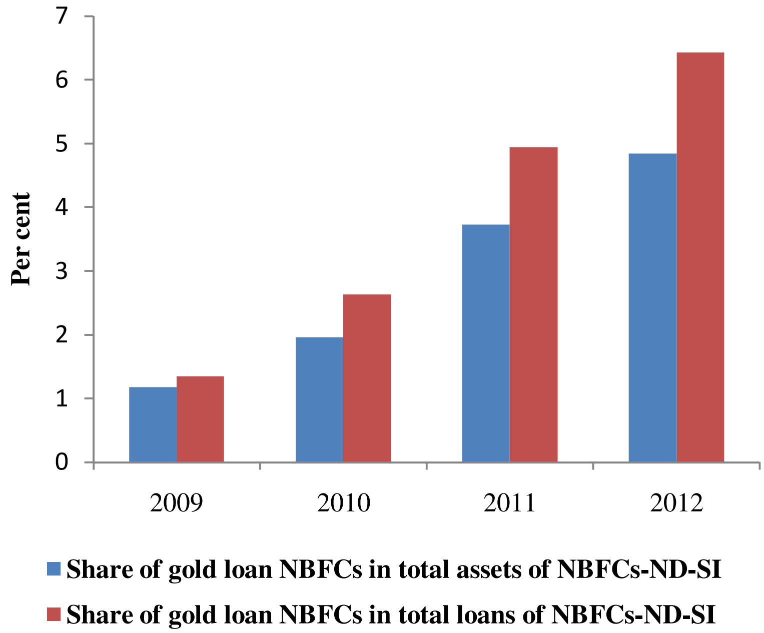
II. Analysis of gold loan NBFCs data on size

10.11 At end-March 2012, there were six NBFC-ND-SIs that were into the provision of gold loans and constituted almost the whole of gold loan non-banking financial business in the country. The implications of gold loan NBFCs for financial stability can be understood from their size within the financial system (non-banking financial system in particular) and their own financial soundness.

Size of gold loan NBFCs

10.12 In terms of total assets of all types of NBFCs-ND-SI, gold loans NBFCs constituted barely 1 per cent at end-March 2008. By 2012, however, their share had risen to 5 per cent. Moreover, their share in total loans from NBFCs-ND-SI in India had risen to 6 per cent (Chart 10.4).

Chart 10.4: Share of gold loans NBFCs in total assets of NBFC-ND-SI sector



Growth in gold loan NBFCs vis-à-vis the entire non-banking financial (NBFC-ND-SI) sector

10.13 In the last three years (March over March), gold loan NBFCs have been one of the fastest growing segment of the non-banking financial sector. The annual growth of gold loan NBFCs has been more than double the growth rate of all NBFCs (Chart 10.5). Assuming that assets of gold loan NBFCs grew at an average rate at which they had grown in the last three years, they would constitute about 33 per cent of total assets of the NBFCs-ND-SI sector by 2016 (Chart 10.6).

Chart 10.5: Growth pattern of gold loan companies and NBFCs-ND-SI sector

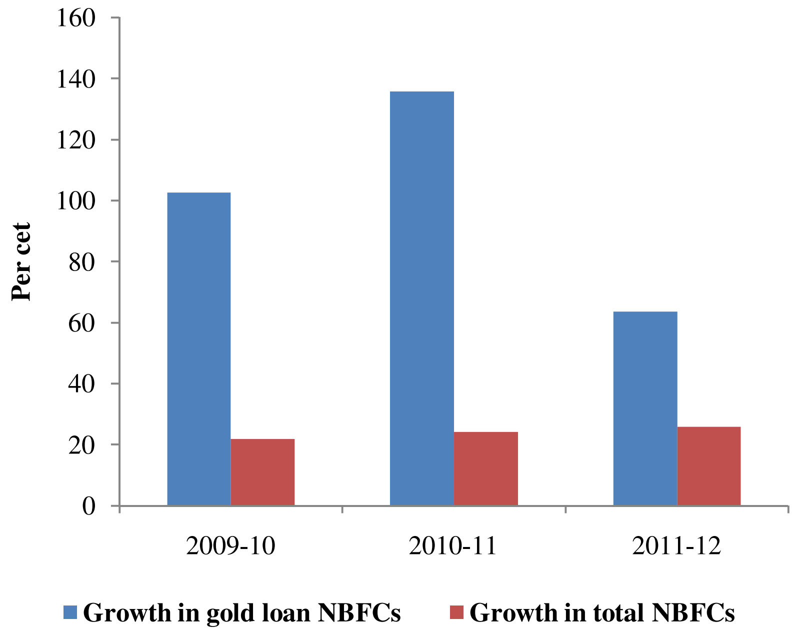
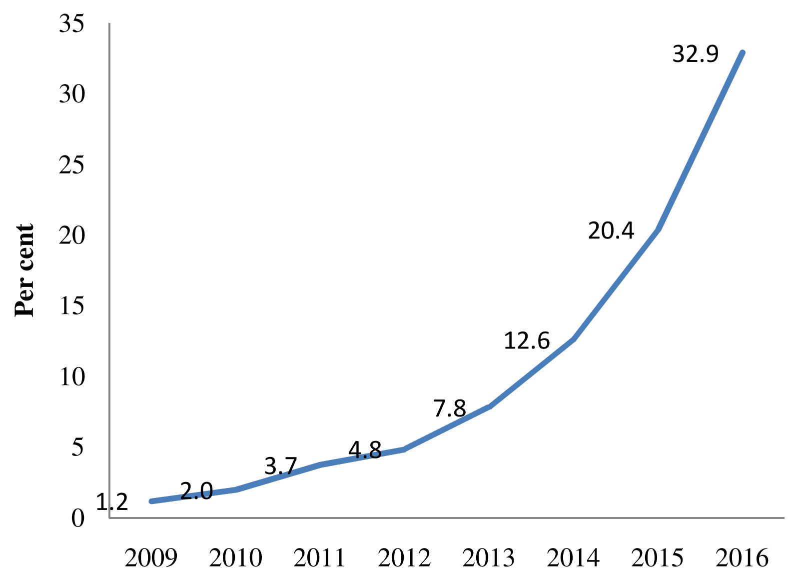


Chart 10.6: Share of gold loan NBFCs in total assets of all NBFCs-ND-SI and their projections



Note: Figures from 2013 onwards are projected shares of gold loan NBFCs assuming a growth of gold loan NBFCs and all NBFCs-ND-SI at an average rate as seen during the three-year period between 2009-10 and 2011-12.

III. Financial soundness of gold loan NBFCs

Asset quality

10.14 Going by the trends in the past four years, asset quality of gold loan NBFCs did not seem to cast any major concern for the stability of these institutions. The ratio of Non-Performing Assets (NPAs as per cent of total credit exposure) remained much lower than the overall NPAs ratio for the NBFCs-ND-SI sector (Table 10.1). One of the reasons commonly cited to the Working Group by both borrowers and gold loan NBFCs for low default was the importance and sentimental value attached to gold collateral by borrowers. Borrowers generally refrained from defaulting on the loan and foregoing their collateral.

Table 10.1: Selected soundness indicators for gold loan NBFCs

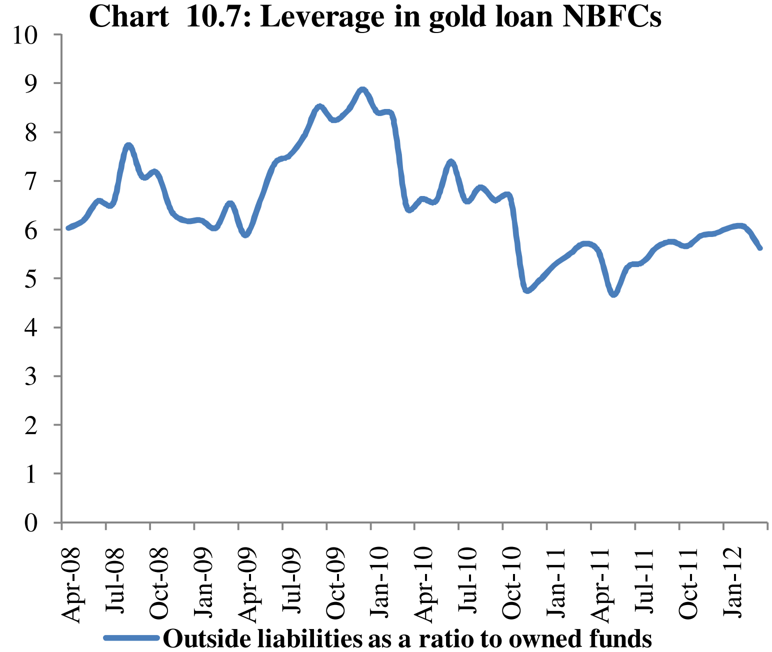
Year	Gross NPAs ratio (per cent)		Outside liabilities to owned funds ratio (leverage ratio)	
	Gold Loan NBFCs	All NBFCs-ND-SI	Gold Loan NBFCs	All NBFCs-ND-SI
2009	0.6	2.9	6.5	2.7
2010	0.6	2.8	6.4	2.6
2011	0.1	1.8	5.7	2.9
2012	0.7	2.1	5.6	2.7

Source: Returns from Department of Non-Banking Supervision, Reserve Bank **Note**: Outside liabilities to owned funds ratio is worked out as total liabilities minus owned funds as a ratio of owned funds.

Leverage

10.15 The leverage of gold loan NBFCs was significantly higher than the overall leverage in the non-banking financial sector. The Working Group on Issues and Concerns in the NBFC Sector (Chairperson Smt. Usha Thorat) in 2011 too had noted a significantly higher leverage for gold loan NBFCs than all other types of NBFCs-ND SI. As per the data presented in Table 1, the leverage ratio of NBFCs-ND-SI was below 3, while it ranged between 5 and 7 for gold loan NBFCs. It is noteworthy, however, that there was a falling trend in the leverage of gold loan NBFCs during 2010-11 and 2011-12 (Chart 10.7). Leverage here refers to overall borrowing by NBFCs including debentures, borrowing (from banks, financial institutions, inter-corporate sources) and commercial paper. The issue of NBFCs' leverage to banks is separately discussed in Section IV. Leverage ratio is worked out taking outside liabilities (total liabilities net of owned funds) as a ratio to owned funds of gold loan NBFCs.

Chart 10.7: Leverage in gold loan NBFCs



Capital adequacy

10.16 Unlike leverage, capital does not appear to be a serious concern for gold loan NBFCs. The minimum Capital to Risk-weighted Assets Ratio (CRAR) for NBFCs-ND SI was raised to 15 per cent since March 2011; it was changed from 10 per cent to 12 per cent in March 2010. Of the gold loan NBFCs that submitted returns to the Reserve Bank, all four were above the 15 per cent norm having capital levels in the range of 15 per cent to 25 per cent at end-March 2012 (Table 10.2).

Table 10.2: Classification of gold loan NBFCs by CRAR

CRAR classification	2009	2010	2011	2012
Less than 15 per cent	1	3	-	-
15 per cent to 25 per cent	2	1	4	4
25 per cent to 35 per cent	-	-	2	-
35 per cent to 45 per cent	-	-	-	-
45 per cent to 55 per cent	-	-	-	-
55 per cent and above	1	1		-
Total	**4**	**5**	**6**	**4**

Source: Returns from Department of Non-Banking Supervision, Nil
Note: The total number of NBFCs refers to NBFCs submitting returns to the Reserve Bank.

IV. Brief analysis of data of commercial banks providing gold loans

Share of gold loans in total loans of banks

10.17 Though banks are a more important source of gold loans in the economy, the size of gold loan portfolio in total loan portfolio of banks has been relatively small. At end-March 2012, gold loans constituted only 2.5 per cent of total loans of banks. The size of gold loans did not differ much across public and private sector banks (Table 10.3).

Table 10.3: Size of gold loans in total loan portfolio of banks

Bank group	2009	2010	2011	2012
Share of retail gold loans by (per cent)				
1. Public sector banks	1.0	1.2	1.5	2.4
2. Private sector banks	1.1	1.6	2.0	2.8
All banks	1.0	1.3	1.6	2.5
Share of total exposure to gold loans (through retail gold loans and loans to gold loan NBFCs) by (per cent)				
All banks	1.1	1.4	1.8	2.8

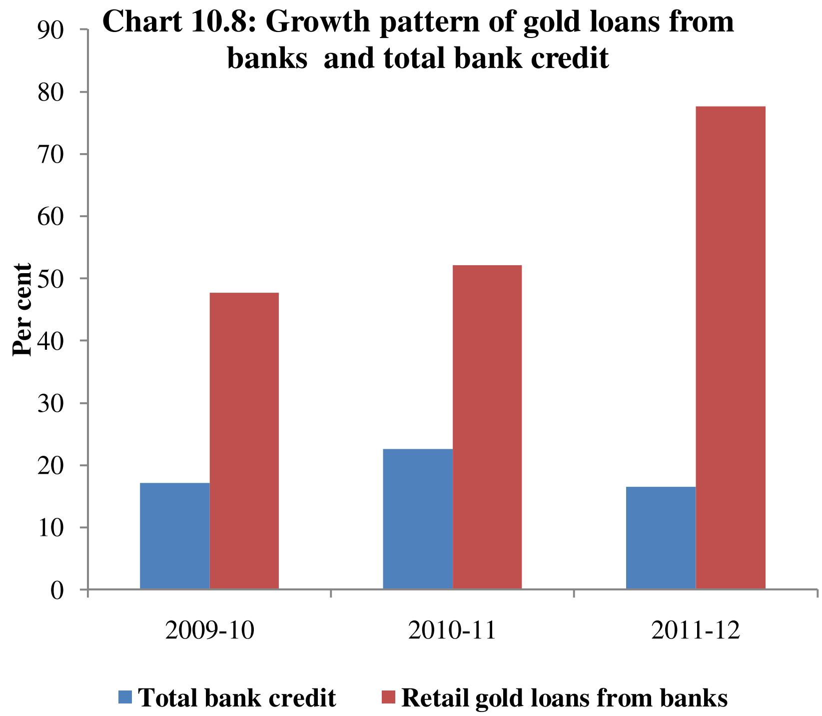
Source: Data collected from various banks

10.18 Even if we accounted for the loans by banks to gold loan NBFCs, the total exposure to gold loans worked out to less than 3 per cent of total bank credit at end-March 2012.[6]

Growth in gold loans from banks

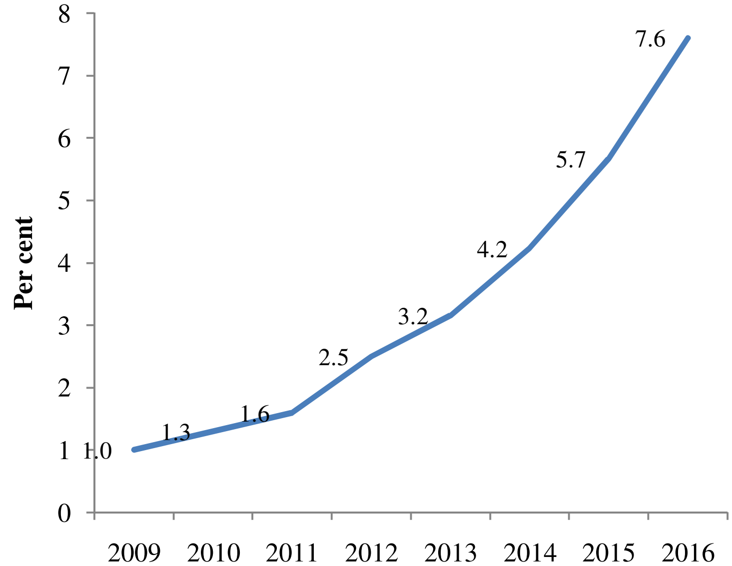
10.19 As already noted, the growth in gold loans from banks to individual borrowers has been on a steady rise during the last four years (Chart 2). Moreover, gold loans to individual borrowers have been one of the fastest growing segments within the overall banking portfolio (Chart 10.8).

[6] Bank credit here is based on only domestic operations taken from the Off-site supervisory returns. This is because the data for domestic and international operations (as provided by balance sheets) are not yet available for all banks for end-March 2012. If total bank credit from domestic and international operations is taken into account, the share of exposure to gold loans for banks would work out to be even smaller.



10.20 Assuming that gold loans to individual borrowers maintained the growth momentum and grew at a rate as seen during the last three years, and assuming that bank credit, on average, grew at 17 per cent per annum, gold loans would emerge as an important segment within bank loan portfolio. By March 2016, gold loans to individual borrowers would occupy a share of about 7 per cent within total bank credit (Chart 10.9).

Chart 10.9: Shares of retail gold loans in credit portfolio of banks and their projections



Note: Figures from 2013 onwards are projected shares of gold loans in total credit of banks assuming a growth of gold loans and total bank credit at an average rate as seen during the three-year period between 2009-10 and 2011-12.

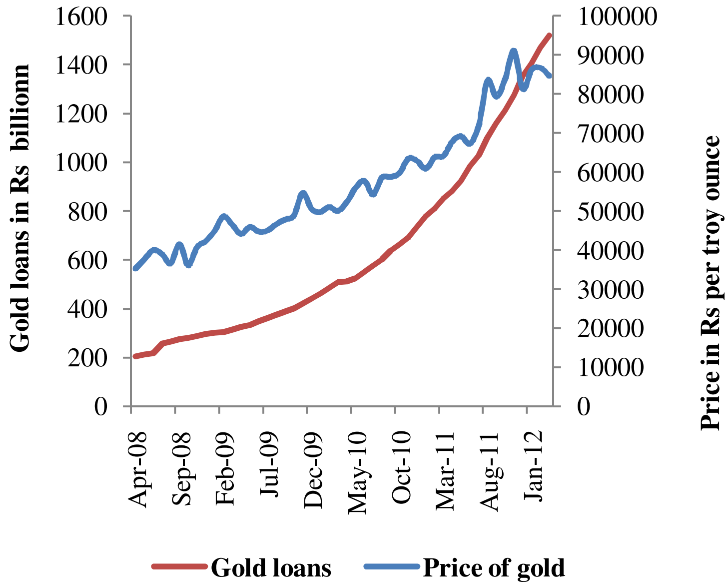
V. Fluctuations in gold prices and stability concerns

10.21 The high growth in gold loans, may it be from NBFCs or from banks, is deemed to be a cause of concern given its linkage with gold prices. A simple analysis of gold loans and gold prices indicates that the two variables have a strong correlation of 0.97 and have charted a largely upward trend over the last four years (Chart 10.10). The relationship between gold prices and gold loans has been explained in detail in Chapter 5 of the Report.

10.22 Rising prices of gold tend to boost both supply and demand for gold loans. First, with rising prices and coupled with a high LTV, households and individuals holding gold, are encouraged to seek credit by pledging this gold. From the supply side, given the rising prices of gold, banks and NBFCs are encouraged to lend more against gold as it is deemed to be a safe collateral.

10.23 The concerns of stability relating to gold loans arise on account of the probability of a sudden drop in gold prices. Such a drop can lead to a spurt in defaults because borrowers are left with little incentive to repay the loan. Another important dimension related to gold loans that adds to the concern about stability is that India imports most of its gold requirements and hence, any fluctuations in global prices can have a direct impact on domestic gold prices and thereby also has the potential to impact the stability of the Indian financial system.

Chart 10.10: Movements in gold loans and gold prices



10.24 However, based on the historical trends in international gold prices, it can be safely predicted that there is very low probability of a drop in gold prices. The probability of a drop in gold prices by more than 40 per cent in a period of 6 months was near to zero (CRISIL, 2012). Consequently, the near-term probability of a major and sudden drop in domestic prices of gold and a resultant adverse impact on asset quality of banks and NBFCs is expected to be low. This issue has been examined in a greater detail elsewhere in this Report.

VI. Analysis of concentration risks for banks arising from their exposure to gold loan NBFCs

10.25 Apart from the impact from gold prices, financial stability can also be possibly hindered by the concentration risks arising from banks' exposure to gold loan NBFCs. Concentration risks essentially arise from credit risk (sectoral/regional exposure), market risk (currency concentration), liquidity risks (concentration of refinance) and operational risk (dependence on business processes/IT systems).

10.26 In the context of gold loan NBFCs, the risks are essentially credit risks and are unidirectional in nature running from NBFCs to banks with defaults from NBFCs being transferred to banks' balance sheets through the channel of bank loans to NBFCs, as shown in Chart 10.11.[7]

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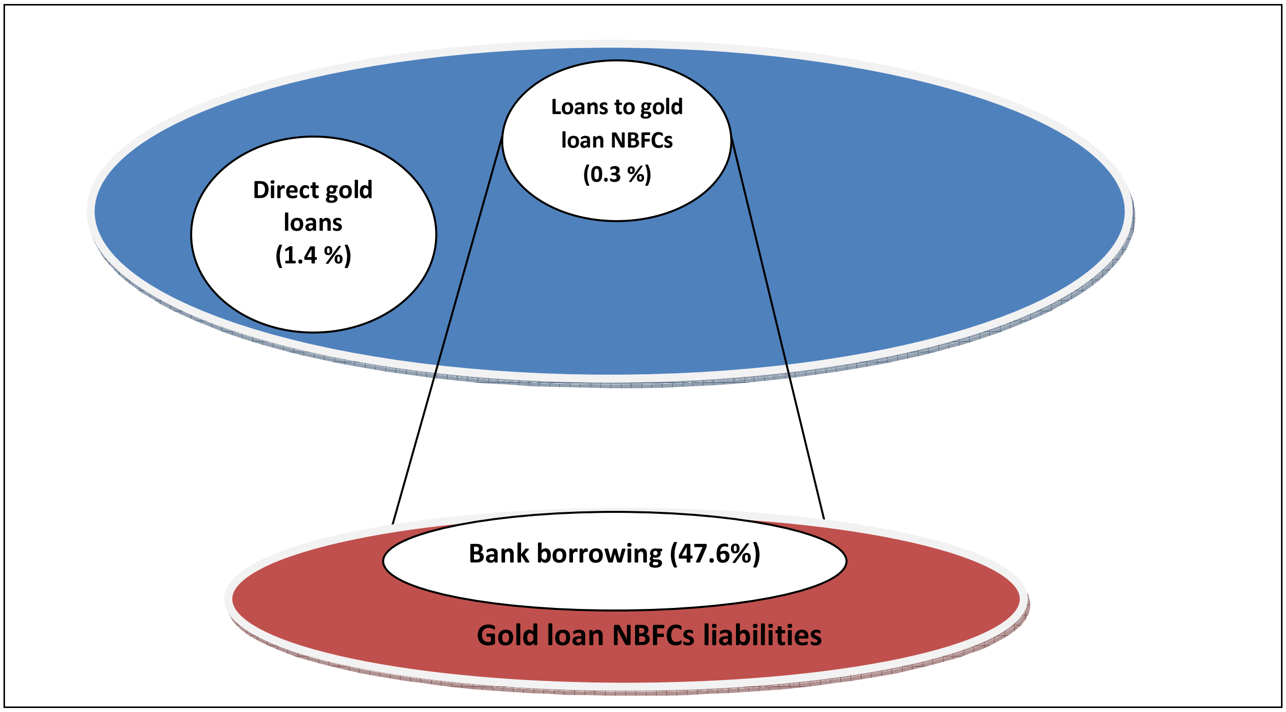
[7] In Chart 6.12, total borrowing by gold loan NBFCs (including those from commercial banks and cooperatives) are taken as per cent of total liabilities of gold loan NBFCs. This is because there is no break up available of the amount of borrowing from commercial and cooperative banks. However, since there are very few cooperative banks which

Chart 10.11: Interconnectedness between banks and gold loan NBFCs



Note: Figures reflect the status at end-March 2012

VII. Sources and uses of funds of gold loans NBFCs

10.27 Generally, the composition of sources of funds can pose risks to financial stability on account of two reasons, (a) the types (b) the maturity profile of these sources.

