

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.

The subject of my talk is going to be the Bank of England's role in the gold market, and not as stated in your programme, the Bank of England's role. I will talk about the Bank of England's role in the gold market in the context of our interest and role in financial markets more generally.

The reason the Bank of England is involved in the financial markets is to support our two core purposes: to promote and maintain monetary and financial stability, which is our contribution to a healthy UK economy. The two areas of the Bank of England that have an operational relationship with the financial markets are the Markets area, which is where I sit – as does David Barley, who works with me in Foreign Exchange and who will be very well known to many of you here – and our Banking Services area, which is where Trevor Stone and his colleagues, who will also be known to many of you, work. The Banking Services area provides wholesale banking and custody services to a wide range of bank customers as well as operating the UK's high-value payment system. Most of what I'm going to say concerns what I know best, which is what the Markets area of the Bank of England does.

We conduct a range of market operations that support monetary and financial stability objectives. The last few years have been fairly interesting and that has increased the menu of operations that we offer quite dramatically. I'll start with sterling operations, which is what I used to do. This is probably the first and most high-profile thing that the Bank of England does. In Markets, we implement monetary policy. This involves operating in the sterling money market,

to set the interest rate that the Monetary Policy Committee (MPC) has set, and since March of this year, it has of course also involved us in buying gilts via a reverse auction to meet the MPC's target for asset purchases, the so-called Quantitative Easing Strategy of the Bank of England. That same programme of asset purchases has also involved us in buying commercial paper and corporate bonds, and we've launched a facility to buy secured commercial paper. All of which are relatively new and a direct result of the financial turbulence we have been through. As part of our sterling operations, we also provide what we call liquidity insurance to the banking system. That is a slightly enigmatic term but what it means in practice is that we offer facilities and operations to the banking system (banks and building societies) that they can make use of when market conditions are stressed, particularly conditions in bank funding markets. Those two facilities include our new discount window facility, which is a collateral swap facility closely modelled on the special liquidity scheme and we offer long-term repose very similar to that offered by the ECB (European Central Bank) against a wide range of collateral.

Over the past year or so we, the ECB, the Swiss National Bank, the Bank of Japan and many others have also provided US dollar operations to banks and that is in the context of swap

agreements put in place between the US Federal Reserve and the other central banks.

My own division, the Foreign Exchange Division, does a number of things. First of all, we manage the government's foreign exchange reserves on behalf of the UK Treasury; we manage the Bank of England's own foreign reserve assets and liabilities, which are smaller than those of the Treasury but significant nonetheless. We also provide foreign exchange and money market services to the Bank of England's customers. In doing all of that, I should say that of course we undertake rigorous and prudent risk management to minimise the risk of financial loss to the public purse and, as important, damage to the Bank's reputation.

I'll conclude this context part of the talk by saying something about our market intelligence function. The operations that we do provide us with a network of market contacts, which enables us to collect market intelligence and surveillance, which are relevant to both the monetary and the financial stability core purposes. That intelligence feeds directly into the Monetary Policy Committee – I brief them every month on what is going on in Markets – and into then Financial Stability Committee at the Bank of England. It has been a very important part of their deliberations over the last few years, as you can imagine. I should say that this is an opportunity to say 'thank you' to all of you who talk to us in any way and on any subject, and provide us with much-needed colour and information on markets. It is very much appreciated. Market intelligence contacts and interests go way beyond the markets that we operate in. They embrace a full range of markets, intermediaries and investors. As demanding as the recent crisis has been for all of us, it certainly helped us that we started off from a position of understanding, for example, the intricacies of the structured credit market and the asset-backed securities markets, and I should also say the myriad investment vehicles within which those assets were held and funded.

While the financial strains of the last few years have involved the Bank in a wide range of markets that we have never previously been involved in, we have always been linked in some way to the gold market. The Bank's role has evolved over time, and there are now very broadly two aspects to what we do.

The first stems from our management of the UK's gold reserves, which as I've said are owned by the government and which we manage as agents for the UK Treasury. The second aspect is a sort of port manteau of involvements that in effect help to contribute to the effectiveness and efficiency of the gold market. One way that 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, and the other main way is through our 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.

