GOLDEN OPPORTUNITIES

During the past several years, the price of gold has hit new highs and set new records on a regular basis, causing institutions to look for ways to use the highly valued asset to best advantage.

This interest is not surprising, given the amount of gold that is held privately and by sovereigns. Approximately 28% of gold reserves are held privately, with the remainder being held by sovereigns, with the U.S., Germany and the IMF holding the most significant proportions.[1]

Optimizing gold holdings

Facing diminished liquidity over the past few years, institutions have been searching for ways to optimize all assets to their greatest effect. Financing trends seek to fully utilize all asset classes, including non-standard securities such as exchange-traded funds (ETFs), Middle East eurobonds and fund units. Following the financial crisis, many institutions chose gold as a hedge against inflation, to support their trading strategies, or to maintain strong capital reserves. The emergence of exchange-traded funds and exchange-traded commodities, backed by bullion, also drove surging demand for physical gold. According to Peter Smith, head of J.P. Morgan's gold vaulting service, "There is growing interest from ETFs and other fund institutions, as well as from corporates, to store precious metals."

While gold is undeniably valuable, historically it has also been a relatively immobile asset. As it became a proportionately larger share of the balance sheet, however, the question of how best to monetize gold became increasingly common.

Using gold to diversify the collateral pool

Gold has many characteristics that make it appealing as collateral. It is liquid, high quality, and traded and priced globally. As counterparties seek to diversify their collateral pools and stringently review their collateral options, gold takes its place amidst other high grade collateral such as government securities and cash. Gold has the added attraction for collateral takers of being "right way collateral," which means that in times of crisis, its price is generally expected to rise, thus providing added protection and diversification to traditional forms of non-cash collateral such as fixed income or equities. According to John Rivett, global business executive for collateral management, "It would be difficult to find a more stable and secure asset than gold. Gold shines when there's a flight to quality: it runs counter to the market in valuation whenever there's a credit crunch or fear of contagion."

Understanding the global gold market

Commercial gold vaults exist in New York, Zurich, Singapore, Dubai and other locations. However, London has long been the hub of the world's 24-hour global gold market as it is perfectly situated from a time zone perspective to serve as the center of trading and liquidity. In fact, according to the London Bullion Market Association, "Most global over-the-counter gold and silver trading is cleared through the London Bullion Market clearing system, with deals between parties throughout the world settled and cleared in London."[2]

The characteristics of the London market uniquely support the use of gold as collateral by ensuring:

- **Quality and liquidity**: "London Good Delivery" sets the standard for gold quality. Rigorous specifications as to size and purity ensure that each London Good Delivery gold bar meets pre-set standards with little to no variation between one bar and the next. This consistency ensures that counterparties will receive gold of an expected quality (99.5%

New Ways to Put Gold to Work

J.P. Morgan recently integrated its gold vaulting service in London with its tri-party collateral agency service.

- J.P. Morgan operates one of the two largest commercial gold vaults in London (one of only six in the City) and is a member of the London gold clearing system.
- J.P. Morgan is also one of the few truly global providers of collateral management services. As collateral agent, J.P. Morgan works with two parties that have an established collateralized lending or financing arrangement.

Linking these two services allows for the use of gold as collateral in tri-party secured financing transactions. John Rivett notes that this gives institutions a new avenue to mobilize their physical collateral inventory alongside their securities inventory and to monetize their gold positions in an operationally efficient manner. J.P. Morgan clients have several options:

- Unallocated gold custodied with J.P. Morgan can be used immediately as collateral, once the appropriate documentation is completed.
- Gold that meets the London Good Delivery unallocated gold standard but which is held in another London gold vault can be delivered to J.P. Morgan with J.P. Morgan as custodian. As noted earlier, use of the London clearing system simplifies this process for unallocated gold. In fact, the six clearing firms form a company called London Precious Metals Clearing Ltd to streamline this process, which in many cases is a simple book entry.
- Allocated gold can be converted by most bullion banks/agents to unallocated gold and can then be used within the collateral program.
- Gold held outside of London can be transferred to J.P. Morgan's London vault either directly or via one of the other London gold vaults using the process described above.

Once the gold is delivered, it is reflected in the client's books and records and can be used as collateral in a variety of transactions. Since unallocated gold is being used, it can be apportioned in quantities smaller than a gold bar, increasing its flexibility as a collateral asset.

According to John Rivett, "We continue to uncover ways to use gold as collateral. Today, we're talking about stock loan escrow and tri-party repo transactions, but nearly every client has other ideas they wish to discuss." Gold could be used to satisfy initial margin for clearing members subject to Dodd-Frank regulations, for example, joining other high grade assets such as cash or government securities to satisfy the initial margin demands of central counterparties. Rivett notes that J.P. Morgan is helping clients imagine how gold might fit into their trading or collateralization strategies and how they could monetize this asset class.

fine), which allows the metal to be easily transferred between members of the London Bullion Market. Ultimately, this facilitates trading and market liquidity—both desirable attributes for collateral.

