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AN OVERVIEW ON GOLD LOAN BUSINESS OF NBFCs

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Abstract

Gold loan is a secured loan in which the borrowers pledge their gold ornaments and in turn get money on the basis of value of gold pledge. The loan amount is disbursed by either banking or non-banking institutions. This article gives detailed account on process of obtaining gold loan, key features and importance of gold loan and other details regarding gold loan borrowing.

Key Words

Gold loan, borrowing, banking, non-banking institutions.

A gold loan, also known as a loan against gold, is a secured loan where the borrower pledges their gold ornaments, ranging from 18 to 24 carats based on the policy framework of lending institutions and controller (Reserve Bank of India) guidelines, as collateral to the lender. The loan amount disbursed is typically by Banks and Non-Banking Finance Companies are should maintain a Loan to Value (LTV) ratio of 75 per cent on the outstanding amount of loan including the interest on an ongoing basis, failing which the loan will be treated as a Non Performing Asset (NPA) depending on the gold's quality**.** This type of loan allows borrowers to access funds using their gold as security, with the amount received directly linked to the value of the pledged gold.

Normally, banks and NBFCs do not provide loans against primary forms of gold, such as gold coins or bars. A gold loan business involves lending money to individual borrowers using gold jewellery as collateral for short-term loans, typically less than one year. This type of lending is prevalent in many countries, particularly in regions where gold is culturally significant and widely owned.

Detailed Process of Obtaining a Gold Loan

Customer Inquiry and on boarding

- The process begins when a customer expresses interest in obtaining a loan against their gold.
- The customer may visit a gold loan provider's branch office or apply online.
- The customer provides personal details, the desired loan amount, and information about the gold they intend to pledge as collateral.

Gold Valuation and KYC verification

- Upon receiving the loan application, the gold loan provider assesses the value of the gold offered as collateral.
- The valuation is based on factors such as the purity of the gold, its weight, and prevailing market rates. As a standardization measure for valuation, the RBI has instructed RRBs and NBFCs to convert the purity of lower-purity gold ornaments to a 22-carat standard.[3]
- Trained personnel appraises the gold using calibrated weighing scales and purity testing methods.

Loan Approval and Documentation

- Once the gold valuation is completed and meets the lender's criteria, the loan is approved.
- The borrower completes necessary documentation, including loan agreements, pledge forms, and other legal documents.
- The terms and conditions of the loan, including interest rates, repayment schedule, and any additional fees, are clearly outlined in the agreement.

Loan Agreement

- A loan agreement is drafted, clearly stating the loan amount, interest rate, repayment terms, tenure, processing charges, and penalties (if applicable).
- The borrower signs the agreement, confirming their consent to the terms.

Disbursement of Funds

- After completing the documentation process, the loan amount is disbursed to the borrower.
- The borrower may receive the funds in cash, through a bank transfer, or as a demand draft, depending on the lender's policies and the borrower's preference.
- Gold loan in cash restricted to NBFC up to ₹ 20,000/- per borrower. [4] Instead, they should be disbursed through bank transfers, checks, or UPI. This threshold aligns with broader guidelines aimed at curbing cash transactions and promoting digital transactions, making it easier to track funds and reduce money laundering risks.

Safe-keeping of Gold

Gold collateral must be stored in high-security vaults within the NBFC's branch premises or in an approved secure location, such as a centralized vault. These storage areas are typically equipped with surveillance systems, alarms, and restricted access controls to prevent unauthorized access.

- The gold provided as collateral is securely stored by the lender throughout the loan tenure. NBFCs are required to insure pledged gold against risks like theft, fire, or other forms of loss or damage. This insurance policy should cover the full value of the gold stored.
- Most gold loan providers have robust security measures in place to safeguard the pledged gold against theft, damage, or loss. A dual custody arrangement, where two employees are required to access the gold vault, is commonly used to reduce fraud risk and provide accountability.

