

**Meeting Between Staff of the Federal Reserve Board and the London Bullion Market Association (LMBA)
September 12, 2017**

Participants: Constance Horsley, Benjamin McDonough, Dafina Stewart, and Christopher Powell (Federal Reserve Board)

Sakhila Mirza (LMBA), Marvin Goldstein (Stroock & Stroock & Lavan LLP)

Summary: Staff of the Federal Reserve Board met with representatives of the London Bullion Market Association to discuss the potential impact of the proposed net stable funding ratio (NSFR) rule on precious metals clearing and settlement as well as on the costs of finance for precious metals producers and consumers. Specifically, LMBA representatives noted the unintended negative impact on the gold financial market as a result of the proposed rule's assignment of an 85 percent required stable funding factor to commodities, including gold and other precious metals. LMBA also provided an overview of how the London Precious Metals Clearing system works.

Attachments

Net Stable Funding Ratio and precious metals markets

On 23 November 2016, the European Commission published a legislative proposal amending Regulation 575/2013 on prudential requirements for credit institutions and investment firms (CRR). The proposal would, if adopted, apply new Basel Committee on Banking Supervision (BCBS) standards in Union law, including the Net Stable Funding Ratio (NSFR).

The London Bullion Market Association (LBMA) and London Precious Metal Clearing Limited (LPMCL) are greatly concerned about the prospective impact of the NSFR on precious metals clearing and settlement as well as the costs of finance for precious metals producers and consumers. This position paper explains why, and what can be done to avoid for these unintended consequences

LBMA and LPMCL

The London Bullion Market Association (LBMA) represents the global markets for gold and silver bullion, platinum and palladium (collectively “precious metals”). Participants in these markets include the majority of the central banks, mining companies, precious metal producers, refiners and fabricators. The LBMA membership includes 146 companies active in the metal markets or providing services to market participants. London Precious Metals Clearing Limited (LPMCL) was created by LBMA members in 2001 for the specific purpose of developing and administering a system for the clearing and settlement of gold and silver transactions. It is a not-for-profit company owned and operated by the five LBMA member banks: HSBC, ICBC Standard Bank, JP Morgan, Scotiabank and UBS.

Precious metals markets

Precious metals markets are used daily by a wide range of market participants from central banks to jewellers, mining companies to manufacturers. Gold is the largest and most important precious metals market. Gold is used in a wide range of consumer goods and industrial processes. It remains a staple for central bank reserves with approximately 74% of Eurosystem reserves held currently in gold. Gold is commonly used as a safe alternative to foreign exchange and is the ultimate safe harbour asset for professional and retail investors in times of uncertainty.

1. Clearing and settlement

LPMCL operates the clearing and settlement system for gold and silver bullion transactions. The five LPMCL clearing banks hold a proportion of gold and silver bullion that is specifically assigned to one owner (“allocated metal”). The LPMCL clearing banks act as custodian for the allocated metal, which is available to the owner at any time. The clearing bank cannot sell or transfer this metal to a third party. The allocated metal is neither asset nor liability for the clearing bank. The allocated metal is held “off-balance sheet” and is excluded from the proposed required stable funding (RSF) calculation.

However, the majority of gold and silver bullion held by LPMCL clearing banks for clearing and settlement purposes is “unallocated metal”. This is metal deposited with clearing banks by market participants, which clearing banks may use to clear and settle physical metal transactions between market participants. This unallocated metal is fungible, and as such provides the liquidity of the clearing and settlement system. It allows the clearing banks to debit or credit market participants accounts with metal immediately while the seller’s metal is delivered to the buyer (which usually occurs within two working days of the day of the transaction or “T+2”). Unallocated metal deposited with the clearing bank is recorded as an asset and is held “on-balance sheet”. It is subject to the proposed RSF calculation.

LPMCL serves clients including central banks, central counterparties (CCPs), other commercial banks, and financial institutions and many varied non-bank market participants. CCPs rely on the LPMCL system to manage precious metal collateral and physical delivery of precious metal derivative contracts. Commercial banks rely on the LPMCL system for safe clearing and settlement of precious metal transactions. Non-bank market participants rely on the LPMCL system for short-term liquidity. With daily cleared transactions of over EUR 20 billion, the LPMCL system is unique and indispensable.

