Update

New Restrictions on NBFCs: Lending Against Gold & Branching

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The Reserve Bank of India (RBI) had set up a working group to study the lurking issues relating to NBFC's model of extending loans for gold as collateral. The working group submitted its report earlier this year in February, 2013[1]. The apex bank after duly considering the recommendations of the working group came up with a fresh set of guidelines for such a lending model vide its notification[2]dated September 16th, 2013.

Why these guidelines?

The current practices of extending gold loans by NBFCs and the systemic and inherent risks involved in such loans compelled RBI to review its guidelines prescribed for the same. The working group after having analyzed the scenario asserted the following as some of the reasons:

- ***Inadequate Infrastructure***: It was observed that repective branches of most of the NBFCs did not have adequate infrastructure for storage of gold. Consequently gold from such branches had to be moved to branches where proper deposit vaults existed, thereby imperilling its safety.
- ***Limited/ Low Restrictions***: NBFCs went into massive expansion by opening large number of branches as the restrictions pertaining to number of branches and seeking approvals for the such expansion were limited or non-available.
- ***Poor Documentation Practises***: The working group found out that the documentation process with regard to lending differed from NBFCs to NBFCs. There was no uniform practise that was being followed. It was also found that the pawn tickets issued by the lenders did not even contain proper disclosures regarding the weight of the gold, the assessed value of the jewels etc.
- ***Irregular Auctioning Procedures***: The auctioning procedures followed by the NBFCs were found to be very irregular. The NBFCs conducted auctions every three months only in their district headquarters. It was also found that some of the branches failed to even record the details of the auctions. In some cases, it was also observed that the excess money received from the auction was not even refunded to the borrowers.
- ***Irregular Valuation of Gold***: There was no standard procedure for carrying out valuation of the gold jewelleries. The practises were arbitrary and unitary. The valuation procedures lacked transparency making borrowers completely unaware of valuation prices that existed on the date of pledge.
- ***Misleading Advertisements***: There were also occurrences of misleading advertisements relating to lending facilities and disbursements of loans. Such

[1]http://www.rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=699#s9
[2]http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=8418&Mode=0

advertisements claimed that that processing of loans was a matter of 3-5 minutes, however, in reality the formalities and disbursement of loans took much longer a time.

- ***Cash Handling Risks***: Prior to the guidelines, loan disbursements through cheques were available only for amounts that were more Rs. 10 lakhs. This means that loan amounts less than 10 lakhs could be easily disbursed in cash, consequently increasing the risks of cash handling significantly.

What do the guidelines say?

The guidelines with respect to disbursal of loans against gold collateral have broadly been divided as under:

1. ***Adequate Infrastructural Requirements***

NBFCs and its branches that are involved in lending against gold as collateral will now have to ensure and comply with certain minimum level of infrastructural requirements including but not limited to safe deposit vaults, appropriate security measures etc. assets. The branches are required to examine their existing infrastructure and accordingly make arrangements/ changes for ensuring safekeeping of gold. It also states that no new branches can now be opened without proper safety measures in place. An applicant seeking registration as NBFC, with a business plan to engage primarily in lending against gold jewellery, needs to ensure that it satisfies the safe keeping requirements before is applies to RBI for CoR.

2. ***Check on the NBFCs' opening of branches***

In order to keep a check on the rampant growth of NBFCs branches, RBI has prescribed that any NBFC looking forward to open branches in excess of 1000 in number will now have to seek prior approval from the RBI. NBFCs with 1000 or more existing branches henceforth will have to get prior permission of the RBI before setting up any other new branch.

3. ***Determination of LTV***

The RBI, with a view to standardize the procedure for valuation of the gold jewellery and to make it more clear for the borrower has prescribed that gold now shall be valued at the average of the closing prices of 22 Carat gold for the preceding 30 days as quoted by The Bombay Bullion Association Ltd. It also states that the lender must inform the purity of the gold and its weight to the borrower on their letter head. In case the purity of the gold is less than 22 Carats it should be valued proportionately. However, there is no change in the LTV ratio of loans against jewellery which continues to be at 60%.

4. *Verification of ownership of the gold collateral*

In order regularise the lending practises of the NBFCs RBI has prescribed that Board of the company shall lay down policy for ascertaining ownership of gold that is considered as collateral. With respect to ownership of the jewellery, the RBI prescribed that all the NBFCs shall set up a system for the verification of such ownership as approved by the Board of the company and shall strictly adhere to the KYC guidelines as prescribed by the RBI.

5. *Auctioning norms*

RBI with a view to establish fair auctioning practises has also come up with the following:

- The lender company shall have its policy relating to auctioning approved by its Board.
- Sufficient prior notice shall be issued to the borrower for holding an auction.
- The auction should take place in the same town/ taluka where the lending branch, is situated.
- The reserve price for the auction should not be less than 85% of the average of closing prices of 22 Carats gold as quoted by The Bombay Bullion Association Ltd for the preceding 30 days. In case the purity of the gold is lower, then such price should be arrived at proportionately.
- The lender has to mandatorily provide to the borrower, the details regarding the amount fetched in the auction, the amount adjusted against overdues and any outstanding amount in that is received excess.
- The NBFCs are required to disclose in its Annual Report the details of the auctions along with details of loan accounts, outstanding amounts etc, conducted by it during any financial year.

6. *Other General Instructions*

There are certain other compliances that are now required to be observed as:

- NBFCs shall now obtain a copy of PAN Card of the borrower where the value of transaction exceeds Rs. 5 lakhs.
- Loans of Rs. 1 lakh and above shall be disbursed through means of cheque only.
- All the branches shall maintain standardized documents.
- NBFCs shall abstain from making misleading advertisements.

Update

RBI has made necessary alterations in the Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007 to give effect to the above instructions.

What would be the impact of the guidelines?

RBI, vide its guidelines, on hand seeks to expand the scope of its supervision and standardization of policies, while on the other it has diluted its role in the areas where the company's Board is to lay down approve policies for auction procedures..

Impact on the Lenders:

The impact of the guidelines in the market is likely to be against the NBFCs as regulation now seeks to curb the independence of such lending companies. With large finance corporations having existing branches of more than 1000, now have to face procedural brunt of seeking prior approvals from the RBI. The companies may now also have to align its existing policies with standardised ones as prescribed which may turn out to be tedious and extensive.

Impact on the Borrowers:

RBI has taken sufficient efforts to secure the interests of the borrowers associated with such lending models. However, borrowers may face issues when required to establish ownership of the gold collateral. India has an age old custom, where jewelleries are primarily transferred one person to his successors/ heirs intestate. In such a situation, establishing a good/clear title would cause problems to the borrower, thereby deterring him unable to seek the funding/facility.

Snapshot of the applicability of the guidelines:

Provisions/ Restrictions relating to	***NBFCs primarily engaged in lending against gold***	***Other NBFCs***
1. Infrastructure for security of the Gold Jewellery	***Will have to ensure that it has proper infrastructure even before applying to the RBI for CoR.***	***Will have to maintain proper infrastructure for ensuring the safe keeping of the Gold Jewellery.***
2. Opening of branches beyond 1000 in numbers	***Prior permission from RBI is required***	***Prior permission from RBI is required***
3. Valuation of Gold	***As per the standards set***	***As per the standards set***
4. Auctioning norms	***In addition to the existing norms***	***In addition to the existing norms***
5. Verification of ownership	***Will have to follow the Board's policy***	***Will have to follow the Board's policy***
6. Others	***Will have to comply with the provisions set down by RBI***	***Will have to comply with the provisions set down by RBI***