I will say a little about our management of the government's reserves and how gold fits into that. The Bank of England has a remit from the UK Treasury that is set annually and that sets out the terms of management of the UK's Foreign Exchange reserves, which include holdings of gold. To give you an idea of the approximate magnitudes, the government's reserves include almost 10 million fine ounces of gold with a market value of around \$10 billion. Coincidentally, that represents around 15% of the government's reserve assets. These assets and liabilities are held on the government's own balance sheet, separate to the Bank's. The investment decisions are taken by the Treasury but supported by the Bank's own analysis and advice, and the high-level decisions have three main strategic goals. First of all, the reserves have to be fit for the policy purposes for which they are held. This is to be a source of foreign currency-like liquidity for day-to-day and for exceptional government needs. Secondly, the reserves have to be held securely, and therefore credit and market risks are kept within strict limits. And the third leg of the holy trinity, which is subject to the first two goals, is to minimise the overall cost of holding reserves. The Treasury takes the high-level decisions and they set us a benchmark. In our day-to-day management of the reserves, we have discretion to deviate from that benchmark within agreed limits to generate additional return. A portion of the currency reserves are invested in highly liquid government debt and the Bank aims to return in excess of the benchmark by taking active trading positions in government bond and related interest rate markets. In this context, the Bank of England is much the same as any other market participant. I think the same is true of our activity in the gold market; when we are

managing gold on behalf of the Treasury, we are a participant in the market just as we are in the government debt markets. In the next context, our involvement and our responsibilities are much the same as for any other market participant.

In the past, the benchmark for our gold portfolio included an element of unsecured gold lending. On that, and as with the currency reserves, the Bank of England had some discretion to deviate from benchmark by varying the amount of gold loaned and the maturity of the loans. For reasons you all know, lease rates have been extremely low for a number of years. The elimination of producer hedges has put significant downward pressure on lease rates. Over a period of time, it became clear to us that the low lease rates meant that it was becoming unrealistic for us to achieve a benchmark return that justified the operational and the credit risks in unsecured lending. As a result, gold lending as part of the government gold reserve management was suspended in 2007.

I'm not planning to cover the rebalancing of the government's reserves via the gold auctions that we carried out between 1999 and 2002. This process was very well described at your conference in Lisbon in 2003 by my colleague Graham Young and in a very erudite article in the Bank of England's quarterly bulletin of the summer of 2003 that covered that process. All I'm planning to say here is to note that those auctions were conducted within the framework of the first Central Bank Agreement on sales, and the UK has not made further gold sales and, accordingly, we are and have not been a signatory to either of the two subsequent Central Bank Agreements.

I'll move on now to speak about our own involvement in the gold market. I'll start with custody, which is run out of our Banking Services area.

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

commercial firms in London and around the world provide custodial services, although these are most commonly provided on an unallocated basis. As you know, 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. As I'm sure you also know, owners of gold are able to mobilise those holdings conveniently by making or receiving book entry transfers between the accounts of our customers at the Bank. Transfers affected in this way are advantageous because there is [no?] requirement for the gold to be physically removed from the Bank's vaults. Instead, the title to the bars is transferred in 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 way. The 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 market. We certainly value the dialogue on this and on every other aspect of the gold market in London. As a parallel with the government's gold lease facility on the Bank of England's side, which grew out of our role as custodian, is that we used to accept gold unsecured deposits from other central banks and then on place them in the market in our own name at a price that took into account the operational and credit risk involved. However, like the government's gold reserve, given historically low lease rates, the Bank is no longer able to on place gold deposits at a margin that justifies the credit or the operational risks involved. As such, we don't currently accept gold deposits from other central banks for on placement.

Finally, I would like to talk about our 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. I know the LBMA maintains a very close working relationship with the FSA. The trading in wholesale bullion, as in the other wholesale markets in so-called non-investment products, such as foreign exchange and sterling wholesale deposits, to the extent that it is not covered by the FSA's handbook, is instead covered by the Non Investment Products code – known by its acronym the NIPS Code. The NIPS Code's provisions are, where appropriate,

consistent with the relevant parallel provisions in the FSA's handbook, bearing in mind in particular that some firms will operate both in the non-investment and investment product markets. It is the Bank of England that facilitates the production of the NIPS Code. It is produced and maintained jointly by the London Foreign Exchange Standing Committee, for which the Bank of England provides a Chairman – your humble servant – and a Secretariat, and by the Money Markets Liaison Group for which we provide a similar service, and also by the Management Committee of the LBMA and other market associations. The FSA is an active participant in the development of the Code and expects the management of authorised firms to take 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 it is consulted on all its proposed changes to the Code.

The past two years have presented many 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 again for your invitation and for your attention, and I am looking forward to participating in what I am sure will be a productive and successful conference.