



Surveying the Indian Gold Loan Market

Executive Summary

Gold has long been a valued commodity, particularly in India where it is considered auspicious, and has been in use for centuries in the form of jewelry, coins and other assets. Though gold is a highly liquid asset, it wasn't until recently that consumers leveraged it effectively to meet their liquidity needs.

Lenders provide loans by securing gold assets as collateral. Compared with the rest of the world, in India the gold loan market is big business. Until a decade back, most of the lending was in the unorganized sector through pawnbrokers and money lenders. However, this scenario changed with the entrance of organized sector players such as banks and non-banking finance companies (NBFCs) which now command more than 25% of the market.

The organized gold loan market has grown at 40% CAGR from 2002 to 2010. NBFCs have been a major driving force behind this growth given their extensive network, faster turnaround time, higher loan-to-value ratios and the ability to serve non-bankable customers. Of late, banks have improved their gold loan product features and services. Coupled with comparatively lower interest rates and charges, banks stand to gain market share at the expense of NBFCs in the near future.

With rapid growth, regulatory scrutiny has increased on gold loan lending practices. NBFCs are under greater focus as a result of their higher interest rates and charges, and non-adherence to

know your customer (KYC) regulations. This may further impact the dominance of NBFCs in the gold loan market.

At just 1.2% of the total gold stock in the country at present, gold loans have a huge growth potential. However, firms need to develop distribution, product and risk mitigation strategies to get a share of the pie in a profitable and sustainable fashion.

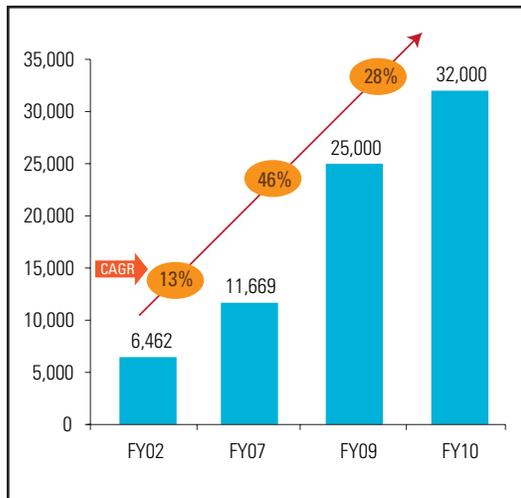
Background: Gold and the Indian Society

As previously noted, gold has traditionally been among the most liquid assets and is an accepted universal currency. It has traditionally been consumed by individuals in the form of jewelry, especially in India where it is considered auspicious. Gold is presumed to be a safe haven in times of economic uncertainty, a fact exemplified by a 30% increase in the value of gold over the past year.

India is one of the largest markets for gold, accounting for approximately 10% of the total world gold stock as of 2010. Rural India accounts for 65% of this gold stock. Though gold prices have increased at more than 19% CAGR from 2002 to 2010, gold stock in India has grown at 22% CAGR during the same period to 18,000 tons (Rs. 32,000 billion) as depicted in Figure 1. The demand for gold has followed a regional trend with southern India accounting for 40% of annual demand, followed by the west (25%), north (20-25%) and east (10-15%).

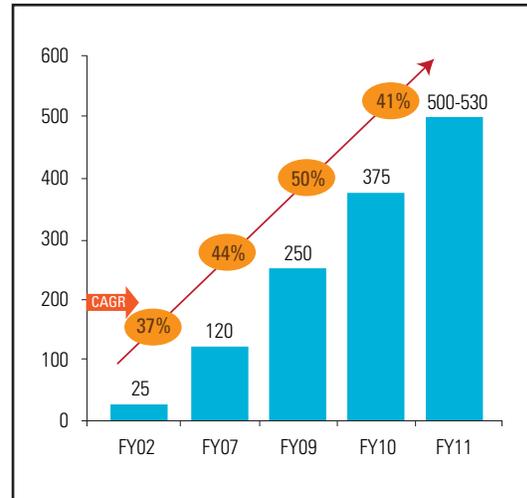


Value of Gold Stock (Rs. Bn)



Source: Muthoot Finance, August 2011
Figure 1

Organized Gold Loan Market Size (Rs. Bn)



