10 DOWNING STREET

(1)

Prime Minister

The Chancellor wishes to discuss this on Wednesday. There is a major presentational problem. In seeking to safeguard its position in the legal action against the auditors, the Bank are forced to downplay any weaknesses in its supervision. This will create an impression of whitewash, with the Bank blaming JMB and the auditors but being insufficiently self critical (even if in practice it is taking the criticisms very seriously).

AT
7/6

P.S. You may find it easier to look at the Annexes in the order C, B, A.

R16

SECRET

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

PRIME MINISTER

REVIEW OF BANKING SUPERVISION AND JOHNSON MATTHEY BANKERS

In my minute of 10 December 1984, I told you that I intended to set up a Review Committee to look at our system of banking supervision in the light of the Johnson Matthey Bankers (JMB) affair. I announced the review in a statement to the House on 17 December. I asked the Governor to chair the Committee and its members included Peter Middleton and an experienced banker, Derek Van der Weyer.

2. The Committee has now submitted its report, which I attach as Annex A. Its recommendations are summarised on pages 25-30. The Report is a competent and authoritative piece of work, with which I largely agree. While I do not feel committed to every detail of its recommendations, I propose to publish the report as a Command Paper. It will be used as a basis for early consultation with interested parties, supplemented as necessary by consultative papers on particular topics. I would then hope to publish a White Paper on Banking Supervision towards the end of the year, and to prepare legislation for introduction in the 1986-87 session. You will recall that QL Committee has already provisionally allocated a firm place in the legislative programme for a Banking Bill.

3. I also enclose at Annex B an account by the Bank of England of events leading to the collapse of JMB and the subsequent rescue operation by the Bank. This will be published with the Bank of England's Annual Report and accounts.

4. I intend to lay both these documents before the House and to make a statement on 18 June. I attach a rough draft of the statement at Annex C. I should like to discuss this with you when I see you next Wednesday. It is clearly too long but I have not yet decided how much I can leave out. I would propose to circulate a final version to interested colleagues.

5. I apologise for the length of these papers. The background to the Committee's recommendations is fully covered in its report and more summarily in the draft statement, and I shall not go over it again in this minute. There are, however, several important points which I should add:-

(i) The terms of reference of the Review Committee were confined to reviewing the supervisory system. The Committee were not asked to conduct a post-mortem into JMB.

(ii) The account at Annex B has been prepared by the Bank, who are solely responsible for it. It omits any suggestion that the Bank of England supervisors were in any way to blame for the scale of the collapse. I am clear that supervisory lapses did occur, and the Governor accepts this. But the Bank of England intend to initiate, through JMB, legal action against JMB's former auditors, Arthur Young. The Governor is therefore unwilling for the Bank to admit any contributory responsibility, since this would

jeopardise their suit. I am advised that anything critical which I say about the supervisors' role in the affair will also carry risks, albeit somewhat less, for the Bank's action. However, I do not believe that my statement will carry credibility unless it includes some mention of the supervisors' mistakes. Paragraph 19 of the statement has been drafted accordingly.

(iii) As you will recall from my earlier minute, I was not wholly convinced that the consequences of allowing JMB to fail would have been as serious as to justify a full scale rescue operation by the Bank of England. These doubts persist, and you will see from paragraph 7 of my draft statement that I have refrained from endorsing the Governor's action.

Rachel Lomax

NIGEL LAWSON

7 June 1985

(approved by the Chancellor and signed in his absence.)

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ANNEX A

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REPORT OF THE COMMITTEE SET UP TO CONSIDER
THE SYSTEM OF BANKING SUPERVISION

Section	Subject	Page
I	Introduction	1
II	The nature of the supervisory process	3
III	The two-tier system of authorisation under the Banking Act	4
IV	The relationships between the managements, supervisors and auditors of banks	7
V	Large exposures	12
VI	Quality of assets and control systems	15
VII	The adequacy, scope and timeliness of data received for supervisory purposes	16
VIII	Parental support	17
IX	Staffing and organisation of the Banking Supervision Division	19
X	Consolidated supervision	21
XI	Matters raised with the Committee by the official group considering the desirability of amendments to the Banking Act	22
XII	Towards implementation of the Committee's proposals	25
XIII	Summary of recommendations	25
Appendix	Terms of Reference	

REPORT OF THE COMMITTEE SET UP TO CONSIDER THE SYSTEM OF BANKING SUPERVISION

I Introduction

1 The Chancellor of the Exchequer and the Governor of the Bank of England agreed in December 1984 that a Committee should be established, under the Chairmanship of the Governor, to consider the present system for supervising banks* and whether any early changes in supervisory procedures were called for in the light of the problems which had arisen in Johnson Matthey Bankers Limited (JMB). The members of the Committee were:

Mr R Leigh-Pemberton	Governor, Bank of England (Chairman)
Mr C W McMahon	Deputy Governor, Bank of England
Mr W P Cooke	Associate Director, Bank of England
Sir Peter Middleton	Permanent Secretary, H M Treasury
Mr F Cassell	Deputy Secretary, H M Treasury
Mr D Vander Weyer	Deputy Chairman, British Telecom plc, Director, Barclays Bank plc

The Secretary was Mr I M Cobbold of the Bank of England.

2 Within the broad terms of reference set out in the previous paragraph, the Committee was asked to give particular attention to the relationship between auditors and supervisors; staff experience and training and the adequacy and deployment of staff resources in the Banking Supervision Division of the Bank of England; the handling of concentrations of risk; the assessment of quality of assets; and notification and collection of statistics. The Committee was asked to draw attention to any areas where, if changes were to be made in supervisory arrangements, these would support the need for the review of

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* In this report the word "banks" is used to include both banks and licensed deposit-takers authorised under the Banking Act 1979, except where recognised banks are specifically referred to.

amendment of the Banking Act 1979. The Committee was asked to produce its report as soon as possible after the end of the year. The full terms of reference, which were published on 17 December, are attached as an appendix.

3 We were not asked to examine the reasons why the particular problems which arose in the case of JMB occurred, nor to consider the reasons for mounting the rescue operation, both of which will be discussed in the Bank of England's Annual Report. Our brief was rather to draw lessons for the system of supervision from the circumstances which gave rise to the decision by the Bank at the beginning of October 1984 to acquire JMB and to consider more widely the Bank's existing supervisory procedures.

4 We have met as a Committee on fifteen occasions and have considered a range of papers produced by the Banking Supervision Division and by an official group drawn from the Treasury and the Bank, set up to consider the desirability of making amendments to the Banking Act. We have also held discussions with senior officials of the Banking Supervision Division and with Mr T P Lankester of the Treasury, the Chairman of the official group.

5 We requested the views of the Institutes of Chartered Accountants in England and Wales and of Scotland on the relationship between banks' auditors and the supervisors. They prepared a memorandum for us, which has been published, and we have held discussions with their representatives. We have also held discussions with a number of senior bankers and received written representations from certain representative bodies and individuals. As indicated in paragraph 79 below, we believe that further consultations will be necessary before a number of our recommendations can be put into practice.

6 We are grateful to all those who have assisted us in our work, and in particular to the Secretary of the Committee.

II The nature of the supervisory process

7 No system of banking supervision has yet been developed which avoids all bank failures. The special characteristics of the system of banking supervision currently in operation in the United Kingdom are its flexible nature and the part played in it by the co-operation of banks secured through regular contacts between the supervisors and banks' managements. The current supervisory regime in this country is widely held to be an important factor in the maintenance of London's role as an international centre.

8 We did not examine in any detail the possibility of changing to a basically different system. We do not believe that the present system is fundamentally flawed but we have identified a number of important improvements which we believe should be made.

9 Continued reliance on a flexible system has three major implications. First, if the Bank is not itself to carry out detailed inspections of banks' books, it must be able to rely on the assistance and co-operation of the professional firms who do carry out this task: the banks' auditors. As will be seen in Section IV below, we believe it is important that co-ordination and contact between supervisors and auditors be improved in a number of ways. Secondly, it requires the continued co-operation of the banks which are supervised. We believe that the existing high level of co-operation between the banks and the supervisors can be maintained and that banks will remain responsive to the concerns of the supervisors. The system cannot, however, rely totally on this responsiveness in all circumstances; the supervisors must have adequate powers to deal with cases where this co-operation is not forthcoming. Thirdly, we believe that for the proper working of the present system, it is essential to improve the capacity of the supervisors to exercise the crucial qualitative judgments on the management, the loan book, the adequacy of capital and other elements of the business of the banks which they are supervising. It will be seen that most of the recommendations made in the rest of this report are directed to that end.

III The two-tier system of authorisation under the Banking Act

10 The Banking Act provides for the authorisation of a deposit-taking institution either as a recognised bank or as a licensed deposit-taker. The relevant criteria are set out in the Banking Act (Schedule 2); the most important differences are that for recognition as a bank the applicant must demonstrate that it provides a wide range of banking services and possesses a high reputation and standing in the financial community.

11 When the Banking Act was introduced, it was the intention that the two-tier system would allow the Bank to continue its traditional style of supervision over the major banks but would give it somewhat greater legal powers over licensed deposit-takers, many of which had not previously been subject to supervision. It was also intended that by broadly restricting the use of banking names and descriptions to recognised banks the system should make the general public aware of the difference of function and/or standing of the institutions within the two tiers.

12 Following from this differentiation in the legal framework, the styles of supervision of the two types of institution have developed somewhat differently. Supervision of recognised banks takes account of the experience and standing of the institutions and relies considerably on mutual trust and the co-operation of management. The smaller licensed institutions accept and generally appreciate a more direct form of supervision with clearer guidance on the standards expected of them. JMB's position as a recognised bank was a factor in the delay in the supervisors becoming aware of, and reacting to, its growing problems.

13 More generally, the two-tier system has not fully achieved its objective of signalling some differentiation between the institutions in the two tiers and has led to confusion in the public mind on the way in which the related criteria of function and status are applied. There is also no clear division in the use of banking names and descriptions between the institutions in the two tiers. Branches of overseas banks which are licensed are allowed to use their names with the qualification "licensed

deposit-taker" shown equally prominently and licensed institutions are able to describe their services as "banking services". Personal depositors also seem to attach more importance to the fact that an institution is officially authorised than to whether or not it is a recognised bank.

