

THE BANGKO SENTRAL NG PILIPINAS AND GOLD – A SYMBIOTIC RELATIONSHIP

BY MARIA RAMONA GERTRUDES T. SANTIAGO, SENIOR ASSISTANT GOVERNOR, BANGKO SENTRAL NG PILIPINAS

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INTRODUCTION

On 7 August 2019, we saw the spot gold price ascending beyond US\$1,500 per fine troy ounce (FTO), eventually soaring to a six-year high of \$1,557.31 on 4 September 2019, as investors sought safe havens amid a confluence of factors, such as the growing negative yielding debt, escalating trade and geopolitical tensions, and dovish monetary policies among advanced economies. The significant rise of gold prices this year, expected or otherwise, has led to greater attention on gold and its underpinnings.

PHILIPPINES HAS AN ESTIMATED \$840 BILLION WORTH OF UNTAPPED MINERAL WEALTH AND IN 2018 THE OUTPUT FROM MINING ACTIVITIES WAS VALUED AT AROUND \$3.4 BILLION

This conference serves as an excellent venue to talk about the prospects, issues, risks and opportunities for precious metals, including gold.

I will talk about the relationship of the Bangko Sentral ng Pilipinas with gold through the small-scale mining industry. My goal is to underscore that the links between the country, the BSP and gold form a symbiotic relationship. We will look at existing laws in my country, describe the relationship between the BSP and small-scale miners, and conclude with an outlook. From here on, I will refer to gold producers, small-scale miners and other individuals who sell their gold to the BSP as panners.

GOLD MINING IN THE PHILIPPINES

The Philippines is one of the most mineral-rich countries in the world. According to the Mines and Geosciences Bureau of the Philippines (MGB), the country has an estimated \$840 billion worth of untapped mineral wealth. In 2018, the output from mining activities was valued at around \$3.4 billion. Meanwhile, the total production value of metallic minerals for the same

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period was about \$2.3 billion, with gold accounting for about 37%. The Philippines is one of the top producers of gold in Asia and in the world. According to the World Gold Council (WGC), the Philippines ranks number 3 in Asia and number 24 in the world, based on gold production in 2018. Currently, the country has eight gold mines and two gold processing plants.

MGB data shows that around 75% of the gold mined in the country in 2015 came from small-scale miners.

Small-scale miners – or panners – are individuals or groups that organise themselves voluntarily to form duly licensed co-operatives that engage in the extraction of minerals or ore-bearing materials from the ground. They rely heavily on manual labour, using simple implements and methods rather than explosives or heavy mining equipment.

MINING ACTS

An important milestone in the country's mining industry was the passage of the People's Small-Scale Mining Act (PSSMA). This act is meant to generate employment opportunities, especially in mineral-rich areas where people have little means to access other employment opportunities. Accordingly, various government agencies worked together to put in place an orderly and rational scheme for the development and utilisation of mineral resources in a certain area. More importantly, under the Act, panners are mandated to sell to the BSP the gold they produce from any mineral areas. In turn, the BSP is required to buy the gold at prevailing market prices. In short, the benefit of this law is that it allows panners to access international market prices through the BSP.

Four years after the PSSMA was introduced, the Philippine Mining Act (PMA) of 1996 was enacted to revitalise the Philippine mining industry through fiscal reforms and incentives. It is considered to be one of the most socially and environmentally sensitive pieces of legislation in its class, as it contains specific provisions that consider the following: first, local government empowerment; second, respect and concern for the indigenous cultural communities; third, equitable sharing of benefits of natural wealth; fourth, economic demands of the present generation while providing the necessary foundation for future generations; and fifth, protection and wise management of the environment.

Of these two laws, the PSSMA marked an important turning point for the BSP and the Philippine gold industry. The Act formalised the relationship between the BSP and the local gold industry through the panners. This is what we refer to as a symbiotic relationship between the BSP and the panners. The passage of the legislation has resulted in the following advantages for the panners. Panners have a guaranteed buyer of gold in the BSP, which allows them to access fair market prices and rely on the creditworthiness of the BSP. When panners engage other gold buyers, these buyers may quote off-market prices with no assurance that transactions are conducted at arm's length. Further, panners can access the BSP's gold-buying stations across the country, thereby ensuring that the gold transactions are safe and legal. Finally, panners stand to benefit from the BSP's efforts to lobby for the removal of the sales tax imposed on panners.

On the other hand, the BSP has gained in the following ways.

