

Free Gold

Do negative lease rates imply that central banks are flooding the market with gold?

Last month **FT Alphaville's** Izabella Kaminska commented on **gold lease rates**. The gold lease rate is the interest rate at which an individual or financial institution will lend physical gold to another individual or institution. Kaminska points out that gold lease rates have been negative since early 2009 and continue to get more negative. Why would anyone want to lend gold at a negative interest rate? Her theory is that central banks are responsible for setting rates below zero. In short, central bankers are willing to receive negative interest rates, effectively paying private banks to borrow gold, so as to encourage the yellow metal to flow out of central bank vaults into the market, thereby suppressing the gold price. This lent gold is supposedly being fed into ETFs like the SPDR Gold Trust.¹

While this is probably the first time a central bank gold suppression story has ever graced the pink sheets of the FT, we're not so sure we agree. Although statistics on gold lending are hard to find, those that we have managed to scrounge up tend to contradict the idea that central banks are manipulating gold lease rates to negative levels in order to coax gold into the market.

The **Reserve Bank of Australia** (RBA) is one of the few central banks in the world that reports on its gold lending program. It reports AUD\$40 million in gold loans outstanding as of June 30, 2011. The average term of these loans was three to twelve months with an effective rate of 0.30%. These lease rates are low, but certainly not negative. Nor does the RBA give any indication that they are currently stuffing gold ETFs with lent gold. In 2003 the RBA was lending 98% of its gold into the market (79 tonnes). This amount declined to 53% in 2007 (43 tonnes). By 2011 the RBA was lending out just 1% of its gold (1 tonne).

Another relatively transparent central bank is the **Swiss National Bank** (SNB), the seventh largest holder of gold in the world. The SNB reported interest income from gold loans of CHF 9.5 million in 2010, implying a lease rate of around 0.30-0.50% – no negative lease rate here. Nor is it increasing its gold lending program. In 2003 the SNB had about 17% of its gold out on loan (233 tonnes). By Dec 31, 2009 this amount had contracted to about 10% of its gold (93 tonnes), and just this year loans collapsed to a mere 1.5% (15 tonnes).

The **Bank of England** (BOE) is responsible for managing the UK Treasury's stock of gold, including lending it into the market for yield. The BOE also manages a portion of the gold that other central banks have deposited in its vaults. The BOE can lend this gold out in its own name should the foreign central bank want to

earn a yield on its gold. Each month on its website, the BOE discloses the total amount of gold it is lending on behalf of other central banks. In 2000, it was managing 100 tonnes worth of foreign central bank gold loans. At the same time, the Treasury had some 200 tonnes on loan, about half of its 437 tonnes of reserves. In 2007 the BOE announced the suspension of all lending of UK Treasury gold because it was "becoming unrealistic for us to achieve a benchmark return that justified the operation and the credit risks of unsecured lending." It also ceased accepting foreign central bank gold loan business, and currently manages none of these loans whatsoever.

Pressed by the official opposition party, the Dutch Secretary of the Treasury recently disclosed that while the country's central bank, the **Dutch National Bank** (DNB), had lent a portion of its gold in the past, it ceased all gold loans in 2008.

Since few other central banks disclose their loan books, it's hard to determine the full extent of central bank lending. The reserve currency central banks (the US and Euroland) in particular are large gold holders but, save for the Dutch, disclose neither the extent of their loans nor the price at which they lease. We know that these banks were heavily involved in the gold lending market in the past. Nor is a higher gold price in their interests since it encourages other central banks to substitute US and Euro-denominated reserve assets with gold.

But, if the RBA, SNB, BOE, and DNB are representative of the other western central banks, then central bankers are certainly not lending gold at negative rates. Nor are they lending out terrific amounts of gold into the market. Rather, it seems that they are disengaging from the gold lending market. Existing central bank gold loans are steadily maturing without being rolled over, the lent ounces flowing back into the coffers of central banks. Part of this is due to the fact that gold producers, who for hedging purposes were historically the largest borrowers of central bank gold (via bullion banks), are far less eager to hedge their future production. Another reason is that central banks have become more wary of lending their gold to private banks because of deteriorating credit quality.

So, if not central banks, then who is causing the odd phenomenon of negative gold lease rates?

First, it helps to understand how lease rates are quoted. The **London Bullion Market Association** (LBMA) publishes what it calls the *derived* lease rate. This is the rate at which the market-making members of the LBMA will probably lend each other gold. This group is comprised of nine of the world's largest banks, including the likes of ScotiaMocatta, HSBC, Gold-

1. *Why Gold Forward Rate Inversion is Important*

<http://ftalphaville.ft.com/blog/2011/09/14/677021/>

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man Sachs, JP Morgan, and UBS.