14 We were told by the Banking Supervision Division that the administration of the two-tier system has caused considerable difficulties and that a great deal of time and effort has had to be expended in order to apply the criteria fairly and consistently. Moreover the desire to achieve recognised status and meet the services criterion has in some cases encouraged institutions to diversify or expand in ways which are artificial and, at worst, could be counter-prudential. It has also become evident that, in practice, movement between the tiers would normally only be upwards from licensed to recognised status. Revocation of recognition and replacing it with a licence carries some risk. The change in category of authorisation would immediately become public knowledge and could lead to a serious loss of confidence in the bank. The benefit of closely controlling its business by applying stringent conditions to its licence while its problems were being resolved in an orderly manner could be jeopardised and its difficulties intensified.

15 When considering the arguments for and against retaining the two-tier system, we took into account that there were only relatively small differences in the powers of the Bank in respect of recognised banks and licensed deposit-takers. The most important difference in the existing powers is that the Bank is able to obtain information from licensed deposit-takers, but was not given similar powers in respect of recognised banks because it was felt that these banks would always comply voluntarily with requests for information. We noted that the existence of the difference in powers has in one respect proved to be perverse. When requests were made to some banks for information on individual large exposures, where considerations of customer confidentiality were a factor, the lawyers for the banks expressed concern because the absence of a legal requirement to provide the information left the banks at risk if a customer challenged the

disclosure of the information. Although the Bank believes that the banks are already adequately protected at law, we concluded that the Bank's powers to obtain information should be extended to recognised banks.

16 For all these reasons, we recommend that the Banking Act should be amended to replace the two-tier system with a single authorisation to take deposits. All the powers given to the Bank under the Act would then apply equally to all authorised institutions and we accept that all authorised institutions would in consequence be entitled to use banking names and descriptions.

17 We do not intend that the change to a single tier of authorisation should affect to any significant extent the way in which the Bank conducts its supervision of major banks which are soundly run, or its relationship with them. The change will, however, make it easier for the Bank to deal with any problems that may arise in future amongst what are currently recognised banks.

18 We consider that, if the amalgamation of the two tiers takes place, the criteria for authorisation under the Banking Act should remain broadly unchanged - apart from the two major additional requirements for recognition referred to in paragraph 10, which would be removed. There are certain differences between the criteria for recognition and for a licence, however, which will need to be resolved in drawing up a new set of criteria. We noted, in particular, that two of the existing criteria, while having broadly the same meaning, carry slightly different emphases, each of which we believe should be retained. They are the present requirement that all directors, controllers and managers of licensed deposit-takers should be "fit and proper" and the requirement that the business of recognised banks should be carried on with integrity and prudence and those professional skills which are consistent with the range and scale of the bank's business. We recommend that both requirements should be included in the new single set of criteria.

19 The only other significantly different requirement between the two existing sets of criteria is that recognised banks require minimum net assets of £5 million at the time of authorisation (£250,000 if a highly specialised banking service is provided), while licensed deposit-takers require minimum net assets of £250,000. We consider that the move to a single tier and the availability of banking names to all institutions justifies some increase in the minimum net assets requirement from £250,000. Inflation since 1979 would in any case justify an increase to over £400,000. We recommend that the minimum should be set at £1 million.

20 We do not recommend that existing institutions with net assets below £1 million should lose their authorisation as a result of this change. However, we noted that the purchase of such an existing institution would provide a method of obtaining authorisation under the Act without meeting the revised minimum net assets criterion for new applicants (assuming that the institution under its new owner continued to fulfil the other criteria for authorisation). We therefore recommend that an amendment should be made to the Banking Act to require an existing institution to meet the new minimum requirement for net assets on a change of ownership.

IV The relationships between the managements, supervisors and auditors of banks

21 The management of a bank lies in the hands of its directors and executives. It is not the function of either the auditors or the supervisors to take over the role of management; they all have their own discrete functions.

22 In our view, it is most important that all the directors, not only those in executive positions, involve themselves in a bank's affairs. In particular, non-executive directors should ensure that they are given sufficient information to be able to satisfy themselves that the policy guidelines and systems approved by the Board are being followed. We also believe that this is essential in order that the non-executive directors are able to make a constructive contribution to the direction of the bank's business, including forming their own view of the quality of its lending and other risk assets.

23 Audit committees, which are normally composed largely of non-executive directors, can play a particularly useful role in monitoring the operations of a bank. To do so, however, they must not restrict their activities to matters related to the preparation of the annual accounts. They must become involved in assessing and monitoring the bank's control systems and receiving reports from both internal and external auditors.

24 Banks have been relatively slow to follow the example of commercial companies and appoint finance directors to their boards. This may be understandable in the sense that all the executive directors are "financial". We believe, however, that there is an important role to be played by a finance director who, apart from the managing director and the chairman, will be best placed to take an overall view of the business. It is not an easy role, as the finance director must be prepared to question and challenge the decisions of his colleagues, but it can be a most important one. JMB had neither a finance director nor an audit committee.

25 An audit committee and a finance director share many of the concerns of the external auditors and the supervisors and can assist them in carrying out their functions. The auditor is required to make a judgment on the totality of the picture presented by a bank's accounts, drawn up by the management, and to certify that they present a true and fair picture of the affairs of the bank and not a misleading one. The supervisors must satisfy themselves that the business of the bank is being conducted prudently and that depositors' money is not being put at risk to an unacceptable degree. The work carried out by the auditors can greatly assist the supervisors, particularly where the latter do not, as part of their regular supervisory processes, carry out on-site inspections. The auditors will be assisted if they are aware of any concerns or requirements the supervisors may have.

26 If the auditors and the supervisors are to be able to assist each other to carry out their respective functions there must be a dialogue between them. This process is at present hindered by the confidentiality constraints on both parties. The auditors of

a bank have the same duties under the Companies Acts as the auditors of other companies. The auditors are appointed by the shareholders and report to them. Under present conventions and practices, auditors feel constrained by the duty of confidentiality which they owe to their client not to disclose information to third parties, including the supervisors. The supervisors, for their part, are bound by the confidentiality provisions in Section 19 of the Banking Act from disclosing information obtained in the course of supervision to the auditors.

27 Confidentiality constraints on both the supervisors and the auditors can be overcome by obtaining the specific permission of the bank concerned for a dialogue to take place. Such permission has been sought and given in certain cases. It could be withheld, however, in circumstances where such a dialogue was very necessary. We recommend that the Bank should, as an interim measure, seek the agreement of all authorised institutions for such dialogues to take place and should obtain it as a matter of routine from all newly authorised institutions. While a great deal of progress can be made by obtaining the agreement of banks in this way, we believe that provisions should be included in legislation to remove the confidentiality restraints. These would clearly establish the position of both parties and remove the possibility that in certain cases consent might be withheld.

28 We do not wish the arrangements for a dialogue between the supervisors and banks' auditors to upset the basic relationship between the auditors and their clients, the banks. The lines of communication should normally be between the supervisors and a bank and between a bank and its auditors. The bank would commission from the auditors any information required by the supervisors and its representatives would normally be able to attend any meetings between the two. Although direct communication between the supervisors and the auditors is only likely to be necessary in exceptional circumstances, it should be possible for this to take place.

29 We believe, following our discussions with bankers and the representatives of the Institutes, that the auditors can provide valuable assistance to the supervisors, in particular with their

assessment of the design and operation of a bank's control systems. It will also be helpful for the supervisors to be aware of the discussions which have taken place between the management and the auditors on the need for provisions against bad and doubtful debts. In particular the supervisors will want to know whether the auditors feel that the bank is being cautious or whether they have only reluctantly been convinced that the provisions made are adequate. It will be helpful to the auditors, in their turn, to know of the supervisors' requirements for a bank and to be aware of any areas which are causing them concern.

30 We envisage that the dialogue between supervisors and auditors will take place partly through meetings and partly through written material. Auditors frequently send their clients a "management letter" at the end of an audit, commenting on various matters which have come to their attention. We consider that this letter should be made available as a matter of course to the supervisors. The supervisors will, however, also wish to receive some further information from the auditors, for example, on provisions and the adequacy of control systems which may not always be covered in an appropriate way in the management letter. It should be possible to adapt the management letter to meet the supervisors' requirements but this will need to be discussed between the supervisors, the banks and the accountancy profession. The supervisors may also wish a bank to commission special reports from its auditors from time to time. A bank would be expected to make available to its auditors copies of letters from the supervisors setting out any requirements for that bank or raising points of concern.

31 The supervisors rely to a large extent for information on the returns submitted to them by banks, mainly on a quarterly basis. The principal return used for supervisory purposes is certified by a director or senior manager of the bank and the accuracy of the data provided has not been a major cause for concern. We nevertheless consider that improvements in the standards of reporting could be effected if the supervisors were given powers to require these returns to be audited. It is not proposed that

these powers should be used as a matter of routine; but they should be available for carrying out spot checks and for following up any inaccuracies which are detected.

32 The supervisors are rightly concerned that they should be able to rely on the work done by the auditors since this work can give them much of the assurance about the health and general soundness of a bank which would otherwise have to be obtained through inspections by the supervisors themselves. The dialogue proposed between auditors and supervisors in the previous paragraphs will greatly assist in this respect. It is obviously necessary, however, that the supervisors should have full confidence in the competence of the auditors themselves; in particular that they are properly qualified in terms of training and experience for the rather specialised business of auditing banks. The Institutes of Chartered Accountants already provide guidance to auditors operating in specialised fields such as banking, and offer training courses. This advice is very valuable and we hope that the Institutes will consider ways of extending the assistance which they offer.

33 In some countries, the supervisors have to approve a bank's auditors before they can take up their appointment. We considered whether to recommend this procedure but decided against it on the grounds that it could conflict with the right of shareholders to appoint the auditor and would make it more difficult for firms which had not previously done so to begin to audit banks. We also considered but rejected a proposal that the supervisors should have powers to require the dismissal of auditors because this would again conflict with the position under the Companies Acts. Occasional cases may arise where the supervisors consider that the auditors are not competent to audit a bank or have been negligent. We propose that, in order that the supervisors may have a report on which they can rely, the Bank should be given powers to require a bank to appoint a second firm of accountants to make a report, covering similar ground to a statutory audit, and at the bank's expense. The Bank already has some powers under Sections 16 and 17 of the Banking Act to obtain information from licensed deposit-takers and to commission

investigations into all authorised institutions, but we believe that these powers will need some amendment in order to implement this proposal.

34 If the performance of the auditors, or of other professional advisers to a bank, is found to be seriously deficient by the supervisors, we recommend that the Bank should be given powers to pass information to the relevant professional body so that the possibility of disciplinary proceedings can be considered. This proposal would require an amendment to Section 19 of the Banking Act.

35 We have been greatly assisted in our consideration of the relationship between the supervisors and banks' auditors by our discussions with representatives of the Institutes of Chartered Accountants. We believe that the proposals outlined in this Section are generally acceptable to the accountancy profession.