- Types of sources – Gold loan NBFCs are not entitled to raise public deposits but borrow from various institutional sources, such as banks, Financial Institutions (FIs), inter-corporate sources and directly from the market by way of commercial papers (CPs) and non-convertible debentures (Chart 10.12).

- Borrowings from FIs and inter-corporate borrowings have a miniscule share in total sources of funds of gold loan NBFCs (less than 2 per cent of all sources of funds taken together).

- Though CPs are another short-term source available to these NBFCs of raising funds from the market, they have been insignificant in share (accounting for about 2 per cent of all sources of funds) for gold loan NBFCs.

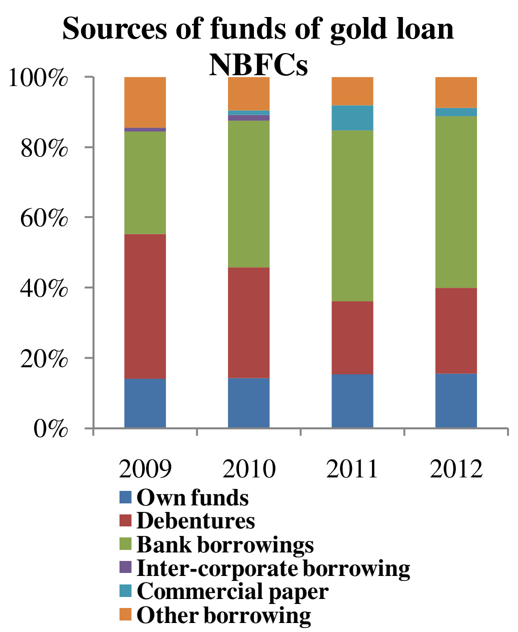
have exposure to gold loans, even if we remove the borrowings from cooperatives, the figures would not be significantly different.

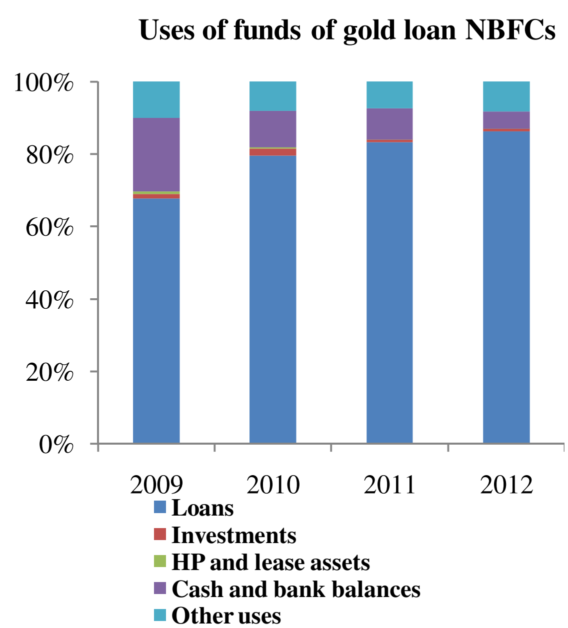
- Bank borrowings have by far been the most favoured means of raising funds by these NBFCs. The share of bank borrowings in their total liabilities increased from 28 per cent at end-March 2009 to 48 per cent at end-March 2012.[8]

- Bank borrowings have been a more important source of funds than debentures (non-convertible debentures) for gold loan NBFCs. However, in 2011-12, there was a marginal shift within the sources of funds of gold loan NBFCs in favour of debentures. Unlike retail public deposits, debentures are secured. Further, they are raised through private placements and are generally wholesale in nature.

- The share of owned funds (paid up capital and reserves), which is regarded as the safest and most reliable source of fund for any financial institution, has remained in the range of 13-15 per cent in the recent years, showing little signs of change.

Chart 10.12: Composition of sources and uses of funds of gold loan NBFCs





10.28 At the present juncture, the types of sources of funds of NBFCs does not appear to be an immediate cause of concern giving rise to concentration credit risks given that (i) loans to gold loan NBFCs form only a miniscule portion of total liabilities of banks. Even at the bank-level, exposure of banks to gold loan NBCFs through loans given to these NBFCs appears to be small (Table 10.4). Moreover, even if we assume that borrowings by NBFCs

[8] Banks also subscribe to the CPs of these institutions. However, the data on the breakup of CPs by ownership are not available. Moreover, even if that is accounted for, the total share of banks would work out to be only a little higher than what is given here.

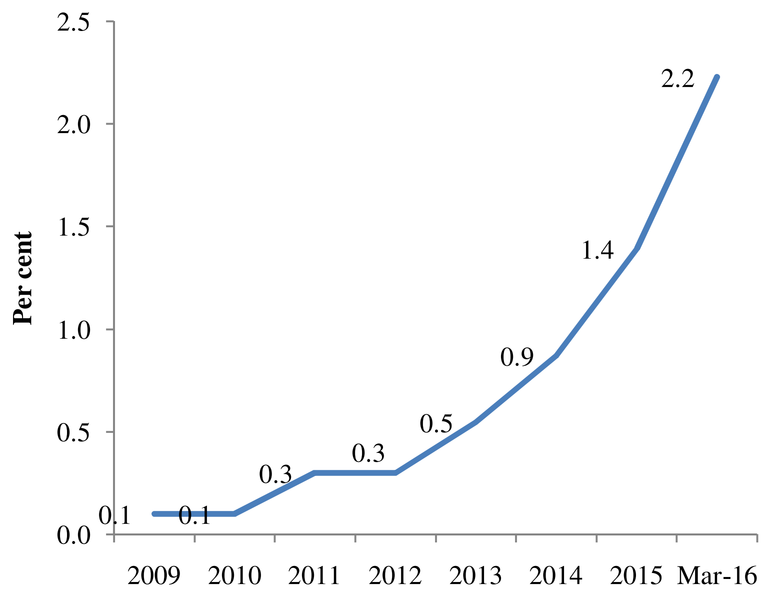
from banks continue to post an average growth as during the last three years, they would only be about 2 per cent of total assets of banks by 2016 (Chart 10.13); (ii) the Reserve Bank has already removed gold loans for agriculture by NBFCs from the priority sector category of banks, partly discouraging the rising trend of bank borrowings by gold loan NBFCs; (iii) banks are guided by exposure norms, which stipulate that the exposure (both lending and investment, including off-balance sheet exposures) of a bank to a single NBFC should not exceed 7.5 per cent of the bank's capital funds as per its last audited balance sheet. This norm caps the extent of funds on-lent to gold loan NBFCs.

Table 10.4: Distribution of banks by their exposure to gold loan NBFCs

Size classes (per cent of total assets)	2009			2012		
	Public sector banks	Private sector banks	All banks	Public sector banks	Private sector banks	All banks
Less than 0.1	20	6	26	4	3	7
0.1 to 0.3	-	2	2	8	4	12
0.3 to 0.5	1	2	3	5	-	5
0.5 to 0.7	-	-	-	2	2	4
0.7 to 1	-	-	-	1	-	1
1 to 2	-	1	1	1	2	3
Total	**21**	**11**	**32**	**21**	**11**	**32**

Source: Compiled from data taken from individual banks

Chart 10.13: Shares of borrowings by gold loan NBFCs in total assets of banks



Note: Figures from 2013 onwards are projected shares of borrowings by gold loans NBFCs in total assets of banks assuming a growth of borrowings and total bank assets at an average rate as seen during the three-year period between 2009-10 and 2011-12.

Maturity profile of sources

10.29 Sources of funds can be a cause of concern if their maturity profile does not match with that of the uses of funds. This is particularly a concern in the case of infrastructure finance NBFCs but not so much for gold loan NBFCs.

10.30 In the case of gold loan NBFCs, the major use of funds is gold loans, accounting for 86 per cent of all assets (Chart 12). The detailed breakup of the maturity profile of gold loans is not available. However, given the purposes of loans (usually for meeting consumption and small production needs), and their clientele (usually belonging to middle income groups from rural/semi-urban areas), it can be safely assumed that gold loans from these companies are of short to medium-term maturity. Their sources of funds too are largely on the shorter end of the maturity spectrum. For instance, commercial papers usually come with a maturity of up to one year while non-convertible debentures have a maturity of 3-5 years. Also, inter-corporate deposits and borrowings from banks are typically of shorter maturity.

10.31 Further, the ALM guidelines issued by the Reserve Bank, which mandate these NBFCs to maintain a gap not exceeding 15 per cent of their net cash outflows in the 1-30/31 day bucket, are expected to take care of ALM mismatches, if any, that may arise in the course of business of these NBFCs.

VIII. Interlinkages between gold loan NBFCs and some unincorporated bodies – Risks from regulatory arbitrage

10.32 Apart from interlinkages between banks and NBFCs, there is also a likelihood of interlinkages within the NBFCs segment itself, giving rise to the possibility of implicit regulatory arbitrage. Such interlinkages arise from gold loan NBFCs having unincorporated sister concerns. These sister concerns undertake financial activities on behalf of the gold loan NBFCs, which are not permitted by the regulator.

10.33 To illustrate, it has been observed during the course of scrutiny of books of gold loan NBFCs that they float unincorporated entities (proprietary or partnership) wherein the chairman is proprietor or directors of the NBFC are partners. These entities indulge in collecting deposits from the public through the branches of NBFCs which hold Reserve Bank's Certificates of Registration. These concerns fully make use of the infrastructure of the registered gold loan NBFCs *viz*., branch premises and manpower. Depositors are generally unaware of the difference between the registered gold loan NBFC and the unincorporated entity with which the deposits are actually placed. The entire amount collected through deposits is credited to the personal account of the Chairman of the gold loan NBFC. It is generally expected that the Chairman would use the funds to strengthen the funds base of the gold loan NBFC through such deposits. Since these NBFCs are registered as non-deposit taking companies, they access deposits without having to comply with the regulatory requirements (maintenance of SLR and regular reporting to RBI) as applicable to deposit taking NBFCs.

10.34 Such activities amount to violation of regulations since the registered gold loan NBFC being non-deposit taking entity it is barred from accepting public deposits. Moreover, such activities are also risky for financial stability because if the gold loan NBFC is unable to repay the deposits, it can shake public confidence in the NBFC and consequently, the non-banking financial sector itself. If such activities multiply, they can endanger domestic financial stability. Regulator should take note of such practices by the NBFCs and take appropriate action against erring NBFCs.

IX. Conclusions:

The rapid increase in the growth of gold loan market warrants careful monitoring

10.35 The gold loan industry comprises banks (commercial and cooperative) and gold loan NBFCs. Though banks have been the most important supplier of gold loans, there has been a striking growth in the provision of gold loans by gold loan NBFCs steadily raising their share in total provision of gold loans in the recent years. On average, the growth in gold loans provided by gold loan NBFCs has ranged above 100 per cent per annum during the last four years. The growth in gold loans from banks has been relatively lower, ranging between 70 and 80 per cent per annum, but has certainly been much higher than the average growth in bank credit of about 16-17 per cent during the last three years. The gold loan NBFCs studied by the Group constitute six Non-Deposit Taking but Systemically Important NBFCs (having an asset size of over Rs. 100 crore). They accounted for less than 5 per cent of total assets of the NBFC-ND-SI sector. However, there has been a striking growth in the asset size of the gold loan NBFCs in the recent years; it has been double the growth rate of all NBFCs-ND-SI. If the assets of gold loan NBFCs grew at a rate at which they grew during 2009-2012, they would constitute about 33 per cent of total assets of the NBFCs-ND-SI sector by 2016. At the present juncture, any stress in these NBFCs does not appear to be a direct threat to financial stability given their small size. However, going by their striking growth, it is desirable that their activities may be closely monitored through regular and more frequent collection of relevant financial data, analysis and monitoring. More frequent on-site and off-site supervision will also be required.

High leverage of the gold loan NBFCs is a cause for concern

10.36 Given the strong backing of gold as high-value collateral for gold loans, the ratio of Non-Performing Assets (NPAs) (NPAs as per cent of total credit exposure) has generally been significantly lower than the overall NPAs ratio for the NBFCs-ND-SI sector. They are conforming to the extant capital adequacy norms as well. However, the other indicator of financial soundness, namely, leverage appears to be a cause of concern. The leverage of gold loan NBFCs has been significantly higher than the overall leverage in the NBFCs-ND-SI sector and has been steadily growing.

10.37 Though the current level of leverage of the gold loan NBFCs is not a serious cause for concern, going forward, there is a need for improving owned funds of the NBFCs. Higher levels of capital are required for (a) raising their owned sources of funds and consequently, reducing their reliance on borrowed funds and their leverage. (b) though the present levels of NPAs for gold loan companies are low and the probability of any drop in gold prices also seems to be low, higher capital can be a general cushion for these companies against unforeseen losses, if any, on their balance sheets.

There is a need for improving owned funds of NBFCs

10.38 Asset quality and capital adequacy of gold loan NBFCs appears to be fairly sound. These NBFCs are meeting the capital adequacy norms fixed by the Reserve Bank at the present juncture. However, this does not rule out the need to further step up capital levels in order to improve the owned funds of these institutions. This would also help in bringing down the leverage of these institutions.

Probability of volatility in gold prices impacting the gold loan market is low

10.39 One of the reasons providing a boost to gold loans in India (through both non-banking and banking channels) has been the continued rise in gold prices. However, the probability of a sudden drop in gold prices leading to a spurt in defaults has been estimated to be very low. Thus, the near-term probability of a major and sudden drop in domestic prices of gold and a resultant adverse impact on asset quality of banks and NBFCs is expected to be low.

Banks' exposure to individual gold jewellery loans is miniscule

10.40 As regards the banking sector, their existing exposure in the form of individual gold loans appears small and hence, any stress in gold loan portfolio may not have serious repercussions for the stability of the banking sector as a whole. Even if we accounted for the loans given by banks to gold loan NBFCs, the total exposure of banks to gold loans still worked to be less than 3 per cent of total bank credit by end-March 2012. However again, given the striking growth in gold loans from banks in the recent years, gold loans can emerge as an important constituent of the total loan portfolio of banks with implications for the stability of the banking sector.

Loans given to gold loan NBFCs by banks at present form only a negligible portion of the banks' total assets and may not have significant implications for the stability of the financial system

10.41 As gold loan NBFCs are highly leveraged, their reliance on external sources of borrowing has been significantly higher than internal owned funds. The share of owned funds (capital, and reserves and surplus) has remained largely unchanged during the recent years for these companies. On the other hand, banks have emerged as the most prominent source of borrowing for these companies. Only in 2011-12, there has been a perceptible rise in the share of debentures in total borrowing of gold loan NBFCs. It is noteworthy, however, that though bank borrowings have been the largest source of funds for gold loan NBFCs, they form only a negligible portion of banks' total assets. Further, the exposure of no bank to a gold loan NBFCs is higher than 7 per cent of its own Tier I capital. Moreover, the whole of the gold loan portfolio of banks is smaller than their capital base and hence even 100 per cent losses in the portfolio can be borne. Thus, the concentration of banks to gold loan NBFCs is a small portion of the total assets of the banking sector. Hence, such concentration may not have significant implications for the stability of the financial system at the present juncture.

X. Recommendation:

Need for monitoring transactions between gold loan NBFCs and unincorporated bodies

10.42 There are also interlinkages within the gold loan NBFC segment in the form of gold loan NBFCs floating unincorporated sister concerns to undertake financial activities, which are not permitted by the regulator. Such activities primarily involve raising public deposits and diverting these funds towards the registered gold loan NBFC. Raising public deposits by such illegitimate means can have implications for public confidence in the concerned NBFCs and non-banking financial sector as a whole. If such activities are not curbed in time, they can threaten the stability of financial system. There is a need for monitoring transactions between gold loan NBFCs and unincorporated bodies. There is a need to bring the sister concerns floated by the NBFC-ND-SIs under the ambit of monitoring and regulation in the interests of ensuring domestic financial stability.

11. Customer Protection - Practices Followed by Gold Loans NBFCs

11.1 The practices followed by the gold loan NBFCs in assessing proposals, disbursal of loans, collection of interest, levying of penal interest, redemption of ornaments, auctioning of jewellery, etc., have given rise to discontentment among borrowers. The practices followed are not uniform and at times perceived as discriminatory. This chapter reviews the current practices of NBFCs involved in lending against the collateral of gold and makes an assessment of the approach adopted by the NBFCs that has implications for borrower protection.

11.2 The gold loan business of the NBFC sector has increased multifold in recent times. What used to be a one to one transaction between a pawn broker and borrower has now changed into a much depended upon gold loan facility by the NBFCs. According to the gold loans NBFCs, approximately over a lakh borrowers take recourse to gold loans daily. The gold loans NBFCs increased the geographical outreach extensively to make available their services now in all parts of the country. The number of branches is proliferated all over India. This was contrary to the earlier observed trend of concentrating in Southern States like Kerala, Karnataka and Tamil Nadu. The stigma attached to borrowing against gold does no longer exist. The NBFCs are heavily advertising that they have crafted various flexible options and products to suit the requirement of the borrowers. More and more lower and middle class borrowers are attracted by the terms and flexibility with which gold loans are available. Concomitantly, the sharp increase in international gold prices facilitated improved volumes of loan availability. There has been a perceptible shift of borrowers from the informal sector, viz, money lenders, pawn brokers, *mahajans* etc., towards the gold loans NBFCs. This was rendered possible due to the flexibility and convenience offered by the NBFCS at relatively lower rates of interest and also leveraging the belief that these NBFCs are functioning as per the regulations of the Reserve Bank. The NBFCs registration with RBI commanded the trust of the borrowers.

11.3 Many factors account for the popularity of the gold loans provided by NBFCs. The absence of attractive and flexible savings schemes customized to economically poorer class to hedge them against inflation, rapid appreciation of gold value and easy availability of gold loans and its geographical reach collectively are responsible for the recent rapid increase in demand for gold. As the quantum of gold jewellery in the economy goes up, the easy availability of gold loans stoke the demand for gold loans. Agricultural labourers and farmers have been increasingly availing gold loans for their seasonal credit requirements. As gold price increases, people's interest in buying gold also seems to have increased considerably, with the expectation that there would be further upward movement in gold price in future. The average size of the gold loan increased due to the rapid price increase of the gold. The increase in policy rate hikes, the gloom in the micro-finance sector, constricted availability of retail personal loans from banks also could have contributed to the rapid increase in the demand for gold loans in recent years. The rapid rise of volume in transactions has also witnessed rise in customer complaints. The phenomenal growth of gold loan business coincided with large imports of gold, large scale financing of NBFCs by banks make apprehension that overall systemic stability is threatened. In order to understand the rapid growth in gold loan business and various related issues arising, it is imperative to examine the current business practices of gold loan companies.

11.4 As mentioned earlier, the Working Group held discussions with various stakeholders such as gold loan NBFCs, banks extending gold loans, gold loan borrowers, etc., to understand the nuances under various practices followed by the gold loan NBFCs. The discussions with Association of Gold Loan Companies (AGLOC) was held on April 23, 2012 at Kochi and further the Group had discussions with various customers of the gold loan companies at Thiruvananthapuram on April 30, 2012 to comprehend various issues and practices from borrowers' perspective. The Working Group also had discussions with select leading bankers engaged in gold loan business to understand their perspective and related procedures. Based on these discussions and the inputs provided by supervisory officials from RBI, the practices followed by gold loan companies and the issues currently involved are documented in this chapter.

I. Current Practices followed by NBFCs

11.5 The gold loan by NBFCs is mainly extended to individual borrowers against the collateral of jewelries both for consumption and productive purposes. NBFCs do not extend loans against the security of bullion or gold coins. Though there are many NBFCs that offer gold loans, about 95 per cent of the gold loan business is handled by three companies, *viz.*, Muthoot Finance, Mannapuram Finance and Muthoot Fin Corporation. These companies have crafted various market products to suit the varying needs of different types of customers and the details are generally displayed on their websites. A brief summary of various related practices is provided here on the basis of the Working Group's discussions with the gold loans NBFCs.

Assaying procedures

11.6 Most gold loans NBFCs rely on their staff members for assaying the quality of the gold jewelleries pledged. The major market player companies have established their own in-house training facilities to equip their staff in gold appraisal. The physical methods of gold appraisal by gold loans NBFC staff members do have the possibility of risk arising out of inaccurate appraisal of gold content. For addressing this, gold loans NBFCs deploy a team of internal supervisors and auditors who periodically visits branches and cross-verify the quality and quantity of pledged gold by the branch staff.

