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20 June 1985

BANKING SUPERVISION AND JOHNSON MATTHEY BANKERS

The Chancellor of the Exchequer, the Rt Hon Nigel Lawson MP, made a statement today in the House of Commons on banking supervision and Johnson Matthey Bankers (JMB).

The Chancellor said that he was satisfied that in rescuing JMB the Governor was acting properly within his discretion. The cause of JMB's collapse had been serious management shortcomings within JMB. But the Bank of England supervisors could not escape criticism for failing to respond more quickly to the danger signals.

The Chancellor announced that he would consider very carefully the report, published today, of the Committee set up to review banking supervision. The Committee's two main recommendations are that:-

- the two-tier system of authorisation, distinguishing between recognised banks and licensed deposit-takers, should be abolished, and the powers given to the Bank under the Banking Act should apply to all authorised institutions.

- there should in future be a regular dialogue between the Bank of England supervisors and banks' auditors.

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NOTES TO EDITORS

The Bank of England acquired Johnson Matthey Bankers (JMB) on 1 October 1984.

On 17 December 1984 the Chancellor of the Exchequer announced in the House of Commons that a Committee would be set up under the Chairmanship of the Governor consisting of senior Bank and Treasury officials and a senior outside expert, Mr Deryk Vander Weyer, to consider the present supervisory system and whether any early changes in supervisory procedures were called for in the light of the problems which had arisen in JMB. The Committee's Report is published today as Cmnd 9550.

The Bank of England has today published (as an annex to its Annual Report and Accounts) a note on the events leading to the failure of JMB, the subsequent rescue by the Bank, and the Bank's conduct of JMB's affairs since 1 October 1984.

BANKING SUPERVISION AND JOHNSON MATTHEY BANKERS

In my statement on 17 December, 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.

2. The Review Committee has now presented its 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. Many of the recommendations do not require legislation. Some are already being implemented. But some of the Committee's proposals do require fresh legislation. I therefore propose to publish a White Paper later this year, with the intention of bringing a Banking Bill before the House as soon as possible. The group of Treasury and Bank officials which I set up under the Review Committee's terms of reference is continuing its detailed examination of the Banking Act 1979.

3. I am most 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 the Treasury, and a distinguished commercial banker, Mr Deryk Vander Weyer.

4. A note by the Bank of England on events leading to the failure of JMB, the subsequent rescue by the Bank, and its conduct of JMB's affairs is annexed to the Bank's Annual Report and Accounts, which have been laid before the House today.

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

adequate control systems. JMB was also guilty of serious misreporting to the supervisory authority.

6. The circumstances described in the Bank's report must inevitably raise questions about the role of the auditors, Arthur Young. The board of JMB, which is a wholly-owned subsidiary of the Bank of England, has today announced that it will be initiating legal action against Arthur Young.

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

8. The board of JMB now estimates the company's losses at £248m. Of this £130m has been met by JMB's original capital, reserves and provisions, and £50m by a cash injection from Johnson Matthey plc, the former parent company. The rest of the losses are to be met from the indemnity of £150m, split pound for pound between the Bank of England and a group of private sector banks and members of the London gold market. Potential claims on the indemnity to date thus amount to £68m, of which £34m falls to the Bank. Though in many instances recoveries will be only over the long term, JMB's present board of directors are satisfied that the total eventual calls on the indemnity will fall comfortably within the £150m ceiling.

9. Since JMB is now its wholly owned subsidiary, the Bank of England of course stands fully behind it. On 22 November the Bank placed a deposit of £100m with JMB, which has since been converted into £100m of additional capital to strengthen JMB's balance sheet. This will, of course, be fully reflected in the price the Bank of England receives for the sale of JMB back to the private sector, which it plans to conclude as soon as practicable.

10. The Review Committee has made 34 specific recommendations. Their implementation will require action by the Bank of England, supervised institutions, their auditors and the Government. The Committee proposes two fundamental changes in the present arrangements, and several important modifications. It has taken the view, which I share, that the JMB case exposes serious

shortcomings in the present legislative framework and supervisory procedures. I shall in my statement outline only the Committee's main proposals. A full summary of their recommendations is annexed to their report.

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

12. 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 - has not always guaranteed prudence and responsibility.

13. 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. The Committee accepts that all authorised institutions would in consequence be entitled to use banking names.

14. I also intend to tighten the criteria for authorisation, including the minimum net assets required.

15. The second fundamental change recommended by the Review Committee concerns 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.

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

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

18. This is clearly an unsatisfactory state of affairs. It is in 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.

19. 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 to shareholders. This responsibility cannot be shuffled off to auditors or supervisors. The overriding lesson of the JMB collapse is that banks must have in place adequate management and control systems. I therefore endorse the Committee's suggestion that banks should appoint an audit committee and finance director where they do not already have them.

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

21. The work of the Supervision Division has increased greatly in both complexity and volume in recent years, and the Bank of England now supervises over 600 institutions. In general it does a difficult job diligently and well. But in the case of JMB the supervisors cannot escape criticism for failing to respond more quickly to the danger signals.

22. The Committee has recommended that the staff of the division would benefit from wider commercial experience; that there should be more secondments in both directions between the division and commercial banks; 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. It has suggested that more staff are needed.

