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When Markets Break | Episode 2
David Gornall, Former Chairman, LBMA London Bullion Market Association

This week, SmarterMarkets™ host David Greely is joined by David Gornall, the former Global Head of Precious Metals Trading at Natixis and Former Chairman of the London Bullion Market Association (LBMA). Together, they discuss the massive dislocation between the gold markets in New York and London in March 2020 during the early days of the COVID-19 lockdown.

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Announcer (15s):
Welcome to Smarter Markets, a weekly podcast, featuring the icons and entrepreneurs of technology, commodities, and finance ranting on the inadequacies of our systems and riffing on ideas for how to solve them. Together we examine the questions are we facing a crisis of information or a crisis of trust and will building Smarter Markets be the antidote?

David Greely (39s):
Welcome back to When Markets Break on SmarterMarkets. In this podcast series, we're looking back at past market crises with people who were there to learn what went wrong and what we can learn from it. I'm Dave Greely, Chief Economist at Abaxx Technologies. Our guest today is David Gornall, Former Global Head of Precious Metals Trading at Natixis and a Former Chairman of the LBMA. We'll be discussing the massive dislocation between the gold markets in New York and London in March, 2020 during the early days of the COVID-19 lockdowns. Hello, David, welcome to Smarter Markets.

David Gornall (01m 13s):
Hi David.

David Greely (01m 14s):
Thanks for joining us today to discuss this, you know, really tumultuous period in the gold market. I'd like to start off by giving our listeners a very brief description of the event and then turn to you to help us understand the context and walk us through the experience. Now in the gold market, the most heavily traded futures market is located in New York City while the most heavily traded physical spot market is located in London. Typically the difference in the price of gold or the spread between the prompt futures contract in New York and the physical spot price in London is small, like around a $50 per troy ounce, but on March 25th 2020 that spread blew out to an unprecedented $60 or more per troy ounce. Now fortunes were made and fortunes were lost. You know, according to Bloomberg, JP Morgan made more than a billion dollars in 2020 in precious metals as the pandemic created unprecedented arbitrage opportunities including this one. So before we dive into it, just to help us set some context, I wanted to ask you, why is this price spread between London and New York so important in the gold market and how big of a deal was it to market participants that it reached, you know, $60 or more per troy ounce?

David Gornall (02m 33s):
Hi David, well, to put this event into some context, we should say that the, the new premium over London has always been a few cents and sometimes a few dollars an ounce. So for the market to move up to $67, this was really a seismic move that the risk of this differential which we call the EFP was modeled to be around about a dollar, say a dollar and half I think, and stress tested to around five. The other important aspect of the gold market to understand is that the physical over the counter spot market is in London and the futures market is in New York and what we'll see is physical gold. That's held in London being typically hedged with a short futures contract deliverable in New York. Now, whilst this isn't an optimal solution, there are good reasons why this is the preferred hedge mechanism of a physical trader and first of all, the futures offers a price spread that's narrow and stable. An often yield, a better forward tango than London OTC forwards and the exchange age also removes the OTC bilateral credit risk that an OTC trade carries as the differential widen anyone with a short hedge was getting squeeze. So the exchange margin calls would force banks to make a decision on whether to maintain the short, pay the margin and try and deliver or close out and pay the loss.

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David Greely (03m 55s):
That's a big decision to make and I'm sure there was a lot of stress and anxiety around those types of decisions. I know that, you know, the trigger for the blowout in the spread between New York and London were the shutdowns that were occurring to try to stop the spread of COVID-19 in those early days of the pandemic airline flights were being curved between Europe and the US. We all experienced that some of the gold refineries in Switzerland were being closed. As many workplaces were and normally the airlines transporting gold between London and New York and refineries manufacturing, small bars from big bars and big bars from small bars tended to keep the price spreads narrow and I think to be fair that COVID-19 pandemic was incredibly disruptive across markets in the economy globally, but was there something particular about the market structure of the gold market that made it especially vulnerable to an event like this?