Source: Muthoot Finance, August 2011
Figure 2

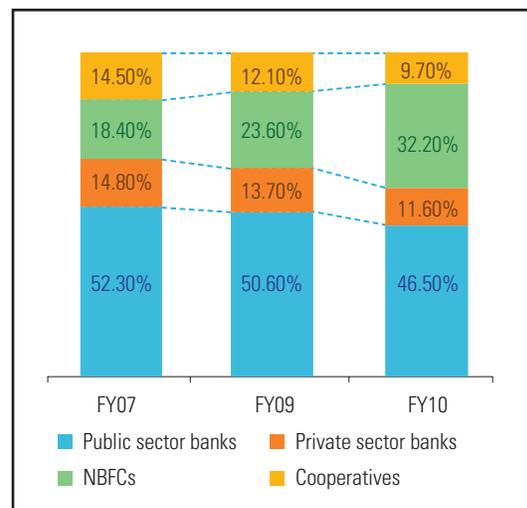
Indian households typically have an emotional attachment and sense of personal belonging to the gold they own, which is usually in the form of jewelry, coins or bars. Thus, gold owned by Indian families is rarely liquidated unless in extreme financial need – consequently, monetary value of a gold investment is rarely realized. But, pledging gold ornaments and other gold assets to local pawnbrokers and money lenders to avail loans has been prevalent in the Indian society for many decades, particularly in rural areas. However, over the past decade, the organized sector - banks and NBFCs - have taken the lead. The urban populace is also beginning to realize the potential value that can be realized through gold loans, which has led to rapid growth of the gold loan market in India.

Looking for Gold in the Indian Gold Loan Market

Major Players

The key players in the Indian gold loan market include the unorganized sector, banks - public/private/cooperatives and NBFCs. While the unorganized sector, comprising local pawnbrokers and moneylenders, has traditionally dominated the gold loan market for many decades and still commands nearly 75% of the market, the organized sector, led by NBFCs, is catching up fast. The organized sector has grown at a rapid pace of

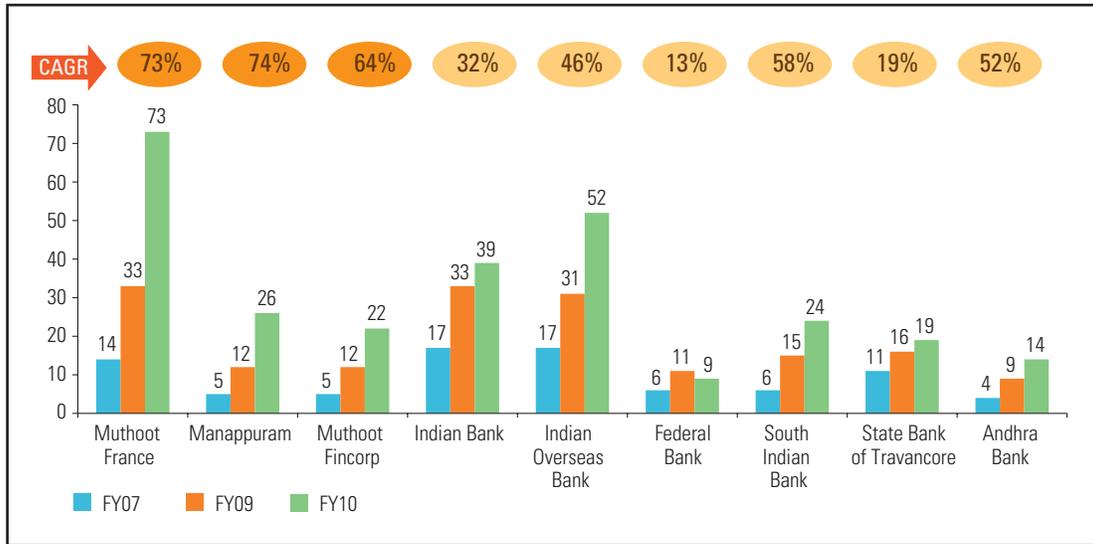
Share of Organized Market Players (%)



Source: Muthoot Finance, August 2011
Figure 3

40% CAGR from 2002 to 2010 (see Figure 2) and is expected to grow by 33% to 41% CAGR in 2011. And in doing so, these companies are challenging the dominance of the large unorganized sector. Within the organized sector, NBFCs have grown at a rapid rate from 18.4% in FY07 to 32.2% in FY10 as depicted in Figure 3.

Gold Loan Portfolio of Key Market Players (Rs. Bn)



Source: Muthoot Finance, August 2011

Figure 4

Figure 4 depicts the gold loan portfolio size for key organized sector players, again highlighting the rapidly growing dominance of NBFCs (e.g., Muthoot Finance, Manappuram and Muthoot Fincorp).

