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THE GROWTH OF GOLD LOAN NBFCS IN INDIA: A CASE STUDY ON MUTHOOT FINANCE

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ABSTRACT

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. Lenders provide loans by securing gold assets as collateral. Compared with the rest of the world, in India the gold loan market is big business. Until a decade back, most of the lending was in the unorganized sector through pawnbrokers and money lenders. However, this scenario changed with the entrance of organized sector players such as banks and non-banking finance companies (NBFCs) which now command more than 30% of the market. The recent regulatory measures initiated by the Reserve Bank are in the right direction and is expected to make the gold loans NBFCs robust and reduce the regulatory gaps between banks and gold loans NBFCs. With rapid growth, regulatory scrutiny has increased on gold loan lending practices. NBFCs are under greater focus as a result of their higher interest rates and charges, and non-adherence to know your customer (KYC) regulations. This may further impact the dominance of NBFCs in the gold loan market. This will be a study about the growth of Gold loan NBFCs in India with respect to the updated RBI guidelines. A case study on Muthoot finance has to be done which will be helpful for the successful completion of the paper.

KEYWORDS
Gold, Gold Loan Market, NBFC, RBI guidelines.

INTRODUCTION

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 whose value 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 or liquidate the same through sale.

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.

RBI DIRECTION AND FUNCTIONING OF NBFCs

The recent direction by the Reserve Bank of India asking gold loan companies not to give loans in excess of 60 per cent of the value of the collateral has hit the non-banking finance companies where it hurts the most. The gold loan firms make robust profits only when their loan-to-value (LTV) goes closer to the value of the jewellery.

In the case of Manappuram Finance - the second largest gold loan company - the average loan-to-value ratio is 66 per cent, 6 percentage points above the RBI's prudential norm.

The largest gold loan firm, Muthoot Finance, charges an interest rate of between 12 and 24 per cent, and its average loan ticket size at the end of December 2011 quarter was Rs 40,000 - a 25 per cent year-on-year increase. The rate of interest tends to be on the lower side if the loan amount sought is at the lower side of the value of the jewellery and for a short period. But few borrowers would want to pledge too many pieces of jewellery to get the best rate. They would not mind paying a slightly higher rate if fewer ornaments would do for the pledge.

THE SUCCESS STORY OF MUTHOOT FINANCE

As the gold loan companies, all based in Kerala, showed feverish growth in business in recent quarters, the keen watchers of the sector saw the trouble coming. They knew RBI, as the watchdog, would not sit tight and do nothing as one sector overheated (the RBI calls this **concentration risk**). For example, Muthoot Finance's total income grew 91 per cent year-on-year at the end of the December 2011 quarter. All the leading players have been aggressively opening new branches to tap the latent demand and grow their business. Their **USP (Unique Selling Proposition)** lies in the ease with which they dispense loans in about 10 minutes after submitting the jewellery.

Gold loan firms have been growing steadily because they are known to lend against jewellery and not primary gold. Indian families, especially in the South where these firms get bulk of their business, have a certain sentiment attached to each piece of the family jewellery. They would have bought them on different occasions - such as marriage, birthday, and anniversaries - and hence, would not want to lose them at any cost. This explains why the **non-performing assets (NPA) at these companies are very small.**

With the loan-to-value dropping, the established players are bound to face competition from unorganised lenders. To save and grow their turf, the gold loan non-banking finance companies may have to cut their peak rates of interest and keep their loan products attractive. Even then, it is doubtful if they can ever return to their heydays of the gold loan hungama.

Muthoot run 18 different businesses, from houseboats to rubber plantations. But mention the name 'Muthoot' and only one of these comes to mind: gold loans. Muthoot Finance, a non-banking finance company, or NBFC, run by the four Muthoot brothers, has made a remarkable success of a business historically associated with pawnbrokers. It is today the largest lender against gold jewellery in the country with around 130 tonnes of gold currently in its vaults held against advances of Rs 20,766 crore. Indeed, the enthusiastic response to Muthoot Finance's initial public offer in May 2011 year - oversubscribed 24.5 times and netting Rs 906 crore - makes the brothers, who own 80 per cent of the stake, worth nearly a billion dollars.

