Gold loan NBFCs: Better placed to handle Gold Price Risk

Gold Price Movements

Past few months have seen high volatility in gold price thanks to the market's expectation on US central bank's policy on interest rate. The fear of moving away from close to zero interest rates in the US market has resulted in the fall of gold prices significantly in USD terms during the period from May 2015 to September 2015. However, same has reversed its direction since US Central Bank's decision on the interest rate in September 2015. At the same time, INR depreciation against USD meant that lower gold price variation in rupee terms. During the period mentioned above, the gold price in India dropped marginally from Rs.2,453/gm (May 04, 2015) to Rs.2,387/gm (September 30, 2015) after touching a low of Rs.2,249/gm on August 06, 2015. During past few years also, gold price has seen periods of high volatility. After continuous increase in the price from April 2007 to August 2012 with periods of little volatility, gold price peaked in September 2012. Since September 2012, gold price witnessed declining trend and increased volatility. The price movement of gold for the past few years is shown below.

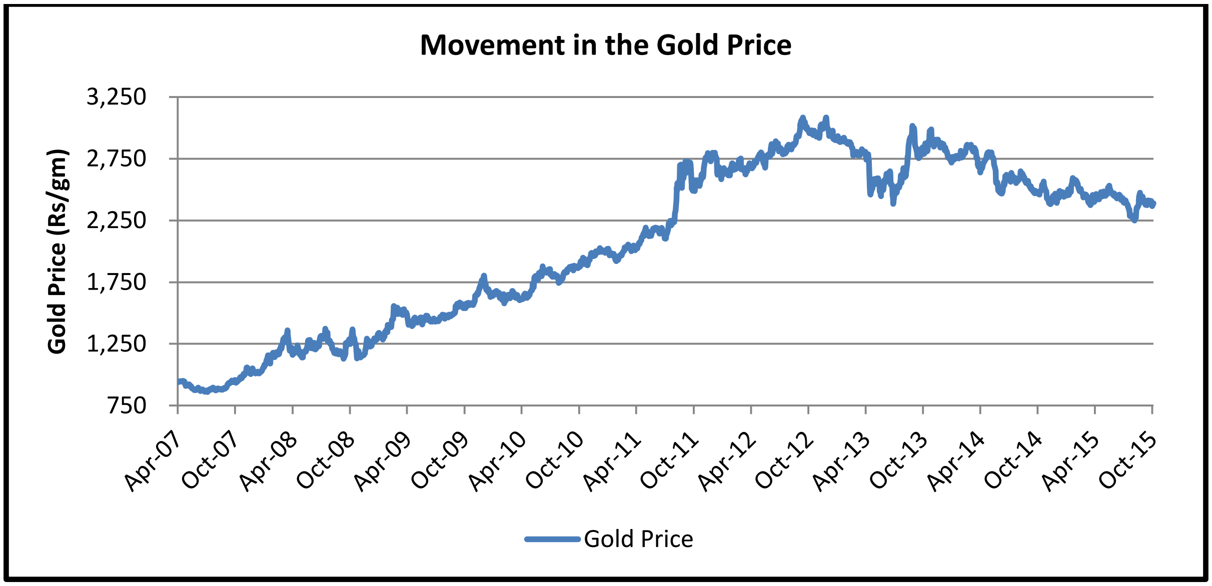


Chart 1: Movement in Gold Price - Source: www.nseindia.com, Goldman Sachs Gold Exchange Traded Scheme (GOLDBEES)

Gold Loan NBFCs AUM moved in trend with movement in gold prices

Domestic market has seen emergence of many players in the gold loan NBFC industry in the last decade, with few companies crossing assets under management (AUM) of Rs.100 billion in FY12. With gold price increasing continuously during the period from 2007 to mid of 2012, large players in the industry also reported continuous growth in AUM during that period. Subsequently in tandem with decline in the gold prices, AUM of these companies has seen some decline. Following chart captures movement of AUM of top two listed players.

