GMS and SGBS: Leveraging the Gold Derivatives Market: P K Singhal

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The Union Finance Minister, while presenting the Annual Budget 2015-16 on 28 February this year, announced two schemes aimed at better utilization of the country's gold stock and meeting Indians' penchant for gold, while keeping imports of the metal under check. Draft outlines of the two schemes were subsequently announced. The Gold Monetization Scheme, or GMS, attempts to mobilize the idle gold held by the public into interest-bearing redeemable deposits, while the Sovereign Gold Bond Scheme, or the SGBS, envisages the government to float bonds, the price of which will be linked to gold prices.

Both the schemes target the retail gold market and, by removing some of the flaws that existed in similar schemes launched on earlier occasions, have the potential to meet the multiple objectives they seek to achieve.

Using the derivatives market

It is important to note in this context that some institutions in India's gold economy are already functioning in a manner that complements the government's efforts at mitigating public demand for physical gold. The Multi Commodity Exchange of India, or MCX, for instance, has been helping thousands of stakeholders in India's gold market manage their risks arising from uncertainty and volatility in gold prices. To the extent that MCX has been providing an efficient and transparent platform for hedging, it has been making the holding of idle gold as a risk management measure, redundant. Hedging reduces the risk of uncertain price changes and, therefore, discourages physical market participants from accumulating their physical requirements unless backed by actual demand.

Hedging for banks

Given the pre-eminence of MCX in India's gold economy and the complementarity with the above-mentioned schemes' objectives, the exchange platform can play a significant role in the execution of the schemes. The biggest role of MCX would be in providing hedging solutions to the issuer of the gold bond (under SGBS) and the gold collecting banks (under GMS). Under the GMS, banks would have a fixed liability to the public against collection of a metal whose price is known to be volatile. Hence, it is important for banks to hedge, in part or in full, to enable which, necessary notifications need to be made in the Banking Regulation Act, 1949. Further, in lines with the advisory issued by the RBI to banks on 28 May, 2015, banks may be asked to encourage their gold borrowers too to hedge to mitigate the credit risk to banks. With the highest liquidity among Indian commodity exchanges, MCX gold futures can be the right hedging instrument for the gold collecting banks.

While gold mobilized by banks under the GMS would need to be hedged, idle gold underlying, i.e. backing for gold products like ETFs, also need to be channelized under the scheme and hedged. Gold ETFs are 100 percent backed by physical gold, the aggregate quantum of which was about 254 tons as on 31 March 2015, which is presently lying idle like household jewelry.

MCX as a cost-effective channel for depositing and trading gold and gold certificates

A possible problem that can arise in the GMS is the relatively fewer number of purity testing centers through which the public needs to go before depositing their assayed gold with the banks. MCX can again help plug in this gap. Since MCX currently accepts only

LBMA approved gold bars for physical delivery, stored in approved vaults, with a minimum 995 purity, the purity assurance is already in place at MCX. Hence, the scheme may carry a provision that MCX gold traders can directly transfer their gold stored in MCX-designated vaults to banks without any need for further purity verification. This will lead to the creation of a new cost-effective channel for depositing gold.

Another way in which a liquid gold derivatives platform can complement the GMS is by providing a platform for trading in the gold deposit certificates that banks issue after collecting gold. There is surely going to be unforeseen need for cash by the depositors, to meet which GMS already permits pre-mature withdrawal. The need for liquidity can be achieved with much lower cost if a liquid secondary market is created for the gold deposit certificate. For this purpose, these certificates can be recognized as collateral for accessing finance and be given 'negotiable instrument' status. The pricing and associated interest rate of these tradable certificates can be market-determined. This will be a win-win for both the banks and the gold depositors.

MCX gold price as reference price

Finally, the GMS and the SGBS are both going to require a well-established reference price of gold at the time of redemption, especially when redeemed in cash under the GMS. Given the length of time in existence, liquidity, market share and the fact that it has emerged as the most accepted reference price for physical market gold transactions across country, MCX gold prices can be considered as most appropriate reference prices.

MCX, being the number one commodity exchange in India (with 98% market share in 2014-15) and number three in the world for gold (according to the Futures Industry Association) has an extensive reach with around 2000 active members and 49,000 Authorized Persons reaching out to over 22 lakh unique clients operating through around 4,80,000 terminals across 1,879 cities and towns across India. In fact, more than 1,62,000 unique clients participated in gold trading alone on MCX during 2014-15. The transparently discovered gold prices on the MCX platform have been known to be the most scientific and well-accepted as the pan-India reference price for the yellow metal across the country. Hence, it is only natural that the gold prices discovered by MCX are accepted as the reference prices required for the execution of the schemes. Besides, such an extensive network mentioned above can also be used to market the two schemes.

Concluding remarks

Over the years, MCX has created not just a robust risk management platform of global standards, but also a robust ecosystem surrounding this platform. As elaborated above, this platform and the ecosystem can be leveraged in multiple ways for the successful execution of the GMS and SGBS. By their very design, the schemes explicitly target small depositors, which resonates with the various-sized MCX gold contracts available for trading, with contract-size being as small as 1 gram. Hence the objective of attracting small depositors can get a fillip by integrating the MCX platform, and hence its participants, with the GMS and SGBS.

With the right policies and design of the schemes, MCX platform can be used effectively to increase the accessibility of gold owners or potential investors spread across the country to embrace the two schemes, thereby ensuring their success.

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