Valuation of gold jewelleries

11.7 For valuing the gold content of jewelleries pledged, the weight of embedded stones and making charges are deducted. From the rest, 75 to 80 per cent of the value of gold was financed earlier. By taking into account the deductions in value as above, effectively 70 percent of the value of gold jewellery is generally considered for the Loan to Value Ratio. Recently, the RBI has prescribed the limit of 60 per cent for Loan to Value ratio.

11.8 The movements of gold prices are also reckoned for valuing the gold content of jewelleries by some of the NBFCs. Under this method, the last 90 days spot gold price against the price prevailing on the day of pledge is considered for valuation of gold content.

This practice is usually followed by NBFCs to take care of the price volatility and any sharp correction in the gold prices observed in recent past. Major market players have the internal system to communicate gold prices worked out daily to their branches electronically.

Interest rate

11.9 The interest rate varies as per the type of product designed by the NBFC. It is observed that the interest rate charged varies based on the customer, type of ornament, size and tenure of loan. For loans with lower LTV (loan to value) the interest rates offered are relatively low. The loans with maturity up to three months are charged simple interest rate of 12 per cent per annum. However, if the repayment is defaulted even by a single day the interest rate is increased to 15 per cent for the default period and likewise it seems to increase every additional period to 24 per cent on the entire amount. It is not transparent from the discussions, whether the maximum interest rate is limited to 24 percent or it sometimes could go up to 30 per cent or more. The interest rates on the occasion of default and delay are exorbitantly high. According to the Group's discussions with the NBFCs, major loan portfolio of gold loan NBFCs covers average interest rate of 24 to 26 per cent and only 2 per cent of their portfolio is in the interest rate of 12 per cent. Though NBFCs charge higher interest rates, they still enjoy an edge over the banks in gold loan business due to their flexibility in their business practices *vis-à-vis* banks.

Duration/ Maturity of the loans

11.10 Most of the gold loans are short term loans. The duration of the gold loans range from as short as 7 days to a maximum of 1 year. Majority of gold loan portfolios are within the period of 3 months.

Average size of gold pledged

11.11 The Group's interactions with gold loan NBFCs, reveals that the majority of the gold loans size ranged between Rs.30000 – Rs.50000 and on an average, the physical quantity of gold pledged by a common borrower is said to be around 40 grams. Though the size of loan is relatively low, the increased business volumes offer attractive profit for the companies. This could be one reason for the rapid spread of branches of such companies.

Safeguards and security arrangements

11.12 The NBFCs mostly deals with cash and gold ornaments and so they generally maintain elaborate security arrangements being undertaken at all levels. During the discussions with the executives of the NBFCs on these issues, it is observed that every branch is guarded by an armed or unarmed security guards depending upon the risk profile of the area and the threat and risk perception by the company about the area and premises in which the branch is located. Most of the security personnel deployed, by and large, are retired police staff.

11.13 Almost all the NBFC branches claimed to have steel strong rooms with round the clock alarm systems / surveillance system. All branches are monitored with CCTV and the tapes are kept for record for at least three months. Under the internal control system/procedures, no single person/staff is permitted to enter the strong room under any circumstances. Automatic alarm and CCTV recording is established to ensure the compliance of internal procedures. Branch officials and employees are appointed after scrutiny in all respects. The internal control procedures does not allow NBFCs employees to get away by resigning the job without sufficient advance notice and audit of the jewelleries in a particular branch. But the Working Group found that some branches are not having safe custody facilities and the gold has to be physically moved to other premises regularly. This has security implications.

11.14 During discussions with the NBFCs, it was gathered that the entire value of jewelleries is insured to more than 100 per cent values (replaceable value of jewelleries 150 per cent). But the insurance cost works out to around 1 per cent of their total overheads. It was also reported that, so far, all theft cases reported were done in connivance with an insider by the staff and therefore, these cases were resolved. However, gold loan companies have listed the insufficiency of insurance cover as a risk while listing the various risk factors in their public issue prospectuses. The RBI had also communicated its supervisory concern on the rising number of thefts to one of these companies in 2010.

Documentation

11.15 The format and content of documentation followed by each NBFC appear to be different, although each one of them claims to be giving a pawn ticket and loan agreement copy to the borrower. On a perusal of the copies of documents shown to the Working Group by complaining borrowers, it was evident that the documentation formats and contents in the pawn ticket differs from NBFC to NBFC and also from branch to branch of the same NBFC. Pawn tickets do not contain the specific details of the jewels pawned, their weight in grams and the assessed value of the jewels, etc.

Adherence to KYC norms

11.16 For new customers, all due diligence procedures such as 'Know Your Customer' procedures are generally followed by taking 'on the spot photograph of the borrower' and ensuring the address proof with photo identity card issued by a government authority. During the Group's discussions, the company representatives stated that major companies have formed a KYC/AML policy. A suitable official is designated as reporting and compliance officer for KYC/AML. The policy envisaged introduction of risk-based approach by conducting due diligence as per the perceived risk of the customer and periodic risk categorisation of customer. The branches are instructed to classify repledgers/ jewellers and individual gold loan customers with more than Rs.15.00 lakh exposure as high risk category and also to renew the KYC related documents of high risk and medium risk categories of borrowers once in every two years. It also prescribed that any payment of Rs.10 lakh and above under Gold loan should be made only by means of cheque and any cash payment above that amount would come under the FIU-India reporting. Some companies have a system of issuing an identity card for regular customers. However, it was reported that for disbursal of loans for emergency situation like hospitalisation, etc., the reliance on ID proof was sometime not strictly adhered to. A few instances had come to the notice that non-adherence of KYC norms led to granting loan against stolen/spurious gold. Similarly, some audit reports of the branches did not reveal the adherence of such practice by the branches. It is impossible to have full assurance of complete adherence of these procedures in all the branches particularly after the rapid branch expansion witnessed in recent years. On the specific query relating to the advertisements of '3 minute' and '5 minute' loan sanctions, it was informed that it is more of a marketing slogan and generally are applicable to the existing customers only since the company already documented the necessary details relating to proper address and other details for the existing customers.

Level of default and Non-performing assets

11.17 The emotional or sentimental attachment of gold jewelleries to the owners is considered to be the greatest guarantee against any default in gold loan business in India. Ever increasing price trend of gold in recent years also acts against any attempt to default by borrowers as any default will only result a loss of value for the customers. Therefore, the level of defaults or NPAs is negligible in these segments at around 0.4 to 0.5 per cent. It is believed that bulk of the gold jewelleries in India is invariably possessed by women and therefore, the chances of defaulting on a gold loan and forfeiting their ownership of the jewellery is quite rare.

Procedures for auctioning of pledged jewelleries of overdue loans

11.18 Auctions are conducted by the gold loan companies once in three months or so. Because of the difficulty in conducting auctions to recover the overdue loans at each branch or small town/village level for reasons of safety, security, availability of limited participants, etc., the auctions of pledged jewelleries are conducted by these gold loan companies mostly at the district headquarters. However, auction is done by sending a communication to the pledgee through registered mails. Advertisements in the local newspapers are also to be given. The participants in the auction include representatives from the companies as well. During discussions with companies, the AGLOC members could not give a valid reply for the question, if the auctioned value exceeds the dues of the loan amount outstanding is it refunded to the owners of gold jewelleries. Moreover, it is apparent that, though according to the information provided by the representatives, the size of auctioned jewelleries will only be around 1 per cent or so, there does not seem to be an established procedure or regulation on the auction of gold jewelleries. The NBFC members stated that auctioning takes place after 18 months from the due date for repayment of loan. But this was refuted by many complaining borrowers.

11.19 The supervisory audits have sometime observed considerable time gap between the date of loan overdue and the conducting of auction implying that the concerned customer would be required to pay the interest for such time period. It is also noted that certain branches do not maintain the details of the auction such as the details of bid amounts, list of successful bidders, successful bid amounts, mode of payment of bid amount, etc. The surplus amount realized in auction has also not been returned to the borrower. Even if the volume of jewelleries meant for auctions are stated to be around 1 to 2 percent, considering the vulnerability of the relevant section of borrowers, the Working Group felt that guidelines needs to be given for the auctioning of gold jewelleries.

II. Gold Loan Borrowers' Perspectives

11.20 To have an objective evaluation of the relevant issues involved, the Working Group had held two meetings with gold loan borrowers. First meeting of the Working Group with the randomly invited gold loan borrowers was held on April 30, 2012 at RBI, Thiruvananthapuram. The second meeting with select borrower customers was organised at RBI Regional office, Bengaluru on May 18, 2012. The main purpose of the meeting was to ascertain the views of borrowers about the practices of NBFCs and also to understand their main complainants or grievances against the gold loans of NBFCs. The main points emerged out of these interactions are presented below.

Higher Interest rates

11.21 Higher the loan borrowings from the NBFC higher interest rate will be charged. Similarly, for longer maturity period the interest charged is higher. Above all, the gold loan company charges higher rate of interests depending upon the urgency. Most importantly, even a single day's delay in paying interest or principal, the borrower is automatically pushed into the higher slab of interest rate for the whole period. There is wide spread feeling among the borrowers that the details of interest to be charged and the penal interest to be levied on defaults are deliberately withheld from the customers and undue advantage is taken by the gold loan NBFCs.

Valuation of Gold jewellery

11.22 Most of the borrowers are aware that the valuation is done by deducting the stone weights and some making charges. Of the remaining value, the loan is sanctioned to the extent of 90 to 95 per cent. The customers were comfortable with the higher loan to value ratio, however, effectively it will work out to around 70 to 75 per cent of the market value of the jewellery. The borrower is generally not clear about what is the gold price used for valuing the ornament on the day of pledge. Two relevant case studies are presented in the following (Box 11.1):

Box 11.1: NBFC Gold Loans - Case Studies

Case 1 – A customer with grievance

During the meeting with customers, a gold loan borrower expressed serious concern about the style of operation of the gold loan NBFCs going by his own experience. He stated that he borrowed a loan of Rs. 58,000 for a year. He stated that the company has not even informed any rate of interest rate or the quantum of interest to be paid at the end of maturity of the loan. All that was given to him was just a 'pawn card'. This was an acknowledgement (equivalent to loan sanction letter) given at the time of availing loan. It contained only the gist of the terms and conditions of loan like the loan amount, reset dates of annualized interest charged in case of non-payment within the stipulated dates and the total weight of gold pledged. The pawn ticket does not contain complete details of the annualized rate of interest, maturity period of loan, details of auction procedure in case of default, any other documentation charges, or what is the maturity period of this particular loan etc. The details of the jewels pledged were also not included.

After one year when the borrower went to repay the loan and interest accumulated, he was informed by the company that the total amount outstanding was Rs. 93,500, when the borrower asked for the break-up of the outstanding, the company had replied that it include the interest accumulated with principal. Moreover, they had also stated that the jewels were already auctioned off as he did not come back to pay interest. The borrower was neither informed about the auctioning of his jewels nor called for repaying his loan in between. Above all, though the market value of ornaments in this case was much above the total dues outstanding, the difference if any on the sale of ornaments was not given to the borrower. The borrower was not informed anything at any stage. The borrower, resorted to complaints to police and media and finally at DNBS, RBI. Only on the RBI's intervention, the company officials came for the compromise and finally agreed to pay Rs. 45,000 against the total market value of jewelleries pledged by him to the tune of Rs. 1,60,000. Thus, he stated, even if the company deducts interest amount dues, he still suffered sizable net loss.

Case 2 – Satisfied customer

One borrower stated that she availed the gold loan at much ease from an NBFC on the gold jewels that was rejected by a cooperative bank. She felt they are doing good service and did not find any difficulty in getting back the jewels on repayment of the loan in time. Service charge does not seem to be informed upfront to the borrowers, as they stated that no such service charge is applied on the borrowings. She was charged around 18 per cent per annum that she felt was reasonable. She was aware that banks charge lower interest rate than NBFCs but of the view that the companies take much less time for processing the loan than the banks.

11.23 Based on these interactions and also browsing through the complaints and suggestions by the customers received by the Reserve Bank, following general observations are emerged:

- Higher interest rates charged almost in many cases than what was promised at the time of borrowings. Penalty clauses are generally not explained at the time of availing the loans.

- Documentation procedure followed by NBFCs is inadequate except taking a photo of the borrower and any identity card issued which has the name and address of the borrower.

- Mostly, a 'small pawn ticket' is issued to the borrowers instead of loan agreement/document. This is the only documentary evidence available with the borrower, irrespective of the total quantity of gold pledged and borrowed.

- The pawn ticket does not contain even the basic details such as total market value of jewels pawned, loan to value ratio, valuation done (details of deductions of stones and making charges, etc.) rate of interest, period of loans, penalties, auctioning of jewels etc.

- Customers were unaware of the 'fair practices code' being followed or available.

- The procedure relating to auctioning of jewels is not transparently explained to the borrowers. Even though the borrower is informed by the NBFCs about the auctioning of their jewels, the borrower is not informed where and when the jewels are auctioned. It is impossible for the customers to identify his jewels as all the jewels and ornaments are put together in big lots (in Kilogrammes) and auctioned. Moreover, the place of auctions is located far away from the place of pledge, making it difficult for the borrower to go to that place.

11.24 In the branches, the employees are generally ignorant of the computation of total interest amount due, rate of interest etc., and just rely on computer records. They are unable to clarify any doubts to the customers. For everything, the only answer provided to the customer is that, whatever the computer shows that is final. When asked for the details, the only answer that the customer is informed is that everything is centralised and all computation is done at their Head Office. The branch manger's duty is only to inform the customer what is due and collect the same.

III. Practices followed by commercial banks while extending gold loans

11.25 As the commercial banks are also extending gold loans in a big way to their customers, the Working Group interacted with the senior officials of commercial banks, which are extending gold jewellery loans. The banks are generally satisfied with the volume of gold loan business they are currently handling. The feedback from customers is generally satisfactory, except the fact that the rule framework of the banks is not as flexible as that of the NBFCs. The main points emerged from the discussions are presented below.

Loan to Value (LTV) Ratio

11.26 According to bankers, despite the gold price is on the increase, they take a bit conservative approach towards valuing gold ornaments pledged. At best, they follow a loan to value (LTV) ratio of 70 to 75 per cent, sometimes up to 80 per cent. There is no standard model followed in valuing the gold by bankers. The price used to arrive at the value of ornaments/ jewelleries is also not uniform. Some banks take just week's daily closing price and some banks chose to take 15 days average price or even the particular day's price. This is totally in contrast of NBFCs, which have stated that they take past 90 days average price to arrive at the value of gold. Similar to the NBFCs, banks also deduct certain percentage as making charges after removing the weights of stones from the ornaments. The banks do charge a nominal processing fee.

Valuation of gold jewellery/ Testing for purity of gold

11.27 In order to verify the purity of gold content, valuers are being appointed and trained in-house. Hiring of outside agencies to value gold is not very common among the bankers. At best they may seek second opinion in cases when they could not arrive at the proper valuation because of certain reasons. Mostly the purity test is done based on 'touchstone' or 'acid test' methods. Banks find these methods more reliable. The assaying found to be very expensive requiring a huge investment in the assaying machines but there are also said to be possibilities that the machine committing errors in detecting the purity of gold. Banks do charge certain nominal fee for valuing gold ornaments. Some banks charge a flat Rs. 500 or so. But some customers did say that all the branches of banks are not adequately equipped with the capabilities to assay the quality of gold on all the working days.

Size of gold loans

11.28 The average size of individual gold loans are in the range of Rs.50,000 to Rs.80,000. However, some private banks also lends to the high ticket loans that goes up to as high as Rs. 3 lakhs in urban areas. There were instances of increasing the loans up to Rs. 10 lakhs on case to case basis.

Purpose of gold loans

11.29 Banks invariably ask the borrowers to state the reasons/purpose of loans as against the NBFCs, which do not ask for the purpose. As far as the purpose of gold loans is concerned, the banks stated that in rural areas, most of the loans are taken for agriculture purposes by farmers, sharecroppers, agricultural labourers etc. Loans are taken for social and cultural commitments, marriages, deaths, religious functions. Small traders, education, medical emergency also call for a gold loan. In sum, the gold loans are extended for both productive and consumption purposes. On an average the major portion of gold loans are for agriculture purposes. In the case of public sector banks this ratio is 80 per cent agriculture and 20 per cent for non-agriculture, while the private banks, this proportion is 30 per cent for agriculture, 40 per cent for traders and SSIs and the remaining for all other purposes including education, marriage etc.

Maturity of gold loans

11.30 By and large the banks lend for short-term. The maximum maturity is for one year. However, most of the loans are for three months. However, if it is for agricultural purposes, the maturity of loan coincides with the cropping cycle.

Default rates of gold loans

11.31 As gold ornaments have emotional attachment of the family, commercial banks are also experienced with the general tendency among the borrowers to repay the loans promptly and take back the jewels. Above all with the increasing price of gold, the defaulting of gold loans does not arise. Therefore the level of NPAs in this segment is least among various segments very similar for the gold loans NBFCs as well.

Popularity of gold loans

11.32 Banks had in general conceded to the Working Group that the gold loans have become very popular more because of marketing by NBFCs rather than by banks. However, this has helped the banks also to expand their gold loans business.

Interest rate on gold loans

11.33 Banks, generally, decide the interest rate by adding a margin of 3.5 to 4.0 per cent to the base rate. Besides linking with the base rate, it is also linked with the purpose of loan like whether it is meant for agriculture or non-agricultural purpose. For agriculture loans the interest rates are lower. For non-agriculture, the interest rates will be in the range of 12 to 14 per cent per annum. Banks also offer interest rate concession for senior citizen borrowers on gold loans.

Speed of Disbursal of gold loans

11.34 One of the most important aspects considered in the case of gold loans is the speed of sanction and dispersal of loans. Here the NBFCs have a clear advantage of disbursing the loans in few minutes. On contrary, commercial banks finds it difficult to match their speed with the NBFCs, as they stated to take one hour to half a day at the front office. This is in addition to the time taken at the back office, for valuing gold, complying with other documentation procedures such as KYC norms etc. Mostly the loans amounts are credited to the bank accounts.

Documentation required by banks

11.35 It was clarified by the bankers that they strictly follow the complete KYC norms in this case, it is not sufficient to produce the ID with address proof. The relatively longer time taken to disburse a gold loan is justified by the banks on the ground that gold loans business is not the exclusive business of banks; there are huge number of other activities undertaken by a typical bank branch. Very few banks proposed to establish exclusive branches devoted to gold loans to compete with the NBFCs. In the case of gold loans required for the purpose of agriculture, more documents are required by the banks such as land ownership records, land lease agreement, village panchayat records, etc.

Ownership of gold ornaments

11.36 This is mostly judged based on the experience and asking certain informal questions, because mostly the receipt of gold jewels purchases will not be available with the owners as jewels are being transferred from one generation to other by mere physical transfer in the family. Going by the experience, the bankers are of the view that the theft ornaments will not come to the banks for borrowing against them, they instead approach informal sector to sell them out rightly.

Foreclosure of Loans

11.37 Unlike the NBFCs, all commercial banks unanimously agreed that they allow the borrowers to foreclose the gold loans, i.e., early repayment of loans. They do not charge any penalty on such foreclosures, as gold loans are in general on a single bullet repayment format.

Auctioning of gold jewels/ Ornaments by banks

11.38 Unlike NBFCs, the auctioning of gold jewels by banks is rare. Banks wait as long as 36 months to consider the auction option. If it takes place, it is an elaborate process. Banks follows a set of procedures, which includes advertisements in the news papers, informing the borrowers well in advance the details of place and timing of the auctions as well. Any excess amount recovered out of auctioning of gold in variably given back to the borrowers/owners of the jewellery. The presence of the owners of jewelleries is also a must at the time and place of auction. Though these procedures are followed by banks in general, there is no set procedure being prescribed by ay authority as such.

Why NBFCs are popular in gold loans vis a vis banks?

11.39 According to the gold loan NBFCs mentioned to the Working Group that that their operating costs are lower because of the locally recruited employees. When asked about their extensive TV advertisements with popular cine stars they responded that it is a onetime exercise by only one company, whose benefits were reaped by all the companies. Flexible operating times, accessible location, extremely fast dispensation without asking too many questions on the purpose of loans makes the NBFCs gold loan business popular. These NBFCs never ask the end use purpose of the usage of loans. Mostly gold loans are smaller such as Rs.40000, therefore, cash is disbursed and no hassle of a cheque encashment.

IV. An assessment of the practices followed by the NBFCs

11.40 Gold loans business by NBFCs as well as banks helps the marginal and vulnerable sections of society in meeting their necessary funding requirements. Though there is a steady rise in the complaints against these NBFCs, there is no reason to suspect that the gold loan business is inherently wicked. The growth of gold loan business by this formal segment has reduced the role of 'informal financing' by entities such as money-lenders. Gold loan NBFCs are doing a socially useful function by catering to the requirements of needy and poorer sections of the society. Their popularity is visible in their growth. However, the practices followed by the NBFCs in gold loan business needs to be subjected to scrutiny in order to make this organised financing process free from vagueness, which otherwise leads to exploitation of customers.

11.41 If gold loan companies have to realize the full potential of their branch expansion, they have to realize that customer grievances need to be addressed. Mostly, it has been observed that the employees generally do not explain the product features completely and also customers do not have much time to understand the nuances as the borrowers require funding in emergencies like medical, educational loans, etc. In view of the fact that the financial services should be made available to the users at reasonable prices/charges in line with the objectives of fair practices code and financial inclusion, particularly for the financial transactions involved with low income group, the business practices followed by gold Loan NBFCs needs to be monitored and reviewed.

V. Fair Practices Code and KYC Norms Pertaining to Gold Loans NBFCs

11.42 A Fair Practices Code is generally designed to foster just and equitable principles of conducting business; to maintain high standards of commercial practices and integrity among the relevant players; to prevent fraud and manipulative practices; to build safeguards against unreasonable profits, commissions and other charges; and to maintain collaboration with various agencies to protect borrowers and investors in public interest. In this chapter, an objective assessment has been attempted to take a view on whether NBFCs are adhering to the Fair Practices Code including the KYC norms in extending gold loans and conducting their business.

