WORLD
GOLD
COUNCIL

European Banking Authority
Tower 42 (level 18)
25 Old Broad Street
London EC2N 1HQ
United Kingdom

21 March 2013

Dear Sir/Madam,

EBA/DP/2013/01

The World Gold Council (WGC) would like to respond to the European Banking Authority (EBA) Discussion Paper (DP) on Defining Liquid Assets in the LCR under the draft CRR, 21 February 2013. Our comments focus on questions 2, 3 and 5 of the DP. In addition to our own comments we have sought independent advice from Europe Economics, a consultancy specialising in economic regulation, on the appropriateness of the various liquidity metrics included in the DP. These comments are included as part of the WGC's response.

Our submission comprises of three sets of documents:

1) Summary overview (this document).
2) Data submission ((WGC Data submission_EBA March 2013).
3) The Liquidity of Gold under Proposed EBA Liquidity Test, Europe Economics (Liquidity of gold report_2013).

Please contact me directly should you require any further information or clarification.

Yours sincerely,

Natalie Dempster

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Question 2: "Do you have any additional data source to suggest? Specifically, can you suggest a source of repo data and gold that would fit our needs?"

The following data sources are available to assess the liquidity of the spot gold market (some futures data is also included). A time series for each indicator is included in the attached excel spreadsheet.

Data	**Source**
Price	Bloomberg, Reuters, LBMA
Market size	Thomson Reuters GFMS
Minimum trade size*	WGC
Bid-ask spreads	Thomson Reuters Datastream, Bloomberg
OTC clearing statistics**	LBMA
Estimated OTC daily trading volumes**	LBMA
Gold Forward Offered Rate (GOFO)	LBMA
Demand diversity	Thomson Reuters GFMS
(Futures trading volumes	Bloomberg)

*The minimum trade volume between market makers is typically 1000 ounces, although trades of between 2000-5000 ounces are more usual, according to conversations with bullion dealers.

**The London Bullion Market Association (LBMA) publishes daily averages for the amount of gold cleared between members of the London Precious Metals Clearing Company (LPMCL). This includes data on the amount of gold transferred on average between clearing members measured in millions of troy ounces, the value of gold measured in USD and the average number of transfers recorded each day. The actual volumes of trades they will have undertaken with each other will normally have been far higher. In order to assess the multiple between clearing statistics and trading volumes the LBMA carried out a survey in Q1 2011 of the trading volumes of its market-making members. The survey finds trading volumes to be a multiple of approximately ten times clearing volumes.

Question 3: Do you agree with the list of liquidity metrics under consideration to be used in the EBA assessment, as mentioned in this section and in Annex 5? Can you suggest further metrics the EBA should make use of, where information would be available?

The WGC has taken advice from Europe Economics, a consultancy specialising in economic regulation, on the appropriateness of the various liquidity metrics set out by the EBA. These comments form part of the WGC's submission and are included in full in a separate attachment.

The report highlights two main inadequacies in the liquidity metrics. Namely, that they do not permit an assessment of the "correlation of price with need" or the "diversity of holders".

Europe Economics defines the former as "*how much cash one will get for one's assets when one needs to sell them. If the price of an asset deteriorates when conditions become such that one needs to sell that asset, then one is at risk of being insolvent given a fixed amount of holdings of that asset. If, on the other hand, an asset actually becomes more valuable in adverse financial conditions – perhaps via a flight to quality effect – then holding that asset puts one in a better liquidity position in periods of financial stress compared with more normal periods".*

The study suggests four new liquidity metrics to capture the "correlation of price with need".

This concept encapsulates the "low correlation with risky assets" and "flight to quality" tendencies that were set out by the Basel Committee on Banking Supervision (BCBS)[1] when they first defined the characterstics that high quality liquid assets should exhibit.

