Capital Standards and Gold

Rumors have begun to circulate that the Basel Committee on Supervision is considering modifications to the draft proposals for Basel III standards by changing the risk weights for capital standards by moving gold asset holdings from Tier 3, which has a 50% risk weight, to Tier 1, which has a 100% risk weight. (see for example, http://www.resourceinvestor.com/2012/05/29/is-the-next-big-thing-1700-tonnes-of-gold-purchase?t=precious-metals).

Commentators go on to suggest that this will increase the desire of banks to hold gold and be extremely bullish for the yellow metal. Before you rush out to beat the crowd in loading up on gold, get the facts and analysis straight. Virtually none of the descriptions that are circulating of the changes, like those mentioned above, are accurate. Furthermore, inferred implications for the price of gold don't make one iota of sense.

So here are the facts. First, under the current Basel III proposed rules (see http://www.bis.org/publ/bcbs188.pdf), gold is currently not assigned a risk weight for the purposes of assessing bank capital adequacy. Gold only figures into the calculation of the required net stable funding ratio, which is part of the Basel III liquidity standards, not the capital standards. Under the net stable funding rules, a bank would have to maintain the ratio of available stable funding to the required amount of stable funding at greater than 100%. Different liabilities count towards the definition of available stable funding. For example, Tier 1 and Tier 2 capital, long-term debt, and deposits with maturities greater than one year are regarded as 100% stable, retail deposits with maturities of less than a year are regarded as 85% stable, and so on down to wholesale funding, which is regarded as only 50% stable. Some liabilities are even given zero as a stability weight.

On the asset side, different asset categories are considered to have different liquidity characteristics that require more or less stable funding as a buffer. For example, cash and short-term unsecured instruments with maturities of less than one year are regarded as liquidity and carry a 0% weight. Debt securities with maturities greater than one year carry a 5% weight; corporate covered bonds rated AA or higher carry a 20% weight; gold, lower-rated covered bonds, and equity securities carry a 50% weight; retail loans maturing in less than one year have an 85% weight, and some assets that are deemed illiquid carry a 100% weight. The bottom line of all this is that the lower the weight applied to different asset categories, the lower the amount of stable funds that the proposed Basel III rules would require.

Now, if the proposal is to move gold from its present 50% weight category to 100%, that raises the amount of stable funding needed to support gold holdings and presumably ups the costs of holding gold. Therefore, those arguing that the proposed changes (if they are indeed proposed changes) will increase the demand for gold and be bullish for gold valuations, have it backwards. Any change that increases the stable funding ratio will increase the cost of carrying that asset, while any proposal that lowers the net stable funding ratio will be bullish for the asset.

We have not, as of this writing, been able to verify what proposals are being considered, or even if they are. However, we do know that gold does not figure into current or proposed bank capital standards, as some have suggested. Nor would increasing the stable funding requirement for gold be bullish for that asset.