A. The Fair Practices Code

11.43 The Reserve Bank of India, in exercise of the powers conferred under Section 45 L of the Reserve Bank of India Act, 1934 (Act 2 of 1934) and of all the powers enabling it in this behalf, prescribes broad guidelines on fair practices that are to be framed and approved by the Boards of Directors of all Non- Banking Financial Companies (including RNBCs). The Fair Practices Code so framed and approved by the Board of Directors should be published and disseminated on the web-site of the company, if any, for information of the public.

Guidelines on Fair Practices Code for Non-Banking Financial Companies

11.44 The broad guidelines on Fair Practices Code for Non-Banking Financial Companies were prescribed by Reserve Bank of India in September 2006. In terms of instructions contained in first such circular issued on September 28, 2006, all the NBFCs were advised to put in place the Fair Practices Code based on broad guidelines prescribed in the circular with the approval of their Boards within a month. The NBFCs have the freedom of drafting the Fair Practices Code enhancing the scope of the guidelines, yet, at the same time ensuring that the FPC so drafted in no way will compromise the spirit of the guidelines prescribed by the Regulator. The NBFCs are required to put up the FPC so adopted on their web-site, if any, for information of various stakeholders.

11.45 The Guidelines on FPC for NBFCs have been refined from time to time. The Guidelines on FPC broadly covers the following:

(a) **Aspects involved in pre-sanction of credit facility** - Upfront information to borrower which affects his/her interests and enables him/her to make meaningful comparison with the terms and conditions offered by other NBFCs/ entities and take an informed decision. A system of proper loan application, documents required for sanction of credit facility, acknowledgement of loan proposals and indicative time-frame within which loan proposal will be disposed of. It also covers instructions to the Boards of NBFCs to put in place an appropriate system of laying out internal principles and procedures in determining interest rates and processing and other charges by NBFCs to ensure that rates of interest are not excessive, unsustainable or not conforming to normal financial practice.

(b) **Aspects involved in grant of loan-** The system of communicating in writing to the borrower by means of sanction letter or otherwise the amount of loan sanctioned and terms and conditions attached to it, annualized rate of interest and method of application thereof, acceptance of terms and conditions by borrower and making available a copy of loan agreement to borrower.

(c) **Aspects involved in disbursement of loans –** A system covering issue of notice to the borrower of any changes in the terms and conditions including disbursement schedule, interest rates, service charges, and prepayment charges prospectively and decision to recall / accelerate payment or performance under the loan agreement provided it is in consonance with the terms of the loan agreement.

(d) **Aspects involved in post disbursement / closure :** It covers refraining from interference into the affairs of borrower, consent or objection with reasons therefore for requests of borrower for transfer of loan account to other institution, release of all securities on repayment of all outstanding dues by borrower, refraining from unethical practices / harassment and adherence to non-coercive methods in the matter of recovery of loans, prior notice with full particulars to the borrower about exercise of right of set-off, in case securities are to be retained by NBFC.

(e) **Appropriate Grievance Redressal Mechanism:** The Boards of NBFCs should also lay down appropriate grievance redressal mechanism to resolve disputes arising out of decisions of lending functionaries, periodical review of the compliance with the FPC and functioning of grievances redressal mechanism at various levels of management.

Revised Guidelines

11.46 These guidelines were reviewed recently on March 26, 2012 keeping in view the creation of a new category of NBFCs viz. NBFC-MFIs and also rapid growth in NBFCs' lending against gold jewellery. While the FPC guidelines issued hitherto were generic covering all categories of NBFCs, the revised guidelines for the first time, apart from covering the general principles common for all categories of NBFCs, specifically direct NBFC-MFI and NBFCs lending against collateral of jewellery to adopt certain fair practices that are specific to their lending business and regulatory framework.

Specific Fair Practices for NBFCs lending against collateral of gold jewellery

11.47 In the backdrop of complaints and queries received under Right to Information Act regarding high rates of interest, penal interest due to delayed repayment, auction of pledged gold without proper notice, prepayment charges etc., the guidelines on Fair Practices Code were reviewed keeping in view the specific model of gold loans NBFCs. The specific Fair Practices, in addition to the general guidelines, for NBFCs lending against collateral of gold jewellery makes it mandatory for Boards of these NBFCs -

(i) That they should put in place a Board approved policy for lending against gold that should inter alia, cover the following:

- Adequate steps to ensure that the KYC guidelines stipulated by RBI are complied with and to ensure that due diligence is carried out to check the KYC norms on the customer before extending any loan,
- Proper assaying procedure for the jewellery received,
- Internal systems to satisfy ownership of the gold jewellery,
- Putting in place adequate systems for storing the jewellery in safe custody, reviewing the systems on an on-going basis, training the concerned staff and periodic inspection by internal auditors to ensure that the procedures are strictly adhered to. As a policy, loans against the collateral of gold should not be extended by branches that do not have appropriate facility for storage of the jewellery,
- The jewellery accepted as collateral should be appropriately insured,

- The Board approved policy with regard to auction of jewellery in case of non-repayment shall be transparent and adequate prior notice to the borrower should be given before the auction date. It should also lay down the auction procedure that would be followed. There should be no conflict of interest and the auction process must ensure that there is arm's length relationship in all transactions during the auction including with group companies and related entities,

- The auction should be announced to the public by issue of advertisements in at least 2 newspapers, one in vernacular language and another in national daily newspaper.

- As a policy, the NBFCs themselves shall not participate in the auctions held,

- Gold pledged will be auctioned only through auctioneers approved by the Board.

- The policy shall also cover systems and procedures to be put in place for dealing with fraud including separation of duties of mobilization, execution and approval.

(ii) The loan agreement shall also disclose details regarding auction procedure**.**

11.48 The general principles of Fair Practices and specific guidelines for lending against collateral of gold encompasses wide spectrum of activities covering almost all operative aspects of Gold Loan NBFCs keeping in view the protection of rights and to safeguard interests of customers / borrowers.

VI. Adherence to guidelines on Fair Practices Code

11.49 In order to assess whether the NBFCs are adhering to the Fair Practices Code in extending gold loans, the Working Group held interactive sessions with the members of the Association of Gold Loan Companies (AGLOC) at Kochi and also with select borrowers of gold loan NBFCs at Thiruvanathapuram and Bengaluru to ascertain their views on compliance with guidelines on Fair Practices Code. In addition to these interactions, an analysis of complaints received against major gold loan NBFCs at various Regional Offices of DNBS was also carried out to assess the level of compliance with Fair Practices Code by these NBFCs and the nature of complaints against them.

Working Group's Interaction with the AGLOC:

11.50 During the course of interaction with the Working Group, the members of AGLOC submitted that taking into account a large number of borrowers running to over 75,000 per day spread across all over India, the number of complaints against their companies was insignificant as compared to level of complaints against major commercial banks and that complaints received were being addressed and resolved.

11.51 On a specific query, on the procedure adopted with regard to auctioning of jewellery, the representatives submitted that the size of auctioned jewelleries will be only around 1 to 2 per cent of the pledged jewellery. Auctions are conducted by the companies once in three months, or so, mostly at district headquarters. The auction takes place after 18 months from due date for repayment of loan and prior notice of auction is sent to borrower through registered mail and advertisement of auction is given in local newspapers and participants in auction include representatives of companies as well. The members of the companies were willing to surrender the jewelleries to any governmental agency or third party to conduct auctioning. However, the AGLOC Members could not give a valid reply to a pointed query that if the auctioned value exceeds the dues of loan outstanding would the excess amount be refunded to the borrower/ owner of gold jewellery.

11.52 On interest rates charged to borrowers, the members of AGLOC submitted that range of interest was 12 per cent p.a (simple interest for 3 month maturity) to 26 per cent. According to them, the major portfolio is in the average interest rate of 24 per cent to 26 per cent and only 2 per cent of the loan portfolio carries interest rate of 12 per cent. However, if the repayment is in default even by a single day, the interest rate is increased to higher slab for default period and likewise increases to higher slab for every additional period.

***Working Group's interaction with customers / borrowers of NBFCs**:*

11.53 In order to ascertain views of borrowers and especially complainants on functioning of gold loan NBFCs, the Working Group members met borrowers at Thiruvananthapuram and Bengaluru. The participants were also requested to fill-up a questionnaire (bilingual) to gauge their responses.

11.54 Thiruvananthapuram:

- Almost all the investors/depositors who attended the meeting were unaware that they were investing in debt product (debenture) of these companies and not in deposit. They stated that foreclosure of the deposits / NCDs was accepted by the companies but the company would pay lower rate of interest and not the originally contracted interest rate justifying the lesser maturity period. The NCDs are kept on tap in most of the branches and the maturity is also not fixed and all depended upon the mutual understanding of investor and company. The investors expressed their happiness as the interest payments were promptly being credited in their bank account at regular intervals and received the principal amount on maturity without any problem. Most of the investors / depositors reposed confidence in these companies because they are registered with and regulated by the Reserve Bank and, therefore, felt that their investment was safe but were curious to know whether they could continue their investment in the wake of recent steps of RBI towards tightening the regulatory norms in respect of these companies.

- One of the gold loan borrowers expressed serious concern in the style of operation of the gold loan NBFCs going by his own experience. The company did not even inform any rate of interest or the quantum of interest to be paid on maturity of his loan of Rs. 58,000. All that was given to him was just a 'pawn card'. An acknowledgement (equivalent to loan sanction letter) given at the time of availing loan contained only the gist of the terms and conditions of the loan such as loan amount, reset dates of annualized interest charged in case of non-payment within the stipulated dates and the total weight of the gold pledged but not the rate of interest applicable to his loan, maturity period of loan, details of auction procedure, in case of default, any other documentation charges etc. After one year when the borrower went to repay the loan and interest accumulated, the loan outstanding was indicated as Rs. 93, 500. No satisfactory answer giving details for the break-up of the outstanding amount was given and he was further informed that the jewels were already auctioned. The borrower was not informed anything about the auction at any stage and it was only when he lodged complaints with police and media and finally at Reserve Bank, the company officials came for a compromise after RBI's intervention and finally agreed to pay Rs. 45,000 against the total market value of jewelleries pledged by him to the tune of around Rs.1,60,000. Even after adjustment of interest amount dues, the borrower suffered sizable net loss.

- Generally, higher the loan requirement of a borrower from an NBFC, higher the interest rate they charge and similarly for longer maturity period, the interest rate charged is higher. Above all, depending upon the urgency, the company charges higher rates of interest and most importantly, even if there is a single day delay in paying interest or principal the borrower is automatically pushed into the higher slab of interest rate for the entire period (not for default period alone).

- The borrowers were generally aware that the gold valuation is done by deducting the stone weight and some making charges. With the application of a particular loan to value ratio, the value on which the loan quantum is computed effectively works out to around 70 to 75 per cent of the market value of the jewellery. But, the borrowers were not clear about what is the gold price used for valuing the ornament on the day of pledge. The valuation of gold is very opaque and can vary from borrower to borrower.

11.55 Bengaluru:

The complaints of borrowers / customers of NBFCs, who interacted with members of the Working Group, mainly related to auction of their jewelleries without intimation to them. The following complaints emerged from the Working Group's meeting with them:

- Higher interest rates charged almost in all cases than what was promised to the borrower at the time of borrowings. Penalty payable on delay / default was not informed upfront and the penalties were very stiff.

- No proper documentation procedure was followed by any of these NBFCs except taking a photo of the borrower and any identity card which has the name and address. All that was issued to the borrower is a 'small pawn ticket'. This is the only documentary evidence available with the borrower, irrespective of the total quantity of gold pledged and borrowed. Sometimes these NBFCs are mentioning that they are a bank in the pawn ticket.

- No details are given about the number of articles, weight in gold and their market value. At times, the pawn tickets are hand written without any signature of an authorized representative or the stamp of the company. The pawn ticket does not contain even the details such as total market value of jewels pawned, loan to value ratio, valuation done (details of deductions of stones and making charges etc), rate of interest, period of loans.

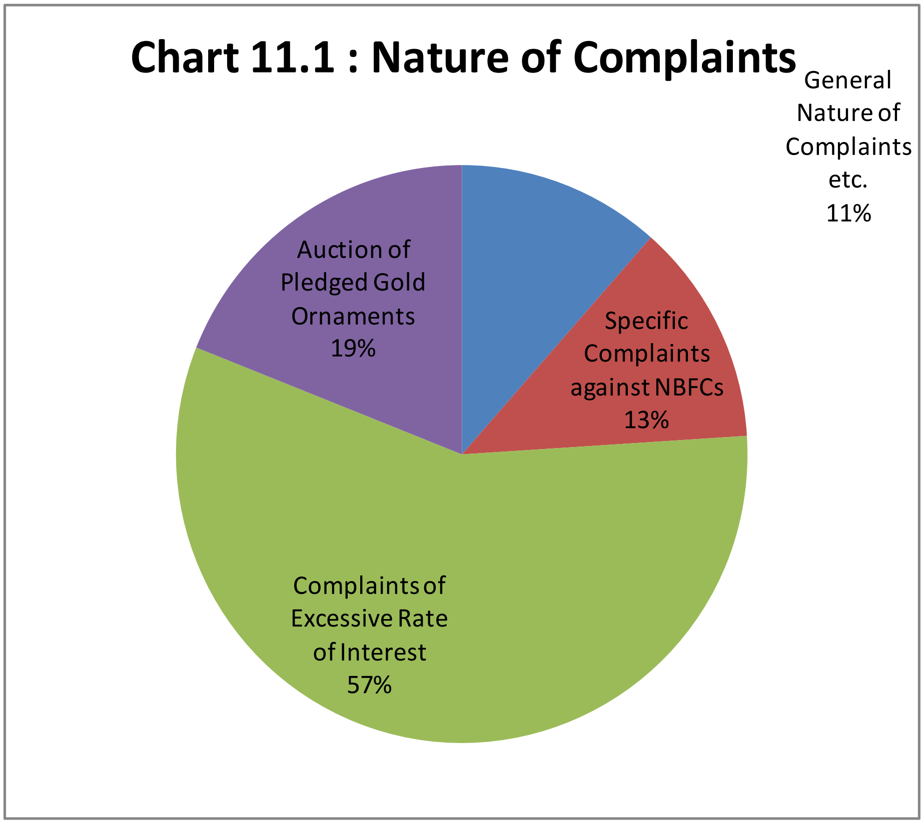
- Customers were unaware of the 'Fair Practices Code' being followed or available.

- The procedure relating to auctioning of jewels are absolutely opaque. Even though the borrower is informed by the NBFCs about the auctioning of their jewels, the borrower is not informed where and when the jewels would be auctioned. It is impossible for the customers to identify his jewels as all the jewels and ornaments are put together in big lots (in kilogrammes) and auctioned. Moreover, the place of auctions is always far away from the place of pledge, it becomes physically impossible to the borrower to go to that place.

- In branches, the employees working are totally ignorant of the computation of total interest amount due, rate of interest, etc. They are unable to clarify any doubts to the customers. For everything, the only answer given to the borrower was that, whatever the computer shows that is final. When asked for the details, the only answer that the customer is informed is that everything is centralised and all computations are done at their Head office. The branch manger's duty is only to inform the customer what is due and collect the same.

VII. Analysis of complaints:

11.56 The complaints received during April 2010 to March 2012 against six major NBFCs in gold loan business at various Regional Offices which were forwarded to Thiruvananthapuram office of DNBS for disposal as these companies were based in Kerala, were examined and their analysis revealed the trends depicted in the chart 11.1 given below.



(a) About 11.5 per cent of the complaints are general in nature: about lack of transparency in operations of gold loan companies and an urgent need to resort to regulated rate of interest structure to safeguard interests of small borrowers.

(b) In respect of about 12.5 per cent of complaints against NBFCs, the matters relating to non-furnishing of information/ documents / statement of interest calculations/ proper receipts for payments received, delay in returning pledged ornaments etc. were amicably settled only after the complainants approached the Reserve Bank.

(c) An overwhelming chunk of about 57.0 per cent of complaints related to excessive rate of interest applied as also other charges levied by these companies. In most of the cases, the documents furnished by these gold loan companies in support of their submissions showed that interest rates were charged as per agreed terms and conditions between the company and the borrower.

(d) About 19.0 per cent of the complaints were connected with auction of pledged gold ornaments without due notice, lack of transparency in procedure of auctioning of gold jewellery, not getting chance to participate in auction etc. In some cases, the matters are sub-judice. In their submissions, companies produced copies of notices sent to borrowers about proposed auction and in some cases acknowledgments of borrowers for having received notice as well.

VIII. Working Group's Observations:

11.57 Most of the companies have crafted several schemes under gold loans and interest rates applicable and redemption periods of each of the loan products / schemes are different. Further, in the event of delay / default of even by one day, the borrower is pushed to a higher slab of interest. It was submitted by the members of AGLOC during the course of interaction with them that, on an average, physical quantity of gold pledged by a common borrower is around 40 grams in case of majority of borrowers. This section of borrower being vulnerable and illiterate, it is quite likely that they do not have fair idea or proper understanding of the complex design of the loan products and are not fully aware of penal interest applicable on delay in repayment. Most of the complaints / disputes pertaining to charging of excessive interest emanate due to lack of knowledge of various loan products. Those who had knowledge of grievance redressal mechanism could take up the matter with RBI and companies agreed to settle matter amicably.

11.58 In terms of the extant instructions of Fair Practices Code, it is obligatory for NBFCs to provide a copy of loan agreement along with enclosure, if any, to the borrower. It is quite likely that this practice is not followed in letter and spirit. Further, it was observed that gold loan companies issue pawn ticket in lieu of a sanction letter which was also not comprehensive and does not clearly indicate rate of interest applicable for the loan availed by borrower.

11.59 There seems to be lack of transparency / clarity on penal interest applicable in case of delayed repayment i.e. whether higher rate of interest is applicable for the delayed period **or** for the entire loan tenure.

11.60 Non-receipt of auction notice in many cases, though sent by companies, is cause of concern. The revised FPC guidelines stipulate that auction should be announced to the public by issue of advertisements in at least 2 newspapers, one in vernacular language and another in national daily newspaper. This guideline is expected to take care of this concern. However, it was understood that most of the gold NBFCs conduct auction either at their Headquarters or in district place. Resultantly, borrowers wanting to redeem loan or participate in auction to get back ornaments pledged could not do so because of receipt of notice at nick of time or logistics involved i.e. distance from place of residence to auction place, cost involved etc.

11.61 It is quite likely in large number of complaints on levying of excessive interest, an element of other charges (cost of notices, dispatch charges, legal, processing, insurance etc.) are involved of which borrower has no knowledge or companies are not very transparent in disclosing this upfront.

IX. Overall Assessment of the Working Group on the Administration of the Fair Practices Code:

11.62 The Fair Practices Code that was conceived and prescribed by the Reserve Bank is comprehensive and provides guidance to the NBFCs on all relevant areas. The basic objectives of the Fair Practices Code are to ensure that the interests of the borrowers are safeguarded and the NBFCs have to conduct their business practices in a fair and just manner. The Association of Gold Loan Companies have drafted an elaborate Fair Practices Code and resolved that the members should adhere to the Code without any exception. The Association's code deals with structuring loan products and applications for loans, compliance with KYC Norms, the process of giving loan against gold, loan appraisal and terms/conditions, disbursement of loans/ changes in terms and conditions, rate of interest, safe custody and security of pledged gold, release of pledged gold, recovery of interest dues, procedure for confiscation and auction of pledged assets on non-repayment of loan dues, missing of pledged items, recruitment of staff, governance and transparency. By and large, this is a comprehensive list of items encompassing all relevant areas for ensuring the safety of borrowers' interests.

11.63 If the gold loans NBFCs adhere to this code in letter and spirit there would not be many complaints, which are of serious nature, against them. However, going by the number and the tenor of the complaints from aggrieved borrowers, some of the NBFCs have left the spirit of the Code to winds. The rules and procedures governing the documentation to be undertaken, interest rate to be charged, penal interest to be levied in case of default, auction procedures to be followed have all been systematically violated by some NBFCs going by the complaints received by the Reserve Bank and the deposition made by the aggrieved borrowers before the Working Group. Majority of the aggrieved borrowers who testified to the Group complained about very high interest rates charged, usurious penal interest rates levied on default, auction of their jewels without notice to them and also keeping them in darkness about the terms and conditions of the loans. However, going by the very large number of branches of the NBFCs functioning, large number of gold loan borrowers of various categories, the absolute number of complaints received against NBFCs may not be very significant. But the Working Group recognizes that the complaints that were received are of very serious nature and should be taken note of to not only expeditiously resolving them but also to ensure that they do not recur. The documentation procedures are non-standard, inadequate and primitive. Given the low economic stature of the gold loan NBFCs' borrowers, of whom majority are illiterates, it is possible that many of them could have been victims without even complaining. One reason for blatant non-adherence to the Fair Practices Code by the NBFCs could be the absence of punitive clauses for non-adherence to the extant Code.

X. Know Your Customers (KYC) Guidelines for NBFCs and Adherence to the Compliance

11.64 The Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 contained guidelines relating to identification of depositors in terms of these directions which every NBFC was mandatorily required to obtain proper introduction of depositors before opening their accounts and accepting deposits and keep on its record the evidence on which it has relied upon the purpose of such introduction. The guidelines were reviewed in the context of the provisions of the Prevention of Money Laundering Act, 2002 and need to put in place systems and procedures to help control financial frauds, identify money laundering as also to safeguard NBFCs from being used for transfer of funds derived from criminal activity or for financing terrorism. The KYC guidelines issued on January 06, 2004 were made applicable to deposit as well as non-deposit accepting NBFCs and were revisited in October 2005 in the context of recommendations made by the Financial Action Task Force (FATF) on Anti Money Laundering (AML) standards on Combating Financing of Terrorism (CFT) and covered persons authorized by NBFCs including brokers / agents to act on their behalf. The KYC guidelines, Anti Money Laundering Standards- Prevention of Money Laundering Act, 2002 have been amended from time to time since then and the current KYC Guidelines and obligations of NBFCs in terms of Rules notified there under are similar to those prescribed to commercial banks.

