Analytical Speaking

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RBI's move to regulate financing by banks to NBFCs engaged in lending against gold- *another jolt to such NBFCs*?

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The market regulator Reserve Bank of India ("RBI") had been concerned on the upsurge in the gold loan business and thought of regulatory and supervisory measures to be put in place for banks' finance to NBFCs. In this regard, notification no. RBI/2011-12/568 dated May 18, 2012 ("Notification 1")[1] was issued to supplement the prudential norms prescribed for NBFCs providing loans against gold jewellery by prescribing limits for exposure of commercial banks. This was also suggested because of the growing dependence of such NBFCs on bank finances.

The Notification 1 comes on the heels of the Monetary Policy Statement 2012-13 announced on April 17, 2012, wherein a reference to the above was made.

This move was to protect the commercial banks from the inherent concentration risks involved in the business models of NBFCs engaged in lending against gold loan jewellery, with the RBI having learnt its lesson from the fiasco of the fall in the share price of Muthoot Finance Limited. Clearly, for investors of this company, "a*ll that glittered was actually not gold*".

The RBI in its notification vide RBI / 2011-12/467 dated March 21, 2012 ("Notification 2")[2] on "Lending against Security of Single Product – Gold Jewellery" ushered in much needed regulations. The major highlights of this notification were:

1. NBFCs to maintain a Loan to Value ratio i.e. LTV of 60% for loans granted against collateral of gold jewellery.
2. NBFCs to also disclose in their balance sheets the percentage of such loans to their total assets.
3. NBFCs primarily engaged in lending against gold jewellery (such loans comprising 50 percent or more of their financial assets) shall maintain a minimum Tier l capital of 12 percent by April 01, 2014.
4. NBFCs should not grant any advance against bullion / primary gold and gold coins

The markets reacted strongly to this move, with the shares of Manappuram Finance Limited and Muthoot Finance Limited the companies tanking by 18.21% and 10.14% respectively and on the same note Muthoot Finance Limited registering a new 52 week low.

For an analytical note on Notification 2, please refer the following link: http://india-financing.com/RBI_move_to_regulate_gold_loan_industry.pdf

In Notification 1, the RBI has advised prescribed commercial banks to:

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[1] http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=7222&Mode=0#ANN

[2] http://rbidocs.rbi.org.in/rdocs/notification/PDFs/CC265_210312.pdf

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1. Maintain their regulatory exposure ceiling on a single NBFC, having gold loans to the extent of 50% or more of its total financial assets at 7.5% of bank's capital funds.

   Earlier, vide notification no. RBI/2006-07/205 dated December 12, 2006 ("Notification 3") the RBI had stipulated exposure of a bank to a single NBFC to be not more than 10%.

   Banks, whose exposure is more than 7.5% at present, would be required to reduce their exposure, not later than six months from the date of the circular. However, the regulatory exposure can be maintained at 12.50% of the banks capital funds if the NBFC on-lends the money borrowed to the infrastructure sector.

   With the recent spurt in gold imports and adverse reaction of the markets to the regulation of the gold loan industry, the RBI has resorted to limit the exposure of commercial banks to such NBFCs. However, whether the move of the RBI to co-relate the infrastructure sector to such lendings by bank will actually crystallize to something positive remains to be seen.

2. Further, commercial banks are also required to have an internal sub-limit on their aggregate exposures to all such NBFCs, having gold loans to the extent of 50 per cent or more of their total financial assets, taken together. Expectedly, these sub-limits should be within the internal limits fixed by the banks for their aggregate exposure to all NBFCs put together.

   The Notification 3 had only propositioned that banks can consider to fix internal limits for their exposure to all NBFCs put together. However, now banks will have to compulsorily decide on the limit and sub-limits for their exposure to all NBFCs put together.

The reaction of the markets has not been very strong to issue of Notification 3 and expectedly so. This would mean that banks will have lesser funds to lend to these NBFCs. However, for these NBFCs, it is not a complete set back as they are guarded against gold price fluctuations as the LTVs are still to be maintained at 60% only. The notification 1 should ideally prompt these NBFCs to adopt more precautions in utilization of internal funds and not resort to external sources of funds.