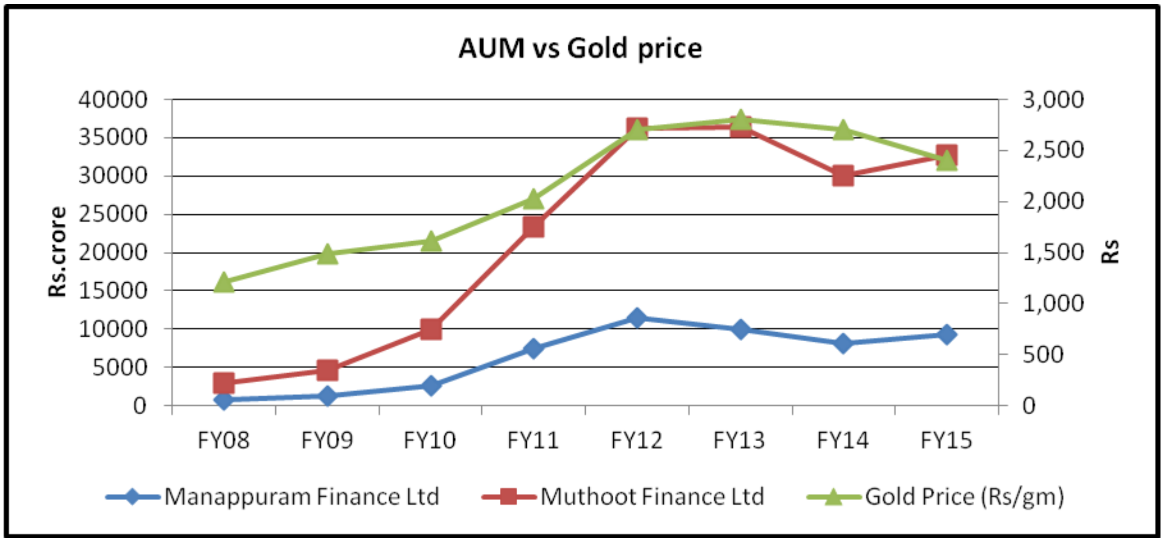


Chart 2: Movement in AUM of large gold loan NBFCs and gold price

Unlike other NBFCs, gold loans NBFCs give much more emphasis on the value of security as compared to cash flow of borrower. This is due to highly liquid nature of the security (gold) offered, possession of security and absence of issues like distress sale affecting the realisable value. Furthermore, the belief that sentimental value attached with gold jewellery would result in borrower repaying his money to get back his gold has been viewed as major positive factor. Though this has been true for larger part of the period (2007 to 2012) & larger part of borrowers, industry started seeing addition of Non-Performing Assets (NPA), initiation of recovery proceedings and consequent under recovery of underlying security in subsequent periods. Some of the players reported losses in few quarters of FY13, as a result of asset quality deterioration.

Steep correction in gold prices after peaking in September 2012 resulted in high LTV (Loan to Value) loans becoming vulnerable with realisable gold value going below loan amount. With fall in prices, many of the borrowers (mainly those who had borrowed at higher LTV) chose to default rather than repay loans and get back their gold jewellery which had reduced in value. As the loans which were extended during the peak of gold prices started showing delinquencies and recovery actions resulted in under recovery/loss.

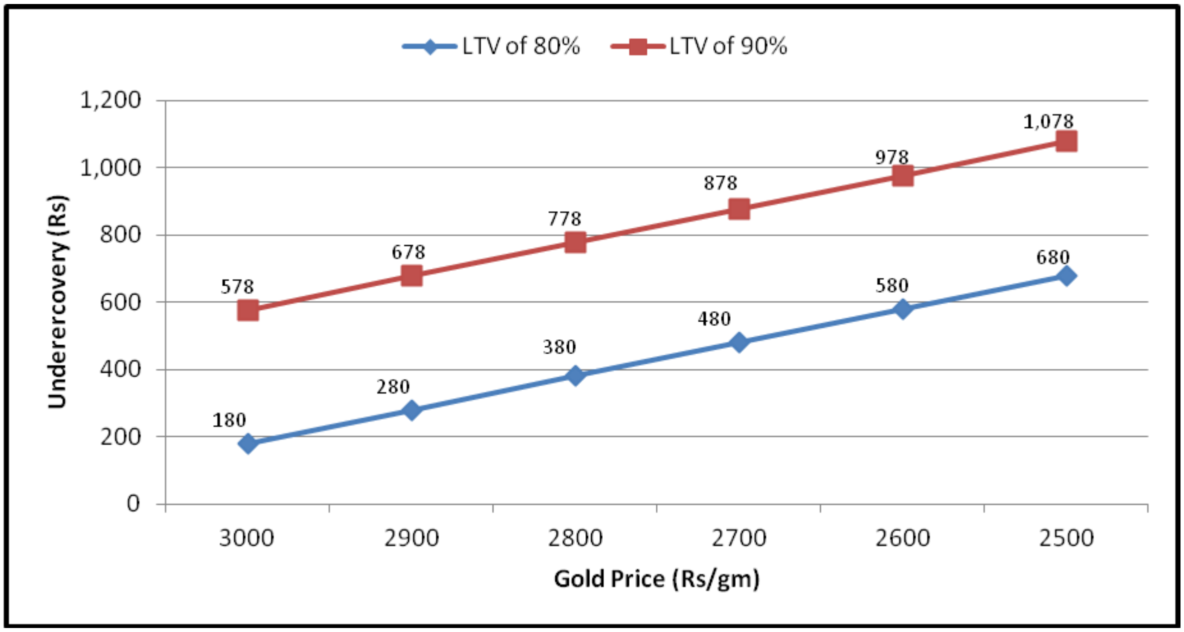
For e.g. a loan which was disbursed at LTV of 80-90% at gold price of Rs.3,000 per gram becomes out of the money (loan outstanding higher than value of underlying security) as the gold price starts falling. Table below shows the loan outstanding at the end of one year & at the time of recovery (assuming recovery process starts at the end of one year). As it can be seen below, at higher LTV, losses had been higher even in a scenario of no change in gold price.