V Large exposures

36 Concentrations of lending and other exposures to individual borrowers or economic sectors have recently been the most important cause of difficulties in banks. This was true, not only in the case of JMB but also in the failures of certain small licensed deposit taking companies in this country. Abroad, the recent problems in Continental Illinois and Penn Square in the United States, Schroeder, Munchmeyer, Hengst & Co in Germany and Kronebanken in Denmark have had similar roots.

37 Many countries have imposed limits in terms of some measurement of capital on large exposures to individual borrowers or groups of related borrowers.* The United Kingdom does not have such legal limits.

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* For example, in the following countries the basic limits, which are subject to various qualifications, are:

United States	15% unsecured
	25% secured by fully marketable securities
Japan	20%-30%
Switzerland	20% unsecured
	40% secured
France	50%
Germany	50%

38 In April 1983, the Bank issued guidance to all authorised institutions stating that "Experience suggests that exposures (loans, acceptances, guarantees etc) to one customer or group of customers should not normally exceed around 10% of an institution's capital base". The notice went on to say that the more an exposure exceeded 10%, the more rigorous the Bank would be in requiring justification for the exposure and that where such loans had been made, the institution would normally be requested to maintain a significantly higher level of capital resources than would otherwise be required.

39 We considered the case for imposing specific limits on large exposures in legislation but concluded that this was not desirable. Other countries' experience has shown that to do so encourages banks to find ways around the requirements and may encourage them to trade up to the specified limit. For some institutions an exposure of even as much as 10% of capital may be excessive and the supervisors need flexibility to agree appropriate policies with individual institutions within overall guidelines.

40 A policy on large exposures has to start from an "at worst" position. The judgment on the acceptable level of exposure is in part a question of the balance of the bank's portfolio and in part a view of the damage which could be suffered if a particular exposure or exposures were to go bad. It is not a judgment on the likelihood of the exposure going bad. Nor is it simply a question of whether the loan is secured or unsecured as this does not necessarily determine the real exposure to risk.

41 A limit placed on large exposures should not be too restrictive. Major corporate borrowers expect to be able to deal in large amounts; too low a limit may force banks to forego good business and make instead smaller, perhaps less good quality, loans. This is particularly a problem for smaller but growing banks which need to take on what are for them relatively large exposures if they are to obtain the business of larger companies. It is much less of a problem for the larger banks.

42 We agree with proposals put forward by the Banking Supervision Division that each bank should be asked to set out in writing its policy on large exposures and that this policy should be formally adopted by its Board. All exposures (including undrawn commitments and contingent liabilities) above 10% of capital would be reported to the Bank and closely examined by the supervisors. No exposure to a single borrower, or to a group of closely related borrowers taken together, should exceed 25% of capital except in the most exceptional circumstances. The existence of exposures over 10% of capital would normally require a bank to maintain greater capital resources than would otherwise be required. Factors such as a long-standing relationship with the borrower, particular expertise in the type of lending, the overall financial standing of the borrower and the security for the loan would be factors to be taken into account when considering different levels of exposure up to 25% of capital, but would not justify an increase beyond that level. Large exposures to borrowers connected with the bank through membership of the same group of companies, by common directors or in other ways, would continue to be particularly closely scrutinised by the Bank and should generally be strongly discouraged.

43 Legitimate concern about political sensitivities makes it undesirable for the Bank to publish general guidelines on the appropriate level of exposures to particular countries. However, control of country exposures is as important as control of exposures to individual customers. We endorse the Banking Supervision Division's present policy of monitoring country risk exposures over 10% of capital and discussing them in detail with banks, except in the cases of lending to the most creditworthy countries.

44 The Bank also needs to monitor banks' exposures to economic sectors both within the United Kingdom and worldwide. The particular monitoring system used will have to have regard to the nature of the individual bank's business. While a broad industrial classification may be appropriate for a large bank, and statistics are already obtained on this basis for exposures within the United Kingdom, a small institution needs to adopt a more closely defined and detailed approach more appropriate to the

scale and range of its activities. We believe banks which do not already have such internal monitoring systems should develop them and that the supervisors should obtain this information from them.

45 While no direct legal penalties are proposed for exceeding the 25% of capital level, breaches should lead to a bank being required to maintain significantly greater capital resources and would reflect on the prudence of its management. Sustained breaches of the 25% ceiling should lead the Bank to consider revoking the bank's deposit-taking authority.

VI Quality of assets and control systems

46 Sustaining the quality of a bank's assets is one of the essential factors in ensuring its continued health. Although it is not the supervisors' role to take individual lending decisions in place of management, the supervisors must always be alert for signs of a deterioration in the quality of a bank's loan book. To complement the information already available to them on banks' loan portfolios, we believe that there are further steps which the supervisors should take to satisfy themselves that banks' control systems, particularly for lending, liquidity and other exposures to risk, are appropriate and are being properly applied in practice. Poor controls were one of the roots of the problems which arose at JMB. The size of the bank's loan book had grown very rapidly since 1981 and the systems in place and their operation in practice proved to be completely inadequate to approve and monitor the volume of lending undertaken. In addition, the administrative processes for taking security against loans were often not properly carried out and the need for provisions not properly identified.

47 We recommend that in addition to the regular meetings which the managements of all banks attend at the Bank, the supervisors should from time to time visit each bank. Some visits already take place, more particularly in the licensed sector, but we believe they should be extended to cover all authorised institutions. The frequency and length of these visits would vary with circumstances. The objective of these visits would not

be to carry out a detailed examination of the bank's books but to assess a wider range of the bank's management team and to consider in greater detail the design of the bank's control systems. The information on control systems obtained through these visits will complement that obtained through the dialogues with banks' auditors, recommended in Section IV.

48 The Banking Supervision Division has developed over the years a capability to carry out investigations where problems arise in a bank or are suspected. We recommend that the Division should be more ready to carry out such detailed investigations at an early stage when there are suspicions that problems are developing. One concern which has arisen in the past has been that knowledge of such an investigation might leak out and cause a loss of confidence in the bank. The visits to banks proposed in the previous paragraph will make it less likely that a special investigation will appear to be an exceptional event.

49 As part of our review, we considered the grading systems used, particularly in the United States, by both banks and supervisors to classify loans. Such systems rely in part on objective criteria and in part on subjective judgments. We believe that these systems can provide useful information to management, auditors and supervisors and that banks which do not already have them should consider introducing them. The systems need to be designed to take account of the particular features of an individual bank's types of lending and do not appear to be easily adaptable to a system-wide reporting mechanism, which would become excessively complex. The supervisors would therefore need to obtain information from individual banks' systems.

VII The adequacy, scope and timeliness of data received for supervisory purposes

50 The Bank has for a number of years collected statistics from the banking system for the purposes of monetary policy and economic and financial analysis. When the system of supervision was extended and enhanced in the mid-1970s, the information required for prudential purposes was to a large extent integrated into the existing returns. Only one of the returns completed by each institution is used exclusively by the supervisors.

51 While there are certain drawbacks in the need to co-ordinate the requirements of all the users of the statistics, we concluded that the present integrated system should be continued. To collect a separate set of data for prudential purposes would overlap to a large extent with the data required by other users, and would place a considerable burden on the banking system and the Bank, which would not be justified by the benefits obtained.

52 We did not identify any major deficiencies in the data received by the supervisors. Minor improvements can always be made and these will doubtless continue to be pursued with the banking system in the normal way. In particular, some additional statistics will be required following the Banking Supervision Division's review of its approach to consolidated supervision which is referred to in Section X. Certain other statistics on exposures to economic sectors and the grading of loans would be obtained outside the integrated reporting system.

53 A substantial delay in providing a return at a crucial time was a factor in delaying the supervisors' identification of the acute problems emerging in JMB. Late reporting may be a sign of problems in an institution. We therefore recommend that the Bank should tighten its procedures for ensuring that all returns used for supervisory purposes are submitted promptly and should consider carrying out an investigation into any bank which fails to provide information within the time allowed.

54 Inaccuracy in the information provided has not proved to be a major problem for the supervisors (although in the case of JMB some of the information given to the Bank on large exposures was significantly misleading). Our recommendation in Section IV that the Bank should be empowered to require banks' auditors to certify their statistical returns will provide an independent check from time to time on the accuracy of the data.

VIII <u>Parental support</u>

55 We were advised that the Bank has always believed that a bank should stand behind its subsidiaries and other related companies,

especially if those companies themselves take deposits. Its view is based on the premise that failure to rescue a subsidiary which got into difficulties would quickly cause a loss of confidence in the parent bank itself. This view is acknowledged and accepted by British banks.

56 The Bank also believes that owners of banks have an additional responsibility not present in the ownership of most other commercial or industrial undertakings, because of the special fiduciary responsibilities on those who run businesses which take deposits from the public. In the mid-1970s, the Bank began to seek letters of comfort from overseas banks with shareholdings in United Kingdom banks which recognised their moral responsibility to stand behind the bank should the need arise. Since then, this practice has been extended to a wider range of non-bank shareholders from both the United Kingdom and overseas. Johnson Matthey plc, the parent company of JMB, had not been asked to provide a comfort letter but had demonstrated its willingness to support the bank in the past. It acknowledged its responsibility to do so when the crisis arose. The problem was its lack of resources to discharge this responsibility.

57 We considered proposals from the Banking Supervision Division to extend its requests for comfort letters to all significant shareholders in United Kingdom banks. These would broadly entail comfort letters being sought from all shareholders who control 15% or more of the voting power, and in some cases shareholders who control 10% or more. The Bank believes that in most cases it is not necessary to formalise the position in respect of shareholdings by United Kingdom banks because of their agreement that they must stand behind their subsidiaries and other related companies in all but the most exceptional circumstances.

58 Having obtained letters of comfort, it is obviously necessary that the Banking Supervision Division should monitor the ability of the givers of those letters to honour their responsibilities should the need arise. We noted that the Division intends to take a closer interest in the position of parent companies and

other large shareholders than it has done previously. We therefore endorse the proposals which are now being implemented. The related question of the consolidated supervision of groups containing a bank is discussed briefly in Section X.

IX Staffing and organisation of the Banking Supervision Division

59 The staff of the Banking Supervision Division totals 94, of whom 23 are senior officials and managers. In addition, there are 36 support staff. The staff are very largely career Bank staff, most of whom have had experience in other parts of the Bank before joining the Banking Supervision Division. The size of the banking supervisory function has grown very substantially since the system of supervision was revised and enhanced in the mid-1970s. However, with growing domestic and international pressures on the banking system, so has the burden of work. An increase in staff numbers is justified to meet the existing level of work and we recognise that certain of our proposals will give rise to the need for some further expansion.

