THE RT HON DR DAVID OWEN MP

HOUSE OF COMMONS
LONDON SW1A 0AA

18 December 1984

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London SW1

Your decision to set up an internal review of the present Bank of England supervisory arrangements in light of the collapse of Johnson Matthey Bankers (JMB) unfortunately does not deal with my main anxiety namely the extent to which public funds are still at risk over and above the present 75 million pounds. I am still very concerned that the Governor, - judging by what he said to me on 13 December and yourself judging by yesterday's exchanges in the House - are proceeding on the assumption that the problems in JMB are confined to a few bad loans in its commercial loanbook and that its core bullion business is basically sound. I fear that there are good prima facie grounds for believing otherwise. The best calculations available appear to demonstrate that JMB has had and will continue to have problems in the bullion sector of its operations. I would be grateful to receive your comments on these calculations and I do not think that this can await your review. As a basis for this figuring, I am assuming a 2-3% interest spread on the existing loans and fees charged for new loans of between 1 and 3% which my economic advisers tell me are normal for this type of business.

On the basis of these assumptions and taking an average loanbook of 287 million pounds - based on the average of the figures quoted in JMB's audited accounts for 1983 and 1984 (see enclosure) - the commercial loanbook activity should have achieved profits over interest costs of between 7.2 million pounds and 13.1 million pounds. Overall bank earnings would be further increased by income from interest on the bank's capital. Taking last year's average UK rate of 9.25%, these additional earnings would amount to between 5.2 million pounds and 7.4 million pounds. Therefore, JMB's total earnings should have ranged from 12.5 million pounds to 20.5 million pounds even if it had done no bullion business at all.

Of course, one must allow for provision for bad debts and estimated overheads. As the financial statements, somewhat unusually, do not disclose a provision figure, I am taking a figure of 3 million pounds to be reasonable. My estimate of 2.9 million pounds for total overheads is based on the figure quoted in the annual accounts, scaled down for the number of employees involved in the banking side of the business. Thus, one would expect to see a gross profit from the commercial loanbook activity of between 6.6 million pounds and 16.6 million pounds. In fact the audited accounts show an adjusted pre-tax profit of only 4 million pounds for all JMB's operations. The obvious conclusion is that the bullion business made sizeable losses.

The foregoing analysis serves to support the argument which I first put to you in my letter of 2 November, namely that the main business of JMB - its bullion operation - is in serious trouble. The underlying losses cannot come from any other source. I note that the Governor, in his letter to me of 9 November, conceded that the major component of JMB's business is bullion and that the smaller associate components are virtually insignificant in overall terms both of turnover and profit. You must admit that it seems most unlikely that these losses could emanate from the minor sections of JMB's business. But is it not also the case that JMB's involvement in the riskier type of commercial lending was necessitated by a need to boost current earnings at the very time when the bullion business was beginning to show signs of ill-health, and did this not contribute directly to the eventual collapse?

The Bank of England's share is now 50%, i.e. 75 million pounds, in the current indemnity agreement, which has still to be signed by the other participants - the clearers, accepting houses, and bullion dealers. Perhaps they too are becoming worried about the health of JMB's bullion operation. If my above calculations are broadly correct, the Bank will find itself having to cover further losses which will necessitate a larger injection of its resources beyond the 75 million pounds already allocated. This explains why I asked you in the House yesterday to confirm that the Bank will not expose an even larger sum of public money to this very real risk at JMB. You gave me no such assurance. Can I repeat my request that you confirm that no further public money will be put at risk over JMB?

Following your Statement in the House yesterday, which is belatedly the first attempt at public accountability for the Bank's actions in the JMB affair, I am releasing this letter and its calculations to the press.

David Owen

## JMB BULLION PROFITABILITY FOOTNOTES

1 Assumes an average balance based on opening and ending balance sheet amounts.

2 Capital calculated as follows:

Case 1: £80MM less £23MM due to subsidiaries.
Case 2: £80MM less £23MM owed to subsidiaries plus £17MM due from subsidiaries.
Case 3: £80MM - as in balance sheet.

3 Assumes immaterial provisions since they are not disclosed in the financial statements.

4 Pretax profit derived as follows:

| | | |
|---|---|---|
| Retained Profit | | £3,100 |
| Less: | Tax adjustment | (3,400) |
| | Group relief | (100) |
| Add: | Good will | 400 |
| | Dividend | 4,000 |
| Adjusted JMB Pretax Profit | | £4,000 |

5 Estimated overhead determined as follows:

Annual report says 540 employees cost £7.8MM. ASSUME total overhad is 200% or £15.6MM. If JMB employs 100 people their estimated overhead is £2.9MM.

# JMB BULLION PROFITABILITY ANALYSIS

(All Data from March 1984 JMB Audited Financial Statements)

| | FOOTNOTES | CASE 1 | CASE 2 | CASE 3 |
|---|---|---|---|---|
| A. JMB Commercial Loan Book: | | | | |
| 1. Loan Book INTEREST: | | | | |
| 3/84 £362MM<br>3/83 £212 | | | | |
| £574 ÷ 2 = £287MM at spreads ranging from 2-3% (increasing in 1/2% increments from Case 1 to Case 3) | 1 | 5,740 | 7,175 | 8,610 |
| B. New Loan Fees - Rates Assumed: 1-3% | | 1,500 | 3,000 | 4,500 |
| | | 7,240 | 10,175 | 13,110 |
| C. INTEREST on Capital at the Years Average Rate of 9.25% | 2 | | | |
| Case 1 - £57MM | | 5,273 | | |
| 2 - £74MM | | | 6,845 | |
| 3 - £80MM | | | | 7,400 |
| | | 12,513 | 17,020 | 20,510 |
| D. Provision for Bad Debts | 3 | 3,000 | 2,000 | 1,000 |
| H. Less Estimated Overhead (w/o allocation between businesses) | 5 | 2,900 | 2,900 | 2,900 |
| F. Estimated Gross Banking Profits | | 6,613 | 12,120 | 16,610 |
| G. Less Retained Profit for the Year | 4 | 4,000 | 4,000 | 4,000 |
| H. Net Bullion Loss (Profit) | | 2,613 | 8,120 | 12,610 |
| I. Adjustment to Ignore Assumption of Interest on Capital (Col. C) | | 5,273 | 5,845 | 7,400 |
| J. Net Bullion Loss (Profit) with Assumption that JMB Earned no Interest on Capital | | (2,660) | 1,275 | 5,210 |