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c David Willetts

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From the Private Secretary

11 December 1984

Johnson Matthey Bankers

The Prime Minister has seen the Chancellor's minute of 10 December. While she will wish to discuss the issues raised with the Chancellor at their next meeting, she is content for an early announcement of the reviews to be made. She has asked that careful consideration be given to the form in which the announcement is made to the House.

(ANDREW TURNBULL)

David Peretz, Esq.,
HM Treasury.

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PRIME MINISTER

JOHNSON MATTHEY BANKERS

I have now considered with the Governor of the Bank of England the events leading up to the rescue of Johnson Matthey Bankers (JMB) on 1 October. I have reached the view that the episode raises important questions about our system of bank supervision. I have therefore asked the Governor - and he has agreed - to chair a joint Bank/Treasury Committee of Review. This will involve an outside consultant.

2. I attach (on a strictly personal basis) the Bank's accounts of the main events preceding the rescue, and of the considerations leading to the Governor's decision. These are attached at annexes A and B. Under present arrangements, the Bank does not require Treasury approval for rescue operations unless support is required in excess of the range permitted by their reserves. The JMB operation did not fall into this category. The Governor therefore notified me of his decision shortly before the announcement - as I have already made clear to the House - and neither sought nor required my approval.

3. It is inevitably a matter of judgment as to how serious the consequences would have been of letting JMB fail, and whether they would have outweighed the moral hazard risk incurred by a rescue. I am not myself yet persuaded that the consequences of failure, either for the gold market or the rest of the banking system, would have been as serious as the Bank clearly believe (see Annex B), particularly if a decision had been taken by the authorities to stand firmly behind the rest of the gold market

with a large short term credit line in cash and gold. Nor do I think the circumstances are anything more than superficially similar to the Continental Illinois case.

4. I do not think an inquest into whether or not the Governor was justified in rescuing JMB could be conclusive or useful. But it is of great importance that we look closely at why JMB collapsed so suddenly and with bad debts on such a large scale, and what can be done to reduce significantly the chances of similar problems in the future.

5. Prime responsibility for a bank's affairs must lie with its management, and whatever the failures of supervision, supervisors cannot be expected to double-check all management decisions. JMB's management quadrupled the bank's loan book between 1981 and 1984. Profitability in the years to 1983 was artifically boosted by inadequate provisioning; and the management failed to inform the Bank of the connection between its major exposures. As problems in the business multiplied, JMB were considerably less than frank, not to say evasive; and they were dilatory in submitting vital statistical returns. Although the Bank were significantly misled, they consider they have no grounds to believe that there was fraud on the part of the JMB's officers. The senior management of JMB has, of course, been culled since the rescue operation.

Failures of supervision

6. This said, however, there clearly were failures of supervision. In particular, the supervisors:-

(i) failed to obtain information and hold meetings with JMB as soon as they should have done. Most crucially, JMB's end-March 1984 statistical return, showing a sharp increase in large exposures, was two months late. There was a further month's delay in arranging a meeting to discuss these figures. This reflects a clear failure to recognise the significance of early warning signals, and a lack of firmness in obliging JMB's management to conform to supervisory requirements. A faster reaction in either case would not have prevented the collapse of JMB; but it might have reduced the scale of the disaster.

(ii) gave the management of JMB too much benefit of the doubt. This reflects the high degree of confidence which the supervisors habitually place in the managers of recognised banks as compared with those of licensed deposit-takers.

(iii) failed to spot serious shortcomings in the quality of JMB's assets. Even when the bad loans were building up so fast, they were still concentrating in their discussions with JMB's management on other areas of concern. It is clear that the supervisors relied far too much in this respect on JMB's external auditors, Arthur Young McClelland Moores. The Bank report that the auditors signed off on 18 June, saying that provisions were adequate, and it was only when the Bank followed up the August meeting that the auditors were called back to re-examine the loan book. Following this, JMB reported to the Bank on 25 September that substantial extra provisions were needed - themselves well short of the provisions eventually judged necessary as the loan book was scrutinized.

7. Some of these omissions stem from failure to operate the present system effectively. Others are due to gaps in the statutory framework provided by the Banking Act 1979. The Review Committee I have set up will accordingly have terms of reference sufficiently wide to cover both these aspects.

8. The Review Committee will report to me as soon as possible after the end of the year on the present supervisory system, and whether any early changes in supervisory procedures are called for in the light of the problems which have arisen in Johnson Matthey Bankers. I have also agreed with the Governor to approach a senior outside expert experienced in commercial banking to report to the Committee. I have in mind for this task Mr Peter Graham, ex-Chief General Manager of Standard and Chartered Bank.

