Proposed BIS Banking Regulations Would Drive Gold Prices Higher

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Proposals from BIS, OCC and FDIC Would Reclassify Gold as a Tier 1 Asset

There are many, many, many, many reasons why gold prices should go higher, despite claims that gold is in a bubble … and despite the fact that gold prices may be manipulated.

A giant new reason may be heading our way …

Specifically, the central banks' central bank – the Bank of International Settlements (BIS) – is considering reclassifying gold as *risk-free* assets as part of the Basel III framework.

As BIS notes in its progress report on Basel III implementation:

> At national discretion, gold bullion held in own vaults or on an allocated basis to the extent backed by bullion liabilities can be treated as cash and therefore risk-weighted at 0%.

(See footnote 32 on page 26).

As Russ Norman – CEO of Sharps Pixley – wrote in May:

> Banking capital adequacy ratios, once the domain of banking specialists are set to become centre stage for the gold market as well as the wider economy. In response to the global banking crisis the rules are to be tightened in terms of the assets that banks must hold and this is potentially going to very much favour gold. The Basel Committee for Bank Supervision (or BCBS) as part of the BIS are arguably the highest authority in banking supervision and it is their role to define capital requirements through the forthcoming Basel III rules.
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> In short, they are meeting to consider making gold a Tier 1 asset for commercial banks with 100% weighting rather than a Tier 3 asset with just a 50% risk weighting as it does today. At the same time they are set to increase the amount of capital banks must set aside as well. A double win potentially.
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> Hitherto banks have been much dis-incentivised to hold gold while being encouraged to hold arguably riskier assets such as equity capital, currencies and debt instruments, none of which have fared too well in the crisis. With this potential change in capital adequacy requirements. bank purchases of gold would drive up its value relative to other high quality qualifying assets, increasing its desirability for regulatory purposes further. This should result in gold being re-priced to bring it on a par with all other high quality assets.

> Currently banks have to have core Tier 1 capital ratio of 4% of which will rise to 6% from the beginning of next year. In addition to its store of value merits, central to the argument in favour of gold as a bank reserve is its countercyclical nature to most other assets in that it tends to be inversely correlated. Gold is ideal as it bears no credit risk. it involves no other counterparty and it is no one's liability. It is a reserve asset diversifier if you like.
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> This is a treble win for gold – it would be a major endorsement of its role in preserving wealth and as a store of value from the highest financial authority, it would lead to significant purchases of gold by major financial institutions and it would lead to a reappraisal of its value with respect to other Tier 1 capital such as quality sovereign debt. Under the new rules gold could become a very significantly larger proportion of a reserve pool which is about to grow very much larger.
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> The 2 questions that come to my mind are when and how much metal – on timing Basel III kicks in from January 2013 with a further tightening in capital adequacy ratios in 2018. That said, it is not yet clear when gold's re-rating to Tier 1 might take place.
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> In terms of amount of gold that could be purchased that is harder still – if we thought that say 2% of total current Tier 1 capital held by commercial banks globally might be converted into gold (forgetting for a moment about the increases in capital yet to be seen) – this would suggest that 2% of the $4,276 bn would be converted to gold. That is equivalent to $85 bn in gold which at current market prices is equivalent to 1,700 tonnes of gold.
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> Another way of looking at this is to consider that commercial banks would be holding gold for precisely the same reason that central banks do – and the largest 110 central banks in the world have 16% of their reserves as gold – as such a figure of just 2% is really quite a modest expectation – ultimately it will be a question of price and expectations of price change that would determine the rate of uptake in the short term.

And the more favorable view of gold by banking authorities is not limited to BIS.

The FDIC issued a proposed rule on June 18, 2012, stating:

> The federal bank regulatory agencies (the agencies) have jointly issued the attached Notice of Proposed Rulemaking (proposed rule) that would revise the measurement of risk-weighted assets by implementing changes made by the Basel Committee on Banking Supervision (BCBS) to international regulatory capital standards and by implementing aspects of the Dodd-Frank Act.
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> The following exposures would receive a zero percent risk weight under the proposal:
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> - Cash;
> - Gold bullion;
> - Direct and unconditional claims on the U.S. government, its central bank, or a U.S. government agency;
> - Exposures unconditionally guaranteed by the U.S. government, its central bank, or a U.S. government agency;
> - Claims on certain supranational entities (such as the International Monetary Fund) and certain multilateral development banking organizations

- Claims on and exposures unconditionally guaranteed by sovereign entities that meet certain criteria (as discussed below).

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The proposal allows banking organizations to recognize the risk mitigating benefits of financial collateral in risk-weighted assets, and defines financial collateral to include:

- cash on deposit at the bank or third-party custodian;
- gold;
- investment grade long-term securities (excluding resecuritizations);
- investment grade short-term instruments (excluding resecuritizations);
- publicly-traded equity securities;
- publicly-traded convertible bonds; and,
- money market mutual fund shares; and other mutual fund shares if a price is quoted daily.

John Butler – Managing Director and Head of the Index Strategies Group at Deutsche Bank in London, Managing Director and Head of European Interest Rate Strategy at Lehman Brothers in London, and now head of Amphora Commodities Alpha Fund – argues:

In what might be the most underreported financial story of the year, US banking regulators recently circulated a memorandum for comment, including proposed adjustments to current regulatory capital risk-weightings for various assets. For the first time, unencumbered gold bullion is to be classified as zero risk, in line with dollar cash, US Treasuries and other explicitly government-guaranteed assets. If implemented, this will be an important step in the re-monetisation of gold and, other factors equal, should be strongly supportive of the gold price, both outright and relative to that for government bonds, the primary beneficiaries of the most recent flight to safety. Stay tuned.

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On 4th June the Federal Reserve, OCC (Office of the Comptroller of the Currency) and FDIC (Federal Deposit Insurance Corporation) collectively circulated a memo asking for comment on their proposed changes to the regulatory capital risk-weighting framework. Section 11, ‘Other Assets’, specifies that a “zero risk weight” is to be applied to “gold bullion held in the banking organization’s own vaults, or held in another depository institution’s vaults on an allocated basis…”.

Whoa. There you have it. As it stands now it would appear that, in the near future, banks will not have their regulatory capital ratios penalised for holding gold instead of government bonds as a safe-haven, zero-risk asset.

While the fundamental backdrop for gold is highly favourable and has been for some years, as the supply of money, credit and government bonds has grown dramatically, this technical aspect of the gold market is also clearly bullish. Indeed, … if gold is re-classified as a zero-risk-weighted asset, “the price is likely to soar to a new, all-time high.” I stand by that statement. In about six months we will know whether I am right, or whether I have misread this one.

Given the potential importance for gold, I’m surprised that this announcement has not been widely reported in the financial press, alternative or even mainstream. Perhaps this is due to the fact that, at this point, the reclassification of gold has only been proposed, not implemented. The change is not due to take effect until 1st January 2013.

With interest rates near zero, however, the opportunity cost of sitting on a non-interest-bearing gold position for six months is close to zero. Yes, gold may appear to be in a downtrend and, yes, it might have been unusually volatile of late, but unless the regulators backtrack, I see this as clearly bullish for gold, enabling much catch-up to Treasuries.

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