Key Features of Gold Loans

The key features of gold loans in the Indian context are described in Figure 5. With easy disbursements,

few limits on cash usage, high LTVs and flexibility, it is easy to see why gold loans are becoming more and more popular.

Why NBFCs Are Growing

By virtue of their business model, NBFCs have grown rapidly over the last few years as evidenced by their increase in market share. A comparison of gold loan features across key players is high-

Gold Loan Features

| | |
|--|--|
| Secured | Loan is borrowed against the gold deposited by the applicant. |
| Multi-purpose | The loan can be used for any purpose, as long as it is not for any illegal activity or speculation in the stock market. NBFCs place even fewer restrictions on the use of loan. |
| Low disbursement times | NBFCs and the unorganized sector disburse loans at a much faster pace (as low as three minutes to a few hours) as compared with banks which may take a few days. |
| High loan-to-value (LTV) ratios | While banks would typically not give more than 75% of the gold value as loan, NBFCs' lending could go as high as 95% in case of high-purity gold. |
| Shorter loan tenures | There is no minimum period for the loan and, if need be, one can return the loan amount the very next day. The average tenure of the loan is about 90 to 100 days. |
| Varied interest rates | The interest rate depends on the tenure and amount of loan. It varies from 12% to 18% in the case of banks, while for NBFCs, it could reach 24%. The interest rates charged by the unorganized segment are much higher and can range from 30% to 50%. Reasonable rates of interest are especially applied if the loan to value (LTV) does not exceed 50-60%. |
| Multiple repayment options | Repayment can be structured as just interest amount with principal being repaid at the end of the period in one lump sum. Repayment through EMI, covering interest as well as principal, can also be an option. |

Figure 5

lighted in Figure 6. The key differentiators for the NBFCs as compared to the banks and cooperatives are:

- Quick loan approvals and disbursements, with minimal documentation.
- Multitude of loan options with higher LTVs.
- Greater accessibility due to better penetration.
- Non-bankable customers are also served.
- Better operating cost structure vis-à-vis banks.
- Convenient hours of operation.
- Flexibility: Provision of very small and very large loan amounts.

Feature Comparison of Gold Lender Offerings

| Loan Feature | Lender Banks/NBFCs | | | | | | | | |
|---------------------------|--|---|---|---|--|--|--|--|-----------------------------------|
| | Muthoot Finance | Manappuram | Muthoot Fincorp | Indian Bank | Indian Overseas Bank | Federal Bank | South Indian Bank | State Bank of Travancore | Andhra Bank |
| Rate of interest (%) | 12% to 21% | | 13.45% to 24% | 12.25% to 15.25% | 12% to 12.5% | 13.5% to 15.75% | 13.75% | 15.00% | |
| Loan-to-value ratio (%) | Avg of 72%, high of 85% | Up to 85% | Up to 90%; 100% in some cases | Lower of 70% or value based on rate per gram and net weight | | Up to 85% | Avg of 73% to 76% | Based on rate per gram and purity | Based on rate per gram and purity |
| Loan tenure | | | 6 to 36 months | | | 6 months to 12 months | 12 months (max) | 6 to 12 months | 24 months (max) |
| Disbursal time | 5 mins | 5 mins | 3 mins to 4 hours | | | | | | |
| Min loan amount (Rs.) | 1,500 | | 500 | | 50,000 | | 10,000 | | |
| Max loan amount (Rs.) | 10 million | 10 million | No limit | 2 million | 1 million | 7.5 million | | 1 million | |
| Purpose | Any | Any | Any | Any | Commercial only | Any | Any | Any | Any |
| Processing fee | 0 | 0 | Rs. 5 to Rs. 75, based on loan amount | 0.5% for loans greater than Rs. 25,000 | Rs. 202 per lakh; Rs. 300 appraiser commission | 0 | 0.25% | | Nominal appraiser charges |
| Pre-payment penalty (Rs.) | 0 | 0 | 0 | | | | | | |
| Documentation | Only ID at disbursal | Only ID at disbursal | Only ID at disbursal | ID proof and asset ownership documents | Proof of commercial activity; unaudited balance sheet for > 3 lakhs; jewel appraisal certificate | Asset ownership proof and bank account | ID proof and asset ownership documents | ID proof and asset ownership documents | ID and residence proof |
| Others important features | <ul style="list-style-type: none"> • In-house evaluation • Schemes with different value per gram and corresponding interest rate | <ul style="list-style-type: none"> • Interest to be paid for number of days loan availed | <ul style="list-style-type: none"> • Part redemption • Part payment • Exclusive counters for loans more than Rs. 25,000 • Prompt payment rebate of 2% • Minimum 7 days interest is payable | | | | <ul style="list-style-type: none"> • Minimum interest is the lower of 5 day interest or Rs. 50 • Schemes with different value per gram | | |