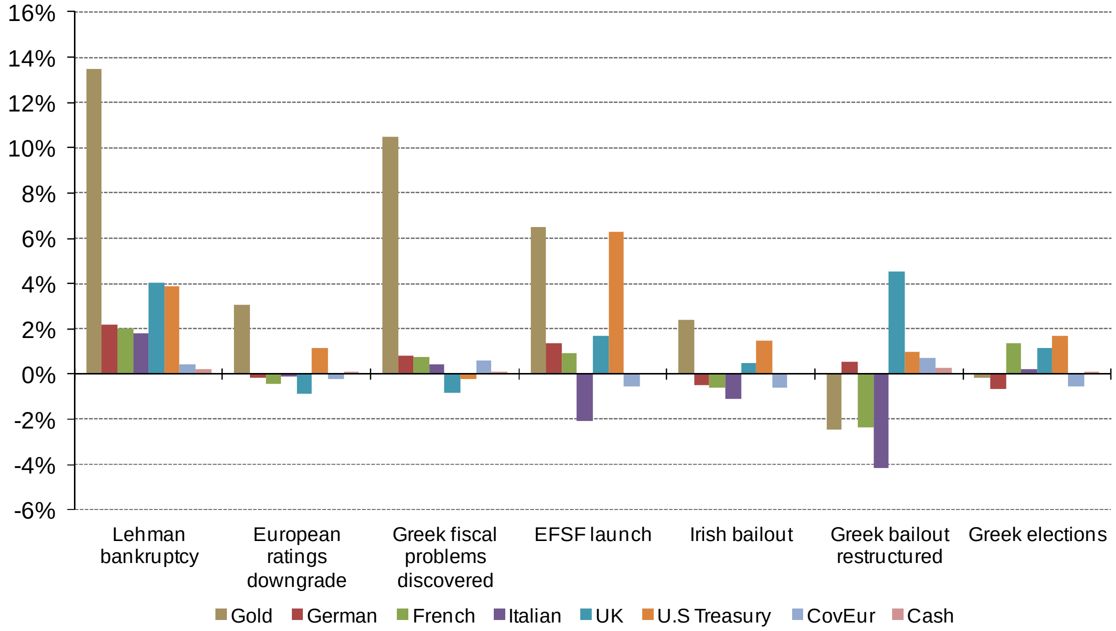
Gold demonstrates "flight to quality" tendencies which could support commercial banks' liquidity positions during stress periods. The chart on page 4 shows the performance of gold vis-a-vis other potential LCR assets during seven liquidity stress events. The periods were identified by examining instances when the US dollar basis, defined as the implied FX swap dollar interest rates, widened significantly, consistent with a pattern that indicates funding pressures among European banks. These instances were cross checked against instances when the spread between the Euro Interbank Offering Rate (Euribor) and EuroOvernight Index Average (EONIA) widened by a rate greater than two and a half standard deviations[2].

[1] International framework for liquidity risk measurement, standards and monitoring, December 2009, Basel Committee on Banking Supervision.

[2] European Case Study: Enhancing commercial bank liquidity buffers with gold, available at www.gold.org/government_affairs/research/.

Performance of LCR assets and gold during European liquidity stress periods

% return for period



Note: Liquidity stress periods identified by the World Gold Council, dates listed in the appendix
Source: Barclays Capital, LBMA, Bloomberg, World Gold Council

On average, gold exhibited by far the best performance during these periods, rising 4.75%. It was also the best performing assets in 5 out of 7 of the liquidity stress events, outperforming potential LCR assets such as German bunds and US Treasuries.

A related point was made by economists Shaun K. Roache and Marco Rossi in an IMF Working Paper published in July 2009, The Effects of Economic News on Commodity Prices: Is gold just another commodity? The authors used a modified version of a GARCH specification to model the impact of changes in commodity prices to “good” and “bad” news scenarios. While the “bad” events were not liquidity stress events, there is still relevance in the authors’ findings when assessing gold’s flight to quality tendencies.

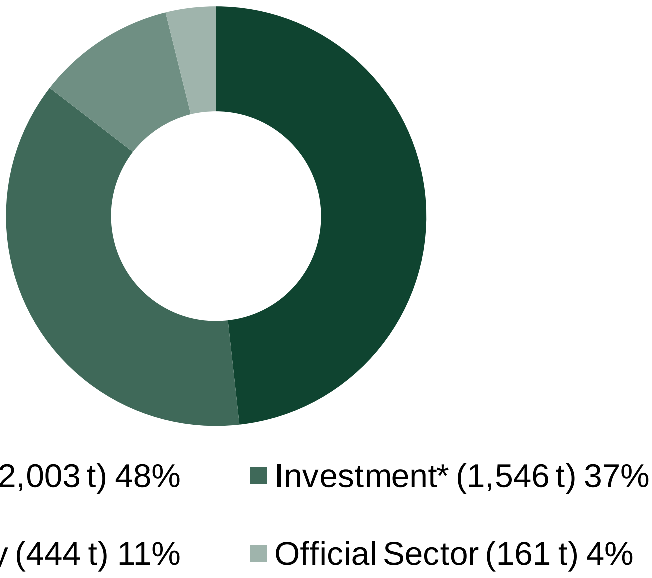
The authors find that: “*gold prices tend to be counter-cyclical, with the price rising when activity indicators are surprisingly weak”*. The results: “*indicate that there are few commodities for which the good-bad news distinction makes any difference, with one exception being gold – bad news affects the gold price much more than good news. The coefficient on the bad news aggregate is statistically significant and much higher than that on good news, a result that is maintained even when we control for the US dollar. ...This is consistent with the view that gold is a safe haven* ....”. They conclude: “*Gold’s high sensitivity to real interest rates and its unique role as a safe-haven and store of value typically leads to a counter-cyclical reaction to surprise news...... It also shows a particularly high sensitivity to negative surprises that might lead financial investors to become more risk averse”.*

Europe Economics do not provide a metric for “diversity of demand” due to data constraints. The intuition is sound, however, namely that while a pool of buyers can be very deep, if the buyers are homogenous then the buying habits of the entire pool can be adversely affected by the same shock and they can quickly disappear en masse.

