Draft Proposal Presented to DGFT

"This document was presented to Dr. Anup Pujari, IAS, Director General of Foreign Trade, Ministry of Commerce, Government of India on September 26, 2012 by the core committee members".

This document is a summary of proposals that emerged out of discussions with the stakeholders of the Indian bullion industry at the 9th India International Gold Convention 2012, held at Hyderabad International Convention Centre (HICC), between 24th and 26th August, 2012.

The proposal comprises three parts, namely,

Part-A: Proposals to reduce dependence on imported gold bullion
Part-B: Proposals on tax reforms in gold bullion
Part-c: Proposals on market reforms in gold bullion

The industry is unanimous in its resolve to engage with the government to create a mutually acceptable, workable plan for development of a vibrant Indian bullion and jewellery industry. A brief background on the reform initiatives initiated by the government in the past is provided in the annexure-1.

The draft is prepared in consultations with the core committee comprising

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Submitted by: Core Committee of 'India International Gold Convention'

Part-A: Proposals to reduce dependence on imported gold bullion.

a. Export of bullion

Liberalise export of bullion by doing away with the value addition criteria and by coming up with guidelines on procedures of refund of import duty as per the prevailing rate at the time of export. The duty refund or duty credit can then be used by an importer for payment of customs duty for permitted import items.

Bullion (995 and 9999 fineness) is the standard product and is considered as and traded like a currency in the international market. Just as currencies cannot be sold at premium over the international market prices, bullion too cannot be exported with value additions and import duties applicable on bullion cannot be exported.

At present the regulation mandates a minimum value-addition of 1.8%. Assuming a price of US$ 1700 per ounce of gold, the value addition component comes to US$ 30.6/ounce (roughly about 50 rupees per gram). Given the competitiveness of the bullion market, it is not practical to get such high premium on standard gold bullion.

The USD value of the bullion to be exported can be fixed as the London PM Fix on the day of the export.For exports made by domestic bullion refiners processing imported dore, the duty refund / credit is the duty paid at the time of import of Dore; consequently the export should be limited only to the extent of import made during the immediate preceding Dore import.

What are the benefits of permitting bullion exports?

1. India has imported about 12000 tonnes of gold bullion during the last 15 years. The average price at which the gold bullion stock was accumulated was around US$600/troy ounce. The current prices are way above the purchase price. Hence there is a strong incentive to export the bullion held in India and earn valuable foreign exchange for the country. If we **assume an export of 100 tonnes per year** on a conservative basis, it would amount to a **foreign exchange inflow of US$ 6 billion annually (at the current price of Rs. 31000 per 10 gram)**. To that extent it would reduce the size of current account deficit.
2. The demand for bullion in India is seasonal. Refineries have to operate round the year and hence export of bullion would be a very important aspect of business for refiners during times when domestic demand is low. It will ensure smooth operation of refineries.
3. India, despite being the largest importer of gold bullion, does not influence or set price of gold bullion in the international market. This is partly due to absence of India in the supply end of the bullion market. If export of bullion is allowed, then two way movement of gold from India would make India a truly global player in gold bullion.

b. Gold Deposit / Certificate / bond scheme

It is estimated that about 18000 tonnes of gold (about 3/5th of India's GDP) is with the Indian households. The present Gold Deposit Scheme has been unsuccessful in mobilising the household gold in India because of various reasons. The present scheme needs to be modified appropriately in order to get the hoard of household gold into circulation. The effective way to substitute imports is by allowing banks to launch "Gold Certificates". The scheme proposes to bring at least INR 5000 cr. of gold every year and reduce import burden on the country. With appropriate incentives, this target could be increased multi-folds. This will also reduce burden on imports.

Proposed changes to the Gold Deposit Scheme:

a) Banks should be allowed to accept gold deposit of standard bars/coins/medallions and need to melt the same as prescribed by the original scheme.
b) Currently only a handful of banks are offering the gold deposit scheme, efforts must be made to market this product to wider audience and more banks should participate in mobilising household gold.
c) Banks should further be allowed to hedge the risk exposure arising from such deposits on domestic commodity exchanges.

