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RBI releases Draft Report of its Working Group on Gold

The Reserve Bank of India (RBI) today placed on its website, the Draft Report of the Working Group to Study the Issues Related to Gold and Gold Loans by Non-Banking Finance Companies (NBFCs) in India (Chairman: Shri K.U.B.Rao, Adviser, Department of Economic and Policy Research). The Reserve Bank has sought comments on the draft report from stakeholders and public. The comments may be mailed up to Friday, January 18, 2013.

The Working Group was assigned with the task of studying whether large gold imports of India are a threat to external stability. The Working Group was also asked, among other things, to study the recent trends in gold loans extended by large gold loan NBFCs and see whether there are any systemic stability issues that arise out of the interconnectedness between banks and gold loans NBFCs. The Working Group followed an eclectic approach to address the terms of reference assigned by undertaking technical exercises to study the relationship among various related economic variables; and to conduct surveys through intense dialogue with all the stakeholders to firm up related views. Existing regulations related to NBFCs-Non-Deposit taking (ND) - Systemically Important (SI) sector were reviewed and recommendations were offered.

Gist of the Working Group's Report:

Macro Issues

Large gold imports are adversely impacting the current account deficit. There is a need to moderate the demand for gold imports, as ensuring external sector's stability is critical. It is necessary to recognise that demand for gold in India is not strictly amenable to policy changes and also is price inelastic due to varied reasons. Banks' role in canalising gold imports is important, but has been declining over the years. There is scope for reviewing the current incentives available for banks to deal with gold imports. In the context of growing demand for gold, it is critical to ensure real returns to investors through various financial savings products, so that their attention can be diverted away from gold, at least, partly. There is a need for banks to introduce new gold-backed financial products that may reduce or postpone the demand for gold imports. Investors' awareness and education is important in the context of channelising the investment to gold-backed financial products. 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. Encouraging loans against the collateral of gold for productive purposes may be a way to do this.

Micro Issues

The financial performance of the gold loans NBFCs and the current level of their borrowings from the banking system are not of significant concern. There appears to be no immediate systemic implications in terms of domestic financial stability due to the interconnectedness of gold loans NBFCs and banking system. Banks and NBFCs may continue to deliver gold jewellery loans, which monetise 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 loan 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.

Key Recommendations

Key recommendations of the Working Group are:

- There is a need to moderate the demand for gold imports considering its impact on the current account deficit
- Fiscal measures to reduce the gold imports may be revisited
- Banks need to design innovative financial instruments that can provide real returns to investors
- Need to convert both rural and urban demand for gold into investment in gold-backed financial instruments through dematerialisation of gold
- Introduction of tax incentives on instruments that can impound idle gold may be considered
- There is a need to recycling of domestic scrap gold
- Limits on the volume and value of gold to be imported by banks may be considered, if required under extreme situation
- Consider imposing export obligation on bulk gold importers
- Banks may expand their gold jewellery loan portfolio to monetise the stocks of idle gold
- The debate on setting up of a gold bank may be revisited
- Banks may continue their role as nominated agencies in gold imports
- Differential pricing of banking services and finance for gold imports may be considered
- Bank finance to purchases of gold bullion may be prohibited
- There should not be any curb or limits on advances against gold jewellery and gold coins by individuals
- Banks may continue retailing of gold coins, given their small volume
- There is no strong case to exempt Metal Gold Loans from the base rate stipulations
- 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
- Products like Gold Accumulation Plan, Gold Linked Account, modified Gold Deposit and Gold Pension Product may be considered for introduction
- Careful evaluation of each of the proposed gold-backed product is critical
- The rapid growth of the assets, borrowings and branch network of gold loan NBFCs need to be monitored continuously

- Need to reduce the interconnectedness of gold loan NBFCs with the formal financial system gradually
- Declining capital adequacy ratio – Need to improve the capital of gold loan NBFCs
- Need to review the current stipulations pertaining to raising of resources through NCDs by gold loan NBFCs
- The exemption available to secured debentures from the definition of “deposit” may be reviewed
- There is a need for monitoring transactions between gold loan NBFCs and unincorporated bodies
- 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
- There is a need to thoroughly review the operational practices followed by gold loans NBFCs
- There is a need to ensure transparent communication of loan terms by gold loans NBFCs
- Institution of a customer complaints and grievances redressal system by gold loans NBFCs is important
- Need to review the auction procedure by gold loans NBFCs
- Location of auctions should be same Taluka where the borrower is located
- Post-auction safeguards to be followed by gold loans NBFCs
- Better disclosure standards to be followed by gold loans NBFCs
- Monitoring the implementation of the Fair Practices Code
- Standard documentation to be followed by gold loans NBFCs
- Use of PAN Card for large gold loan transactions
- Payment through cheque for large gold loan transactions
- As of now, there is no case for conceding level playing field for the gold loan NBFCs with the banks
- There is a case for review of the extant ‘loan to value ratio’
- There is need for a clearly-defined and standardised concept of the term ‘Value’ for prescribing appropriate ‘Loan to Value Ratio’
- Unbridled growth of branches by large gold loan NBFCs needs to be moderated
- There is a need for an ombudsman to address the grievances of gold loan borrowers
- Rationalisation of interest rate structure by gold loans NBFCs

Major Conclusions

- Gold loans have a causal impact on gold imports substantiating the emergence of a liquidity motive for holding gold
- International gold prices and exchange rate significantly and positively affect the gold prices in India
- Increase in gold prices appears to be one factor that increase the gold loans outstanding

- Increase in gold loans extended by NBFCs and banks does 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 sharp sudden drop in gold price by 30 to 40 per cent is a remote possibility causing financial distress to the gold loan NBFCs
- The extant loan to value ratio (LTV) ratio should provide a reasonable risk cover in case the gold prices fall by 10 per cent
- 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
- The sources of funds of gold loan NBFCs do not appear to be an immediate cause of concern giving rise to concentration credit risk
- The striking growth of gold loan NBFCs business warrant that their operations may be closely monitored
- Some gold loan NBFCs have been raising public deposits surreptitiously through unincorporated bodies raising concerns
- 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
- Probability of volatility in gold prices impacting the gold loan market is low
- Gold loans NBFCs are subjected to prudential regulations and reporting requirements
- 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
- 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

Background

It may be recalled that in the Monetary Policy Statement 2012-13 announced on April 17, 2012, the constitution a Working Group to study the gold loan market in India, which has shown rapid strides in recent years. The large rise in the gold loan business, the branch network of gold loan NBFCs, volume of loans disbursed and the quantum of bank borrowings raised certain regulatory concerns. There were also macroeconomic issues like impact of large gold imports on external sector stability. Accordingly, a Working Group was constituted under the Chairmanship of Shri K.U.B.Rao, Adviser, Department of Economic and Policy Research, RBI. The Working Group had internal members from various departments like Department of Economic Policy and Research, Department of Non-Banking Supervision, Department of Banking Operations & Development, Department of Statistics and Information Management and Financial Stability Unit. This Draft Report has taken into account comments received internally from Financial Markets Committee Members and the comments from FSDC Sub-Committee Members.

Alpana Killawala
Chief General Manager

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