BANK OF ENGLAND

Speech

The Role of the Bank of England in the Gold Market

Speech given by

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THE ROLE OF THE BANK OF ENGLAND IN THE GOLD MARKET

1 This morning I would like to talk about the role of the Bank of England in the gold market. One element of that is our management, on behalf of the Government, of the UK's official gold reserves, and I'll be saying a little about that. But I will be saying more about other aspects of our involvement in the gold market that may be less familiar to some people in the audience here. In particular I will describe the Bank's provision of custodial and account management services to central banks and to commercial firms active in the London market, reflecting our role in seeking to ensure the efficiency and effectiveness of the UK financial sector. And I will explain the Bank's contribution to the self-regulation of the wholesale gold market. In all these areas we cooperate closely with the LBMA, and I shall explain how that relationship functions.

2 First, then, the official reserves. The UK is a little unusual, although certainly not unique, in that the official reserves of foreign currency and gold are held on the balance sheet of the Government rather than of the central bank. The Bank of England's role is to manage the reserves portfolio, embracing both foreign currency assets and liabilities, on behalf of the Government, or more specifically the Treasury, our Finance Ministry. We do that according to a Remit which they set for us each year. Strategic decisions about the reserves portfolio, such as high-level asset allocation, are taken by the Treasury. The Bank provides analysis and advice to assist the Treasury in making these decisions; we implement the decisions that the Treasury makes; and we manage the reserves on a day to day basis. I should add that in recent years the Bank's management of the official gold reserves has also taken place within the framework of the 1999 Central Bank Agreement on Gold, with which I imagine you all to be familiar.

3 In the context of gold, the most significant strategic move of recent years was clearly the Government's decision to reduce the holdings of gold in the reserves by just over half as a portfolio diversification measure. This was achieved through the series of auctions that the Bank conducted between 1999 and last year. Now, this is a subject that has already been subject to a considerable amount of comment and analysis, and I don't propose to add much to that here. The Treasury have produced a very comprehensive *Review* of the gold sales programme, which is available on their

website, and if any of you has residual questions about the programme I am sure you will be able to find the answers there. The UK remains a significant holder of gold: we have around 315 tonnes, worth $3½ billion at the current price, making us, still, amongst the largest twenty official holders.

4 Like many other central banks, whether or not they have the reserves on their own balance sheet, our day-to-day management of the gold holdings in the reserves is aimed at achieving a return on them, by lending a portion to the market. As is increasingly common amongst central banks, we have a strategic benchmark for this gold lending portfolio, in our case set by the Treasury. The Bank is able, subject to market and credit risk limits, to adjust the maturity distribution of the actual portfolio, relative to that of the benchmark, in search of additional returns. The return on the actual portfolio relative to the benchmark measures the value that the Bank has been able to add by this 'active management'.

5 Recently, of course, gold lending rates have been extremely low. Commentators seem to be in broad agreement as to why that is. There is a low interest rate environment globally, and one might expect that to influence interest rates on gold. But there are also factors specific to the gold market. In particular, much, although not all, gold lending ultimately facilitates the hedging by gold producers of their future output. And, as is well known, producer hedge books have become smaller recently.

6 Over the past couple of years, a number of central banks have withdrawn some of their gold from the lending market. Gold Fields Mineral Services estimate that outstanding lending by the official sector was 266 tonnes lower at the end of 2002 than it had been a year earlier. In reality this just reflects lower demand from the ultimate borrowers, communicated via the interest rate. In the context of short-term rates in the single digit basis points one might perhaps have expected official lending to fall further, when allowance is made for the compensation necessary to take account of credit risk and transaction costs.

7 I have spoken so far about the Bank of England's role as Agent for the Treasury in managing the official gold reserves. I would like to move on now to the broader market in London and the Bank's role in it.

8 Comparative international data on turnover in the wholesale gold market are sparse, but London is generally considered to be the most significant centre for spot and forward purchases and sales, Over-The-Counter gold derivatives, and, in particular, for gold lending.

9 What is the Bank of England's place in this ? First, we are a very significant custodian of physical gold. Primarily this is gold that belongs to other central banks, but we also store gold in our vaults on behalf of a number of commercial firms that are active in the market. In fact, most of the gold we store is not our own. We are certainly not unique amongst central banks in this custodial role. Most notably, the US Federal Reserve also offers this service to other central banks, although not to private sector institutions. The Fed has the advantage of being located on bedrock so it is able to pile its holdings up to the ceiling. We are stuck with London clay, so we are limited to a certain number of bars per pallet!