60 We consider that the quality and commitment of the existing staff are high. But we believe that they need to be able to draw on a wider commercial experience in order to improve their ability to make judgments about the quality of lending, liquidity and other risk exposures. This experience can best be obtained by a period working in a commercial bank. A few of the existing staff have already had periods on secondment with commercial banks and there have been some inward secondments from commercial banks. We recommend that this programme of secondments in both directions should be significantly increased. In the short term, commercial experience can only be brought into the Division by inward secondments from commercial banks or the recruitment of staff with banking experience. In the longer term, the staffing policies followed should allow for all managers and senior analysts to have spent a period with a commercial bank; some permanent recruitment of experienced commercial bankers should also be considered.

61 The staff of the Division are subject to the Bank's normal policies on recruitment, promotion and staff development. Members of staff normally spend from three to four years in the

Division, although some have been there for much longer. Supervision is essentially a job which can only be learnt through its practice, although commercial experience and training, for example in accountancy, are also very important. It is essential that the managers and analysts responsible for a group of banks get to know them thoroughly and this cannot be done quickly. The banks also appreciate continuity in their contacts with the Division. For these reasons we believe that the Banking Supervision Division should take steps to develop a significant cadre of long-term banking supervisors.

62 The Banking Supervision Division at present has two qualified accountants whose role is primarily to give advice on any accountancy matters which arise. We recommend that some increase in the number of qualified accountants should be made, particularly taking account of our recommendation in Section IV that a dialogue should take place between the supervisors and banks' auditors.

63 The working practices and systems of communication within the Division have needed to develop to take account of the growth in staff numbers, the larger number of institutions supervised and the greater complexity of the work. We have considered, and approved, plans for a number of improvements in the system presented to us by the Division. These plans, which are now being implemented, define more clearly the scope of the responsibilities of senior officials and managers in the Division, clarify the lines of responsibility and control and improve the flows of information. In addition, senior management within the Division has been strengthened. As a result of these changes, the Division should be better able to identify problems and, equally important, to react quickly and decisively by bringing together the necessary staff and expertise when problems do arise.

64 One of the practical difficulties faced by the Division is the need to deal quickly with large volumes of statistics each quarter when they are first received, in order to identify any significant changes in the circumstances of particular banks. We believe that it is important that the returns of all institutions are examined as soon as they are received and that

any questions raised are followed up without delay. Greater use of desk-top computer facilities would assist in this respect, and we welcome the Bank's intention to introduce more terminals in the near future. Greater selectivity in the use of the very large information base will help the senior supervisors to concentrate on the essential problems in a bank and reduce their considerable workload. Our proposals on the staffing of the Division and for improving the supervisors' knowledge of a bank and its management, for example through the contacts with auditors and visits to the bank, will also improve the supervisors' ability to assess the nature of changes identified from the returns.

65 We considered work done by the Banking Supervision Division into the use of computerised early warning systems as a means of identifying the banks which are most at risk. This work concluded that these systems do not, at present, provide a sufficiently reliable means of detecting such banks. However, the subject merits some continued study and experience gained in other countries might usefully be further investigated.

X Consolidated supervision

66 The matters discussed in the previous Sections of the report all derive from particular issues which arose in the case of JMB. Our terms of reference were not, however, confined to such questions and we have also considered certain other issues related to the system of supervision. These are discussed in this Section and the next.

67 In the light of both recent moves towards the formation of financial conglomerates, and the European Communities' Directive on Consolidated Supervision, the Bank has been reviewing its approach to the consolidated supervision of groups containing a bank or banks. We considered a paper setting out the issues raised by the Bank's proposals and accepted its approach. Consultations have subsequently been started with the banks. In due course a paper setting out the approach to be adopted, agreed by the Treasury, will be sent to the EC Commission in order to demonstrate that the United Kingdom is complying with the Directive.

68 We also considered the problems raised by the supervision of conglomerate financial groups where different parts of the group are the responsibility of different supervisory authorities and no one supervisor has the responsibility for the group as a whole. Close co-operation between the various supervisory authorities will obviously be required: in particular, and subject to appropriate safeguards, barriers to the exchange of information between them will need to be removed. Section 19 of the Banking Act provides such a barrier at present. The need to remove these barriers has already been referred to in the White Paper on Financial Services (Cmnd 9432).

69 The supervision of conglomerate groups raises a number of difficult questions which range beyond our terms of reference and which we have not discussed in any detail. We noted, however, that they will need careful consideration by the relevant government departments and supervisory authorities.

XI Matters raised with the Committee by the official group considering the desirability of amendments to the Banking Act

70 The official group, under the chairmanship of Mr Lankester, has assisted us in our study of the various matters covered by our review of the system of supervision. Additionally, as part of its own work into the desirability of amending the Banking Act, the official group has sought our views on certain issues.

(a) Confidentiality of information provided to the Bank

71 Section 19 of the Banking Act provides that information obtained by the Bank under the Act may only be disclosed to other persons in certain specified circumstances. We have already proposed that the Bank should, in certain circumstances, be able to disclose information to a bank's auditors; to the professional body of a bank's advisers where the possibility of disciplinary action being taken against the adviser exists; and to other supervisory bodies.

72 The Bank is at present able to disclose information to the Treasury where it believes this to be in the interests of depositors or in the public interest. Neither the Bank nor the Treasury is permitted to disclose information on these grounds to other government departments. A number of cases have arisen where the Bank and the Treasury have felt the need to have such a power. Examples include disclosure to the Northern Ireland Office, where local knowledge could have assisted in resolving problems in a licensed deposit-taker based in the province; and to the Foreign Office where action to be taken under the Act against overseas institutions could have been diplomatically sensitive.

73 We endorse a proposal by the official group that the Bank should be given power to disclose information to other government departments, with the consent of the Treasury, where the Bank considers this to be in the interests of depositors or in the public interest. We believe however that disclosure to the Revenue departments of information provided for supervisory purposes should continue to be prohibited.

(b) The Bank's enforcement powers in relation to unauthorised institutions

74 The Bank is one of the prosecuting authorities under the Banking Act. In practice, it is likely to be responsible for pursuing most of the cases which arise in England and Wales, except for those which involve other criminal offences, particularly fraud. The more serious offences occurring under the Act are likely to involve institutions which are not authorised to take deposits; indeed, the most common is taking deposits without authorisation. Ironically, however, the Bank has no powers to obtain books and papers from unauthorised institutions in order to provide the evidence for a prosecution.

75 The official group, after preliminary consultations with other interested Departments, has recommended that the Bank should be given powers similar to those enjoyed by the Department of Trade and Industry under Sections 447 and 448 of the Companies Act 1985. Such powers would enable the Bank to require books and papers from any person who appears to be in breach of the Act and

to apply to a magistrate for a warrant to enter premises, accompanied by the police, and seize books and papers. We support this recommendation.

(c) Deposit Protection Scheme

76 The official group has put certain proposals to us for changes to the Deposit Protection Scheme contained in Part II of the Banking Act. We endorse these proposals:

(i) to increase the amount of a protected deposit from £10,000 to £20,000. Inflation since the Banking Act was passed would justify an increase to £16,500. We also favour some closer alignment between the scheme for depositors with banks and that for depositors and investors with building societies who are at present covered up to £30,000 under the societies' voluntary scheme.

(ii) to increase the minimum initial contribution to the Fund from £2,500 to £10,000. This increase would recognise in part that failures are more likely to occur among the smaller institutions and would be in line with the proposed increase (recommended in Section III) in the minimum net assets criterion for authorisation from £250,000 to £1 million.

(iii) to revoke the provisions which enable H M Treasury to exempt from contributing to the Deposit Protection Scheme, overseas banks whose sterling deposits with their United Kingdom offices are as well protected by arrangements in their home countries as they would be under the Scheme. We consider that the Scheme is intended to protect all depositors with sterling deposits placed with banks in the United Kingdom and that all banks authorised under the Banking Act should share the cost of providing that protection. We are also conscious that the existing provisions have proved extremely difficult and time-consuming to apply in practice.

77 The first two proposals set out in the previous paragraph can be effected by Statutory Instrument, subject to affirmative resolution by Parliament. We believe that it is not necessary to change the other monetary amounts specified in the Scheme; in particular that the cash fund does not need to be raised to accommodate the increase in the limit on a protected deposit. The third proposal would require an amendment to the Banking Act.

XII Towards implementation of the Committee's proposals

78 If adopted, some of our proposals can be implemented by the Bank administratively; some can be implemented by statutory instrument; while others will require amendments to the Banking Act. Most will require prior consultation with the banking system and other interested parties.

79 We urge the Government to allocate time for a Banking Bill in the 1986/87 Parliamentary session. If this is agreed, drafting instructions would need to be prepared for Parliamentary Counsel by the beginning of next year. That would suggest that a White Paper should be published in the Autumn. Some of the proposals for amendments to the Banking Act are covered in this report; others will be considered further by the official group. Many of our proposals deal with complex matters and will require detailed consultations before they could be implemented. If the proposed timetable is to be met, informal consultations should be started with the Banking Associations and other interested parties as early as possible in the Summer.

XIII Summary of recommendations

80 The following is a summary of our recommendations:-

The two-tier system of authorisation under the Banking Act

i) The present two-tier system of authorisation should be replaced by a single authorisation to take deposits under the Act. All the powers given to the Bank under the Act should apply to all authorised institutions and all authorised institutions should be entitled to use banking names (paragraph 16).

ii) The new criteria for authorisation should include both a requirement that all directors, controllers and managers are "fit and proper" and a requirement that the business of the bank should be carried on with integrity, prudence and appropriate professional skills (paragraph 18).

iii) The minimum net assets criterion for authorisation should be increased from £250,000 to £1 million (paragraph 19).

iv) Banks already authorised should be required to meet the £1 million minimum net assets criterion on a change of ownership (paragraph 20).

v) If a two-tier system were to be retained, the Bank's powers to obtain information from licensed deposit-takers should be extended to recognised banks (paragraph 15).