- **Flexibility**: The London gold market uses both unallocated and allocated gold. In layman's terms, allocated gold specifically identifies each gold bar with a specific owner. Allocated gold is essentially held in separate accounts; it cannot be pooled with gold from others to satisfy obligations. In contrast, unallocated gold is held in a general pool by the bullion dealer and the customer has a general entitlement to the metal, but not to a specific gold bar. The LMBA states that unallocated gold "is the most convenient, cheapest and most commonly used method of holding the metal."[2]

  In practical terms, unallocated gold is comparable to putting dollars, pounds or euros into the bank. Once deposited, the money becomes fungible—you can withdraw the same amount of money you put in, but you will not receive back the same exact bills that you deposited. The use of unallocated gold allows for amounts smaller than a gold bar to be used as collateral between counterparties—a significant benefit to a collateral program given that a London Good Delivery bar weighs 438.9 ounces, and gold is currently trading for over US$1,700 per ounce.[3]

- **Transparency:** Readily available price information promotes market transparency and aids in daily mark-to-market and margin calculations. Gold is priced by the market twice daily (morning and afternoon) and widely reported by both the financial press and data vendors. Use of a predictable daily price fix point allows counterparties to mitigate their daily exposure and set haircuts to manage ongoing price fluctuations. The afternoon U.S. Dollar London Gold Fix is viewed by market participants as the appropriate way to mark gold given daily price fluctuations and increasing values.

- **Ease of transfer:** The London Bullion Market clears daily using paper transfers that evidence the unallocated gold held between members. This allows them to simply and efficiently settle mutual trades and transfers to/from third parties while mitigating the costs and risks associated with physical movement of bullion. The use of paper transfers and unallocated gold facilitate easy transfers between counterparties when needed.

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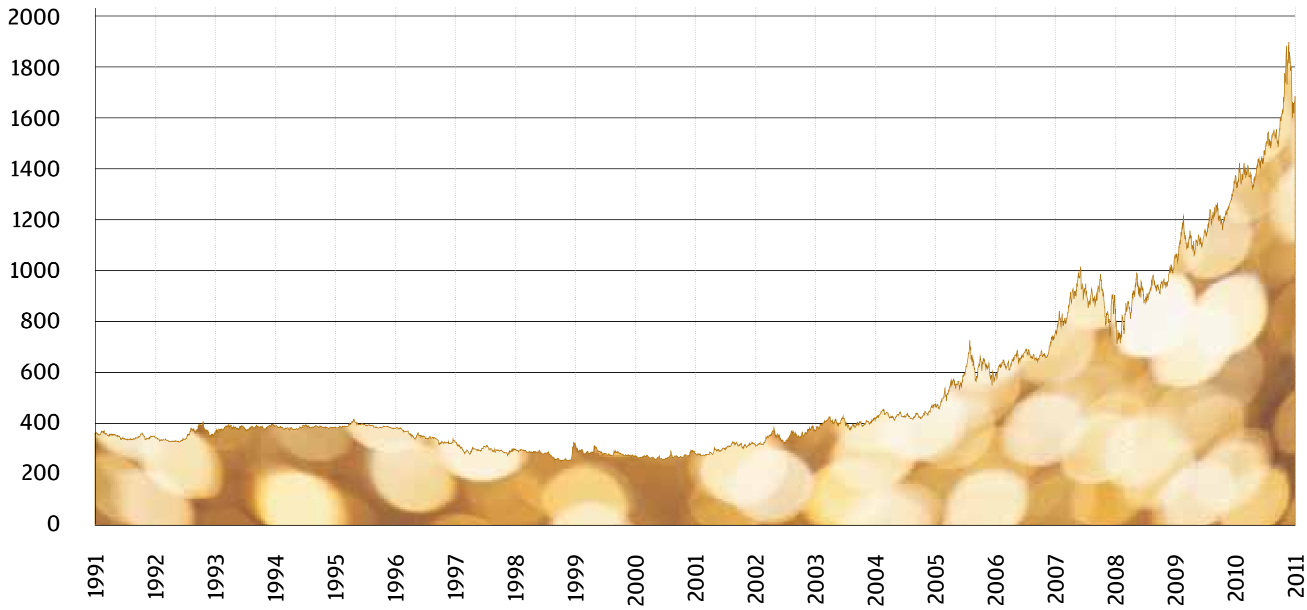
The unique characteristics of the London gold market made it the ideal starting point for using gold as collateral, but opportunities in other markets are currently being assessed. Additionally, as J.P. Morgan works with clients seeking to optimize all of their assets, it is also evaluating the potential for using other metals (such as copper, silver or platinum) or different commodities as collateral. ■

[1] World Gold Council (end 2008)
[2] www.lmba.org.uk
[3] www.gold.org, November 8, 2011

U.S. Dollar London Gold Fix (PM) Rates

OCTOBER 1991 TO OCTOBER 2011

Source: U.S. Dollar London Gold Fix (PM)



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