LBMA

Global Risks - What Should the Asian Market Worry About?

*Transcript of the Keynote speech delivered by **Paul Fisher, LBMA Chairman**, at the second Asia Pacific Precious Metals Conference in Singapore, June 4th 2018.*

Good morning, and my great thanks to the SBMA for inviting myself, and Ruth Crowell, both to speak at today's conference.

I would like to cover three aspects of global risks which could affect the Asian precious metals markets, gold in particular. And, where appropriate, what the LBMA is doing on your behalf to try and mitigate them. But for every risk there is also an opportunity and we also need to consider the positive agenda.

1 New capital and liquidity regime.

Popular focus mostly seems to have been on capital but the liquidity regime is more important than given credit for. Holding more capital raises funding costs, and but holding liquid assets competes with illiquid assets such as retail loans or corporate credit. And it is the liquidity changes which are impacting global markets the most. Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR). Banks are not using their balance sheets as much as they used to, to provide services to clients. So market-making, repo etc. all suffering somewhat. More costly and time consuming for end users to manage portfolios.

Particular problem for gold is NSFR. If implemented as it stands, then it will treat gold as a commodity – 85% stable funding required – rather than as a currency which in many ways it resembles. This could impact on the clearing system in which banks hold unallocated gold on balance sheet, and it could affect hedging activities for producers. The LBMA is working hard to get this changed in Europe which is the relevant regime for London clearing. But it is not yet certain how or when the NSFR will be fully implemented. The NSFR episode showed that there is a requirement for better data on precious metals trading and the LBMA's new data repository, which comes on stream later this year, is designed to address that gap.

Another part of the regulatory agenda is the conduct side. For gold and silver, the issues have included regulation of the daily fixes/benchmarks. The LBMA has had to take the lead in ensuring that there is a viable benchmark setting service and has chosen IBA for gold and now silver. The market seems to be settling down with these processes, but we are keeping a close eye on developments.

Bullion is, of course, traded OTC in an unregulated market. The main specific issue we worry about is the risk of fraudulent bars – not just the metal content but the provenance. Market integrity is one of the main objectives for the LBMA, but our rules only cover large bullion bars at present. We are looking at new technology to see if there is a better method to track and trace bullion bars and our CEO, Ruth Crowell will be talking more about that later today so I won't say any more for now. I will just note that if we collectively fail to ensure integrity of the bullion that is traded in all parts of the global market, then the outcomes for the market as a whole, including Asia could be very bad. To that end it is important that all entities within the global market help the LBMA to progress on this issue.

2 Monetary and Fiscal policy.

We are now in the 10th year of a regime of ultra-low interest rates in the developed world. That is being driven by Western economies, where real growth is slow and inflationary pressure low – but US monetary policy is exported to all those Asian countries who intervene to prevent their currency appreciating against the dollar, so the consequences are global. Despite the fact that the global economy is actually doing pretty well in aggregate, there are huge imbalance within and between countries that pose serious risks to continued prosperity. These risks include fiscal imbalances, trade imbalances and extremes of income distribution.

Western central banks are slowly edging rates up and the 'normalization' of expanded balance sheets is being considered. What could go wrong? Central banks are likely to tread carefully; they will not raise rates quickly for fear of sharp adverse reactions – consumers could be ultra-sensitive to increases in rates from such low levels.

The balance sheets of central banks may stay expanded or unwound cautiously. That is in part because the tough new liquidity regime requires commercial banks to hold more liquidity – and they will likely need to hold more reserves at the central bank as a result. But sudden shocks, or any mis-step by central banks in communicating intentions could cause volatility.

That is the normal risk at this stage of the cycle but it's not the particular risk I would flag. Rather it is US fiscal policy. A big fiscal stimulus to the US economy, at a time when US unemployment is already low, their fiscal and trade deficits large and it is plainly already end-cycle like in financial markets, can only create an unsustainable short term demand-led boom followed by inflation and a sharp downturn. Note that the timing is crucial: the main economic boost would come just before the next US presidential election and the bust afterwards. We've seen that before and we know what happens. Any US inflation may get suppressed for a while by a growing US trade deficit, from an already enhanced level. But if the dollar falls as a result then US inflation can come via that route as well as internally.

The mitigant here would normally be monetary policy which should tighten to offset an unwarranted fiscal stimulus. The risks from that could crystallise in different ways – either an unanticipated timing, degree and pace of Fed tightening - or they don't, they fall behind the curve, leading to even greater degree of tightening later. Either way markets would likely be volatile.

