

Loco London Clearing

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Firstly, thank you to the LBMA for offering me this opportunity to speak to such a distinguished and experienced audience and, secondly, thank you all for attending and for your attention.

A quick introduction to the gold market. The OTC market, which offers flexible and bespoke products and product development, is a 24-hour inter-bank market. There are eight inter-bank market makers, and about 20 additional participant banks. Electronic trading platforms play a larger role lately – these include EBS, Access and FX Trader. The OTC market is essentially the home of the professional, and COMEX – the Commodity Exchange in New York, a futures-based market – is the home of the funds.

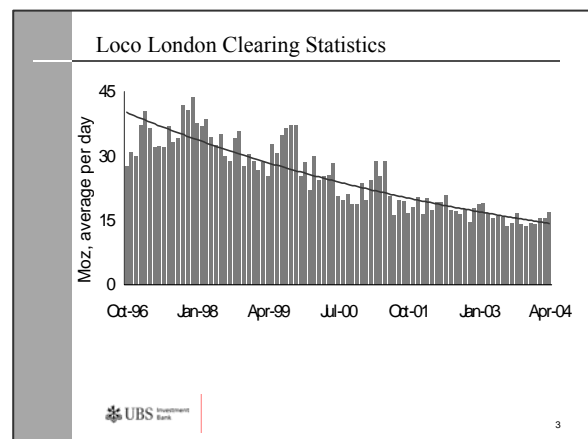
In a global context, London trading in gold started in the 1600s, as Stewart earlier mentioned. Explosive growth of gold mining in California in 1848, followed by Australia and South Africa much later, saw trade increasingly centred in London, where again that expertise and liquidity was leveraged. London is the home of the gold fix that's also been spoken about today; this has been the industry's benchmark since 1919. It is also the centre of the leasing market – the daily gold forward offered rate (GOFO) means are another benchmark.

The loco London clearers are:

- The Bank of Nova Scotia – ScotiaMocatta
- Deutsche AG London
- HSBC USA London
- JP Morgan Chase
- NM Rothschild & Sons Ltd
- UBS AG London

These six will soon be five. As we know, sadly NM Rothschild will be exiting the business, but as of today they are still a clearing member.

This chart of clearing statistics may initially portray a rather negative view, but this includes here are the loco-London book transfers from the books of one party to those of another clearing member. It includes physical transfers and shipments by clearing members, and transfers over clearing members' accounts at the Bank of England.



What I'd like to draw your attention to – and I'll pay some more attention to it later in the presentation – is that, whilst there is a decline, over the last three to four years this has consolidated, and there are specific reasons why we believe this to have happened, and there are still many reasons to be cheerful.

Two of the probable reasons for this decline in book consolidation could be summarised as cyclical changes and structural changes. On the cyclical side, the bullion banking industry consolidation that we are all witnessing produces reducing hedging activities, low lease rates leading to less lending activities, therefore extended duration of deposits and swaps and declining aggregate lending. There are also structural changes – we've seen the use of netting increase very much over the last five to 10 years – and the growth in use of electronic platforms.

Trading in loco London usually requires a clearing account. It allows settlement of metal transactions, subject to the code of market practice, which was covered under the documentation speech that we heard previously from Martin, and this is detailed in a letter of understanding, so there is very formalised and understood documentation for the London bullion market.

It's a robust system. Instructions are sent to the owner via a clearing agent. There are authenticated methods – there's a recognised MT600 series for precious metals – but other secure methods are available, so we do have flexibility. Transfers and movements are detailed on daily account statements, so exceptions are documented, but non-delivery and over-delivery are communicated via any agreed method – telephone, email, etc.

How does the clearing work? Forgive me if there's quite a detailed level of granularity, but I thought it would be worthwhile taking you through the stages of loco London clearing and what it means, to demystify it a little.

Loco London clearing is the daily paper unallocated transfers between London clearers; the transfers of gold and silver only across accounts held between clearers for their own accounts and third parties; and, as mentioned earlier, the clearing out of Zürich for the platinum group metals. It avoids security risk and the cost of physical movement of bullion; has standard market practices that were spoken about earlier; and is subject to standard documentation, as Martin said earlier, that's been worked out and developed over the years.

Both allocated and unallocated account agreements are available. There are allocations for credit purposes, bilateral credit agreements between clearers, and London good delivery, as Stewart spoke about earlier today, which concerns standardised size, quality, and accredited brands per the LBMA London Good Delivery List.

Some short definitions: an unallocated account is an account where specific bars are not set aside, and the customer has a general entitlement to the metal. This is the most convenient, cheapest, and most commonly used method of holding metal. The allocated account, on the other hand, is an account opened when a customer requires metal to be physically segregated, and this needs a detailed list of weights and assays.

Here is a typical transfer example: Bank A sells 1,000oz of gold to Bank B, at a price of \$403.50 on 2 June, for value spot 4 June. On 4 June, Bank B instructs their US dollar clearing agent to pay the \$403,500 to Bank A's standard settlement instructions. Also, on that value date of 4 June, Bank A instructs their gold clearing agent – we'll call them Agent X – to debit their account the 1,000oz of gold and pay these to Bank B's SSIs. Bank B will have pre-advised their clearing agent – we'll call them Y – to expect to receive this 1,000oz for their account from Bank A. Bank A's gold clearer X contacts Bank B's gold clearer Y and confirms the payment over the telephone on recorded lines.

In its own books and records, gold clearer X debits Bank A's customer account, and credits gold clearer Y's exchange account with 1,000oz of gold for the account of Bank B. Clearer Y debits Clearer X's exchange account, and credits Bank B's customer account.

Once all the client and own transfers are agreed between the clearers – by 4:00pm London time – broker transfers or allocations for credit purposes are agreed and effected, to be completed by 4:30pm London time, enabling the vaults to move metal around.

Account statements – the SWIFT MT608s – give the details. These are exchanged between all clearers at the close of business on a daily basis, and any discrepancies are investigated and resolved by the next day, and often on the value day.

I'll briefly outline market practices. These include the SWIFT MT600 series of messages – a dedicated series – for precious metals; netting capability that was mentioned earlier and greatly reduces the credit risk that we talked about; transfer instructions for members and own purposes and for client transfers, with cut-offs at 4:00pm London time on the day of settlement; and lastly clearers having until 4:30pm London time to effect transfers or call for allocation for credit purposes.

What does the future hold? An automated transfer matching system has been in process for some years. It will be Internet-based and will avoid the use of telephone matching, which will please our

regulators. It could reduce systemic risk; it is scheduled to go live this year; and it's been driven by all six— soon to be five – clearers in the interests of the market.

In summary, the OTC gold market is the home of the professional, physical trader. Trading volumes remain healthy, despite a consolidation in the clearing volumes. I think it's fair to say that at a minimum the equivalent of one year's gold production goes through the loco London clearing every week. This tried and tested system is world-renowned.

All the clearers are regulated by the Financial Services Authority. We have close associations with the Bank of England, and London remains the centre of the gold lending and OTC market. Thank you very much for your attention. ■

