THE CONCEPT OF GOLD LOAN IN INDIA

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ABSTRACT

Loans form not just an important source of revenue for banks and other financial institutions, they also add to the economy. The most recent of them being is Gold loans. Gold loans are amongst the newest class of assets which have seen rapid growth in securitisation Gold loans have tremendous prospects for India, which is the largest user of gold since it can easily be used as the most liquid asset and hence facilitates transaction. It can thus be put to more beneficial purposes. The present paper seeks to study the scope and risks of gold loans in India. This work has been carried out following the descriptive and analytical approach and uses secondary data. It provides a deep approach into the topic of Gold Loans and further scrutinizes all the aspects of the same. The paper ends with a proper conclusion.

Keywords: Gold Loans; Loans; Securitisation

INTRODUCTION

The act of giving loan implies the act of giving money, property or other material goods to another in exchange for future repayment of the principal along with the interest or such other finance charges as may have been specified, that acts as an incentive for the lender to engage in the loan. In the case of a standardized loan, the terms are formally laid down in writing before the exchange takes place. Where a lender requires the pledging of collateral, the same is specified in the agreement. Most loans have legal stipulations regarding the maximum interest that can be charged. Also the covenant mentions the length of time before which repayment is required. A loan may be for a specific, one-time amount or can be available as open-ended credit up to a specified ceiling amount. They proceed from individuals, corporations, financial institutions and government.

Loans are a boon to the economy. They result in the growth in the overall money supply in the economy, increase competition, introduce a floodgate of start-ups and help in business expansion. Loans are the primary source of revenue for financial institutions like banks and individuals whose business operates on extending credit facilities. Gold has long been a valued commodity, particularly in India where it is considered auspicious, and has been in use for centuries in the form of jewellery, coins and other assets. Though gold is a highly liquid asset, it wasn’t until recently that consumers leveraged it effectively to meet their liquidity needs. The urban populace is now beginning to realize the potential value that can be realized through gold loans, which has led to rapid growth of the gold loan market in India.

The period of 2011-2012 phase can truly be viewed as a defining period for the gold loans segment as it witnessed a complex interplay of a mix of multiple factors related to demand, supply and regulations which have to quite some extent transformed the growth, competitive landscape and business dynamics of the segment and are expected to continuing doing so in the years to come.
OBJECTIVES

The objectives are

1. To examine the scope of gold loans in India.
2. To examine the risk involved.
3. To analyse the future of gold loans in India

Gold Loans in India: History and Status

Gold loans have become a basis for creation of new financial products such as loans for purchase of gold wherein gold is purchased on the date of loan and held as a pledge until the equated monthly instalments are paid. The concept of Gold loans is not a new phenomenon to the Indians. Lending against gold has been in vogue since the very inception of the process of lending. The origin dates back to several centuries when it was used as the main commodity of exchange in the system of barter and trade. The same holds today for the fulfilment of short term financial requirements. India holds the repute of being the largest user of gold ornaments in the world with states like Kerala and Tamil Nadu topping the list on Indian cities. Taking advantage of this, several Southern companies have roped in to capture the market. Banks in coastal Karnataka (like Syndicate Bank and Canara Bank); Kerala (Federal Bank, South Indian Bank, Catholic Syrian Bank and Dhanalakshmi Bank) and in Tamil Nadu (Indian Bank, Indian Overseas Bank, Karur Vysya Bank and Lakshmi Vilas Bank, among others) entered the gold-loan fray during the 60s in a grand manner. Several commercials promoting institutions, such as Mannapuram gold and Muthoot finance group, raging in the media show the extent to which the market for gold has flourished.

The origin of gold loans took place in the Southern states where the landowners and moneylenders would traditionally lend money against gold at exorbitant rates but without many restrictions for special occasions. This practice continued for several years in the unorganized sector with the pawnbrokers. Their business is impeccable, but the problems arose with the increase in the market rates and interest rates of gold to as high as 24-32%. Most of the borrowers were from relatively lower grounds that lost everything since re-pledging was not possible. When the finance companies collapsed in the ‘80s the people lost all their money. Finally the commercial banks and other Non-banking financial institutions evolved that, in the present day, control up to 25% of the market demand. The interest rates were regulated by the RBI and were further regulated after the nationalization of banks took place in 1969.

Definition and Purposes

Gold loans are secured loans where the person seeking to borrow has to pledge gold ornaments, gold coins, gold bullions or other gold assets as security. The assets are often tested for their purity and on the basis of such examination the loan is provided. The gold, which usually lies idle and earns no money, is utilized towards obtaining loans for other material products.