Gold Savings Account:

To bring about a change in holding of household gold, bullion banking should be promoted. People having gold should be allowed to deposit and withdraw gold bullion from a bullion bank like a normal saving bank account.

a) Gold Savings account will be a gold denominated savings account. All deposits and withdrawal shall be made in gold form only.
b) The account holder shall also receive interest on his gold holdings without having to worry about safekeeping.
c) The account holder can withdraw his holdings by giving a notice to the bullion bank, this way the account holder enjoys the benefit of liquidity of his gold savings.
d) Banks should be allowed to participate in commodity futures exchanges in India to the extent of their exposure in gold savings.

Gold Certificates:

Since gold forms a very important part of asset allocation for small households in India, the absence of **"paper gold"** products results in imports of huge quantities of gold into the country. The investment needs of these classes of investors can be met with paper gold products, thus **reducing the import burden on the country.**

a) Gold Certificate acts as an alternative to investment in physical gold for the Indian Investor. This provides an opportunity to the customer to purchase in INR, a certificate representing the value of a particular quantity of gold.
b) The Bank/institution issuing such certificate in turn will hedge its exposure by using gold forwards as approved by the RBI. Banks should also be allowed to hedge their

exposure through domestic commodity exchanges, given good liquidity and other risk-mitigating elements connected to exchange-traded bullion derivatives

c) Upon maturity the certificate will be settled for INR value of the denominated quantity of gold. This certificate will be redeemable only in rupees.
d) These certificates may also be listed on the exchanges to further provide liquidity.

This product will mimic the price movement of gold in INR without having the need to import physical gold.

Advantages:

Unlock gold bullion idling in the households and convert into financial asset for productive purposes.

Reducing import burden on country by encouraging investment paper gold products.

c. Expand banks role and service spectrum

- Permit banks to 'buy back' bullion and coins onwards for re-sale in the domestic markets.
- Permit banks to offer services based on domestic hedging products. This would expand the service spectrum of the banks
- Permit banks to source gold from domestic refiners.
- Leasing of Precious metals (Including PGM) to industrial manufacturers

The above steps shall result in capping annual gold imports to well less than 500 tonnes.

<u>Jewellery Exporters Issues</u>

1. <u>Operational issues under DGFT for Exports:</u>

1) Draw back rates on jewellery exports in line of Gold Import duty rates.
   Import duty goes up with change in Gold price on regular basis while Draw back rates are still far behind. A system to be set –up to revise draw back rates as soon as Import duty goes up. (Due to change in reference / tariff rate for Gold and rupee change)

2) Clarification to be issued as to time period within which replenishment Gold can be claimed from nominated agency (Say 90/180 days) from export or realization of proceeds whichever is later.
   Time restriction of claiming replenishment Gold should be increased at present few agencies /Bank are of the opinion it has to be 30 day from Export.

2. <u>Operational issues Bullion Imports and operations for Nominated Agencies :</u>

Amendment to RBI notification "RBI/2005-06/155, DBOD.No.IBD.BC. 33 /23.67.001/2005-06"

To bring all nominated agencies including nominated banks at par and to encourage reforms as has been highlighted under the 'gold deposit scheme', we request the amendment to the above mentioned RBI notification.It is requested that point no. 3 sub-point (1) of the above said notification (page no. 2) be amended to include nominated agencies in addition to the nominated banks as follows

"The stand-by LC/BG be issued by scheduled commercial banks in favour of a nominated bank (**include "and nominated agencies")** only and …… import gold."

