Discernible growth of Gold Loan NBFCs in India

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Abstract

Discernible growth of gold loan NBFCs recorded mainly on the backdrop of appreciation in gold price affirming the indicators of financial soundness such as capital adequacy ratio, Non Performing Asset (NPA) and share of borrowing in the total asset of bank that are contained well within the limit specified by RBI. Rules and regulations on gold loan NBFCs and concomitant decline in gold price have led to the saturation of growth of NBFCs. In short, the sharp correction of gold price would have a devastating effect not just on gold loan NBFCs but also on the entire financial market.

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Introduction

Over the years, gold loan NBFCs witnessed an upsurge in Indian financial market, owing mainly to the recent period of appreciation in gold price and consequent increase in the demand for gold loan by all sections of society, especially the poor and middle class to make the both ends meet. Though there are many NBFCs offering gold loans in India, about 95 per cent of the gold loan business is handled by three Kerala based companies, viz., Muthoot Finance, Mannapuram Finance and Muthoot Fin Corporation. Growth of gold loan NBFCs eventuating from various factors including Asset Under Management (AUM), number of branches, and also the number of customers, in the less developed financial market in India raises many concerns such as: did the growth of these companies accelerate from the absence of a well-functioning financial market? Or, how far the policies of RBI were able to keep up the financial standard of these companies? Or, are they financially sustainable? Or, do they pose any threat to the financial system because of their exposure to bank credit? These issues ought to get immediate elucidation and must be settled by appropriate policy interventions. This paper tries to examine some of the above mentioned issues in detail and attempt to arrive in a consensus on each of these issues. The paper is structured into five sections encompassing the introduction and conclusion. While the second section discusses a brief overview of gold loan NBFCs, growth and performances are discussed in the third section. The fourth section discusses the correlation between the NBFCs and the current financial system.

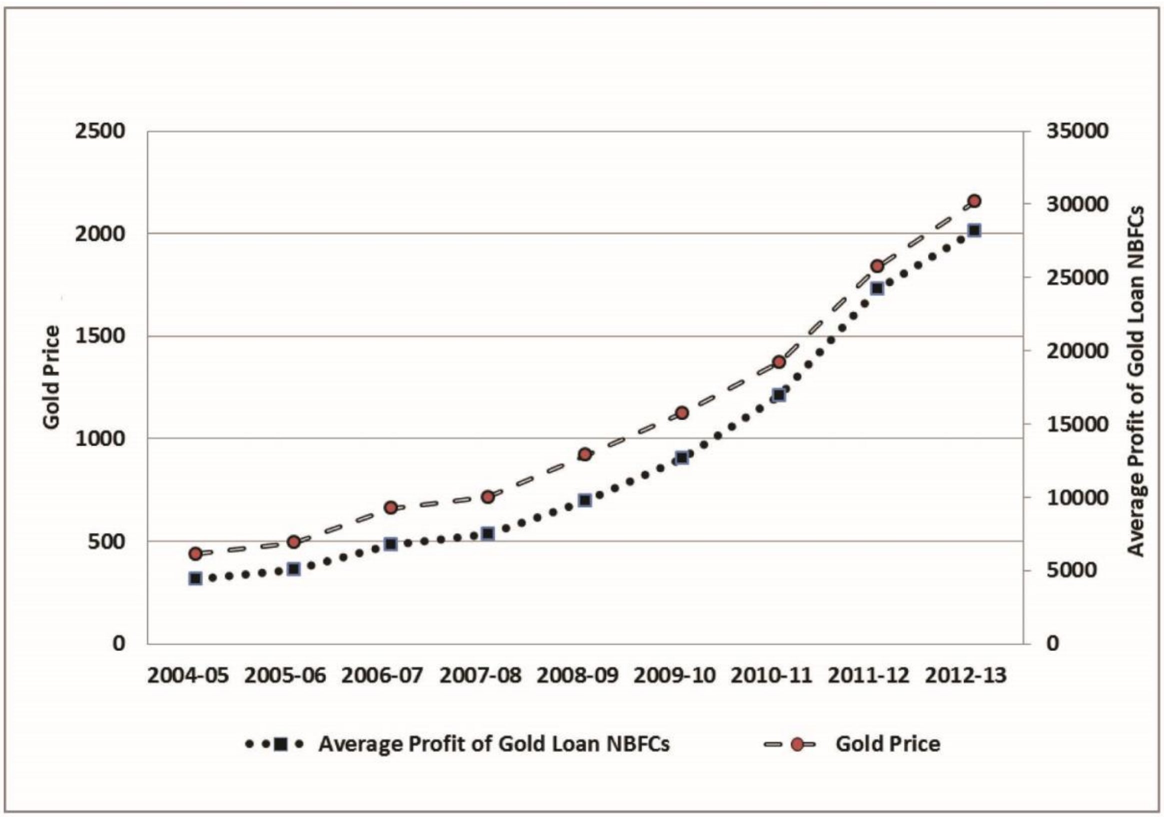
II) Overview of Gold loan NBFCs in India