The Act provides for a steady supply of gold locally, thereby allowing for the organic growth of the gross international reserves or GIR. The increase in the BSP's gold holdings has led to diversification, security, insurance and liquidity benefits. Finally, the accumulation of gold in the reserves has led to the development of the bank's internal capabilities, consistent with a prudent framework for managing the bank's reserves.

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GOLD PROCESS CYCLE

Panners sell their gold to the BSP's various gold-buying stations at prevailing global market rates. Purchased gold in the form of bars or discs are then refined at the BSP's security plant complex and converted into London Good Delivery bars. Once these bars are transferred to the BSP's bullion vault, they form part of the country's reserves. Some of the gold may also be made into semi-finished gold products in the form of grains and sheets for resale to local jewellers and industrial users. The BSP may periodically enter into location swap transactions to mobilise the Good Delivery bars and make these readily available for trading internationally.

BENEFITS TO PANNERS

The first benefit is the ability of the panners to access international market prices without needing to meet the minimum requirements for capital or transaction volume. How are these prices determined? The BSP bases its daily gold rates on quotes submitted by selected LBMA Market-Makers. These rates, which are published on a daily basis, are applied to the gold sales of the panners. In turn, the panners are paid in Philippine pesos based on the prevailing official peso/dollar exchange rate for the day.

Second, the BSP has established buying stations in mineral-rich areas. The existence of these stations makes it easier for the panners to sell their gold while reducing their costs and the risks related to transporting their gold. Currently, the BSP has five gold-buying stations across the country, situated near the gold mining areas. In particular, there are two in Luzon, two in Mindanao and one in metro Manila, which also serves as the gold refinery.

Third, the panners are assured that their transactions are legal and secure. They take comfort in knowing that they receive a fair deal from the BSP's accurate gold-weighing and assaying processes, something that is not certain in an informal market. Furthermore, under the BSP's gold-buying programme, the BSP pays an initial amount equivalent to 99% of the value of the delivery, based on the as-received weight and the preliminary assay by the specific gravity method.

TAXATION AND NEW LAWS

Outside of the Act, the BSP has been a champion of panners in the battle against taxation. In 2011, the BSP's gold purchases declined due to the stricter implementation by the revenue authority of an existing tax collection scheme. This scheme required the BSP to deduct withholding and excise taxes from its payments on gold purchases from the panners, thereby reducing the income of sellers by as much as 7%. The tax scheme resulted in a 96% drop in the BSP's gold purchases in 2012, as panners chose to sell their gold to other informal buyers to avoid the taxes. This situation encouraged the growth of informal markets, which based on anecdotal evidence, allowed the gold to be taken out of the country illegally. Indeed, the tax collection scheme had an adverse impact on both the panners and the BSP. For the panners, the imposition of taxes resulted in

lower income, further marginalising these people who are engaged in subsistence mining. As for the BSP, it lost the opportunity to build up its gold reserves bought with the local currency.

However, after years of discussions with the lawmakers, Republic Act No. 11256 was signed into law on 29 March 2019. Under this law, the income derived from the direct or indirect sale of gold to the BSP by registered panners and accredited traders is exempt from income and excise taxes.

Given the newly enacted law, the BSP hopes that the volume of local gold purchases will normalise towards pre-2011 quantities, before gold sales became subject to the aforementioned taxes.

PROGRAMME BENEFITS

Lastly, the positive impact of the BSP’s gold buying programme is estimated to benefit 500,000 panners, of which about 75% are engaged in subsistence mining. It also supports as many as 2.3 million Filipinos in 30 out of 80 provinces in the country. In 2018, the output from panners amounted to around \$13 million.

As for the BSP, the contribution of the panners to the building of the country’s reserves cannot be understated. The steady supply of gold from domestic sources paid for with Philippine pesos enables the BSP to grow its reserves independent of external sources. Further, the BSP’s reputation has certainly gained from its involvement in gold. The BSP’s steady accumulation of gold through its local trading activities in the 1960s and 1970s led to the construction of a gold refinery. The refinery met LBMA standards and accorded the BSP with recognition for being the only central bank that operates an LBMA accredited refinery.

BACKGROUND

As a brief background, the BSP’s gold holdings in the 1970s, when the bank reserve levels were low, spurred the central bank to include the precious metal in the gross international reserves (GIR). To do so, the locally produced and purchased gold needed to be converted into Good Delivery bars; hence, under the directive of the then President Ferdinand Marcos, in 1974, the BSP established a gold refinery suitable in design and capacity for the needs of the country.

