Gold Monetization Scheme Implementation
Whitepaper by India Gold Policy Centre

Background

The Union Budget for 2015-16 presented in February 2015 announced he intention of the Government to introduce schemes for the monetization of gold. The schemes were approved by the Union Cabinet in early September 2015 and the schemes were formally notified on October 22, 2015.

On October 27, 2015, the India Gold Policy Centre at the Indian Institute of Management, Ahmedabad organized a Workshop on Gold Monetization in Mumbai. The workshop brought together senior decision makers from banks, jewellers, NBFCs, gold refineries, hallmarking agencies, logistics and security agencies as well as policymakers and academicians. The aim was to produce a white paper on the way forward to making the gold monetisation scheme a success.

The plenary session of the workshop featured the inaugural address by Mr. Erkan Kilimci, Executive Director of Markets Department, Central Bank of the Republic of Turkey and the keynote address by Dr. Saurabh Garg, Joint Secretary (Investment), DEA, Ministry of Finance, Government of India.

The plenary session was followed by two closed door panel discussions which followed the Chatham House Rule (participants are free to use information from the discussion, but are not allowed to reveal who made any comment). This format was designed to increase openness of discussion and facilitate a constructive dialogue. Accordingly, this Whitepaper does not attribute the ideas and suggestions emerging from these panel discussions to any individuals.

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The first panel discussion was on integrating the gold value chain into the monetisation of gold, while the second panel was on the role of banks in the monetization of gold. The panels included bankers, academics, industry bodies and participants drawn from all major elements of the gold value chain.

Turkish Experience

In his keynote address at the Workshop, Mr. Erkan Kilimci, Executive Director, Central Bank of Republic of Turkey described the successful Turkish experience with gold monetization and drew parallels between Turkey and India in terms of their cultural affinity towards gold.

Physical gold is a traditional investment for Turkish people. People of Turkey have been exchanging gold on ceremonial occasions like births and marriages and accumulating it as wealth for years. Sustained high level of inflation for years also induced households to hold gold. Turkey is estimated to have accumulated around 5,000 tons gold over the years.

Gold monetization in Turkey was driven by the Central Bank's Reserve Option Mechanism which provides the banks with the option to hold a fraction of their mandatory required reserves for Turkish liabilities in foreign currency and gold. Banks fully utilized the option of holding gold instead of Turkish Lira, and used gold deposits to source the required gold.

Gold deposits in Turkey have been an instrument for achieving financial inclusion especially of unbanked women. Traditionally, Turkish women have used an event called "Golden Days" to socialize and bring gifts to each other. Banks hosted "Golden Days" at bank branches as a cultural event where unbanked women opened gold deposits. By this method, banks not only collected gold deposits, but they also built relationship with customers, especially, the weaker section. In due course, the banks had the opportunity to offer other bank products to these customers.

In the recent past, with the US economy performing well and local banks' USD borrowing costs on the rise, the expectations of customers and the incentives of banks have changed. There has been a shift from gold deposits to USD accounts.

Overall, the Turkish experience shows that even in a society with strong cultural preference for gold, the investment decisions of weaker sections of society are driven by economic considerations. Well designed schemes with adequate incentives to financial intermediaries can be quite successful in bringing gold into the financial mainstream.

Government Policy Goals

In his keynote address, Dr. Saurabh Garg, IAS, DEA, Ministry of Finance (GOI) observed that gold can be a part of the economic strength of a country. It need not remain a separate form of financial ecosystem and that is the attempt through the gold scheme that benefit both to the economy and to the individual.

India imports 900-1000 tonnes of gold annually making it the largest global consumer of gold. China and Turkey are the other major consumers. As per the estimates about 30% (appx 300 tonnes) of gold that is imported is for investment purposes and the balance is for jewellery purpose. Gold imports account for around one fourth of the country's trade deficit; thus a reduction on the reliance on the import of gold can also help in managing the current account deficit. So there was a need to substitute the demand of gold, wherever it was for investment purpose, by a financial product without suppressing the requirements of the domestic sector; thus mobilizing gold into the financial ecosystem.