MUTHOOT FIN TO RAISE RS 6,000 CR IN FY12

Muthoot Finance's rise is due to two factors: its rapidly growing portfolio of gold loans and its low rate of borrower default. The first is the result of an aggressive advertising campaign to underscore the speed and ease with which the company provides the loans, as well as to point out that there is nothing wrong in families monetising gold ornaments in times of need. Muthoot's advertising budget, Rs. 60 crore in 2010/11, has been raised to Rs. 100 crore in the fiscal year. The company is also the main sponsor of the Indian Premier League cricket team, Delhi Daredevils. "We are positioning our product as an option of convenience and removing the stigma attached to pledging jewellery," says George Alexander Muthoot, Managing Director of Muthoot Finance, the youngest of the four brothers. The low default rate, observers believe, lies in Muthoot's accepting only jewellery - not gold bars or coins. For most families gold jewellery has emotional associations: they ensure it comes back to them.

"We have not shut down a single branch so far for want of business," says Muthoot. A new branch costs between Rs 8 lakh and Rs 13 lakh to set up. Customers can borrow up to 90 per cent of the value of the jewellery, for which they pay an annual interest varying between 12 and 24 per cent, depending on the size and tenor of the loan. In cases of default, the jewellery is auctioned off after a period of 16 months from the time it was pledged. The pledged valuables are kept in secure vaults, insured against burglary and fire. In 2010/11, Muthoot Finance's average lending rate was 19.7 per cent, while the cost of funds stood at 8.7 per cent. The average loan size was Rs 35,000.

SO, ARE BANKS THE REAL THREAT?

Not really, feel analysts. For one, dispensing gold loans is hardly the banks' central activity; they can never give it the sort of concentrated attention NBFCs like Muthoot Finance or Manappuram do. Both claim to disburse loans up to Rs 20,000 within 10 minutes of the gold jewellery being submitted - **a speed no bank can match**. Besides, banks need Reserve Bank of India's, or RBI's, permission to set up new branches, while NBFCs are currently under no such obligation.

Yet challenges remain. Though Muthoot Finance has a pan-India presence, around 85 per cent of its business still comes from the four southern states. It is trying hard to expand further in the rest of the country, with the eldest of the four brothers, company Chairman M.G. George Muthoot, who has based himself in Delhi, personally driving the growth in the north.

The RBI decision in February 2012 year, to take gold loan companies off the priority sector lending list for banks, has affected them adversely. Since lending to gold loan NBFCs no longer improves a bank's priority sector credit score, the flow of bank funds has fallen, forcing the NBFCs to tap other sources and increasing their cost of funds. "Our expansion depends on the availability of funds," says Manappuram's Nandakumar.

Why would you pledge gold for a loan when you can borrow from banks without collateral at almost the same rate? Or why would you take gold loan from a non-banking finance company, or NBFC, when banks charge a lower rate?

The answer is convenience. The 'gold loan in five minutes' sales pitch of NBFCs may not be true in letter but is true in spirit. As gold loans are secured, NBFCs relax the due diligence process. Banks, which have to follow strict Reserve Bank of India, or RBI, norms on bad loans and minimum capital, do not have such liberal rules on giving loans, either secured or unsecured.

But should you be guided only by convenience? Moreover, the recent RBI order limiting loans by NBFCs to 60 per cent value of the pledged gold has further taken the sheen off such loans, which are very popular in India.

GOLD LOAN PRIMER

You can take gold loans by pledging jewellery and gold coins (only in case of banks). NBFCs can offer loans only against gold jewellery. The purity of gold should be 18-24 carat. The lenders-banks and NBFCs-determine the value and give a part of that as loan.

Since valuation is done by the lender, you can either accept its figure or walk out. The documents required are address proof, identity proof, signature proof and passport size photographs.