Gold refining operations formally began in 1977, and by October of that year, in compliance with the requirements set by LBMA’s Physical Committee on fineness, weight, marks and appearance, the gold refinery plant, as it was then called, produced its first Good Delivery bar. In September 1979, after meeting LBMA standards, the BSP’s gold refinery was formally recognised as an accredited smelter and assayer of Good Delivery bars. The BSP gold bars were hence accepted in the international bullion market for trading. It is worth mentioning that establishment of the BSP’s gold refinery plant supports the People’s Small-Scale Mining Act, which requires panners to sell their gold to the central bank.

THE LOCALLY PRODUCED AND PURCHASED GOLD NEEDED TO BE CONVERTED INTO GOOD DELIVERY BARS IN 1974 THE BSP ESTABLISHED A GOLD REFINERY SUITABLE IN DESIGN AND CAPACITY FOR THE NEEDS OF THE COUNTRY

Over the years, the BSP’s gold refining operations have consistently complied with LBMA standards. In particular, under its responsible gold sourcing policy, the BSP commits to ensuring that the source of its gold products meets with the standards set forth by LBMA, with the ultimate goal of building customer trust. It may be noted that

the BSP passed its most recent Responsible Gold Guidance third-party audit for the period November 2017 to November 2018, and the Proactive Monitoring in 2016, which is conducted every five years.

Gold accumulation is one way to build the central bank’s foreign reserves. Gold currently represents about 9% to 10% of the country’s GIR. In terms of gold-to-GIR ratio, it reached a peak of 55% in 1990. The Philippines ranks 25th in the World Gold Council official gold holdings as of September 2019.

Given the country’s relatively small economy, the Philippines’ rankings

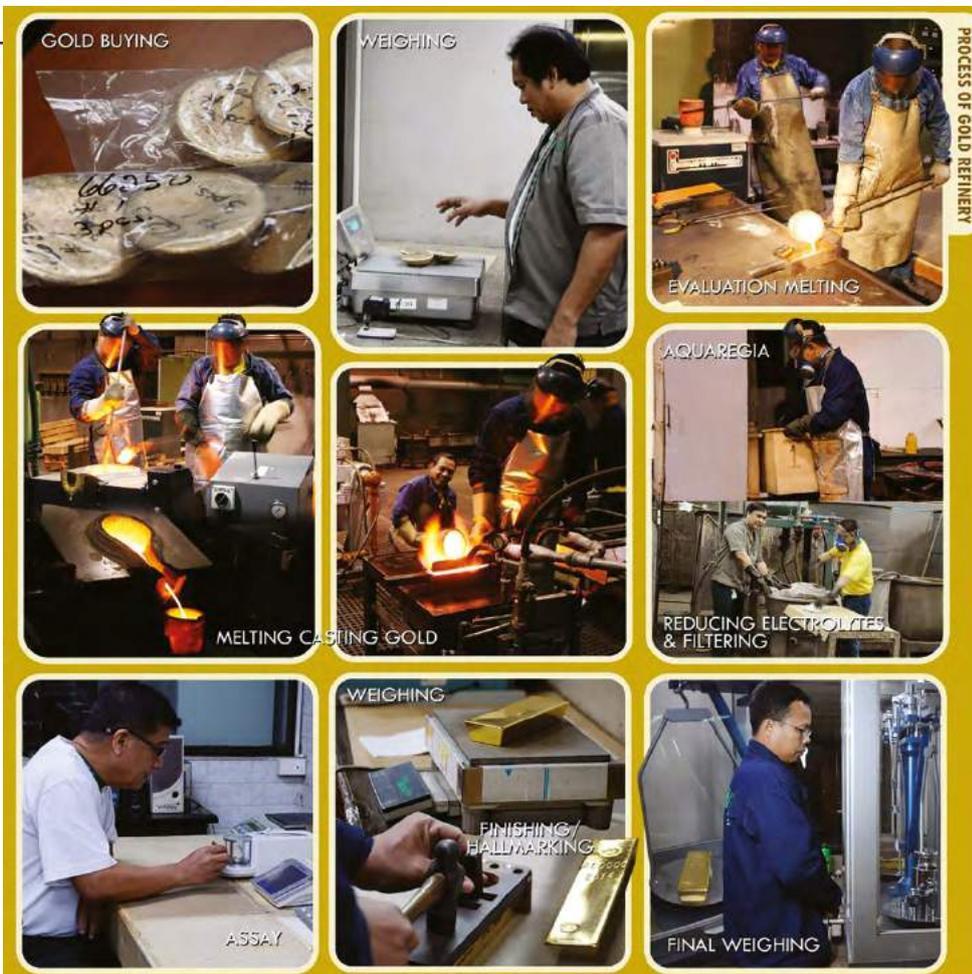
says a lot about how the central bank highly values the role gold plays as a safe-haven asset.