2. Financing the real economy

LBMA member banks provide various financial services to precious metals market participants. Most common amongst these services are short-term precious metal loans. Such loans are available to a variety of non-bank market participants. These loans facilitate precious metals refining, fabrication and manufacturing of consumer goods and jewellery. The loans are usually made and repaid in metal over terms of less than 180 days and constitute short-term assets on bank balance sheets. When a bank enters into a gold financing transaction they will take an active business decision to do so, preceded by standard counterparty checks. Importantly, loans are offered on an uncommitted basis, and as such there is no automatic extension or 'roll-over' of loans based on pre-agreed conditions.

Other typical financing transactions include process financing arrangements – uncommitted facilities under which a bank may loan cash or metal to a market participant to finance or facilitate an industrial or manufacturing process such as refining precious metals. Transactions under such facilities are for terms of less than 180 days. Banks will also finance precious metals refining by purchasing metal ore from mining companies and merchandisers and loaning this ore to refiners for processing. Bank and non-bank market participants alike prefer such financing transactions to more complex, costly and risky derivative or repurchase transactions.

Impact on precious metals markets

The BCBS NSFR standard is designed to oblige banks to finance long-term assets with long-term money and thus avoid the liquidity constraints and failures witnessed during the 2007-2008 global financial crisis. However, neither the BCBS standard nor the European Commission's proposed amendments to CRR expressly exclude from bank NSFR calculations either (a) unallocated balances of precious metal held on balance sheet by the LPMCL clearing banks as a result of clearing and settlement activities, or (b) short-term assets of banks resulting from precious metal loans, transactions under uncommitted facilities and other short-term process financing transactions. Instead, both the standard and the Commission's proposed CRR amendments would apply a 85% required stable funding (RSF) charge to unallocated balances and short-term assets arising from precious metal financing transactions.

An 85% RSF charge would:

- **Undermine clearing and settlement** – required stable funding for short-term assets would significantly raise costs for LPMCL clearing banks to the point that some will exit the clearing and settlement system.
- **Drain liquidity** – required stable funding would dramatically raise costs for LPMCL members taking gold on deposit to be held as unallocated metal relative to the cost of providing custody of allocated metal. This would prevent LPMCL clearing banks from holding unallocated metal and drain essential liquidity from the clearing and settlement system. These unallocated balances are the only material source of liquidity in the clearing and transaction financing systems.
- **Dramatically increase financing costs** – required stable funding would penalise LBMA members who hold unallocated balances of precious metals. This would increase the cost of short-term precious metal financing transactions as stable funding costs are passed through to non-bank market participants. Such cost increases would squeeze miners, restrict refining and raise the costs of an inelastic, key input to industrial and consumer goods.
- **Curtail central bank operations** – fewer LPMCL clearing banks would necessarily curtail central bank deposit, lending and swaps in precious metals. These operations are essential to off-set the costs of storing gold reserves.

Proposed amendments

There are no viable alternatives to the clearing and settlement system operated by the LPMCL clearing banks or the financing transactions described above. All market participants including banks, trading venues and CCPs rely on the clearing and settlement system for physical and paper transactions. OTC derivative substitutes to precious metal loans and similar transactions are significantly more expensive due to foreign exchange risk and margin requirements and are, in any case, subject to CRR requirements in respect of the liquidity coverage ratio, the leverage ratio and NSFR.

None of the BCBS preparatory documents, the NSFR standard, the European Banking Authority's (EBA) report on the net stable funding ratio and the Commission's impact assessment for the proposed CRR 2 amendments consider or quantify the impact of applying required stable funding to unallocated precious metal balances in the clearing and settlement system. Indeed, had the BCBS, the EBA or the Commission considered the treatment of unallocated balances in the clearing and settlement system LBMA and LPMCL believe that these unallocated balances would have been expressly excluded from NSFR calculations. The alternative is to preclude clearing and settlement of precious metal transactions.

LBMA and LPMCL consider the required stable funding for short-term assets to be clearly contrary to the objective of the BCBS standard. Simply put, the short-term assets resulting from bank's precious metal financing transactions do not need stable funding and there is no risk of market failure to justify requiring stable funding for these assets.

LBMA and LPMCL encourage the co-legislators to support amendments to Articles 428c, 428p and 428r of the Commission's CRR 2 proposal in order to:

1. Exempt unallocated precious metal balances from the NSFR calculation; and
2. Exclude bank short-term assets resulting from short-term precious metal financing transactions from required stable funding.

Suggested amendments are included in Annex I to this paper.

