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The Gold (Metal) Loan

The Gold (Metal) Loan, (GML) is the financial arm through which the gold accumulated under the Gold Monetisation Scheme, (GMS), is profitably used by banks. Banks may also lease gold from international suppliers to provide GML to domestic borrowers, which is the avenue that most private banks adopt. Irrespective of how a bank obtains the gold, the net result is that the GML is made available to borrowers by banks on a 'for profit' basis.

Compared to regular Working Capital Limits, (WCL), that are available at 12-14% per annum, the GML offers inventory financing at 3-4% per annum which is extremely attractive. But, in its current avatar, as any borrower would confirm, the GML is not a stable financial product due to a host of reasons that need to be addressed. It may be prudent to point out that till the GML is not reviewed and reintroduced as a robust financial product as one that is acceptable by borrowers, the Gold Monetisation Scheme shall continue to have subdued success.

A less known fact is that the GML contract articulates that the borrowing/lending shall happen in terms of gold itself. That is, the bank is giving gold to the borrower and the borrower must return gold itself to the bank. As gold may only be imported into the country through a RBI Nominated Agency, (most banks are RBI Nominated Agencies), the borrower simply enables the bank by giving it the equivalent money to import gold on their behalf and, with the imported gold, to settle the Gold Contract, (GC), of the GML.

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As such, WCL bank limits are denominated in INR terms and the GML is sanctioned as a sub-limit of the sanctioned WCL. Based on the prevailing market price of gold, the borrower is permitted to 'draw-down' the equivalent quantity of gold. This quantity of gold is, however, subject to any fluctuations in the market price of gold. While any downswing of gold prices entitles the borrower to a higher quantity of gold, any increase in the gold prices results in the bank placing a margin call on the borrower. This is based on the premise that the borrower must remain within the confines of the sanctioned INR amount. The borrower, thus, either injects new capital into the business or simply reduces the quantity of inventory to meet the margin call made by the bank. More often than not, margin calls are fulfilled by reducing the level of inventory and this is where the problem starts for the borrower as well as for the bank.

As mentioned earlier, the GML is a financial product that is used for inventory financing. No business enterprise can possibly be successful if it is unable to have stability in its inventory levels. Moreover, the gold jewellery business is primarily works on an OPEX model, (operating expenditure), wherein the majority of the money required is for inventory. Presuming that a showroom is acquired on lease for which inventory is obtained through a GML, meeting a margin call would result in the closure of the showroom, as the quantity of gold would need to be reduced. This is one of the major reasons for borrowers to shy away from the GML.

The solution lies in going back to understanding the nature of the GML and to evaluate it from with a fresh perspective. If the product deposited, lent and returned is in terms of gold, then why can banks not sanction the GML limits in the weight of gold? Moreover, when banks sanction foreign currency limits in terms of the foreign exchange itself, where there are no margin calls due to volatility of exchange rates, surely they can replicate the same for Gold (Metal) Loan borrowers. This would introduce stability in the inventory levels of the borrower and it would make the GML a desirable financial product, from the perspective of the borrower.

From the perspective of the bank, any increase in gold prices would translate into an increase in the contingent liability of the borrower. Such an increase in liability would also dilute the percentage of collateral securities that the bank would have obtained at the time of sanctioning the credit limits. But this would hold true in the case of foreign currency loans too. Furthermore, as the borrower has no role play in the market prices of gold, banks must recognise the importance of stable inventory levels for any business enterprise. Thus, it is imperative that the GML be sanctioned in the weight of gold, thus removing the entire concept of margin calls based on the gold rate fluctuations.

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Additionally, at the time of closure of the Gold Contract, (GC), banks should be prohibited to charge any profit for the import of gold. Thus, the borrower would be charged by the bank the same amount that is charged by the international supplier of gold to the bank. This is because bullion merchants that import gold by paying upfront are charged little or no premium on the rates charged by the international supplier. The gold rate is based on this price, which makes it vital for borrowers of GML to be charged the same rate, as any higher price would result in the gold being more expensive for the GML borrower. It is important to note that the contribution to the bank's profit from such activity is negligible, but the impact that it would have for the individual borrower would be immense.

One of the most troublesome issue regarding the GML is the availability of gold itself. The GML is based on gold and any interruption in the supply of gold results in the sanctioned GML limits being converted forcibly to the higher interest bearing INR denominated Working Capital Limits, (WCL). This is not a very complicated issue and the resolution of this is relatively easy, but the past few years has seen many occasions where banks were unable to provide gold under the GML. Unfortunately, most times this was due to the RBI not granting permission to the bank to do so, which further highlights the poor understanding of the GML as a financial product. Sum it up to say that the RBI, MOF and the banks need to guarantee that borrowers of the GML shall be provided with gold under the GML to ensure no unnecessary financial duress due to forcible shifting of limits to WCL.

As prescribed by the RBI, the GML is available for a tenor of up to 180 days, after which the GC must be settled. The borrower usually closes the GC within the prescribed 180 period and, on the same day of closure, obtains a fresh GC of the same quantity of gold, which is made available by the bank through importing the same. Needless to say, this increases the imports of gold unnecessarily and this can very easily be stopped by simply increasing the tenor of the GML.

A number of meetings have been held at the RBI and the MOF to deliberate on the extension of the tenor of the GML, all of which have failed in increasing the tenor. Sadly, the reason attributed is that doing so would “negatively impact trade cycles”, which is absolutely incorrect.

Without elaborating on the debate of trade cycles, there is yet another solution that may be implemented to curtail the needless import of gold. Upon the completion of the tenor of 180 days, banks should merely roll over the GML on ‘paper’, with no need to close the GC and to provide gold for the new GC. Permitting this would address the trade cycle argument, yet at the same time, increase the tenor of the GML. It may be worthwhile noting that a few banks only offer the GML for a period of 90 days and ‘roll it over’ for the next 90 days, (which is what is being suggested here). So, if they can do it for 90 days, why not after 180? Do remember that all sanctioned WCL and GML need to

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be reviewed and renewed annually, which is also done on ‘paper’ and without the borrower returning the money at the end of the year, and then taking it again from the bank.

Apart from being the lending arm of banks for the gold accumulated under the GMS, the Government of India should consider using the abnormally low interest rate of the GML as an incentive to boost tax compliances and the reporting of financial transactions.

The fact that the GML is available at an interest rate of 3-4% per annum should be highlighted and advertised. Obviously, qualifying for the GML is based on financial documents and through a thorough evaluation by banks. As such, this would necessitate the reporting of financial transactions, which has been a focus area of the Government. Therefore the low interest rate of the GML could be leveraged to increase reporting of financial transactions, thereby increasing tax compliances.

This sector is one that has seen little financial support from banks, largely due to an incorrect perception of this industry. The GMS was launched in 2015 and continues to have a muted response for a number of reasons.

One of the main ones is that a bank that had taken a deposit of 1.3 tonnes has not been able to lend out the gold accumulated till date! The GML offers many solutions to many problems such a successful GMS, upliftment of MSMEs through an extraordinarily cheap financial product, increase in tax compliance and many more.

All that is needed is an initiator, which is what the Watal Committee Report, “Transforming India’s Gold Market” has been. It is now up to the industry members to push for the implementing of its recommendations. ■

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