

# Session 1

## The Role of the Bank of England in the Gold Market

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Good morning. Thank you to the LBMA for the opportunity to speak to you here today. I would also on a personal note like to say that it is a great honour for me to be sharing a platform with Paul Mercier, who is one of the giants of my world – the world of central banks – where monetary economics meets financial markets. I was very interested to hear what Paul had to say.

It is a great pleasure to have this opportunity to speak to you today. What I have been asked to do this morning is to describe the Bank of England's role in the gold market; in doing that, I will set it in the context of the Bank's interest and role in financial markets more generally.

The Bank of England is involved in financial markets in support of its core purposes to promote and maintain monetary and financial stability as our contribution to a healthy economy. The two areas of the Bank that have an operational relationship with markets are the Markets Area, and Banking Services which provides wholesale banking and custody services to a range of customers, as well as operating the UK's high-value payments systems.

The Markets Area conducts a wide range of operations that support both monetary and financial stability objectives.

We implement monetary policy – that involves operating in the sterling money market to set the

MPC's interest rate; since March of this year it has of course also involved buying gilts via reverse auction to meet the MPC's target for asset purchases. The Asset Purchase Facility has also involved us in buying commercial paper and corporate bonds, and we have also launched a facility under which we stand ready to buy secured commercial paper. We provide liquidity insurance to the banking system. We do that principally via our sterling market operations, which include relatively new facilities and operations such as the Discount Window Facility and extended collateral long-term repos; and over the past year or so also via US dollar repo operations, in the context of swap facilities put in place between the US Federal Reserve and a number of other central banks.

The Foreign Exchange Division manages the government's foreign currency reserves on behalf of the Treasury; we manage the Bank of England's own foreign currency reserve assets and liabilities; and we provide foreign exchange and money market services to the Bank's customers.

In exercising our responsibility to manage both our own balance sheet and the government's foreign currency reserves, we undertake rigorous and prudent risk management to minimise the risks of financial loss or damage to the Bank's reputation.

Our operations form the starting point of an extensive network of market contacts, which enables us to deliver market intelligence and surveillance relevant to both our core purposes. Our market intelligence contacts and interests go far beyond the markets in which we are operational participants, and embrace as full a range of markets, intermediaries and investors as possible. As demanding as the recent market stresses were in all sorts of ways, it helped that we started from a position of understanding of, for example, the structured credit and asset-backed markets, and of the myriad investment vehicles in which those assets were held and funded.

While the financial strains of the past few years have involved the Bank in markets where it previously never had a presence, the Bank has always been linked, in some way, with the gold market. The Bank's role has evolved over time and there are now, very broadly, two aspects to our involvement.

The first stems from the Bank's management of the UK's official gold reserves, which are owned by the government and managed by the Bank as agent for the Treasury.

The second aspect of the Bank's involvement comprises a range of activities in its own capacity, that help to contribute to the effectiveness and efficiency of the gold market. One way this is achieved is through the provision of custodial and account management services to commercial and official sector customers who participate in the London gold market. Another is through the Bank's contribution to the self-regulation of the gold market. Our relationship with the LBMA and regular dialogue with gold market participants are valued and important underpinnings of all aspects of our involvement in the gold market .

Let me begin with the government's reserves. The Bank has a Remit from the Treasury, which is renewed annually and sets out the terms for the management of the UK's foreign exchange reserves. These include holdings of gold. To give an approximate idea of the magnitudes, the government's reserves include almost 10 million fine ounces of gold, with a market value of around \$10 billion, representing around 15% of reserve assets.

These assets and liabilities are held on the government's own balance sheet which is separate to that of the Bank's. The high level investment decisions are taken by the Treasury, supported by the Bank's own analysis and advice. These high level decisions have three goals: first, to make the reserves fit for the policy purposes for which they are held, which is

to be a source of foreign currency liquidity for day-to-day and exceptional government needs; second, to maintain the security of the reserves, and therefore to keep credit and market risks within strict limits; and third, and subject to the first two goals, to minimise the overall cost of holding reserves.

The Treasury's high level investment decisions set a benchmark. In its day-to-day management of the reserves the Bank has discretion to deviate from that benchmark within agreed risk limits, to generate additional return. A portion of the *currency* reserves are invested in highly liquid government debt and the Bank aims to achieve a return in excess of the benchmark in these portfolios by taking active trading positions in government bond markets. In this context, the Bank is much the same as any other market participant. The same is true of our activity in the gold market when managing the gold portfolio on behalf of the Treasury: the Bank is a participant in the market, just as it is in government debt markets, and, in this context, the extent of its involvement and responsibilities are the same as for any other market participant.