David Gornall (04m 49s):
Well, I think to evaluate the vulnerability, we, we should define this part of the market structure as five different risk factors. So in no particular order, the location difference, which translates to your logistical risk, the size of the barrage you mentioned in each market, and we can call that the fungibility risk of metal. The next thing you're gonna need is the expert physical trading knowledge. So I'd call that a risk. If you didn't know how to deliver to an exchange, then there are the internal position limits, and then you've got the bank's own risk, appetite and limit. So there are five things that all play out. And at various times during this dislocation, there was always at least one of these factors prevailing to affect the price and that it's high. All five of them played part in the story. So, as I said, one thing about the peculiarity of having a, a physical spot market in London and a future's contract deliverable in London is this inter deliverability factor.

David Gornall (05m 52s):
So the relocation of gold from predominantly Swiss refineries, as you, you mentioned, was prevented by a ban on passenger flights globally at the time. The other issue was this size of the bar. So in New York, it's a 100 ounce bar that's deliverable. Whereas the size of the bar traded in London is 400 and they're not into deliverable. So apart from the existing stock that sits on exchange, any new 100 ounce or kilo bar must be produced to order. So from a refiner's perspective, this is a just in time premium variety of gold and so you won't usually find them lying around in volts, waiting to be traded and so that we can note that there are about five refiners in Switzerland, there may be eight in total, globally that regularly cast and deliver eligible exchange bars. The other aspect to this broadly speaking was two types of participant in the market.

David Gornall (06m 48s):
You speak very different languages and when you speak to physical traders, it's quite apparent and it very noticeable, but the physical trades is largely trade both markets of London and New York separately, but they'll also trade both at the same time using an AFP, which is a single trade that simultaneously in this example, buyers, futures and sales London at a market rate that represents the price difference between the two. Then there are the financial electronic traders who trade fudges in New York and won't hedge by trading OTC London. So in most cases, the financial futures traders weren't set up to trade the EFP with the OTC physical market. So when they were caught shorter futures, they were only left with one option. They could only buy back their futures position on the exchange and thus driving the price higher. So physical hedges would normally close out their risk of London and New York by buying the EFP.

David Greely (07m 43s):
So outside the commodity markets, I think a lot of our listeners might not be familiar with what an EFP is. Could you explain what an EFP is, the exchange for physical?

David Gornall (07m 53s):
Yeah. So it's, it's a trade that simultaneously involves the purchase of the exchange in the sale of OTC or vice versa at a rate differential in US dollars per ounce. So you can buy the futures and sell the OTC in one, one trade in one in one contract.

David Greely (08m 14s):
So that would be the main way of kind of playing that R between London and New York in the, in the context of the gold market.

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David Gornall (08m 19s):
Yes, because it, it avoids leg lifting. So rather than having to go on and trade, if you have a, a physical trade, you are allowed to put it onto the exchange under the exchange rules. Mm. And so you can eliminate the risk between the two markets without actually going through two venues.

David Greely (08m 36s):
And probably having to post collateral and margin on both?

David Gornall (08m 40s):
Yes. I mean, you're not gonna, you're not gonna remove the two sets of fees on it, but it's certainly removing the, the price differential risk that you're gonna run whilst you decide whether you are gonna do the, the futures first or the OTC first.

David Greely (08m 53s):
Thanks for that. So now that we've kind of set the stage with some of these aspects of the gold market, I guess this is more the fun part. Can you walk us through how that event was experienced in the markets, like how did it play out, you've already told us a bit of all these factors kind of came to the forefront at various things, but, you know, what was the experience of being in the market at that time like?

David Gornall (09m 16s):
Well, I think that for most people that were sitting there watching this unfold, there wasn't really any correction, I think bid followed bid. So as the futures became bid and the prices rose, the electronic futures market makers basically chased the price higher. So we've, we've just talked about how the EFP wasn't used by the futures traders to liquidate their shorts. So if they, if they used the EFP, maybe some would argue that they wouldn't have chased it as high. However, the FP market did actually become a liquid and probably wasn't gonna help them in the end. But what, what we saw was the result was that the new futures prices rose much quicker than the London spot. And then we talked about the supplier. So without adjust in time, stock of a hundred ounce bars or kilo bars, and no refiner is open at the time to create them, the market was left traveling in one direction at velocity I might add.

