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How to Keep Banks From Rigging Gold Prices
By Rosa M. Abrantes-Metz - Dec 19, 2013

Authorities around the world are gradually piecing together a shocking picture of how banks have manipulated benchmarks that influence the price of everything from mortgage loans to foreign currencies.

Another area deserves their scrutiny: gold and silver.

In recent weeks, Bloomberg News and others have reported on concerns, among market participants and regulators, that the process for establishing the price of gold may lend itself to insider trading and other forms of unfair dealing. The available evidence strongly suggests manipulation and, given the structure of the market, possibly collusion.

The price-setting mechanism, known as the fixing, provides an easy vehicle for manipulation. Twice every business day in London, representatives of five banks and some select clients participate in a phone call in which offers to buy and sell gold are put forward. These calls determine the morning and afternoon gold fixings, which serve as the benchmark for trillions of dollars in transactions around the world. Silver fixings work similarly, with only three banks involved.

Such direct communication is conducive to collusive pricing, especially when the group of participating competitors is very small. We now know that collusion distorted both the Libor and Euribor interest-rate benchmarks, which involved many more participants. In those cases the coordination occurred through e-mails and instant messages. In the case of gold and silver, an organized live call allows for real-time signaling of the desired prices, obviating the need for additional contacts.

One needn't look far for a motive. The participating banks all stand to gain both from using the privileged knowledge they glean during the fixing process and from influencing the fixing itself. Aside from trading in the spot markets for gold and silver, they may have significant derivatives positions tied to the benchmarks. The system isn't set up to identify, let alone deter, such activity. It is the participating banks themselves that administer the gold and silver benchmarks.

So are prices being manipulated? Let’s take a look at the evidence. In his book “The Gold Cartel,” commodity analyst Dimitri Speck combines minute-by-minute data from most of 1993 through 2012 to show how gold prices move on an average day (see attached charts). He finds that the spot price of gold tends to drop sharply around the London evening fixing (10 a.m. New York time). A similar, if less pronounced, drop in price occurs around the London morning fixing. The same daily declines can be seen in silver prices from 1998 through 2012.

For both commodities there were, on average, no comparable price changes at any other time of the day. These patterns are consistent with manipulation in both markets.

It’s extremely odd that the prices of gold and silver are still based on such an archaic and exclusive system. Whether or not authorities seek and find conclusive evidence of manipulation, they should learn the lesson of the London interbank offered rate and reform the gold and silver markets in a way that will deter such behavior. Both metals are highly liquid commodities, so their benchmark prices could easily be set by observing actual trades. To ensure reliability, the process should be overseen by an independent institution with the appropriate governance structure and minimal conflicts of interest.

The best way to restore confidence in financial benchmarks is to remove the means, motive and opportunity for abuse.