<u>The relationships between the managements, supervisors and auditors of banks</u>

vi) Banks should consider the appointment of an audit committee and a finance director where they do not already have them (paragraphs 23, 24).

vii) A mechanism should be established to enable a regular dialogue to take place between the supervisors and banks' auditors. Existing confidentiality restraints on both parties should be removed, initially by obtaining the agreement of each bank to a dialogue taking place and, as soon as possible, through legislation (paragraph 27).

viii) The dialogue between the supervisors and banks' auditors should not interfere with the present relationship between a bank and its auditors. The bank should commission from the auditors information required by the supervisors and should normally attend meetings between the two (pargraph 28).

ix) Powers should be taken to permit direct communication between the supervisors and the auditors in exceptional circumstances (paragraph 28).

x) The Bank should be given powers to require that statistical returns used for supervisory purposes are examined by the auditors. This should not become a matter of routine but the powers should be used to carry out spot checks and to follow up any inaccuracies which are detected (paragraph 31).

xi) The Bank should have powers to require a bank to commission a report covering similar ground to a statutory audit from a second firm of accountants where the Banking Supervision Division considers that the bank's auditors are not competent or have been negligent (paragraph 33).

xii) The Bank should be empowered to pass information to the appropriate professional body about a bank's auditors or other advisers to assist that body to consider whether disciplinary action should be taken against the advisers (paragraph 34).

Large exposures

xiii) No exposure to an individual borrower, or to a group of closely related borrowers taken together, should exceed 25% of a bank's capital base, except in the most exceptional circumstances (paragraph 42).

xiv) The Bank should continue to monitor and investigate all exposures in excess of 10% of a bank's capital base (paragraphs 42, 43).

Quality of assets and control systems

xv) The Bank should take further steps to ensure that effective procedures are in place to check that banks' control systems, particularly for lending, are adequate and are being properly applied in practice (paragraph 46).

xvi) To broaden their knowledge of banks' managements and to help in the assessment of their control systems, the supervisors should increase the number of visits paid to banks. The frequency and length of the visits would vary from case to case (paragraph 47).

xvii) Where suspicions of problems arise, a detailed investigation of a bank should be undertaken more readily than has been the case in the past. The increased number of visits recommended above should reduce the risk that such an investigation might itself cause a loss of confidence in the bank (paragraph 48).

xviii) Banks should consider introducing loan grading systems if they do not already have them. The Banking Supervision Division should make use of the information provided by such systems to monitor changes in the quality of a bank's assets (paragraph 49).

The adequacy, scope and timeliness of data received for supervisory purposes

xix) The present integrated system for collecting statistical data for various uses, including supervision, should be retained (paragraph 51).

xx) The Bank should tighten its procedures for ensuring that all returns used for supervisory purposes are submitted promptly and should consider carrying out an investigation into any bank which fails to provide information within the time allowed (paragraph 53).

Parental support

xxi) We endorse the Banking Supervision Division's proposals on comfort letters (paragraphs 57, 58).

Staffing and organisation of the Banking Supervision Division

xxii) Some further increase in staff numbers is justified to meet the existing workload and to carry out certain of our other recommendations (paragraph 59).

xxiii) The staff of the Banking Supervision Division would benefit from wider commercial experience to assist them in their work as supervisors (paragraph 60).

xxiv) The programme of secondments in both directions between the Division and commercial banks should be expanded (paragraph 60).

xxv) A significant cadre of experienced, long-term banking supervisors needs to be built up (paragraph 61).

xxvi) Some increase should be made in the number of professionally qualified accountants working in the Division (paragraph 62).

xxvii) We endorse the proposals produced by the Banking Supervision Division for clarifying the lines of communication within the Division, defining more clearly responsibilities and work practices and improving information flows (paragraph 63).

Consolidated supervision

xxviii) Barriers to the exchange of information between supervisory authorities should be removed (paragraph 68).

xxix) The relevant government departments and supervisory authorities should consider carefully the issues raised by the supervision of financial conglomerates, parts of which are supervised by different supervisory authorities (paragraph 69).

Matters raised with the Committee by the official group considering the desirability of amendments to the Banking Act

xxx) The Bank, with the consent of the Treasury, should be able to disclose information to other government departments (except the Revenue departments) where it considers this to be in the interests of depositors or in the public interest (paragraph 73).

xxxi) The Bank should be given powers in respect of unauthorised institutions similar to those enjoyed by the Department of Trade and Industry under Sections 447 and 448 of the Companies Act 1985 in order to facilitate investigation of offences under the Banking Act (paragraph 75).

xxxii) The amount of a protected deposit under the Deposit Protection Scheme should be increased from £10,000 to £20,000 (paragraph 76).

xxxiii) The amount of the minimum initial contribution to the Deposit Protection Fund should be increased from £2,500 to £10,000 (paragraph 76).

xxxiv) The provisions of the Deposit Protection Scheme which allow the exemption of certain overseas banks should be repealed (paragraph 76).

R. Leigh-Pemberton

C W McMahon

W.P. Cooke

P E Middleton

[illegible]

[illegible]

31 May 1985

APPENDIX

TERMS OF REFERENCE

1 A Committee shall be established under the chairmanship of the Governor and with the participation of the Permanent Secretary to the Treasury consisting of representatives of H M Treasury and the Bank. It is intended to appoint a senior outside expert experienced in commercial banking to enquire and report to the Committee. The Secretary shall be provided by the Bank.

2 The Committee shall consider 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.

3 Issues to which particular attention should be given are the relationship between auditors and supervisors; staff experience and training; the handling of concentrations of risk and the assessment of quality of assets; notification and collection of statistics; and the adequacy and deployment of staff resources in the Banking Supervision Division.

4 The Committee should also draw attention to any areas where, if changes are to be made in supervisory arrangements, these may support the need for review or amendment of the provisions of the 1979 Banking Act.

5 A report should be prepared setting out the Committee's views as soon as possible after the end of the year.

6 Detailed consideration of the desirability for legislative changes will be undertaken by an official group under the Chairmanship of the Treasury with the object of making recommendations in the spring in 1985.

Annex B

The Bank of England and Johnson Matthey Bankers Limited

The Bank of England and Johnson Matthey Bankers Limited

This note is divided into five sections. First, the developments in Johnson Matthey Bankers Limited (JMB) up to September 1984 and the reasons for its failure; second, the Bank's supervision of JMB; third, the rescue operation which was mounted at the end of September 1984; fourth, the reasons for rescuing JMB; while the final section outlines the developments which have taken place since the Bank acquired JMB.

I The development of the business of JMB

JMB was established in 1965 to conduct the banking and bullion business of Johnson Matthey & Co.Ltd (now Johnson Matthey p.l.c.). It became an authorised bank under the Exchange Control Act in 1967 and obtained exemption under the Protection of Depositors Act in 1970. JMB was already being supervised by the Bank before the Banking Act came into effect. After the Banking Act came into effect, JMB was granted authorisation as a recognised bank in April 1980. As one of the five members of the London gold fixing, its business at that time was mainly concentrated on bullion and foreign exchange dealing, with the commercial banking side of the business specialising in trade finance. This spread of business was sufficient to enable JMB to obtain recognition under the normal criteria for a bank providing a wide range of banking services. (The provision of foreign exchange services and trade finance are two of the services required to be provided under the Act for authorisation as a recognised bank.)

Growth of the balance sheet

Total assets of the bank and its subsidiaries in 1980 were £874 million, of which bullion stocks and customers' dealing and metal accounts amounted to £678 million and commercial loans and overdrafts only £34 million. In 1981, the bank began to expand and diversify its loan portfolio. JMB's traditional trade finance business had tended to be based on connections with Pakistan, the Middle East and Nigeria and these areas provided a number of the customers for its expanding lending operations.

The balance sheet of the bank and its subsidiaries, set out in its annual accounts, more than doubled between March 1980 and March 1984 (broadly in line with those of other banks, in aggregate) by which time total assets stood at £2.1 billion (Table 1).

Table 1
£ millions

At end-March	1980	1981	1982	1983	1984
Loans and overdrafts	34	78	135	184	309
Holdings of bullion and customers' bullion-related accounts	678	786	804	1,226	1,359
Total assets	874	1,040	1,183	1,735	2,089

Commercial lending, in the form of loans and overdrafts, grew during the four years much faster than the overall balance sheet. Letters of credit, guarantees and acceptances outstanding also increased rapidly from £18 million in 1980 to £65 million in 1984. Nevertheless, JMB remained very much a specialised bullion trading bank: holdings of bullion and customers' bullion-related accounts, which had amounted to around three quarters of the bank's assets in 1980, still amounted to around two thirds of them at end-March 1984. Although the lending book had been increased markedly, no serious attempt was made to broaden the base of the banking services into, for example, corporate finance or investment management. The JMB group did however diversify to some extent into other financial services by purchasing subsidiaries engaged in soft commodities broking (in the United Kingdom, the United States and Singapore), insurance broking (United Kingdom and the United States) and asset management (United States). The bank did not become involved in large scale financing of sovereign borrowers from developing countries.

Profits and provisions

According to its audited annual accounts, the JMB group's return on shareholders' funds was well over 20% between 1980 and 1983, and the return on total assets varied between 1.1% and 1.6%. This performance compared favourably with that of other banks. During the period between 1980 and 1984 well over three quarters of its profits came from bullion dealing and from sterling and foreign exchange operations partly connected with such dealing (Table 2). In the year to 31 March 1984 total profits fell, with the return on shareholders' funds declining to 9% and on total assets to 0.4%. The fall was attributed in the bank's annual report to 'flat conditions in world bullion markets, intense commission-reducing competition for base metal and commodity futures business, and growing trading problems for our banking customers at home and abroad'.

Table 2

£ millions

Year to end-March	1980	1981	1982	1983	1984
Pre-tax profits	14.4	11.6	16.6	24.3	9.4
of which:					
Dealing (including bullion operations)	13.4	10.0	14.7	20.8	8.9
Banking	1.0	1.6	1.9	3.5	0.5

It was the policy of the JMB board not to make specific bad debt provisions, but rather to write off directly any bad debts. A general provision of £8.0 million was maintained from May 1981 until March 1984. In JMB's quarterly return for June 1984, the Bank was informed that the general provision had been increased to £12.0 million, as from March 1984. After the Bank acquired JMB, it discovered that the general provision had in fact been increased to some £16 million[1] and that part of the general provision was in fact earmarked against a long-standing claim related to an earlier bullion trading transaction. As such this part was more in the nature of a specific than a general provision.

(1) The figure of £20 million for general provisions as at March 1984 given in a press release issued by the Bank of England on 13 May 1985 includes certain debts which had previously been written off in accordance with JMB's normal policy but which have been written back into the accounts and provided against for the purposes of the indemnity arrangements referred to on page 00.