Rs.

Loan to Value Ratio	**80%**	**90%**
Loan per gram	2,400	2,700
Interest @ 26% p.a	624	702
Loan Outstanding (at the end of one year)	3,024	3,402
Add: Interest foregone during recovery period	156	176
Loan Outstanding (at the time of recovery)	3,180	3,578
Under Recovery/Loss (Assuming realisation of Rs.3,000 per gram)	180	578

Chart below shows the extent of under recovery at different gold price points. The loans with higher LTV faced significant losses and many gold loan NBFCs had to report losses/under recovery in many quarters during FY13.

Chart 3: Under recovery at different LTVs



In view of the volatile movements in gold price and losses/under recovery faced by the industry, RBI revised guidelines on LTV in March 2012 when it capped LTV for Gold Loan NBFCs at 60%. Later it revised the same to 75% in the month of January 2014.

Gold Loan NBFCs: Mitigating Market Price Risk through different ways

Though gold price remained less volatile during the period from June 2014 to May 2015, due to the reasons stated at the beginning (expectations on fed policy rate), volatility has increased subsequently. However, the industry has changed its strategy in the recent past to mitigate gold price risk.

Preference to Lower LTV

Initially, the gold loan NBFCs were lending at LTV of greater than 90%. This came down subsequently with RBI capping LTV ratio. In the past one and half year, many NBFCs have started offering loans at relatively lower interest rates for the loans having lower LTV. While this has affected the business volumes and yield to an extent, it results minimisation of credit loss. Lower the LTV, higher the cushion between amount of loan outstanding and realizable value of collateral. E.g. a loan offered at 50% LTV (gold price of Rs.3,000 per gram) remains 'in the money' even at the end of one year even when gold price falls to Rs.2,500 per gram. Chart below shows the extent of under recovery in loans at different LTVs at various price points. As it can be observed from this, lower LTV ensures under recovery is significantly reduced/avoided.

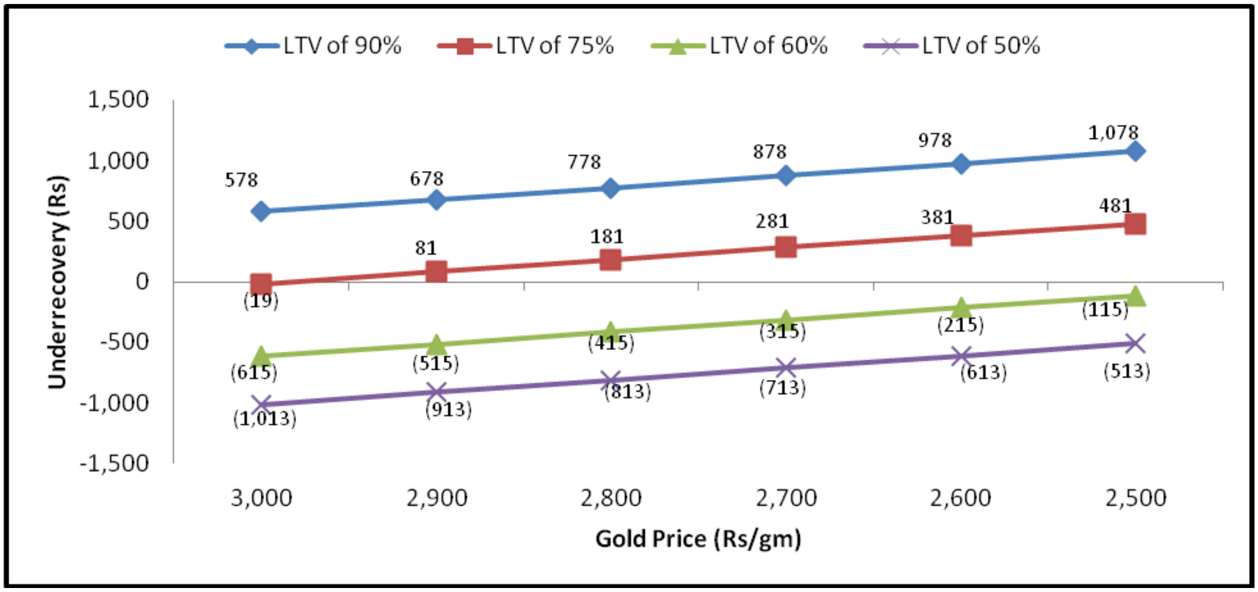


Chart 4: Extent of under recovery at different LTVs; ***Note****: The values inside the parenthesis indicate the collateral value in excess of outstanding loan amount including interest.*

The business volumes of the gold loan NBFCs have been impacted in the past few years (FY13-14) due to falling gold prices & cap in LTV, resulting in de-growth in the loan portfolio.