David Gornall (10m 11s):
And the likes of which we'd never really seen before. I think if you had been fortunate enough to hold eligible material at one of the refineries, you could have thought you were in a better position, but then there were no flights. So, you know, one of the things that people don't really know about the, the gold market is gold isn't really moved around in a commercial way that is on freighters. So they sit in the cargo hold of passenger aircraft. So you're quite often, if you're traveling between gold hub to gold hub, you may well be sitting on a pile of gold underneath you, and that's the way it's moved. So when that mode of transport dried up, so was the ability to deliver gold from hub to hub. So I suppose the next thing we, we saw when things reopened in the refineries was that we had this mass of flight bookings.

David Gornall (11m 02s):
And so we ran out of capacity because very quickly you can imagine how much gold fits on, on an aircraft, but with a lot of the airlines not moving passengers around, they quickly turned these planes into cargo planes. I've seen some pictures where they simply put them on the seats and stacked them neatly in the places where people normally would've been, and that helped to alleviate some of the problems. But in reality, the banks were in particular, were getting caught with the short hedge and the negative variation margins that range between several hundred million and a billion, according to what they stated publicly, such as the size of their, the market losses. I mean, they were, they were huge in the order of magnitude of probably six to seven standard deviations away from any market risk model. So we can say it was a, a, a black Swan event and it definitely had to go undermining the ability to manage market price risk by, by using this method of, of futures hedging versus London gold holdings. But even after that, it didn't get rid of it all together.

David Greely (12m 09s):
Yeah. I would imagine if you were, if you're a gold trader in London and you're used to trying to properly manage your risk, and you're doing it by shorting, you know, futures in New York on the exchange here, and suddenly, you know, that price is bidding up away from you. So your risk management is now the, the leading cause of your pain and there's no way to cover your short, right, because you can't get the a hundred ounce bars that you would need to deliver in New York and even if you have them getting them on a plane to get them to New York, isn't really possible either. So you're stuck trying to just find somebody else to buy that future's contract that

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you're trying to buy it back in New York and the price is just chasing a way up of and away on you. Yeah. How were the participants in London dealing with that?

David Gornall (12m 58s):
Well, once, once they'd overcome the two of those five risks, I talked about you would've thought then it was plain sailing after there. So then we introduced the other three risks, which were the limits, the risk models and the knowledge or ability to deliver. So we mentioned that some participants that had delivered gold already in that delivery month had reached their exchange limit. So the exchange place is a limit on what you can deliver during the active month, and you weren't allowed or able to make a, a second one and there were some exemptions permitted, but they weren't the norm. The second problem that we got to hear about was having overcome those obstacles. Some of the traders had metal in the right place, on the right side of the Atlantic, had the position limits and were about to, to pull the trigger, so to speak.

David Gornall (13m 53s):
And we're prevented of doing so by their risk managers, who said that this was creating more risk. And they were told in uncertain terms to take the hedge off, move the goal back to an OTC vault, and don't put anymore onto the exchange. So you, you can imagine, whilst people have thought, they've, they've got the upper hand in this arbitrage, they hadn't quite got it. And there was another one that frustrated a lot of people that hadn't been accustomed to delivering metal to an exchange that it's quite a nuance process. And if you haven't done it before, you know, you clearly realize that you need an experience person to complete the transfer efficiently in the timeframe allowed. Cause no, one's gonna help you do that. No, one's gonna help you figure it out in a short timeframe. So perfect storm, I'd say.

David Greely (14m 47s):
Yeah, it sounds like just, you know, the exchange, because this was such a, you know, like a multi standard deviation event, just the typical operations and practices weren't designed to try to move that amount of metal in such a short period of time, whether it was the size of the position limits that were allowed, the number of experienced people who know how to move gold in and out of exchange warehouses. I want to come back to the point about the risk management though, cause that's kind of like a fascinating piece. So for you were saying for traders who had gold of the right size in New York who were under their position limits, they could have delivered it into an exchange that was screaming for that it needed metal. What was the risk management thought process that said, no, put it back in an OTC vault in New York, or was it shipped back to London at that point,

David Gornall (15m 34s):
It was shipped back to London because do you remember the, at the start of this, we started talking about the, the model factor. So that there's always a number that a risk manager uses to say, what is fair value? So if you're going to measure this differential and it's only ever traded between one and $5 over the last 50 years, then that's the number you're gonna use and if it throws out a $70 differential, it breaks all the dials on the dashboard and there's just no way of resetting it and a lot of these models are, are looked at regressively and they look at it over a period of time. So once it breaks, it doesn't just break for that, that day or that month. It stays within the risk for sometimes a year or two years thereafter until it levels out. So it actually had some long term implications for the future's market.

