RBI's move to regulate gold loan industry- Thumbs down from investors?

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"*All that glitters is not gold*". This adage might particularly be conceded by the two largest financiers dealing in gold in India i.e. Manappuram Finance Limited and Muthoot Finance Limited. With the premier body Reserve Bank of India ("RBI") coming up with a new notification vide RBI / 2011-12/467 dated March 21, 2012 on "Lending Against Security of Single Product – Gold Jewellery" the shares of both the companies tanked by 18.21% and 10.14% respectively, with Muthoot Finance Limited registering a new 52 week low.

What remained as a largely unregulated market has been tremendously hit by this notification. The major highlights of this notification are:

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.

In this context, the RBI has taken a largely conservative approach by allowing an LTV of only 60%. Traditionally, LTVs stood at 70%-75%, which ensured greater value to customers. On the flip side, a sharp decline in gold prices would have hit the market hard, had the LTVs been maintained at a high level.

With this notification, the RBI has looked to safeguard the interests of the lenders against any major fluctuations in gold prices. With an increasing trade deficit and gold being a major contributor to this, such a move will lead to more skepticism in the minds of the common people. It would probably make more sense to the common man to pledge his gold with local gold dealers, who would probably offer better value. However, he would completely overlook the exhorbitant interest that he would be charged later. Predictably, this move has not been well received by the common man, which is evident from the drastic fall in the share prices of the largest players in this market.

Also, this move has come a tad late. A case in point in this matter would be the decline in the prices of Muthoot Finance Limited. The shares of the company were priced at Rs. 160- Rs. 175 at the time of its public issue in April, 2011 and it raised to Rs. 900 . The investors did not pay any heed to the company's high exposure to gold prices and were left bleeding later with the share price touching a record low of Rs. 148.35 on March 22, 2012. Although the company has been maintaining an LTV close to the prescribed LTV at 62%, yet there is nothing to deny that investors have been left bleeding because of the lax regulations in this field and the company being subject to systemic risks.

Other highlights of this notification are:

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1. 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.

   All NBFCs were required to maintain a capital adequacy ratio of Tier 1 and Tier 2 capital of not less than 15% collectively. With this notification, the Tier 1 capital has been raised to 12% alone and the companies have to ensure this by April 01, 2014. This would mean greater compliance requirement by the companies although there are two more years to ensure this.

2. NBFCs should not grant any advance against bullion / primary gold and gold coins

   It remains to be seen what effect this move will have.

The RBI has clarified that such prudential measures were being taken only to safeguard the interests of the companies against high concentration risks and exposure to adverse movement in gold prices. In this way , the RBI has taken a largely orthodox approach which has not been very well received by investors.

We need to adopt a wait and watch approach to see if this move of the RBI will continue to have a negative effect on the companies or will lead to more entrants in this market.