In the past, the benchmark for the gold portfolio included an element of gold unsecured lending. As with the currency reserves, the Bank had some discretion to vary the amount of gold lent, and the maturity of loans. Of course, lease rates have been extremely low recently for a variety of reasons. As you all know, the elimination of producer hedges over recent years has put significant downward pressure on lease rates. The low lease rates meant it was becoming unrealistic to achieve a benchmark return which justified the operational and credit risk involved

in lending. As such, gold lending was suspended in 2007.

I am not planning to cover the re-balancing of the government's reserves portfolio via gold auctions which the Bank executed between 1999 and 2002. This process was well-described in my colleague Graham Young's speech to your conference in Lisbon in 2003, and in the Bank's Quarterly Bulletin in the summer of that year. The auctions were conducted within the framework of the first central bank agreement on gold sales. The UK has not made further gold sales, and accordingly has not been a signatory to the two subsequent central bank agreements.

I'll move on now from our role as Agent for the Treasury and speak about the other aspects of the Bank's involvement with the gold market.

The Bank has one of the largest gold vaults in the world holding a significant amount of physical gold; to give you a broad idea of the magnitudes, which are published in our annual report and accounts, there are around 400,000 gold bars in our vaults, with a market value at current prices of around £100 billion. The gold in the Bank's vaults is held on behalf of its customers, which include other central banks and international financial institutions, members of the LBMA as well as the UK Treasury. The Bank is not unique in its role as a custodian and other central banks do offer similar facilities, most notably the Federal Reserve.

Other commercial firms, in London and around the world, provide custodial services, although these are more commonly provided on an unallocated basis. As you know, this means that

the owner has ownership of a specific quantity of gold but no title to individual bars. However, the Bank provides an account management service on an allocated basis. That means that our customers holding gold at the Bank have title to specific bars.

Moreover, owners are also able to mobilise those gold holdings conveniently by making or receiving what are known as 'book entry transfers' between the accounts of our customers at the Bank. Transfers effected in this way are advantageous because there is no requirement for the gold to be physically moved within the Bank's vaults; instead, title to specific bars is transferred within the Bank's back-office system. The Bank is probably unique in providing this kind of account management service on the scale that we do. The service provides an important element of the gold market infrastructure in London which helps participants to trade in a secure and efficient manner.

This system has grown up organically over a long period of time, rather than by specific design, and very much in response to representations from participants in the London gold market.

Another activity which grew from the Bank's role as a custodian was that we accepted gold unsecured deposits from other central banks and then on-placed them in the market in our own name, at a price which took into account operational costs and credit risk. However, owing to historically low lease rates, the Bank is no longer able to on-place gold deposits at a margin which justifies the credit risk or the costs

incurred. As such the Bank does not currently accept gold deposits for on-placement.

Finally, I would like to talk about the Bank's very limited role in the regulation of the gold market. The regulation of the financial services industry in the UK is overseen by the Financial Services Authority under the Financial Services and Markets Act 2000. I know that the LBMA maintains a close working relationship with the FSA. However, trading in the wholesale bullion market, as in other wholesale markets in Non-Investment Products such as the foreign exchange market and sterling wholesale deposit market, to the extent not covered by the FSA's Handbook is instead covered by the Non-Investment Products Code. It is known by its acronym, the NIPs Code. This is a code of good practice for participants in these wholesale 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's provisions are, where appropriate, consistent with the relevant parallel provisions in the FSA Handbook, bearing in mind, in particular, that some firms will operate both in the non-investment and investment product markets.

The Bank of England facilitates the production of the NIPs Code. It is produced and maintained jointly by the London Foreign Exchange Joint Standing Committee, for which the Bank of England provides a Chairman (me, as Head of the Foreign Exchange Division) and a secretariat; by the Money Markets Liaison

Group, for which we provide a similar service; and by the Management Committee of the LBMA and other market associations. The Financial Services Authority is an active participant in the development of the Code and expects the management of authorised firms to take due account of it when conducting business in products covered by the code. The LBMA has endorsed the NIPs Code on behalf of the bullion market, and is consulted on all proposed changes to the Code.

The past two years or so have posed many new challenges, including to those of us responsible for the Bank's operations in financial markets. I hope I have succeeded in giving you an impression of the range of our activities and interests, which include, and will continue to include, our role in the gold market. Thank you for your invitation, and for your attention - I am looking forward to participating in what I am sure will be a productive and successful conference.