Repayment of Loan

- The borrower is required to repay the loan amount within the agreed-upon tenure, typically ranging from a few months to a few years.

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- Repayment can be made in the form of periodic instalments or as a lump sum at the end of the loan term.
- NBFCs have developed or leased or purchased a digital platforms for easy repayment through mobile apps, internet banking, or digital wallets. This permitted the borrowers to service principle, interest or part payment without visiting the branch.
- Failure to repay the loan within the specified period may result in the forfeiture of the pledged gold.

Closure of Loan and Release of Gold

- Once the borrower repays the loan in full, including any accrued interest and fees, the loan is considered closed, and the pledged gold is returned to the borrower.
- The lender updates its records accordingly and provides the borrower with a release certificate or acknowledgment of closure.

Gold Loan NBFCs: Key Features and Importance

Definition and Classification

- **Gold Loan NBFCs:** Non-Banking Financial Companies (NBFCs) whose principal business involves lending against the security of gold are categorized as Gold Loan NBFCs.
- **Business Criteria:** For an NBFC to be classified as a Gold Loan NBFC, loans against gold must constitute 50 per cent or more of its total business. [5]
- **Incorporation and Regulation:** These NBFCs are incorporated under the Companies Act, 1956, and operate under the guidelines of the Reserve Bank of India (RBI).

Context and Need:

- **Idle Domestic Gold Stock:** India holds a massive stock of domestic gold, much of which remains idle in safe lockers or personal custody.
- **Government Initiatives:** The Government of India introduced a gold bond scheme to utilize this underutilized gold, but it has seen only nominal conversion rates, failing to channel idle gold into productive use. The government has promoted SGBs to encourage financial gold holdings, with incentives such as interest payments and tax benefits. However, adoption remains limited due to strong cultural preferences for physical gold

Scope of Gold Loan NBFCs

- **Utilization of Idle Gold:** Gold Loan NBFCs play a crucial role in making use of idle gold by providing a productive channel for it.
- **Short-Term Financial Needs:** These NBFCs cater to a diverse range of borrowers, including:
  - Common household individuals
  - Entrepreneurs
  - Businesspeople
  - Real estate investors
  - Salaried employees
  - Daily workers
  - Shop keepers and vendors etc.

- **Sources of Pledged Gold**: The gold pledged by borrowers is often purchased from their savings or received as gifts on special occasions such as weddings, festivals, birthdays, or anniversaries. Additionally, gold is frequently passed down through generations as family heirlooms, symbolizing wealth and tradition, though it otherwise remains unproductive.

Advantages of Gold Loans

The gold loan business provides individuals with access to quick and hassle-free financing by leveraging their gold assets as collateral. However, borrowers should carefully consider the terms and conditions of the loan, including interest rates and repayment terms, before entering into a gold loan agreement. Proper understanding and planning can help borrowers avoid potential financial pitfalls and make the most of their gold assets. The major benefits of gold loan detailed as below:

1. **Immediate Disbursement and Quick Processing**: Gold loans, being a secured form of loan, offer the advantage of immediate fund disbursement. Banks may take a few hours to process and disburse the loan amount, while NBFCs can often complete the process in just a few minutes. This makes gold loans an excellent source of immediate capital for both individuals and businesses.
2. **No Guarantor or External Collateral Required:** Gold loans are typically processed based solely on the value of the gold collateral provided by the borrower. Therefore, there is no need for additional security or a guarantor, except for the compliance with proper Know Your Customer (KYC) norms.
3. **High Loan-to-Value Ratio**: Both banks and Non-Banking Financial Companies (NBFCs) generally offer a high loan-to-value (LTV) ratio for gold loans. This means that borrowers can obtain a significant percentage of their gold's market value as a loan. Typically, the LTV ratio ranges up to 75 per cent . This feature provides substantial financial leverage and makes gold loans a preferred choice for individuals seeking quick and substantial funding.
4. **Low Rates of Interest:** Compared to personal loans or other unsecured loans, gold loans often come with lower interest rates, making them a more affordable borrowing option for individuals and businesses.
5. **No Credit Score Requirement:** Although banks and NBFCs are required to upload loan details to credit agencies, gold loans do not place as much emphasis on the borrower’s credit score since the loan is secured by gold. This makes gold loans accessible to a broader range of people, including those with low or no credit scores.
6. **No Restriction on End Usage:** Borrowers can use the funds from gold loans for any permitted activities, including but not limited to business promotion, agriculture, education, construction, seasonal requirements, functional needs, and any other immediate financial needs. There are typically no restrictions on how the loan amount can be utilized, providing flexibility to borrowers. However, in its latest instructions, the RBI has directed NBFCs and RRBs to monitor the end use of gold loans. [6]
7. **Flexible Repayment Options:** Many lenders offer flexible repayment options for gold loans, including weekly payments, equated monthly instalments (EMIs), bullet payments,

