A CONCEPT PAPER: GOLD SAVINGS PRODUCT WITH DEFERRED OR REDUCED DOLLAR OUTFLOW

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BACKGROUND OF THE CURRENT STUDY

An average investor wanting to protect wealth from depreciating currency would look to invest in gold. A farmer, who buys gold each season during harvest, considers gold as an asset not only for wealth creation or protection of wealth, but it is also seen as collateral that could be pledged and borrow in the event of any natural calamities. Such intuitive approach to wealth creation and insurance has been some out of the several drivers of investment demand in India. In India it is estimated that atleast 30% to 40% of the total gold demand is from investment market which is approximately $10 billion annually[1]. Much of such hoarding is not just about hedging against inflation but it is also a systematic accumulation plan so that these gold bars can be exchanged for cash, and in certain occasions same is exchanged for jewelry by only paying the making charges, thereby protecting themselves from any incremental effect on prices.

The supply for these are however imported gold leading to forego of dollars for accumulating a metal that doesn’t yield any interest, the investor risks theft and there is a cost of holding metal in safe vaults. And for the government the cost of foregoing the dollar isn’t resulting to a tangible increase in value addition to economy. Moreover, traceability has been a major concern after the first transaction with retail customer. The exchange of bars for jewellery is a practice observed during various discussions with retailers. It has however been difficult to prove empirically, that is because there is no traceability to this transaction.

Gold products available for investors:

Reserve Bank of India launched Sovereign Gold Bonds with the intention of postponing the physical purchase of gold. The result of which is approximately 23 tonnes of gold has been invested in government backed gold bonds since November 2015. The price of this is derived from polled price of India Bullion Jewellers Association. The investor gets an annualized 2.5% yield for holding an instrument which is not backed by physical gold and the interest earning is tax free. The government’s target was to sell approximately Rs. 15,000 crores equivalent of SGB each year that is approximately a little over 50 tonnes. The flipside of this instrument is although the government pays a yield to investor, it is the exchequer that takes the upside price

[1] WGC and Thomson Reuters GFMS

risk. And for the consumer it is settled in cash after an eight year lock in period, the price of settlement is not that of the day the bond is redeemed, and instead would be previous three days average price. Thus the rate at a retail store would be different from that of the SGB price.

The only other investment product for retail investors are gold ETF or buy the futures from exchange. Both have its drawbacks like management fees with respect to ETF and cost of a forward roll with respect to exchange listed futures.

More importantly each of the above products are embedded with basic customs duty of 10%, thus for any reason should the duty decrease investors lose the equivalent value which is driven by a government policy. This by itself doesn't provide flexibility to the government in reducing customs duty fearing the loss to investors.

OBJECTIVE OF THE PRODUCT

1. Incentivise import of gold only where there is value addition
2. Limit the dollar outflow for investment gold
3. Create a traceability at first form of conversion from an investment gold to jewelry
4. Investors take the price risk and government stays away from this business
5. Investor should have an incentive
6. The product should be fungible and can be used as a collateral

SIGNIFICANCE OF THE CURRENT WORK

We have conceptualized a product that hits each objective as outlined above. The product has been detailed in the pages (3-5) below.
Should product is found feasible after evaluating various risk parameters; it could have significant bearing on reducing dollar outflow related to gold. More particularly the network of post office payments bank can help a better rural penetration.

This would be the first phase of the project; similar approach would be then taken to evaluate it for various emerging economies.

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DESCRIPTION OF THE RESEARCH METHODOLOGY

Every product has its own risk elements, it is thus important to identify those risk elements and address it in a more comprehensive product note. For this purpose we would have to back test with price series of LBMA price, gold forward rates and exchange rates.
The back testing would evaluate risks in scenarios of higher price volatility in gold and exchange rates.
Evaluate parameters on who should be the custodian of gold.
The methodology would include interviews with bankers both domestic and international to get their feedback on the product.

PRODUCT NOTE:

INVESTING IN GOLD BY DEFERRING DOLLAR OUTFLOW:

In a normal financing operation between a supplier bank and domestic bank, a supplier bank would sanction a limit. The domestic bank in essence can have an exposure to that extent with supplier. Thus it is just an exposure and not an outward dollar payment. The product recommended below would actually work on similar line.

Steps:

1. An investor approaches domestic bank, and place order for an ounce of gold, let's say deliverable 12 months forward.
2. Gold is credited into the gold account and customers savings account debited. Since the order is a future delivery, the full price is debited from the investor's savings account.
3. The price of gold will be of 12-month forward (tenor can be at discretion of bank), which is 2.5% higher than current price due to the forward premium. However, investor doesn't pay customs duty or GST component thus 13% of the value is saved for the investor notionally. For instance a buyer of 1 kg gold is able to deploy the notional saving of approximately rupees two lakhs elsewhere. And investor gets bank rate for the gold which is substantially less than the retail rate. Thus, an investor has made an immediate notional profit due to the current BCD.
4. Domestic bank will simultaneously cover USDINR for the period and book Gold Forwards by paying 2.5% of the value on the value date.
5. At the time of expiry let's say one year (as in the above example) investor can redeem it in cash or physical metal or transfer the ounces to a jeweler (which is empanelled by banks) account for purchase of jewellery or can even roll it forward. Redemption will be at the prevailing rate on date of application to redeem.