9. I would expect the main issues to be covered in this first phase to be the following:-

(a) The relationship between auditors and supervisors. At present the auditors and supervisors are prevented respectively by professional secrecy and the terms of the Banking Act 1979 from communicating directly about the affairs of a particular bank. There might, however, be immediate scope for improved communication, compatible with existing legislation, with the express consent of the management of the bank concerned;

(b) the staffing of the Banking of England's Supervision Department. Do its staff have the right experience of training? Are their resources adequate, and are they deployed to best effect?

(c) How can the supervisors be better placed to take a view on the quality of assets?

(d) Can procedures be improved for notification and discussion with supervisors of large and connected exposures?

(e) Can improvements be made to ensure prompt reporting of the necessary supervisory statistics collected from banks by the Bank of England?

10. The Committee will also draw attention to any proposed changes arising from this enquiry which may support the need to review or amend the Banking Act 1979. In parallel with this, a group of Treasury and Bank officials under Treasury chairmanship will consider in detail the desirability of legislative changes in the supervisory framework. This group will make recommendations to the Governor's Committee in the spring of 1985. I intend that in the light of the lessons of the JMB case, and other shortcomings in the Banking Act which experience has brought to light, it should take a radical and comprehensive view. Among the issues I have asked it to address are:-

(i) Is it right, with a rapidly expanding banking sector, to maintain the two tier system, whereby recognised banks are subject to a much less strict supervisory regime than licenced deposit-takers?

(ii) Are there lessons to be learned from foreign systems of banking supervision? In particular, without undermining the undoubted advantages of our present flexible and discretionary system, would it be wise to include some quantitative guidelines in statute - e.g. on large exposures?

(iii) (See para 6 (iii) above). Does the law concerning confidentiality of supervisory information need to be changed, e.g. to permit the Bank to communicate directly with the auditors?

I suggest A (iv) Should there be legal sanctions on those who mislead the supervisors?

11. I shall also be considering further with the Governor the adequacy of the present arrangements for notification and consultation about potential rescues by the Bank.

Announcement

12. There has already been considerable criticism in the House, and in correspondence, of the decision to rescue JMB, with David Owen and Dennis Skinner particularly prominent. Subject to your views, I propose to announce the review in a Written Answer on the lines set out in annex C at the earliest convenient date.

NIGEL LAWSON
10 December 1984

The Rescue Operation for JMB

Tuesday 25 September The Bank was advised by JMB, following a special investigation by their auditors, Arthur Youngs, that substantial provisions of the order of £70mn were required against two large exposures. JMB proposed to ask their clearing bank (National Westminster) to guarantee the loans for a substantial fee and an option to acquire the bank in six months' time.

Wednesday 26 September We were advised that Johnson Matthey PLC could not itself recapitalise JMB and that a rights issue would be difficult. National Westminster declined to provide a guarantee but offered to arrange liquidity support from the clearing banks. National Westminster doubted that they would be prepared to buy JMB but agreed to consider it seriously.

Thursday 27 September Arthur Youngs having conducted an urgent review of the majority of the loan portfolio estimated the need for provisons was now £99.6mn. The Deputy Governor saw representatives of the clearing banks to discuss liquidity support for JMB of £200mn - the Bank would contribute 10%. National Westminster expressed reluctance to buy JMB but were asked to think again.

It became clear that liquidity support would also be required for Johnson Matthey plc; Morgan Guaranty, the lead bank for an existing $175mn syndicated facility, agreed to coordinate support.

The Board of Johnson Matthey plc reluctantly agreed that JMB would have to be sold and acknowledged their responsibility to stand behind it. Bank of Nova Scotia was approached for liquidity support as a substantial lender of gold to Johnson Matthey plc and indicated their interest in acquiring JMB.

Friday 28 September The clearing banks reported that their partial examination of the loan book suggested a provisioning requirement of at least £150mn. National Westminster confirmed that the uncertainties about JMB's true position precluded an acquisition by them. Charter Consolidated, the principal shareholder of Johnson Matthey plc, indicated that they could not mount a takeover for the group, not least because of anti-trust difficulties, but that they would consider what support they could make available.

Saturday 29 September The clearing banks were asked to purchase JMB's loan portfolio. They warned that any price they could pay would leave JMB insolvent but they offered to work out the loan book on a no profit, no loss basis. Bank of Nova Scotia confirmed that they were keen to buy JMB but wanted an unlimited guarantee.