Gold is very different in this respect. Data on diversity of demand is available on a quarterly basis from Thomson Reuters GFMS, but due to copyright restrictions cannot be made publically available with this submission. We strongly encourage EBA to procure this data directly as we believe diversity of demand, as discussed in the Europe Economics paper, to be fundamental to the assessment of liquidity.

In the five years to end-2012, 48% of demand came from the jewellery market (mainly Indian and Chinese consumers), 37% from the investment sector, 11% from technology sectors and 4% from central banks. Each consumer group has a different buying motivation and reacts differently to changes in the price.

5-year average annual gold demand (2008-2012)
Annual average: 4,153 t



* Includes bars, coins, ETFs, OTC purchases and gold stock movements
t: tonnes
Source: Thomson Reuters GFMS, World Gold Council

Other WGC comments

The WGC would also like to make the following points which will be relevant to the EBA's assessment of how assets fare against the fundamental definition of liquid assets set out in Article 404(3) of the draft CRR.

1. Gold can be held on an "allocated" or "unallocated" basis. Allocated gold bullion is held on a physically segregated basis where the gold bars are identified by a unique bar number. The holder has full title to the metal. Unallocated gold holders do not have individual bars allocated to them, rather a general entitlement to the metal.

2. Gold is eligible collateral under the **European Market Infrastructure Regulation** (Article 46(3)).

   "In order to ensure consistent application of this Article, ESMA shall, after consulting EBA, the ESRB and the ESCB, develop draft regulatory technical standards specifying:

   (a) the type of collateral that could be considered highly liquid, such as cash, gold, government and high-quality corporate bonds and covered bonds;

   This is defined in Article 39 of the Delegated Regulation (No 153/2013):

   "For the purposes of Article 46(1) of Regulation (EU) No 648/2012, financial instruments, bank guarantees and gold that meet the conditions set out in Annex I shall be considered as, highly liquid collateral."

3. Each of Europe's major Central Counterparties Clearing Houses (CCPs) now accept gold as collateral. The haircuts they apply are set out below:

   a. ICE Clear Europe 12%

   b. LCH Clearnet 14%

   c. CME Group 15%

4. The European Parliament's Economic and Monetary Affairs (ECON) Committee voted on 4 February 2013 to include gold as eligible collateral under Article 57(3) of the report on the **Central Securities Depositories Regulation (CSDR**):

   "If collateral is required to manage its corresponding credit risk, it shall accept only highly liquid collateral as defined in Article 46 of Regulation (EU) No 648/2012 and the regulatory technical standards adopted pursuant thereto;"

5. Gold is tradeable on a spot, forward and swap basis. There is also an active gold repo market, known as a gold "leasing" market. The Gold Forward Offered Rate (GOFO) which represents the rate at which dealers will lend gold on a swap basis against US dollars can be found on the LBMA's website and are included in the attached excel spreadsheet. While data on gold swaps is not readily available, the BIS Annual Report June 2010 provides some details of large commercial banks gold swap transactions with the BIS during the crisis period (see page 163, BIS 80th annual report). Alternatively, the EBA could procure this data directly from bullion banks.

6. The price of gold is settled twice each London business day by telephone at 10:30am and 3:00pm and it provides market users with the opportunity to buy and sell gold at a single quoted price. Known as the gold fix, it also provides a published benchmark price that is widely used as a pricing medium by producers, consumers, investors and central banks. For over 80 years, the London Gold Fixing Company which consists of 5 banks - Deutsche Bank AG London, Barclays Capital, Bank of Nova Scotia-Scotia Mocatta, HSBC and Societe Generale - has been issuing this benchmark. At the start of each session, the Chairman (selected from one of the banks) announces an opening price to the other 4 members who relay this price to their clients. The clients will declare themselves to be either buyers or sellers at that price. Provided there are both buyers and sellers at the price announced, members are then asked to state the number of bars they wish to trade. If there isn’t a balance between buyers and sellers at the initially announced gold price, then the price is adjusted up and down until demand and supply is matched, at which point the price is declared "fixed" and all business is conducted on the basis of that price. In order for the price to be “fixed” the buy amount and the sell amount have to be within 50 bars of each other.

   To ensure transparency, clients have the option to be kept advised of price changes, together with the level of interest, while the settling is in progress and they are free to cancel, increase or decrease their interest on the basis of this information.