6. Bank can structure the product to their convenience or their ability to deploy the capital. The mandate from top management is necessary to make it successful.
7. For step 3 & 4 Options could be an alternative

Who takes the price risk?

It is the investor who is exposed to price risk as the redemption will be of price on the day of closure.

What is the cost for banks?

Gold Forward interest rate for a year (GoFo) = 2.65% (as of 30th August, range = 2 to 3%)

USDINR 12-month forward = 4.3% (as of 30th August, but can range from 4% to 6%). Banks will be selling gold ounces in rupees however at time of redemption bank needs to import gold by paying dollar. Thus the banks cover their dollar risk through forward thus this cost.

Total hedging cost = GoFo+ INR forward= 6.95% (as of 30th August, but can range from 6.5% to 8.5%)

Call money rate for overnight = 6.45% (as of 30th August)

MCLR = 8.4% (as of 30th August)

One year fixed deposit rate = 7.25% (as of 30th August)

Limitations:

The cost of taking such gold deposit can at times be 1% higher than the call money rate for banks, and more than the cost of mobilizing fixed deposits, which in other words is a loss for banks to source deposits through this product. However, it still can be run profitable. And that is the reason we have explained the product in a scenario where the cost of hedging is going to be more than a percentage from the conventional source of funding.

At today’s rate as given above it is very favorable but may not be same all the period.

The product can only fit into a contract listed on exchanges or the denomination at which banks are willing to do forward booking. The research work would also explore the feasibility for denominations less than an Ounce.

What is the Incentive for banks?

Deploy investor's cash to high yielding asset: Banks have various opportunities to invest the cash from investor for a yield of 10% or more. Thus they earn atleast 2.5% (10%- 8.5%).

Retail gold at a higher premium: In a normal scenario where a bank supplies gold to wholesale customer they charge 50 cents/oz premium and when the end retail consumer buys gold from the jewellery retailer, they would pay in the range of 3% ($36/oz) to 5% ($60/oz) higher than the landed price. In the days when banks used to retail gold coins they were selling it at a mark-up of nothing less than 6% in lean season and 13% in peak season. Thus in case of this product, banks could charge customer 4% if the investor wants to redeem physical metal or charge 3% management fees if cash settled; nevertheless, that is something to be left for market to decide. The trade can be made profitable, however the mandate needs to be strong from top management.

What are the benefits for the customer?

1. Notional saving on outright payment of 10% BCD and 3% GST. Important to note that while buying wallet based gold products in India customers are paying 3% GST in advance although they aren't taking delivery of same.
2. When a retail customer sells bullion to a GST registered retailer they charge GST from the customer as it is an unregistered dealer purchase. In this case it can be avoided if the customer is willing to settle in cash and transfer the ounces to a jewellery retailer's ounces account. To note here is we will need a settlement bank to make this operational.
3. Let's assume the investor views price has rallied to a level expected and wants to exit, he could cash settle the position; the domestic bank does the same with supplier bank. In such an event gold is not imported at all.
4. Investor can use this gold accumulated in the account as a collateral not just for personal loan but could be used for corporate loan or housing finance or avail overdraft facility. This is the most liquid and most fungible collateral in the market.
5. This product when well marketed in rural areas can be very popular, as they don't have trouble related to vaulting, they trust banks, they need to pay 13% lower price for gold thereby making it more appealing than buying from the smuggled gold market, they can use it for collateral, this would perfectly fit into their seasonality based consumption and placing it as collateral. (The product should be named thinking rural consumers as the target.)

Benefits of this product for country and policy framework:

1. Dollar outflow limited to cost of hedging untill customer redeems it for converting to jewellery, this would ensure imported gold turns into a value added product (also coins, small investment bars, jewellery manufactured in India).
2. Banks get to deploy the fund for higher rates, which ensures investments into gold is used for economic activity.
3. Gives a stiff competition to smuggled gold market as an investor gets to buy gold 13% cheaper than imported gold, smuggled gold is normally sold only at 1 to 2 % lower than officially imported gold, excluding GST.
4. Big push to GMS on a prospective basis.
5. Essentially, the product postpones physical flow of gold for a year, and, thereby, outflow of foreign exchange, but creates more liquidity in the system based on the gold – it gives a onetime bump to the gold triggered liquidity and also to the financialization of gold.
6. The gold forwards can be rolled over for more than a year and if any supplier bank has good liquidity to provide gold forwards for longer tenor, all the more encouraging.
7. This again fits very well into the idea of an independent bullion bank – or with banks that are tasked with the responsibility of moving forward with the bullion banking expertise and scale.
8. Using of Options to add volumes into exchanges and add liquidity in far month contracts.