Sunday 30 September It was determined that a £250mn liquidity support package was needed for Johnson Matthey PLC. The Morgan Guaranty syndicate made achievement of this target a condition of their continued support.

The gold market offered liquidity support for JMB. Bank of Nova Scotia confirmed again that they were looking for an unlimited guarantee. The clearing banks, Morgan Guaranty syndicate and other large lenders to the group were asked to contribute to a limited guarantee; they were reluctant. In the evening, Bank of Nova Scotia finally turned down a limited guarantee except in terms quite unacceptable to the Bank and withdrew.

It was then decided that the only alternative was for the Bank to buy JMB for a nominal consideration and Johnson Matthey PLC agreed to put £50 million in cash into JMB. At the same time an indemnity was sought from the banks to limit the Bank's risk on the loan book: the aim was for an indemnity of £100mn, so that approximately £250mn of JMB's loan book would be covered. The gold market agreed to provide £30mn and the clearing banks very reluctantly £20mn. A general liquidity support arrangement for JMB was no longer considered necessary but a support arrangement for gold liquidity was put in place.

The £250mn of facilities for Johnson Matthey plc were substantially in place by the morning. Charter Consolidated agreed to subscribe for £25mn of convertible preference shares in Johnson Matthey plc to assist the company to pay down the £50 million to JMB.

The arrangements were notified to the Chancellor and announced at 8.00am on Monday 1 October.

On Tuesday 2 October heads of agreement between the Bank and Johnson Matthey plc for the sale of JMB were signed.

Subsequently changes were negotiated with other shareholders of Johnson Matthey PLC in the terms of the subscription of preference shares by Charter Consolidated.

The indemnity arrangement and the contributions from individual institutions have now been agreed.

n.b. (Treasury note : the private banks finally agreed to provide indemnities of up to £75m, on condition that this be matched £ for £ by the Bank. The Bank would be liable for any further indemnity required).

ANNEX B

The reasons for rescuing JMB

1. The primary argument for rescuing JMB was its membership of the London gold market. The failure of JMB would, in the opinion of the Bank and of the other members of the gold market, have had a critical effect on the other members and thus on the market itself, with the serious risk that the loss of confidence would spread much more widely to affect other British banks and the banking system and London's position as an international financial centre.

2. The London gold market is probably the most important international gold market. Although there are no reliable statistics to prove this, it is possible that as much as half the world's gold trading is carried out here. The failure of one of the five main participants would in the Bank's view have dealt a substantial blow to the reputation and functioning of that market and would very likely have led to the transfer of much of the business abroad, mainly to Switzerland. Business would have been withdrawn rapidly in the face of uncertainty over the extent of the crisis and once removed would have been very difficult to recapture. The apparent inability or unwillingness of the authorities to deal with the problem would have undermined confidence not just in the gold market but in London as a banking and financial centre at a time when it is undergoing major structural changes which should help to maintain its standing as one of the primary financial centres.

3. The Johnson Matthey group played a special role in the London gold market. Not only was it one of the five members of the daily fixing but alone among the participants it had refining capacity. This is an important encouragement to overseas traders to use the London market, particularly because of the facility to break down standard bars into small bars, for which there is an increasing demand, but also for the ability to refine gold in other forms into standard bars.

4. A further reason arguing for the rescue was the nature of some of JMB's customers. As part of its bullion operations it had received substantial deposits of gold from several foreign governments and central banks, particularly in Eastern Europe, the largest of these amounting to the equivalent of over £50 mn. Losses on these

deposits would have had serious implications for the standing of, and confidence in, British banks generally and could well have added a troublesome dimension to our political relations with the countries concerned.

5. Over and above these factors, it is important to recognise that the London gold market is not simply a market in the sense of, say, the London Metal Exchange. It is a group of institutions, a substantial proportion of whose liabilities are in the form of deposits of gold traditionally withdrawable at short notice so increasing their vulnerability to a loss of confidence. The members of the market do substantial amounts of business amongst themselves and also provide a specialist service to the rest of the banking system, both here and abroad. The other four members of the gold market, Samuel Montagu, Rothschilds, Sharps Pixley and Mocatta and Goldsmid risked being severely affected by the failure of JMB and the losses incurred by its bullion counterparties. Already in Hong Kong in the early hours of Monday morning, 1 October, some banks were refusing to lend them dollars; failure to deal with the situation would have risked deposits being called from them, their borrowing lines being severely curtailed, borrowing costs increased and some counterparties and customers ceasing to do business with them. Two of the houses expressed the view to us that if JMB was not rescued their own businesses would come under very serious strain and might be unable to continue to trade within a few days.