Note that this is a derived rate. Banks don't actually disclose to the public the precise rates at which they will lend gold amongst each other. Luckily, we know the rates at which banks lend cash to each other on an unsecured basis – the **London Interbank Offer Rate** (LIBOR) – and the rate at which they will swap their gold for cash for some period of time – the **Gold Forward Offered rate** (GOFO). Because you can arbitrage between the lease rate, LIBOR, and GOFO, you can back out lease rates using the posted GOFO and LIBOR numbers. (If you are curious, see right.) The one month derived lease rate is currently -0.2%.

In general, commercial banks borrow gold for a number of reasons. First, they borrow because they can lend gold onward at a higher rate to jewelers, miners, or hedge funds. Second, they may borrow gold in order to sell it short. Finally, banks borrow gold in order to hold it in their own vaults as the reserve base for fractional gold lending businesses. Investors who want exposure to gold but don't care to hold the actual physical commodity can buy gold paper certificates from the bank. These certificates promise to deliver a certain amount of physical gold. Because it is rare that investors simultaneously demand the gold they are entitled to, the bank can issue, say, \$100 million worth of gold paper certificates upon \$5 million worth of gold bars. Should the bank wish to augment its reserves because it expects redemptions, it can simply borrow the necessary gold from other banks.

So why are market-making banks currently paying a 0.2% fee for the privilege of lending gold for one month to other market-making banks? After all, isn't a lender supposed to receive interest, not pay interest? The only explanation for negative interest rates, as far as we can see, is that market-making banks are being paid an even better rate by non-banks anxious to lend their gold. Therefore the market-making banks can earn a spread by lending at one negative interest rate, the current one month lease rate of -0.2%, while borrowing at an even-more negative interest rate, say -0.3%.

What sort of "non-banks" might be supplying leased gold to the market-making banks at these extremely negative rates? As we already pointed out, central banks seem willing to lend only at positive rates, which leaves only one other source: the investing public. We think there is a possibility that the public's desire to lend gold to banks is so high that they are willing to pay these banks a significantly negative interest rate to do so.

The public effectively lends gold to banks when they deposit their

Calculating Derived Lease Rates

A bank that wants to borrow cash from another bank has two options: either borrow unsecured and pay LIBOR or submit gold as collateral and pay GOFO. In the latter case, the borrowing bank will have to lease some gold in order to have the collateral to submit. If the lease rate is too high, then the all-in cost of leasing gold, submitting it as collateral and paying GOFO in order to borrow cash will *exceed* the cost of paying LIBOR to get cash unsecured. Everyone will want to borrow at LIBOR. In order to encourage would-be borrowers to lease gold, submit it as collateral for cash and pay GOFO, lease rates will have to fall. But, if lease rates fall too low, then the all-in cost of leasing gold and paying GOFO to get cash will be *below* LIBOR, and everyone will want to lease gold in order to have collateral to get cash. Gold lenders will have to increase lease rates in order to balance the market. The upshot is that, in general, the potential to arbitrage between LIBOR and GOFO means that the following condition should hold: $LIBOR = GOFO + \text{lease rate}$. Funding costs should equilibrate across markets.

physical gold in **unallocated** form at a bank. In **allocated** form, the bank is obliged to keep the depositor's precise gold bar in its vault untouched. But in unallocated form, the bank can do whatever it wants with the clients' deposited gold. This therefore constitutes a loan of gold from the public to the bank. The negative interest rate received by the borrowing bank is probably in the form of client fees or bid-ask spreads. The bank can lend this borrowed gold on to a second bank at a profit by paying this second bank a slightly less-negative interest rate, keep it in their vaults and use it as reserves to support their fractional paper gold businesses, or sell it short.

The idea that the public would lend to banks at a negative rate is not without precedent. Anyone depositing money into a chequing account is essentially giving the bank a negative interest rate loan. The depositor receives no interest on the deposit and must pay a monthly fee for the privilege, while the bank is free to do whatever it wishes with the deposited money.

Kaminska's idea that central banks are setting negative interest rates so as to encourage the flow of gold into the market is an interesting one, but unlikely. Without data from the US and the larger European central banks like the Bundesbank, it's hard to flesh out the full picture. But those central banks that do report gold lending numbers seem to be only lending at positive rates. Furthermore, they are shrinking their loans rather than expanding them. By serving as the cheapest source of lent gold, the investing public has effectively priced central banks out of the gold lending market. Because they are anxious to deposit gold in unallocated form, the public is probably responsible for the phenomenon of negative lease rates, not central bankers.

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October 26, 2011

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