Monetization schemes have been tried in the past, but due to various reasons they did not succeed as much as they should and based on the feedback of old schemes the 2015 schemes have been formulated. Improvements of the scheme over the previous ones are – greater choice to depositors in terms of tenures, smaller amounts of deposit, redemption, interest rates ; better infrastructure engaging more than 300 BIS certified collection centres and refineries; greater transparency, faster processing and a range of options for banks to utilize deposited gold.

Dr. Garg also talked about the Government's Sovereign Gold Bond Scheme and the Gold Coin.

Marketing the GMS

The GMS postulates a Tripartite Agreement between the Bank, the Collection Centre (Hallmarking Agency) and the Refinery to leverage on the complementary strengths of these three stakeholders. A key issue that came up in the Workshop was who should take the initiative in marketing the scheme. Several alternative models could be thought of:

- Customers actually walk into the banks and bank redirects them to collection centres. What is the level of awareness and training of bank staff at the frontend in order to explain the scheme to a customer.
- Customers may directly go to a melting centre and then melting centre may suggest a number of nearby bank branches. Therefore, banks become the back offices. Are the hallmarking centres ready to take the lead to market the GMS in this manner?
- The refinery may set up their own collection centres and work in partnership with a bank to market the GMS to customers. Are the refineries prepared to invest in this kind of infrastructure?

The conclusion of the Workshop was that banks should take the ownership as the customer knows only the bank, not the other two parties. The Indian investor feels banks to be safe enough for deposits, be it money or gold. Only the banks have the experience in B2C relationship, the other two (hallmarking centres and refineries) have been only into B2B relationship.

Tripartite Structure

There was considerable discussion on structuring the relationship between the bank, the collection centre and the refinery. One model was of two bipartite relations:

1. between the bank and the hallmarking centre OR between the bank and refiner, and
2. between the hallmarking centre and the refiner

Banks have reservations with regard to exposure on SME clients, and this affects the comfort level of banks in dealing directly with hallmarking centres. Banks would also worry about reputational risks – in case of any dispute, customer will only come to bank; hence, reputation of bank is at stake in whatsoever agreement the three parties enter into.

Participants felt that banks would place more faith in a good refinery. One suggestion was that the refineries could take ownership of the process by setting up collection centres as their sub-unit which they have control over. This would definitely depend on the economic viability for the refiner to put an additional investment and whether it will make enough returns.

Gold Purity Dispute Resolution

The customer would get a purity report from the hallmarking centre and would expect a credit based on that. The bank would get usable gold only after it is refined at the refinery; and there would often be a mismatch between the purity determined at the hallmarking centre and the actual gold realized by the refinery. In particular, it was mentioned that the presence of platinum group metals (PGMs) may be hard to detect at the assaying stage. The Tripartite Agreement between the bank, the hallmarking centre and the refinery would need to specify how this discrepancy would be dealt with.

This is a new risk for the banks because at present, banks import refined gold bars from large overseas suppliers and there have been very few problems regarding purity of bar. In the few cases that have occurred, there has been mechanism for replacement of the gold bar by the international supplier. Dealing with local refiners will bring in reputation risks for banks with retail customers (as depositors) as well as with jewellers who will source gold from banks.

Another issue that arises in this context is that the refiners are accredited by NABL (National Accreditation Board for Testing and Calibration Laboratories) while the hallmarking centres are accredited by the BIS (Bureau of Indian Standards). International gold suppliers are accredited by the LBMA (London Bullion Market Association).

There was a view that banks will have to get comfortable with local refiners, and their customers also have to get used to accepting non-LBMA Gold if banks have to source locally. It was pointed out that some Indian commodity exchanges have accredited local refiners.

Infrastructure, Logistics and IT Systems

Infrastructure

There are only about 330 assaying hallmarking centres which are certified by the Bureau of Indian Standards (BIS) as against over 600 districts in the country. Ideally we should have one hallmarking centres per district. Currently, the hallmarking centres are concentrated in regions where there is significant manufacturing activity. There may not be any centres in some important state capitals where the jewellers source their jewellery from other parts of India. Nobody has thought of opening assaying centres in these locations because the business was not big enough to make a hallmarking centre economically viable. If the GMS leads to greater market demand for assaying facilities, it is expected that more such centers would come up.

