Regulation Update

Adding Gold to Europe's Liquidity Buffers

By Natalie Dempster, Director of Government Affairs, World Gold Council

The capital-adequacy requirements set out in the third Basel banking supervision accords, endorsed by G20 leaders in November last year, are a crucial means of preventing a repeat of the liquidity crisis that occurred in 2008.

There is, though, room for improvement in the design of the proposed rules. The rules would require banks to hold buffers of high-quality liquid assets, designed to cushion them from acute short-term funding strains. While the proposals are clearly a significant step forward in ensuring such strains are avoided, the definition of liquid assets is too limited: as they stand, the proposals only permit banks to hold cash, high-quality government bonds and high-quality non-financial corporate and covered bonds (the latter two with a 'haircut' – a discount – to reflect their higher credit risk).

In a world of hugely elevated sovereign-debt risk, there is a real danger that under the existing proposals banks would become overly dependent on government bonds for liquidity. In the last crisis, sovereign bonds were far from immune to liquidity issues, and given the current record levels of Western government debt and ongoing concerns over sovereign-debt downgrades (or even defaults), a repeat of this scenario would pose a real risk to the liquidity provisions.

This issue could be remedied with added asset diversification. The more assets eligible for inclusion in the liquidity buffers, the less distortion the new regulations will cause in any one market and the lower the concentration risk for commercial banks.

The ultimate high-quality liquid asset is generally considered to be gold. That is because gold bears no credit risk: it involves no counterparty and is no one's liability. The risks associated with it are not correlated – not related – to the risks of other financial assets, making it an effective diversifier, a characteristic underpinned by its uniquely diverse demand base. At the height of the 2007-09 liquidity crisis, it was used extensively by fund managers to raise the cash necessary to meet margin calls – to add cash to their account with their broker – and to pay redemptions in order to stay in business. To date, however, gold has not been included under Basel III's liquidity proposals.

The Institute of International Finance summarised the curious nature of gold's omission when, last April, it submitted comments on Basel III: "It is striking that gold is not recognised as having liquidity value, whereas gold is virtually always liquefiable for cash and tends to benefit from a perceived 'safe haven' status".

The bottom line is that more debate is needed, as the current standards are short-sighted. In Europe, the European Commission, under the leadership of Michel Barnier, commissioner for the internal market, has begun work on the fourth capital-requirement directive (CRD IV), which will transpose Basel III into draft law. That will be reviewed by the European Parliament rapporteur Othmar Karas and the members of the European Parliament's economic and monetary affairs committee. There is still time to amend the regulation to reflect a reality recognised by government treasuries and individual households for centuries – that in bad times, as in good times, there is a market for gold. ■