

Bullion Banking Explained

Events in the final four months of 1999 have focused attention on several aspects of the precious metals markets. One focal point has been the degree to which participants in these markets do not really understand how the markets work. One of the most visible examples of this is the fact that many observers do not seem to understand how bullion banks and dealers trade metal back and forth, and manage their businesses.

The way in which banks monetize their gold and silver positions, using them as collateral for subsequent trades, is integral to understanding what has been driving gold and silver prices over the past several years.

With the start of the London Bullion Market Association's release of monthly trading data, the market has become aware that 100 times more gold and silver trade hands each year, just in the major markets, than is produced or used. Some market participants have wondered aloud how 10 billion ounces of gold could trade via the major markets each year, compared to 120 million ounces of total supply and demand, while roughly 100 billion ounces of silver change hand, compared to around 628 million ounces of new supply.

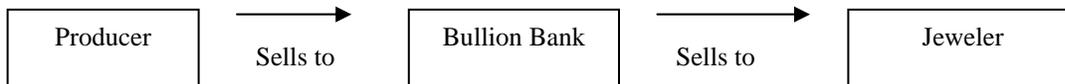
The gold and silver markets are unique in that, of all the commodities markets only in these two markets are there people who believe that forward sales represent an acceleration of physical supply to the market.

Producers in the petroleum, natural gas, copper, aluminum, nickel, corn, wheat, soybean, and numerous other commodity markets all sell forward. In some of these commodities markets the equivalent share of annual production sold forward is much larger than that in the gold and silver markets. Yet, in none of these markets do producers, analysts, and others suggest that someone loans physical supplies of these commodities to dealers, who sell it on a spot basis to cover their forward purchase commitments. No one pretends that the central banks of the world have untold oil stocks that they secretly lend to dealers, who sell this on the spot market to cover forward purchase commitments. Producers in these other markets do not accuse themselves of unduly depressing glutting the physical market with their forward sales. Analysts do not include lines of "supply from hedging" in their tallies of annual new supply entering the market.

Years ago, I made that point in response to a question after a speech. I ended my response with the rhetorical question: Why would a trading company, able to hedge its forward purchase commitments in all commodities with paper hedges, choose the expensive and cumbersome route of hedging its gold and silver forwards with physical sales, when it was clearly unnecessary.

This article may help to clarify the complex world of commodity banking, in which gold, silver, and other commodities are treated as assets, collateralized and traded against. When we explain these processes to clients, we often refer to the same mechanics as they are applied to deposits, loans, and assets by commercial banks in U.S. dollars and other currencies. Banks treat their metal deposits in much the same way as they do deposits denominated in money, as the reserve asset against which they lend additional money to borrowers.

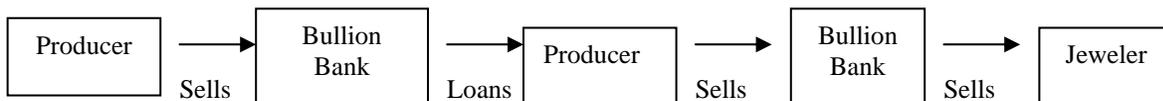
Consider the following exceedingly simplified schematic diagram of how a bullion dealer trades gold.



This is an extremely simplified explanation of how a bullion bank buys gold from a producer and then sells it to a jeweler. In reality, a bullion dealer will have numerous purchases and sales it is making at any given time, and several positions representing forward commitments to buy and sell; loans; swaps; repurchase agreements; metal held on an unallocated basis; metal owned or committed to in the form of concentrates, dore, and scrap; and other positions in gold and silver at any given time.

The collection of these positions is called the gold book run by that bullion bank. In the world of banking accounting, many of these positions are gold-denominated assets, some of which the bank can use as collateral for borrowings and lendings in gold or currencies.

Now, let us complicate the diagram by adding a gold loan.



In this example, the first producer sells gold to a bullion bank. The bank loans this gold to another (or the same) producer in a gold loan. The producer then sells the gold to the bullion bank, which sells the gold to a jeweler. In this way, the banker has made two transactions with the same volume of gold. Instead of merely earning the very small margin available on spot gold purchases and sales, the banker has managed to add to its fees for this gold the interest and banking fees attached to a gold loan and a second purchase. In this way, the bank increases the profitability of its bullion trading operation.

Imagine, if you will, that the bank can line up three or more producers and others who want to borrow this gold. All of a sudden, that one ounce of gold is now involved in half a dozen transactions. The physical volume involved has not changed, but the turnover has multiplied. This is the basic building block of bullion banking. This admittedly rudimentary outline of bullion banking holds the key to understanding how bullion banking allows for a multiple of trades to be based on one lot of metal.

Many banks use factor loadings of 5 to 10 for their gold and silver, meaning that they will loan or sell 5 to 10 times as much metal as they have either purchased or committed to buy. One dealer we know uses a leverage factor of 40. (Long Term Capital Management had a leverage factor of 100 when it nearly collapsed in 1998.)

A bank does not even have to be buying gold at a particular time to be able to use it as collateral against which it can trade, sell forward, and lend gold. If a bank has gold held in an unallocated account, or a forward purchase on

its books committing a producer to sell its gold later, it can use these gold assets as collateral for additional gold trades.

In the second quarter 1998, one of our mining clients had a forward sale on its books which was coming due at an unattractive price. This was a silver trade, with a forward sale locked in at \$5.00 coming due when silver was trading at \$6.00 per ounce. In fairness to the producer, its bank had forced it to sell forward, forcing it to use forwards instead of more efficient options positions, as part of the terms of a revolving credit facility the bank had extended the producer. On our advice the producer rolled the position forward, and sold that month's silver output at the higher \$6 spot price. The chief financial officer of the mining company asked us why the bank, which had a \$1 per ounce profit on the position, would allow them to roll the position forward. The explanation is that having a silver position on its books at \$6 per ounce provides the bank silver assets that it can collateralize many times over, which is worth a lot more to a bank than \$1 per ounce in one-time profits.

It is hoped that this discussion will help readers better understand the complexity of bullion banking, and why it is that an increase in trading turnover does not necessarily reflect an increase in spot physical supplies. The market mechanics are much more complex than some observers suggest.

During the 1980s the turnover and open interest in copper on the London Metals Exchange rose around 17-fold. The physical copper market only doubled during that time. The increase in turnover far in excess of the growth rate in the physical copper market was made possible by the ability of metal traders to hypothecate, or collateralize, their metals books.

What does this mean for precious metals producers, consumers, analysts, investors, and others? It is critical that market participants fully understand the markets in which they work, so that they can more accurately anticipate the consequences of changes in market conditions. We all are increasingly overloaded with work and bombarded with reading. In this environment, we need to find filters that allow us to discriminate good from bad information and analysis, to allow us to focus on what is important. One way to filter research out is to know how the market mechanics operate, and to avoid reports that do not reflect even a basic knowledge of market conditions. A major bullion dealer at one of the most active bullion banks in the world made a comment to me in early 1998 that succinctly put in context what one's approach should be toward those comments about how bullion banks and monetary authorities were colluding to drive the price down. The banker said, "Do these people have any idea whatsoever how gold is traded?" The answer is no.

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