David Greely (16m 26s):
Yeah. I imagine those were some colorful conversations. I'd love to get back to, you know, some of the some of the longer term implications, but before we do, you know, we, we've been talking a lot about the gold market and, you know, in market events like this one that are disruptive enough to be memorable, it's usually not just one thing that goes wrong, but there's a lot of things going on and knock on effects that can feed on each other, as you said, or, you know, impact other markets. So, you know, outside of what was happening in gold, New York and London, were there other problems at the same time, you know, in the wider gold market or the wider, precious metals markets that had to be dealt with as well?

David Gornall (17m 06s):
Well, let's yeah, let's look at the wider gold market. So what it wasn't just London and New York that was affected by this. So in, in China and India, I think China was, was the, the largest discount ever seen to London. So from New York, it was, it was monumental and the same was going on in India. So you have to realize what the, you know, the me, the Western mantra is to hoard gold in times of turmoil. It's the rainy day fund. Whereas the Asians tend to use gold in that time. So where there is turmoil, they, they tend to dishold and then they go to cash. So this was their rainy day. So they're cashing out. So the opposite effect is happening. So you've got massive

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discounts in China and India. They're not able to explore before somebody said, well, hang on. Why, why don't you just connect those two, they have to remain within the country. So that's probably one of the reasons why they went to an even deeper discount, but in terms of broader, precious metals, yes, we saw the same differentials occurring in silver and platinum and all the way down the supply chain to the, the coin market in the us ended up around a hundred dollars premium. So it wasn't just London, New York. That was just one example of how the dislocation happened.

David Greely (18m 23s):
Right. And when you speak of the dislocations in the silver market, as an example, was that similar reasons for the gold market?

David Gornall (18m 32s):
Yeah. It's not quite the same thing because the standards are very similar. So you can't, you can move bars, but you don't put silver on an aircraft when it's $20 an ounce So you would typically ship silver by sea freight container and that's when you can find them. So we've all read about the problems of supply chain management for a lack of vessels, a lack of containers and so silver got caught up in, in that very typical supply chain problem, even though the bars with the same size in London as they were in New York.

David Greely (19m 09s):
Remember when I first got into commodities I was told that commodities is all logistics. You need to understand logistics. It certainly seems like the case here. Now I wanted to ask you what ultimately brought this event to a resolution, like, did it resolve of itself naturally over time or did participants regulators have to step in and sort things out?

David Gornall (19m 33s):
Well, I think the answer to that was it, it happened in, in increments over a period of time. So we've got the active futures months. So it did take a few months to unwind it wasn't a few weeks and at the end of it, when, when gold did start to flow into exchange, we actually saw very temporarily a discount to London, but that didn't last very long. So the, the answer to that is it, it did resolve itself as the four, four of the five main risks became manageable. Did the regulators get involved, not really. CME is a self-regulatory organization and they looked at creating another delivery point in London for 400 ounce bars, but that contract was a new contract and it wasn't inter deliverable with the hundred ounce liquid futures contract. So it really didn't have too much of an effect. I think the traders and the risk managers together thought was probably more prudent to keep some gold in New York from now on. I don't believe that they ever kept that much there, but certainly it's the case that some traders keep more gold in New York than they ever did before.

David Greely (20m 44s):
Yeah. And how did this like, did this leave a lasting impression on traders and risk managers behavior, you mentioned that some of these effects lingered, so, you know, maybe keeping a little bit more gold in New York though. You sound a little skeptical about that, but just, you know, once a spread that I think it's for a long time, people thought was, you know, ah, dollar, maybe $5 at the worst, and after you've seen it go to 60, it probably changes the way you think about what's possible in the future. So has that changed some of those dynamics about, you know, how the gold traders in London hedge their risk and how they think about that?