23. The Bank has already begun to implement these recommendations. The division is being strengthened both in numbers and in the range of expertise available. Some rearrangement of responsibilities has taken place within the division and further secondments to and from commercial banks have been arranged. To provide advice at a senior level, Mr Sidney Procter, Chief Executive of the Royal Bank of Scotland Group, who retires from that position on 30 September, has accepted the Governor's invitation to serve on a part-time basis as an adviser on banking supervisory issues.

24. JMB's failure stemmed directly from a number of large, related exposures. The Committee recommends - and the Bank of England has 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.

25. An effective system of banking supervision is essential not merely for the protection of depositors but for the financial health of the economy as a whole.

26. The Review Committee's report brings out very clearly the lessons to be learned from the collapse of Johnson Matthey Bankers. But more than that, it proposes a number of important changes to banking supervision in this country, which I am confident will greatly strengthen the system and make a repetition of the JMB affair very much less likely to occur. I commend it to the House.

Bank of England

Press Notice

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The Bank of England's Annual Report, laid before Parliament today, contains an annex commenting on Johnson Matthey Bankers Ltd (JMB). This draws attention to the deficiencies revealed in JMB's operations prior to its acquisition by the Bank last September.

The decision has been taken by JMB, after legal advice, to make a claim for damages against Arthur Young, who were its auditors until they agreed to resign on 30 January 1985. The claim is likely to be substantial. Because of this proposed litigation neither JMB nor the Bank is able to comment further on aspects of JMB's affairs which may have a bearing on the claim.

The annex also contains references to the proposal to recapitalise JMB. Following the approval of the High Court, the recapitalisation has now been effected and the Bank of England's deposit of £100 mn repaid.

20 June 1985.

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CONFIDENTIAL UNTIL PUBLICATION

Bank of England Report and accounts for the year ended 28 February 1985

The *Report and accounts* is to be issued on Thursday 20 June following a statement by the Chancellor of the Exchequer in the House of Commons concerning Johnson Matthey Bankers Limited (JMB); a note on JMB is annexed to the Report.

The Bank's *Report* starts with a foreword by the Governor and goes on to describe operations and activities of the Bank during the year other than those concerned with the conduct of domestic monetary policy and external policy which are the subject of regular commentary in the *Quarterly Bulletin*. The three sections cover the Bank's management of the stock register and note issue (pages 7—9); other developments, including the Bank's involvement in changes taking place in payments systems, regulation of the securities industry and the gilt-edged and money markets (pages 10—11); and internal administration (pages 13—14).

The Bank's *accounts* (pages 15—30) show an operating profit for the Banking Department of £37.7 million, after provision for payments to be made under an indemnity given to JMB, compared with £65.3 million in 1983/84. After a payment to H M Treasury in lieu of dividend of £25.3 million (£21.7 million in 1983/84) and a tax charge of £4.9 million (£31.8 million in 1983/84), the profit transferred to reserves was £7.5 million (£11.8 million in 1983/84); on a current cost basis the profit before tax and dividend was some £9 million less than in the historical cost accounts. As stated by the Chancellor in the House of Commons, the payment in lieu of dividend has been determined in a way which is unaffected by the impact on the Bank of its liability to make payments to JMB under the indemnity.

The *Issue Department* accounts (page 30) show that the profits of the note issue, payable to the Treasury, amounted to £1,089.8 million (£1,198.0 million in 1983/84).

An annex to the Report (pages 31—42) describes the circumstances surrounding the failure of JMB and its acquisition by the Bank for a nominal consideration at the end of September 1984. This annex is in five parts. The first section outlines the development of JMB's business, particularly between 1980 and 1984, and discusses the causes of its failure. The Bank's supervision of JMB is then described and lessons drawn about ways the present system of supervision could be improved. Details of the rescue operation are given in the third section which is followed by an explanation of the reasons for the rescue. The annex concludes with an account of the Bank's stewardship of JMB since acquisition.

The annual report of the Bank on its supervisory activities under the Banking Act 1979 appears on pages 43—63. A section on supervisory developments notes the trend towards the formation of integrated financial services groups. The Bank's review of its approach to the consolidated supervision of groups containing a bank is discussed. The terms and treatment of subordinated debt issues are considered from the point of view of measuring capital adequacy, and off balance sheet risks are also discussed.

As in previous years the report includes a section on the interpretation and application of the Banking Act. At the end of the year, 605 institutions were authorised under the Act: 28 institutions were granted licences during the year and 6 were granted recognition as banks; 2 institutions had their deposit-taking authority revoked by the Bank and 14 surrendered their authority. During the year criminal proceedings in respect of illegal deposit-taking under Section 1 of the Act were concluded in two cases.

June 1985

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 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.

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 25. 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

(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 30.

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'. The Bank was told by JMB's management of downward revisions to their profit forecasts for the year to 31 March 1984, which were confirmed by lower profits reported on the quarterly returns. These were blamed on quiet trading in the bullion markets. Profit forecasts were not being reduced as they should have been, because the extent of the provisions required was not recognised by the management.

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 learned that in the Far East 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 Baring 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 31, 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.