Figure 6

Loan Interest Rate Comparison Across Categories

| Loan Category | Lender Banks/NBFCs | | | | | | | |
|---------------|--------------------|------------|-----------------|------------------|----------------------|------------------|-------------------|--------------------------|
| | Muthoot Finance | Manappuram | Muthoot Fincorp | Indian Bank | Indian Overseas Bank | Federal Bank | South Indian Bank | State Bank of Travancore |
| Home Loan | NA | NA | NA | 11% to 11.75% | 11% to 11.75% | 11.03% to 11.53% | 13.65% to 14.90% | 11.5% to 12.25% |
| Car Loan | NA | | | 11.75% to 12% | 13.25% to 13.75% | 12.25% to 13.25% | 13.65% to 15.15% | 12.5% to 13.25% |
| Gold Loan | 12% to 21% | | 13.45% to 24% | 12.25% to 15.25% | 12% to 12.5% | 13.5% to 15.75% | 13.75% | 15.00% |
| Personal Loan | NA | NA | NA | 17.25% | 15.75% | 17.75% to 20.25% | 17.90% | 19.25% to 19.75% |

Figure 7

A comparison of interest rates charged by lenders across loan categories is shown in Figure 7. The comparison of interest rates shows that gold loans fetch banks higher rates as compared to home loans and car loans. Hence, this category is being targeted aggressively by banks. However, NBFCs have a much greater focus on gold loans and continue to provide attractive loan features which enable them to charge higher rates, generate higher profits and grow rapidly in a singular direction.

Risks to Borrowers and Lenders

Since lenders take possession of the gold assets in a loan transaction, in case of a theft they may not have sufficient funds to compensate all the borrowers for their loss in its entirety. This is more important for loans placed in the unorganized sector; banks/NBFCs usually have better security and insurance coverage. Furthermore, financial packages cannot compensate for the personal attachment a borrower has with the gold assets.

Moreover, a sharp decline in gold prices increases the original LTV. A lender may require an immediate recovery of any amount that exceeds the original LTV ratio, but the borrower may be unable to pay this amount. Restructuring of the loan may be required in these cases. Additionally, if the value of the pledged asset declines, a borrower may be more willing to default on the loan. This poses a serious concentration risk to the lender, especially to the NBFCs that have a high exposure to gold loans and lend at high LTV ratios.

The increase in gold prices over the last few years, coupled with the surge in gold loan borrowings during this period, could create a gold bubble which could burst in the event of a significant correction in gold prices. Banks/NBFCs with significant exposure to gold loans could face widespread defaults, which could adversely impact the economy.

The organized sector today manages these risks through various methods such as enhanced security, insurance cover, buying gold futures, etc.

Regulatory Environment

While there are no means of controlling the unorganized sector, the organized sector of banks and NBFCs come under the purview of the Reserve Bank of India (RBI) which has norms to regulate the gold loan market.

NBFCs had been traditionally disbursing gold loans through funds received from banks under priority lending for the agricultural sector. The loans under this category enjoy an interest rate discount of approximately 200 bps over the normal interest rates charged by banks. But to reduce the risk in the system, the RBI ruled in February 2011 that bank credit to NBFCs for lending against gold jewelry will not be treated as exposure to the agricultural sector. The resulting higher interest rate for funds is expected to promote better lending practices by NBFCs to creditworthy borrowers.

With the continued rapid growth of the gold loan market in India, RBI has started examining

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lenders, especially NBFCs, for possible concentration risks (i.e., risks due to a sharp decline in the prices of gold for a lender with a large exposure to gold assets pledged against the loans).

All lenders are required to adhere to the KYC norms. NBFCs allegedly have not strictly followed this regulation and hence have been under the RBI's scanner for some time now.

Currently, NBFCs' gold loans are regulated by RBI. However, some state governments require compliance with relevant state money lending statutes. If the state governments succeed in enforcing this regulation, the profit margin of NBFCs would be further squeezed.

There have been recent complaints regarding high interest rates and penalty rates charged by NBFCs. This has caught the attention of

regulators; any regulatory move in this regard would impact the profit margin of NBFCs.