Gold loans are obtained through banks or other Non-banking financial institutions that specialize in such loans. Usually 80% of the total market reigning value of the gold is provided. At the end of the payment of the principal amount along with the necessary interest, the borrower is allowed to recover his assets in the same state and same weight.

The only caveat to such loan is that the consumer must be sure of his ability to repay the loan, or else the lender obtains a legal possession over the same.

Gold has a huge advantage over other such assets. It has been considered amongst the most liquid asset in the world. Also it is universally accepted as a mode of exchange. India is one of the largest markets for gold accounting for almost 10% of the world’s total gold stock in 2010. While pawnbrokers and moneylenders have dominated the market traditionally and still command close to 75% of the market, the modern financial institutions are catching up fast. The organized gold market has witnessed a surge
of close to 40% in the recent years. NBFC’s have been a major force for this growth due to their extensive network, higher loan-value ratio and lower turnaround time. Banks have also followed cue, and are gaining ground. With raging growth, regulatory scrutiny has been beefed up on lending practices such as rigorous implementation of Know Your Customer (KYC) norms. The RBI also assesses the concentration risk that may result from a steep drop in prices.

Like every other loan, gold loans charge processing fees, interest charge, valuation charge, late payment penalty and pre-payment penalty. Some of the lending organizations may not charge all the fees. It is essential that the borrower goes through all necessary terms and conditions since it may affect the outstanding amount.

**Essential Documents for Availing Loan**

The documentation process for obtaining a loan against gold is simple, easy and available over the counter instantly.

Very often all one needs to do is walk up to any non-banking lending institution and avail the money in as less as 15 minutes as advertised. The documentation required is usually less as compared to that of banks, where one might be asked to show ID proof and other personal details and also to prove whether the gold is actually owned by the person.

In case of Non-Banking lending institutions, however, a higher rate of interest is charged since they do not evaluate the credit-worthiness and process is less rigorous. Given below are lists of documents that are usually required however the list might change according to the lending company:

1. Identity proof of the applicant – Voter’s ID, Passport or Driving License
2. Signature proof – Passport, Voter’s ID, Driving License or any other document with the borrower’s authentic signature.
3. Address proof – ration card, electricity bill, telephone bill and other document which authenticates the borrower’s current residential address.
4. Two passport size photographs

Again, one should avail of the loan only when one is sure of repaying it. It is important to do a bit of market researching to have a good idea of the interest rates and loan-to-value that is being offered instead of randomly selecting a lender.

**Advantages of Gold Loans**

Gold loan is a secured loan- where gold ornaments, bullions or coins are kept as a security. This loan can be used for any number of purposes but towards the commission of any illegal activity or speculation in the share market. NBFCs have fewer restrictions on the purpose of the loan. The loan applicant does not have to disclose his income or salary. It can be availed by non-working individuals too. The loan is disbursed quickly and with less documentation involved so it can be utilized for immediate purposes. Disbursement through NBFCs spans a couple of minutes while those from banks may require a maximum of one or two days. Gold loans have a higher Loan-to-value ratio. NBFC’s offer up to 95% of the purity of the gold while banks restrict themselves to a maximum of 75% of the purity. There is no minimum tenure. If need be, it can be paid the very next day. Average loan period varies from 90-100 days. The interest rate varies according to the tenure and amount of loan. In the case of NBFCs it is higher, around 25% whereas it can be around 12-15% in the case of banks. Rates of interest are reasonable where the LTV rate does not exceed 50-60%. Repayment can be made in one lump or it can be done in instalments.

**Risks Generally Involved**

Where lenders take possession of the gold assets in a loan transaction, in case of a theft they may not have sufficient funds to compensate all the borrowers for their loss in its entirety. This is more
important for loans placed in the unorganized sector. Banks and NBFCs usually have better security and insurance coverage. Regardless, financial packages cannot compensate for the personal attachment a borrower has with the gold assets. Often, the jewelry is in the nature of a family heirloom, acquired during important occasions like a marriage, or the birth of a child and so on.

In the way that the black component in real estate deals results in undervaluation of property, so too does the making charge add to the security of the lender in gold loans. Because making charges are not financed even as they get priced into all purchases of gold jewellery, it’s a hidden cushion to the lender the way the black money component in a real estate transaction is.