Part-B: Proposals on tax reforms in bullion industry

3. Tax reforms for higher compliance and operational ease
    a. For operational convenience, the prevailing ad valorem import duty ongold be notified in Indian rupees and on weight basis once in a month.
    b. Uniform VAT with a set-off provision for CST will simplify procedure & reduce transaction costs.
    c. Given that gold in bullion and jewellery form is used as a saving tool, it is requested that GST on bullion and jewellery be maintained at 1% as a special case.
    d. Align TCS limit on Bullion with that for jewellery, i.e. from 2 lakh to Rs. 5 lakhs.
    e. For import of scrap, the issues to be addressed are:
        I. determination of gold / silver & residual base metal content in the scrap for the purpose of levying import duty
        II. transparency of the origin of scrap vis-a-vis a turn round activity in jewellery
        III. import duty & excise applicability
        IV. import under duty free import licence for subsequent export of bullion / product and its value addition
    f. Recently DGFT has advised refineries to apply for an import licence for import of Dore. This is the first instance where an import licence is being stipulated for import of a freely importable raw material / a material that is not coming under a banned import category. The requirement needs to be reviewed, as it is an anachronism in the current trade regime.

4. **Facilitate hedging using gold futures contract by actual users:** Hedgers using the platform of gold futures to manage risks are not permitted to avail tax benefits if they do not opt for physical delivery. This is because gains from futures trading are treated as gains from 'speculation' business in case of non-delivery, though users might be genuine hedgers. Such tax treatment (exists both under IT Act, 1961 as well as the proposed Direct Taxes Code) discourages the bullion market participants from hedging. This issue needs to be resolved for encouraging bullion market participants to transparently manage their risks.

Part-C: Proposals on market reforms in bullion industry

Need for bullion banks:

Running a refinery is very capital intensive. All over the world, the refiner & miner relationships are facilitated by specialised bullion banks, which enables smooth transfer of risks, swap bullion with cash and vice-versa besides provide finance for operations. There is a crying need for one or more banks in India to have departments dedicated to such facility, thereby being recognised as integrated Bullion Bank. Consignment, safe keeping, processing, refining & purchase agreements are the global industry standard and it is high time one or more RBI mandated banks authorised to import gold made this transformation.

Enact FCRA Amendment Bill:

As has been well recognized, a vibrant commodity derivatives market helps in efficient functioning of underlying physical market. In this regard, certain policy measures need to be brought upon for the further development of the bullion market. One of the important measures being the amendment of the Forward Contracts (Regulation) Act, 1952. Currently, A variety of derivative products (most notably, options) which are particularly suited to the small bullion traders and jewelers, are not allowed under the existing statute. Hence, the proposed FCRA Amendment Bill, currently placed in the parliament, should be ***immediately passed***.

A glaring shortcoming of the commodity derivatives market is the prohibition of banks and other financial institutions from entering into this market. Given their own risk exposure and that of their clients,banks should also be allowed to hedge through domestic commodity exchanges. Besides, by hedging on domestic exchange, banks would be hedging the price risk in Indian Rupee and thus negating any need for hedging FOREX risk.

By being able to participate in domestic commodity exchanges, banks can also buy gold from exchanges and deliver to their customers as and when they place a demand, thus reducing the need for hoarding of gold by banks. Moreover, allowing various financial institutions like banks, mutual funds, insurance companies, etc. will bring in more heterogeneity in participation in the commodity derivatives market, infuse more liquidity in the system, and in the process, will smoothen the entry and exit barriers in the market through lowering of impact costs (and bid-ask spread), and will enhance the hedging efficiency (better risk management).

For such institutional participation and more specifically banks' participation to take place, there is a need for an executive decision to make trading on commodity derivative exchange an eligible activity u/s 6(1)(o) of The Banking Regulation Act, 1949.

Gold mining:

India has a significant potential reserve of gold and other precious metals. Mining and exploration policy for precious metals shall greatly benefit the industry.

Industry development fund:

Allocate a portion of the customs duty levy for research and development of the bullion industry, including but not limited to, exploration and prospecting of gold mines within the country, set up hallmarking / assaying facilities, incentivise refining infrastructure, etc.