11.65 During the course of interaction with members of AGLOC at Kochi, it was submitted to the Working Group that NBFCs are strictly adhering to KYC norms prescribed by RBI and there are no instances of deviation from these norms. The advertisements relating to '3 minute' and '5 minute' loan sanctions are applicable to the existing customers only. The company already has the necessary details relating to proper address, identity proof and other details of the existing customers. In case of new customers, all due diligence procedures prescribed under KYC norms are followed by taking 'on the spot photograph of the borrower' and ensuring the address proof.

Working Group's Observations

11.66 The NBFCs have been able to register very rapid growth in the span of last 3-4 years basically on account of their operational flexibility and reach. Their business model is disbursement of quick / easy loan named as "3 minute" loans with easy or material documentation. Concerns, therefore, have arisen on whether proper KYC is being undertaken on the clients. It is gathered from the discussions with companies and borrowers that while the basic documents of identification and residential proof are obtained, there is hardly any appraisal of need based credit of the borrowers as main business drive is disbursal of loan against the most liquid and secured asset i.e. gold jewellery. Resultantly, the credit appraisal, purpose of credit etc. take backseats.

11.67 Almost all transactions, disbursal as well as repayment of loan, irrespective of amount involved, are in cash. The large scale handling of cash at branch network across the country also poses security concerns. It is reported that increasing trend in incidence of cash robbery (by outsiders) and misappropriation of cash at branches involving staff members of gold loan NBFCs has been observed in the recent past.

11.68 As per the recent media reports customers will no longer be able to buy gold bars or coins worth more than Rs 2 lakh – even by paying cash – without furnishing the Permanent Account Number (PAN) of the buyer. It is now mandatory on the part of the seller to collect tax at source on such sales. The PAN is treated as the proof of identity for this purpose. These measures aim not just to check the flow of unaccounted money in the bullion and jewellery trade but also to reduce gold import. Against this backdrop of regulatory requirements, it is imperative on part of these companies to insist upon PAN card as additional KYC documents in all high value transactions.

XII. Recommendations:

Need to thoroughly review the practices followed by NBFCs

11.69 The rapid growth of operations witnessed by the major companies in recent years may be difficult to sustain as competition is also increasing. Their focus should be on 100 per cent resolution of customer complaints, standardization of procedures and documentation across all their branches, ensuring transparent communication to the borrowers about the loan terms, putting in place unambiguous auction procedures and provide more financial buffers to protect against unforeseen shocks. In order to ensure the healthy growth of gold loan business, the short-comings noticed in the various practices followed by gold loan companies need to be address to make this business sustainable.

Ensure transparent communication of loan terms

11.70 All the major gold loan companies generally display the details of their various loan products on their web-site to fulfill their obligation of transparency. On the other hand, majority of the customer grievances pertain to the excess interest charged. The main reason for this lies in the non-transparent communication of the loan terms to the customers by the employees of the gold loans NBFCs. Majority of the gold loan borrowers belong to the low-income, less educated sections of society and the gold loan companies need to instruct their sales staff to properly explain the various terms and penalties to be levied. The widely prevalent practice of issuing a small pawn ticket needs to be replaced with proper loan contract indicating all the applicable terms and levies and penal interest charges transparently. The loan document would help the customer to understand the charges even in cases of emergency loans as he can refer the loan documents later at ease.

Customer complaints and grievances redressal system

11.71 The gold loan companies need to put in place a proper customer complaints redressal system to handle the customer complaints in a time-bound manner. This system needs to be established at all levels starting from the branch offices. The customers need to be told about the existence of such system by properly displaying the contact details at all branch offices.

Auction procedure

11.72 As auctions conducted with regard to defaulted loans are said to be around 1 to 2 per cent of total loan size, there does not seem to be an established procedure or regulation on the auction of gold jewelleries. Considering the vulnerability of a section of the borrowers to questionable methods of auction, the Working Group is of the view that Boards of Gold Loan NBFCs need to adopt specific guidelines on auctioning of jewelleries based on broad regulatory prescriptions and a revised Fair Practices Code. It may be stipulated that the pledged gold ornaments should be auctioned off at a price closure to the prevailing rate in the market on the day of auction, so that the borrowers' interests are protected. Accordingly, the reserve price may be decided. This should take care of the complaints against gold loan NBFCs on auction related issues.

Location of auctions

11.73 The auction of gold pledged at the same branch or same town is an ideal situation in borrowers' interest, but the same may not be practical from administrative, cost effectiveness and security angles for NBFCs. The auction may be conducted preferably in the Taluka Head Quarters, which will offer at least a last minute opportunity to borrower who attaches emotional value to ornaments to redeem the gold pledged.

Post-auction safeguards

11.74 In the cases of auction of gold ornaments, it should be mandatory on the part of NBFCs to provide full details of value fetched by it in auction, outstanding dues adjusted and balance, if any, outstanding or payable to borrower by way of registered letter. This step would not only stem complaints against NBFCs on auction but also provide opportunity to borrower to pursue the matter to redress his grievance, if any. Keeping in view small number of such cases, as per NBFCs' submission, it should be possible to strictly adhere to this procedure.

Disclosure standards

11.75 The NBFCs may claim that they are displaying all the required information about the schemes, rates of interest and other details in their premises. But, this may not be true in the case of all the branches, going by the ignorance shown by the complaining borrowers to the Working Group. The NBFCs need to ensure that the details of interest rates for various loan products for different maturities, penal interest applicable in case of delay / default in repayment, policy / practice adopted by company to determine net weight of gold ornaments, gold rate applicable (whether current market price or average of some period) to determine value of gold jewelleries, margin held and procedure adopted for auction of gold pledged are prominently displayed in local language at all their branches. Regulator may prescribe punitive action, if the NBFCs fail in these disclosures. As part of the disclosure norms the Reserve Bank may prescribe that the gold loan companies disclose in their Annual Report the details of auctions conducted during the financial year such as number of auctions conducted during the year, loan accounts involved, outstanding loan dues, value fetched in auctions, balance amount refunded and recovered from borrower, whether the company had also participated in the auction and, if yes, the details of the bids, value of jewellery purchased etc.

Monitoring the implementation of the Fair Practices Code

11.76 The Reserve Bank (DNBS) issued revised guidelines on the Fair Practices Code on March 26, 2012. These revised guidelines provide specific guidance to gold loans NBFCs about the practices to be followed. While this has largely addressed most of the concerns and has positive steps to protect and safeguard interest of borrowers, especially vulnerable sections, the Working Group is of the view that the regulator should monitor the strict adherence of the fair practices by gold loan NBFCs during the course of on-site supervision.

Standard documentation

11.77 The documentation followed by various NBFCs and by various branches of the same NBFC differs considerably. The pawn tickets are not having the required details on the type and number of jewels pledged, their weight in grams, their purity and market value on the date of transaction. There are many complaints that loan agreement copies are not furnished to the borrowers by the NBFCs. Since the pawn tickets are issued by NBFCs in lieu of sanction letter and absence of a system of providing copy of entire loan agreement document, the same needs to be comprehensive, preferably in vernacular language, clearly indicating description of each item of jewellery and its weight, annualized rate of interest applicable (and not just various slabs of interest for various loan products), maturity period of loan sanctioned to the borrower, due date on which auction would be conducted in case borrower fails to repay loan, other charges applicable (cost of notices, postal charges, legal fee, insurance etc.) on loan. Statement of account with full working details should be provided to the borrower on closure of the loan account. Even the pawn tickets and cash receipts given were handwritten in some cases. In other words, the documents should be simplified and standardized. Therefore, the Working Group is of the opinion that the documentation has to be standardised with all required details and legal requirements. There are two options to consider. Reserve Bank may prescribe a set of documents, like the pawn ticket, loan agreement etc., to be used by all the gold loan companies in a standard format. Alternatively, the members of AGLOC may finalise a set of documents duly considering local laws, which can be vetted by Reserve Bank. The AGLOC may advise all its members for adopting these standard set of documents in all transactions. Some Pawn Brokers Acts or Money Lenders Act say like Tamil Nadu State Acts contain useful model formats for conceiving such standard documentation. This step will safeguard the interests of the gold loan borrowers to a great extent.

Use of PAN Card

11.78 The Working Group recommends that gold loans NBFCs may obtain a copy of PAN Card in all the loan proposals exceeding rupees two lakhs to strengthen mechanism of KYC.

Payment through cheque

11.79 All loans exceeding a reasonable limit, say, rupees two lakhs may be disbursed by way of cheque in name of borrowers and not in cash. This reduces risks associated with handling of high volume of cash transactions at branches of gold loan companies and KYC compliance is also strengthened as the payment is made through a bank account. This will not cause any distress to small borrowers but will be applicable to big ticket loans.

11.80 In sum, the Working Group is of the view that mere enunciation of a fair Practices Code by the NBFCs is a paper exercise. There is a strong need for standardization of the documentation, transparency in the interest rate stipulations and prescription of an auction policy that takes into account the interests of the defaulted borrowers.

12. Prudential Norms Relating to Gold Loan NBFCs – An Assessment

12.1 The regulation of the gold loan business dates back to the era of gold control, when the Gold Control Act 1968 was in force. The focus necessarily was on curbing the use of gold for speculative purposes. The banks were not allowed to grant advances for purchase of gold. Restrictions were also in place prohibiting banks from financing against the security of gold bullion and primary gold. Over a period, and especially after the abolition of Gold Control Act in 1992, some of these regulations were gradually relaxed. However, the business of gold loans by banks is still substantially controlled through various instructions on the subject by Reserve Bank. As per the assigned Terms of Reference, the Working Group has reviewed the extant regulatory norms relating to gold loans NBFCs with a view to recommending any modifications, if necessary.

I. Evolution of Policy for financing against the security of Gold/gold ornaments

12.2 The banks are not permitted to finance purchase of gold, whether in the form of bullion, primary gold, gold coins or jewellery. Financing against the security of bullion or primary gold is also not permitted. However, loans can be given against specially minted gold coins and ornaments and jewellery. But the banks are required to monitor the end use of funds and can lend only for the approved non speculative purposes. A substantial part of these loans is for the purpose of consumption. Another significant portion, especially in rural and semi urban areas, has been for the purpose of agriculture. These loans have also enjoyed the benefit of being classified as priority sector loans. The Govt. of India through Exim Policy 1997 – 2002, permitted import of gold by certain nominated agencies *viz*., MMTC, HHEC, STC, SBI and other agencies authorised by Reserve Bank for sale to jewellery manufacturers, exporters, NRIs, holders of Special Import licences and domestic users. In 1998, the Foreign Exchange Department of Reserve Bank also allowed import of gold by nominated banks on loan / consignment basis. Later in the same year, it was decided to permit nominated banks / agencies to grant gold (metal) loans as per the Exim Policy and the Hand Book of Procedures of the Exim Policy subject to certain conditions. Interest charged to the borrowers was to be linked to the international gold interest rate. In contrast, finance against the security of gold was priced with reference to domestic interest rates.

Overview of NBFC sector

12.3 Non-Banking Financial Companies (NBFCs) play an important role in broadening access to financial services. They are increasingly being recognised as supplementary to the banking system, mainly due to their widespread presence in rural areas and various customised financial services/products offered by these institutions which address the need of rural customers. They have been helping to bridge the credit gaps in several sectors where the institutions like banks are unable to venture. With the growing importance assigned to financial inclusion, NBFCs have come to be regarded as important financial intermediaries, particularly for the small-scale and retail sectors.

Regulatory Framework of NBFCs: Evolution Over time

12.4 The regulatory regime for NBFCs is relatively different in certain respects from that of the banks. However, the recent global financial crisis has highlighted the importance of widening the focus of NBFC regulations to address the risks arising from regulatory gaps, from arbitrage opportunities and from the inter-connectedness of various activities and entities comprising the financial system. The steady increase in bank credit to NBFCs over recent years has raised the possibility of risks being transferred from the NBFC sector to the banking sector. At the same time, it has become equally important to ensure that the dynamism displayed by NBFCs in delivering innovation and their ability to serve the far-flung areas of the country for meeting the credit needs of the productive sectors of the economy is not curbed. Therefore, need has emerged to rationalise the classification of NBFCs so that the objectives of regulation are met in an optimal and balanced manner.

12.5 NBFCs came under the regulatory purview of the Reserve Bank with the introduction of Chapter III B in the Reserve Bank of India Act, 1934. The Working Group on Financial Companies constituted in April 1992 (Chairman: A. C. Shah) set out the agenda for reforms in the NBFC sector. In addition to this, the Reserve Bank constituted an Expert Group on Designing a Supervisory Framework for NBFCs in April 1995 (Chairman: P.R.Khanna) to suggest the on-site inspection and off-site surveillance System for the NBFCs depending upon their asset size and the nature of business.

12.6 A new regulatory framework for NBFCs was introduced in 1998 focusing on the regulations for deposit taking NBFCs. The initiatives taken with respect to deposit taking NBFCs had brought in discipline in their functioning, besides reducing the instances of default in repayment obligations to the depositor community. Also, on January 31, 1998 directions were issued by the Reserve Bank with respect to acceptance of public deposits, prudential norms and companies' auditor's report. The Government of India appointed a Task Force on NBFCs (Chairman: C.M.Vasudev) to suggest improvements in the procedure for dealing with customer complaints and for involving the State Governments in regulating the NBFCs and unincorporated bodies.

12.7 The following regulations are presently applicable to NBFCs; these regulations also apply to gold loans NBFCs.

Mandatory Registration

12.8 All NBFCs irrespective of their size with intent to carry on the business of a non-banking financial institution are required to get them registered with the Bank and obtain Certificate of Registration. This has been made mandatory with the amendment to the RBI Act, in 1997. Since then all NBFCs which applied and which have been found eligible have been granted Certificates of Registration. New companies getting incorporated after 1997 which want to commence the business of an NBFI are also applying for Certificate of Registration to Reserve Bank. As on date, the Reserve Bank issued Certificates of Registration to over 12300 NBFCs and all these companies carry on the NBFI activities *i.e.* financing, hire purchase, equipment leasing, investment etc.

Classification

12.9 Registered NBFCs are broadly classified based on their eligibility to accept public deposits as "Deposit taking companies" and "Non-Deposit taking Companies". Further, the companies are sub-classified based on the principal activity they carry on *viz*., Loan Company, Investment Company, Asset Finance Company, Infrastructure Finance Company, Core Investment Company, Micro-Finance Institution, IDF-NBFC. However, there is no separate classification for Gold Loan Companies. They are classified as Loan Companies.

Prudential Regulations

12.10 The Reserve Bank has put in place a prudential regulatory framework with effect from January 1998 for all the NBFCs with regard to income recognition, asset classification and provisioning against Non Performing Assets (NPAs) and concentration of credit/investment norms. The prudential regulations were modified with effect from April 2007 wherein a separate classification of companies by their size has been brought out *viz*., Non-Deposit taking Systemically Important Non-Banking Financial Companies (NBFC-ND-SI). Companies, which are not accepting public deposits and the asset size of which is Rs.100 crore and above are classified as NBFC-ND-SI. These companies are comprehensively monitored and inspected to evaluate their financial health vis-à-vis their adherence to Banks' prudential regulations etc. Gold Loan Companies which are under study fall into the group of NBFC-ND-SI. They need to follow certain mandatory prudential regulations and reporting requirements of the Reserve Bank. They are as under:

- **Capital Adequacy Ratio:** NBFCs are required to have a capital to risk weighted ratio of 15 per cent with a Tier I capital of 12 per cent by April 2014.

- **Income recognition:** Gold Loan companies will have to stop recognising income on its loans when the installment or other dues remain outstanding for more than 180 days. Such income recognized earlier will have to be reversed.

- **Asset Classification:** Gold Loan companies shall, after taking into account the degree of well defined credit weaknesses and extent of dependence on collateral security for realisation, classify their loans and advances and any other forms of credit into the following classes, namely: (i) Standard assets; (ii) Sub-standard assets; (iii) Doubtful assets; and (iv) Loss assets.

- **Provisioning requirements:** Every non-banking financial company shall, after taking into account the time lag between an account becoming non-performing, its recognition as such, the realisation of the security and the erosion over time in the value of security charged, make prescribed provision against all categories of assets. The provisioning requirement in respect of loans, advances and other credit facilities including bills purchased and discounted shall be as shown in Table 12.1.

<table>
<tr><th colspan="3">Table 12.1 Provisioning requirement in respect of loans, advances and other credit facilities including bills purchased and discounted</th></tr>
<tr><td>Loss Assets</td><td colspan="2">The entire asset shall be written off. If the assets are permitted to remain in the books for any reason, 100% of the outstanding should be provided for;</td></tr>
<tr><td rowspan="7">Doubtful Assets</td><td colspan="2">(a) 100 per cent provision to the extent to which the advance is not covered by the realisable value of the security to which the non-banking financial company has a valid recourse shall be made. The realisable value is to be estimated on a realistic basis;</td></tr>
<tr><td colspan="2">(b) In addition to item (a) above, depending upon the period for which the asset has remained doubtful, provision to the extent of 20 per cent to 50 per cent of the secured portion (i.e. estimated realisable value of the outstanding) shall be made on the following basis : -</td></tr>
<tr><td colspan="2">Period for which the asset has been considered as doubtful</td></tr>
<tr><td>Period</td><td>Per cent of provision</td></tr>
<tr><td>Up to one year</td><td>20</td></tr>
<tr><td>One to three years</td><td>30</td></tr>
<tr><td>More than three years</td><td>50</td></tr>
<tr><td>Sub-standard assets</td><td colspan="2">A general provision of 10 per cent of total outstanding shall be made</td></tr>
<tr><td>Standard Assets</td><td colspan="2">Every Non Banking Financial Company shall make provision for standard assets at 0.25 per cent of the outstanding, which shall not be reckoned for arriving at net NPAs. The provision towards standard assets need not be netted from gross advances but shall be shown separately as ‘Contingent Provisions against Standard Assets’ in the balance sheet.” The gold loan companies have been, by and large, complying with Banks’ prudential regulatory guidelines.</td></tr>
<tr><td></td><td colspan="2">Till recently RBI has not placed any restrictions on the quantum of loan NBFCs</td></tr>
</table>

Loan to Value Ratio	(Gold Loan companies) can sanction against the security of gold jewellery. With effect from March 21, 2012 RBI directed NBFCs which are mainly into financing against gold jewellery to sanction loan to value ratio of 60 per cent. Such NBFCs, otherwise used to enjoy much higher loan-to-value ratio (70-80 per cent) than banks (55-60 per cent) till recent past.

12.11 The Report of the Working Group on the Issues and Concerns in the NBFC Sector (Chairperson: Smt. Usha Thorat) focusing on the issues and concerns of NBFC sector made a number of useful recommendations in order to further rationalise the existing classification of NBFCs based on their evolving business activities in the context of changed economic scenario. Among other things, the Group recommended a single category of loan/investment company in view of the fact that there is no difference in the regulatory framework for loan companies and investment companies and since most of the NBFCs-ND-SI are a mixture of loan and investment companies. Also, the Thorat Working Group has recommended that AFCs should be retained as a separate category of NBFC, though principal business for AFCs may be redefined. A minimum of 75 per cent of the assets of AFCs (as against 60 per cent presently) should be in asset financing activities and at least 75 per cent of total income should be from these asset financing activities.

12.12 Besides, the key features of the current regulatory regime as prescribed by the Reserve Bank for gold-loan NBFCs also contain the following features:

1. Loans not to be granted by NBFCs against the collateral of bullion, primary gold, gold coins;

2. Tier I capital requirement raised to 12 per cent from the extant 10 per cent by April, 2014 for NBFCs; and

3. Mandatory disclosure of percentage of gold loans in total assets portfolio of NBFCs in the balance sheet.

4. In addition to this, NBFCs are also instructed by the Reserve Bank to lay down a broad policy covering adequate steps to ensure that Know Your Customer (KYC) guidelines as stipulated by the Reserve Bank are complied with by the NBFCs.

5. In order to restrict the flow of funds from banks to NBFCs actively engaged in gold loan business, it has been decided that gold loan portfolio buyouts and lending to gold loan NBFCs by banks will no more be eligible to be counted as priority sector lending.

6. Keeping in view the possibility of risk contagion, the Reserve Bank has directed banks to reduce their regulatory exposure ceiling in a single NBFC, having gold loans to the extent of 50 per cent or more of its total financial assets, from the existing 10 per cent to 7.5 per cent of banks' capital funds.

7. Also the risk weightage for gold loans is 100 per cent for NBFCs as against 75 per cent for banks offering gold loans for agricultural purposes.

8. It is also reported that the restrictions on banks' financing for / against gold are not being adhered to in some pockets, possibly because of certain perceived ambiguities in the instructions. Efforts are, therefore, on to reiterate the major instructions as also to tighten a few other norms, so as to bring more regulatory clarity to this business by banks and to ensure that bank loan for / against gold is not used for speculative purposes.

II. Differences in regulatory regime between banks and NBFCs

12.13 The Working Group's interaction with the Association of Gold Loan Companies (AGLOC) brought out a few differences in regulations over banks versus NBFCs leading to the perceived discrimination in the regulatory treatment. These can broadly be grouped as under:

a. ***Removal of Priority Sector Tag for Agricultural Gold Loans of NBFCs:*** Till February 2011, NBFCs which sanctioned loans against the pledge of gold jewels for agricultural purposes were being treated as priority sector and they used to get loans from banks at concessional rate of interest as applicable to priority sector on assignment of their goal loan portfolio to banks. In February 2011, the tag has since been removed and they are treated as commercial loans. As a result, individual banks charge the NBFCs accordingly; this, the NBFCs lament, has increased their cost of borrowing.

b. ***LTV Ratio:*** Banks do not have any restriction of the quantum of loan against the gold jewellery, whereas NBFCs have to maintain an LTV cap of 60 per cent. This distorts the level playing field, as the NBFCs complain. Since banks perform several activities and hold several portfolios of assets and the portfolio of loans against gold/gold jewellery is less than 1 per cent of their portfolio, they can afford to have their own LTV ratio. However, NBFCs which hold only gold loans in their asset portfolio, any crash in the prices of gold will undermine the value of its portfolio and this may put NBFCs into adverse position. The regulatory restriction on the NBFCs appear to be reasonable and it can be watched for a while before any modification be thought of.

c. ***Income Recognition and Asset Classification:*** Banks have to recognise income up to 90 days on accrual basis and they have to stop recognising thereafter. Further, they will have to classify the assets as sub-standard on which recognition of income on accrual basis stops after 90 days. The period allowed to NBFCs for such a classification is 180 days.

d. ***Risk Weights:*** For banks, the risk weights are prescribed at 75 per cent on gold loans for agriculture purposes, whereas for the gold loan NBFCs the risk weight is placed at 100 per cent.

e. ***Banking Ombudsman:*** In case of complaints against banks, there is a body of Banking Ombudsman to hear the grievances of the bank customers and pass awards wherever necessary. Such a no-cost grievances redressal body is not available for the customers of NBFCs.