The causes of the failure

JMB entered into several large exposures, each of them equivalent to over 10% of the bank's capital base, as part of its banking operations. The two largest commercial debtors which eventually precipitated the crisis had been customers of JMB for several years; both were loosely associated groups of companies run by businessmen from Pakistan. By June 1983 the sizes of the exposures to these debtors were equivalent to 26% and 17% of JMB's capital base respectively. They had grown to 51% and 25% of capital base by December 1983. They continued to grow rapidly during the first half of 1984, reaching some 76% and 39% of JMB's capital base, respectively, in June 1984. The differences between the actual exposures and the levels reported to the Bank are set out on page 00. The total loan book also grew very rapidly in 1984 increasing by over a third, in sterling terms, in the six months between end-March 1984 and the time of the rescue. (The larger part of this rise reflected an increase in JMB's lending but since much of this was in US dollars, the total was also affected by the downward movement in the sterling/US dollar exchange rate in this period.) Many of JMB's other debts have since proved to be bad or doubtful, including some other large exposures.

In 1984 problems began to arise with the two large exposures. JMB was faced with a familiar banker's dilemma of deciding whether to lend more to help the customer trade out of its problems or to refuse further credit and bring about the customer's failure. JMB chose the former course.

The roots of JMB's problems were, however, more deep-seated. The loan book had grown very rapidly since 1981 and it has become clear since JMB's acquisition by the Bank that the controls and systems were inadequate; that the organisation and management of the commercial banking and credit monitoring activities had serious shortcomings; and that insufficient attention had been given to the concentration of risks involved. Security was not required from borrowers when this might have been expected under normal banking practice; and even when security was required the steps necessary to

give the bank title to the security were not always taken properly. The need for provisions against bad and doubtful debts was not assessed with the proper degree of caution. The judgement of management in approving so many loans which have required substantial provisions was clearly defective. However, no evidence of fraud by the directors or staff of JMB has been discovered, except in one case dealt with before, and immaterial to, the collapse. Lending against bullion was not a factor in the loan losses. (Further references to the problems and shortcomings which the new, post-September 1984, management discovered in JMB will be found in the last section of this note.)

II The Bank's supervision of JMB

In 1981 and the first half of 1982 JMB's capital ratios were more than adequate and, even allowing for the nature of its business, left room on the Bank's normal criteria for an appreciable expansion of the balance sheet. The ratios weakened during late 1982 and the first half of 1983 before stabilising at the level which prevailed until the late summer of 1984. At that level they were still in line with those of many other banks.

Until the year ending on 31 March 1984, JMB's profit performance had been good and the Bank's knowledge of their bad debt experience, up to and including that year, gave no indication of any sizable problems. The annual accounts carried unqualified audit reports and included a note that 'Provision is made for all known doubtful debts'.

Particular attention was devoted at regular prudential interviews to discussing bullion trading, which was the dominant part of JMB's business. The Bank drew JMB's attention, in the course of 1983, to some concerns it had about the adequacy of its liquidity position. Management responded positively and the position was improved over the following months. Inadequate liquidity was not a serious problem at the time of the crisis. Also during 1983, there was a rapid increase in lending to JMB's commodity subsidiaries. The Bank took up with JMB's management the scale of the exposures, which suggested weak controls in the bank, and the exposures were substantially reduced after the Bank had made clear its concern about them. In the five months, October 1983 to February 1984, the Bank held three meetings with JMB's management at which the two concerns described in this paragraph were particularly discussed.

The Bank's identification of the problems building up in the commercial loan book was seriously hindered by misreporting of the large exposures (which were significantly understated in the returns), and by late reporting, particularly for the March 1984 quarter. Table 3 shows the exposures to the two largest borrowers as they have subsequently been discovered to be and as they were reported to the Bank from June 1983 to June 1984.

Table 3
Percentage of capital base

	Reported		Actual	
Customer:	A	B	A	B
1983				
June	15	12	26	17
September	18	—	45	21
December	27	18	51	25
1984				
March	42	30	65	34
June	38	34	76	39

In December 1983 these exposures, reported at 27% and 18% of capital, were not significantly out of line with the size of exposures carried by many other banks (though JMB's exposures were not to first-class names). One other large commercial exposure, which is now considered doubtful, was reported in the March 1984 return as equivalent to 14% of capital; this was about half the true exposure. A further doubtful exposure equivalent to 27% of capital was omitted altogether. The levels of the largest exposures at the end of March, even as reported, would have caused the Bank to request an early meeting with JMB's management. But the report for March, which was due in the middle of April, was not received until June in spite of JMB being pressed to provide it on several occasions.

After the March return was received, the Bank asked for a meeting with JMB in July; but this was delayed at the request of JMB's management and a

meeting was arranged early in August. This meeting was held on JMB's premises and lasted for most of the day. By the time of this meeting the end-June returns had also been received. Although the two exposures then stood at some 76% and 39% of capital respectively, the returns showed that the larger of the two exposures had been reduced from 42% to 38% of capital, while the smaller had increased from 30% to 34%. A new exposure equivalent to 17% of capital was reported for the first time. It was not until just before the August meeting that the Bank discovered that the new exposure was to a company related to the larger of the two other borrowers, bringing that exposure apparently to 55% of JMB's capital, still an understatement. It was following the August meeting, at which the Bank expressed serious concern about these loans that JMB requested its auditors to examine the loans in greater depth. As a result of this examination, the extent of the provisions required began to become clear to the management of JMB. The management then advised the Bank on 25 September that provisions were required against these loans which would substantially reduce the bank's net worth. The development of the rescue operation is covered in Section III.

Lessons for the future

The problems which arose at JMB give rise to a number of questions about ways in which the present system of supervision should be improved. Two features of the existing system of supervision, which were highlighted by the problems which arose at JMB, are the Bank's lack of any detailed analysis of the quality of the loans in a large part of a bank's loan book and the difficulties for the supervisors of assessing the quality and effectiveness of control procedures. The Bank relies heavily on a bank's external auditors to cover these subjects during the course of their work. The auditors need to satisfy themselves as to the basis on which the directors arrive at their valuation of a bank's assets if they are to give a clean audit report. They can also be expected to review the adequacy of a bank's controls and systems during the course of an audit and to make comments to management on any aspects they consider to be less than satisfactory.

Other features of the Bank's supervision are the practice of relying on the accuracy of banks' returns and the encouragement given to banks' managements to bring their concerns to the Bank at an early stage. The Bank's reliance on these features has, on the whole, been justified; but it proved not to have been justified in the case of JMB. One of the problems may have been that management and the parent company did not themselves realise the extent to which JMB was building up problems and subsequently did not appreciate their seriousness. In addition, reporting was inaccurate and misleading and at a critical point was late—and significantly later than the Bank stipulates. It appears that most of the misreporting was due to the deficient systems in JMB, a lack of understanding of the Bank's reporting requirements and lack of co-ordination between different departments, rather than to a deliberate attempt to mislead the Bank.

Some of the problems which arose in JMB in 1983 such as weak liquidity and excessive lending to the commodity subsidiaries, were addressed by the management but only after these shortcomings had been raised with JMB's management by the Bank. In late 1983, the attention accorded to the adequacy of the liquidity of the bullion business and the control systems associated with intra-group lending reflected the importance given to these factors by the Bank at that time. Both were features which, had they not been rectified, could have led to serious difficulties for the bank. In this connection, it should be emphasised that the critical problem which surfaced in September 1984 was in no way connected with the bullion business, which was generally well managed and profitable. The problems related exclusively to JMB's commercial lending business.

In the commercial lending part of the business, the problems of deficient systems, poor lending judgements and inadequate monitoring and control were not identified or pursued by the board or the

parent company of JMB. The information in the regular returns made to the Bank gave some clues to possible problems in these areas—for example, the rapid growth of the commercial loan book, the large exposures to less than first class names and the declining risk asset ratio. But, as has been seen, much of the information was seriously deficient and for the period between December 1983 and June 1984 not available. Had accurate end-March figures been received on time and the August meeting, at which the Bank's concerns about the loans were made clear to management, been held earlier, it should have been possible to prevent some of the late rapid growth of the loan book as a whole, and in particular of the major problem loans. This might have made it possible to contain the bank's difficulties. Even then, however, JMB's ultimate losses would have been very substantial.

The issues raised in this section about the system of supervision are covered in the Report of the Committee set up by the Chancellor of the Exchequer, to consider changes to the system. The Committee comprised the Governor (Chairman), the Deputy Governor, Mr W P Cooke (Associate Director with responsibility for banking supervision), Sir Peter Middleton (the Permanent Secretary to H M Treasury), Mr Frank Cassell (Deputy Secretary, H M Treasury) and Mr Deryk Vander Weyer (Deputy Chairman of British Telecommunications p.l.c., and a director of Barclays Bank p.l.c.).

The Committee was asked by the Chancellor to consider in particular: the relationship between auditors and supervisors; the handling of concentrations of risk and the assessment of the quality of assets; the notification and collection of statistics; the adequacy and deployment of staff resources and the experience and training of staff in the Banking Supervision Division of the Bank; and whether any changes were needed to the Banking Act.

III The rescue operation

The Bank was advised by JMB on Tuesday, 25 September 1984, after its auditors, Arthur Young, had examined the two largest loans, that the directors considered that substantial provisions were required against these loans to an extent which drastically reduced JMB's net worth but did not make it insolvent. At the Bank's urging, the auditors during the next two days carried out a review of a wider cross-section of the loan book. Meanwhile the Bank discussed with the clearing banks the provision of liquidity support for JMB to deal with any withdrawal of deposits when the need for large scale provisions was announced. The further work by the auditors identified the need for other provisions which effectively exhausted the capital of the JMB group. It was then evident that liquidity support for the bank would not be sufficient on its own and that if JMB could not be recapitalised, or its losses underwritten by a third party, it would have to cease trading. An investigation of the loan book was undertaken by a team from the clearing banks, which worked through the Thursday night, 27/28 September and identified the probable need for substantially greater provisions, although the amount could not be accurately assessed in the time available. Their findings were confirmed by a separate examination of the loan book by Price Waterhouse, commissioned by the Bank.

As soon as the need for large scale provisions against the two large loans was known, the Bank discussed with JMB and other parties the ways in which support could be provided. The parent company of JMB, Johnson Matthey p.l.c., was approached first. While acknowledging its responsibility to stand behind the bank, Johnson Matthey p.l.c. indicated that it would be unable to provide from its own resources all the support which would be required.

Certain possible purchasers of the bank, including a clearing bank, a major overseas bank and the members of the London gold market collectively, were approached. However, none of them felt able to commit themselves in the time available, given the considerable uncertainties over the level of the provisions required. Other solutions, such as the sale of the loan book and the introduction of new

minority shareholders, were being explored simultaneously but had to be abandoned for the same reason.

