A proposed fundamental change in Gold classification to benefit the Fund.

Proposed Banking Regulations would cause Gold prices to push significantly higher!

The Bank of International Settlements (BIS), the Central Bank's central bank, is considering reclassifying gold as a risk-free asset as part of the Basel III framework, as BIS notes in its progress report on Basel III implementation.

"At national discretion, gold bullion held in own vaults or on an allocated basis to the extent backed by bullion liabilities can be treated as cash and therefore risk-weighted at 0%."

This would obviously have a very strong effect on banking capital adequacy ratios (CAR), once the domain of banking specialists. The impact is set to take the gold market to centre stage and hence have a far reaching effect on the wider global economy.

If activated this would be a major endorsement of Gold and its role in wealth preservation and underlines its role within RIO.

Simply put the rules are to be tightened in terms of the assets that banks must hold. This is potentially going to bolster gold and further underpin its current value/price resistance levels and hence strengthen the case for further upside in its price.

The Basel Committee for Bank Supervision (or BCBS), which is part of the BIS, is arguably the highest authority in banking supervision and it is its role to define capital requirements through the forthcoming Basel III rules.

Our research shows that the Committee is meeting to **consider making gold a Tier 1 asset for commercial banks with 100% weighting rather than a Tier 3 asset with just a 50% risk weighting, as is the situation today**. In layman terms Tier 1 assets are basically the most stable, bedrock risk-free types of assets which a bank can hold.

More importantly, under the Basel III international framework all banks will require to hold more Tier 1 assets. This is being considered, of course, to avoid the possibility of future bank meltdowns and reduce the impact of any crisis which is evolving. At the same time the framework is set to increase the amount of capital that banks will be required to hold.

For more than a decade banks have been much disincentivised to hold gold while being encouraged to hold arguably riskier assets such as equity capital, currencies and debt instruments, none of which have fared well in the current crisis.

This potential change in capital adequacy requirements will result in banks purchasing more gold. In turn this will drive up its value, increasing the desirability for further regulation. Should the proposals within Basel III be sanctioned this would result in gold being re-priced to bring it on a par with all other high quality assets. I have been an avid advocate of gold since 2002. It now looks set to really shine.

Currently banks must have a core Tier 1 capital ratio of 4%. This will rise to 6% from the beginning of next year. In addition to its store of value merits, central to the argument in favour of gold as a bank reserve is its counter cyclical nature to most other assets. It tends to be inversely correlated. Gold is ideal as it bears no credit risk and involves no other counterparty and hence no liability.

This situation is a potential "big win" for gold and, should it be ranked as a Tier 1 asset, that would be a major endorsement of its role in preserving wealth. As acknowledged as a store of value from the highest financial authority, it will encourage significant purchases by major financial institutions and very likely lead to a reappraisal of its value with respect to other Tier 1 capital, such as quality sovereign debt. This would be good news for those investing or trading in gold such as the RIO Professional Investors Fund.

The Basel III framework is scheduled to take effect from January 2013 with a further tightening in capital adequacy ratios in 2018.

In terms of the amount of gold that could be purchased that is hard to assess. If say 2% of total current Tier 1 capital held by commercial banks globally were converted into gold (forgetting for a moment increases in capital yet to be seen) this would suggest that 2% of the Tier 1 $4,276 bn would be converted to gold. That is equivalent to $85 bn in gold which, at current market prices, is equivalent to 1,700 tonnes of gold.

The Federal Bank regulatory agencies (the agencies) on 18th June 2012 jointly issued a Notice of Proposed Rulemaking (proposed rule) that would revise the measurement of risk-weighted assets by implementing changes made by the Basel Committee on Banking Supervision (BCBS) to international regulatory capital standards and by implementing aspects of the Dodd-Frank Act.

The following exposures would receive a zero percent risk weighting under the proposal:

- Cash;
- **Gold bullion**;
- Direct and unconditional claims on the U.S. government, its central bank, or a U.S. government agency;
- Exposures unconditionally guaranteed by the U.S. government, its central bank, or a U.S. government agency;
- Claims on certain supranational entities (such as the International Monetary Fund) and certain multilateral development banking organisations
- Claims on and exposures unconditionally guaranteed by sovereign entities that meet certain criteria (as below).

The proposal allows banking organisations to recognise the risk mitigating benefits of financial collateral in risk-weighted assets, and defines financial collateral to include:

- cash on deposit at the bank or third-party custodian;
- **gold**;
- investment grade long-term securities (excluding resecuritisations);
- investment grade short-term instruments (excluding resecuritisations);
- publicly-traded equity securities;
- publicly-traded convertible bonds; and,
- money market mutual fund shares; and other mutual fund shares if a price is quoted daily.

This story is the most under-reported financial story of the year. US banking regulators recently circulated a memorandum for comment, including proposed adjustments to current regulatory capital risk-weightings for various assets. For the first time, unencumbered gold bullion is to be classified as zero risk, in line with dollar cash, US Treasuries and other explicitly government-guaranteed assets. If implemented, this will be an important step in the re-monetisation of gold and, other factors being equal, should strongly support the gold price, both outright and relative to that for government bonds.

On 4th June the Federal Reserve, OCC, and FDIC collectively circulated a memo asking for comment on their proposed changes to the regulatory capital risk-weighting framework. Section 11, 'Other Assets', specifies that a "zero risk weight" is to be applied to "gold bullion held in a banking organisation's own vaults, or held in another depository institution's vaults on an allocated basis.

It appears that, in the near future, banks will not have their regulatory capital ratios penalised for holding gold instead of government bonds as a safe-haven, zero-risk asset.

Those invested in RIO Professional Investors Fund should agree that the fundamental backdrop for gold is highly favourable as it has been for some years. I take this opportunity to state that this is amplified when we consider the statistical fact that the supply of money, credit and government bonds has grown dramatically. Hence this technical appreciation of the gold market is also clearly bullish. If gold is re-classified as a zero-risk-weighted asset, the price of gold is likely to rise to a new all-time high. In a few months it will be revealed whether this appreciation is correct.

Considering the world importance of the above, I am very surprised that this announcement has not been widely reported in the financial press. Are we once more ahead of the media? After all, the change is not due to take effect until 1st January 2013.

Members should consider that with interest rates near zero, the opportunity cost of sitting on a non-interest-bearing gold position for six months is close to zero. Statistics may show that gold appears to be in a downtrend, it might have been unusually volatile over the past few months but, unless the regulators backtrack, this is as clearly a significant bullish signal for gold.

RIO Professional Investors Fund continues to outperform its benchmark return, statistics depict a telling story the facts show that it has significantly outperformed the main markets over the past three year period which has been one of the toughest markets this decade. It has became the envy of many in the industry, as part of its asset allocation the fund continues to both trade and invest in gold, that being the case this fund is positioned to benefit from the above, if my predictions are proven correct and the proposals set out above are adopted, the commodity market will witness a gold rally.

William Gray
Fund Manager
RIO Professional Investors Fund