Role of Technology

Information technology has played an increasingly important role in the rapid growth of the gold loan market.

- Technology provides scalability to gold loan businesses, enabling quick roll-out of branches and efficient penetration of the underserved markets.
- Provision of accurate real-time information has led to faster decision making and reduced turnaround time for loan disbursements.
- Technology has significantly reduced human intervention and thereby, the approval, disbursement and repayment processes have become much faster, simpler and more robust. Better adherence to lending regulations (KYC, priority lending, etc.), consonance in firm-wide lending activities, efficient tracking of borrower accounts, process transparency and minimization of operational costs are some of the major benefits realized through the use of technology.

Gold loan firms use negligible or small-scale proprietary IT systems. These are proving to be inadequate given gold lenders' strong growth. Hence, firms are increasingly looking to leverage technology for further growth. They are engaging enterprise solution providers to provide integrated solutions for loan origination, servicing and collections.

Conclusions

For borrowers, gold loans have emerged as one of the best means of raising quick, short-term capital. For lenders, gold loans are more advantageous compared with home and car loans because of the shorter tenures, lower processing time and cost, and greater returns due to higher interest rates. These factors, along with appreciation in value of gold, have led to an explosion in the gold loan market. With everyone wanting a piece of this action, the organized sector is challenging the large unorganized gold loan market dominated by pawnbrokers and moneylenders, with NBFCs leading the pack due to simpler approval and disbursement processes, flexible products and better accessibility.

An examination of these trends makes clear that banks/NBFCs that aren't yet into the gold loan market might find it attractive. This is due to the following factors:

- Better ROI due to lower cost, higher interest rates and strong collateral.
- Ability to compensate for lower off-take of car/home loans.
- Scope for cross-sell opportunities in future including other gold-based products.
- Opportunity to capture the growing underserved and under-penetrated market.

With approximately 65% of the market in rural areas, firms need to develop strategies to target this segment effectively and provide better accessibility to borrowers. When expanding, firms need to ensure consonance of services and operations throughout the network.

Firms need to manage risks related to possible sharp fall in gold prices and non-adherence of regulatory norms and also need to ensure that physical assets are properly valued, stored and documented. Firms need to invest in technology to better manage the increasing volumes and to reduce risks.

Recent Developments and Future Outlook

To compete with NBFCs, banks have recently improved/streamlined their loan processes - with some banks purchasing assaying machines to disburse loans in 15 minutes. This poses a challenge to the growing dominance of NBFCs in the gold loan market, more so since banks usually charge lower rates of interest compared with NBFCs.

Gold loans are among the newest class of assets which have seen rapid growth in securitization. But, with the restriction on agricultural sector status of gold loans by RBI, the pace of securitization of these loans is slowing down as most of these securitizations focused on benefits accrued through the use of agricultural sector status. Also, RBI's draft securitization guidelines (Sept. 2011) had proposed minimum holding period (MHP) of 12 months for allowing securitization transactions. Given the short tenure of gold loans (a year and lesser), securitization of the same will not be possible. A new proposal is under consideration to modify the MHP for gold loans to two months, which would allow securitization of gold loans. This would further provide liquidity to the primary market and provide a boost to the overall gold loan market.

The government views gold loans as an effective means of meeting the demand for micro-finance in India. This would encourage framing of policies favorable to the growth of the gold loan market.

To counter the rise in borrowing costs due to removal of agricultural sector status on loans

from banks, NBFCs are seeking newer avenues of borrowing. In addition to using bonds and commercial papers, NBFCs are attracting huge private equity investments of late.

Gold loans have become a basis for creation of new financial products such as loans for purchase of gold wherein gold is purchased on the date of the loan and held as a pledge until the equated monthly installments are paid. Gold saving schemes are also emerging wherein the customers pay regular cash flows which on maturity are added with a certain amount of interest payment to purchase gold for customers.

With frequent hikes in interest rates by the RBI and the subsequent hike in rates by banks, the cost of personal loan borrowing is increasing. This will lead to an increased consumer willingness to secure gold loans.

Since more than 75% of the gold loan market is still with the unorganized segment as of 2010, the organized segment has a huge potential for growth through cannibalization of the unorganized segment. A bigger, better and more efficient network of branches would help the organized segment target this growth area.

The gold loan market in India is still under-penetrated considering the abundant availability of gold as collateral with Indian private households and the existing size of the gold loan market (approximately 1.2% of the total gold stock). This presents a significant scope for growth of the gold loan market.

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