



Stefan Ingves
Chairman
Basel Committee on Banking Supervision
Centralbahnplatz 2
4051 Basel
Switzerland

10 April 2014

Dear Dr Ingves,

The World Gold Council welcomes the opportunity to submit comments to the **Consultative Document: Basel III – The Net Stable Funding Ratio**. Our comments focus on the proposed Required Stable Funding (RSF) factor for gold of 85%, which we believe is punitively high given gold's market and fundamental characteristics and is inconsistent with gold's treatment in other global financial regulations.

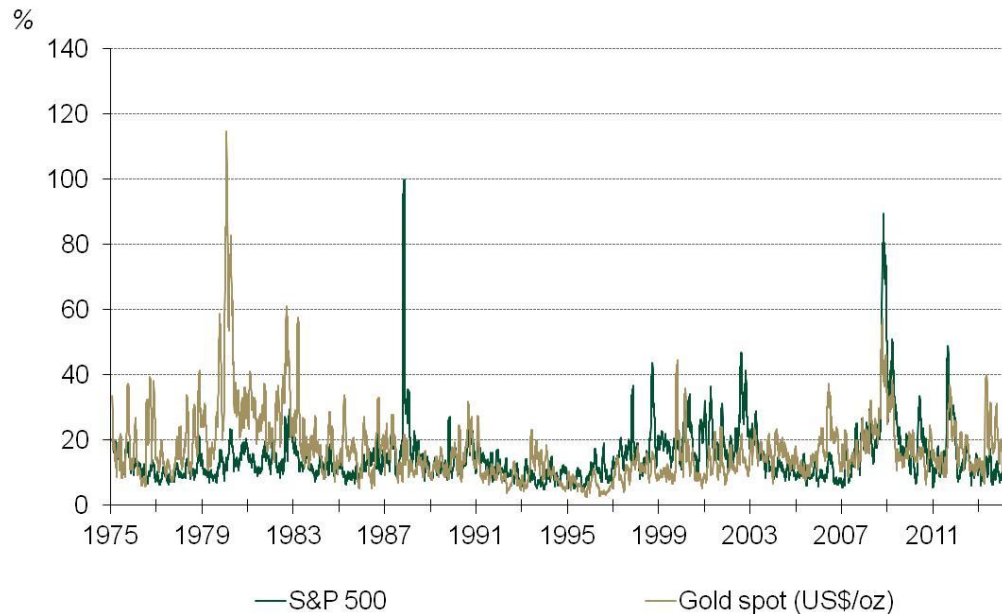
Specifically, the World Gold Council would like to highlight the following four points:

1. Gold has a similar volatility to equity indices yet has been given a notably different RSF.

The long-run price volatility of gold is comparable to the long-run volatility of the S&P 500 with exhibiting a volatility of approximately 20% over the past 10 years. However, individual equities are much more volatile. In fact, gold's volatility has been lower than 94% of all individual S&P 500 stocks over the past 10 years. This means about only 30 stocks in the S&P 500 have been less volatile. Moreover, gold's volatility exhibits a positive skew, while there is no skew on equities. Specifically, gold is more volatile when the price is increasing, rather than decreasing, consistent with the flight-to-quality inflows that gold often experiences during times of financial distress. Given gold's more favourable volatility characteristics, the haircut applied to gold of 85% seems punitive vis-a-vis the 50% haircut that has been applied to common equity shares.

Chart 1: Gold long-run volatility versus S&P500 (%)

Gold's long-run volatility* (vs S&P 500)