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or partial payments based on the borrower's fund availability. One attractive feature of gold loans is the option to pay only the interest throughout the loan period, keeping the loan as standard, with the principal amount due at the end of the loan term.

8. **Minimal Documentation:** Gold loans typically require minimal documentation, often including valid Know Your Customer (KYC) documents along with a loan application form. This simplicity in documentation makes the application process straight-forward and quicker for borrowers.
9. **Retains Ownership of Gold:** A significant advantage of gold loans is that borrowers retain ownership of their gold, provided they adhere to the loan repayment terms. The pledged gold is returned to the borrower upon full repayment of the loan, including any accrued interest and fees. The borrower must repay the loan amount according to the agreed-upon contract terms to regain possession of their gold. Unlike selling gold for immediate funds, a gold loan allows the borrower to leverage their asset without relinquishing ownership.
10. **Short-Term Borrowing Solution**: Gold loans are ideal for short-term capital needs and can be repaid quickly without long-term financial commitments.
11. **Insurance Coverage:** Lenders typically provide insurance coverage for the gold ornaments pledged with them, ensuring the safekeeping of assets. This gives borrowers peace of mind regarding the security of their pledged gold.

These benefits make gold loans a convenient and efficient way to secure immediate capital for urgent financial requirements compared to other type of loans.

Role in Financial Inclusion

- **Bridging Credit Gaps:** Gold Loan NBFCs fill the gap in short-term credit arrangements, which can be difficult to secure from traditional banks.
- **Accessibility:** These NBFCs provide accessible and convenient financial solutions, especially for those who may not have access to formal banking channels.

Gold Loan NBFCs are essential financial institutions that leverage the substantial stock of idle gold in India. By offering loans against gold with quick processing, minimal documentation, and flexible terms, they cater to the short-term financial needs of a wide range of borrowers. These NBFCs not only make productive use of idle gold but also bridge critical gaps in short-term credit availability, contributing significantly to financial inclusion and economic activity.

Growth in the Assets under Management (AUM) of Gold-Loan NBFCs

The growth in the assets under management (AUM) of gold-loan Non-Banking Financial Companies (NBFCs) has been driven by three key factors:

1. **Customer Retention**: Gold-loan NBFCs have demonstrated an ability to hold on to their customers, as evidenced by a steady customer base. This loyalty is crucial for sustained growth and stability.
2. **Focus on Small and Mid-Size Loans**: By concentrating on small and mid-size loans, gold-loan NBFCs cater to a broad segment of the population, ensuring a diverse portfolio and mitigating risks associated with large, single-borrower loans.

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3. **Expanding Branch Networks**: Increasing their reach by expanding branch networks has enabled gold-loan NBFCs to tap into new markets and customer segments, further driving growth.

These trends have resulted in the market share of gold-loan NBFCs remaining resilient at over 60 per cent between March 2021 and September 2023, despite strong competition from banks. [8]

Working of Gold loan NBFCs

Gold loan NBFCs can be structured as limited liability companies or private limited companies registered and regulated by the Reserve Bank of India (RBI). These companies must comply with RBI guidelines for lending against gold ornaments and submit periodic returns to the RBI, including reports on Non-Performing Assets (NPA) trends.