Logistics

The GMS would entail moving small quantities of gold to the refineries from a large number of hallmarking centres in many different locations. There are problems with state level taxation, with shortage of armed guards, and so on; yet, the general view in the Workshop was that this logistics can be managed. A parallel was drawn with the movement of cash to thousands of ATMs across the country. It has taken several years for this logistic network to be established, but today, it is working well.

IT Systems

Systems and processes need to be created to bridge the gap between different levels of scale involved in the GMS:

- Customers may walk in with small quantities (say 30 or 50 g) of gold
- Refineries might require accumulating enough amount of gold (several kg) to refine it.
- The smallest unit of refined gold that could have a physically identified ownership might be a one kg gold bar.

This means that there is a need for a sophisticated accounting system that can keep track of small quantities of gold. For example, it should be possible to determine that there is an identifiable gold bar (1 kg) lying in a particular refiner's vault out of which 30 g belongs to a specific bank and the remaining 970 g belongs to the refiner itself. A parallel was drawn with the process of dematerialization of shares by the depositories which eliminated the problem of round lots of shares and made it easy to achieve ownership and transfers of small lots of shares. Some members felt that there is a need to create a similar IT system to track the flow of small quantities of gold through the system. Another parallel was with the system that commodity exchanges have build to track the stock of commodities at various accredited warehouses.

On part of refining, the scale of challenge lies in how successful the scheme is. If the scheme is successful, chances are that the quantity of gold received may be sufficient for the process of refining.

Alternative Channels

Jewellers have not been permitted to become collection centres for the GMS. They are also not permitted to perform hallmarking of their own jewellery because of the need for an independent third party assurance of quality. However, currently, jewellers do buy gold from their customers in small quantities of even 5 g or 10 g. Apart from the banks, they are the other stakeholder with a large customer base. Hallmarking centres have hitherto dealt with the jewellers and not directly with the customers, and the jewellers may not be happy with the hallmarking centres dealing independently with the consumers.

Another possibility is the emergence of auction centres for sale and purchase of the jewellery without melting it down.

Taxation Worries

- When it comes to movement of gold across states, there are several issues of state level taxation and different interpretations of central taxes (like service tax).
- Much of the gold in the hands of households today was acquired over many years in small lots. Many individuals are worried that if they deposit 500 g of gold, they would have to explain the income source for this based on today's valuation of this gold. While everybody understands that GMS is not a tax amnesty scheme, there needs to be some assurance that every deposit would not lead to a roving enquiry by the tax administration.

Pricing and Risk Management

Rate of Interest

The interest rate that banks would be willing to offer to the depositor would be determined by the banks' desired net interest rate margins (NIM). In the gold deposit, the banks are effectively borrowing gold from the depositors, and the banks are also borrowing gold from international supplier at the globally determined lease rates. Banks would have to consider what rates banks are able to borrow from international markets, at what rates they can lend to the domestic market and what additional cost would be involved to invest as an infrastructure cost to this activity. They would not want to offer a rate that does not ensure a minimal/logical NIM.

Interest rate would not be the key factor in evincing customer interest in this product because after all the scheme will save him from the hassle of buying, hiding/storing gold as an idle asset and paying for insurance for its security.

The success of the scheme lies in providing comfort to the customer in depositing gold with a reasonable KYC and without a perceptive fear of being questioned for its source.

Asset Liability Management

The banks would currently be more agents of the government and kind of passing the gold back to the govt. For banks to come as principals and borrow in their own books the important thing would be AML management and how they are all allowed to do that. Because till that is allowed frankly, the Gold is not of much value to banks.

From ALM perspective certainly the policy is far from where it needs to because banks can get a lot of Gold but they have to lend in a certain lot to the jeweller what do they do till they get a certain lot. And if I have borrowed for five years and if they get their loan back in six month, what do they do till they get their next. The whole ALM issue is thus not really addressed

Regulatory Issues

CRR and SLR

There were some concerns that the banks might not be happy with holding gold as part of their SLR but no CRR offset. The international bullion market is operating at much lower level than the internal one. Therefore, it was necessary to incentivize the monetization of gold. One of the reasons why the regulator has not granted CRR and only an SLR exemption was granted is because it creates so much of liquidity. A 0.25 basis cut in CRR results in a liquidity ejection to the tune of 35,000 crores. So that could be another fear of inflation. Participants however expressed the hope that while the CRR exemption has not been given, it is not a closed chapter. Over a period of time as things evolve and we see a measurable amount of success, this may be reviewed and revised.