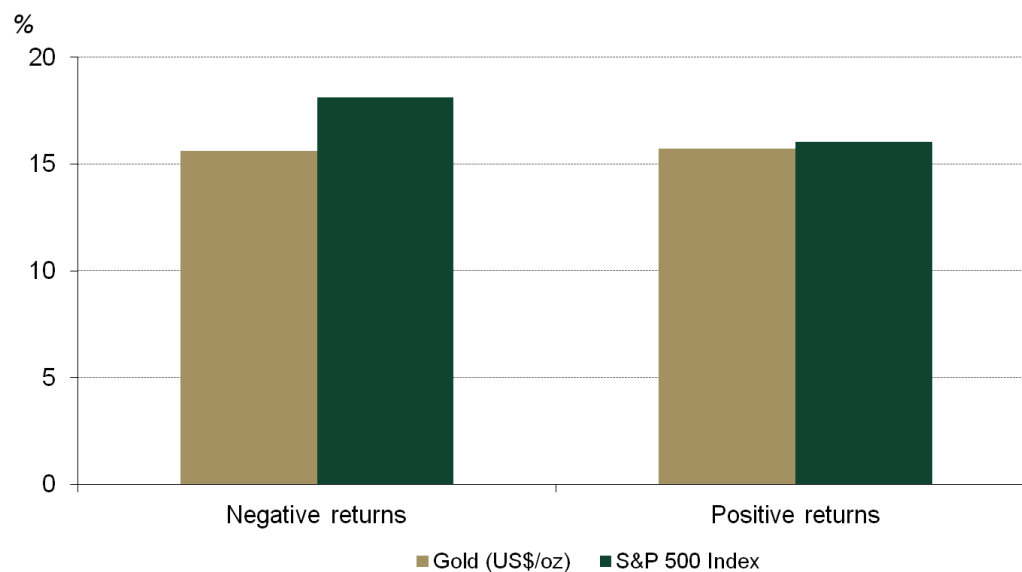


* 22-day rolling volatility

Source: Bloomberg, World Gold Council

Chart 2: Annualised volatility of positive versus negative weekly returns (%)

Annualised volatility of positive and negative weekly returns for gold (US\$/oz) and S&P 500



Note: Computed using weekly returns from Dec 1986 to Dec 2013.

Source: Bloomberg, LBMA, World Gold Council

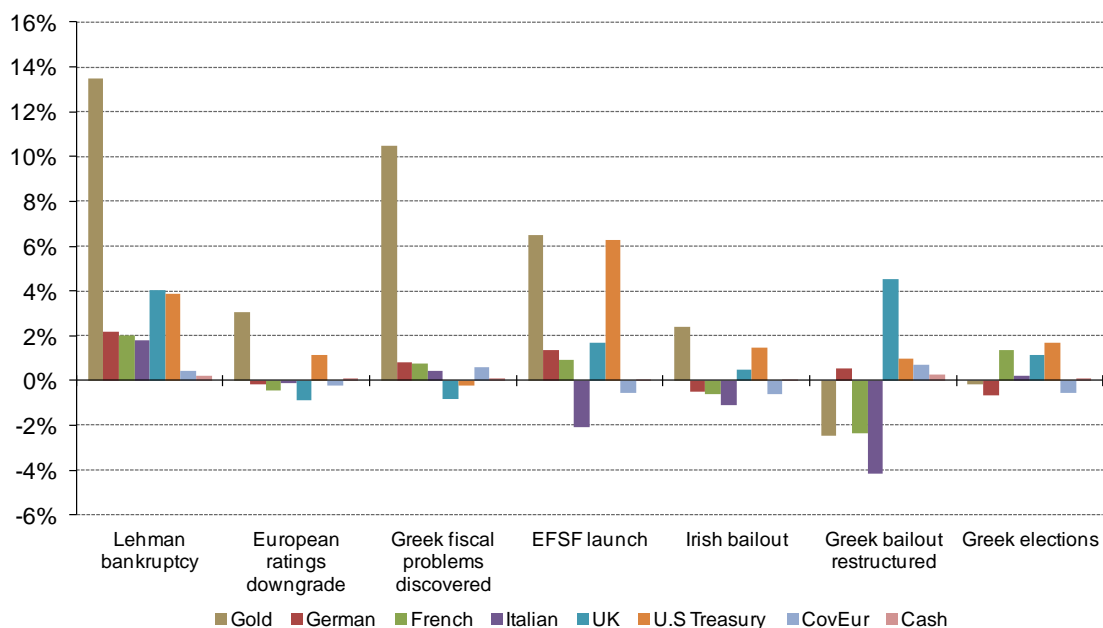
2. Gold's flight-to-quality tendencies support liquidity during times of stress.

Gold demonstrates flight-to-quality tendencies which could support commercial banks' liquidity positions during a one-year stress period. Chart 3 shows the performance of gold vis-a-vis assets which have been given a lower RSF 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 Euro Overnight Index Average (EONIA) widened by a rate greater than two and a half standard deviations¹.

Chart 3: Gold returns (%) during liquidity stress periods

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 asset in 5 out of 7 of the liquidity stress events, outperforming assets such as German bunds and US Treasuries.

3. Gold is fundamentally different to other commodities but has been given the same RSF.

Gold is fundamentally different to other commodities. The financial market for gold is deep and liquid. Gold trades in an around the clock global market, serving both as a monetary asset, as a quasi currency, a consumer good, an industrial and technology good and a form of investment.

With respect to supply, unlike agricultural and energy commodities, gold is not consumed in a normal sense as virtually all of the gold that has ever been mined still exists. The vast majority of gold remains in use in the hands of central banks and governments, financial institutions and other commercial institutions, as well as the general public in the form of jewellery and dentistry. This

¹ European Case Study: Enhancing commercial bank liquidity buffers with gold, available at www.gold.org/government_affairs/research/.