Regulators Overview

1. **Reserve Bank of India (RBI):** The primary regulator for gold loan NBFCs, setting guidelines for operations, lending practices, and ensuring financial stability.
2. **Securities and Exchange Board of India (SEBI):** Regulates issues related to debentures and other securities.
3. **Insurance Regulatory and Development Authority of India (IRDAI):** Oversees any insurance products that may be offered by gold loan NBFCs to cover pledged gold ornaments.
4. **Ministry of Corporate Affairs (MCA):** Regulates the incorporation, compliance, and governance of companies.

Gold loan NBFCs operate within this regulatory framework to ensure compliance, transparency, and the protection of customer's interests.

Working time

Gold loan NBFCs typically provide customer service for more than eight hours a day. The opening and closing time of branches are determined by several factors, including:

1. **Risk associated with extended working time:** Considering security concerns, especially when dealing with high-value items like gold, NBFCs ensure that the branches are open during safe hours.
2. **Floating population:** Branch hours are aligned with peak times, when more customers are likely to visit, ensuring maximum accessibility and convenience.
3. **Competitor and shop timings:** Aligning with the operating hours of competitors and nearby shops can help in attracting more customers by providing convenient timings.
4. **Weather conditions:** In regions with extreme weather conditions, branch timings may be adjusted to ensure the safety and comfort of both customers and staff.

By considering these factors, gold loan NBFCs aim to optimize their operational hours to provide the best possible service to their customers while maintaining security and efficiency.

Branch Operations

The parent NBFC ensures adequate employee strength at each branch, considering both business potential and security aspects. Typically, a branch has the following structure:

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1. **Branch In Charge and Assistant Branch In Charge**: These individuals are primarily responsible for the custody and management of valuables within the branch. They oversee daily operations, customer service, and compliance with regulatory guidelines.
2. **Dual Custody of Strong Room/Vault Room Keys**: To enhance security, most NBFCs insist on dual custody of keys to the strong room or vault room. This means that both the Branch In Charge and the Assistant Branch In Charge hold separate keys.
3. **Joint Operations of Strong Room/Vault**: Any operation involving the strong room or vault, such as accessing or securing valuables, requires the presence and cooperation of both custodians. This joint custody system ensures a higher level of security and accountability, reducing the risk of unauthorized access or mishandling of valuables.

By implementing these measures, gold loan NBFCs can maintain high security standards and ensure the safe custody of customer's pledged gold articles.

Marketing method and Customer on boarding

The main beneficiaries of gold loan NBFCs are individuals in the middle and lower economic segments. These NBFCs attract borrowers through various marketing activities and referrals from existing customers. Compared to commercial banks, gold loan NBFCs have more relaxed customer on-boarding rules, provided the gold quality is good and valid KYC documents are presented. As per RBI guidelines, company officials must verify the ownership of the pledged gold ornaments. Each customer is assigned a unique Customer Identification Number for future reference.

Main Marketing Methods for On boarding New Customers

a. Advertisement through Visual Media

- **Television and Cinema:** These are the primary visual media for advertisements, offering wide reach. However, the high cost of these advertisements is often likely to be prohibitive for small and medium-sized NBFCs.

b. Advertisement through Print Media

- **Newspapers, Magazines, Weekly Publications:** These offer broad reach and are more cost-effective than visual media. Yet, for NBFCs with marginal profits, even these costs can be high, pushing them to consider other methods.

c. Advertisement through Social Media

- **Innovative and Cost-Effective:** With the rise of social media, many NBFCs have opened new pages and sponsored various programs based on subscriber numbers. This method is widely accepted and relatively low-cost, making it popular among NBFCs.

d. Other Methods

- **Pamphlet Distribution, Wall Painting, Vehicle Advertisements, Hoardings, Brochures:** These traditional methods are often used by NBFCs to maximize their advertising budget effectively. They are particularly useful in the early stages of an NBFC's growth for customer on boarding.
- **Radio Announcements and Jingles (FM/AM):** This method provides a localized reach and is cost-effective.