10 And there are of course many commercial firms providing vaulting facilities, in London and elsewhere around the world. Most often, however, commercial bank storage services are conducted on an un-allocated basis. This means, as many of you will be aware, that the owner has a claim on the commercial bank where it is held for a certain amount of gold, but does not have title to specific bars.

11 What the Bank provides is an account management service on an allocated basis. That means that those holding gold at the Bank, particularly other central banks, have the reassurance of knowing that they have title to specific bars; but they are also able to mobilise those gold holdings conveniently by making or receiving so-called 'electronic book entry transfers' between their account at the Bank and the account of their counterparty. Such a transfer does not require gold to be physically moved within the Bank's vaults; rather, title to the bars in question is transferred within the Bank's IT systems. We are probably unique in offering this kind of account management service on the scale that we do, and to a large number both of central bank and private sector participants in the market. The significance of this facility is that it provides an important element of the infrastructure that brings market participants together.

12 This system is one that has grown up organically over a long period of time, and very much in response to representations from our central bank customers and from the London market itself. It has no doubt been a factor in London maintaining its position as the most significant international centre in the wholesale gold market. However, other factors have, I am sure, been even more significant. In particular the establishment, and promotion by the LBMA, of London Good Delivery standards, has been crucial. Many aspects of the wholesale market could not exist in the absence of the fungibility and general acceptability of different bars within the London clearing system. Such is the confidence in this market standard that the term London Good Delivery is recognised and respected world-wide.

13 A further activity, one that grew out of the Bank's custodial role, is that we are prepared to accept gold deposits from other central banks, which we lend on to the market in our own name, at a margin to reflect the cost and credit risk incurred. Our central bank customers thereby gain the convenience of being able to generate a return on part of their gold holdings, whilst only having to manage a single front and back office relationship. The assets and liabilities denominated in gold on the Bank's own balance sheet derive entirely from this borrowing and lending activity. Since we publish these figures on our website each month in accordance with the IMF's disclosure standards, anyone who is interested may track this business from there. At end-April it totalled around forty-five tonnes, reflecting the current interest rate environment. It has been above one hundred tonnes in the past.

14 We are happy that we have been in a position to assist the development of the market in these ways, but we are not wholly selfless! We do charge fees for the facilities we provide. More broadly these activities reflect the Bank's role in seeking to ensure the effectiveness of the UK's financial services, which we do in part by supporting the development of an efficient financial infrastructure.

15 Finally, I would like to say a word about the Bank's role in the regulation of the gold market in the UK. This is, in fact, a very limited one. Since the establishment of the Financial Services Authority in 1998, it has been the regulator of individual institutions. The wholesale bullion market is considered to be an inter-professional market, or, in the distinctive parlance of the UK regulatory framework, a 'non-investment products' market. This means that, in general, the principle of

caveat emptor applies and the market is expected to be self-regulating. The same is true, as it should be, of the foreign exchange and cash money markets in the UK.

16 As has always been the case, the Bank of England contributes to the self-regulation of all these markets. Nowadays we do that by facilitating the production of the Non-Investment Products Code, known by its acronym, the NIPs Code. This is a code of good practice for participants in these wholesale, over-the-counter markets, covering such things as dealing procedures and conventions. It provides a framework for market participants to gauge what is, and what is not, reasonable and professional conduct. The NIPs Code is produced and maintained jointly by the London Foreign Exchange Joint Standing Committee, for which the Bank of England provides a Chairman and a secretariat; by the Money Markets Liaison Group, for which we provide a similar service; and by the Management Committee of the LBMA. The Financial Services Authority has also participated in the development of the Code and says that it expects the management of authorised firms to take due account of it. The LBMA has endorsed the NIPs Code on behalf of the bullion market, and is consulted on all proposed changes to the Code.

17 In fact it should be apparent from much that I have said that the Bank works very closely with the LBMA in a variety of contexts. Representatives of the Bank are invited to attend meetings of the Management and Physical Committees of the LBMA as observers, and beyond that we have a very close ongoing working relationship. It seems to us that the LBMA and its participant firms do an excellent job of promoting the bullion markets, increasingly at a global level rather than solely in London, and it has been a great pleasure for me to be able to speak at the LBMA's annual conference today.