12.14 The other differences in the regulatory treatment for NBFCs and the banks have also been explained in the following Table 12.2.

Table 12.2: Differential Regulatory Treatment for NBFCs vis-à-vis Banks

Items	Banks	NBFCs-D	NBFCs-ND
CRR	6 per cent of NDTL	N.A	N.A
SLR	24 per cent of NDTL	15 per cent of public deposits	N.A
Branch expansion	RBI approval required	Limited restriction	N.A
Exposure to capital market	40 per cent of net worth	Limited restriction	N.A
Priority sector lending target	40 per cent of ANBC	N.A	N.A
CRAR	9 per cent	15 per cent	15 per cent NBFC-ND-SI
Period for classifying loans as NPAs	90 days	180/360 days	180/360 days

N.A.: Not applicable

Regulatory arbitrage

12.15 The differences in the level of regulation of the banks and NBFCs undertaking similar activities can give rise to regulatory arbitrage. The main argument put forward for reducing the regulatory gap between banks and NBFCs is that bank-like financial institutions providing similar kind of products/services should be treated similarly. The financial linkages between NBFC and bank is established through the lending channel whereby NBFCs avail of bank finance for their operations as advances or by way of banks' subscription to debentures and commercial paper issued by them. Given the financial linkage between banks and NBFCs, there is a possibility of risk contagion that may arise due to the regulatory arbitrage since NBFCs are not as tightly regulated as banks.

Case for reducing the regulatory gap

12.16 It is well recognised that there are both differences and similarities between banks and NBFCs. Banks and NBFCs compete for some similar kinds of business on the asset side. NBFCs offer products/services which include leasing and hire-purchase, corporate loans, investment in non-convertible debentures etc. However, NBFCs do not provide operating account facilities like savings and current deposits, cash credits, overdrafts etc. On the assets side there is hardly any difference as both banks and NBFCs undertake loaning and investment activities. Some NBFCs may, however, be more focused on capital market related activities. While there are strong arguments seeking for regulatory convergence, there are equally strong views against it, according to which, NBFCs and banks should not be treated as similar to each other, but rather as complementary entities. NBFCs serve niche areas and are more flexible and borrower friendly. In many cases, particularly in the rural and semi-urban areas, they have contributed to widespread connectivity and offered products which banks have not been able to. Thus, NBFCs play a valuable economic role, which must be supported through an appropriately designed regulatory framework.

Recent measures to reduce the regulatory arbitrage

12.17 However, the policy and regulatory framework in India deals with NBFCs and banks differently. NBFCs can undertake activities that are not permitted to be undertaken by banks or which the banks are permitted to undertake in a restricted manner (for example, financing of acquisitions and mergers, capital market activities, etc). Though the revised framework, which was put in place in 2006 attempted to address the regulatory gaps of banks and NBFCs partly addressed the issue by putting similar capital adequacy, credit concentration norms and capital market exposure norms for the bank group as a whole, including the bank sponsored NBFCs, some regulatory gaps still persist. The Working Group on Issues and Concerns of the NBFC Sector (Chairperson: Smt. Usha Thorat) has recommended for calibrated use of prudential measures in order to gradually bring down the regulatory gaps between banks and NBFC sector. In addition to this, Thorat Group was also of the view that some of the best practices followed by the banks in the areas of governance, compensation, accounting and disclosure norms should also be introduced in the NBFC sector for their own benefit. The recommendations of the working group include, *inter alia*, Tier I capital for CRAR to be set at 12 per cent for NBFCs, higher risk weights for capital market exposure, introduction of liquidity ratio for all registered NBFCs, and similar asset classification and provisioning norms as banks to be applied to NBFCs. Apart from this, the Working Group also suggested that the NBFCs should also be given the benefit under SARFAESI Act, 2002, which will ensure smooth transition of NBFCs to new regulatory regime.

III. Is there a case for level playing field between gold loans NBFCs and banks providing gold jewellery loans?

12.18 There were strong pleas made by the Association of Gold Loan Companies (AGLOC) that they deserve a level playing field with the banks providing gold jewellery loans in terms of extant regulations governing their functioning. The Working Group has examined this issue. The rationale behind the differential regulatory treatment for banks and NBFCs lies in difference between the overall business models followed by these two types of entities. Banks have better corporate governance practices and follow stricter accounting and disclosure norms than NBFCs. Also the inter-linkage between banks and NBFCs has increased in recent years with the increased dependence of gold loan NBFCs on public funds including bank finances, thus creating the possibility of systemic risk in the financial sector in future. In addition to this, it is also believed that rapid expansion of gold loans in recent years by these NBFCs has worked in favour of local moneylenders, who offer gold loans to customers against very high interest rates, and then use the gold as collateral to borrow from these NBFCs at a comparatively lower rate.

12.19 The case for an absolute level playing field for NBFCs with banks is weak, at present, due to the fact that while for banks the gold jewellery finance is only a miniscule proportion of their total assets, for the NBFCs the gold loan assets entirely dominate their portfolio. It may be noted that banks do not face 'concentration risk' on account of their gold loan activities, whereas the gold loans NBFCs are susceptible to risks associated with absolute concentration of their business in one commodity. Further, the banks with their strong resource base can have better risk management capabilities as compared with NBFCs, which depend upon banks for their resources. The case for a level playing field can be reviewed, if the regulatory gaps between banks and gold loans NBFC sector are brought down gradually, which was earlier suggested by the Working Group on Issues Related to NBFCs (Chairperson Smt. Usha Thorat).

IV. Likely Impact of the New Regulatory Regime Adopted by the Reserve Bank for Gold-loan NBFCs: the Way Forward

12.20 As a result of the implementation of new regulatory norms, all vital parameters of business growth of gold-loan NBFCs, *i.e.*, profitability, yield, funding costs will moderate. Moderation of the business growth is already visible in the financial performance of the top two major NBFCs (**Table 12.3, Table 12.4 and Table 12.5)**.

Table 12.3: Growth (Q-on-Q) in Gold Loans Outstanding by Systemically Important Major Gold Loan NBFCs (%)

	2011-12				2012-13
	Q1	Q2	Q3	Q4	Q1
Systemically Important Major Gold Loan NBFC 1	97	81	66	55	30
Systemically Important Major Gold Loan NBFC 2	170	115	89	54	20

Table 12.4: Growth (Q-on-Q) in Bank Borrowings by Systemically Important Major Gold Loan NBFCs (%)

	2011-12				2012-13
	Q1	Q2	Q3	Q4	Q1
Systemically Important Major Gold Loan NBFC 1	97	50	22	18	5
Systemically Important Major Gold Loan NBFC 2	115	79	75	82	44

Table 12.5: Growth (Q-on-Q) in Other Borrowings by Systemically Important Major Gold Loan NBFCs (%)					
	2011-12				2012-13
	Q1	Q2	Q3	Q4	Q1
Systemically Important Major Gold Loan NBFC 1	69	126	116	79	57
Systemically Important Major Gold Loan NBFC 2	270	200	405	20	-26

12.21 Some independent estimates suggest that NBFCs may witness a decline of about 80 basis points on their profitability after the implementation of the new regulations. However, while implementing the new set of regulations that imposed a cap on LTV ratio for gold loans, NBFCs may take resort to unsecured loans. Going forward, NBFCs offering gold loans should review their existing business model, which includes, *inter alia*, enhancing risk management practices, liquidity positions, and improving accounting standard as well as existing corporate governance framework, in order to ensure a smooth transition to the new regulatory regime, as prescribed by the Reserve Bank. Moderation in the operations of the gold loans NBFCs may, however, provide increased opportunity to the banks to further enhancing their share in gold loan market. For this to happen, banks will have to reorient their business models and customer services in order to fully tap the business opportunities in the gold loan market, as they may still lack the speed to deliver the borrowers whose needs are catered to by gold loans NBFCs, so far.

V. Observations of the Working Group

Rationale for recent regulatory tightening of NBFCs ND SI

12.22 An assessment of the extant regulatory framework reveals amply the rationale for regulatory tightening in the recent months. The gold loans NBFCs are considered to be having an organic link with banking sector on account of their reliance on the latter to source funds. The prudential norms as applicable for banking groups may have to be made applicable to the NBFCs as NBFCs-D may access public funds, either directly or indirectly through public deposits, CPs, debentures, inter-corporate deposits and bank finance. NBFC–NDs may also access public funds through all of the above modes except through public deposits. The application of minimal regulation to NBFCs-ND that are large and systemically important and also have access to public funds can be a potential source of systemic risk contagion even though these entities are not members of the payment and settlement systems. This, in addition to the rapid growth of share of gold loans NBFCs in the gold loan market has laid down the need to review the extant regulatory framework for gold loans NBFCs by the Reserve Bank. It has been observed that during 2009-10 and 2010-11, gold loans NBFCs registered a growth of over 100 per cent in their gold loan business as against relatively lower growth by public sector banks. Besides, two recent developments have prompted the Reserve Bank to review the existing guidelines to banks for financing against gold as collateral. One is the widening current account deficit and the large scale import of gold into the country. The second is extremely high pace of growth of gold loans NBFCs engaged primarily in the business of gold loans. One implicit objective of the ongoing regulatory tightening of gold loans NBFCs primarily engaged in gold loan business is to reduce the demand for gold. Given the fact that gold imports have remained price inelastic and created pressure on the trade balance of the country in recent months, curbing the demand for gold remains a major policy objective.

12.23 The Group firmly believes that the gold loan NBFCs are doing a socially useful function in their interaction with low and middle class population by providing timely financial assistance. It is true that lakhs of individuals take recourse to these gold loan NBFCs for their immediate financial requirements. This is all the more an important reason for ensuring the financial health of the gold loans NBFCs through regulation. If any of these NBFCs fails, it not only brings gloom to the promoters of the NBFCs but also drives the needy borrowers to scramble back at the doors of money lenders and pawn brokers to their utter disadvantage. This reason provides a strong rationale for careful regulation of the activities of these gold loans NBFCs. Due to the possible impact of recent regulations on the gold loans NBFCs operations, their growth and profitability may decelerate in the short run. But in the medium and long run, the Working Group believes that these regulations will help the gold loans NBFCs to become robust in their financial strength and operational vigor and risk management.

12.24 These factors provide reasonable justification for the recent regulatory actions by the Reserve bank. The Working Group endorses the recent regulatory measures taken by RBI and recommends the continuation of the current regulatory stipulations. The growth rate of business expansion of the major gold loan NBFCs, both in terms of assets acquired and number of branches opened need to slow down to sustainable levels. What is a sustainable level of growth for the gold loan NBFCs is a company-specific matter and each NBFC should evaluate its financial performance, its existing overall gearing structure and business volume to consolidate its operations. The Working Group recognises that the expansion of gold loans by the leading gold loan NBFCs has already started moderating as revealed by more recent data.

VI. Recommendations

Review of extant 'loan to value ratio'

12.25 There is a tradeoff between the goal to monetise as much idle gold as possible and a restrictive 'loan to value ratio' imposed on gold loan NBFCs. 'Loan to Value Ratio' is an important tool that can vary the expansion of the quantum of gold loans. While all other recent regulations and supervisory stipulations and arrangements may continue, there appears to be a case for reviewing the current 'loan to value ratio' of 60 per cent in the light of a significant moderation in the loan books of gold loans NBFCs. As gold loans NBFCs have already braced for conforming to all regulatory stipulations, the 'loan to value ratio' can be broadly increased to 75 per cent. It may be noted that the rapid decline in gold loans extended by gold loans NBFCs in more recent months implicitly points out that as the 'loan to value ratio' is constricted, people will again be going back to pawn brokers and money lenders, whose 'loan to value ratio' could be as high as 90 to 95 per cent. That may not be a positive development to accept even from the financial inclusion point of view. Therefore, once the business levels of these gold loans NBFCs come to a level as considered 'appropriate' by the Reserve Bank, there appears to be a case for relooking at the currently prescribed 'loan to value ratio' of 60 per cent.

Standardisation of the 'Value' concept

12.26 The recent reduction in the loan to value ratio to 60 per cent for the gold loan NBFCs by the Reserve Bank has been a reason for acrimony by the gold loan NBFCs. As demonstrated in the Working Group's analysis of volatility in Gold prices and its impact on the gold loan NBFCs, the loan to value ratio to 60 per cent provides cushion for withstanding any price volatility due to unforeseen shocks. Having said that, the Group expresses its dismay at the differing ways in which the value of gold is determined by various gold loan NBFCs. Some companies add 10 to 15 per cent flat from the price of the gold as making charges and taxes before they consider the value of gold, thus, inflating the value of the metal before applying the loan to value ratio for deciding the quantum of loan to be given. They also deduct the stone weight value according to their valuation. Some companies take the value of the gold as the average of the last 90 days. Some take the average of a month's gold prices as the norm. There are, yet another group they may take only the particular day's gold price to decide the value. The point to make here is that there is no standard method, which these companies adopt to arrive at the value of the gold before applying the loan to value ratio. It is gathered that the loan to value ratio may change according to the customer or the type of jewel and the purity of the gold. Thus, the calculation of loan to value ratio is purely discretionary and sometimes arbitrary. During the Working Group's discussions with the borrowers, the Group witnessed a strong desire that there is need for a well-defined concept of the term 'value' and this standardised concept should be used by all gold loan NBFCs without their discretion to have transparency. The bankers with whom the Group interacted had also strongly favoured the need for a standard prescription of what constitutes the value of gold used to make jewellery, which is of 22 carats purity normally. Reserve Bank also relied upon the loan to value ratio to reduce the expansion of gold loans. Therefore, the Working Group recommends that there is a need for standardisation of the concept of 'value' in determining the 'Loan to Value Ratio'. The Reserve Bank needs to take view on this and provide for a standard definition/approach to define the concept of 'value'. If necessary, the AGLOC can be consulted on this. The Working Group has a suggestion to make to standardise the concept of loan to value ratio as explained below.

a. LTV Calculation at Present

12.27 The process followed by some leading gold loans NBFCs for calculation of LTV at present is as follows. The price of ornaments is arrived at by obtaining the quotation for a typical gold ornament purchased from three or four jewellery shops in Kerala. As on July 17, 2012 the price of gold jewellery is Rs.3460 per gram. The breakup of the price of jewellery would be (Table 12.6):-

Table 12.6: Break-up of the jewellery price	Rupees
Price of 22 carat gold as on 17/07/2012	2750
Add: Approx. making charges /manufacturing loss normally charged by the Jeweller	550
VAT/Taxes	160
Add: Price per gram the consumer has to pay for the Jewellery	3460
The gold loan NBFC fixes 60 per cent of Rs 3460 as the maximum LTV which is Rs.2076.	

12.28 In order to decide the 'value' of jewellery in a uniform and standardized manner, the following methodology is suggested by the Working Group.

Table 12.7: Break-up of the jewellery price	Rupees
Price of 22 carat gold as on July 07,2012 (30 days average of Mumbai bullion market rate fixed once in a week)	2750
The LTV may be fixed at, say, **75 per cent of the metal value** (This does not include making charges, manufacturing loss or taxes)	2060
The gold loan NBFC fixes 75 per cent of metal value of Rs 2750 as the maximum LTV, which is Rs.2060, which is marginally lower than the value as calculated in the above table.	

12.29 Instead of a pre-specified LTV like the extant LTV cap of 60 per cent, the 'value' may be capped at, say, 75 per cent. This percentage can be fixed on the price of 22 carat gold prevailing at Mumbai bullion market (which is Rs. 2750 as on July 17, 2012). The price can be taken as the 30 days average and fixed every week /fortnight. Depending upon the purity of gold, the gold loan NBFC will have the flexibility to decide what the value is subject to the overall cap of 75 per cent. The objective of this suggestion is to make the concept of 'value' transparent, convenient and uniform across all major gold loans NBFCs, especially, the systemically important NBFC-ND-SIs. This method can standardise the concept of 'value' in the gold loan business.

b. Advantages of the proposed system:

12.30 It is simple to calculate and can be understood by the borrowers, as no addition of making charges, wastage or taxes are to be added and only the 'metal value' is taken into consideration. Since the maximum LTV is fixed as 75 per cent of the gold price, there is a margin of 25 per cent available on the value. This takes care of any short term volatility in the prices of gold. The gold loan NBFC can use its discretion depending upon the purity of the gold within the overall LTV cap. The cap can always be reviewed, if necessary. Since the replacement value of the jewellery is Rs. 3460 there is an additional cushion, which prompts the customer to redeem his pledge even if there is a fall in the price of gold. The sentimental attachment to the pledged ornaments acts as yet another reason for the customer to redeem the loan. The AGLOC can fix the Maximum Advance Rate per gram of gold in the above manner at agreed intervals of, say, a fortnight or a month. It is desirable that all major gold loan NBFCs may follow this method or any other method of calculating 'value' as decided by the Reserve Bank.

12.31 What is required is a standard method for assessing and arriving at the value of gold for various purities used for manufacturing jewellery. It may be noted that this is important as the volume of expansion of gold loans is directly linked to the 'value' concept. It is desirable that the gold loans NBFCs need to adopt a standard approach to value the gold jewellery, as this sector further expands in future. The method to be prescribed can be adopted by all the gold loan companies for the sake of uniformity and non-discriminatory treatment across various customer segments. However, it may also have to be acknowledged that the prescription of a particular 'loan to value ratio' may not be a panacea for all the ills associated as it has come to the knowledge of the Working Group that the prescribed loan to value ratio can be circumvented through "grossing-up" of the value of gold as per the discretion of the NBFC and also by granting a "topping-up" through additional clean loans in the name of some other related individual. The on-site inspections should carefully monitor any such "grossing-up" or "top-up" activities are resorted to by the NBFCs.

Restrictions on number of branches

12.32 The rapid pace at which some of these NBFCs have opened the branches calls for a careful look. Some of the borrowers unequivocally maintained that many of these branches lack basic amenities and could possibly endanger the safety of the gold pledged with these NBFCs. All the branches of the NBFCs should conform to a minimum standard in terms of borrower convenience and safety of the gold pledged. There appears to be a justification for imposing the requirement of an approval for the new of branches an NBFC, which has already expanded beyond say 1000 branches, they can open in a year. The focus of the already expanded NBFCs should be on consolidation of the existing network. Unbridled growth of these NBFC branches may not be in the overall interests of the concerned NBFC or the sector. This is because more the number of branches, from where safety related concerns spurt, less will be the confidence of borrowers to venture to these NBFCs. A considered view may be taken by the Reserve Bank on this issue whether prior approval of the Reserve Bank can be made mandatory beyond 1000 branches. Alternatively, a ceiling on the number of branches a NBFC can open in a year beyond 1000 branches can be considered.

Extension of Ombudsman Scheme for customers of NBFCs

12.33 Since a large number of complaints are being received against the NBFCs, there is a need for an Ombudsman to hear the grievances and dispose of the same. This will be a no-cost service to the customers and will go a long way in disciplining the NBFCs as well.

Rationalisation of interest rate structure

12.34 Majority of the complaints that have come to the notice of the Working Group against the NBFCs are related to the charging of interest more than intimated to them at the time of loan disbursement. Even if there is a delay of few days, some NBFCs appear to be over charging the interest. As bulk of the gold loans is small ticket and for short periods, there appears to be a strong justification for imposing an interest cap on the loans disbursed by them. This provides safety net to the illiterate and lower middle class borrowers who are unable to defend themselves from the overcharging of the interest by the erring NBFCs. Some NBFCs, which maintain that they are an alternative to the pawn brokers and money lenders, at times do resort to unethical practices in charging high interest rates. Therefore, there are sufficient grounds to rationalise the interest rate structure including the penalty for default in repayment. Such rationalisation may act as a potential restraint on the NBFCs to use their discretion in overcharging the borrowers. In order to arrive at a reasonable pricing of the loans, it may be prescribed that the gold loans NBFCs may adopt an interest rate linked to a bench mark rate like bank rate or State Bank of India's maximum advance rate. This will bring transparency and act as a check on over charging from the vulnerable borrowers. Alternatively, Reserve Bank can also consider imposing a cap on the interest rates to be charged on gold loans by the NBFCs.

13. Summary of Recommendations and Major Conclusions

Major Recommendations

1. Demand for Gold Imports and External Sector Stability

There is a need to moderate the demand for gold imports

13.1 Large gold imports are a strain on the external sector's stability. Given the precarious global economic situation and its impact on the Indian economy, there is a need to reduce the CAD considerably. Due to falling gold re-exports, India's trade deficit as well as CAD as ratio to GDP worsened by 0.3 percentage points in 2011-12. Viewed from the fact that India has a large appetite for gold, it is desirable that the economy needs to moderate the demand for gold imports to bring down the CAD to a more sustainable level. In this context, the Working Group has the following suggestions to make.

A. Demand reduction measures:

Fiscal measures to reduce the gold imports

13.2 Currently, there is a system of imposing import duty on *ad valorem* basis on gold imports. Recognising the implications of high imports of gold, the Government undertook certain fiscal measures in recent months to curb demand for gold as indicated in para 3.33 of this Report. However, looking at the pattern of gold consumption in India and quantum of gold imports, raising the import duties did not seem to have had the desired impact on bringing down gold demand. If considered appropriate, further hike in the import duties may have to be contemplated to dissuade gold imports. The limitation of the fiscal route to curb the demand for gold imports is that, beyond a level, we cannot raise the import duty as it may give lead to buyers taking recourse to purchases from unauthorised sources of supply. There are also restrictions on carrying of gold and gold jewellery by incoming Indian community from abroad. If need be, this may also have to be reviewed to make bringing gold into the country less attractive option.