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- **Cross-Selling and Upselling:** NBFCs also use these strategies to promote additional products to their existing customer.

Customer on boarding

1. **Target audience:** Middle and lower economic segments.
2. **Easier than banks:** Quality of gold and valid KYC documents are crucial.
3. **Unique Identification:** Each customer gets a unique ID for future reference.
4. **Marketing Strategy:** Mix of high-cost, broad-reach strategies (like visual media) and cost-effective, localized methods (like social media and pamphlets).

By understanding these marketing strategies and customer on boarding processes, gold loan NBFCs can effectively reach and serve their target audience, ensuring growth and customer satisfaction.

Valuation of the ornaments and fixing the loan amount.

Gold loan NBFCs place a significant emphasis on accurately valuing the gold ornaments to determine the loan amount. Here's an overview of the process:

1. Gold Appraisal Training

- **On-Job Training:** Employees receive comprehensive on-the-job training in gold appraisal to ensure accurate valuation.
- **Skill Development:** The training includes techniques for assessing the purity and quality of gold, using standard industry methods and tools.

2. Purity Check

- **Purity Assessment:** Employees check the purity of the gold ornaments. The purity is typically measured in carats, with 22 carats being a common standard for high-quality gold ornaments.
- **Tools and Techniques:** Various tools and techniques, such as touchstone testing, acid tests, and electronic gold testers are used to determine the carat value of the gold.

3. Loan to Value (LTV) Calculation

- **LTV Ratio:** The Loan to Value (LTV) ratio is a crucial factor in determining the loan amount. It represents the percentage of the gold's market value that can be lent to the borrower. NBFCs are directed to provide up to 75 per cent of the closing price of 22 carat gold for preceding thirty-day average gold price published by the Indian Bullion and Jewellers Association. [7]
- **Carat-Based Deduction:** Based on the carat value, appropriate deductions are applied to the LTV ratio. For example, 22-carat gold typically qualifies for a higher LTV percentage, potentially up to 100 per cent . To standardize valuation and ensure transparency for borrowers, gold ornaments and jewellery accepted as security or collateral will be valued at the average closing price of 22-carat gold over the preceding 30 days, as quoted by the India Bullion and Jewellers Association Ltd. (formerly known as the Bombay Bullion Association Ltd.). If the gold is of purity less than 22 carats, the bank should convert the collateral into 22 carat and value it based on the exact grams. In other words, jewellery with lower purity will be valued proportionately. [9]

Interest rate fixation.

Each companies will have a loan policy and interest rate policy approved by the board of directors. The interest rate will be fixed based on the risk involved, amount of loan sanctioned, tenure of loan and cost of fund. In recent years the rates are influenced by the lending rate of banks and other competitors of the company.

There is no interest cap fixed by RBI but it is instructed to show the details of annualized interest charged from a customer in the loan agreement.

Repayment of Loans

The company demands the interest and principle amount only at the time of end of loan tenure. As a measure of customer service, companies are allowing part payment and part release of the security, if the customer is not having the full repayment amount before the tenure. The bullet payment option is the main advantage of the gold loan. Equated monthly instalment schemes are also provided by the NBFCs.

Classification of Loans

Asset Classification and Special Mention Accounts (SMA) for NBFCs

Non-Banking Financial Companies (NBFCs) are required to recognize early signs of stress in loan accounts promptly upon default. This is achieved by classifying such assets as Special Mention Accounts (SMA) based on the duration for which the principal or interest payments are overdue. The classification criteria are as follows. [10]

Special Mention Accounts (SMA) Classification

- SMA-0: Overdue up to 30 days
- SMA-1: Overdue for more than 30 days and up to 60 days
- SMA-2: Overdue for more than 60 days and up to 180 days

The instructions for SMA classification are applicable to all loan types, including retail loans, irrespective of the size of the exposure of the lending institution.