Operational Issues

Some participants expressed the view that some of the operational flexibility that was present in the 1999 scheme is missing in the current scheme. It would be useful to provide greater flexibility to the banks in several areas:

- In the 1999 scheme, any bank which had mobilized gold could in turn lend it to another bank, if they did not have an avenue to deploy the gold.
- The 1999 scheme said for replenishing the deposits, banks could buy Gold locally from the local markets. The current scheme does not seem to permit this.
- Though there is a vibrant domestic exchange when there a gold-rupee contract which is inclusive of customs duty, the current scheme does not appear to allow the banks to use this market for hedging the gold

price risk. The notification says banks can hedge in the OTC markets as well as the overseas exchange.

- There have been gaps between the finance ministry's original draft and the actual RBI regulations.

Addressing some of these issues would help make the scheme attractive enough for the banks to actively promote it to their customers.

Financial Inclusion

In Turkey, gold monetization was also a part of financial inclusion. They used to have days when women would come in with their gold, and banks would open up an account. Once the banks have acquired a new customer, they had the opportunity to cross sell pensions and other products to them. Would the banks be primarily concerned with short term profits (NIM) or would they look at these opportunities as well.

It is estimated that the penetration of gold in the form of saving and holding across the Indian household is more than 80% hhereas in the case of banking accounts even after the Jan-Dhan Yojana it is less than 50% active accounts. Therefore there is a huge potential for using gold deposits as the initial step in providing banking accounts. But there is a cost attached to reaching out to them.

Inputs from the World Gold Council

The World Gold Council has submitted a response to the Government on the monetization scheme. The recommendations are based on four key pillars:

Trust It is vital that consumers, banks and jewellers have trust in the quality of gold flowing around the monestisation ecosystem.

Ease of use Transactions must be easy. If they are not, it is unlikely savers will deposit their gold.

Incentives Each market participant – from the depositor to the bank to the refiner – must be incentivised to use and develop the scheme. In the initial stages, till the depositor gets comfortable with the entire process, and the bankers, it may be useful to look at significantly higher level of incentives from the government.

Scalability It should lead to build up of adequate infrastructure over the medium term that is self sustaining and scalable.

Their specific recommendations include:

- Leverage bank and NBFC branches to enhance distribution
- Use of technology to make the depositing process quicker

- Establish global standards and accreditation in the value chain
- Make the scheme more flexible – smaller deposits, multiple deposits, partial withdrawal and transfer.
- Allow for loan against gold deposit account
- Allow for use of gold collected against CRR requirement
- Use gold as a collateral with RBI to avail discount on the repo rate
- Import duty exemption and loan against gold to be set-off against the 'Priority Sector' lending targets of banks.
- Interbank transaction of gold certificates
- Allow for banks to hedge the gold collected under the scheme
- Link GMS to Pradhan Mantri Jan Dhan Yojana
- Concerted marketing efforts at launch and beyond
- Leverage Jeweller Network
- Tax and other incentives to enable the up-gradation or creation of new infrastructure

Conclusion

Compared to the 1999 scheme, the most important difference is that in 1999 the banks sent the gold to the Mint for assaying and it took 90 days for this process. The customer did not know what was happening in between. No one wanted to part with their gold under these conditions. The current scheme is saying that the collection centre will assay the gold in the presence of the customer and provide the information on the purity of gold. This customer centric model will hopefully lead to a better result.

Taking the Turkey benchmark (collecting about 50 tons out of 5,000 tons of total household savings), if India also collects 1% of 24,000 tons, it will mean 240 tons, that would mean a significant reduction in imports.

To realize this potential, there is a need to remove practical impediments in the scheme. It is clear that the success of the scheme depends on vigorous marketing efforts by the banks, and it is therefore necessary to incentivize the banks to take the initiative. The Government needs to keep monitoring the progress of the scheme to ensure that all large banks, hallmarking centres and refineries enter into Tripartite Agreements to broaden the reach of the scheme.

It is also necessary to address the concerns of small depositors that gold deposits could lead to roving tax inquiries. While the scheme is not and should not become a tax amnesty scheme, an individual using this instrument should not face inquiries any more onerous than that of an individual making a similar monetary deposit.