There is a need to design innovative financial instruments that can provide real returns

13.3 If interest earned on various savings instruments is attractive and positive, a part of the demand for gold will be automatically diverted to the financial instruments. Demand for gold will come down considerable with the availability of alternative instruments for investment with real rates of return. Growing demand for gold in the country especially in the rural side is an indication that households with high levels of savings are in need of instruments that are very easily accessible and equally attractive to gold in terms of return as well as liquidity. Banking sector should come forward to tap this huge untapped source of funds from being diverted to buy gold. It is necessary to introduce savings schemes and instruments that can provide real returns. The schemes to be conceived should also ensure liquidity of the savings comparable to gold or gold jewellery. The dominant reason why a person may like to hold his savings in the form of gold is to hedge against inflation. Therefore, offering a real rate of interest considering the high inflation rate prevailing, as an incentive on a financial instrument would better address the issue of excessive clamor for gold imports. Therefore, products analogous to Inflation Indexed Bonds and other innovative products may have to be considered as alternatives.

Converting rural and urban demand for gold into investment in gold related instruments

13.4 Investor education and financial literacy are critical. The availability of and awareness about gold-backed financial instruments in India is very limited, especially in rural areas. However, this trend seems to be changing in recent years, with slowly picking up the investment demand for gold. With appropriate investor education about the positive aspects of investment in gold-backed financial products, it is possible to reduce the demand for physical gold or we can, at least, postpone the demand for gold to future. There is a possibility to attract investment demand for gold with the spread of financial literacy to entice investment in gold-backed and gold related investment instruments. This can bring down demand for physical gold. The demand from the urban consumers can be diverted towards dematerialised gold investments. Steps need to be taken to enhance awareness of potential gold buyers to the alternatives available with good returns and liquidity. In this context, there is a need for designing new gold-backed financial products.

There is a need to introduce new gold-backed financial products to reduce the demand for physical gold

13.5 There is a need to consider introducing new gold-backed financial products to reduce the demand for physical gold. Products that may be considered are Modified Gold Deposit Scheme (gold taken as a deposit is recycled for meeting domestic demand and given back at the time of maturity); Gold Accumulation Plan (the product is a saving plan catered to even small buyers of gold in which the gold imports are deferred till the time of actual delivery of gold); Gold Linked Account (the entire transaction takes place outside India and import of gold is not involved); and Gold Pension Product (the customer surrenders gold to the bank on agreement to receive streams of monthly pension till his death). Careful evaluation of the feasibility of introducing each proposed gold-backed product is critical.

Limits on the volume and value of gold to be imported by canalising agencies and nominated banks

13.6 The canalising agencies like MMTC, STC and the nominated banks are playing a major role in canalising gold imports into the country. The imports through banking channel are about 56 per cent of total gold imports. These imports are largely for selling gold to jewellery manufacturers and at retail level. Setting value or quantum limits for canalising agencies and banks to import gold can also reduce the demand for gold. Such limits can be reviewed periodically. However, the Group recognises the fact that choking supply channels cannot be an appropriate way to reduce the demand unless under compelling circumstances. We need to address the excessive demand issue.

Imposing export obligation on importers

13.7 It may be noted that the share of gold re-exported with value addition from the country as a proportion to gold imported is declining steadily (Chart 3.11 page 28 of the Report). In this context, such of those entities importing bulk gold through banking and non-banking channels can be asked to an export obligation based on a certain percentage of imports of the gold.

B. Supply-related measures:

Recycling of domestic gold

13.8 Temples in India holds large quantities of gold jewellery offered by devotees to the deities. There is also significant amount of scrap gold in the country. Some estimates say that scrap gold that comes into the system is nearly 300 tonnes per annum. It would be worth trying to channel the existing supplies of scrap gold in the country into the financial system, so that the unproductive nature of the gold asset is turned into a financially-productive medium. Presently canalising agencies are used as a unidirectional channel to import and sell gold in the country. The Group wonders whether these can be made a bi-directional channels, i.e., they be allowed to buy back the tamper proof gold coins at transparent prices. For this, canalising agencies can have a two way quote with very little margin. This would facilitate the agencies to recycle domestically available gold rather than import and sell gold. This would also be more attractive because the price fetched by the customer from the agencies is relatively higher with less loss when compared with any the price offered seller of gold coins to jewellery shops. This step has the potential to reduce the demand for gold imports by facilitating availability of domestically idling gold stocks. It may, however, be recognised that the rationale for allowing banks to buyback gold coins would be with the expectation that this may reduce the import of gold through recycling of domestic gold. The Working Group is conscious of the fact that the opposite outcome is also a possibility as the availability of two-way quotes may increase the attractiveness of gold purchase and hence the demand for gold. Therefore, under the current situation of high current account deficit, status quo of giving only a sale quote for gold coins by the nominated banks may be considered. Subsequently, when the CAD declines to a sustainable level and as considered appropriate from time to time, Reserve Bank may permit banks to offer two-way quotes. Such of those banks that may opt for both buying and selling gold coins will have to manage the sum of consequential risks, which may not be different from other trading risks. While permitting the banks to offer two-way quotes, Reserve Bank will also have to consider any macroeconomic risks (other than the possible impact on CAD) because of the special nature of gold.

Introduction of tax incentives on instruments that can impound gold

13.9 Gold Bonds and Gold Deposits Schemes that may encourage gold holders to deposit their idle gold holdings with banks can be designed with in-built tax incentives by Government. This would encourage investors to invest in gold bonds. The impounded gold through gold bonds can be used to reduce the demand for gold imports. There can be a lock in period. This would impound domestic gold in various forms, such as jewels, ornaments and coins. While making this suggestion, the Group is conscious of the fact that currently only around 3 per cent of the population has income above the minimum limit chargeable to tax under Income Tax Act. With the majority of the gold buyers hailing from rural areas, a view prevails that the rural people are even otherwise not subjected to income tax and therefore fiscal incentive route may not be effective. However, the Group makes this suggestion keeping in view High Networth Individuals who are holding idle gold who may opt for the instruments with fiscal sops to diversify their portfolios.

C. Measures to increase the monetisation of gold

Banks may expand their gold jewellery loan portfolio

13.10 There is great scope for expanding financial inclusion in extending gold jewellery loans. If banks continue to increase their gold jewellery loans portfolio, the reliance of economically weaker sections of the society on money lenders and pawn brokers will come down considerably. Banks may make the gold jewellery product more flexible and encourage people to avail this fully collaterilised loan for all types of productive purposes. This greatly facilitates monetisation of huge stocks of gold in the country.

Setting up of a bullion corporation

13.11 It may be recalled that in the Union Budget of February 1992, it was announced an intention to set up a gold bank, which would undertake various types of operations in gold. The Group believes that there is a need to revisit the earlier debate on setting up of Gold Corporation or Gold Bank in India. The purpose of the suggested gold corporation can be as a 'backstop facility' to provide refinance to institutions lending against the collateral of gold or besides being a backstop facility, it can also undertake retailing functions in gold including pooling of idle gold in the system. On the other extreme, the gold corporation may be empowered with wide-ranging activities related to the entire spectrum of gold policies. The gold corporation can make official purchases and sales of gold. It may issue gold bonds and collect the gold stocks. The objectives of such gold corporation can also be to mobilising domestic non-official gold holdings; channelise them into a centralised pool over a period of time and to deploy them in a productive manner in the best interests of growth and development of the country. The corporation can be authorized to buy and sell gold on their behalf and on behalf of their clients. The suggested gold corporation may be empowered to handle the country's gold reserves. In sum, the gold bank may be given powers to import, export, trade, lend and borrow gold and deal in gold derivatives. Its role should be that of an intermediary in gold transactions, providing liquidity to holders of gold. The proposed gold bank may take care of the liquidity needs of gold holders. As the central banks world over have been fortifying their reserves by enhancing the share of gold, it is logical to expect that the suggested gold corporation can be nurtured under the Reserve Bank's umbrella. The modalities to setup the Gold Bank can be examined by the Reserve Bank through preparation of a concept paper.

2. Role of Banks in Gold Imports and Retailing Gold Coins

Banks may continue their role as nominated agencies in gold imports

13.12 The Working Group is of the view that banking sector, as a formal channel, has been playing an important role in the gold imports and gold supply catering to the huge demand for gold. Their discontinuation from this role may not materially alter the demand for gold, but, may possibly give rise to the participation of unauthorsied channels entering the gold supply chain as the demand for gold will not come down. The Working Group envisages that it would be difficult to displace the role for banks in gold imports. Purchase of gold coins etc., from banks gives retail customers a sense of comfort and reliability, contributing to a rise in demand at the margin. The Working Group recognises that this is contrary to the desirable objective of moderating demand. But, the fact is that gold coins retailing by banks is a small portion of gold that is retailed through banks and it virtually makes no difference whether banks are selling the coins or not to the overall gold imports.

Differential pricing of banking services and finance for gold imports

13.13 Differential pricing of banking services and finance for gold imports such as stipulation of high cash margin on opening of LCs for import of gold and imposition of surcharge on interest on gold metal loans to domestic jewellery manufacturers may be considered by the banks.

Bank finance to purchases of gold bullion may be prohibited

13.14 We may explicitly prohibit banks from extending advances for purchase of gold bullion/primary gold/jewellery/coins/ingots/gold ETF/gold MF units with the exception of providing working capital finance to jewellers.

There should not be any curb or limits on advances against gold jewellery by individuals

13.16 The Working Group is of the view that there need not be any curb or limits on advances against gold jewellery and tamper proof gold coins for productive purposes subject to internal policies to be formulated by banks, including appropriate LTV, while ensuring that the advance is not used for speculative purposes and or purchase of gold;

Banks may be allowed to retail gold coins

13.17 Import of gold coins by banks could be prohibited but share of these items being very low it would not have any perceptible impact on CAD. Therefore, banks may be allowed to retail the gold products like gold coins.

Banks may play significant role in monetising idle stocks of gold

13.18 As said, earlier, there is great scope for expanding financial inclusion in extending gold jewellery loans. If banks continue to increase their gold jewellery loans portfolio, the reliance of economically weaker sections of the society on money lenders and pawn brokers will come down considerably. Banks may make the gold jewellery product more flexible and encourage people to avail this fully collaterilised loan. This greatly facilitates monetisation of huge stocks of gold in the country. At present only less than three per cent of the gold stocks in the country are used for availing gold loans. There is tremendous potential for gold loan market. Given the superior quality of gold as collateral, the prudential norms like risk weights and provisioning on gold loans may be relatively softer than other loans to encourage banks.

There is no strong case to exempt Metal Gold Loans from the base rate stipulations

13.19 The Working Group is of the view that there is no strong case to exempt MGL from the base rate stipulations. There are three reasons for making this recommendation. First, exemption of MGL from the base rate may adversely affect the monetary policy transmission, second, the beneficiaries of these loans are not deprived sections of the society and third, refinance is not available on MGL from any organization.

3. Gold-backed Financial Instruments – Scope for Introduction in India

There is an imperative need to consider introducing new gold-backed financial products to unlock the hidden economic value in the idle gold in the economy

13.20 The Working Group is of the view that given the large stock of gold in India and the requirement to unlock the hidden economic value in the idle gold stock, there is an imperative need as also scope for introducing new gold-backed products. The options available for consideration to introducing new gold-backed products in the Indian markets may be considered.

Products like Gold Accumulation Plan, Gold Linked Account, modified Gold Deposit and Gold Pension Product may be considered for introduction

13.21 The Working Group has identified, based on discussions with experts and broadly classified the gold-backed products that can be considered for the Indian investors into five categories. They are: products, which seek to monetise a portion of the privately held stock of gold (Modified Gold Deposit Scheme); products, which aim to financialise the incremental demand for gold by facilitating systematic investment in gold (Gold Accumulation Plan, Gold Certificate, e-Gold Plan through Banking Channel, Paper Gold); products, which allow active management of customer's gold portfolio by providing flexibility for buying/ selling gold on the lines of ETFs (Gold linked Account and Gold Securities); Derivative products, which enable customers to take positions depending upon their view on gold prices (Gold linked Dual Account and Gold Securitisation); and Gold Pension Product. The Working Group is of the view that products like Gold Accumulation

Plan, Gold Linked Account, Modified Gold Deposit Scheme and Gold Pension Product may be considered for introduction in India by the banks.

Careful evaluation of each proposed gold-backed product is critical

13.22 Introduction of these products in India presupposes a thorough review under the extant regulations. The Reserve Bank may take considered view of each of the gold-backed products discussed by the Working Group subject to a careful study of the features of each of the products, regulatory clearances, cost aspects, appetite for the product and ability to manage the related risk by the banks. The connected legal aspects also require a re-look. Investor education assumes critical importance for each product. In sum, there is a need and scope to consider new gold-backed products after careful evaluation of each product by relevant regulatory departments and regulators.

Usage of gold reserves with ETFs for alternative purposes

13.22A To gainfully use the gold reserves with Indian ETFs and reduce the demand for gold, we may think about putting a certain part of the total corpus of the fund to be 'loaned' to the permitted categories of bulk gold importers like nominated agencies to import gold. In India, some importers have access to gold borrowings with pre-specified limits and they pay interest for the gold borrowed. The transaction is eventually settled by purchasing gold at the end of the tenor of the loan. Such a step would increase the returns on the ETF investments and the demand for gold imports is postponed and thereby reducing the pressure on stressed balance of payments. Alternatively, ETFs may also be allowed to invest their gold holdings in gold certificates with Banks. If, SEBI examines these proposals, operational modalities can be worked out.

4. Liability Management - Assessment of Financial Performance of Gold Loan NBFCs-ND-SI

The rapid growth of their assets, borrowings and branch network needs to be monitored continuously

13.23 One of the major concerns of the growth story of the gold loan companies is the pace at which their assets size has grown in volume as well as the expansion of branch network. The rapid growth of their assets, borrowings and branch network needs to be viewed with circumspection and measures to moderate such growth to more sustainable levels are desirable.

Need to reduce the interconnectedness with the formal financial system:

13.24 An analysis of the sources of funds of gold loan NBFCs revealed that their dependence on the banking sector witnessed an increase during the last five years. Borrowings from the banking sector were the biggest source of funds for the gold loan

NBFCs. The consistent increase in the dependence of the gold loan NBFCs on the banking sector raises concerns. Gold loan NBFCs should gradually reduce their dependence on the bank finance so as to bring down the interconnectedness with the formal financial system.

Declining capital adequacy ratio – Need to improve the capital.

13.25 The capital adequacy ratio of gold loan NBFCs witnessed a continuous declining trend during period under study. Further, the capital adequacy ratio of gold loan NBFCs was also lower than that of the NBFCs-ND-SI sector as a whole. The decline in the capital adequacy ratio despite increase in capital funds points to the aggressive asset growth that took place during the period under study. The gold loans NBFCs should strive to improve their capital.

Need to review the current stipulations pertaining to raising resources through NCDs

13.26 Some gold loans NBFCs have been circumventing Reserve Bank (IDMD) stipulations on Non-Convertible Debentures (NCDs) and mobilization of funds on retail form bearing ticket size of as less as rupees five thousands from public practically on tap at their branches. This is tantamount to raising 'surrogate deposits' because of exemption they are enjoying under Section 67(3) of Companies Act, 1956 from the stipulation of not more than 49 persons for private placement. If the present exemption available to NBFCs under Section 67 (3) of the Companies Act is removed or basic slab of individual contribution to NCD is prescribed for a minimum investment of Rs.10 lakh or so for private placement, it will deter retail investors to subscribe and confine private placements of NCDs by gold loans NBFCs to institutions and High Net worth Individuals. The issue may be taken up with Government of India for necessary amendments and issuing appropriate directions to companies.

The exemption available to secured debentures from the definition of "deposit" may be reviewed

13.27 While recognizing the need for deepening and broadening the bond market vis-à-vis the safety of retail depositors' and investors' funds in the hands of the NBFCs, it is recommended that the exemption available to secured debentures from the definition of "deposit" may be withdrawn. It is a trade-off in favour of the retail depositors and investors in a non-deposit taking company, which accepts camouflaged public deposits in the form of secured debentures. The deposit acceptance activity may be left to the banking system, where regulatory and supervisory framework is more robust. Similarly, exemption available from the definition of deposit to "Subordinated Debt" also needs to be withdrawn as the retail subscribers do not know the features and implications of subscription to such instruments. Recent regulatory measures on errant NBFCs saw such investors seeking repayment of subordinated debt instruments. Further, companies canvass for such subscriptions camouflaging them as deposits to the retail investors.

5. Recent Trends in Gold Loans and Domestic Financial Stability

Need for monitoring transactions between gold loan NBFCs and unincorporated bodies

13.28 There are interlinkages within the gold loan NBFC segment in the form of gold loan NBFCs floating unincorporated sister concerns to undertake financial activities, which are not permitted by the regulator. Such activities primarily involve raising public deposits and diverting these funds towards the registered gold loan NBFC. Raising public deposits by such illegitimate means can have implications for public confidence in the concerned NBFCs and non-banking financial sector as a whole. If such activities are not curbed in time, they can threaten the stability of financial system. There is a need for monitoring transactions between gold loan NBFCs and unincorporated bodies. There is a need to bring the sister concerns floated by the NBFC-ND-SIs under the ambit of monitoring and regulation in the interests of ensuring domestic financial stability.

Though leverage of the gold loan NBFCs is not a cause for concern at the present juncture, going forward, there is a need for improving owned funds of the NBFCs.

13.29 Though present level of leverage of the gold loan NBFCs is not a cause for concern at the present juncture, going forward, there is a need for improving owned funds of the NBFCs. Higher levels of capital are required for (a) raising their own sources of funds and consequently, reducing their reliance on borrowed funds and their leverage. (b) though the present levels of NPAs for gold loan companies are low and the probability of any drop in gold prices also seems to be low, higher capital can be a general cushion for these companies against unforeseen losses, if any, on their balance sheets.

6. Customer Protection - Practices Followed by Gold Loans NBFCs

Need to thoroughly review the practices followed by gold loans NBFCs

13.30 The rapid growth of operations witnessed by the major companies in recent years may be difficult to sustain as competition is also increasing. Their focus should be on 100 per cent resolution of customer complaints, standardization of procedures and documentation across all their branches, ensuring transparent communication to the borrowers about the loan terms, putting in place unambiguous auction procedures and provide more financial buffers to protect against unforeseen shocks. In order to ensure the healthy growth of gold loan business, the short-comings noticed in the various practices followed by gold loan companies need to be address to make this business sustainable.

Need to ensure transparent communication of loan terms

13.31 All the major gold loan companies generally display the details of their various loan products on their web-site to fulfill their obligation of transparency. On the other hand, majority of the customer grievances pertain to the excess interest charged. The main reason for this lies in the non-transparent communication of the loan terms to the customers by the employees of the gold loans NBFCs. Majority of the gold loan borrowers belong to the low-income, less educated sections of society and the gold loan companies need to instruct their sales staff to properly explain the various terms and penalties to be levied. The widely prevalent practice of issuing a small pawn ticket needs to be replaced with proper loan contract indicating all the applicable terms and levies and penal interest charges transparently. The loan document would help the customer to understand the charges even in cases of emergency loans as he can refer the loan documents later at ease.

Institution of a customer complaints and grievances redressal system

13.32 The gold loan companies need to put in place a proper customer complaints redressal system to handle the customer complaints in a time-bound manner. This system needs to be established at all levels starting from the branch offices. The customers need to be told about the existence of such system by properly displaying the contact details at all branch offices.

Need to review the auction procedure

13.33 As auctions conducted with regard to defaulted loans are said to be around 1 to 2 per cent of total loan size, there does not seem to be an established procedure or regulation on the auction of gold jewelleries. Considering the vulnerability of a section of the borrowers to questionable methods of auction, the Working Group is of the view that Boards of Gold Loan NBFCs need to adopt specific guidelines on auctioning of jewelleries based on broad regulatory prescriptions and a revised Fair Practices Code. It may be stipulated that the pledged gold ornaments should be auctioned off at a price closure to the prevailing rate in the market on the day of auction, so that the borrowers' interests are protected. Accordingly, the reserve price may be decided. This should take care of the complaints against gold loan NBFCs on auction related issues.

Location of auctions

13.34 The auction of gold pledged at the same branch or same town is an ideal situation in borrowers' interest, but the same may not be practical from administrative, cost effectiveness and security angles for NBFCs. The auction may be conducted preferably in the Taluka Head Quarters, which will offer at least a last minute opportunity to borrower who attaches emotional value to ornaments to redeem the gold pledged.

Post-auction safeguards

13.35 In the cases of auction of gold ornaments, it should be mandatory on the part of NBFCs to provide full details of value fetched by it in auction, outstanding dues adjusted and balance, if any, outstanding or payable to borrower by way of registered letter. This step would not only stem complaints against NBFCs on auction but also provide opportunity to borrower to pursue the matter to redress his grievance, if any. Keeping in view small number of such cases, as per NBFCs' submission, it should be possible to strictly adhere to this procedure.

Disclosure standards

13.36 The NBFCs need to ensure that the details of interest rates for various loan products for different maturities, penal interest applicable in case of delay / default in repayment, policy / practice adopted by company to determine net weight of gold ornaments, gold rate applicable (whether current market price or average of some period) to determine value of gold jewelleries, margin held and procedure adopted for auction of gold pledged are prominently displayed in local language at all their branches. Regulator may prescribe punitive action, if the NBFCs fail in these disclosures. As part of the disclosure norms the Reserve Bank may prescribe that the gold loan companies disclose in their Annual Report the details of auctions conducted during the financial year such as number of auctions conducted during the year, loan accounts involved, outstanding loan dues, value fetched in auctions, balance amount refunded and recovered from borrower, whether the company had also participated in the auction and, if yes, the details of the bids, value of jewellery purchased etc.

Monitoring the implementation of the Fair Practices Code

13.37 The Reserve Bank (DNBS) issued revised guidelines on the Fair Practices Code on March 26, 2012. These revised guidelines provide specific guidance to gold loans NBFCs about the practices to be followed. While this has largely addressed most of the concerns and has positive steps to protect and safeguard interest of borrowers, especially vulnerable sections, the Working Group is of the view that the regulator should monitor the strict adherence of the fair practices by gold loan NBFCs during the course of on-site supervision.