In Europe we have issues around Britain leaving the EU, and issues in other member states such as Italy. In Asia you have political tensions too, not just from North Korea, but also between other major powers. Gold may well benefit from risk aversion in such an environment – as it might from the other uncertainties associated with the Trump regime. But all that is outside the scope of the LBMA's operations. Just be prepared for a rough ride!

3 Other policy matters.
We are constantly concerned about a wide range of policies which could impact on the global trading of gold. Navigating the politics of international sanctions is one present source of risk for example.

But in the third leg of this speech I want to focus on risks which are, as yet, mainly unanticipated: climate change and sustainability issues more generally. Let me be clear – these issues are known about and expected – but they are not yet factored in to everyone's risk management policies and business models hence the 'unanticipated' tag. This will not be a sermon. But the planet is warming and climate is changing. And environmental issues of pollution etc. are becoming ever more important in the daily lives of citizens. I am not going to linger on the physical risks: droughts, floods, storms etc. which could hit Asia hard. The implications of a rising sea level could be particularly devastating for many of the great Asian coastal cities.

Even if we collectively succeed in limiting global warming – and that requires moving to net zero carbon emissions later this century - we will all face big risks along the way. The transition to a low carbon emission economy will change the demand for goods and services. The move from fossil fuels to renewables and hence petrol/diesel to electric cars are just two of the most obvious structural changes. New goods and services will be needed to support a lower-carbon, less polluting economy. There is promising research that suggests precious metals could have a part to play in that through nanotechnology. There will be many such business opportunities.

But governments have promised to take action to limit global warming. We don't know yet precisely what they will do. But details are beginning to emerge. China is probably the most advanced in using regulations on the financial sector to limit polluting activities. But the EU has now taken a positive forward step. Last year I served on its High-Level Experts Group on Sustainable Finance and we already have the first legislative proposals being published – around a 'green taxonomy', 'fiduciary duties', benchmarking asset portfolios and a consultation on investment advice. Many other countries – such as Brazil - have also initiated policy actions of various sorts. And the UK is busy promoting Green Finance out of London.

But something you definitely need to know is that banking (and insurance) regulators are now on the case. Various international groups have been set up to promote the incorporation of sustainability into supervision – especially through risk management regimes, with regulators such as the Bank of England, the Dutch central bank and the Californian Insurance Supervisor leading the way. And the Financial Stability Board Task Force on Climate-Related Financial Disclosures, operating under the auspices of the G20, has produced a set of disclosure recommendations that many governments have already endorsed.

I will leave you to look up the various details as my main point is that this is just the start. Laws, regulations and rules will be coming your way! These will represent risks if you do not comply and opportunities if you do so please try to make yourself aware.

In the gold market there are two forthcoming initiatives. The LBMA has for some time maintained guidance on responsible sourcing of gold, then silver and this will be rolled out to other precious metals. We are now working on incorporating more environmental factors into that guidance – and we are confident that all LBMA members will – and will want to – comply with it.

The World Gold Council is also working on the issue and their report should be out shortly. The risk for producers is clear. Fossil fuel extraction and use has a limited future and will likely be the subject of much regulatory pressure, and a reduction in related asset values. Precious metal extraction needs to distance itself from that. Energy use in the precious metals industry - both extraction and refining – although a small part of the total global economy, and producing high value products, is undeniably intensive. But that just means that there are tremendous gains to be had from moving to cheaper, cleaner energy sources and more efficient production techniques. The best, most profitable producers are embracing these changes already – much better to do so in advance of official and market pressures than be subject to them

The biggest risk of all – and the most expensive outcome - is if we fail to limit global warming. If that happens, then the results could be so catastrophic that I am not sure that even gold under the mattress will be a very helpful hedge.

Conclusion

That concludes my review of three big risks which may impact on the Asian precious metals markets. Where appropriate the LBMA is leading the way to try and mitigate the risks and promote new opportunities: in particular on market integrity and conduct. Also on transparency. Transparency for the market where we are already publishing data on London vault holdings and will be publishing trade data in due course. And transparency for the LBMA itself with a new Annual Review, publication of Board minutes, and a Board effectiveness review. The LBMA regularly undertakes outreach to the global market through events and communications. And we now have a representative –Jeremy East – permanently located in Asia.

I hope to see many of you at our own conference in Boston at the end of October. Thank you

About LBMA: LBMA is the international trade association that represents the wholesale over-the-counter market for gold and silver bullion. LBMA undertakes many activities on behalf of its members and the wider market, setting industry standards including good delivery and refining standards, ownership of the precious metal benchmark prices as well as serving as a point of contact for the regulatory authorities. For more information, please visit www.lbma.org.uk.

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