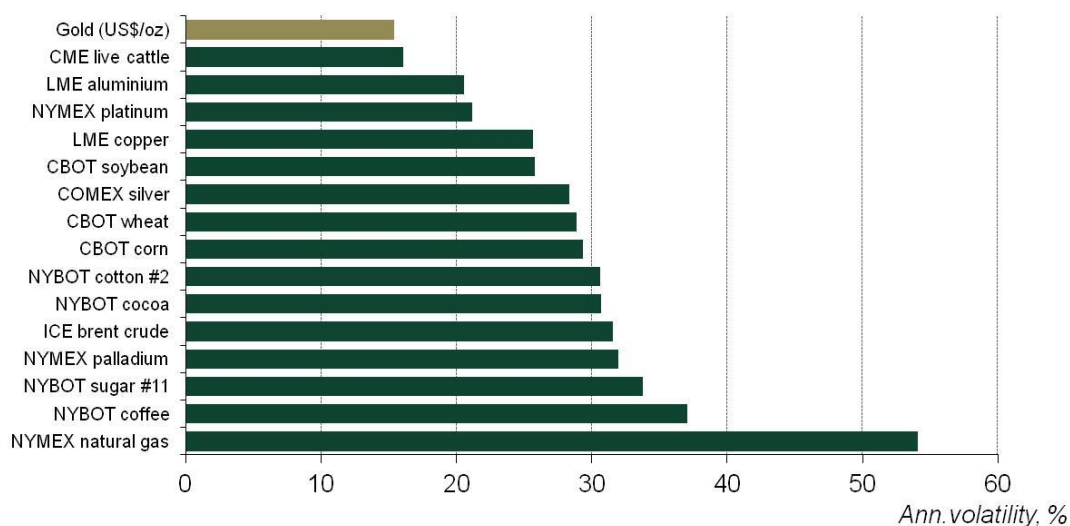
contrasts significantly with other commodities, which can be more finite in supply and can spoil or be spent in normal consumption behaviour. The existence of large and liquid above ground stocks means the supply of gold to the market does not suffer similar pressures as other commodity markets.

Gold mine production is derived from numerous separate operations on all continents of the world (other than Antarctica) making it a truly global commodity with limited supply concentration risks in contrast to many other commodities. For example, no single region produces more than 20% of global mine supply. Therefore, any disruption to production in any one locality is unlikely to affect a significant number of these operations simultaneously.

As a result, gold's volatility is substantially lower than other commodities. For example, between 1987 and Q1 2014 the volatility of gold was 15.4%, compared to the volatility of 54.1% for natural gas. It is unrealistic to expect the liquidation of a substantial long gold contract to have the same impact on the market as the liquidation of a long gas contract, yet the two commodities have been applied the same RSF.

Chart 4: Gold volatility versus other commodities (%)

Long-run volatility of various commodities, 1987 - 2014



Note: Annualised volatility of monthly log returns, from Dec 1987 to Marc 2014. NYMEX natural gas from April 1990, ICE Brent from July 1988.
Source: Bloomberg, World Gold Council

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”.

4. Global banking regulators and central bankers recognise gold’s quality and define it as being a “zero-risk weighted” asset.

Official institutions, regulators, and market participants have historically treated gold differently from other commodities. Central banks hold large stocks of gold in their reserves in recognition of the stability that gold can bring to the financial sector and the value of monetary reserves. Central banks have been significant net purchasers of gold since the Lehman crisis, buying 389 tonnes of gold in 2013 worth US\$16.7 billion at the average gold price.

Basel II recognises gold as currency as its volatility is much more in line with other currencies. Basel II also classifies gold as a zero-risk weighted asset for gold liabilities². The International Monetary Fund categorises gold held by monetary authorities as a financial instrument termed as “monetary gold.”³

In 2010, gold was stipulated as high quality collateral under the European Market Infrastructure Regulation (Article 46(3)). Since then, all of Europe’s main Clearing Houses⁴ have permitted gold to be accepted as collateral, applying a haircut of between 12% and 15%.

Gold is also stipulated under the BCBS/IOSCO guidance for collateral requirements for non-centrally cleared derivatives (Sept 2013). Finally, gold has been included as eligible collateral for Depositories under the EU’s Central Securities Depositories Regulation (CSDR).

We would respectfully ask that the BCBS take note of the aforementioned characteristics and the inconsistency that an RSF of 85% would create with gold’s treatment in other global regulations and by the world’s central banks.

Yours sincerely,



Natalie Dempster

Managing Director, Central Banks & Public Policy

² International convergence of capital requirement and capital standards, June 2006.

³ International Monetary Fund, Monetary and financial statistics manual, October 2000.

⁴ ICE Clear Europe, LCH.Clearnet and CME Group.

Appendix 1: Periods of extreme liquidity stress

Event	Start Date	End Date
Lehman bankruptcy	12/09/08	3/10/08
European downgrades	13/02/09	27/2/09
Greece fiscal problems	30/10/09	27/11/09
EFSF launch	30/4/10	7/5/10
Irish bailout	5/11/10	12/11/10
Greece bailout	16/9/11	4/11/11
Greek elections	18/5/12	22/6/12