LBMA members remain at your disposal to discuss any of the elements of this position paper and provide additional input as required.

Sakhila M. Mirza
General Counsel



1-2 Royal Exchange Buildings
Royal Exchange
London EC3V 3LF
Tel: 020 7337 9773

Email: Sakhila.Mirza@lbma.org.uk

Web: www.lbma.org.uk

Annex I – Suggested amendments

<p style="text-align: center;">Article 428c</p> <p style="text-align: center;">Calculation of the net stable funding ratio</p>	<p style="text-align: center;">Proposed amendment</p>
<p>1. Unless specified otherwise in this Title, institutions shall take into account assets, liabilities and off-balance sheet items on a gross basis.</p> <p>[...]</p>	<p>1. Unless specified otherwise in this Title, institutions shall take into account assets, liabilities and off-balance sheet items on a gross basis.</p> <p>[...]</p> <p>4. Institutions providing precious metal clearing and settlement services shall not take into account precious metal balances resulting from the provision of these services.</p>
<p>Justification</p> <p>Applying stable funding requirements to unallocated balances would be contrary to the objectives of the NSFR standard and would jeopardise the clearing and settlement system for precious metals. Institutions providing precious metal clearing and settlement services should exclude unallocated balances in precious metals that arise from clearing and settlement operations from their net stable funding ratio calculation.</p>	
<p style="text-align: center;">Article 428p</p> <p style="text-align: center;">Calculation of the amount of required stable funding</p>	<p style="text-align: center;">Proposed amendment</p>
<p>1. Unless specified otherwise in this Chapter, the amount of required stable funding shall be calculated by multiplying the accounting value of various categories or types of assets and off-balance sheet items by the appropriate required stable funding factors to be applied in accordance with Section 2. The total amount of required stable funding shall be the sum of the weighted amounts of assets and off-balance sheet items.</p> <p>[...]</p>	<p>1. Unless specified otherwise in this Chapter, the amount of required stable funding shall be calculated by multiplying the accounting value of various categories or types of assets and off-balance sheet items by the appropriate required stable funding factors to be applied in accordance with Section 2. The total amount of required stable funding shall be the sum of the weighted amounts of assets and off-balance sheet items.</p> <p>[...]</p> <p>6a Institutions shall exclude from the calculation of the amount of required stable funding assets resulting from the provision of precious metal clearing and settlement services and assets resulting from precious metal financing transactions of a term of 180 days or less.</p>
<p>Justification</p> <p>Applying stable funding requirements to unallocated balances would be contrary to the objectives of the NSFR standard and would jeopardise the clearing and settlement system for precious metals. Institutions providing precious metal clearing and settlement services should exclude unallocated balances in precious metals that arise from clearing and settlement operations from their net stable funding ratio calculation.</p> <p>Applying stable funding requirements to short-term assets that result from precious metal financing transactions would be contrary to the objectives of the NSFR standard and greatly increase the costs of finance for non-bank participants in precious metals markets.</p>	