For the BSP, sourcing gold from the domestic markets makes sense. Buying gold using pesos increases the country’s reserves, whereas buying gold with US dollars only alters the composition of the reserves but does not increase it. It is also important to mention that maintaining an adequate level

of GIR improves a country’s creditworthiness. Creditors and credit-rating agencies pay particular attention to a country’s GIR level. Finally, a higher level of GIR serves as a buffer against external economic and financial shocks by providing adequate cover for the country’s import payments and foreign-denominated debt obligations.

REASONS FOR HOLDING GOLD IN RESERVE

Why does the BSP hold gold in the reserves? Gold is an effective diversifier of the assets of a central bank. A correlation exercise conducted by the BSP showed that the correlation among global fixed income markets was in most cases higher than the correlation between gold and each of the individual fixed-income markets covered.





Second, gold provides more security than most other assets, since it is considered a hard asset and is not an obligation of any particular government or entity.

As such, investors may hold it in perpetuity without regard to credit risk. Likewise, gold is physically indestructible, allowing for the storage of value over time. For this reason, jewellery demand from countries led by China and India account for about half of total gold demand.

Third, gold may be viewed as a kind of insurance. The correlation analysis previously mentioned also showed that while gold and fixed income assets usually move together, there will be periods when gold performs positively compared to bonds. This showcases the attribute of gold as insurance against the poor performance of other markets, including fixed income.

This is observed particularly in periods of extreme risk aversion, when investors purchase bullion more than fixed income assets. As such, gold acts not only as a diversifier but also as insurance, thereby preserving capital when needed.

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Finally, gold generates liquidity quite easily. Gold is a very liquid asset, and according to LBMA's clearing data, a daily average volume of 18 to 24 million FTO of unallocated gold was cleared in the first six months of 2019. That said, gold can generate liquidity not just by sales, but also through other instruments.

SUMMARY

The symbiotic relationship between the BSP and the gold market has led to the development of the BSP's gold reserve management capability. As such, the BSP's strategy in managing this asset has evolved over the years. The bank can engage in an array of transaction types, namely location swaps, spot trading, deposits, options, gold-backed loans and gold financial swaps. In engaging in these various transactions, the safety of the asset and the confidentiality of the transactions are of paramount importance; hence, the BSP has a strict counterparty selection process. Currently, these counterparties are limited to top international financial institutions, taking into consideration credit rating, financial strength, performance and other factors in determining exposure limits.

Looking ahead, gold will likely remain an important asset for some central banks, particularly the BSP, that view gold as a reliable asset in times of uncertainty. It is a good diversifier of the reserve portfolio. In a survey conducted by the World Gold Council in September 2018, 18% of central banks said they intended to increase their gold holdings in the next 12 months. With a legal framework in place and exemption of gold sales to the BSP from taxes, the BSP and the panners have been able to collaborate in a manner that is beneficial to both. Accordingly, the BSP is optimistic that the symbiotic relationship between itself and the panners will continue, and that the corresponding benefits for both the central bank and market participants will remain in place.

Head office of the Bangko Sentral ng Pilipinas



Maria Ramona Gertrudes T. Santiago is the Senior Assistant Governor of the Financial Market Operations Sub-Sector (FMOSS) of the Bangko Sentral ng Pilipinas (BSP). As head of FMOSS (formerly the Treasury Department) she oversees and provides direction over two vital functions of the Bank: managing the country's international reserves and ensuring that the BSP effectively carries out its mandate of promoting price stability through effective conduct of domestic market operations.

Within the BSP, she is a member of numerous committees, the most notable of which are the Advisory Committee and the Investment Management Committee. She is also a member of the Executives' Meeting of the East Asia and the Pacific Central Banks (EMEAP) Working Group on Financial Markets, and the Supervisory Committee of the ABF Pan Asia Bond Index Fund, among others.

Amid the recent wave of financial crises in the U.S. and Europe and the challenging investment environment, she spearheaded major changes in the governance structure and framework for managing the international reserves. Under her stewardship, reserves were managed in a prudent manner, adhering to sound risk management practices, in order to ensure the preservation of capital over the long term.