Launch of Shorter Tenure loans & Periodical collection of interest

Though the loans are backed by highly liquid collateral (gold) resulting in relatively higher recovery and low loss given default, the price risk associated with the collateral impacts the ultimate recovery. Even assuming price remains stable, effective tenure of loans also impacts the under recovery. In order to reduce risk arising from the same, NBFCs have been focusing on extending short-term loans, i.e., three months, six months and nine months loans. Relatively lower tenure ensures that at any point of time, value of security is higher than obligation of borrower and losses are minimized on timely recovery through auction.

Chart below shows the extent of under recovery for three, six and nine-month loans as against loan with tenure of one year. As it can be observed from the chart, under recovery from shorter tenure loan is significantly lower than loans with one year tenure.

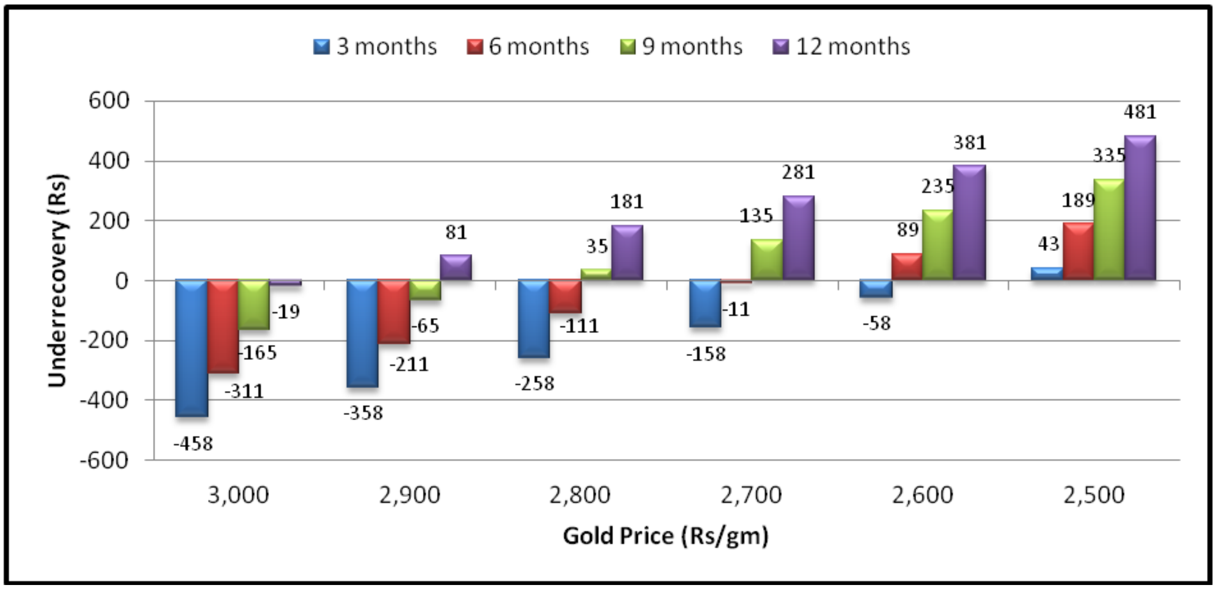


Chart 5: Under recovery in loans with different tenure; ***Note****: The values inside the parenthesis indicate the collateral value in excess of outstanding loan amount including interest.*

Entities with these risk mitigations placed better to handle gold price risk

The gold loan NBFC industry has gone through a phase of consolidation in the past few years on account of slew of regulatory changes by RBI following significant fall in gold prices. At the same time these companies have evolved and adopted various risk mitigation strategies like offering relatively more loans at lower LTVs, offering short-term products like three/six/nine month loans against traditional one-year products along with periodical collection of interest to ensure that loans are in the money. As a result they are better placed to handle the gold price risk as compared with the past.

Contact:

P.Sudhakar
AGM
p.sudhakar@careratings.com
91-044-28490813

P.Edwin Irudayaraj
Manager
edwin.raj@careratings.com
91-044-28490813