If you fail to pay regular interest or principal and interest, the lender sends reminders, usually after three, six and 12 months. After that, if you still do not pay up, the gold is melted and auctioned to recover the outstanding amount.

BANK VS NBFC

As both banks and NBFCs offer gold loans, a comparison of rates, eligibility rules and loan amounts offered by them is important.

DEGREE OF FREEDOM

FUNCTIONAL RESTRICTIONS ON NBFCS VIS-À-VIS BANKS

Functions	Banks	NBFCs
Demand deposits	Can invite demand deposits	Can't collect demand deposits
Issue cheques	Can issue	Can't issue
Deposit insurance facility	Available	Not available
Term deposits	Can take short-term deposits	Deposit term of at least 1 year

LOAN-TO-VALUE

The RBI decides how much loan can be given as a proportion of the gold's value. At present, NBFCs cannot offer more than 60 per cent. Earlier, there was no such cap and usually NBFCs used to give up to 80-90 per cent value of the gold pledged. This means on jewellery worth Rs 5 lakh, you can now get Rs 3 lakh from an NBFC, as against Rs 4-4.5 lakh earlier.

INTEREST RATES

Despite collateral, NBFCs charge very high rates. Manappuram Finance charges 2.17 per cent a month or 26 per cent annually on Rs 1,800/gm loan while Muthoot Fincorp charges 24-27 per cent annually. Muthoot Finance has a wider range, 12-24 per cent. It offers a maximum loan of Rs 50,000 at 12 per cent and a maximum loan of Rs 25,000 at 27 per cent for a tenure of three months.

Banks, on the other hand, are offering gold loans at 14-16 per cent a year excluding the 1-2 per cent processing fee. The interest is charged on a diminishing balance basis. Thomas John Muthoot, chairman and managing director, Muthoot Fincorp, says since banks' cost of funds is extremely low, they can charge less. Banks have access to low-cost deposits in savings and current accounts. NBFCs are not allowed to collect low-cost short-term deposits. 27 per cent is the highest interest rate charged by any NBFC on gold loans.

REPAYMENT

NBFCs allow borrowers to repay just the interest regularly during the tenure of the loan and pay the principal at the end of the tenure. Gold loans by most banks, especially public sector banks, are term loans, which means both interest and principal have to be paid regularly. Most NBFCs allow prepayment without penalty. Banks do not offer this facility.

In case of default, the gold pledged is melted and auctioned by the lender to recover the outstanding amount However, banks are free to decide the loan-to-value ratio. You can, therefore, get a higher amount by pledging the same gold with a bank than with an NBFC.

Satkam Divya, business head, Rupeetalk.com, says the cap imposed on NBFCs will give banks an edge. "Banks have a diversified business and, therefore, are better equipped to absorb losses from fall in the value of gold against which the loan has been given," says Satkam Divya.

However, there is one disadvantage of taking gold loans from banks-the total amount you can get is much less. For instance, Muthoot Finance and Manappuram Finance offer loans up to Rs 1 crore, while Muthoot Fincorp has no limit. HDFC Bank and ICICI Bank give a maximum of Rs 10 lakh and Rs 15 lakh, respectively. Federal Bank offers loans up to Rs 75 lakh.

GOLD Vs. PERSONAL LOAN

The eligibility criteria and the due diligence for personal loans are much stricter because they are unsecured. In case of default, the lender does not have the option of selling the borrower's assets. Interest rates on personal loans vary from 16 per cent to 24 per cent, excluding the processing fee, which is 1.5-2.5 per cent of the loan amount. The loan amount depends on income. The limit is Rs 15-20 lakh depending on income and credit history. For salaried people availing of personal loan from ICICI Bank, the net monthly salary has to be at least Rs 20,000, while for taking a loan from HDFC Bank, the monthly salary has to be at least Rs 15,000. Then there are pre-payment charges that could be as high as 5 per cent of the outstanding loan amount. Unlike in gold loans, both interest and principal have to be paid in monthly instalments.