Gold is an idle asset in the hands of individuals and there is a huge unlocked economic value in the Indian economy, which is said to have anywhere between 18000 to 20000 tonnes of gold. Yet, only three per cent of this idle gold stock is being used for raising gold loans. But, gold loan NBFCs came to public attention when Manappuram Finance Limited hit the capital market in November 2010 with a Qualified Institutional Placement (QIP) for Rs. 1,000 Crores, followed by Muthoot Finance Limited's Initial Public Offer in April, 2011 of around Rs. 900 Crores. Later, Muthoot Finance Limited as well as Manappuram Finance Limited also came up with a Non Convertible Debentures (NCDs) of significant amount. Growth of NBFCs occurred both in terms of the size of their balance sheet and their physical presence that compelled to increase their dependence on public funds including bank finance and non-convertible debentures. Aggressive structuring of gold loans resulting from the uncomplicated, undemanding and fast process of documentation along with the higher Loan to Value (LTV) ratio include some of the major factors that augment the growth of Gold loan NBFCs. Upsurge and widespread establishment of these companies invited regulatory headwinds from March 2012 and since then, many rules and regulations were imposed on this sector with a view to contain their growth. Fixation of Loan To Value[1] ratio is the main norm employed by the RBI that imposed a slashed LTV of 60 percent as compared to the earlier level of 80 percent, for loans granted against the collateral of gold on 21st march 2012. Growth of NBFCs started to saturate since then and RBI raised LTV up to 75 per cent on 3rd January 2014.

III) Growth and Performance of Gold loan NBFCs in India

The ascending price of gold, the quantum of black money in the market, the general price level, the rate of return on alternate financial assets, the lack of easy availability of alternative financial products, the easy availability and highly liquid nature of gold, the prevalence of specific socio-cultural system, are some of the major driving factors triggering gold demand that has led to the huge accumulation of gold in India. Both organized and unorganized gold loan businesses have been growing along with the accumulation of gold, however, the recent period of appreciation in gold price has mainly led to the growth of organized loan businesses. Since the market share of gold loans NBFCs dominated by Muhoot and manappuram LTD. Therefore, average profit of Gold Loan NBFCs in the figure1 is the averge of profit after tax of Muthoot Finance LTD and Manappuram Finance LTD. Figure 1, showing the co-movement of gold price and profit growth of Gold loan NBFCs clearly indicates that the growth of profit started in 2005 concomitant with the appreciation of gold, lasts up to the end of 2013. Looking back, the sustained increase in gold prices had two positive strokes for the gold loan business. On the one hand, it kept scaling the eligible loan amount per gram of gold which made gold loans a compelling proposition for the customers, and on the other hand, it kept defaults in check because of the rising market value of the pledged security. In the event of default, the lender did not suffer much loss because the proceeds from auction of the pledged jewellery were adequate to cover the loan outstanding.

Figure 1: Average Profit of Gold Loan NBFCs and Gold Price



Source: Calculated using RBI data base and various anual reports of Muthoot Finance LTD, Manappuram Finance LTD

Now that the Bull Run in gold price appears to be over, it is likely that the business will eventually stabilize to a period of steady growth. At this juncture, it is necessary to ascertain the growth and level of sustainability of the gold loan NBFCs by evaluating their financial performance and their sources and uses of funds. Moreover, on account of their striking growth, it is necessary 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 is also asked for.

Implementation of RBI guidelines will necessarily restrict the competitive positions of gold loan NBFCs vis-à vis those of banks and the unorganized sector. In such a situation, while borrowers with limited stocks of jewellery may move to the unorganized sector that will continue to offer loans at higher LTV ratios, the interest-sensitive borrowers on the other side will shift to Nationalized banks that offer loans at much lower costs for similar or higher LTV ratios.

IV) Interconnectedness of NBFCs in the financial system

Gold loan NBFCs' interconnectedness with the formal financial system increased in proportion in the recent years as gold is also preferably held indirectly by leveraged institutions like banks and non-banks as collateral in their loans. However, a sizeable portion of their borrowings come from the banking system. Since, the primary business of these NBFCs is lending against gold, any drastic fall in the gold market leading to a sharp correction in the gold price will potentially have a disturbing effect on the banking system. 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. The consistent increase in the dependence of the gold loan NBFCs on the banking sector seriously raises sincere concern. There is a need for the NBFCs to reduce their over-dependence on any one source and necessarily develop a balanced system of financial sourcing, while strengthening their capital funds as a risk buffer. Inter-linkage between banks and gold loan NBFCs could potentially create the possibility of systemic risk in the financial sector, if unchecked. It may be pointed out that banks do face 'concentration risk' on account of their gold loan activities, since the business of gold loans NBFCs are associated with absolute concentration in one commodity. This risk may reduce in future as the gold loans NBFCs are now trying to maximize their profit by diversifying into loans backed by land and other securities.

However, indicators of financial soundness such as capital adequacy ratio, Non-Performing assets, are contained well within the limit (RBI 2013: 14 &16). Conversely, 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. And hence, any stress in gold loan portfolio may not have serious repercussions on 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 (RBI 2013: 172, 173). The indicator of financial soundness, namely, leverage of gold loan NBFCs appears to be a cause of concern. In addition, there is a need for improving the owned funds of NBFCs. Higher level of capital is 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 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.

Conclusion

Gold loan NBFCs cater the needy sections of the society, especially the poor and the middle class to keep up their social and economic life, as they otherwise are not eligible to get credit from the banking sector. Discernible growth of gold loan NBFCs recorded mainly on the backdrop of appreciation in gold price affirming the indicators of financial soundness such as capital adequacy ratio, Non Performing Asset (NPA) and share of borrowing in the total asset of bank that are contained well within the limit specified by RBI. Rules and regulations on gold loan NBFCs and concomitant decline in gold price have led to the saturation of growth of NBFCs. In short, the sharp correction of gold price would have a devastating effect not just on gold loan NBFCs but also on the entire financial market.

End note

1. The loan-to-value (LTV) ratio is a financial term used to express the ratio of a loan to the value of gold pledged

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