David Gornall (21m 23s):
No, I think risk managers have longer memories than traders do. So I think the traders looking forward to getting back on the horse again and business as usual where the risk manager's never gonna let him forget it. So I suppose the answer is that that there's a lot more prudence involved in managing those risks and positions, I would assume now, but I, I think at the time, a lot of people did question this whole structure of the market and, and how it came to be and it, there was certainly, it did create an effect that led people to think about how to build a fungible global system of liquidity. So, you know, not just one in London, but multiple delivery points, but then as the market corrected itself, and this unwound a lot of people lost interest in trying to find a long term resolution, it was just too hard to do. So that idea got put on the back burner, you know, will it come back again, maybe.

David Greely (22m 19s):
And, you know, with the idea that these ideas might come back again, or like, I'm curious, how vulnerable do you see the gold market being to this sort of thing happening again. It sounds like there may have been some lessons to be learned, but you know, it also sounds like we went back to business as usual fairly quickly.

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David Gornall (22m 38s):
Yeah, we did. I think the, the two things I've noticed aside from the reduction in limits was the, the greater use of forward London hedging. So we mentioned earlier that whilst some believe that the futures is a much more efficient way of hedging because of its liquidity, its simplicity and its lack of counterparty risk. The alternative was always there to go back to OTC forward hedging and that's certainly what we've seen when we look at the trade data. So the, the 6 million ounce daily average of Fords and swaps on gold in London after this event became 10 million and it remained 10 million and I think it's still the same today and it's had peaks into the sort of 15, 20 million ounce area. So I think what it tells you is that the system of using futures to hedge physical isn't as widely used as it was before the dislocation event.

David Greely (23m 34s):
And when you look at the gold market, as someone who's been in it for a long time, you know, and was once chairman of the LBMA what, when you look at it, what problems do you see remaining, you know, that were, you know, we, we discussed, I think maybe five problems or five issues in the market that, you know, created some of the vulnerability that we saw in March, 2020, which of those do you think remain and which are the most important to be addressed?

David Gornall (23m 59s):
Well, I think it, it might serve a lot of a, a lot of needs if when we didn't mention the, the, the London metal exchange although, you know, most conversations in the commodity market do involve the LME at the moment for different reasons. But I mean they had a contract that was Loco London, but what's interesting about looking at their model for base metals is that it allows delivery into locations. So you don't need to move metal around for the sake of moving metal because the terminal market only exists in one or two places. You know, it should be possible to, to use a multiple of locations in a more standardized contract. So does that mean building another futures contract that represents the 400 ounce bar, maybe it may be more relevant to look at one that that uses the kilo bar, which is that the, the choice of the physical trader and it's the choice of the physical market when it comes to end users. So I think that those subjects have remained at the forefront of a lot of these conversations that we've had vis-à-vis, the structure of the market going forward.

David Greely (25m 10s):
And if, if you were to, when you look to the future, what do you see as a more robust way of building the gold market. I know it sounds like a lot of this is stuff that's kind of evolved over time, but is it, you know, more global, more standardized in terms of fungibility of the delivered product. What do you think you would change if you could?

David Gornall (25m 32s):
Well, I think it's not, it's not for one person to say what they would change it's for one person to listen to what everybody else would like to see and I think people would like to see a bigger and more developed gold market. I think they'd like to see a lot of the local centers being more included rather than acting as outlying hubs and so I think you know, the synergy is a global market rather than having out outliers and you'll get more connectivity you pull more liquidity, and that's what everybody wants at the end of the day. Nobody wants to deal in, in a pool of liquidity that, that evaporates as this differential did in 2020. So, you know, the deepest pool of liquidity will always win. And I, and I think it's really up to the users of the market to, to come up and design their own future proof system that allows everybody in allows everybody to have access and to remove some of the barriers that we've seen in these examples, that can be very disruptive to the market.

David Greely (26m 39s):
Thanks again, to David Gornall, Former Global Head of Precious Metals Trading at Natixis and a Former Chairman of the London Bullion Market Association. We hope you enjoyed the episode. Please join us next week. As we continue, when markets break on Smarter Markets, we hope you'll join us.

Announcer (26m 55s):
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Announcer (27m 32s):
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