<u>Reforms in the Exchange Traded Funds segment of gold investments:</u>

On the gold ETFs, at present there are 14 AMCs with over Rs. 10100 cr. AUMs. Our expense ratios are out of alignment with the rest of the world. Absence of liquidity and depth in the market increases the impact costs of the trade. Permitting gold to be leased out with suitable framework that will reduce the liquidity risks, duration risks and credit risks together with periodic independent audits, can bring down expense ratios and make the product proposition attractive for customers. We appeal to the regulators to look at this possibility with suitable caveats.

Integrating physical market (jewellery segment) with gold ETF or gold units in dematerialised form is the next logical step. This is ideal for the consumers as it completes the chain and enables them to convert savings into metal as per needs. Digitisation of the markets will ensures tax compliance and clear audit trail. Industry requests government to enable this process by broad-basing the participant network from the current estimated 5 lakhs users.

Another heartening trend is the corporate participation in Gold ETFs. As per the NSE report, about 55% of the AUM in gold ETFs is contributed by corporate (as on March 2012). The corporate's contribution was little over 30% in March 2011. Thus, gold ETFs have a healthy mix of corporate and retail participation. While there are minor operational issues, this is ideal for the consumers as it completes the chain and enables her to convert savings into metal as per needs. For the government too, it ensures tax compliance and clear audit trail. Industry requests government to enable this process by broad-basing the participant network from the current estimated 5 lakhs users. Additionally, as Gold ETFs are exposed to price volatility of gold, hence Mutual Funds offering Gold ETFs should be allowed to hedge on domestic commodity exchanges.

Permit Silver ETF

It is requested that government permit the launch of Silver ETFs. Currently, there is a lack of clarity over regulatory jurisdiction (whether SEBI or FMC) under which silver ETF comes. It is requested that the government decide on this issue at the earliest. Given the issues and challenges related to storage and movement of physical silver and also higher volatility in the silver markets, the industry needs such a product proposition and is open to accepting government's decision on the choice of regulator.

Annexure-1: Background on reforms in Indian bullion markets in recent times

Some of the progressive reforms initiated by the Indian government in the bullion markets since 1996 are given below.

I. Liberalisation of import of gold through nominated agencies (1993);
II. Expanding the nominated agencies to include banks, star export houses(1997);
III. Introduction of futures market / contracts in gold and silver (2002);
IV. Launch of gold ETFs in the stock exchanges (2007);
V. Thrust on jewellery exports through SEZs; f. (Gold loan for importation of gold for value-addition).
VI. The inverted duty structure between the dore/concentrate and standard bullion bar was set right (2007) and enabling environment is being created for developing a robust refining infrastructure.
VII. Recently issued a licence to a major jewellery manufacturer to import gold direct for its in-house actual use.

Results

a. LBMA gold price (expressed in Indian rupee) and Indian gold price differential reduced to less than 0.5% (2009-10). This encouraged legal business and eliminated incentives for parallel trade.
b. Tax collection from imports improved from less than Rs. 500 cr. to over Rs. 2000 cr. in 2010-11.
c. Export of gold jewellery increased (from USD 5.2 billion in 2006-07 to USD 9.5 billion in 2011-12 Source: GJEPC)
d. Employment opportunities in bullion and jewellery sector increased four folds during the last 10 years.
e. Modern organised retail formats starting coming up in jewellery sector. These are transparent, tax compliance systems with huge employment potential.
f. Six modern refineries are being set-up in the country
g. 14 AMCs are operating gold ETF as on today with over 5 lakh investors under their fold and about Rs. 10100 cr. under management.

Why invest in Gold?
Between 1970 and 2010, a long 40 year period, gold in Indian rupee terms has yielded an average annual return of over 11%, during the same period annual inflation (WPI based) was 7.5%. Secondly, in 34 out of the 40 years gold outperformed inflation. Gold has outperformed inflation and has also shown remarkable consistency. (Based on data source obtained from RBI). Thus, consistent performance of gold is the basic reason for investor's appetite for gold in India. With income level rising, the trend in investment into gold will go up.