Cash-for-gold loans hide shadow-banking risks in India

New Delhi/Mumbai, Dec 20: When Rashmi Deshmukh needed money for her hand-knit clothing business in Mumbai, she couldn't wait for bank approval. Instead, she put up her wedding jewelry as collateral at a loan-for-gold company to get cash on the spot.

Muthoot Fincorp, which advertises three-minute gold loans and has 3,125 branches across India, charged 24% annual interest. While a bank gets half that rate, it would have loaned her less and required paperwork, she said.

"It's faster, it's easier, it isn't cheaper, but I get more for my gold from Muthoot than the bank," said Deshmukh, 37, who borrowed ₹250,000 ($4,576) in October because she had more orders than yarn ahead of this year's holiday season.

Assets at non-bank lenders such as Muthoot have increased 20% annually for the past five years to $670 billion, according to a November report by the Financial Stability Board. That makes India the world's second-fastest-growing market, after Indonesia, for lending outside the banking system, or shadow banking. It also poses risks for a country where 65% of the population and 92% of small businesses don't have access to banks, World Bank and government data show.

"With non-bank companies accounting for almost 40% of India's financial system, policy makers are struggling to tame inflation and reverse slowing growth," said Ashima Goyal, a Mumbai-based economics professor and member of the central bank's technical advisory committee. While the Reserve Bank of India raised interest rates 13 times from mid-March 2010 through April of this year, inflation has remained above 8% for 21 of 26 months, according to data compiled by Bloomberg.

Having so much money outside government control "stands in the way of smooth transmission of monetary policy," Goyal said.

The largely unregulated shadow-banking system also creates risks for Indians putting money into alternative investments. More than 6,000 people in the southern state of Tamil Nadu filed complaints in the past five months after investing in emu farms that failed to pay promised returns. Sahara Group, which owns New York's Plaza Hotel, was ordered by India's Supreme Court in August to refund 22 million investors $3 billion obtained through improper bond sales in the country's largest case involving a non-bank financial firm.

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The official figure for India's shadow-banking industry counts only what non-bank financial companies register with the central bank. The true size is much larger, including private lending and money channeled into more than 10,000 collective investment funds known as chits.

"It's impossible to calculate," said Kavita Rao, an economist at the National Institute of Public Finance and Policy in New Delhi who was appointed by the government last year to lead a panel to study the black-market economy. "India's shadows are dark and deep. There's just no way to know how much our informal lending is worth."

If the government knew where all loans went, it could more effectively target measures to direct the economy, said Shinjini Kumar, a director at PricewaterhouseCoopers in Mumbai.

"When liquidity goes and gets trapped and doesn't create economic activity, that's where there's great concern for stunting economic growth," Kumar said.

While raising interest rates should increase the cost of money and discourage inflation, non-bank companies, which need only a license to lend money, aren't subject to central bank limits on how much they can charge.

The Reserve Bank has been tightening regulation of non-bank lending to "reduce the risk in the system," deputy governor Anand Sinhahad said. "Shadow banking is seen as a dirty word," he had said. "What we are trying is to keep an eye on that segment and whenever necessary take necessary action."

The central bank on December 12 published draft guidelines aimed at tightening the rules for non-banking firms. The proposals call for Reserve Bank approval of ownership transfers, increased scrutiny of directors and greater disclosure in financial statements.

In November, the government banned banks from granting loans for the purpose of buying gold. The move was designed to prevent cash from exiting the banking system and no longer contributing to financial activity, such as lending, that fosters economic growth.

Gold holdings by individuals and corporations total about $950 billion, a number that includes savings outside of the banking system as well as gold held in bank deposits, according to Bhargav Vaidya, director of BN Vaidya & Associates, a Mumbai-based gold-traders advisory firm.

The RBI said it was regulating 12,375 non-bank financial institutions as of May. Among the largest are Mahindra & Mahindra Financial Services and Muthoot Capital Services, a publicly traded company controlled by the same family that runs Muthoot Fincorp and which also makes loans for gold.

Deshmukh, who turned over her jewelry as collateral, said she isn't worried about getting her gold back. She plans to let Muthoot Fincorp hang onto it to for at least another year while she makes payments. *Bloomberg*