"Personal loans are the costliest form of credit after credit cards," says Rakish Goyal, senior vice-president, Bonanza Portfolio.

TABLE 1

A comparison of gold and personal loans

Features	Gold loan from NBFCs	Gold loan from banks	Personal loans
Security	Secured	Secured	Unsecured
Processing fee	Nil	As applicable	As applicable
Proof of salary/income	Not required	Not required	Required
Maximum loan amount	Up to Rs 1 crore	Rs 10-15 lakh	Up to Rs 20 lakh
Tenure	6-36 months	1 year	Up to 5 years
Prepayment options	Only interest servicing during loan tenure	Both interest + principal	Both interest + principal
Prepayment charges	Mostly nil	As applicable	As applicable
Loan-to-value	60%	80-90%	Not applicable
Interest rates	20-27%	14-17%	16-25%

TABLE 2

NBFCs and banks head-to-head on gold loan parameters

Banks/NBFC	Maximum loan	LTV	Interest rate	Tenure
Muthoot Finance	Up to Rs 50 lakh	Up to 60%	12-27%	NA
Mannapuram	Up to Rs 1cr	Up to 60%	26%	1 yr
Muthoot Fincorp	No ceiling	Up to 60%	24-27%	3 yrs
HDFC Bank	Rs 10 lakh	Up to 100%	NA	2 yrs
ICICI Bank	Rs 15 lakh	NA	16%	1 yr
Federal Bank	Rs 75 lakh	Up to 80%	15.65%	1 yr
Union Bank of India	Up to Rs 5 lakh	Up to 80%	NA	NA
PNB	Up to Rs 2 lakh#	NA	14.75%	1 yr
Bank of Baroda	Up to Rs 2 lakh	Up to 25%	14.75%	NA

THE FINAL CALL

Gold loans offered by NBFCs are hassle-free, easy to take and require little documentation. They have easier repayment options and no processing fee, though the rates are higher than bank gold loans or personal loans. Those who cannot fulfil the strict eligibility and documentation criteria of banks can tap this avenue. Those who have good credit history, the required documents and are in mid- to high-income categories should look for options available with banks.

CHARGES AND OTHER STRINGS ATTACHED

Most banks charge a processing fee of 1-2 per cent of the loan value. ICICI Bank charges 1 per cent while HDFC Bank charges 1.5 per cent. NBFCs like Manappuram Finance, Muthoot Finance and Reliance Commercial Finance do not charge any processing fee.

Banks also charge a fee for valuing gold. NBFCs do not charge anything for this. Banks usually restrict funds' end use. Some offer loans only for agriculture. HDFC Bank's eligibility column has a note that says "the loan amount cannot be used for speculative activities, any purpose linked to capital market activities or for any anti-social purposes." Bank of Baroda mentions that the loan will be disbursed for "working capital requirement and/or purchase of equipment for development of shops.

GOLD NBFCs OFFER POTENTIAL BORROWERS SUPERIOR ADVANTAGES IN TERMS OF COST AND SECURITY

The commendable growth of major gold loan non-banking financial companies (NBFC) in India has attracted a lot of attention recently. Some comments have even hinted at the customers being poor victims fleeced by these companies out to make a quick profit.But the extraordinary growth in their business also means that despite other institutional options, individuals who require money urgently, and possess some gold, show a marked preference for the service of the gold loan NBFCs.

At the same time, no one can accuse the gold loan companies of being monopolists with sufficient coercive power to make people choose them over other options. Gold loan NBFCs, obviously then, meet a vital need in the market in a way superior to other players.

SO WHAT IS IT THAT MAKES THEM SUPERIOR?

1. CREDIBILITY AND CREDENTIALS

While availing a gold loan, customers must temporarily part with the family jewels which are precious to them beyond mere monetary value. They would rather entrust these to a lender who can be trusted to keep them secure and return these when required, intact and undamaged.