Regulatory Controls Imposed on NBFCs by the Reserve Bank of India (RBI)

The Reserve Bank of India (RBI) imposes several regulatory controls on Non-Banking Financial Companies (NBFCs) to ensure their soundness, stability, and compliance with the broader financial system's integrity. These controls cover various aspects including registration, capital requirements, asset classification, prudential norms, governance, and transparency. Here are the key regulatory controls:

Registration and Licensing

- **Mandatory Registration:** All NBFCs must register with the RBI to commence or carry on business. They must obtain a Certificate of Registration (CoR) from the RBI.
- **Minimum Net Owned Fund:** NBFCs are required to maintain a minimum net owned fund of ₹2 crore (₹5 crore for NBFCs engaged in specific activities).

Capital Adequacy Requirements

- **Capital to Risk-Weighted Assets Ratio (CRAR):** NBFCs must maintain a minimum CRAR to absorb potential losses. The current requirement is typically 15 per cent , although it may vary for different types of NBFCs.

- **Tier-I and Tier-II Capital:** NBFCs must ensure adequate Tier-I (core) and Tier-II (supplementary) capital to meet the required CRAR. [12]

Asset Classification and Provisioning Norms

- **Standard Assets:** Provisioning of 0.25 per cent to 0.40 per cent on standard assets.
- **Non-Performing Assets (NPAs):** Classification and provisioning norms for sub-standard, doubtful, and loss assets.
- **Special Mention Accounts (SMA):** Classification of assets as SMA-0, SMA-1, and SMA-2 based on the duration of overdue payments.

Prudential Norms

- **Exposure Norms:** Limits on credit exposure to single and group borrowers to mitigate concentration risk.
- **Related Party Transactions:** Stringent guidelines on transactions with related parties to prevent conflicts of interest and ensure transparency.
- **Asset-Liability Management (ALM):** Requirements for effective ALM practices, including liquidity risk management.

Governance and Risk Management

- **Corporate Governance:** Guidelines on the composition of the board, appointment of independent directors, and functioning of various board committees.
- **Risk Management Framework:** NBFCs must implement robust risk management practices, including credit risk, market risk, and operational risk management.

Transparency and Disclosures

- **Periodic Reporting:** Mandatory submission of periodic financial statements, returns, and other information to the RBI.
- **Disclosures:** Requirements for public disclosures related to financial performance, risk exposures, and governance practices.

Regulatory Framework for Different Layers

- **Base Layer (NBFC-BL):** NBFCs with an asset size below ₹1000 crore and those involved in specific activities like peer-to-peer lending and account aggregation.
- **Middle Layer (NBFC-ML):** Larger NBFCs with stricter regulatory requirements.
- **Upper Layer (NBFC-UL):** Systemically important NBFCs with more rigorous controls.
- **Top Layer (NBFC-TL):** Ideally expected to be empty, reserved for NBFCs posing extreme systemic risks.

Sector-Specific Regulations

- **Gold Loan NBFCs:** Specific guidelines on lending against gold, including loan-to-value (LTV) ratios and risk management.
- **Infrastructure Finance Companies (IFCs):** Regulations for NBFCs financing infrastructure projects, including capital and exposure norms.

Financial Inclusion and Consumer Protection

- **Microfinance Institutions (MFIs):** Regulations for NBFC-MFIs to ensure responsible lending, interest rate caps, and borrower protection.

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- **Grievance Redressal Mechanism:** NBFCs must establish effective mechanisms to address customer complaints and disputes.

The RBI imposes comprehensive regulatory controls on NBFCs to ensure their stability, transparency, and compliance with the financial system's integrity. These controls encompass registration, capital adequacy, asset classification, prudential norms, governance, transparency, and specific regulations for different layers and sectors within the NBFC landscape. These measures aim to safeguard the interests of depositors and borrowers while promoting the overall health of the financial system.

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