6. Rothschilds and Samuel Montagu are members of the Accepting Houses Committee, as is Kleinwort Benson which owns Sharps Pixley. (Samuel Montagu and Mocatta and Goldsmid are subsidiaries of Midland Bank and Standard Chartered respectively.) It was the clear view of the Bank and of others involved in the rescue operation over the weekend of 29/30 September that the ramifications of a failure would not have been confined to the members of the gold market but would have spread to other British banks. One Accepting House not involved in the gold market had its name refused in Hong Kong on the Monday morning. Major US and European banks were reported to be refusing to deal with any UK House. Midland and Standard Chartered would inevitably have been involved in supporting their subsidiaries. Given Midland's problems with Crocker and its well advertised exposure

to problem debtor countries, market anxieties, still heightened after the Continental Illinois failure, could quickly have spread to Midland Bank itself. Standard Chartered might also have been affected. A number of other UK banks also had sizeable direct exposures to JMB and to other members of the Johnson Matthey group, and would have been directly affected by their failure. It is not likely that the danger to all those banks with exposures to the group would have been unmanageable but for those closer to the gold market the repercussions could have been severe.

7. When considering its response to JMB's problems, the Bank had the example of Continental Illinois very much in its mind. Although Continental Illinois was eventually rescued, the crisis lasted over a number of weeks. With hindsight, it is clear that the relatively indecisive handling of the problem by the US authorities was a major contributory factor to the upset in markets. Large amounts of money were moved from US banks into UK, Japanese and other European banks which were able to take the funds on favourable terms; these movements have not yet been completely unwound. The rapid and decisive action in the event taken to rescue JMB has subsequently been praised and welcomed by supervisory authorities and banks abroad. The failure of JMB, because of its prominence as a member of the gold market, rather than its size, risked provoking a similar upset in markets and reviving comment about the capital strength of major British banks. A substantial outflow of funds from London would, of course, have had adverse repercussions on the exchange rate and interest rates.

8. The alternative of allowing JMB to fail was also examined. In order to try to contain the repercussions outlined above it would probably have been necessary to support the liquidity positions of the other members of the gold market and of other British banks with very large facilities.

9. Support facilities on the scale which would have been required, including in particular substantial lines in gold, could not have been provided by the Bank relying on its own resources. Either the EEA's gold would have had to be made available or a Government guarantee would have had to be sought to support gold borrowings from other sources. The Bank was very reluctant to contemplate involving

public funds directly in the rescue operation. Furthermore, it was only late on Sunday that the negotiations for the purchase of JMB by Bank of Nova Scotia - the favoured solution - broke down. It would have been impossible in the remaining time available to have arranged the support facilities which might have been required on the scale likely to be necessary. Moreover, the Continental Illinois rescue demonstrated the lack of reliance which can nowadays be placed on even very large liquidity safety nets to stem a loss of confidence. Experience with crisis management in the past has also demonstrated that the most effective response is to take decisive action to overcome the initial problem and prevent shock waves arising. It is far more difficult to contain the repercussions and restore confidence at one or more removes.

10. A further alternative considered at a meeting on the Sunday night was the liquidation of both PLC and JMB and the immediate purchase by the Bank from the liquidator of the bullion business of JMB. It is however very doubtful whether such an operation could have been organised in the few hours available even if the Board of PLC had been able to contemplate it as a proper course given their responsibilities to the shareholders. Moreover, JMB is the largest creditor of PLC through gold placed with its refineries and the liquidation of the parent company would almost certainly have made the bullion business of JMB unviable: JMB could not in the circumstances have survived if PLC went down. This factor was crucial in the appraisal of how much capital could be injected into JMB by PLC as a condition of the disposal. The aim of the Bank was to maximise this injection without producing such an erosion of the net worth of PLC as to render unachievable the agreement of the safety net which was necessary for its own survival.

The conclusion

11. Late on the Sunday night, the Bank had come down to two options. The only solution which would ensure that JMB could open for business in London on the Monday morning was for the Bank itself to acquire the company. The alternative was liquidation. For the reasons described above we were convinced that JMB had to be rescued, a view which we have not departed from with the benefit of hindsight.

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ANNEX C

I have now considered with the Governor of the Bank of England the events leading up to the rescue operation for Johnson Matthey Bankers. It is clear there are some important issues to be considered about our present system of banking supervision, and the legislative framework within which it is conducted.

2. We have therefore agreed jointly to review the present supervisory system and whether any early changes in supervisory procedures or amendment of provisions of the 1979 Banking Act are called for.

3. I shall of course inform the House of the results of the review and any legislative changes I consider necessary in the light of it.