A sharp decline in gold prices increases the original LTV. A lender may require an immediate recovery of any amount that exceeds the original LTV ratio, but the borrower may be unable to pay this amount. Restructuring of the loan may be required in these cases. Additionally, if the value of the pledged asset declines, a borrower may be more willing to default on the loan. This poses a serious concentration risk to the lender, especially to the NBFCs that have a high exposure to gold loans and lend at high LTV ratios. The increase in gold prices over the last few years, coupled with the surge in gold loan borrowings during this period, could create a gold bubble which could burst in the event of a significant correction in gold prices. Banks and NBFCs with significant exposure to gold loans could face widespread defaults, which could adversely impact the economy. The organized sector today manages these risks through various methods such as enhanced security, insurance cover, buying gold futures, etc.

**Regulatory Environment**

While there are no means of controlling the unorganized sector, the organized sector of banks and NBFCs come under the purview of the Reserve Bank of India (RBI) which has norms to regulate the gold loan market.

NBFCs had been traditionally disbursing gold loans through funds received from banks under priority lending for the agricultural sector. But the RBI, in February 2011 ruled that bank credit to NBFCs for lending against gold jewellery will not be treated as exposure to the agricultural sector to reduce the risk factor in the system. The resulting higher interest rate for funds is expected to promote better lending practices by NBFCs to creditworthy borrowers especially in the light of the higher concentration risks (risks due to a sharp decline in the prices of gold for a lender with a large exposure to gold assets pledged against the loans), that now pose a threat to the economy.

All lenders are required to adhere to the KYC norms. NBFCs allegedly have not strictly followed this regulation and hence have been under the RBI’s scanner for some time now. Currently, NBFCs’ gold loans are regulated by RBI. However, some state governments require compliance with relevant state money lending statutes. If the state governments succeed in enforcing this regulation, the profit margin of NBFCs would witness a further drop.

**Recent Developments and Future of Gold Loans**

To compete with NBFCs, banks have recently improved/streamlined their loan processes – with some banks purchasing assaying machines to disburse loans in 15 minutes. This poses a challenge to the growing dominance of NBFCs in the gold loan market, more so since banks usually charge lower rates of interest compared with NBFCs.

The government considers gold loans as an effective means of meeting the demand for micro-finance in India. This would encourage framing of policies favourable to the growth of the gold loan market.

Gold saving schemes have also emerged wherein the customers pay regular cash flows which on maturity are added with a certain amount of interest payment to purchase gold for customers.

With frequent hikes in interest rates by the RBI and the subsequent hike in rates by banks, the cost of personal loan borrowing is increasing. This will lead to an increased consumer willingness to secure gold loans.
Since more than 75% of the gold loan market is still with the unorganized segment as of 2010, the organized segment has a huge potential for growth through larger penetration, extensive networks and more efficient branches.

The existing size of the gold loan market is approximately 1.2% of the total gold stock available. Hence there is a significant scope for further growth of the gold loan lending sector. India is one of the largest markets for gold accounting for ~10% (18,000-20,000 tons) of the global gold stock. Rural India is estimated to hold around 65% of this. Shaped by sentimental and structural factors, country’s demand for gold has been buoyant defying the phenomenal rally in price. It is estimated that ~10% of country’s gold stock has been pledged, of which, ~75% is in the unorganized market (money lenders, pawn brokers, etc) and balance ~25% in organized market (specialized NBFCs, other NBFCs, commercial/cooperative banks, etc)\(^1\).

**CONCLUSION**

For borrowers, gold loans have emerged as one of the best means of raising quick, short-term capital. For lenders, gold loans are more advantageous compared with home and car loans because of the shorter tenures, lower processing time and cost, and greater returns due to higher interest rates. These factors, along with appreciation in value of gold, have led to an explosion in the gold loan market. The organized sector is challenging the large unorganized gold loan market dominated by pawnbrokers and moneylenders, with NBFCs leading the pack due to simpler approval and disbursal processes, flexible products and better accessibility.

Further expansion in the organized sector is required. When expanding, firms need to ensure consonance of services and operations throughout the network. Also efficient tracking of borrower accounts, process transparency and minimization of operational costs are essential.

Firms need to manage risks related to possible sharp fall in gold prices and non-adherence of regulatory norms and also need to ensure that physical assets are properly valued, stored and documented. Firms need to invest in technology to better manage the increasing volumes and to reduce risks. Provision of accurate real-time information will lead to faster decision making and reduced turnaround time for loan disbursals.

**REFERENCES**