The final potential purchaser withdrew during the late evening of Sunday, 30 September. The early stages of the negotiations for a rescue had been conducted with complete secrecy but questions had started to be raised in the domestic and international markets on Friday 28 September. By the Sunday night, news agency tapes were reporting that a London bullion house was in difficulties. It was clear to all those present in the Bank that night, including representatives of Johnson Matthey p.l.c., the clearing banks and the other members of the gold market, that without a solution being agreed, JMB would be unable to open for business on the Monday morning. If this was to be avoided, the only possible solution in the time available was for the Bank itself to take responsibility for providing the support required.

Once the decision to rescue JMB had been taken in principle, for the reasons described in the next section, the Bank sought the co-operation of Johnson Matthey p.l.c., of other members of the gold market and of major commercial banks in meeting the cost of the operation. The parent company agreed to sell JMB to the Bank for a nominal £1 and to inject £50 million into the bank before it was sold. This sum was judged by all concerned in the rescue operation to be the maximum that Johnson Matthey p.l.c. could contribute without seriously impairing its own creditworthiness. Undertakings to contribute support were secured from the banks and other members of the gold market. This support was later embodied in an agreement under which the Bank provided JMB with an indemnity of up to £150 million to meet losses in the commercial loan book, while the banks and the other members of the gold market agreed to counter-indemnify the Bank for half of any such losses. The counter-indemnitors have agreed to share any calls on them in the following proportions. The clearing banks have agreed to divide £35 million between them, the members of the gold market £30 million and the other Accepting Houses £10 million.

IV The reasons for the rescue operation

The Bank's fundamental reason for rescuing JMB was a deep concern for the systemic consequences if it was allowed to fail. The Bank, the commercial banks and the other members of the gold market involved on the night of 30 September 1984 were convinced that, had JMB not been rescued, there would have been unacceptable consequences for the banking system as a whole. This belief the Bank still holds.

At first sight, it might seem implausible that the failure of a relatively small bank like JMB, not widely known outside the bullion markets, could have such consequences. Certainly there should be no presumption that the failure of any bank would be thought to carry such risk for the system that it would be rescued. But, in the particular circumstances of JMB last September, several special factors were present which were judged to be conclusive. They are as follows.

JMB is a member of the London gold market. This is not simply a market in a sense analagous to, say, the copper market. It comprises a group of banks and members of banking groups, a substantial proportion of whose liabilities are in the form of deposits of gold, traditionally withdrawable at short notice. London is probably the most important international gold market and is involved in placing and taking gold deposits with a large number of institutions all over the world. The members of the market also do a substantial amount of business with each other. The failure of one of the five main participants would therefore have created a situation of extreme uncertainty.

The other members of the gold market would, because of their presumed exposure to JMB, have come under immediate suspicion and there would probably have been a very rapid withdrawal of liquid funds from all of them. The pressure that this would have been likely to put on the other four members could quite quickly have been translated, in the classical manner of confidence crises, to other banks, in Britain and, perhaps, because of the international nature of the market, to banks

abroad. The Bank believed, and still believes, that it would not have been possible to have convinced the markets in the first few days after the crisis that the problems did not derive from JMB's bullion business. Equally, no statements or promises of liquidity support could have been relied on to contain an ensuing loss of confidence in other members of the gold market and other banks. The possibility of allowing JMB to fail and seeking to contain the consequences of its failure was considered during the week of the rescue operation, but was rejected. This was partly for the reason just given and partly because providing the necessary liquidity in gold would have been beyond the Bank's own resources. It would have necessitated recourse either to the gold owned by the Government in the Exchange Equalisation Account or to a Government guarantee for the borrowing of gold from other sources. It was quite impractical, certainly in the time available, to have set up what would have been an open-ended and possibly very large commitment of this kind.

At the time the rescue occurred, confidence in financial markets generally was fragile in the wake of the continuing international debt problems and particularly of the crisis at Continental Illinois National Bank where, despite the action taken by the US authorities to rescue that bank, US banks suffered some loss of confidence for some time afterwards. The speed and magnitude of the problems that could have developed in the wake of the failure of JMB were demonstrated to the Bank in the early hours of Monday, 1 October. While the form of the rescue operation was still being discussed, and there had been no announcement made about the difficulties in JMB, it was reported from the Far East that some major foreign banks were refusing to deal with first-class British banks (including some not belonging to the gold market) with whom they had very long-standing connections. This strongly underlined the need for speedy and decisive action.

During the Continental Illinois crisis large amounts of money had moved from US banks into UK, other European and Japanese banks. The failure of JMB, because of its prominence as a member of the gold market, risked provoking a similar movement away from British banks. Much of the funds which moved out of the US banks remained in dollars, but sterling lacks the dollar's pre-eminent position and it was clearly a possibility that the move would have been out of sterling as well as out of British banks.

In addition to the foregoing general concerns, there were two other important, if subsidiary, factors which related to JMB itself. Although JMB is only one of the five members of the daily gold fixing, it is the only one which is part of a group which has refining capacity. This refinery constitutes for two reasons an important encouragement to overseas traders to use the London market. It possesses the facility to break down standard bars into smaller bars for which there is an increasing demand; and it has a capacity to refine gold in other forms into standard bars. This refining capacity was a major part of the Johnson Matthey group outside JMB. The failure of JMB would have virtually certainly brought down the whole of the group and could thereby have damaged the position of the gold market.

The second factor was a consideration of a rather different kind. As part of its bullion operations JMB received substantial deposits of gold from a number of foreign governments and central banks. Losses on these official deposits could have had particularly serious implications for the standing of and confidence in British banks generally.

V Developments since the Bank acquired JMB

Immediately following the acquisition of JMB by the Bank steps were taken to reorganise the board: Mr R D Galpin, an Executive Director of the Bank, was appointed Chairman and the resignations were accepted of six members of the previous board. Two of the former directors, Mr J J Shaw and Mr P J K Smith, were confirmed in their appointments and five new directors appointed. These were: Mr P Brenan as Finance Director, Mr G R A Copus and Mr M J Harper as Banking Directors, Mr P W Moss to oversee JMB's commodity subsidiaries and Mr L T G Preston who, with Mr

Smith, has responsibility for the bullion and markets area. Mr Shaw is also Chairman of JMB's insurance broking subsidiary.

Mr Brenan, a member of the Council of the Institute of Chartered Accountants, was at one time the Finance Director of Hambros Bank Ltd; Mr Copus was previously Senior Director of Standard Chartered Merchant Bank Ltd and Mr Harper a Managing Director of Charterhouse Japhet p.l.c. Mr Moss had been Finance Director of Czarnikow Ltd and Mr Preston a Director of Standard Chartered Bank and previously in charge of the foreign exchange operations of the Bank.

Price Waterhouse were appointed as investigating accountants to review and report on the financial condition of the JMB Group as at 30 September 1984. They were asked to cover all aspects of JMB's business. Their report has confirmed the belief held by the Bank when JMB was acquired that its problems were confined to its commercial lending activities.

An important task for the new board of JMB, in consultation with Price Waterhouse, has been to establish the level of provisions required by a review in detail of each of its loan facilities. The detailed review of the loan portfolio is largely complete. In the light of then current circumstances the level of provisions deemed appropriate by the new board of JMB as at 31 March 1985 was £245 million, of which only £20 million had been provided by the previous management.

Price Waterhouse have reported that the capital, reserves and bad debt provisions of the JMB group stood at some £130 million as at 30 September 1984 before the additional provisions required for loan losses had been made. This amount, together with the £50 million injected by Johnson Matthey p.l.c., has been absorbed in meeting these provisions; consequently approximately £180 million of the identified £245 million of provisions has been met from JMB's own resources. To meet the balance of the provisions against JMB's commercial loan book, together with a contribution towards funding costs, the Bank has provided JMB with an indemnity of up to a maximum of £150 million. The Bank's liability is offset by counter-indemnities of up to £75 million from a number of banks and members of the London gold market. The indemnity agreement, signed on 29 March, after lengthy and complex negotiations, provides for calls to be made as at 31 March, with subsequent adjustments, upwards or downwards, on a quarterly basis until 31 March 1986. The total amount for which the Bank and the counter-indemnitors are liable as at 31 March this year is likely to be of the order of £65 million. By 30 April the directors of JMB had identified the need to increase provisions by £3 million. This, and any subsequent adjustment, upwards or downwards, found necessary before the end of June, will be reflected in the indemnitors' liability to be calculated at that date. The Bank has thought it right, however, to provide in its own accounts for half of the adjustment identified at the end of April.

In its efforts to recover as much as possible of the expected losses, the board of JMB is intent to pursue all the legal and other remedies open to it.

An immediate step taken on acquisition was to halt the outward flow of lending where lending limits had been breached or were not properly established. Most of the authorities granted to individuals to commit JMB were temporarily withdrawn and an Executive Committee established, meeting on a daily basis, to control JMB's activities. Control of JMB's operations by the new management was thus quickly established, and as the new directors joined the board the process of appraising its activities was put in train. Immediate action was required in handling, with the help of merchant bank advisers appointed for this purpose, the two largest exposures which had precipitated the crisis. Shortly afterwards, in one case, suits were instituted in the US Courts by the debtor against JMB and the Bank, each for an amount of $300 million. Both actions lapsed on 24 May.

Much of JMB's lending had been in US dollars and

where provisions against such loans have had to be made, it has been necessary to purchase currency to cover these potential losses. Such cover has been effected using a deposit of £100 million placed with JMB by the Bank in November. This deposit has also enabled JMB to make two-way business in the money markets.

A comprehensive review of JMB's lending operations was started in early October. This revealed deficiencies in JMB's records, and it soon became clear that the work involved in reordering the loan portfolio and records was too large and too complicated to be undertaken under the direction of the new board by the existing staff. Accordingly, approaches were made to a number of clearing and other banks for secondees to assist in this process. There was an immediate and helpful response and within a matter of days seconded staff with the necessary skills and experience had arrived. There are currently some 35 such staff working in the banking area of JMB.

With their assistance, significant repayments and reductions in JMB's commitments totalling some £65 million have been achieved. Facilities and credit files are now in better order. A complete reorganisation of the trade finance and bill department has taken place with fundamental improvements being made in its systems, records and controls. In this area there has been a need to reconstruct over a period of some years the facts surrounding over 1,500 separate accounts.

The structure of JMB's banking department has been reorganised and a number of banking review teams established with particular responsibilities. Such teams are led by secondees who have brought to the task skills, such as experience in realisations and credit assessment, which have been essential in dealing with the complicated lending situations which have been discovered.