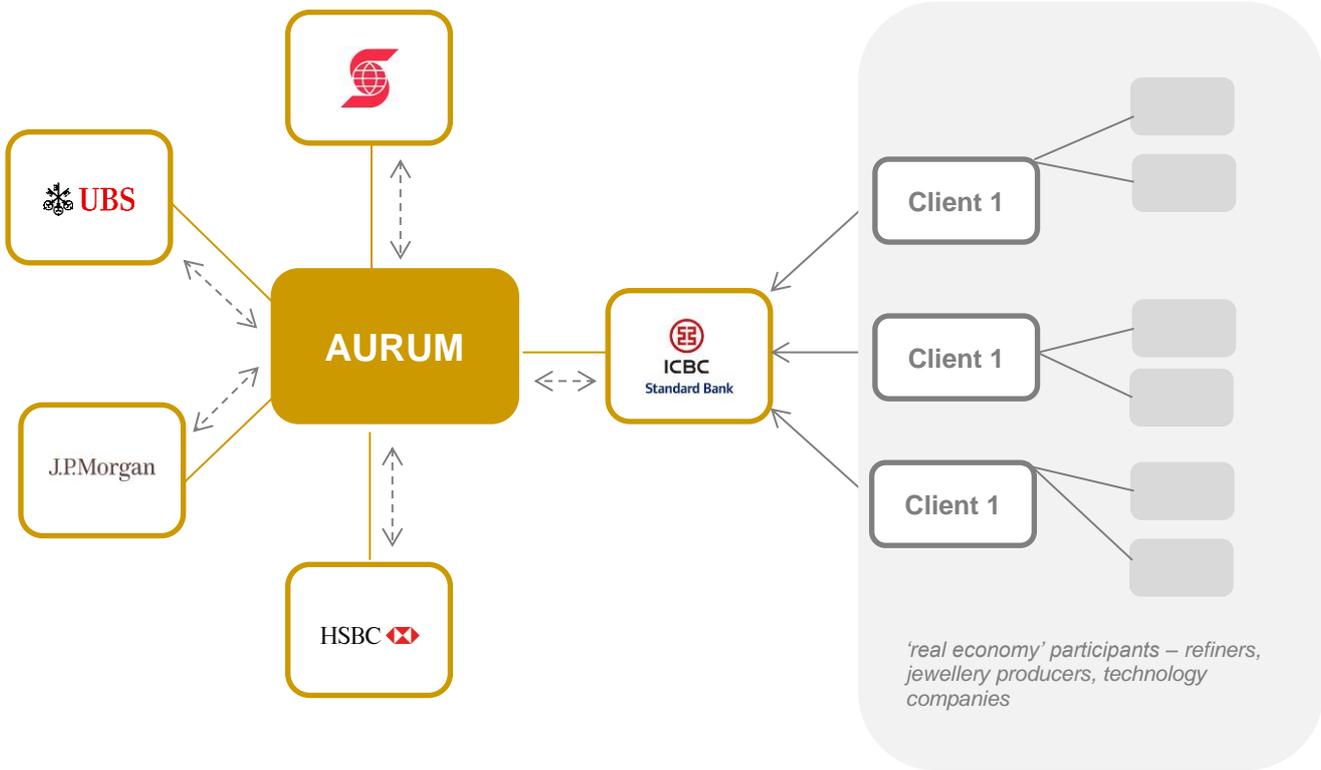
<p style="text-align: center;">Article 428r</p> <p style="text-align: center;">0% required stable funding factor</p>	<p style="text-align: center;">Proposed amendment</p>
<p>1. The following assets shall be subject to a 0% required stable funding factor:</p> <p>[...]</p>	<p>1. The following assets shall be subject to a 0% required stable funding factor:</p> <p>[...]</p> <p><i>g Assets resulting from the provision of precious metal clearing and settlement services, including metal held on behalf of clients.</i></p> <p><i>h Assets resulting from precious metal financing transactions of a term of 180 days or less, including metal held on behalf of clients.</i></p>
<p style="text-align: center;">Justification</p> <p>Applying stable funding requirements to unallocated balances would be contrary to the objectives of the NSFR standard and would jeopardise the clearing and settlement system for precious metals. Institutions providing precious metal clearing and settlement services should exclude unallocated balances in precious metals that arise from clearing and settlement operations from their net stable funding ratio calculation.</p> <p>Applying stable funding requirements to short-term assets that result from precious metal financing transactions would be contrary to the objectives of the NSFR standard and greatly increase the costs of finance for non-bank participants in precious metals markets.</p>	

London Precious Metals Clearing – An Overview

London Precious Metals Clearing Limited (LPMCL) operates the clearing and settlement system for gold and silver bullion transactions. The clearing and settling of bullion transactions in London takes place across an electronic clearing system, AURUM, by the five LBMA members who provide clearing services - HSBC, ICBC Standard Bank, JPMorgan, Scotiabank and UBS. The LPMCL system is a unique and indispensable method to settle OTC trades in physical precious metals.

Precious Metals Clearing Process in Five Steps

Step 1	Clearing banks maintain precious metals accounts between themselves
Step 2	Client sends bullion settlement request (deliver / receive) to its clearing bank by 16.00
Step 3	By 16.30 clearing banks decide to enact transfers to other banks or allocate new bullion
Step 4	Clearing banks settle the accounts they maintain between themselves via AURUM
Step 5	Clearing banks net client instructions on their account by COB



Advantages of Precious Metals Clearing

- ✓ Bullion held in unallocated accounts → no need to physically move to vaults
- ✓ Simple and efficient settlement → transactions settled through account credits / debits
- ✓ Daily netting → lowers the number of settlements, increases security
- ✓ Low transaction risks → settlement occurs the next business day
- ✓ Certainty → every shareholder can call on his unallocated account with other shareholders