The large gold loan NBFCs are almost like banks and are well-governed, with established policies and procedures. Their branches have sufficient security measures such as strong rooms, CCTV cameras, guards and also specific procedures regarding access, in order to ensure safety of the collateral. Besides, they insure the gold against theft and other unforeseen events. Audits and inspections guarantee the continued integrity of the holdings. Handling and storage is also done carefully, so as to not damage the ornaments.

Apart from these, the reputation of the lenders and transparent institutionalised procedures followed by them assures borrowers of a fair deal. The major gold NBFCs have in place proper **KYC (know your customer)** as well **as Fair Practice Codes**. In cases of recovery, too, borrowers are given notice and a chance to redeem the gold or keep their auction in abeyance through payment of interest, as in any bank.

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.

2. CONVENIENCE AND COMFORT

Convenience is another important aspect that influences a borrower when he thinks of taking a loan against gold. For obvious reasons, he/she would not desire to commute long distances with the gold or cash in their possession. Since most locations are covered by gold loan NBFCs, the potential borrower can find a branch nearby with ease.

Moreover, since the borrowers mostly require small loans against a collateral that is universally acceptable as quickly as possible, and the NBFCs are specialised institutions with employees highly experienced in the assessment and disbursal of gold loans, they can obtain these much faster than at other lenders. Some vestiges of the disrepute normally attached to gold loans still clings to the product.

A posh bank environment, where many high net worth customers would be around, does not put a gold loan borrower at ease. However, in the specialised environment of a gold loan NBFC, he is assured of being comfortable and at ease as the primary customer and concern of the lender.

3. CLOSENESS, CONFIDENCE, COST

Many gold loan NBFCs recruit at least some of their employees in each branch locally. Transfers are not too frequent and the branch ambience suits the locality as well. This ensures that the borrower enjoys the benefits of familiarity, besides the service of employees fluent in the local language and customs. That makes it easier for him/her to interact and clear their doubts.

The gold loan NBFC, ultimately, has only one business: Making loans against gold. That is its bread and butter. The potential gold loan customer can, therefore, be confident about being given quality service by trained and customer-centric employees. They can also be assured of the confidentiality of dealings.

Banks, by virtue of being the custodians of savings and current account deposits as well as float funds from remittances and clearing, have a considerable volume of low-cost money at their disposal. This keeps their cost of funds low. In addition, they are eligible for interest subvention on account of certain categories of priority sector advances. All these enable them to extend gold loans at relatively low interest rates.

Since gold loan NBFCs raise their funds through various other means, for which they have to pay a higher price, and gold loan making, which is labour-intensive, is their main business, they have to charge a higher rate to run a profitable business and ensure returns for all stakeholders.

Customers who approach gold loan NBFCs are aware of this higher cost. They are additionally aware that gold loans through NBFCs also require the necessary KYC documentation. Yet, many borrowers are willing to approach the NBFC in preference to banks. There are reasons for that.

Banks charge processing fees and also jewel appraisers' fee. Since appraising is done by a professional appraiser, the loans can also be extended only when he is available. Besides, for a bank, gold loan is only one among its many businesses.

Till recently, it was not a preferred mode of lending in view of the various difficulties involved – including the high security and care required in the preservation of the collateral.

When a borrower approaches a lender, he calculates the costs not only in terms of interest, but also in terms of all the elements listed above. Many borrowers from gold NBFCs are migrants from pawnbrokers. For them, the rates charged by the NBFCs are considerably lower. The others that come weigh all the benefits of the NBFC experience against that at a busy bank branch.

They, quite naturally then, opt for the NBFCs.

CONCLUSION

To summarize, RBI guidelines might moderate the growth and impact the profitability of gold loan NBFCs in short term. In the long term, however, they are expected to enhance the gold loan NBFCs' ability to assimilate the impact of any sharp decline in gold prices, thereby improving the sector's asset quality. These guidelines should not only strengthen the well-capitalized established business players but also help regulate new players which lack the experience or the necessary understanding of the business, making the gold loan market more mature.

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