Standard documentation

13.38 The documentation followed by various NBFCs and by various branches of the same NBFC differs considerably. The pawn tickets are not having the required details on the type and number of jewels pledged, their weight in grams, their purity and market value on the date of transaction. There are many complaints that loan agreement copies are not furnished to the borrowers by the NBFCs. Therefore, the Working Group is of the opinion that the documentation has to be standardised with all required details and legal requirements. There are two options to consider. Reserve Bank may prescribe a set of basic documents like the pawn ticket, loan agreement etc., to be used by all the gold loan companies in a standard format. Alternatively, the members of AGLOC may finalise a set of documents duly considering local laws, which can be vetted by Reserve Bank. The AGLOC may advise all its members for adopting these standard set of documents in all transactions. Some Pawn Brokers Acts or Money Lenders Act say like Tamil Nadu State Acts contain useful model formats for conceiving such standard documentation. This step will safeguard the interests of the gold loan borrowers to a great extent.

Use of PAN Card for large gold loan transactions

13.39 The Working Group recommends that gold loans NBFCs may obtain a copy of PAN Card in all the loan proposals exceeding rupees two lakhs to strengthen mechanism of KYC.

Payment through cheque for large gold loan transactions

13.40 All loans exceeding a reasonable limit, say, rupees two lakhs may be disbursed by way of cheque in name of borrowers and not in cash. This reduces risks associated with handling of high volume of cash transactions at branches of gold loan companies and KYC compliance is also strengthened as the payment is made through a bank account. This will not cause any distress to small borrowers, but will be applicable to only big ticket loans.

7. Prudential Norms Relating to Gold Loan NBFCs – An Assessment

As of now, there is no case for conceding level playing field for the gold loan NBFCs with the banks

13.41 The case for an absolute level playing field for NBFCs with banks is weak, at present, due to the fact that while for banks the gold jewellery finance is only a miniscule proportion of their total assets, for the NBFCs the gold loan assets entirely dominate their portfolio. It may be noted that banks do not face 'concentration risk' on account of their gold loan activities, whereas the gold loans NBFCs are susceptible to risks associated with absolute concentration of their business in one commodity. Further, the banks with their strong resource base can have better risk management capabilities as compared with NBFCs, which depend upon banks for their resources. The case for a level playing field can be reviewed, if the regulatory gaps between banks and gold loans NBFC sector are brought down gradually, which was earlier suggested by the Working Group on Issues Related to NBFCs (Chairperson Smt. Usha Thorat).

Review of the extant 'loan to value ratio'

13.42 There is a tradeoff between the goal to monetise as much idle gold as possible and a lower 'loan to value ratio' prescribed on gold loan NBFCs. 'Loan to Value Ratio' is an important tool that can vary the expansion of the quantum of gold loans. While all other recent regulations and supervisory stipulations and arrangements for gold loan NBFCs may continue, there appears to be a case for reviewing the current 'loan to value ratio' of 60 per cent in the light of a significant moderation in the loan books of gold loans NBFCs. As gold loans NBFCs have already braced for conforming to all regulatory stipulations, the 'loan to value ratio' can be broadly increased to 75 per cent. It may be noted that the rapid decline in gold loans extended by gold loans NBFCs in more recent months implicitly points out that as the 'loan to value ratio' is constricted and people will again be going back to pawn brokers and money lenders, whose loan to value ratio could be as high as 90 to 95 per cent. That may not be a positive development to accept from the financial inclusion angle. Therefore, once the business levels of these gold loans NBFCs come to a level as considered 'appropriate' by the Reserve Bank, there appears to be a case for revisiting at the currently prescribed 'loan to value ratio' of 60 per cent.

There is need for a clearly-defined and standardised concept of the term 'Value' for prescribing appropriate 'Loan to Value Ratio'

13.43 'Loan to Value Ratio' is an important tool that can vary the expansion of the quantum of gold loans. The Group expresses its dismay at the differing ways in which the 'value' of gold is determined by various gold loan NBFCs and banks. The calculation of loan to value ratio is purely discretionary and sometimes arbitrary. The Working Group recommends that there is a need for standardisation of the concept of 'value' in determining the 'Loan to Value Ratio' by the gold loans NBFCs. The Reserve Bank needs to take view on this and provide for a standard definition/approach to define the concept of 'value'. If necessary, the AGLOC can be consulted on this. Instead of a pre-specified loan to value ratio like the extant 'loan to value ratio' of 60 per cent, the 'value' may be capped at, say, 75 per cent. This percentage can be fixed on the price of 22 carat gold prevailing at Mumbai bullion market. The price can be taken as the 30 days average and fixed every week /fortnight by the AGLOC. Depending upon the purity of gold, the gold loan NBFC will have the flexibility to decide what the value is subject to the overall cap of 75 per cent. The objective of this suggestion is to make the concept of 'value' transparent, convenient and uniform across all major gold loans NBFCs, especially, the systemically important NBFC-ND-SIs. This method can possibly standardise the concept of 'value' in the gold loan business.

Unbridled growth of branches by large gold loan NBFCs needs to be moderated

13.44 The rapid pace at which some of these NBFCs have opened the branches calls for a careful look. Some of the borrowers unequivocally maintained that many of these branches lack basic amenities and could possibly endanger the safety of the gold pledged with these NBFCs. All the branches of the NBFCs should conform to a minimum standard in terms of borrower convenience and safety of the gold pledged. There appears to be a justification for imposing the requirement of an approval for the new of branches an NBFC, which has already expanded beyond say 1000 branches, they can open in a year. The focus of the already expanded NBFCs should be on consolidation of the existing network. Unbridled growth of these NBFC branches may not be in the overall interests of the concerned NBFC or the sector. This is because more the number of branches, from where safety related concerns spurt, less will be the confidence of borrowers to venture to these NBFCs. A considered view may be taken by the Reserve Bank on this issue whether prior approval of the Reserve Bank can be made mandatory beyond 1000 branches. Alternatively, a ceiling on the number of branches a NBFC can open in a year beyond 1000 branches can be considered.

There is a need for an ombudsman to address the grievances of gold loan borrowers

13.45 Since a large number of complaints are being received against the NBFCs, there is a need for an Ombudsman to hear the grievances and dispose of the same. This will be a no-cost service to the customers and will go a long way in disciplining the NBFCs as well.

Rationalisation of interest rate structure

13.46 Majority of the complaints that have come to the notice of the Working Group against the NBFCs relate to the charging of interest more than intimated to them at the time of loan disbursement. Even if there is a delay of few days, some NBFCs appear to be over charging the interest. As bulk of the gold loans is small ticket and for short periods, there appears to be a strong justification for imposing an interest cap on the loans disbursed by them. This provides safety net to the illiterate and lower middle class borrowers who are unable to defend themselves from the overcharging of the interest by the erring NBFCs. Some NBFCs, which maintain that they are an alternative to the pawn brokers and money lenders, at times do resort to unethical practices in charging high interest rates. Therefore, there are sufficient grounds to rationalise the interest rate structure including the penalties for default in repayment. Such rationalisation may act as a potential restraint on the NBFCs to use their discretion in overcharging the borrowers. In order to arrive at a reasonable pricing of the loans, it may be prescribed that the gold loans NBFCs may consider adoption of an interest rate linked to a bench mark rate like State Bank of India's maximum advance rate. This will bring transparency and act as a check on over charging from the vulnerable borrowers. Alternatively, Reserve Bank can also consider imposing a cap on the interest rates to be charged on gold loans by the NBFCs.

Chapter-wise Major Conclusions

1. Recent Trends in Gold Loans and Influence on Gold Imports

Gold loans have a causal impact on gold imports substantiating the emergence of a liquidity motive for holding gold

13.47 Gold loans have a causal impact on gold imports substantiating the emergence of a liquidity motive for holding gold, which could be pledged by households as collateral to tide over temporary mismatches in liquidity. This relationship is valid when either gold loans by NBFCs or total gold loans outstanding (including banks) are considered. Possible rationale for this relationship could be that when the gold prices were generally increasing, with a liberal loan to value ratio, people are generally induced to invest in gold due to the prospects of gold value appreciation and the possibility to raise a loan in case of need. Prospects of securing a gold loan could be an enabling incentive for an individual to invest in gold. But, it should be clearly recognised that availability of gold loans alone cannot push up gold imports.

2. Recent Trends in Gold Loans and Impact on Gold Prices

Increase in gold prices appears to be one factor that increase the gold loans outstanding

13.48 The increase in gold price appears to be leading to increase in gold loans outstanding. The economic logic for this relationship is that, when the gold prices were generally increasing, with a liberal loan to value ratio, people are generally induced to invest in gold due to the prospects of gold value appreciation and also the possibility to raise a loan in case of need.

However, increase in gold loans extended by NBFCs and banks does not impact significantly the gold prices in India

13.49 The granger causality results show that the increase in gold prices in India leads to increase in gold loans, but increase in gold loans does not lead to increase in gold prices. In the long run and short run, increase in gold loans extended by NBFCs and banks does not impact significantly the gold prices in India. Possible explanation for this relationship is that gold loans are raised for the purpose of consumption as well as productive purposes. Gold prices in India are a function of international gold prices, exchange rate, domestic demand etc.

On the basis of empirical analysis of volatility in gold price, it is difficult to estimate future prices of gold

13.50 We cannot model the future volatility of gold prices based on historical price volatility. The volatility in gold prices from time to time was the outcome of various factors. These factors have not remained constant over time. Therefore, through empirical analysis of historical gold price, we cannot estimate future behaviour of gold price.

Going by the past trends, a drop in gold price by 30 to 40 per cent is a remote possibility causing financial distress to the gold loan NBFCs

13.51 The analysis of the past data reveals that there is a distant possibility of a drop in gold price of more than 40 per cent. Even the possibility of 30 per cent decline is rare during a time horizon of one to six months. But, a likelihood of decline in gold price of 10 per cent or above could be in the range of 3.3 per cent to 14.6 per cent during one month to six month period.

The extant loan to value ratio (LTV) ratio of 60 per cent should provide a reasonable risk cover in case the gold prices fall by 10 per cent

13.52 The current stipulation that all gold loan NBFCs shall maintain an LTV ratio not exceeding 60 per cent for loans granted against the collateral of gold jewellery would ensure that these NBFCs would maintain reasonable risk cover against gold price volatility for such loans.

When there is a fall in the gold prices, the loss to be booked depends on the value of jewels that may have to be auctioned and not on the value of entire collateral the gold loans NBFCs hold

13.53 It needs to be noted that even when there is a fall in the gold prices, the loss to be booked depends on the value of jewels that may have to be auctioned and not on the value of entire collateral the gold loans NBFCs hold. Normally, the jewellery that may go for auction is in the range of 2 or at best 3 per cent of the entire collateral held per annum. It is also pertinent to recognise that the gold price decline takes place over months and the average repayment period of the gold loans NBFCs is between 3 to 6 months.

3. Recent Trends in Gold Loans and Domestic Financial Stability

Asset quality, NPAs as per cent of total credit exposure and Capital adequacy of gold loan NBFCs are not a cause for concern at present

13.54 Going by the trends in the past four years, asset quality of gold loan NBFCs did not seem to cast any major concern for the stability of these institutions. The ratio of Non-Performing Assets (NPAs as per cent of total credit exposure) remained much lower than the overall NPAs ratio for the non-banking financial sector. Capital adequacy also does not appear to be a serious concern for gold loan NBFCs.

The sources of funds of gold loan NBFCs also do not appear to be an immediate cause of concern giving rise to concentration credit risk

13.55 The sources of funds of gold loan NBFCs do not appear to be an immediate cause of concern giving rise to concentration credit risks. This is because, loans to gold loan NBFCs form only a miniscule portion of total liabilities of banks. Even at the bank-level, exposure of banks to gold loan NBFCs through loans given to these NBFCs appears to be small.

The striking growth of gold loan NBFCs business warrant that their operations may be closely monitored

13.56 At the present juncture, any stress in these gold loans NBFCs does not appear to be a direct threat to financial stability given their small size in the system. However, going by their striking growth, it is desirable that their activities may be closely monitored through regular relevant financial data collection, analysis and monitoring. More frequent on-site and off-site supervision will also be required.

Some gold loan NBFCs have been raising public deposits surreptitiously through unincorporated bodies raising concerns

13.57 There are inter-linkages within the gold loans NBFC segment in the form of gold loan NBFCs floating unincorporated sister concerns to raise public deposits, which are not permitted by the Regulator. Such activities primarily involve raising public deposits and diverting these funds towards the registered gold loan NBFCs. Raising public deposits by such illegitimate means can have implications for public confidence in the concerned NBFCs and non-banking financial sector as a whole. If such activities are not curbed in time, they can have implications for the stability of financial system.

Banking sector's existing exposure in the form of their individual gold loans appears small and may not have any significant repercussions for the stability of the banking sector at present

13.58 Banking sector's existing exposure in the form of individual gold loans appears small and hence, any stress in gold loan portfolio may not have any serious repercussions for the stability of the banking sector as a whole. Even if we accounted for the loans given by banks to gold loan NBFCs, the total exposure of banks to gold loans still worked to be less than 3 per cent of total bank credit by end-March 2012. However, a word of caution is that given the striking growth in gold loans from banks in the recent years, gold loans can emerge as an important constituent of the total loan portfolio of banks that may raise systemic concerns.

Probability of volatility in gold prices impacting the gold loan market is low

13.59 One of the reasons providing a boost to gold loans in India (through both non-banking and banking channels) has been the continued rise in gold prices. However, the probability of a sudden drop in gold prices leading to a spurt in defaults has been estimated to be very low. Thus, the near-term probability of a major and sudden drop in domestic prices of gold and a resultant adverse impact on asset quality of banks and NBFCs is expected to be low.

4. Prudential Norms Relating to Gold Loan NBFCs – An Assessment

Gold loans NBFCs are subjected to prudential regulations and reporting requirements

13.60 Gold loan NBFCs fall into the group of NBFC-ND-SI. They need to follow certain mandatory prudential regulations and reporting requirements prescribed by the Reserve Bank. Gold loan NBFCs are required to have a capital to risk weighted ratio of 15 per cent with a Tier I capital of 12 per cent by April 2014. Gold Loan NBFCs will have to stop recognising income on its loans when the installment or other dues remain outstanding for more than 180 days. They shall classify their loans and advances and any other forms of credit into standard, sub-standard, doubtful and loss assets. The gold loan companies shall make prescribed provisions against all categories of assets.

Gold loans NBFCs are also subjected to KYC norms and other stipulations

13.61 The extant regulations also prescribe that loans are not to be granted by gold loans NBFCs against the collateral of bullion, primary gold, gold coins. gold loans NBFCs are instructed by the Reserve Bank to lay down a broad policy covering adequate steps to ensure that KYC guidelines as stipulated by the Reserve Bank are complied with by the NBFCs. Keeping in view the possibility of risk contagion, the Reserve Bank has directed banks to reduce their regulatory exposure ceiling in a single NBFC, having gold loans to the extent of 50 per cent or more of its total financial assets, from the existing 10 per cent to 7.5 per cent of banks' capital funds. Also, the risk weight for gold loans is 100 per cent for NBFCs as against 75 per cent for banks offering gold loans for agricultural purposes.

The regulatory treatment for banks and gold loan NBFCs is different

13.62 The rationale behind the differential regulatory treatment for banks and gold loan NBFCs lies in the difference between the overall business models followed by these two types of entities. Banks have better corporate governance practices and follow stricter accounting, risk management capabilities and disclosure norms than gold loan NBFCs. Also the inter-linkage between banks and gold loan NBFCs has increased in recent years with the increased dependence of gold loan NBFCs on public funds including bank finances, thus creating the possibility of systemic risk in the financial sector if unchecked.

Gold loans NBFCs are doing a socially useful function and that provides a strong rationale for a careful regulation of the activities of these NBFCs

13.63 The Group believes that the gold loans NBFCs through their lending operations with low and middle class population by providing timely financial assistance are rendering a socially useful function. It is true that lakhs of individuals take recourse to these gold loan NBFCs for their immediate financial requirements. This is an important reason for ensuring the financial health of these gold loans NBFCs through strict monitoring of their operations and regulation. If any of these gold loans NBFCs fail, it not only brings gloom to the promoters of the NBFCs but also drives the needy borrowers to scramble back at the doors of money lenders and pawn brokers to their utter disadvantage. This reason provides a strong rationale for carefully monitoring and regulation of the activities of these gold loans NBFCs.

The recent slew of regulatory measures taken by RBI on the functioning of the gold loan NBFCs may be continued to ensure a healthy growth of the sector in the medium and long term

13.64 The Group recommends, with the exception of a review of the Loan to Value Ratio, the continuation of the current prudential stipulations till the growth rate of business expansion of the major gold loan NBFCs both in terms of assets acquired and number of branches opened, decelerate to more sustainable levels. What is a sustainable level of growth for the gold loan NBFCs is a company-specific matter and each gold loan NBFC should evaluate its financial performance, sources and uses of funds, its existing overall gearing structure and business volume to consolidate its operations. The Working Group believes that a review of the extant regulations is feasible when the NBFCs' operations consolidate and their rate of growth in borrowings and branch expansion moderates besides improving their capital funds.

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Smt. Jayanthi K.Anand	Director, DEPR, RBI	RBI
Smt.Chandini	Deputy General Manager, DNBS, RBI	RBI
Shri A.K.Gunasekharan	Deputy General Manager, DNBS, RBI	RBI
Senior Officers of the Commercial Banks		
Shri Dr.V.Eswaran	General Manager	State Bank of India
Shri J.Packirisamy	General Manager	State Bank of India
Shri Santanu Mukherjee	General Manager	State Bank of Travancore
Shri Rajiv Sharma	Deputy General Manager	State Bank of Travancore
Shri Joseph Mathew	Deputy General Manager	State Bank of India
Shri M.Balakrishnan	Deputy General Manager	Indian Bank
Shri K.Subramanyam	General Manager	Indian Overseas Bank
Shri Swaminathan Srini	Sr.Vice President	HDFC Bank
Shri Harsh Dugar	Sr. Vice President and Regional Head	HDFC Bank
Shri R.Premkumar	General Manager	Dhana Lakshmi Bank
Shri D.Sampath	General Manager	Federal Bank
Shri A.G.Varughese	General Manager	South Indian Bank
Shri Y.Prasad	Deputy General Manager	Andhra Bank

Participants in the meeting with gold loan borrowers at Bengaluru on May 18, 2012

Name	Designation	Institution
Shri K.U.B.Rao	Adviser, DEPR	RBI
Smt. Uma Shankar	Regional Director	RBI
Shri SMN Swamy	General Manager, DNBS	RBI
Shri Ashok Sahoo	Director, DEPR	RBI
Shri A.Karunagaran	Assistant Adviser DEPR	RBI
Shri N.C.Pradhan	Research Officer, DEPR	RBI
Shri K.R.K.Reddy	Assistant General Manager	RBI
Shri N.K.Srikantiah	Manager	RBI

Working Group's Meeting with Consultants/ Experts on Gold-backed Products May 22 and 23, 2012 at RBI, Mumbai		
Name	**Designation**	**Institution**
Shri K.U.B.Rao	Adviser, DEPR	RBI
Shri Ajay Mitra*	Managing Director, India	World Gold Council, India
Shri Alok Kshirsagar	Director	McKinsey and Company
Shri Sharad Mohan	Chief Operating Officer	Citibank N.A
Shri C. Chandrasekhar	Sr. Vice President	Mecklai Financial Consultants
Shri Deepak Singhal	CGM-in-C, DBOD	RBI
Shri Rajesh Verma	CGM, DBOD	RBI
Shri Krishnan Vishwanathan	Engagement Manager	McKinsey and Company.
Ms. Anuja Trivedi	Programme Manager	World Gold Council, India
Shri Dhiraj Singh	Commodity Research Analyst	Citibank N.A
Shri Rajat Monga	CFO and Group President	Yes Bank
Ms. Shubada Rao	Chief Economist	Yes Bank
* Shri Ajay Mitra has since left his position in the World Gold Council, India.		

Working Group's Meeting with CRISIL Team on May 16, 2012 at the RBI, Mumbai		
Name	**Designation**	**Institution**
Shri Nagarajan Narasimhan	Senior Director	CRISIL
Ms. Rupali Shankar	Director	CRISIL
Shri Ramesh	Manager	CRISIL
Working Group's Meeting with IMacS Team on May 15, 2012 at the RBI, Mumbai		
Name	**Designation**	**Institution**
Shri Shriram	Chief General Manager	IMacS, Chennai
Shri Mohit Singh	Sr. Analyst	IMacS, Chennai
Ms Shalini Gupta	Asst. General Manager	IMacS, Chennai

List of Reserve Bank's Officers Associated with the Working Group's Report (*Other than the Members*)

No.	Chapter	Name of the Officers Associated
1	Gold loan market in India – An overview	N.C.Pradhan, DEPR Anand Shankar, DEPR Suraj.S, DEPR
2	Recent Trends in Gold Loans and Influence on Gold Imports	Alex Philip, DEPR Pankaj Kumar, DEPR
3	Recent Trends in Gold Imports and External Sector Vulnerability	Rajeev Jain, DEPR Anand Shankar, DEPR
4	Recent Trends in Gold Loans and Impact on Gold Prices	Edwin Prabhu, DEPR N.C.Pradhan, DEPR Alex Philip, DEPR
5	Recent Trends in Gold Loans and Systemic Stability	Pallavi Chavan, DEPR M. Sreeramulu, DNBS
6	Assessment of Financial Performance of Gold Loan NBFCs-ND-SI	Rakhe Balachandran, DEPR M. Sreeramulu, DNBS
7	Regulatory Norms Relating to Gold Loan NBFCs – An Assessment	Shromona Ganguly, DEPR
8	Fair Practices Code and KYC Norms Pertaining to Gold Loans NBFCs	S.Suraj, DEPR
9	Gold-backed Financial Instruments – Scope for Introduction	Krittika Banerjee, DEPR
10	Role of Banks in Gold Imports and Retailing Gold Coins	Rajesh Jai Kanth, DBOD
11	Metal Gold Loans – Applicability of Base Rate	Rakhe Balachandran, DEPR