The operations of the banking division have been the subject of a review by outside consultants and a team of secondees selected for that purpose. The manner in which funds were allocated in support of the banking operations of JMB has also been subject to close examination, following which a number of necessary changes were made. Management below director level has been strengthened through the use of senior secondees from other banks or by direct recruitment of individuals with the requisite experience.

All these developments have increased the demand for space and in the interests of efficiency, considerable relocation of functions and staff has been necessary.

In addition to the Executive Committee already mentioned, which now meets weekly, a new Credit Committee has been formed; its responsibilities have been closely defined and the procedures which existed before have been reorganised and tightened. An Audit Committee of the board and an internal audit function have been established; neither existed before. Arthur Young agreed to resign as JMB's auditors and Price Waterhouse have been appointed in their place. Freshfields have been appointed JMB's legal advisers, Deloitte, Haskins and Sells its tax consultants and R Watson & Sons have been appointed actuaries to the new Pension Fund which has been established by transfer of the actuarially calculated proportion of Johnson Matthey p.l.c.'s Pension Fund. A Staff Committee of the board has also been set up. The former parent company provided a variety of management services, including payroll, security and insurance, to JMB. These have all been subject to review and have been taken over by JMB; and a security manager has been appointed.

Arrangements have been entered into with each member of staff for JMB to take over his or her contract of employment which had been with Johnson Matthey p.l.c.; and steps taken to inculcate within the banking area a more thorough understanding of banking procedures.

Under the direction of the Finance Director, new budgeting and financial reporting methods have been introduced; and management information improved. The implementation of a new computer

system has been put in hand with significant enhancements to remedy serious deficiencies and replace inadequate manual records. The Chief Accountant of JMB has been given a more active role in the executive of the Bank; his function had previously been more one of book-keeping than of monitoring and reporting on financial performance and risk. The working capital requirements of the JMB Group's overseas subsidiaries have been examined; some repatriation of funds has already taken place and more is in prospect. The boards of the subsidiary companies have been reconstructed and in the currently quiet conditions of the commodity futures markets, a reduction of some 40 staff in total has been made in JMB's broking subsidiaries in London and New York. The activities of two further subsidiaries, Johnson Matthey and Wallace Singapore Pte Ltd and Johnson Matthey Asset Management Inc., neither of which had been making profits, have been brought to a close.

Overall control of JMB's lending operations was found to be generally deficient both in its nature and extent. This was not true of the dealing areas where a review of the operating systems and procedures revealed no serious weaknesses—and none which could not be quickly addressed. Steps have been taken to ensure the continued smooth operation of the bullion business in international markets. Various visits to dealing counterparties abroad have been undertaken and JMB, which continues to participate in the London gold fixing, continues to trade profitably overall in the bullion markets and elsewhere outside the banking area.

The new board recognised that some of its decisions would involve additional overhead costs. However these have been kept to the minimum necessary and are in line with the new board's intention to correct the deficiencies in JMB's organisation and systems which existed at the time of acquisition; and to strengthen the control and supervision of its banking operations. The board is also working to retain and develop sound profitable business within the banking area. All steps being taken should facilitate JMB's return to the private sector.

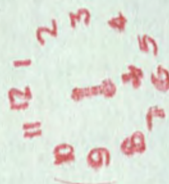
It is the Bank's intention to dispose of JMB at the earliest practicable opportunity. A number of institutions have already expressed interest in acquiring JMB and Barings Brothers & Co Ltd have been appointed by the Bank to advise on the strategy for disposal. With disposal in mind, and to provide JMB with a capital base appropriate to its level of business, the intention to reorganise the capital of JMB has recently been announced in a press release on 13 May. This will involve the cancellation of 59,999,900 issued and 15,000,000 unissued Ordinary Shares of £1 each and the subscription by the Bank of £75 million of fresh equity, of which £25 million will be in redeemable form, together with £25 million of subordinated loan stock with a final maturity date of 1995. The end of JMB's current accounting period has been postponed from 31 March to 30 June to enable the reconstruction to take effect prior to its accounting date. Following the reconstruction, the deposit made by the Bank last autumn, referred to on page 00, will be repaid.

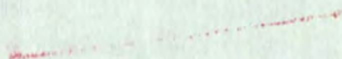
The past six months have created considerable pressure on the staff of JMB who, to their credit, have responded well in difficult circumstances. The Bank is grateful to them and also to those financial institutions who joined in the indemnity arrangements; to the clearing and other banks who so readily seconded experienced staff to JMB to assist in the recovery process; to the secondees themselves; and to the new board.

Economic Policy:

Domestic Monetary Policy

PT 13





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ANNEX C

C9/BI

REVIEW OF BANKING SUPERVISION

In my statement on 17 December 1984, I told the House that the Johnson Matthey Bankers affair raised important issues about our present procedures of banking supervision, and the legislative framework within which it is conducted. I announced a full review, which would consider whether any early changes in present supervisory procedures were called for in the light of the problems which had arisen in Johnson Matthey Bankers, and whether there was a need to review or amend the Banking Act 1979. I placed the terms of reference of the Review Committee in the library of the House.

2. The Review Committee have now presented their report, which I have arranged to be published as a Command Paper and have laid before the House. I shall be considering the Committee's proposals carefully. In the meantime, I have accepted the report as a basis for immediate consultation with the banking associations and other interested parties. Some of the Committee's recommendations would require legislation. The Government propose to publish a White Paper later this year, with the intention of bringing a Banking Bill before the House at the earliest possible opportunity.

3. I am extremely grateful to the Governor of the Bank of England, who has chaired the Review Committee, and to its members, who comprised senior officials of the Bank of England and Treasury, and a distinguished commercial banker, Mr Derek Van der Weyer.

4. I have today also laid before the House, as required by Section 4 of the Banking Act 1979, the Governor's Annual Report under that Act. A note by the Bank of England on events leading to the failure of JMB and the subsequent rescue by the Bank and its conduct of JMB's affairs is annexed to the Annual Report.

5. The Bank's account makes it clear that serious shortcomings in the management of JMB led to its collapse - heavy concentration of exposures, lack of adequate control systems and over-rapid expansion of the loan book.

6. It also reveals lapses on the part of the auditors, Arthur Young McClelland Moores. I understand that the present board of JMB, which of course is a wholly-owned subsidiary of the Bank of England, have today announced their intention of initiating legal action against them.

7. The Bank's account also sets out their reasons for rescuing JMB. In mounting the rescue, I am satisfied that the Governor was acting properly within his discretion.

8. The Review Committee have made 34 specific recommendations. Their implementation will require action by the Bank of England, supervised institutions, their auditors and the Government. The Committee propose two fundamental changes in the present arrangements, and several important modifications. They have taken the view, which I share, that the JMB case exposes shortcomings in the present legislative framework and supervisory techniques employed by the Bank of England. I shall in my statement outline only the Committee's main proposals. A full summary of their recommendations is annexed to their report.

9. The Banking Act 1979 draws a distinction between recognised banks and licensed deposit-takers. JMB was, and still is, a recognised bank.

10. Most of the Act's provisions, and of the Bank's powers set out in it, relate to licensed deposit-takers. A dual system of supervision has resulted. Licensed deposit-takers have been subject to a more rigorous regime of supervision, whereas the supervisors have relied heavily on the integrity and co-operation of the management of recognised banks. With most banks, this confidence has not been misplaced. But the banking industry has expanded rapidly, and its activities have diversified. Recognised bank status - as we have seen with

JMB - cannot be regarded as a guarantee of prudence and responsibility.

11. The committee recommends that the two-tier system be abolished and that the powers given to the Bank under the Act should apply to all authorised institutions. I accept this recommendation. It follows that all institutions authorised under the Banking Act will be entitled to use banking names.

12. I also intend to tighten the criteria for authorisation.

13. The second fundamental change recommended by the Review Committee concerns the role of bank auditors. In this context, I am grateful to the Institutes of Chartered Accountants of England and Wales and of Scotland for the co-operation they have afforded the Committee.

14. The Committee recommend that there should in future be a regular dialogue between the supervisors and banks' auditors. I strongly endorse this proposal.

15. A bank's auditors are uniquely placed to monitor its control systems and assess its financial prudence. At present the accountancy profession considers itself prevented by a duty of confidentiality to the client from passing information to the supervisors. The supervisors are themselves inhibited by the Banking Act from communicating supervisory information to third parties without the institution's consent.

16. It is in precisely those cases where consent is not forthcoming that dialogue might be most necessary. This is why I accept the Committee's recommendation that the constraints on contact between auditors and supervisors be removed.

17. I emphasise, however, that it is the directors and senior managers of banks who are responsible for the conduct of their business. They have duties both to depositors and shareholders.

This responsibility cannot be side-stepped and shifted to auditors or supervisors. If there is one overriding lesson of the JMB collapse, it is that banks must have in place adequate management and control systems. I therefore strongly endorse the Committee's suggestion that banks ought to appoint an audit committee and a finance director where they do not already have one.

18. The Committee has also made important recommendations on the staffing and organisation of the Banking Supervision Division of the Bank of England.

19. JMB's senior managers were clearly gravely at fault. But the supervisors cannot escape blame for failing to pick up the danger signals.

20. This lapse must be seen in perspective. The Bank of England supervises over 600 institutions. It has carried out these duties conscientiously and with considerable success.

21. The Committee have recommended that the staff of the division would benefit from wider commercial experience; that the programme of secondments in both directions between the division and commercial banks should be expanded; that a significant cadre of experienced long-term banking supervisors must be built up; and that there should be more professionally qualified accountants in the division. They have suggested that more staff are needed. The Governor has accepted all the Committee's recommendations, and has begun to implement them. The manager directly responsible for supervising JMB has been moved to another part of the Bank, [and changes have been made in certain senior posts concerned with the banking supervision division.]

22. JMB's failure stemmed directly from a number of large, related exposures. The Committee recommend - and the Bank of England have accepted - that in future no exposure to a

borrower, or to closely related borrowers, should exceed 25 per cent of the lender's capital base, other than in the most exceptional circumstances.

23. Many of the Committee's recommendations do not need legislation. Some are already being implemented. Following further consultation, proposals for changes in the statutory framework will be set out in the White Paper to be published later this year.

24. I do not claim that these recommendations will prevent further bank failures. No system of supervision can guarantee that. It is the responsibility of the management of banks to conduct their business prudently. It would be wrong for the supervisory system to offer them so little scope that they could no longer take the commercial risks inherent in banking.

25. Important lessons have been learnt from JMB's collapse. The Review Committee's report provides the basis for a stronger supervisory system. I commend it to the House.

I think we need a stronger ending. One is almost left looking for the next collapse or collapses.

MT